First Trust
Capital Management

Insights on Private Equity

The Secondary Fund Opportunity

UNDERSTANDING SECONDARIES

The private equity secondary market involves the purchase and sale of pre-existing investor commitments to private equity funds and, at its core, is a market that exists to provide liquidity to an otherwise illiquid asset class. In a private equity secondaries transaction, the buyer (a "secondary fund") acquires both the underlying interest in the existing fund and the liabilities tied to future capital commitments, usually at a time when the fund is largely invested. In contrast, primary funds represent a blind pool of capital raised from Limited Partners (LPs) that are strategically allocated to fund investments with each asset sourced at the discretion of the General Partner (GP) over time.

Secondary funds have two structural advantages compared to primary funds: J-curve mitigation and a substantial reduction of blind pool risk.

The J-curve refers to the time (usually early in a private equity fund's life) during which the performance of the fund experiences muted or negative returns due to the fund's fee burden. This phenomenon arises due to the presence of management fees and investment costs at a time when capital contributions to underlying investments remain low. As the fund matures and unrealized gains accumulate, the return profile gradually assumes a J-curve shape.

In a new fund, capital is allocated from LPs to targeted portfolio companies that have yet to be identified. For new primary funds, high-quality deal flow to the GP is key, as the GP is set to make all the fund allocation decisions without LP approval and is relied upon to make informed company analysis and investment decisions. This is often referred to as blind pool risk.

A DIFFERENTIATED WAY TO ACCESS PRIVATE EQUITY

By acquiring more seasoned investments through secondary funds, investors can diminish or potentially eliminate the initial negative return profile associated with primary funds. This enables investors to access fund investments with the potential for positive returns earlier, thereby shortening their capital lock-up period, and may result in a more efficient cash flow profile.

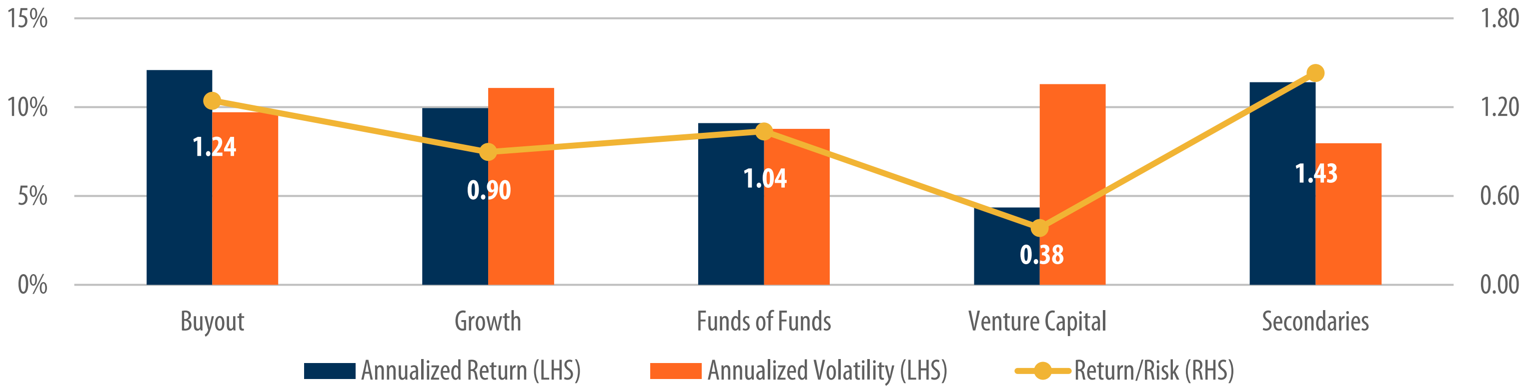
In the case of secondary investments, portfolio companies are already known, enabling investors to evaluate past performance and project future value potential. Furthermore, the information asymmetry in secondary fund investing may offer immediate diversification by providing exposure to a range of older vintage investments diversified across managers, strategies, industries, and geographies. This may present an attractive opportunity for investors seeking diversified exposure to the private markets.

Regardless of the macroeconomic backdrop, sellers of primary investments may divest their commitments for several factors. Primary investment funds typically have an average lifespan of 7-10 years; thus, investors have a prolonged capital lock-up period, reducing their ability to make tactical allocation decisions. Liquidity considerations often drive divestment decisions, as GPs and LPs may seek to convert their interests into liquid assets in order to allocate to new opportunities. Furthermore, investors may opt to sell their interests to strategically rebalance their portfolios, addressing any overweight to specific investment mandates, sectors, geographies, or regulatory constraints. Commitments may also be sold if investors wish to avoid future capital calls or when the fund's lifecycle concludes without the successful raising of a continuation fund. Due to the structural and non-economic need for liquidity, divestment of fund commitments frequently creates opportunities for buyers to access them at a discount to Net Asset Value (NAV), thereby enhancing the return potential within the secondary market.

HISTORIC RETURN PROFILE

The combination of J-curve mitigation, reduction in blind pool risk, portfolio diversification, and the acquisition of commitments at discounted NAV prices may produce a potentially attractive opportunity for investors seeking private market exposure and favorable risk-adjusted returns.

PRIVATE CAPITAL QUARTERLY INDEX



Source: Preqin. Data from 3/31/01-3/31/23. The Preqin Private Capital Quarterly Index captures the return earned by investors on average in their private capital portfolios for each asset class: Secondaries, Buyout, FoFs, Growth, and Venture Capital. Past performance is not a guarantee of future results.

THE CURRENT MARKET LANDSCAPE IN SECONDARIES

Over the past year, the market entered a new regime characterized by elevated inflation, surging interest rates, and heightened levels of economic and geopolitical uncertainty. Each of these factors has exerted distinct pressures on both the public and private markets. The private equity market has come into sharp focus amid market turmoil and the sell-off in public equities during 2022, which has created a dislocation between public and private equity performance. According to Forge, public equities reversed in 2023 but the market did not see a corresponding change in the direction of private equity valuations, which remain down 50-60% from their peaks in 2021.

Due to the inherent advantages associated with private equity secondaries, as well as the prevailing conditions in the current market, the private equity secondary market may currently offer a compelling opportunity for risk-adjusted returns. The sell-off of public equities in 2022, combined with ongoing uncertainty in economic and monetary policy, has led to a material imbalance in supply and demand. This situation has effectively transformed the secondary market into one that heavily favors buyers, as GPs and LPs continue to search for liquidity.

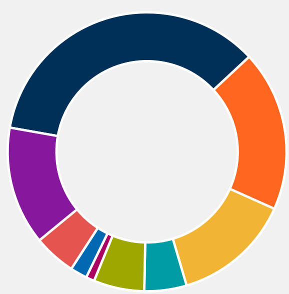
The increase in forced selling can be attributed to the denominator effect, liquidity needs, and an unattractive initial public offering (IPO) and merger and acquisitions (M&A) environment. The denominator effect is characterized by a scenario where a significant decrease in the value of one portion of a portfolio pulls the entire value of the portfolio down. Consequently, segments of a portfolio that did not experience a decline in value now constitute a larger proportion of the overall portfolio. In 2022, the public markets witnessed one of the worst years on record with significant declines in both equities and bonds, while the private equity markets remained relatively stable. Subsequently, managers have found themselves compelled to rebalance their allocations, resulting in an influx of supply in the secondary market with transactions at mid-single to double-digit discounts to NAV. This has created a compelling opportunity for investors with dry powder to step in to pick through the wreckage and selectively deploy their capital with the potential benefit of portfolio visibility.

IS NOW AN OPPORTUNE TIME TO INVEST IN THE SECONDARY MARKET?

According to data from Preqin, Fund of Funds (FoFs) and Pension Funds are expected to be the primary sellers of fund commitments into the secondary market over the next 12-24 months.

Source: Preqin Pro. Data as of May 2023.

SECONDARY SELLERS BY TYPE

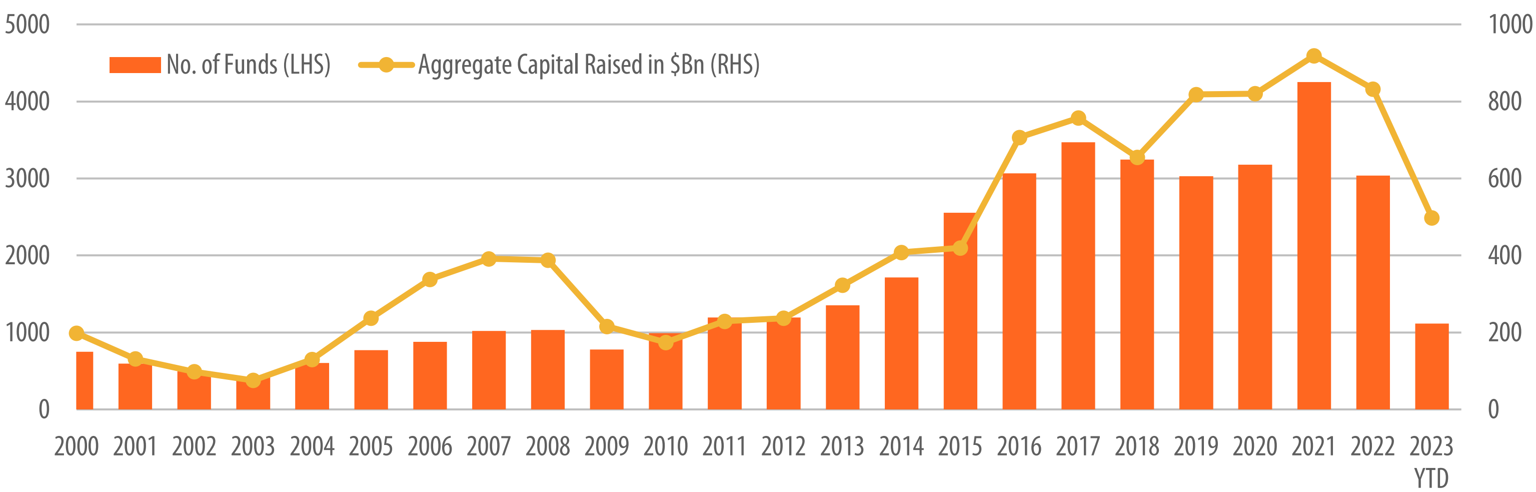


Asset Manager/FoFs	36%
Pension Funds	19%
Family Office	14%
Insurance Company	5%
Wealth Management	6%
Foundation	1%
Endowment Plans	2%
Bank	5%
Others	14%

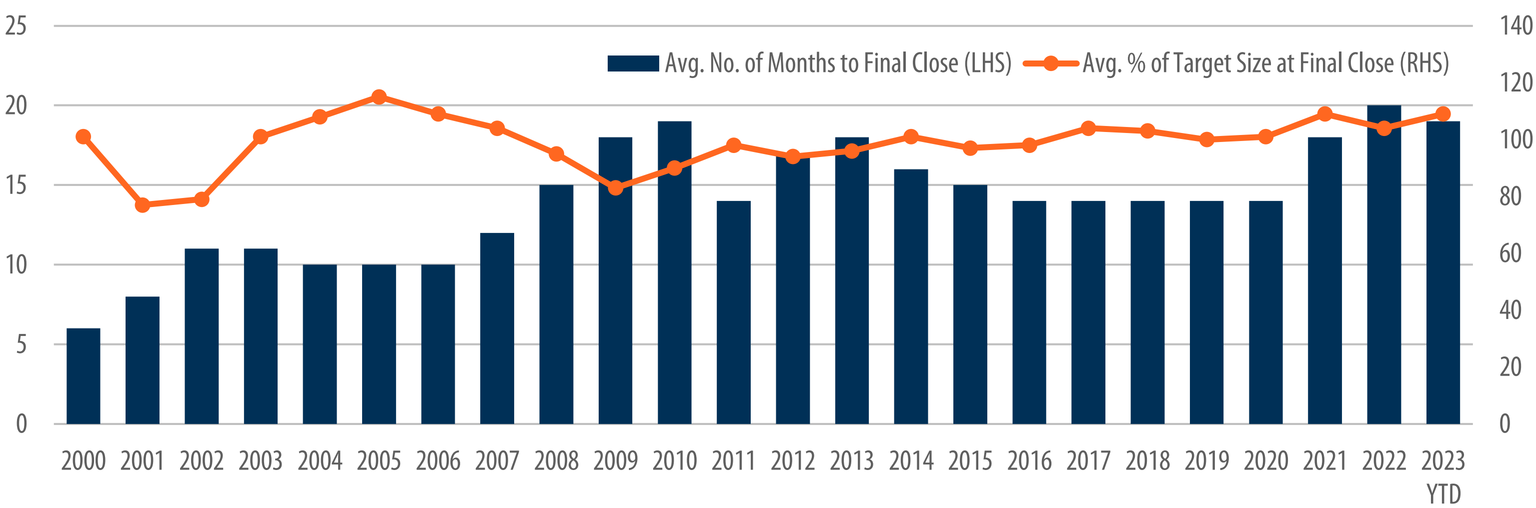
PRIVATE MARKET TURMOIL CREATES A BUYER'S MARKET

Increased secondaries supply is also being driven by heightened demand for liquidity from both GPs and LPs. Liquidity requirements can emerge for a range of reasons, including investor redemptions, debt repayments, or maintaining a buffer on liquid assets. Liquidity demand has increased due to a confluence of factors, including subdued activity in the IPO and M&A markets, as well as a challenging fundraising landscape. Consequently, the anticipated time frame for investors to realize capital returns has been materially extended. For context, a decrease in deal exits (IPO) and continuation vehicles has led to an uptick in the supply of opportunities on the secondary market. The high demand for liquidity has increased capital needs from secondary investors, placing significant pressure on pricing within the secondary market.

HISTORICAL FUNDRAISING OF PRIVATE EQUITY STRATEGIES



AVERAGE TIME SPENT RAISING CAPITAL



Source for charts: Preqin. 2023 data year-to-date as of 9/15/23.

As evident from the top chart above, private equity fundraising in terms of both capital raised and new funds hit historic levels in 2021. Over the past 12 months ending 9/15/23, this environment has materially shifted and fundraising year-to-date is now on track to be significantly lower relative to previous years. Furthermore, the bottom chart data indicates the time frame to secure capital commitments has been extended. New fund capital raises in 2023 are now averaging 19 months, a notable 36% increase compared to three years ago. We believe it is clear that investors are restrained from funding new investment opportunities due to the lack of expected distributions from more-seasoned vintages.

THE CASE FOR SECONDARIES

Given the future liquidity needs for investors, the lack of distributions from previous vintages now causing forced selling, and the supply of secondaries at discounted NAV's coming to the market, we believe there is a potential opportunity for buyers.

There is a reason secondaries' performance tends to peak in periods immediately following dislocation. It occurred after the global financial crisis and the dotcom crash, and we see similar confluence of market conditions now.

MANAGER SELECTION MATTERS IN SECONDARY INVESTING

Within each asset class in the private and public markets is a key component: manager selection. Specifically, within the private market there is a high delta between lower quartile and upper quartile manager returns. At First Trust Capital Management, through our dedicated research team, we have a network of GPs that both parallel our investment theses and have shown success throughout previous positive and negative market cycles. Given the longer expected time horizon of private equity investing, we believe the compounding effect of standing within the upper quartile return distribution is extremely powerful to the end investor. Looking at our GP relationships, we expect this to remain the case as our team gains ongoing insight when deploying capital into the private equity secondaries space.

DEFINITIONS

Limited Partner (LP): An investor in a limited partnership. The general partner is liable for the actions of the partnership while the limited partners are generally protected from legal actions and any losses beyond their original investment. The limited partner receives income, capital gains and tax benefits.

General Partner (GP): A class of partner in a partnership. The general partner retains liability for the actions of the partnership. In the private equity world, the GP is the fund manager while the limited partners (LPs) are the institutional and high net worth investors in the partnership. The GP earns a management fee and a percentage of profits (see carried interest).

Delta: The theoretical estimate of how much an option's value may change given a $1 move up or down in the underlying security. The Delta values range from -1 to +1, with 0 representing an option where the premium barely moves relative to price changes in the underlying stock.

Standard Deviation: A measure of price variability (risk).

Initial Public Offering (IPO): The initial offering of shares in a private company to the public. New public offerings must be registered with the Securities and Exchange Commission.

Mergers and Acquisitions (M&A): Refers to the consolidation of companies or their major assets through financial transactions between companies.