Secondaries of Funds of Funds

Over the last few years, we have seen a meaningful increase in secondary sales of funds of funds and secondary funds.

There are several factors driving this activity beyond the simple desire to reduce exposure or create liquidity. One of the main reasons is that the investment programs of many earlier funds of funds investors have matured to the point where they are now comfortable investing directly in funds and consequently view these investments as non-core. Another reason is that funds of funds are by their nature very long-dated investments making them common targets for clean up sales – since they have so many underlying investments, the 'tails' on these funds can be quite long, with the current NAV representing a fraction of the original commitment.

For buyers, fund of funds secondaries can present a compelling opportunity. Here are some of the potential advantages and disadvantages of pursuing this type of transaction:

Advantages:

- Diversification - akin to buying an index, a single purchase allows the buyer to gain access to a diversified pool of funds across managers, vintages & geographies which in turn minimizes beta.
- High quality assets - as funds of funds generally invest in well regarded, brand-name managers, a secondary can provide an effective way to gain quality exposure to prior vintages.
- Limited competition - while there are more buyers for funds of funds as of late, the market is still less competitive than that for buying direct funds on a secondary basis. Therefore, buyers may achieve better terms and have more time to diligence and execute the opportunity.

Disadvantages:

- Extra fee layer - an additional layer of fees applies to these investments, dragging on returns. However, buyers can simply factor this into their models (on a NPV basis, fees typically represent 3-10% of the current NAV). Further, some passive and resource constrained direct LPs may in fact benefit from this added layer of management.
- Difficult to underwrite - buyers are not usually able to do a bottom-up analysis as there are too many funds and they generally will not have transparency into the portfolios of the underlying fund investments.
- Transferability - managers of funds of funds tend to be more selective as to whom they will allow transfer, tending to prefer pensions, endowments, sovereign funds, and family offices, and generally resisting transfer to competitors such as other funds of funds and secondary funds.

These advantages and disadvantages also largely apply to buying secondaries of secondary funds, but the quality of the underlying assets within secondary funds is generally not as high given the opportunistic nature of their mandate. Further, secondary funds tend to buy assets at discounts and immediately write up their purchases to the NAV reported by the underlying fund manager. Thus, some of the ultimate gains of the secondary fund may be already reflected in the appreciated NAV and locked in by the seller.

In spite of some of the challenges associated with pursuing secondary purchases of funds of funds and secondary funds, interest in selling and buying is on the rise.

Setter Capital is a leading advisor to buyers and sellers of private equity secondaries, with deep expertise in the fund of fund secondary space. If you are considering buying or selling funds of funds or secondary funds, we would welcome hearing from you to discuss specifics.