BOCCONI STUDENTS FOR
ALTERNATIVE INVESTMENTS

THE RISE OF THE SECONDARY MARKET: UNLOCKING LIQUIDITY AND GROWTH OPPORTUNITIES

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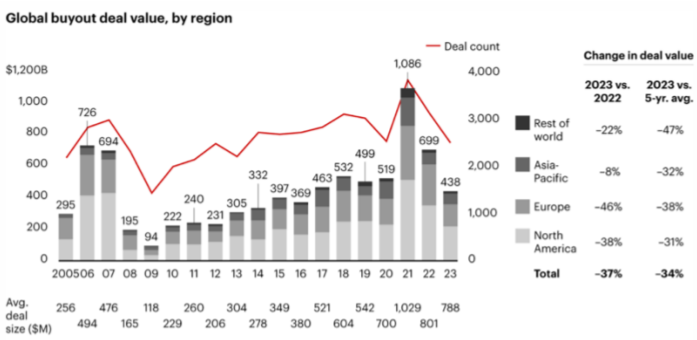
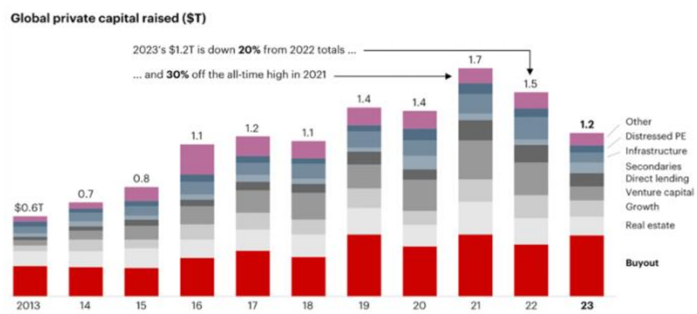
Introduction to the Secondaries Trend

The past three years have seen a decline in both the count and value of private equity deals around the world. This decline has been particularly stark in Europe and North America, with the total deal value of these regions declining by 46% and 38% respectively between 2022 and 2023. The US Fed's decision to rapidly raise rates from 0 to 5.25 - 5.5% over the span of just one year was a significant catalyst of the slump in private equity deals, while persistently high inflation and geopolitical turmoil also presented additional headwinds to the sector. Because of these factors, private equity deal count and value in 2023 dropped to a level below that of 2017.



Correspondingly, the fundraising of capital also dropped, reflected by a decrease from 1.7 trillion USD in 2021 to 1.5 trillion and 1.2 trillion in 2022 and 2023 respectively. Within numerous sources of global private capital raising, secondaries has been one of the only categories to record an increase, having grown by 92%. In spite of this decrease in capital raised, the demand for capital has grown, leading to intense competition because of the mismatch between supply and demand.



The US Fed's recent decisions to cut rates (combined with expectations of further rate cuts) has created opportunity for a resurgence in private equity deals, with capital-intensive sectors such as digital infrastructure particularly poised to benefit. Rate cuts not only lead to lower borrowing costs that stimulate investment and deal activity, but also reduce companies' burden of debt service and enable them to pursue new growth initiatives.

Additionally, the recent election of Donald Trump as US president could provide further tailwinds for private equity, as he will likely emphasise deregulation and creating business-friendly environments by lowering bureaucratic barriers. Areas to follow include the anti-trust environment (specifically, many expect Trump to replace Lina Khan as the Head of the Federal Trade Commission, as Khan has led a fierce crackdown on antitrust) as well as Trump's promise to lower corporate taxes. These events would likely stimulate investor confidence and private equity deal activity. At the same time, Trump's economic policies (for example, concerning import and export taxes) may lead to an increase in inflation. The US Fed's previous decisions to cut rates stem from confidence over lowered inflation rates, so a potential reignition of inflation may decrease the number of future rate cuts. In this case, this would somewhat counteract the deal-friendly tailwinds.

Overall, although the recent few years have seen a decline in private equity deal activity, the recent US election introduces several key policy factors that will greatly impact upcoming years' prospects. With most of these factors likely presenting positive tailwinds towards the sector, it is likely that private equity will trend up in both the count and value of deals.

The Rise of the Private Equity Secondary Market

A secondary market is a financial marketplace where issued instruments are traded. In private equity, secondary transactions involve selling fund stakes during the fund's lifecycle rather than directly investing in new companies. Secondary private equity funds specialize in acquiring these fund stakes from investors seeking early liquidity.

In recent years, secondary markets have seen a significant expansion. This growth is driven by the maturation of primary markets, characterized by fund expirations, delayed portfolio company exits, and slower capital distributions. Simultaneously, secondary transactions enhance portfolio management efficiency by providing higher liquidity to exiting investors and facilitating access for new entrants.
A key driver of this trend is the ability to mitigate blind pool risk, which arises when investors allocate capital to a portfolio not yet constructed, creating a "blind pool." Secondary transactions reduce this uncertainty, providing investors greater visibility into underlying assets and portfolio performance, thereby increasing their appeal.

The traditional structure of a private equity fund involves two primary components. On one side, capital is raised from investors, typically institutional (such as banks, insurance companies, pension funds, and family offices) or qualified investors, collectively referred to as Limited Partners (LPs). On the other side, a management entity, the General Partner (GP), is responsible for actively managing the fund's portfolio companies. Before the emergence of the secondary market, LPs seeking to exit their investments before the fund's maturity faced significant discounts on their liquidation price. Secondary funds within the private equity industry now play a critical role in facilitating the sale or restructuring of private equity positions. This generates liquidity for sellers while enabling the efficient reallocation of capital within the asset class

Secondary market solutions fall into two main categories: GP-led and LP-led.
GP-led transactions are initiated by the General Partner (GP) to optimize portfolio management and offer liquidity to Limited Partners (LPs). Historically, these were the dominant form of secondary transactions. A common example is the Continuation Fund, where the GP transfers one or more assets from the original fund to a new vehicle. LPs can either roll their stakes into the continuation fund or divest them to new investors. These solutions have gained traction in recent years as GPs address slowing exits and rising liquidity needs.

LP-led transactions, by contrast, are driven by LPs seeking liquidity or portfolio rebalancing. These can take the form of direct sales, where LPs sell stakes to other investors, or tender offers, where the GP organizes a structured sale that enables multiple LPs exits simultaneously.

Both approaches underscore the secondary market's evolution in addressing liquidity needs and improving investment management.

Opportunities and Challenges in Private Equity Secondaries

Following an overview of secondary transactions and an examination of the various secondary market solutions, we will proceed to present the numerous advantages these investments offer to both GPs and LPs. Secondly, we will examine the challenges and potential risks that investors should be aware of.

Unlocking Value Through GP-Led Secondary Deals:

There are a number of compelling advantages associated with secondary transactions. Firstly, general partners typically select the best-performing assets for transfer to continuation vehicles. The robust positioning of these assets and the flexibility of GPs to retain them for extended periods enable GPs to allocate sufficient time for the implementation of value-crating initiatives and to pursue an exit in favourable market conditions. Moreover, the single-asset nature of such continuation vehicles allows for the mitigation of unwanted broader portfolio risk. Additionally, single-asset deals demonstrate higher return potential, with 62% of investors targeting a net IRR exceeding 20%, compared to 40% for multi-asset GP-led deals and LP-led deals.

Advantages for LPs and Investors:

The secondary market permits LPs to pursue an early exit, to liquidate assets, or to rebalance their portfolios. This is particularly noteworthy given the inherently illiquid nature of private equity transactions. Conversely, secondaries permit investors to purchase private equity assets that are already several years into their performance cycle, frequently at a discounted price. This enables investors to circumvent the J-curve phenomenon by entering at a later stage and effectively starting to realise returns at an earlier point. Furthermore, investors can avoid the "blind pool" risk by knowing precisely the assets in which they are investing.

Navigating Risks in the Secondary Market

While the secondary market offers numerous advantages to LPs, GPs and new investors, it is important to acknowledge the potential challenges that may arise. One of the most significant challenges is the existence of information asymmetry. While existing GPs and LPs possess a comprehensive understanding of the asset or stake they are selling, new investors often have limited information about the underlying investment. The limited information available regarding the underlying asset makes the valuation of the asset and the associated risks a particularly challenging task. Furthermore, when it comes to the valuation of the investment, the competing objectives of the seller (who aims to achieve the highest price) and the buyer (who seeks a lower price) add another layer of complexity. The lack of publicly available market data makes defining a fair price an extremely challenging endeavour.
In addition, secondary transactions are frequently subject to legal and regulatory complexities. The transfer of fund interests may necessitate the involvement of general partners, limited partners, or regulatory authorities. Legal disputes, tax liabilities, or regulatory changes can introduce uncertainties and affect the fund's performance.

To summarize, private equity secondary transactions present a distinctive combination of advantages and challenges. The opportunities for GPs, LPs, and investors are substantial, ranging from increased flexibility and early exits to mitigating blind pool risks and achieving potentially higher returns. However, there are significant challenges too, including information asymmetry, valuation difficulties, and legal hurdles. Understanding these dynamics is critical for navigating the secondary market effectively.

Real-World Applications and Market Trends

As of 2024, the private equity secondary market has reached unprecedented volume levels, continuing its upward trajectory. Secondary deals, in which investors in private equity funds sell their stakes to new investors for cash, or a PE firm arranges the sale of a company stake to a new fund, are forecast to smash all-time records. Matt Swain, an executive at Houlihan Lokey, predicts a record-breaking $150bn spate of sales — an increase of more than 25 per cent from 2023. What drives this surge? Primarily, institutional investors are seeking liquidity within the current financial landscape. On a global scale, M&A activity and IPO markets are facing headwinds, failing to provide effective exit strategies in the short term. The framework is even worsened from a macroeconomic perspective, as higher interest rates and tightening monetary policies further contribute to an uncertain environment. Therefore, in such a dynamic and uncertain context, secondary transactions offer a way to rebalance portfolios, meet cash flow needs, and offset risk.

In addition to LP-driven activity, GPs are increasingly leveraging the secondary market through sponsor-led transactions. These allow GPs to extend their hold on certain assets or funds while providing liquidity to existing investors, securing both additional time and capital for optimizing value in portfolio companies.

Furthermore, the evolution of the secondary market is evident in the growing diversity of assets being traded. Beyond traditional buyout funds, the market now includes venture capital, credit, and infrastructure assets, catering not only to institutional investors but even to retail investors in some cases. Looking ahead, the secondaries market is poised to play an increasingly central role in PE. As private markets continue to grow, so will the demand for liquidity and, most notably, portfolio flexibility, making secondaries an essential element of modern portfolio management for institutional investors. In addition, the adoption of technology and data-driven analytics is expected to provide even more precise valuation tools and accurate risk assessments, fostering the efficiency of secondary transactions. Nevertheless, while secondaries provide a valuable instrument to navigate volatile markets, they are not immune to macroeconomic shifts, which will continue to affect transaction volumes and valuations. Even so, they remain a critical mechanism for addressing liquidity challenges in uncertain times. Recent developments underscore this expanding role. LGT Capital Partners has raised over $7 billion for its Crown Global Secondaries VI fund, targeting a diverse range of private equity strategies, while Goldman Sachs Asset Management secured $3.4 billion for its Vintage Real Estate Partners III fund, focusing on stakes in real estate funds. These milestones highlight the growing importance of secondaries as a solution for institutional investors navigating today's complex financial environment.

Bain Capital's €735 million acquisition of Somacis PCB Industries from Chequers Capital Partners exemplifies a strategic secondary market private equity transaction. The deal, completed on November 26, 2024, saw Bain Capital purchase a controlling stake from Chequers Capital, which had owned the company for a 2-year holding period since September 2022. Notably, Chequers Capital chose to reinvest alongside Bain Capital, retaining a minority stake in Somacis. Therefore, this transaction demonstrates the efficiency of secondary buyouts in providing liquidity to existing investors while still leaving room for additional investment of resources over a broadened time frame. Moreover, Chequers' reinvestment reflects confidence in Somacis's future prospects and ensures continuity in its strategic direction. The management team, led by CEO Giovanni Tridenti, also reinvested in the company, aligning their interests with the new ownership structure.

Founded in 1972 and headquartered in Castelfidardo, Ancona, Somacis operates five state-of-the-art facilities across Europe, North America, and Asia, where it produces high-complexity PCBs for high-tech applications requiring unwavering reliability in sectors such as telecommunications, medical, defense, industrial, and automotive industries. Bain Capital acquired its majority stake in Somacis. Thanks to a significant growth achieved through organic investments and selective acquisitions, the company has established itself as a global player in PCBs. In 2023, Somacis reported revenues of €181 million and an EBITDA of €50 million, increasing from €25 million in 2022, with continued growth projected for the current year.

Bain Capital's objective is to accelerate Somacis's growth, particularly through international acquisitions. According to Ivano Sessa, the partner at Bain Capital overseeing the operation, Somacis is well-positioned to capitalize on the long-term increase in PCB demand in the United States and the European Union. The company is already evaluating potential acquisition targets to expand its global footprint. Philippe Guérin, Managing Partner of Chequers Capital, expressed satisfaction with the reinvestment alongside Bain Capital and the excellent management team, aiming to become the leading global operator in their niches. The transaction was facilitated by Jefferies, serving as the financial advisor to Somacis and Chequers Capital, while Morgan Stanley and Bank of America advised Bain Capital.

This acquisition highlights the dynamic nature of secondary transactions in PE, offering liquidity solutions for exiting investors and growth opportunities for portfolio companies under new ownership. Bain Capital's strategic vision, combined with Somacis's strong market position and operational excellence, sets the stage for continued innovation and expansion in the high-tech PCB manufacturing industry.

Conclusion

The rising private equity secondary market is set to give the game-changing impact on the financial scene by providing the needed flexibility to the unpredictable macroeconomic conditions. Looking ahead, the synergistic process of the changing needs of investors, rising demand for portfolio rebalancing, and the ongoing advancement in valuation and analytics will further boost the attraction and efficiency of the market.

The continued growth of GP-led transactions, particularly continuation funds, will allow General Partners to maximise value creation timelines while meeting Limited Partners' liquidity requirements. On the other hand, LP-led deals will remain a significant tool for institutional investors seeking early exits, diversification, and enhanced portfolio management.

However, obstacles including issues like data asymmetry, valuation complexities, and regulatory constraints still persist. In addition, macroeconomic factors such as interest rate shifts, inflation trends, and geopolitical dynamics will significantly influence transaction volumes and asset valuations. Despite these challenges, the secondary market is well-positioned to become more efficient as private equity stabilises, remaining an essential pillar of modern private equity, ensuring investment flexibility, fostering capital efficiency, and promoting continued growth opportunities for worldwide investors.

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