Private Equity Secondary Market Pricing H1 2014

- Robert McGrath, Managing Director, Setter Capital

Most commentators contend generally that secondary pricing across all private equity strategies has risen in the last several years, but the important question is what exactly does one mean by 'pricing'? To get a more nuanced understanding of the changes in the secondary market over a period of time, one must consider not just the discount or premium to NAV as of the most recent reference date, but also the changes in NAV over time, capital calls, along with interim and prior period distributions. Further considerations include the evolution in buyers' return requirements, pricing dispersion and the variability between different categories of funds since broad statements of overall market pricing may mask interesting market sub-trends.

As seen in Fig. 3, pricing and price dispersion of the "Most Sought After Funds" (as ranked and published separately by Setter Capital and referred herein as 'Top Funds') relative to all funds differs materially across the board with the widest differences in the VC and the mature fund spaces. These Top Funds tend to be the brand name, larger funds, with larger LP bases which attract more buyers and ultimately command stronger pricing. For example, select buyers are willing to aggressively price a mature, pre-2007 Apollo or Blackstone fund that has a great deal of public exposure, whereas, they would be unwilling to offer a full price for a non-brand name fund with a similar portfolio profile. In addition, many buyers would aggressively price premier VC funds but have little to no interest in most other VC funds. For those funds not high on buyers' shortlists, an attractive price is the only way to motivate them.

Pricing and Supply of Less Drawn Funds

In contrast to the crisis period, sellers today are not selling their recent vintage funds as these are seen to have the most upside potential and liquidity is rarely an issue. For similar reasons, many buyers in this environment are interested to buy younger funds at full or even premium prices, particularly as these transactions significantly mitigate the J-curve effect. In addition, this pricing trend may also reflect the continuing emergence of non-traditional secondary buyers which may be willing to pay a high price for certain managers irrespective of a fund's funded level.

Changes in Pricing and Supply of Mature Funds - 2011 to Today

As for changes in pricing, market clearing bids for individual LBO funds and portfolios of mature LBO/VC funds have increased considerably in absolute terms over the last few years, even though the discount to NAV has only narrowed slightly. The main difference is observable not so much in the price paid, but rather in the compression of buyers' return requirements in the present market relative to earlier in the cycle. For instance, a basket of highly sought after 2006 vintage LBO funds (Apollo VI, Bain IX, Madison Dearborn V, KKR 2006 and TPG V) currently prices in the higher 90s relative to Dec-31-2013 NAV – which is only a few percent higher than it would have achieved in 2011. However, today the package of funds is marked at a ~1.5X multiple (December 2013 valuations), whereas the same basket was held at only a ~1X multiple in 2011 (December 2010 valuations) with presumably much more perceived upside potential.

While the exact way to objectively measure changes in pricing in the secondary market is still up for debate, it does seem hard to deny that the liquidity of the private equity asset class has improved measurably in recent years. This is largely due to the continued proliferation of buyers of all stripes in the market. Improving liquidity leads naturally to better pricing for sellers, and a more efficient and accessible market for buyers. While we expect this trend to continue in the coming quarters and years, investors should take note that liquidity appears to have improved most amongst the most highly sought after funds and therefore there may be more liquidity and secondary pricing risk associated with investing in lesser known managers.

Fig. 3: 2014 Average Pricing and Price Dispersion For Different Vintages*

	2002-2005 Vintages		2006-2009 Vintages		2010-2013 Vintages	
	Dispersion	Average	Dispersion	Average	Dispersion	Average
Most Sought After Funds						
Top 25 VC Funds	75-100	85	85-110	93	85-120	97
Top 50 US LBO Funds	80-110	92	87-113	98	95-115	107
Top 40 Euro LBO	85-100	90	90-110	100	90-115	105
All Funds						
All VC Funds	50-100	77	55-110	81	40-120	72
All US LBO Funds	65-110	86	70-113	92	70-115	93
All Euro LBO Funds	70-100	85	77-110	91	65-115	95

** Average Pricing is the average top bid offered for the funds of the specific type/vintage based off of Dec-31-2013 NAV. Pricing Dispersion is the range of top bids for each fund within the specific type/vintage, taking out the bottom 10% and top 5% of prices. Top bids are those received by Setter Capital and estimates where data is sparse (e.g. there are very few bids for less drawn VC funds in today's environment given the lack of supply).*