BAIRD

CAPITAL FORMATION TRANSFORMATION IN THE SECONDARY MARKET

THE PROLIFERATION OF SEMI-LIQUID FUNDS IS DRIVING SECONDARY BUYER CAPACITY TO NEW HEIGHTS, WITH WIDER REVERBERATIONS UNFOLDING

Participants in the private equity secondaries market have long highlighted a critical challenge: the market's persistent undercapitalization. For decades, access to liquidity solutions for fund managers and LPs has come from predominantly institutional closed-end secondary funds. While those vehicles have scaled impressively, the pace of addressable market supply has consistently outpaced that new capital formation. Despite the attractive supply-demand characteristics in secondaries and the resulting strong performance of the asset class, institutional capital has simply struggled to keep up with the vast market opportunity.

Enter the semi-liquid vehicle, a product designed to democratize access to private alternatives for the largely untapped retail investor channel. These open-ended funds, which resemble traditional mutual funds (regulated under the SEC's Investment Company Act of 1940, aka the "'40 Act"), have long existed for private credit and real estate strategies. ***More recently, as the secondary market has grown in scale and popularity, asset managers have increasingly recognized that secondary strategies also meet the requirements of open-ended funds and thus have been launching new products in the category that are gaining remarkable traction.*** The broad diversification, high-velocity deployment, consistent distributions and cash recycling targeted by most secondary managers are proving to align well with products offering periodic on-demand liquidity.

This new emergence of PE-focused evergreen funds is driving a convergence of two powerful trends: (1) the long-untapped appetite among high-net-worth investors for private equity, and (2) the persistent undercapitalization of the secondary market. The results of this convergence are already proving powerful, with the potential to create reverberative impacts across the broader private equity ecosystem.

In contrast to closed-end private equity funds, "'40 Act" vehicles have no defined term or limitation on new investor inflows. As new inflows are received and portfolio distributions occur, that cash is rapidly deployed into new investments. That high-velocity deployment and recycling is critical to avoid a cash drag on overall returns. New investors fund their full commitment upon initial subscription, with monthly or quarterly opportunities for liquidity (usually subject to an initial 1– or 2–year gate). ***This structure has attracted institutional capital, but the primary appeal has been to wealthy individuals who have historically lacked easy access to private equity products and tend to place greater value on discretionary liquidity.***

[1] Per Boston Consulting Group and iCapital research.

While each '40 Act fund differs in allocation across various PE strategies, many include outsized weightings to secondaries. These fund managers are targeting broad diversification, resulting in hundreds to thousands of underlying companies in a single portfolio. This can be considered akin to "private equity beta," as variation in returns among '40 Act funds is largely driven by differing strategy allocations and proficiency in fund management. A fund manager's challenge lies in balancing sufficient cash levels to service ongoing investor redemptions, inflows and distributions. Secondaries is an ideal strategy to accomplish these objectives given the opportunity to achieve immediate diversification into portfolios of seasoned assets.

Today, nearly every scaled secondary asset manager has either launched or announced plans for an evergreen vehicle as an avenue to access the high-net-worth investor channel and address the market's surplus of investment opportunities. While these vehicles can take time to scale, once a diversified portfolio is built, the structure creates a perpetual flywheel that, under normal market conditions, should rarely rely on new investor subscriptions to fund new investments.

It's now expected that buyers in any given secondary process, whether a GP-led or LP-led transaction, are utilizing capital from a '40 Act fund alongside traditional sources, in some cases nearly doubling the buyer's investment capacity. Buyer check sizes have now become a moving target to the upside, with many secondary managers themselves struggling to predict their own deployment capacity in even the coming 2–3 quarters.

This dynamic is particularly salient in a period where retail inflows into private equity are increasingly relevant. ***Estimated global investable asset value is expected to reach ~$350 trillion by 2025, with ~$220 trillion (~65%) attributable to high-net-worth investors who are actively diversifying into private markets.*** By 2025, HNWI allocations to private equity are expected to comprise more than 10% of all capital raised by private equity funds and reach $1.2 trillion, more than double 2022 levels.[1] The largest private equity firms in the world are increasingly recognizing that this tectonic shift represents a substantial opportunity for AUM growth going forward.

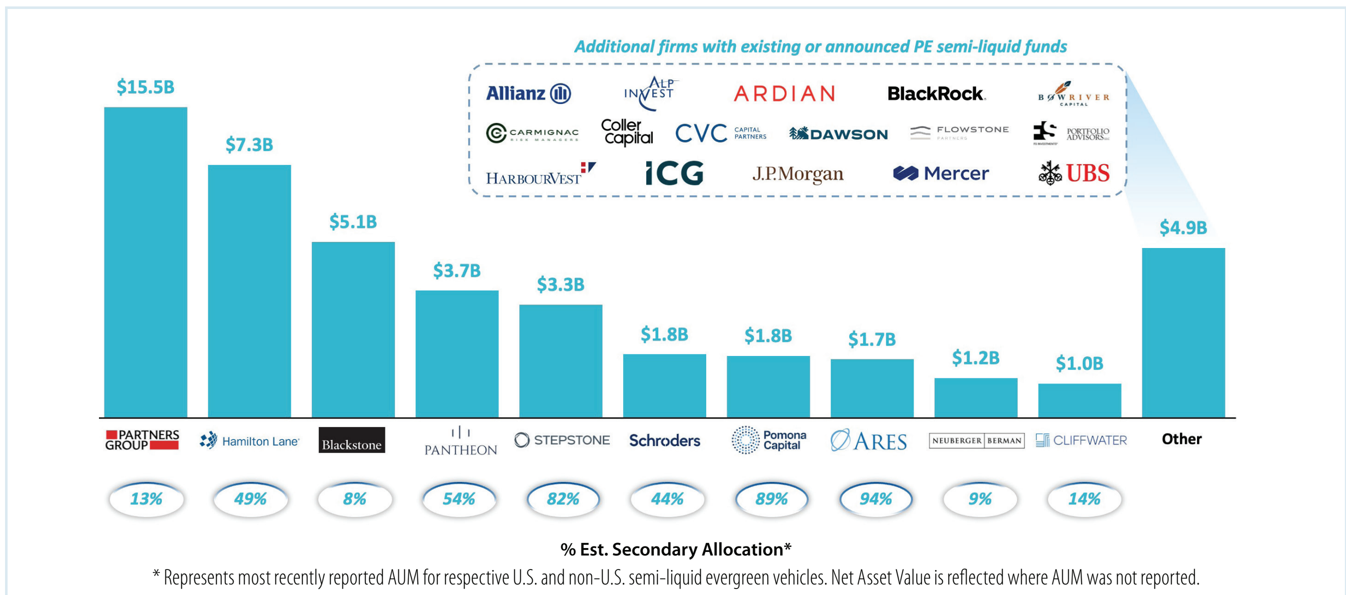
Partners Group is well known as an early mover in utilizing this structure, having launched one of the first evergreen vehicles. Their evergreen program stands at over $15 billion in AUM, and while much work has gone into creating this scale, it's a leading

> "Over the coming years, if we're correct and you start to see allocations go from the low single digits to the mid-single digits [percentage of HNWI investable assets], that literally is trillions of dollars that have the potential to move to alternative products."
>
> — Craig Larson, Head of KKR Investor Relations
> Q4 2023 Earnings Call

indicator of what's possible. Other investors have followed suit, including the likes of Hamilton Lane, Blackstone, Apollo, Pantheon, StepStone, and Ares, along with several others as noted below.

Today, we estimate ~$50 billion in aggregate AUM across evergreen vehicles that maintain secondary allocations. Further, ***in the last twelve months, over $11 billion in dry powder[2] has been raised across these vehicles with nearly $6 billion of that capital deployed in secondary investments. As managers aim to invest their dry powder rapidly, this is akin to a new ~$24 billion secondary fund appearing in the market virtually overnight*** ($6 bn/year over a typical 4–year fund deployment cycle). To put this in context, the largest secondary programs in the world, such as Blackstone Strategic Partners or Lexington Partners, boast flagship funds approximately at that scale. This illustrates the remarkable momentum behind these vehicles. Notably, ***over 95% of the aforementioned ~$6 billion in LTM secondary dry powder was created through new investor inflows, suggesting tremendous acceleration of investor demand for the product.*** These dynamics are not surprising amidst a muted distribution environment, but nevertheless suggest a compounding market impact. Over the coming years, as dry powder within these vehicles scales beyond their existing $50 billion in AUM, they will consume increasing look-through ownership of private assets globally.

Since these evergreen vehicles are targeting diversified secondary exposure with a lower relative cost of capital, it should be unsurprising that investors have recently observed an uptick in pricing for secondary transactions. Many secondary investors focused on LP portfolio transactions have been struggling to compete on price, with evergreen vehicles often assigned blame. ***In several recent instances, investors with '40 Act fund participation have purportedly underwritten to IRRs as low as 10–12%, creating challenging competitive dynamics for traditional buyers with higher return targets.*** As a result, perception of relative value has recently shifted



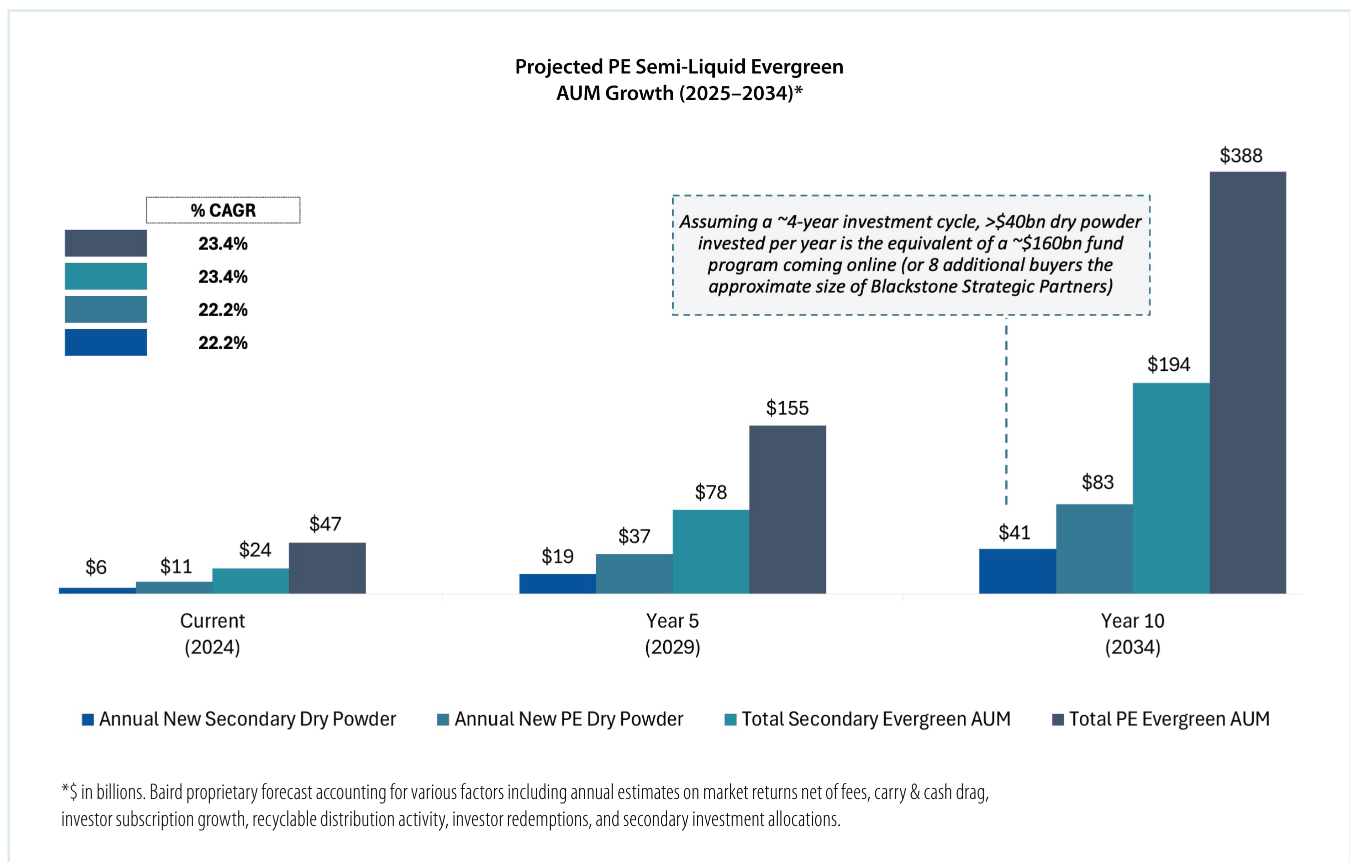
* Represents most recently reported AUM for respective U.S. and non-U.S. semi-liquid evergreen vehicles. Net Asset Value is reflected where AUM was not reported.

[2] Dry powder is defined as new investor subscriptions plus recyclable distributions less investor redemptions and vehicle expenses and is intended to estimate the amount of capital that is being deployed into new investments after accounting for cash outflows.

towards GP-led secondaries, a side of the market where evergreen vehicles have more limited participation and influence given the more concentrated nature of those transactions. This is a dynamic few were talking about 12 months ago but is a very real phenomenon driving secondary fund deployment today.

Looking forward, we believe the advent of semi-liquid evergreen vehicles, and the suitability of secondaries to these funds, represents a potential tectonic shift in the way capital formation will occur across private equity more broadly.

Diversified asset managers seeking new avenues for growth are viewing '40 Act funds as a critical new distribution channel still in the early innings of penetration. ***Considering the recent fundraising momentum from secondary platforms, it's easy to imagine the secondary-focused evergreen market scaling to approximately $200 billon within 5–10 years with tens of billions in annual secondary dry powder generated.*** With this expected capital formation, we believe the long-observed undercapitalization in this market will gradually soften as further growth in secondary market adoption, innovation and transaction activity takes hold.



*$ in billions. Baird proprietary forecast accounting for various factors including annual estimates on market returns net of fees, carry & cash drag, investor subscription growth, recyclable distribution activity, investor redemptions, and secondary investment allocations.

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