PRIVATE AND CONFIDENTIAL

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PANTHEON **PERSPECTIVES**

ARE WE IN A GOLDEN AGE FOR **PRIVATE MARKET SECONDARIES?**

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Market commentary

Research view

Key takeaways

1 Investors are facing an array of liquidity challenges relating to falls in public market valuations and reduced distributions from private market portfolios.

2 This is increasing the volume of deals flowing through the secondary markets.

3 The longer-term growth story continuesfor secondaries across private equity, and in the rapidly-evolving areas of infrastructure and private credit.

4 Market inefficiencies and current valuation dynamics are also creating a favorable pricing environment for secondary managers.

Introduction

In the wake of a significant market dislocation and against a challenged economic backdrop, the secondaries market has come to the fore as a key tool for investors seeking liquidity, as well as those seeking to manage and rotate their roster of private markets managers. This builds on a long-term growth story that has seen secondaries top $100bn in annual transaction volume over the past two years[1] with growth not only in private equity (PE) but also in the rapidly evolving secondary markets for infrastructure and private credit.

What this means in practice is that there is a rich stream of deal flow, and compelling pricing dynamics, for secondaries managers in the current market – and so a potentially unique opportunity for investors to access the best of private markets via secondary investments. This paper, the first in our new Pantheon Perspectives series offering our insights into key market trends, will provide a detailed view on why the current market conditions are generating increased opportunities in secondaries, as well as a look at how trends compare across private market asset classes.

Liquidity mismatch

History tells us that during times of significant market dislocation, such as the one we are experiencing now, some of the most attractive buying opportunities for secondaries tend to arise. The denominator effect – where investors' listed exposure falls sharply during market turbulence (as we saw in 2022), causing private markets allocations to increase beyond target – coupled with headwinds

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in the broader macroeconomic and market environment that have led to consequential liquidity challenges for investors, have created a heightened focus on liquidity and creative portfolio management solutions.

Specifically, a narrowing of exit options in the current environment has substantially slowed the distributions generated from existing private market portfolios. In 2022, IPO market activity fell to its lowest level since the GFC, including the share backed by private equity. In all, there were just 32 private equity exit-event IPOs last year, down from 295 in 2021.[2] While we are now beginning to see some flickering of life in the IPO market, this is on the back of an effective closure of the market as an exit route for a sustained period of time.

Meanwhile, M&A activity, especially in the middle market, proved more resilient in 2022, but has seen a decline so far this year, with firms exercising caution in the valuation environment. The value of Q1 2023 M&A transactions was $935bn, which softened further to $873bn in Q2, down 42% from a Q4 2021 peak of $1.5tn (see page 6).[3]

At the same time, the pace of new private market deals has fallen by a much smaller order of magnitude, creating a liquidity mismatch that is exacerbated by investors' desire to continue to allocate and re-up with managers in the market with new primary funds. New fundraising in 2022 amounted to $1.4tn, reflecting five-year compound annual growth rates of between 3% for private equity and 9% and 10% for infrastructure & real assets and private credit respectively (see page 5).[4]

Growth story continues

'GPs, too, are looking to secondary managers, and the growing array of GP-initiated secondary solutions on offer, as a means to provide liquidity to their LPs and to extend hold periods for their highest-quality assets.'

This all adds up to a strong motivating factor driving more investors to look to generate liquidity by selling existing private market fund positions on the secondary market. General Partners (GPs), too, are looking to secondary managers, and the growing array of GP-initiated secondary solutions on offer, as a means to provide liquidity to their Limited Partners (LPs) and to extend hold periods for their highest-quality assets.'

Last year, despite a slight slowing of activity in the second half as pricing expectations for sellers were recalibrated, the secondary market globally saw $111bn of transactions completed, second only to 2021's record annual total - and of which $53bn was accounted for by GP-initiated deals (see page 7).[1] Continued strong transaction activity reflects buoyed investor appetite against the backdrop of market dislocation, historically associated with strong performance for secondary fund vintages deploying capital in disrupted market conditions.

All of this follows a period of notable growth in secondaries activity in recent years, as the market has become increasingly mainstream in private equity and established itself rapidly in infrastructure and private credit. In the 1990s, the number of dedicated funds raised annually increased from three in 1990 to ten in 1999, while the average fund size gradually grew from $74mn in 1990 to $285mn by the end of the decade. Fast forward to the current market, and as noted secondaries transactions topped $100bn in 2022 for the second year in succession. The market was coming off

'We believe that turnover levels – which range from 1.8% for private equity to 0.7% and 0.6% for infrastructure and private credit respectively – are still very modest, leaving a lot of room to grow.'

the back of a 12-month period in which 100 secondary funds were raised globally.[5]

While private equity has traditionally dominated the secondaries landscape and continues to be the most active asset class, with $91bn transacted in 2022, there has been a significant increase in activity among other private market asset classes. Infrastructure and private credit, which are otherwise seeing demand from investors due to their potential to be used as a hedge for elevated inflation and rising rates, continued to see increased secondaries activity last year to a combined $13bn.[6] Notably, this intermediary-reported deal volume does not capture the full scale of the opportunity, as these younger secondaries markets rely to a larger extent on off-market deal sourcing; as a comparison Pantheon saw secondary market deal flow of $37bn in infrastructure and $22bn in private credit last year (see pages 7-8).[7]

While this all adds up to substantial growth from the market's early years, we believe that turnover levels – which range from 1.8% for private equity to 0.7% and 0.6% for infrastructure and private credit respectively (see page 5) – are still very modest, leaving a lot of room to grow.[8] Investors want to more proactively manage portfolios today, with private market allocations no longer 'set it and forget it'. Secondaries allow investors to change the trajectory of their programs and respond to market conditions, as we have seen in recent quarters.

The future of private market secondaries

'Today's "unique opportunity" is part of the longer-running evolution and development of the secondaries market – and it's a growth story that we believe is only just getting started.'

In our view, the significant opportunities created by the current market conditions will be in place for at least the remainder of 2023 – and quite possibly beyond. Looking longer-term, the established nature of the market should mean that it continues to play an important role in providing a portfolio management and liquidity mechanism for investors. GP-led deals will also continue to play a prominent role, providing a liquidity option that solves for fundamental limitations of the private markets model and the fixed lifespan of funds.

As the market continues to mature and diversify, we would expect to see increased specialization and for secondaries to grow as an attractive allocation option within investors' private markets portfolios. This further reflects the differentiated characteristics of these investments compared to primary fund commitments, in the form of enhanced visibility on underlying portfolios, shorter duration and mitigation of the J-curve through buying into established portfolios, and potential for discounts against prevailing valuations that can boost IRR returns.[9]

In summary, today's "unique opportunity" is part of the longer-running evolution and development of the secondaries market – and it's a growth story that we believe is only just getting started.

Research view

A brief history of Secondaries[10]

1990s
Secondaries 1.0

First dedicated funds in the 1980s, but the 1990s is when a more noticeable market began to develop. Pantheon completed its first secondary investments in 1988.

In the 1990s, the market was dominated by PE, with a focus on sales of LP stakes in buyout funds by distressed investors to a handful of specialist investors. The number of dedicated funds raised annually increased from three in 1990 to ten in 1999, and the average fund size gradually grew from $74mn in 1990 to $285mn by the end of the decade.

2000s
Secondaries 2.0

The market gained greater attention in the 2000s, with investment banks creating dedicated secondary advisory teams to run sale processes. Pantheon raised its first Global Secondary Fund in 2000.

Assets under management (AUM) increased nine-fold over the decade, from $9bn to $76bn. The number of funds raised annually surged from 10 in 2000 to over 40 in 2006 and 2008, while the average fund size also rose significantly from $212mn in 2000 to $693mn in 2009.

2010s
Secondaries 3.0

In the 2010s, GP-led deals became increasingly common as market sophistication increased. GPs began proactively seeking liquidity for LPs, and these deals accounted for 30% of all deal value by 2019.

AUM continued to swell as investor interest in the market grew, reaching $276bn by 2019, and the average fund size surpassed $1bn for the first time in 2015. Additionally, secondaries investors began to emerge in infrastructure and private credit. Pantheon completed its first infrastructure secondary transactions in 2010 and launched one of the world's first dedicated credit secondary funds in 2018.

2020s
A golden age?

Entering the 2020s, the market demonstrated depth, maturity, and sophistication. Over 100 secondary funds were raised in 2021, with a variety of specialties targeting different needs for LPs and GPs.

Specialized vehicles, such as those designed for GP-led deals, emerged to address liquidity horizon mismatches and facilitate longer hold periods. GP-led deals accounted for 50% of total deal value by 2022, highlighting their increasing importance in the market. Pantheon closed its first dedicated GP solutions secondaries vehicle in 2021.

Differences across asset classes

The long-term dynamics underpinning the secondaries markets remain robust, with addressable primary markets growing by between 17% to 24% CAGR over the past five years to 2022 (see Figure 1 below). Turnover rates, how much of each addressable market finds its way to a completed secondary transaction, are hovering between 0.6% to 1.8%, with private equity still the most active. There has been increasing momentum in some of the other asset classes, in particular Infrastructure, where 2022's intermediary-reported figure of $9bn is the highest level we have seen from available data.

A shortage of buyside capital due to the relative paucity of dedicated managers in infrastructure and private credit, and even in relation to the scale of the opportunity in key segments in private equity, continue to create inefficiencies in the market (see Figure 2 below). These issues can be exacerbated by restrictions on potential buyers for assets in fund LPAs, limited buyside experience for newer managers, and reduced intermediary coverage in more nascent markets.

Figure 1:
Secondary market across asset classes in 2022

	Private Equity	Infra & Real Assets	Private Credit
Investible Primary Market ($bn)*	$5,839 | +24% 5yr CAGR	$1,166 | +17% 5yr CAGR	$1,061 | +22% 5yr CAGR
Primary Fundraising ($bn)**	$784 | +3% 5yr CAGR	$192 | +9% 5yr CAGR	$210 | +10% 5yr CAGR
Secondary Volume ($bn)***	$91	$9	$4
3-Year Average Turnover Rate****	1.8%	0.7%	0.6%
Market Overview	Mature, diversified market across various cap sizes, with specialized managers and wide pricing range.	This fast-growing market has seen strong demand for high quality assets, creating narrow pricing ranges and intensifying the importance of specialized knowledge.	Portfolios highly diversified with numerous assets, fewer buyers, and less intermediation in deal flow.
Concentration	Established buyers and sellers, with some concentration among high-end managers.	Market dominated by a few scaled players, facing supply overhang from fundraising and unrealized assets.	Small manager population despite new entrants, driven by rapid growth in private credit, leading to a significant supply overhang.
State of Play	Strong fundraising and deal flow growth, but supply of deals is outpacing demand, leading to highly selective investment process.	There continues to be especially high demand for concentrated positions in mature, high-quality funds, supporting pricing.	Recent interest rate rises boosted asset class demand with a focus on secondaries for downside mitigation.

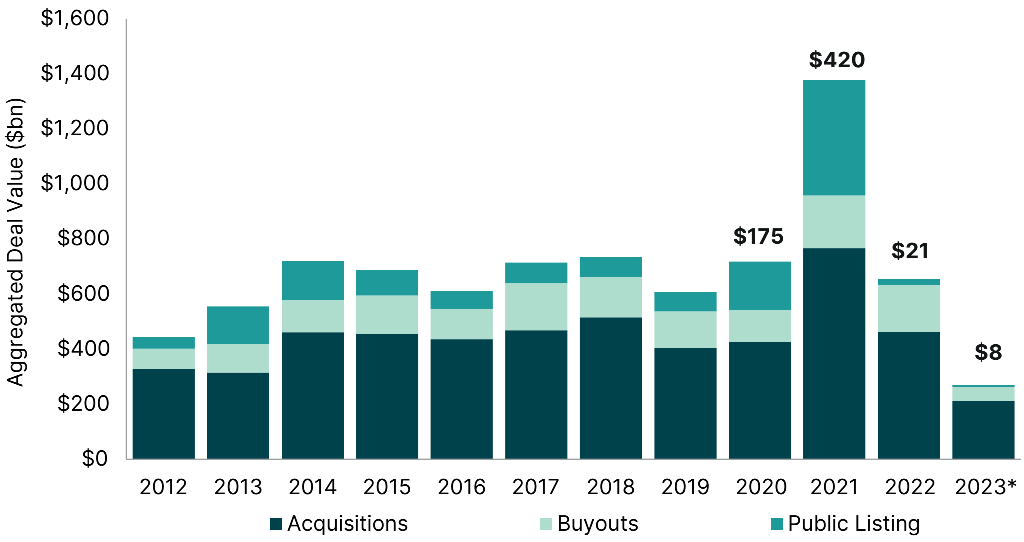
Exit slowdown

The growth of private markets secondary investments in the current market is being supported by reduced exit opportunities and broader market volatility. Specifically, there has been a severe decline in initial public offerings (IPOs). Looking at US and European exit activity, since 2008, IPOs have accounted for 17% of a total of $8.7tn in PE exits across the two regions, reaching a peak of 30% in the highly active market of 2021. As overall exits plummeted in 2022, IPOs' share fell to a mere 3% of total value, pushing investors towards longer hold periods and alternative liquidity solutions (see Figure 3 below).

This reduced IPO activity can be attributed to investors' hesitancy amid ongoing valuation uncertainty, following the market correction in 2022 and ongoing volatility in the months since.[11] Listed market pricing remains fairly subdued. As at the end of June, the MSCI All Country World Index was still 10% below its late 2021 peak despite a notable recovery so far this year, following a 27% peak-to-trough decline that reached its nadir in October 2022.[12]

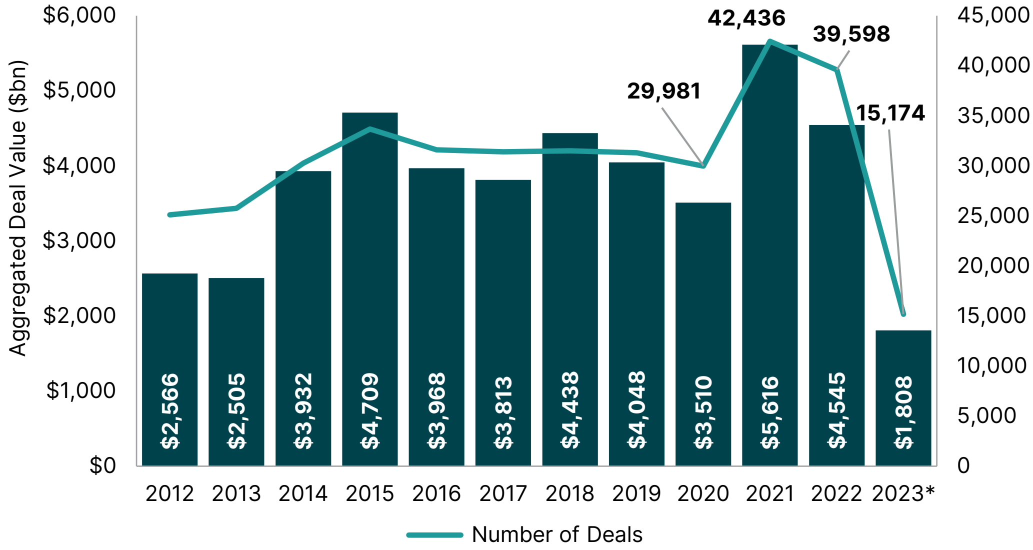
A study conducted by the Institute for Private Capital reveals that the current cold market, characterized by reduced IPO exits and market volatility, has lasted for 16 months, which is twice the average duration of previous cold markets over the past 50 years. In fact, the current market episode is the third-longest cold market since 1975. Based on their analysis, the study estimates a 75% probability that the current market will become the second-longest cold market since the 1970s.[13]

Figure 3:
US and European PE exit activity



Source: Pantheon, PitchBook as of 30 June 2023

Figure 4:
Global M&A activity



Source: Pantheon, PitchBook as of 30 June 2023

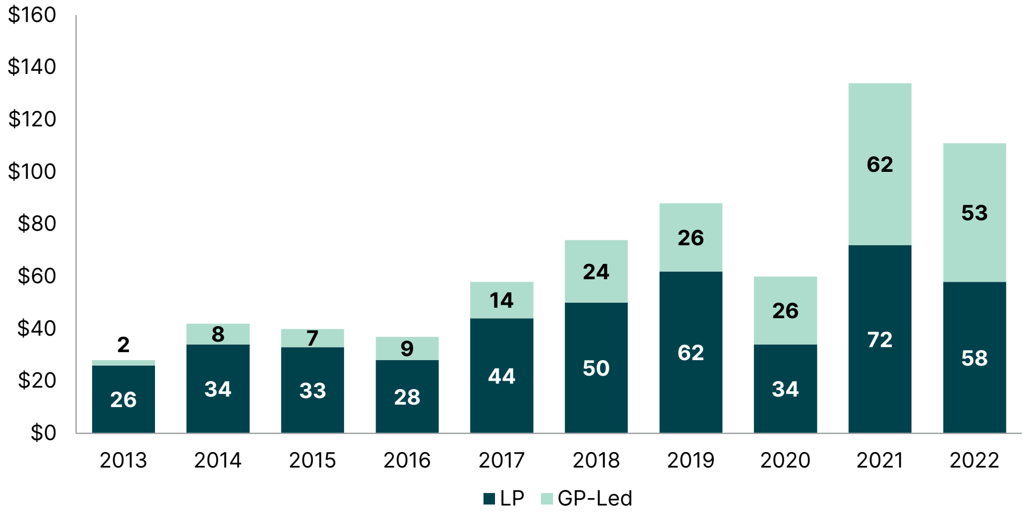
In contrast, mid-market private equity managers typically rely on mergers and acquisitions as a more common route to exit investments compared to IPOs, which are typically associated with larger exits. While the M&A market has not experienced the effective shutdown seen in the IPO space, there has still been a decline in transaction volumes. This reflects private equity firms and strategic buyers on both sides of prospective deals exercising caution on valuations.[14]

Figure 4 shows the volume and value of global M&A transactions over the past decade. It shows that, over the five years to 2022, the total number of transactions each year was between 29,000 in the Covid-affected 2020 to a little more than 42,000 in the bumper market of 2021, while aggregated deal value ranged from $3.5tn in 2020 to $5.6tn the following year. So far this year, activity has been more subdued, with $1.8tn of deal volume completed in H1.

These findings highlight the prolonged period of market turbulence and the challenges faced by investors, further emphasizing the attractiveness and importance of secondary investments in private markets as a means to achieve liquidity.

Secondary market deal flow

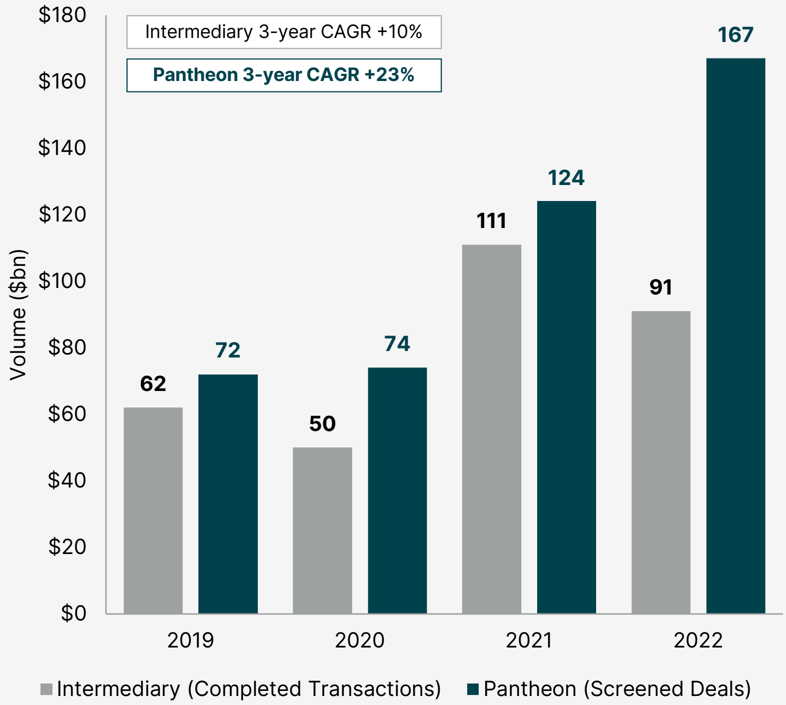
Figure 5:
Intermediary-reported transaction volume ($bn)



Source: Greenhill Global Secondary Market Review February 2023.

Pantheon screening vs intermediary deal volumes[15]

Figure 6a: Private Equity



The PE secondaries market has experienced a positive growth trend in recent years. Intermediary deal flow shows a 3-year compound annual growth rate (CAGR) of +10%. Pantheon has outpaced the intermediary data, with a +23% 3-year CAGR.

Pantheon's closely aligned screened deals and reported transactions from intermediaries suggest that the PE secondaries market, being more established, is well-served by intermediaries compared to the newer private credit and infrastructure secondaries markets.

Figure 6b: Infrastructure

Intermediaries have reported a 3-year CAGR of +6% in infrastructure secondary transactions, while Pantheon has seen a CAGR of +17% in deals screened. This highlights significant expansion and penetration within the sector.

The disconnect between the two datasets suggests that intermediary coverage may not be as complete due to the market's relative smaller size and emerging nature. Successful participation in the market requires specialized knowledge and experience to navigate its specific dynamics and nuances.

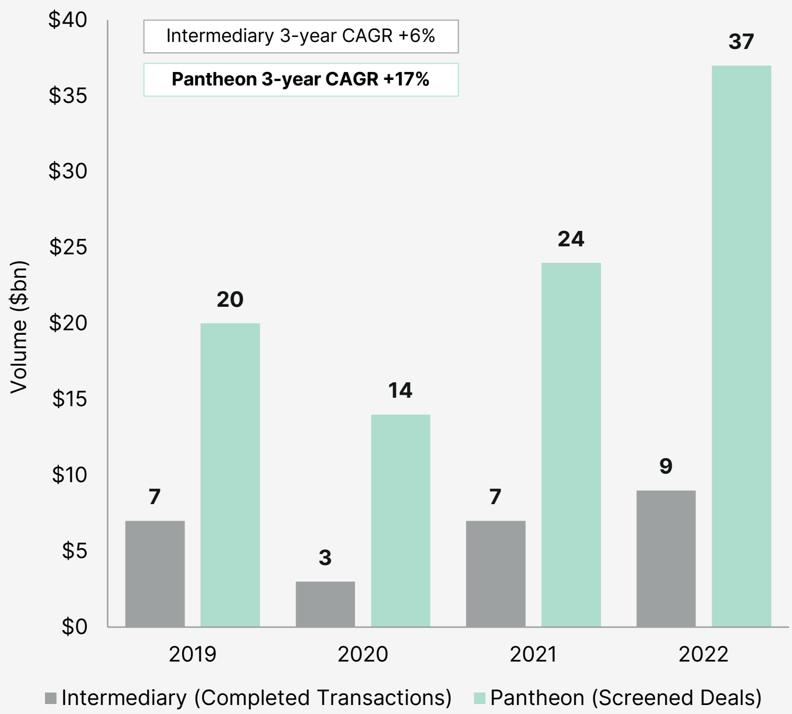
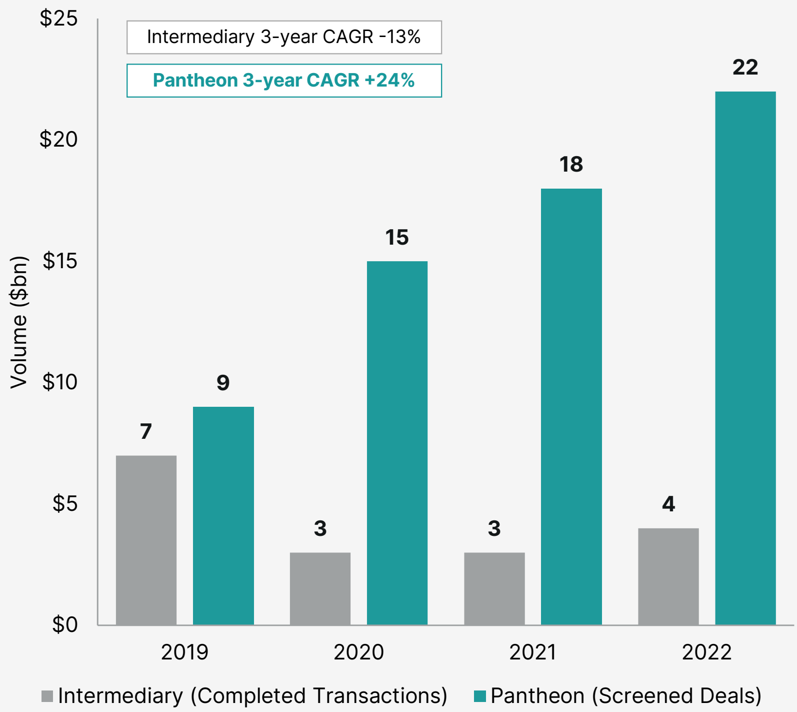


Figure 6c: Private Credit



Intermediaries in the private credit secondaries market have shown a 3-year CAGR of -13%, indicating a slight decline in intermediary activity since a strong 2019. In contrast, Pantheon has achieved a 3-year CAGR of +24% in deals screened, reflecting developed specialized coverage within this sector.

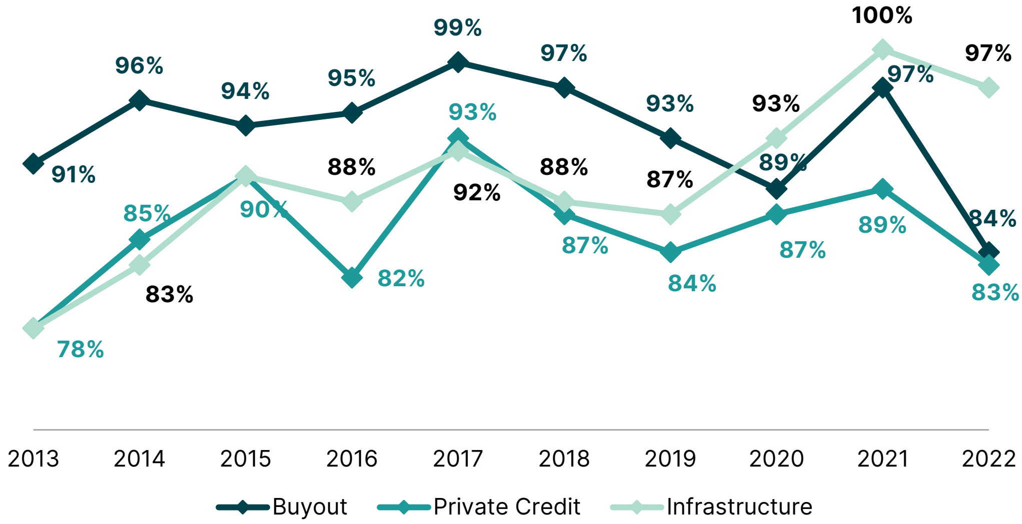
The disconnect between the two datasets suggests, similar but in a more pronounced fashion than the infrastructure secondary market, intermediary coverage is not as comprehensive. Operating in the private debt secondaries market requires in-depth knowledge and experience due to its unique characteristics and dynamics.

Pricing environment

Given the high volume of secondary deal flow and relative lack of capital, coupled with the more uncertain macro environment that has an obvious implication for valuations in the current market, we are now seeing more deals being done at discounts that are significantly higher than in recent times. Figure 7 below shows pricing in the secondary market from 2013 to 2022 – and highlights heightened discounts across all three private market asset classes ranging from 16% and 17% for private equity and private credit respectively, to 3% for infrastructure.

In reality, the secondaries market saw a slight dip in activity in H2 2022 as sellers adjusted to the new pricing reality, and we expect – and our teams have seen – significantly lower pricing of between 10-20% discounts and even more in some cases across all asset classes, and for even some of the highest-quality portfolios and assets.

Figure 7:
Secondary market pricing



Source: Greenhill Global Secondary Market Review February 2023, pricing as at 30 June 2022

1 Source: Pantheon, Greenhill Global Secondary Market Review, February 2023
2 Source: Pantheon, PitchBook as of 30 June 2023. Includes PE-backed exits from North America and Europe.
3 Source: Pantheon, PitchBook as of 30 June 2023. Includes global M&A deal activity.
4 Source: Pantheon, Preqin as of 31 December 2022. Private equity includes venture capital. Secondaries and fund of funds excluded.
5 Source: Pantheon, Preqin.
6 Source: Pantheon, Greenhill Global Secondary Market Review, February 2023. Private Equity includes Buyout and Venture/Growth.
7 Source: Pantheon.
8 Source: Pantheon, Preqin, Greenhill Global Secondary Market Review, February 2023. Turnover calculated as annual secondary transaction volume (Greenhill) divided by end of year unrealized value (Preqin).
9 Pantheon opinion.
10 Source: Preqin, Pantheon opinion.
11 Pantheon opinion.
12 Source: Pantheon, Refinitiv.
13 Source: 'Is the US IPO Market About to Thaw?', Institute for Private Capital and Private Equity Research Consortium, June 2023. Authors define a cold market as "any month when the centered three-month moving average of the number of IPOs is in the historical bottom quartile, which corresponds to an average of 5 or fewer IPOs per month. Similarly, a hot market would be the top quartile of this 3-month average, and we call the inter-quartile range a "normal" market."
14 Pantheon opinion.
15 Source: Pantheon, Greenhill Global Secondary Market Review, February 2023

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