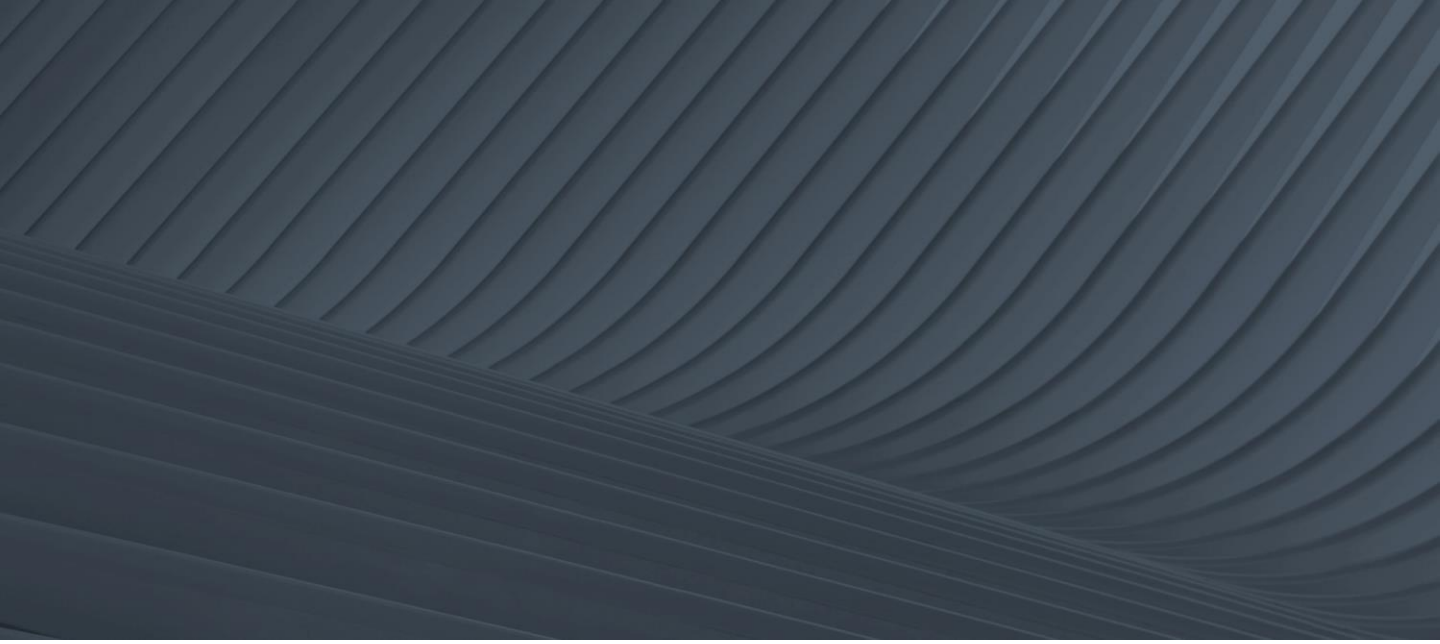
The Secondary Market is Getting Smaller

Why proportionally fewer funds trade today than 10 years ago



Introduction

The private equity secondary market has experienced remarkable growth over the past decade, particularly in LP-led secondaries. Yet, when comparing the growth of secondary market volume to the growth of private market assets under management (AUM), a surprising trend emerges: **Proportionally fewer funds are being traded today than ten years ago.** This paper explores the underlying reasons for this disparity.

While it is no longer taboo for limited partners (LPs) to sell on the secondary market, the anticipated adoption of secondaries as a standard portfolio management tool has not materialized. We outline key factors contributing to this phenomenon and examine the challenges that must be overcome for the secondary market to fulfill its potential.

A Tale of Two Markets

When intermediaries estimate secondary market volume, they typically conflate two distinct transaction types: GP-led secondaries and LP-led secondaries. **Despite both having "secondaries" in their names, they differ significantly and, from Overbay's perspective, shouldn't be lumped together.**

The "Secondary Market" for Companies

Since the inception of private equity, a "secondary market" has existed for PE-backed companies. Fund managers (or "GPs") have had the ability to sell their portfolio companies to various buyers through typical M&A transactions or IPOs. **In GP-led secondaries, a general partner sells one or more portfolio companies from an older fund, to a new fund they establish and manage.** GP-led secondaries simply represent the latest option for GPs and should therefore be viewed within the broader spectrum of exit paths available for PE-backed companies.

Estimated Volume[1]
$500B+

GP selling a Private Company

Buyers

Strategic Buyers
M&A

IPO
Public Markets

Other PE Firms
Secondary Buyout

Themselves + Secondary Funds
GP-led

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[1]Institutional Investor, Solid Opportunities in Secondaries, July 2023.

The True Secondary Market

The Secondary Market for Funds

In LP-led secondaries, institutions (or "limited partners") sell one or more of their fund commitments to a secondary buyer through a negotiated transaction. Globally, there are several thousand institutional fund investors, or limited partners, including pensions and endowments. They have the option to sell their commitments to one of the 100+ secondary funds or other opportunistic secondary buyers. Approximately $60 billion worth of funds trade among these groups each year.

This LP-led Secondary Market is the actual market for investors in private funds, providing institutions with a means to get liquidity on their investments, should they choose to do so.

Estimated Volume[1]

$60B+

LP selling Fund Commitments

Buyers

Secondary Funds

Opportunistic Buyers

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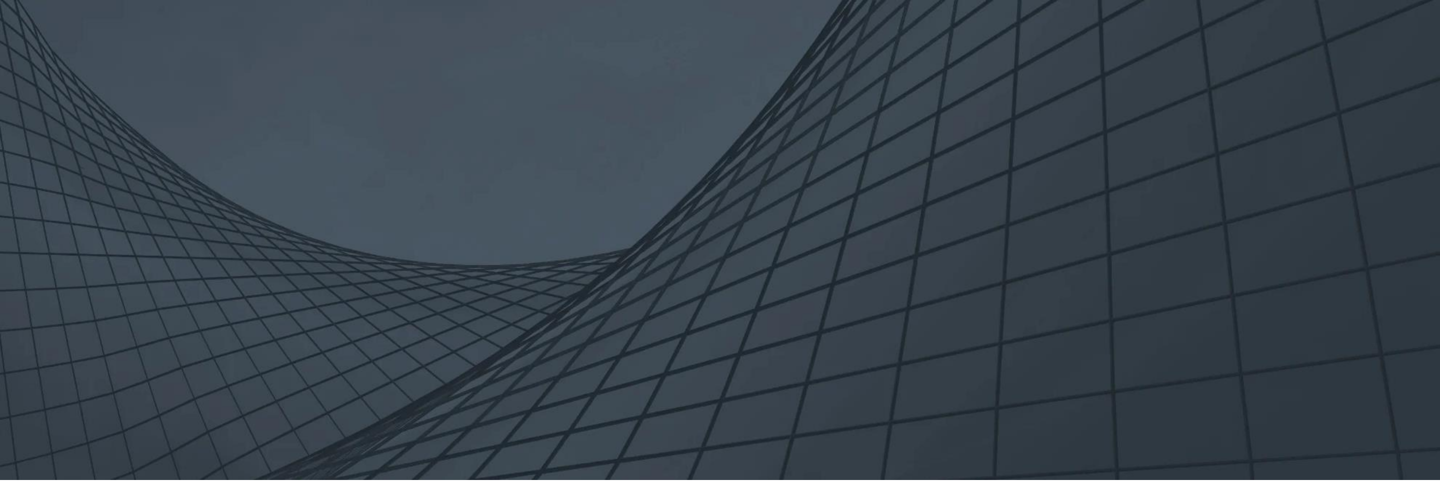
[1]Evercore H1 2024 Secondary Market Review, July 2024.



Growth of LP-led Secondaries

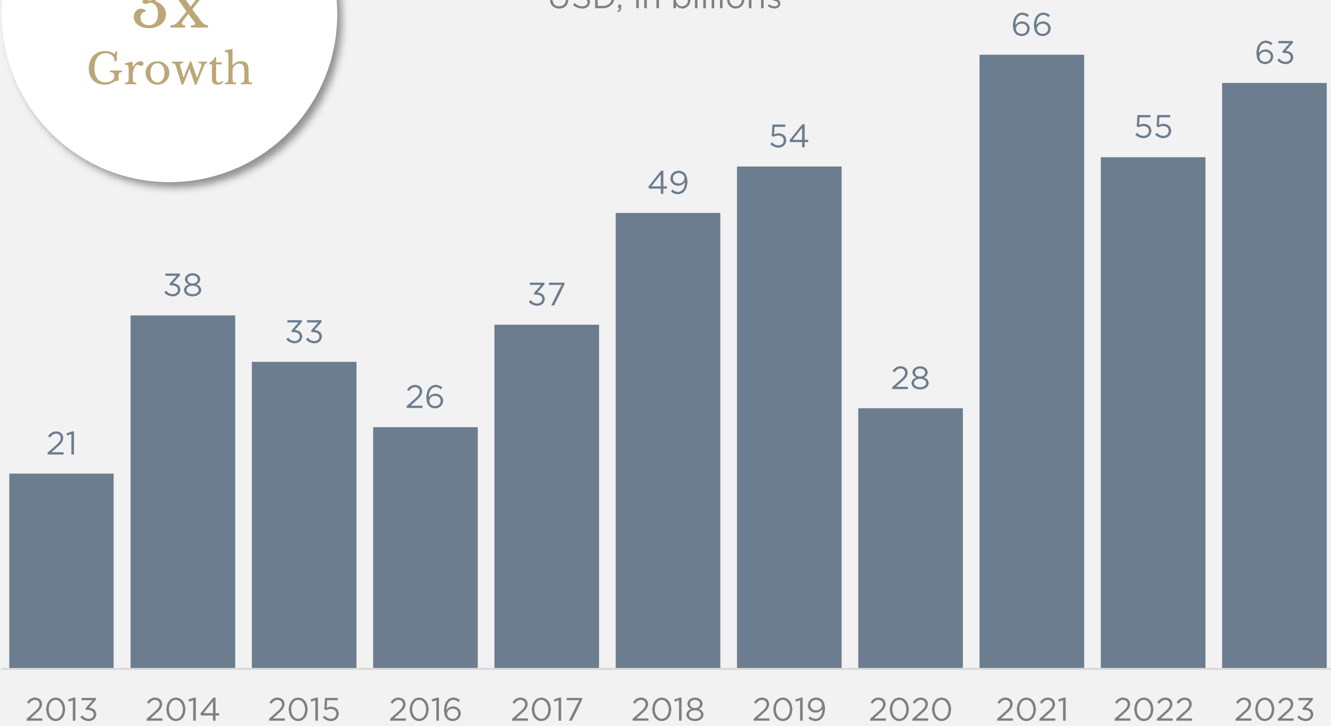
Traditional, or LP-led, secondary transactions can trace their origins back to the 1980s. However, the secondary market arguably did not gain significance until the early 2010s, following the Global Financial Crisis ("GFC").

Since the GFC, the volume of the secondary market has consistently been measured in tens of billions and has exhibited steady growth, expanding beyond private equity to include other private market strategies.

2013-2023
3x
Growth

LP-led Market Volume

USD, in billions[1]



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[1]Evercore H1 2024 Secondary Market Review, July 2024.

Growth of Private Capital AUM

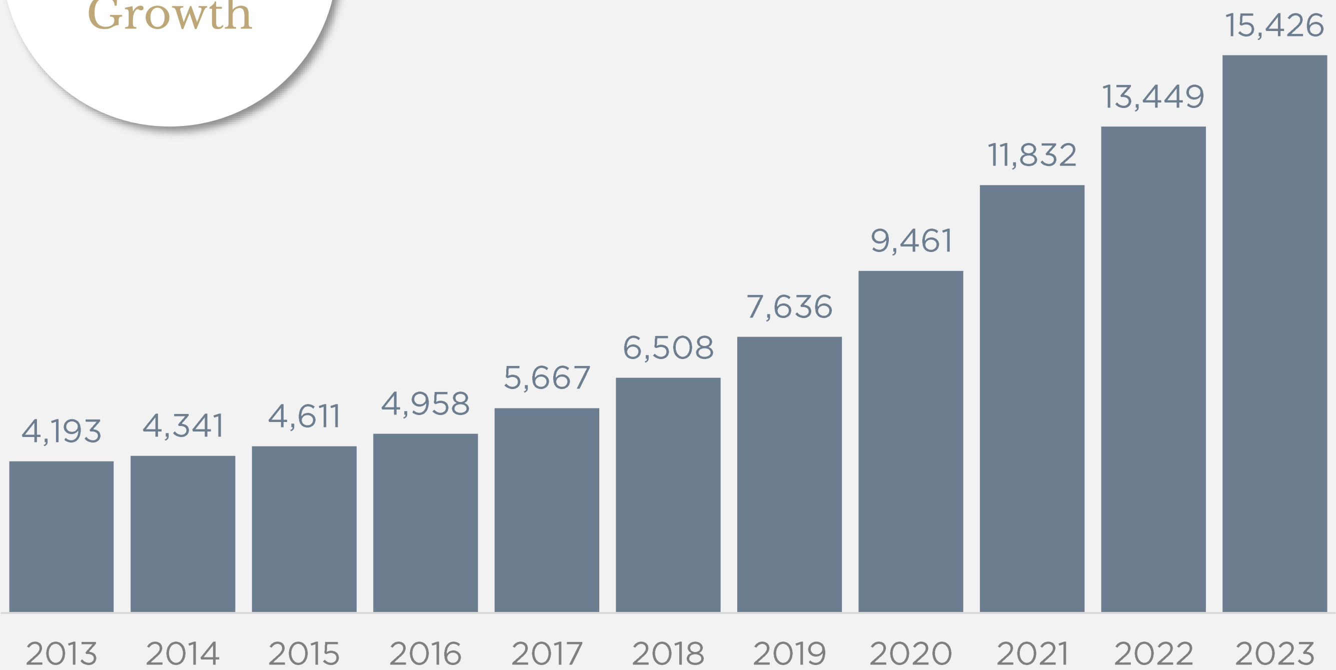
While the growth of the secondary market for funds is noteworthy, it has failed to keep pace with the growth of private capital AUM—which has quadrupled over the past decade.

2013-2023

~4x Growth

Private Capital AUM

USD, in billions[1]



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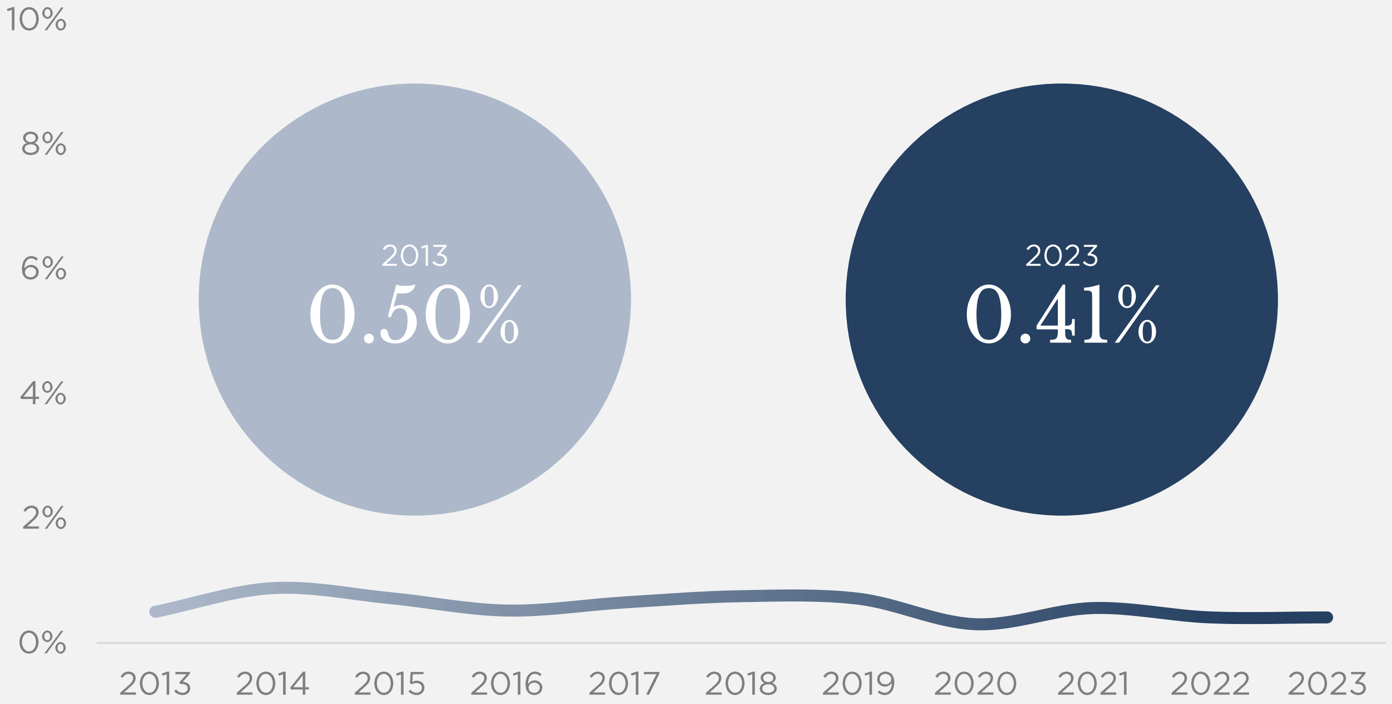
[1]Preqin Data, 2024.

LP-led Secondaries are Falling Behind

As a result, despite the broadening and maturation of LP-led secondaries, it is worth noting that the secondary market volume, as a proportion of private capital assets under management ("AUM"), has been declining. **In other words, as a percentage of private capital AUM, fewer sales occur today than 10 years ago.**

LP-led Secondary Market Volume

As a % of Private Capital AUM[1,2]



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[1]Overbay analysis. Evercore H1 2024 Secondary Market Review, July 2024. [2]Preqin Data, 2024.

Why Aren't More LPs Selling?

Despite growing awareness of the benefits of secondary transactions, LPs have not widely adopted them as a portfolio management strategy. Overbay identifies three key barriers:

1. Friction Costs

Secondary transactions are time-intensive and costly, taking 2–6 months to complete. LPs must hire intermediaries, engage legal counsel and navigate GP relationships, with expenses often exceeding 1% of transaction value.

2. Lack of Expertise

Many LPs lack the experience and tools for underwriting portfolios, assessing GP valuations and navigating the secondary market, leading to hesitancy and uncertainty about potential outcomes.

3. Misaligned Incentives

Selling fund interests and redeploying the capital can maximize value for an institution over the long-term. However, a conflict often arises for investment professionals whose compensation is linked to short-term performance metrics.

Since fund interests typically trade at a discount, selling them can negatively impact bonuses. This misalignment frequently discourages decision-makers from pursuing sales, even when such actions align with the institution's broader, long-term objectives.

The secondary market is an essential tool for liquidity and portfolio management, but it has yet to achieve its full potential. Despite increasing acceptance, barriers such as friction costs, limited expertise and economic misalignment continue to constrain broader adoption.

While transaction costs may decrease and secondary expertise may expand over time, the market's growth may still lag due to the misalignment of incentives. Overcoming this issue will require a fundamental overhaul of compensation structures and a reevaluation of how strategic decisions are assessed.

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