Simplifying Private Equity Secondaries

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Private equity has traditionally been dominated by large institutions, but is gaining ground in individual investor portfolios, helped by a growing secondary market that has made allocating to private equity easier.

Key takeaways

- Private equity funds operate in the massive market of private companies, working with management teams to improve operations and increase the value of the enterprise
- Secondary investments offer access to private equity funds after capital has been largely deployed, sidestepping the initial drawdown and accelerating the time investors receive potential distributions
- Mutual funds that invest in private equity may offer low investment minimums, quarterly liquidity and other key benefits unavailable in traditional PE funds

Introduction: Investing in the core of the American economy

For every Amazon or Apple traded on public stock exchanges, there are a thousand privately held businesses seeking investor capital to grow. Roughly seven million private incorporated businesses currently operate in the United States, a third of which employ at least 50 workers. These companies represent every major industry, from technology to manufacturing to retail, and include some of the fastest growing and most disruptive startups (Exhibit 1).

Exhibit 1: **Access to a wide field of opportunities not offered in public markets**

[1] Source: Nasdaq, as of 08/30/22.
[2] Source: US Census Bureau, as of 2019 (released 02/11/22).

Historically, private equity (PE) has been an exclusive club for large institutional investors such as pension funds, sovereign wealth funds and insurance companies, along with family offices and certain ultra-high-net-worth investors. However, the emergence of new investment vehicles has opened the market to a wider range of investors. Some of these investment solutions address hurdles that have discouraged broader adoption in the past by lowering investment minimums, simplifying tax forms and offering regular liquidity.

What's different about today? Why are new pathways opening to investors? The answer is in the growing access to private equity interests. For accredited investors who have been appropriately advised, private equity secondaries may offer an attractive way to differentiate a well-diversified portfolio.

What is private equity?

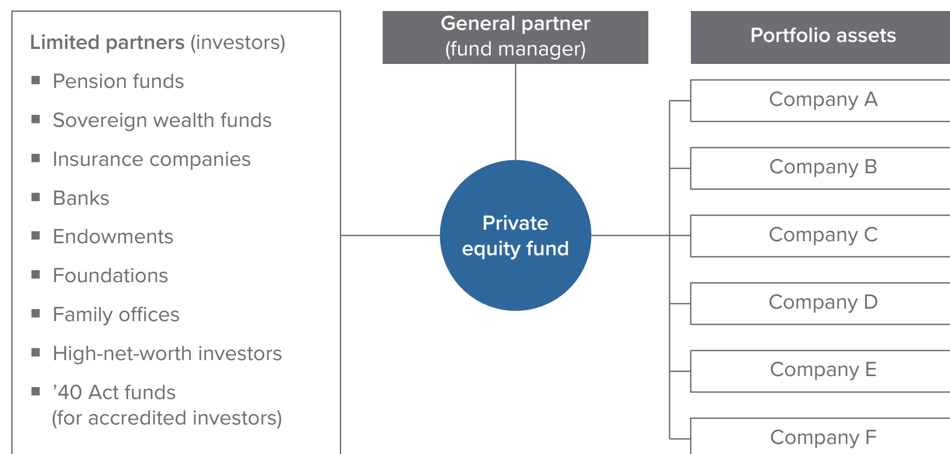
Private transactions on an institutional scale

When a privately owned company wants to grow its operations, it may seek funding from a private equity firm in exchange for a stake in future profits. This approach may offer an attractive alternative to conventional forms of finance such as taking out a bank loan (which can be expensive) or listing on a public stock exchange (which may not be feasible).

The private equity firm raises capital from investors, known as limited partners, pooling the funds with its own capital into a fund that invests in a diversified portfolio on behalf of the limited partners (Exhibit 2). Portfolio assets typically consist of the equity (e.g., stock) of private companies, but may also include debt investments, commercial real estate and infrastructure projects such as solar farms, transportation systems or water treatment plants.

Private equity managers raise capital to deploy on behalf of investors, lending their expertise in operations, finance and strategy to increase the value of the companies in their portfolio.

Exhibit 2: A PE fund's general partner invests on behalf of its limited partners



Source: Pomona Capital.

Private equity managers may bring expertise and resources to the companies in their portfolios. By working with company management teams, the sponsor may seek to enhance the equity value of its investments in several ways:

- **Accelerating revenue growth:** The sponsor and management team may drive additional revenues by launching new products, expanding to new markets, increasing sales efforts and making acquisitions
- **Enhancing profit margins:** Cost savings may be achieved by focusing on higher-margin products, leveraging economies of scale and fine-tuning product pricing
- **Improving the capital structure:** As a company generates cashflow, it may be able to reduce its debt over time, reducing its financial risk
- **Upgrading operations:** A sponsor may help the company improve its management, market strategy and operating model, potentially increasing the value of the enterprise

As with any investment, private equity involves risk, and success is not guaranteed. However, top private equity managers tend to have a strong track record of enhancing the economic performance of portfolio companies. Historically, differences in manager skill and a fund's investment strategy, geographic concentration and industry focus have resulted in a wide dispersion of performance among private equity funds relative to public market funds. As a result, the ability to research and access the right managers may be critical in an investor's experience in private equity.

Private equity is a long-term investment

Investments in the private markets have key differences from those in publicly traded equities. In contrast with the real-time auction-based pricing of the New York Stock Exchange or the Nasdaq, the value of private companies is calculated infrequently, usually once a quarter. Moreover, the long-term nature of private equity investing means that capital is often locked up for the life of the fund.

A typical private equity fund is structured with a finite life span of about 10 years, which may be extended if needed, subject to approval by the limited partners:

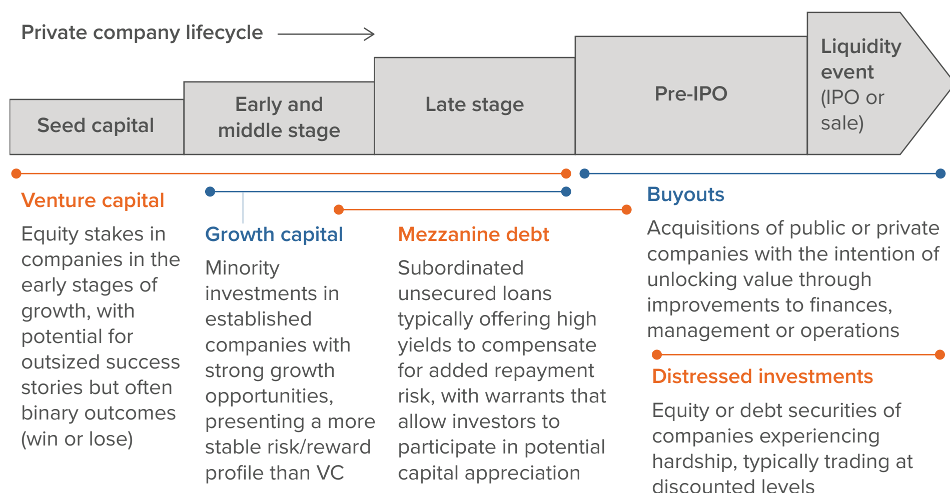
Private equity funds are designed as long-term investment vehicles, deploying capital then harvesting returns over the span of about 10 years.

Marketing	Drawdown / Investment	Realization / Exit	Extension
1 year	3–5 years	5–7 years	2 years
Investors commit capital	Capital is called as investments are identified	Potential earnings and proceeds from sale or IPO are distributed to investors	May only occur if approved by limited partners

Private equity managers may employ different investment strategies at various stages of a company's life cycle – from high-risk venture capital to buyouts of mature companies.

Private companies often require additional capital throughout their lifecycle, offering investors multiple opportunities for investment. During this time, private equity managers may employ a range of strategies to realize value (Exhibit 3). The most established are buyouts of private companies or divisions of larger companies for development and eventual sale. By contrast, venture capital tends to involve higher risk, targeting start-ups and early-stage growth companies.

Exhibit 3: Different PE strategies have unique risk/reward characteristics



Source: Pomona Capital. The descriptions above represent the views and opinions of Pomona Capital.

Secondary market investing: accelerating the curve

Private equity secondaries provide access to institutional private equity with greater flexibility and potentially accelerated cash flow for the end investor.

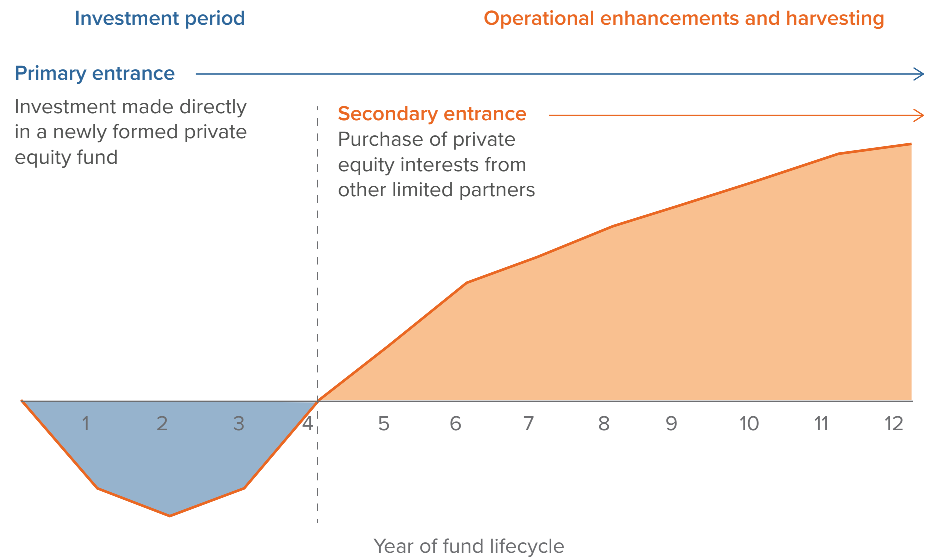
When a limited partner wants to make an early exit, they can sell their interests in a fund to other investors through the secondary market. This transaction provides liquidity to the primary investor and potentially compelling benefits to incoming investors.

Secondaries involve buying interests in a private equity fund from an existing limited partner, typically after a fund's investment period.

Potential benefits include:

- **Limiting the J-curve drag:** A secondary investment typically takes place after a PE fund has invested a significant portion of its capital (typically three to seven years into its lifecycle). One potential benefit of this is that a secondary investment may limit the impact of the "J-curve," named for the shape of the intended pathway of returns (Exhibit 4). Some of the reasons may be that in a fund's early years, the general partner makes investments that typically have little or no growth for several years while the fund continues to incur expenses. As portfolio companies grow, the sale or refinancing of these companies may generate cash distributions on top of any unrealized gains reflected in the fund's net asset value (NAV). This phase is characterized by the rising section of the J-curve, allowing secondary investors to potentially mitigate the initial dip typically experienced at the start of a fund's lifecycle.

Exhibit 4: Investing later in a fund's lifecycle may mitigate the J-curve effect



Source: Pomona Capital. This chart is for illustrative purposes and does not represent past or projected performance of an actual product. There is no guarantee performance will match this illustration. There is no guarantee that there will be any cash flow earned from the investment given the risks of investing in private equity. Technically, a secondary investment may occur at any time during the life of a fund. Investments in private equity involve risk, and an investor may lose some or all their investment.

Registered investment vehicles can help simplify the process of allocating to private equity.

- **Faster distributions and exit:** A related benefit to J-curve mitigation is that secondary investors are entering closer to the period when distributions may begin to limited partners as fund investments generate positive cashflow. Investors are also closer to the end of a fund's life, when remaining assets are liquidated and any gains (or losses) are realized.
- **Transparency:** After a few years, most funds will have already invested a large portion of the capital committed by investors. Whereas primary investors commit capital to a blind pool, in which investments have yet to be made, secondary investors can analyze each asset in the portfolio and make their own determination of value.
- **Discounted pricing:** To entice secondary buyers to acquire their fund interests today, primary investors may sell their ownership interest at a discount to the present value of the underlying assets, recognizing that the buyer takes on the risk of waiting for potential realizations from the fund's investment in the future. Well-resourced fund managers may take advantage of the many anomalies in this market to identify and capitalize on value opportunities.

Institutional private equity wrapped in a mutual fund

Many investors may associate private equity with obstacles that may have discouraged participation in the past. As an alternative, investors may consider registered investment vehicles that target private equity assets, including secondary and primary investments, as well as direct and co-investment opportunities.

Typically offered to accredited investors, these funds may provide advantages over traditional private equity funds. For example:

Potential benefit	Private equity '40-Act fund	Traditional private equity fund
Low investment minimums	$25,000	$1 million or more
Simplified tax filing	Form 1099	Schedule K-1
Quarterly liquidity	Periodic redemptions limited to a percentage of either the fund's NAV (tender offer fund) or the investor's position (interval fund)	Liquidity available through secondary markets, fund distributions or at the end of the fund's life
Diversification	May be diversified across sectors, geographies, investment types, vintage years and asset sizes	Frequently focused on a defined subset of sectors, with concentrated holdings
No capital calls	Capital put to work immediately	Capital invested over several years and called as needed
IRA-friendly	Ability to invest through IRAs means potential for tax-deferred growth	Often not qualified for IRA investment

Investing in private equity doesn't have to be complicated. Talk to your financial advisor today to see if a registered private equity fund may be suitable for your portfolio.

Investing with Voya and Pomona Capital

- Founded in 1994, Pomona Capital has been a fully owned subsidiary of Voya Investment Management since 2000.
- Eligible accredited investors have access to many of the same funds and opportunities typically reserved for the world's largest institutional investors.
- Our global team of 40+ private equity professionals conducts granular analysis of potential investments, led by a senior investment team with more than 12 years of experience on average.
- Relationships with more than 600 private equity funds provide a large pool for identifying potential opportunities.
- Our secondaries-focused strategy – complemented by primary funds and co-investment – seeks to identify assets with above-average quality, near-term liquidity and below-market prices.

Risks of investing

There are no guarantees a diversified portfolio will outperform a non-diversified portfolio. Diversification does not guarantee a profit or ensure against loss. **Past performance is no guarantee of future results**.

Private equity may not be suitable for every investor, may involve a high degree of risk, and may be appropriate investments only for sophisticated investors who are capable of understanding and assuming the risks involved. Private equity investments are subject to various risks. These risks are generally related to: (i) the ability of the manager to select and manage successful investment opportunities; (ii) the quality of the management of each company in which a private equity fund invests; (iii) the ability of a private equity fund to liquidate its investments; and (iv) general economic conditions. Private equity funds that focus on buyouts have generally been dependent on the availability of debt or equity financing to fund the acquisitions of their investments. Depending on market conditions, however, the availability of such financing may be reduced dramatically, limiting the ability of such private equity funds to obtain the required financing or reducing their expected rate of return. Private equity funds, as well as securities that invest in such funds and companies in which such funds or securities may invest, tend to lack the liquidity associated with the securities of publicly traded companies and as a result are inherently more speculative.

All investments in bonds are subject to market risks. Bonds have fixed principal and return if held to maturity, but may fluctuate in the interim. Generally, when interest rates rise, bond prices fall. Bonds with longer maturities tend to be more sensitive to changes in interest rates.

All equity investing involves risks of fluctuating prices and the uncertainties of rates of return and yield inherent in investing. Foreign investing does pose special risks including currency fluctuation, economic and political risks not found in investments that are solely domestic. Emerging market stocks may be especially volatile. Stock of an issuer in the Fund's portfolio may decline in price if the issuer fails to make anticipated dividend payments because, among other reasons, the issuer of the security experiences a decline in its financial condition. Securities of small- and mid-sized companies may entail greater price volatility and less liquidity than investing in stocks of larger companies.

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