2024

HMC CAPITAL

Secondary Strategy in Private Equity

How can allocating to secondary funds optimize an illiquid investment program?

Lately, there has been a growing inclusion of illiquid alternative funds in investment portfolios. This trend is driven by easier access to these funds compared to the past and by the recognition of their benefits in maximizing the risk-return balance.

However, launching an illiquid investment program presents significant challenges. Constructing a portfolio with traditional assets, such as public equities and fixed-income securities, offers immediate exposure to assets, enabling investors to adjust or liquidate portions of their investments as needed. Moreover, traditional investments typically require a lower initial capital commitment.

On the other hand, building a portfolio of illiquid fund investments requires greater planning and caution due to the unique characteristics of private investments and the lifecycle of the funds. Some of the key challenges when starting an illiquid investment program include:

Investment return profile and cash flow patterns (J-Curve);

Initial concentration in a single strategy and "vintage" — a term used to denote the year a fund was launched, analogous to a wine harvest;

"Blind pool": committing capital to a fund without knowing in advance which companies the fund will invest in; and

Limited access to managers, either due to minimum investment size requirements or limited capacity.

To a certain degree, these challenges can be addressed, reduced, or mitigated through allocation to secondary funds. This report aims to explore how secondary investments can help mitigate the J-Curve effect in an alternative investment portfolio.

Curva-J

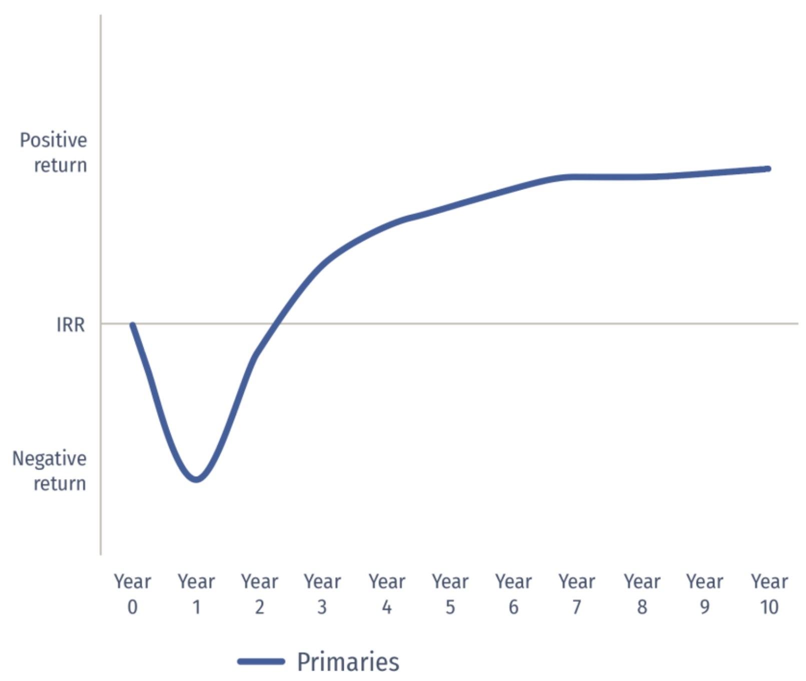
The J-Curve is a graph that illustrates the expected performance of a private equity fund over time. It is named for its shape, which resembles the letter "J."

Early Stage (Downturn of the Curve): In the initial years, a private equity fund often experiences losses or negative returns, as investor capital is being called and invested in companies that have not yet had the opportunity to increase in value.

Middle and Later Stage (Upturn of the Curve): Over time, investments begin to yield returns as the companies the fund has invested in start to grow and increase in value. Returns become positive, allowing the manager to distribute capital to investors and forming the upward portion of the J-Curve.

For mature investment programs, the cycle of capital calls and distributions can create a self-sustaining portfolio, where profits from one private equity investment are reinvested into the capital calls of another. However, early-stage programs often face challenges with initial years characterized by negative cash flows and returns.

Illustration secondary and primary fund IRRs



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In contrast to conventional illiquid funds, secondary private equity funds show a reverse J-Curve pattern. This is due to:

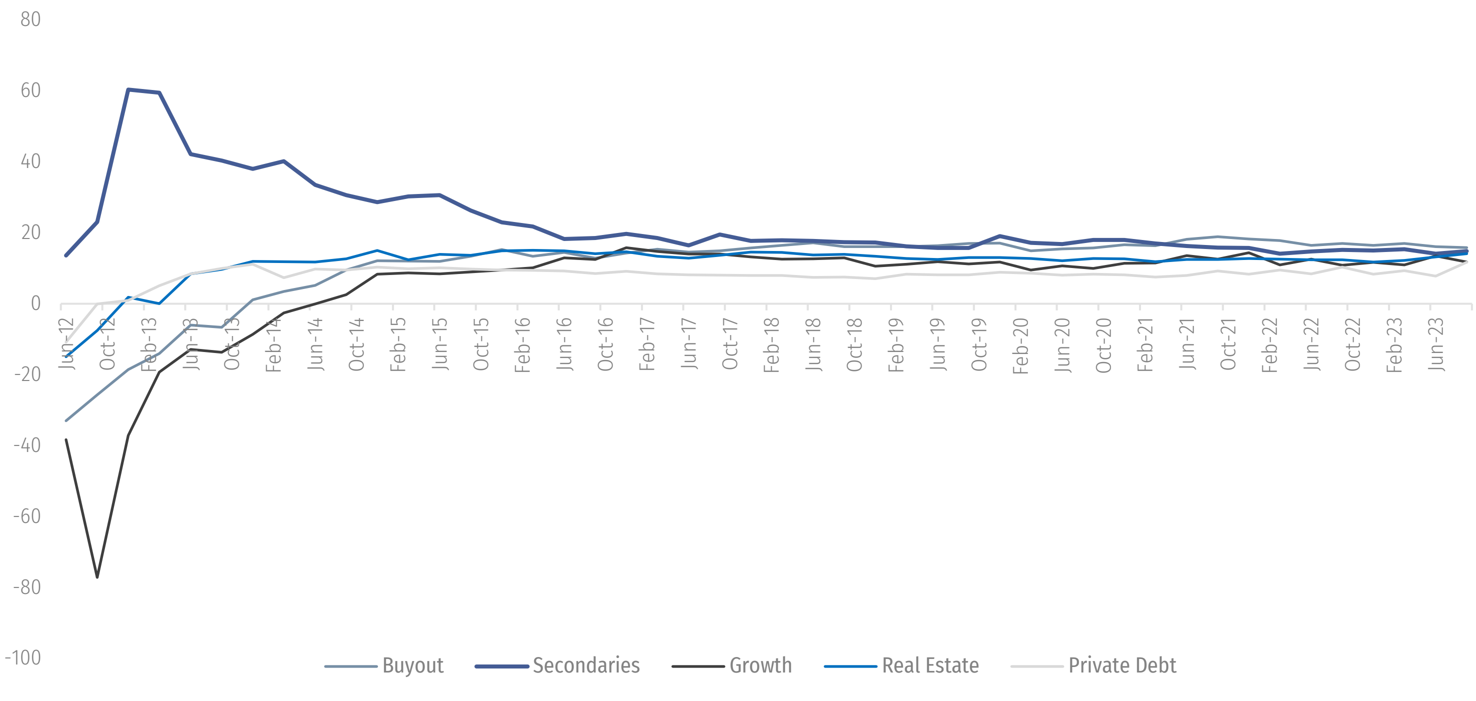
- **Price Discount:** Shares in private equity funds on the secondary market are often purchased at a discount to their net asset value (NAV). For example, if an investor's share in private equity fund XYZ is valued at $100, but a secondary market manager ABC purchases it for $90—a 10% discount—the investment is immediately recorded at its true value of $100. This results in an immediate return of 11.1%, as the investment was acquired for $90 and is now valued at $100.

- **Immediate access to mature investments:** Secondary funds typically acquire existing private equity investments that are already midway through their lifecycle. These investments have generally progressed beyond the early stages of value creation and operational improvements. By acquiring stakes in projects that have already overcome initial challenges and are starting to generate returns, secondary funds can often avoid or significantly reduce the initial period of negative returns.

- **Accelerated capital distributions:** Secondary funds invest in more mature assets, which are often already generating returns or nearing a sale at the time of investment. As a result, the distribution phase is accelerated compared to primary traditional private equity funds, which usually take 5-7 years to start returning capital to investors.

In practice, the inverted J-Curve for secondary funds is illustrated graphically as a line that starts at a higher point, signifying initial positive returns, and continues to rise as assets are realized and distributions are made to investors. The chart below highlights the differences between the return trajectories of traditional alternative funds and secondary funds.

Net IRR Preqin Pool of Funds (Vintage 2012)



Source: Preqin Pro. HMC's own calculations. The performance data represents the median Net IRR for the 2012 vintage. The "Portfolio" data includes the average returns of different private market strategies (Buyouts, Growth, Real Estate, and Private Debt), equally weighted, excluding secondaries funds. The "Portfolio with Secondaries" includes secondaries funds with a 40% weighting, with the remaining strategies equally weighted.

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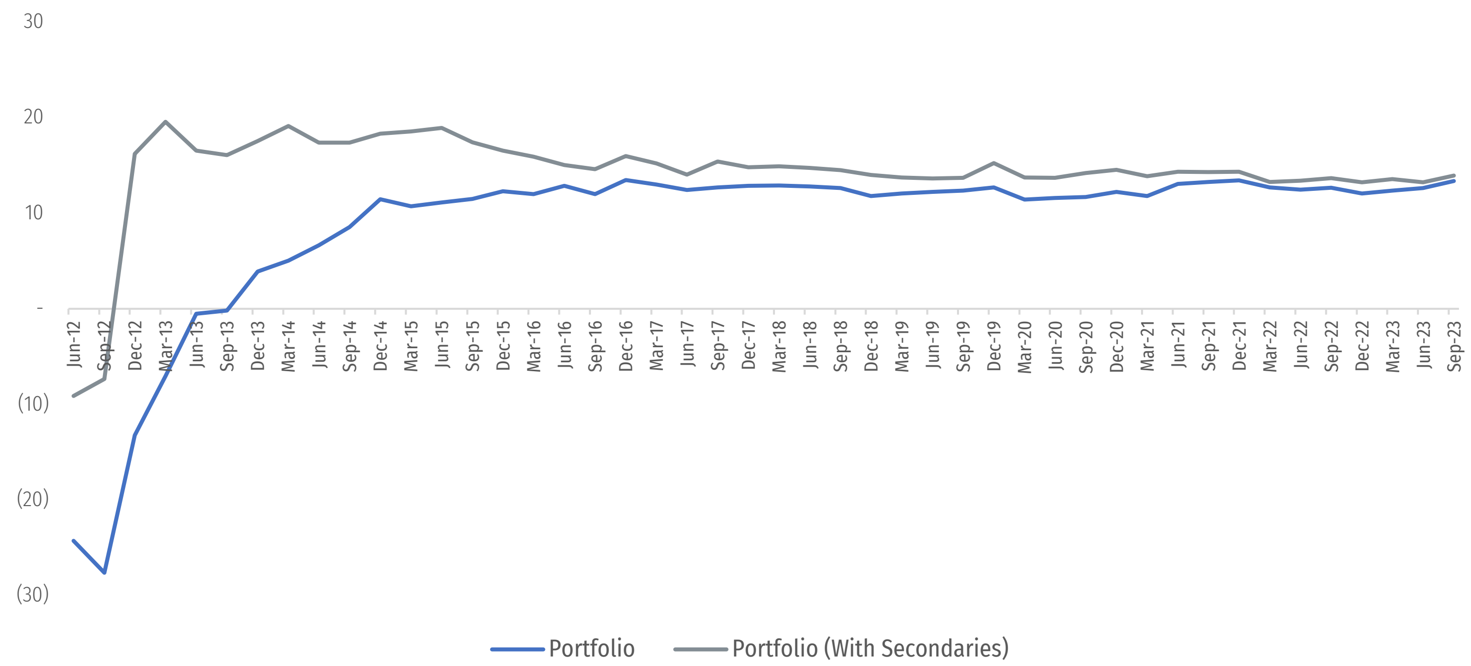
This appealing feature of secondary funds makes them an attractive option for investors seeking to minimize initial exposure to negative returns from an early-stage alternative investment program. By starting a liquid investment program with secondary funds or a mix of secondary and traditional private equity funds, investors can benefit from a more stable and positive return trajectory at the beginning of the program—as shown in the chart below.

Net IRR Portfolio (Vintage 2012)



Source: Preqin Pro. HMC's own calculations. The performance data represents the median Net IRR. The 2012 vintage was used as a reference to illustrate the long-term performance trends of several private market strategies.

Know more about secondaries

About HMC CAPITAL

HMC Capital is a leading financial consulting and investment firm.

Founded in 2009, we have been pioneers in developing alternative investments for our clients.
We offer personalized services with a unique academic and educational approach, providing access to specific technical training on-demand and Masterclasses in partnership with the world's top universities.
More than **US$ 16.5 billion** in assets under management and distribution, **from institutional and private investors.**

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