MULTIPLICITY CONVERSATIONS

Q2 / 2021

CHRISTOPH LANDOLT DISCUSSES KEY CONSIDERATIONS FOR SELLERS IN THE PRIVATE EQUITY SECONDARY MARKET

Q: If you had one advise to potential sellers in the secondary market, what would it be?

Historically, most publications on the private equity secondary market focused on the J-curve mitigation effect, the ability to buy fund interests at a discount, and superior selection skills to explain the higher internal rates of return (IRR) of secondary funds vs. primary funds. Most of these publications were prepared by secondary buyers and, in our view, omitted THE critical factor for potential sellers: top-performing mature funds tend to continue their very strong performance in the last few years of their life; bad funds will do the opposite.

Q: Why is this so relevant for a potential seller?

This is very relevant as most primary investors anchor on their investments' book value when they approach the secondary market. They would rather sell a great fund at NAV or a small premium, than to accept a material discount on a bottom-quartile fund whose GP has likely overstated the valuation. In our view, that is what secondary buyers capitalize on and explains a big part of their outperformance. Secondary buyers know that they "can't eat the NAV" and rather must care about expected future cash flows.

Q: So sellers leave a lot of money on the table by acting irrationally?

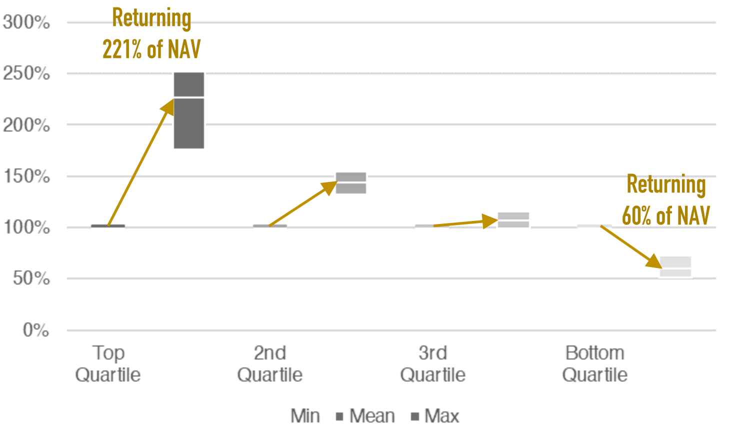
At least historically, this was the case in our view. A disproportionate share of secondaries happened in top-quality funds that continued to post great results for the benefit of the secondary buyer. Wearing accounting goggles and looking at NAV instead of expected future cash flows can be costly.

We put some numbers on it by looking at data produced by Preqin. We measured the recovery over their remaining life of a fund in % of its NAV in year 8 to 9. A top-performing fund has historically returned 221% of NAV/residual value that it reported in year 8 or 9. The bottom-quartile funds recovered a mere 60% of NAV!

As counterintuitive as it sounds, a seller would often have been better off getting rid of the worst performers than holding on to the top funds. Or to put it in terms of loss-aversion: selling a top-quartile fund at a substantial premium, appears to be a much worse proposition than selling a bottom-quartile fund at a huge discount when you take a longer-term, rational perspective.

Chart: Average total value to paid-in (TVPI) of private market funds over their remaining life

Source: Preqin, 1999-2011 vintages, ending values measured at 30 Sept. 2017



Q: How does this huge difference in future cash flows across the performance quartiles play out in terms of secondary market pricing?

Well, a secondary buyer really just looks at future expected cash flows and discounts them back to today. Let's now make the heroic assumption that all secondary buyers are looking to achieve a target multiple of 1.6x (as per Preqin's recent surveys, the average number should be around there).

Using historical distribution patterns of our mature (i.e., 8-9 years old) private market funds, let's then calculate the 'fair' secondary price by dividing these funds' cumulative future distribution by 1.6.

The average top-quartile fund distributed between 176% and 252% of their year 8-9 net asset value (NAV), with the long-term average being 221%. Using the 1.6x 'fair' multiple, a top-quartile fund should trade at a 42% premium to its NAV!

At the other end of the spectrum, a bottom-quartile fund's 'fair' price would be a 62% discount to NAV.

Do you have any questions or feedback for us? Please contact Christoph at cl@mpag.com, or call him on +41 44 500 4554.

Christoph Landolt is an Investment Manager with Multiplicity Partners. Christoph has more than 20 years of experience in the financial industry and as a private investor. Before joining Multiplicity, Christoph was Head Portfolio Management International at Bank Julius Baer and gained substantial experience alternative investments and corporate finance at Man Investments. Christoph holds a master's degree in Computer Science and Finance from the University of Zurich and is a CAIA Charterholder.

ABOUT MULTIPLICITY PARTNERS

Multiplicity Partners is an investment firm specialised in providing liquidity solutions to holders of private market funds and distressed assets. The firm also offers a range of advisory and governance services across alternative assets.

Multiplicity Partners has been an active participant in the secondary market for fund interests and distressed assets since 2010. The team has successfully completed more than a hundred transactions across a wide range of illiquid and complex financial assets. Each partner contributes more than 15 years of relevant experience, giving us the collective capabilities to effectively identify, analyse and execute attractive investment opportunities in hard-to-value assets. Multiplicity Partners was founded in 2010 and is based in Zurich, Switzerland.

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