

Private market secondaries: A primer



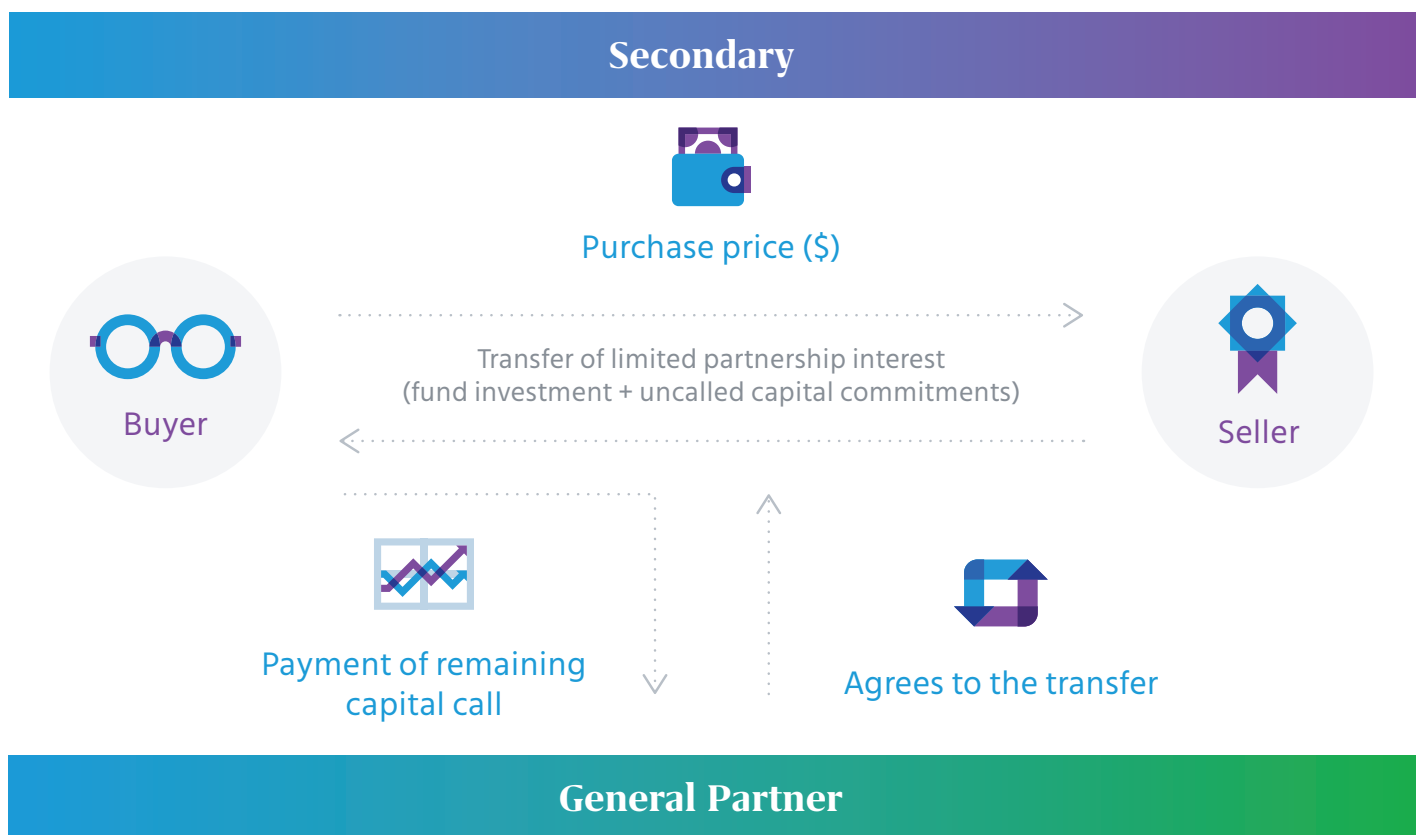
The secondary private market has matured and grown substantially over the past two decades from a niche market exhibiting scarce liquidity and steep discounts to a functional market with steady volumes and numerous participants. It now represents an important and mainstream component of the overall private market asset class, offering risk adjusted return profiles and defensive attributes.

What are private market secondaries?

Private market secondaries have historically focused on the purchase of existing limited partnership interests in private market funds (either single limited partnership interests or a diversified portfolio of multiple interests). This is in contrast to a primary commitment to a private market fund, which is made at inception and prior to any investments.

In a secondary transaction the purchaser acquires the seller's interest in a fund's existing assets as well as the seller's obligation to meet uncalled capital commitments. Figure 1 illustrates a typical secondary limited partnership interest transaction.

Figure 1: Traditional secondary limited partnership interest transaction



The secondary private market has evolved over time to include a number of different types of transactions and structures, including transactions that are “stapled” along with a primary commitment to a fund, General Partner (GP) spinouts, fund restructurings, GP-led tender

offers for limited partnership interests, and limited partnership interests. In addition, complex and creative deal structures continue to become more prevalent in the secondary market, including deferred payments to sellers, preferred distribution waterfalls and other mechanisms.

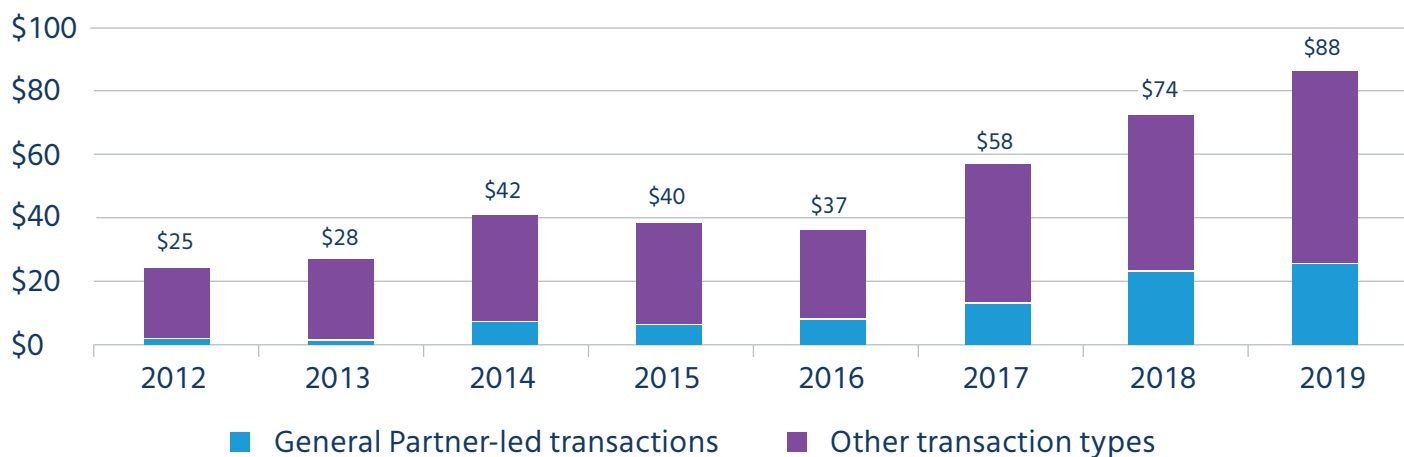
Size of the secondary market

The secondary market was initially viewed primarily as an opportunistic market associated with financial distress. However, it has evolved to become an important portfolio management tool for many private market investors, both as buyers and sellers, as further described below. The secondary market has matured into an active and dynamic market that covers all private market strategies, including private equity, real estate, infrastructure, real assets and credit. In

addition, the growing use of intermediaries and advisors is making the market more efficient. Figure 2 highlights the growth of the market since 2012. Although growing with some speed, secondary transactions still make up a small percentage of global private market assets under management. In 2019, secondary transaction volume reached approximately \$88 billion,¹ which is less than 1.5% of the \$6.5 trillion in total private market assets under management.²



Figure 2: Annual secondary private market transaction volume (USD billions)

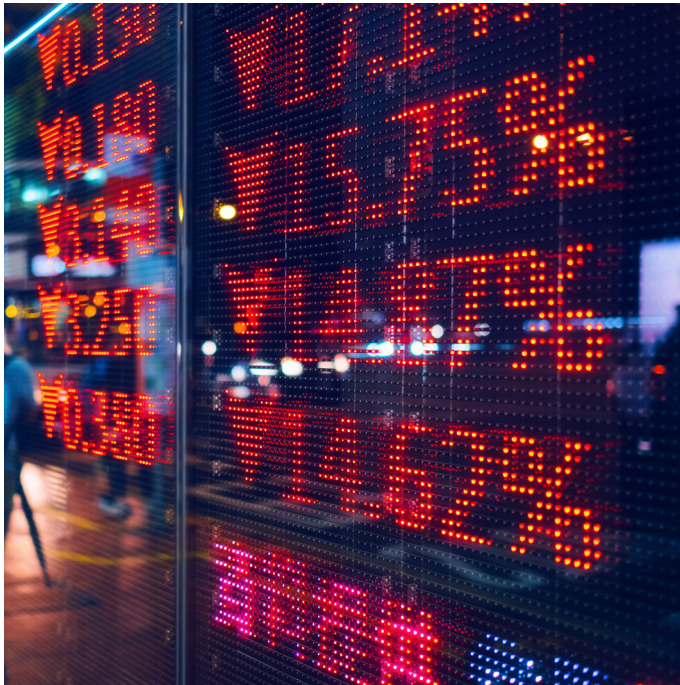


Source: Greenhill, *Global Secondary Market Trends & Outlook*, January 2020.

¹ Source: Greenhill, *Global Secondary Market Trends & Outlook*, January 2020.

² Source: McKinsey & Company, *McKinsey Global Private Markets Review 2020*.

Motivations of secondary sellers



There are a variety of reasons why investors sell their private market holdings. The primary rationale for selling interests during the economic expansion over the past ten years has been proactive portfolio management, but sellers may also be motivated by a need for liquidity, particularly during periods of market distress, or to reduce the administrative burden of the private market portfolio. Although sellers

in secondary transactions were traditionally limited partners, GPs themselves have increasingly begun to utilize the secondary market as a path to generate liquidity or access capital for their own portfolios. In 2019, GP-led transaction volume amounted to approximately \$26 billion, or 30% of the total secondary market transaction volume³. Figure 3 provides further details on the primary motivations of sellers.

Figure 3: Primary motivations of secondary sellers

Portfolio management	Desire for liquidity	Administrative needs
<ul style="list-style-type: none"> • Address asset allocation changes • Reduce exposure to specific vintage years, investment strategies or managers • Manage portfolio cash flows • Exit/reduce exposure to funds with poor performance • Focus private markets portfolio on core managers 	<ul style="list-style-type: none"> • Realize gains in strong-performing funds • Liquidity needs for program outside of private investments • Slower than anticipated realizations in private markets portfolio • Exiting private markets 	<ul style="list-style-type: none"> • Reduce number of General Partner relationships • Eliminate “tail-end” fund investments that may no longer “move the needle” • Address merger or consolidation of plan or company

³ Source: Greenhill, *Global Secondary Market Trends & Outlook*, January 2020.

Reasons for considering investing in secondary investments

The characteristics of a secondary transaction provide many benefits to a private market portfolio that are not available when making primary commitments to private market funds. Therefore, there is strong demand from institutional investors to invest in the secondary market. Greenhill estimates that there was over \$150 billion of dry powder⁴ focused

on the secondary market as of year-end 2019. In addition, the top five largest secondary funds in the market as of January 2020 were actively raising capital worth \$43 billion.⁵ There are a number of reasons that investors are interested in purchasing private market secondary interests, as summarized in Figure 4 below.

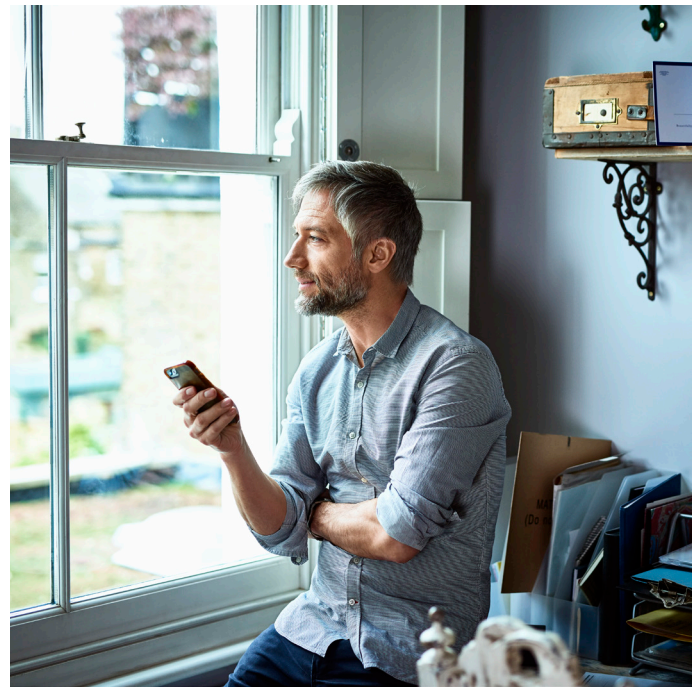


Figure 4: Reasons for considering investing in secondaries

- | | |
|-------------------------------------------|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| Mitigate the J-Curve effect | <ul style="list-style-type: none"> Acquiring portfolios of mature assets that are closer to value creation and exit provides faster liquidity that leads to reduced capital-at-risk. Additionally, secondaries mitigate some of the fee drag that occurs when committing to primary market funds. |
| Reduce blind pool⁶ risk | <ul style="list-style-type: none"> Through the funded nature of a secondary transaction, most of the underlying assets are generally known at the time of investment. |
| Enhanced diversification | <ul style="list-style-type: none"> Secondary transactions enable investors to “fill” the portfolio with a range of historical vintage years. |
| Accelerated exposure build up | <ul style="list-style-type: none"> Compared to primary fund commitments, which are funded over period of several years, secondary purchases allow for the faster deployment of capital in private equity, which can accelerate the build-up of a target allocation in the asset class. |
| Earlier return of capital | <ul style="list-style-type: none"> Due to the later entry point, secondary investments typically distribute cash back to the investor more quickly than primary investments. |

⁴ “Dry powder” refers to the amount of committed, but unallocated capital that private market funds have on hand.

⁵ Source: Greenhill, *Global Secondary Market Trends & Outlook*, January 2020.

⁶ “Blind pool” is a form of limited partnership that does not specify what investment opportunities the General Partner plans to pursue. Blind pools may be used to acquire real estate, high-tech companies, and to fund research and development.

Potential risks to consider

Apart from the risks inherent in primary private market investing, there are additional transactional issues and risks involved in the purchase of secondary investments.

Given the later entry into a fund, secondary buyers have visibility on the existing portfolio holdings in the fund, which requires an additional layer of due diligence compared with primary commitments to a blind-pool fund.⁶ In addition to evaluating a GP's ability to make future investments, secondary buyers must also analyze each underlying portfolio company in the fund and its

performance, valuation and prospects. Additionally, buyers must also analyze the fund's agreements and its annual reports and financial statements as part of the due diligence process. All transfers must comply with the requirements of the existing partnership agreement of the fund, including the consent of the GP, and in some instances, the right of refusal held by other investors. For limited partners investing in secondary funds, additional risk considerations include portfolio construction and leverage.

Implementation options

There are various ways to implement secondaries into a private market program. For example, institutional investors can pursue secondaries directly or indirectly through a specialized secondary investment fund manager. Figure 5 outlines key considerations for these two primary implementation approaches.

Figure 5: Implementation considerations

Direct	Secondary funds
<ul style="list-style-type: none"> + More control over transactions + Savings on manager fees - Requires resources for origination and execution that have the requisite skill set for evaluating the transaction - Requires ability to move and respond quickly 	<ul style="list-style-type: none"> + Large, established teams dedicated to secondary investing + Ability to respond quickly to market shifts and opportunities - Commit to blind pool - Incur additional layer of fees

More than 85% of secondary buyers are dedicated secondary funds.⁷ Given the challenge of competing against specialized investment managers with dedicated capital, other secondary buyers are limited to some of the largest institutional limited partners, family offices and fund-of-funds managers. In addition, many investors pursue secondaries using a hybrid approach, investing and developing relationships with secondary fund managers and then investing opportunistically on their own (or co-investing alongside their managers).

⁷ Source: Setter Capital, *Setter Volume Report FY 2019*.

Important Notices

References to Mercer shall be construed to include Mercer LLC and/or its associated companies.

© Mercer LLC 2020. All rights reserved.

This contains confidential and proprietary information of Mercer and is intended for the exclusive use of the parties to whom it was provided by Mercer. Its content may not be modified, sold or otherwise provided, in whole or in part, to any other person or entity without Mercer's prior written permission.

The opinions expressed herein are the intellectual property of Mercer and are subject to change without notice. They are not intended to convey any guarantees as to the future performance of the investment products, asset classes or capital markets discussed.

Funds of private capital funds are available to sophisticated investors only who are accredited investors and qualified purchasers.

Mercer does not provide tax or legal advice. You should contact your tax advisor, accountant and/or attorney before making any decisions with tax or legal implications.

This does not constitute an offer to purchase or sell any securities.

For Mercer's conflict of interest disclosures, contact your Mercer representative or see www.mercer.com/conflictsofinterest.

This does not contain investment advice relating to your particular circumstances. No investment decision should be made based on this information without first obtaining appropriate professional advice and considering your circumstances. Mercer provides recommendations based on the particular client's circumstances, investment objectives and needs. As such, investment results will vary, and actual results may differ materially.

Information contained herein may have been obtained from a range of third-party sources. Although the information is believed to be reliable, Mercer has not sought to verify it independently. As such, Mercer makes no representations or warranties as to the accuracy of the information presented and takes no responsibility or liability (including for indirect, consequential or incidental damages) for any error, omission or inaccuracy in the data supplied by any third party.

This presentation is for sophisticated investors only who are accredited investors and qualified purchasers.

Funds of private capital funds are speculative and involve a high degree of risk. Private capital fund managers have total authority over the private capital funds. The use of a single advisor applying similar strategies could mean lack of diversification and, consequentially, higher risk. Funds of private capital funds are not liquid and require investors to commit to funding capital calls over a period of several years; any default on a capital call may result in substantial penalties and/or legal action. An investor could lose all or a substantial amount of his or her investment. There may be restrictions on transferring interests in private capital funds. Funds of private capital funds' fees and expenses may offset private capital funds' profits. Funds of private capital funds are not required to provide periodic pricing or valuation information to investors. Funds of private capital funds may involve complex tax structures and delays in distributing important tax information. Funds of private capital funds are not subject to the same regulatory requirements as mutual funds. Fund offering may only be made through a private placement memorandum (PPM).

Not all services mentioned are available in all jurisdictions. Please contact your Mercer representative for more information.

Investment management and advisory services for US clients are provided by Mercer Investments LLC (Mercer Investments). Mercer Investments LLC is registered to do business as "Mercer Investment Advisers LLC" in the following states: Arizona, California, Florida, Illinois, Kentucky, North Carolina, Oklahoma, and Pennsylvania; as "Mercer Investments LLC (Delaware)" in Georgia; and as "Mercer Investments LLC of Delaware" in Louisiana.

Mercer Investments is a federally registered investment adviser under the Investment Advisers Act of 1940, as amended. Registration as an investment adviser does not imply a certain level of skill or training. The oral and written communications of an adviser provide you with information about which you determine to hire or retain an adviser. Mercer Investments' Form ADV Parts 2A and 2B can be obtained by written request directed to: Compliance Department, Mercer Investments, 99 High Street, Boston, MA 02110.

Certain regulated services in Europe are provided by Mercer Global Investments Europe Limited, Mercer (Ireland) Limited and Mercer Limited. Mercer Global Investments Europe Limited and Mercer (Ireland) Limited are regulated by the Central Bank of Ireland. Mercer Limited is authorized and regulated by the Financial Conduct Authority. Registered in England and Wales No. 984275. Registered Office: 1 Tower Place West, Tower Place, London EC3R 5BU.

June 2020