The art of the exit:

Unlocking liquidity via private equity secondaries

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Federated Hermes
Private Markets

www.federatedhermes.com/private-markets
For professional investors only

No two exits in private equity are the same. A challenging economic backdrop, alongside higher interest rates and a dampened IPO market has made for a complex divestment landscape.

Effectively unlocking the value in a fund and returning that value to investors is the final phase of the private equity cycle. In a market where exits are gridlocked; where private equity holding periods are being extended; and where the disconnect between buyers' and sellers' valuations remain stubbornly wide, the private equity industry must draw on a range of skills and strategies to return cash to investors.

Global buyout-backed exit value was down 66% in 2023 versus 2021, leaving the industry with an estimated $3.2 trillion in unexited assets sitting in general partner (GP) portfolios.[1] In Q1 2024, private equity exits reached their lowest level in three years.[2]

The dormancy of the exit market is leaving investors without cash to commit to new opportunities, stagnating private equity allocations within investor portfolios. Despite expectations that macroeconomic conditions are set to improve, 2024 is projected to be the second worst year for exits since 2016.[3]

Against this challenging backdrop, we believe managers that prepare for exits and are able to offer creative liquidity solutions will be among the most successful.

Leading the drive for liquidity

At Federated Hermes Private Equity, a core tenet of our investment strategy is to exit investments at optimal points in our funds' lifecycles and we draw on a range of strategies to achieve this.

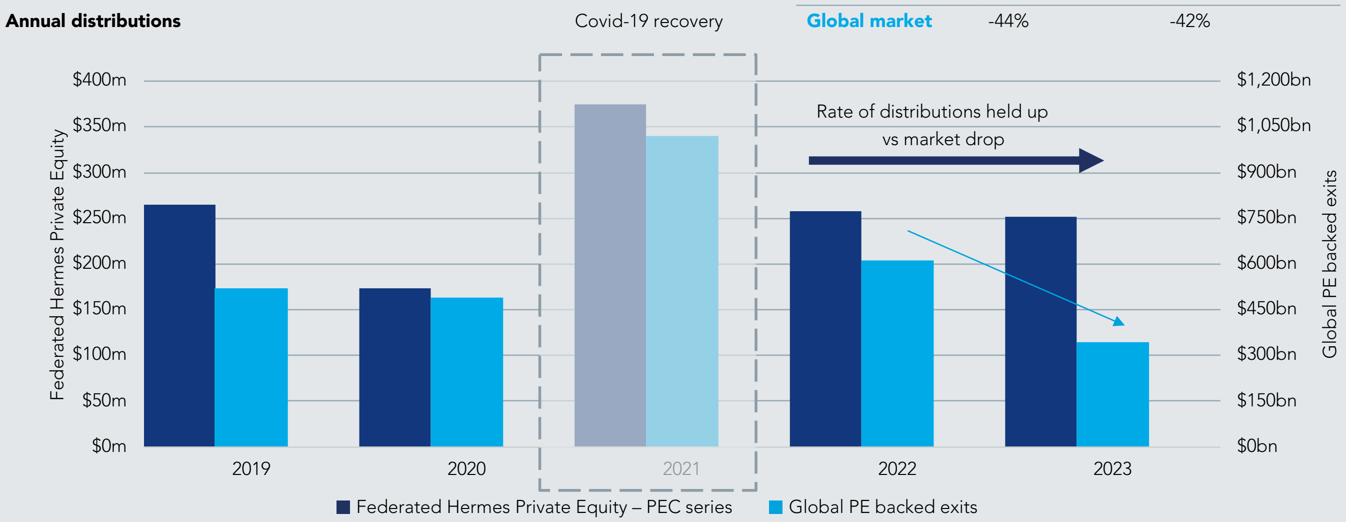
As both a fund investor and a co-investor, we do not typically control the ultimate exit of an investment. As such, the secondary market creates a platform for us to engage in proactive liquidity management.

The strength of our approach is supported by our track record: since 2010, we have distributed $2.2bn to investors through proactive secondary sales.[4] This differentiates us in an industry where funds increasingly remain illiquid for an extended period. We seek to maintain one of the industry's leading distributions-to-paid-in-capital (DPI) ratios (a measure of the cumulative distributions paid by a private equity fund to its limited partners).

Drop in industry-wide exit activity

Our flagship co-investment series (PEC) has weathered market headwinds

	2022 – 2023 YoY change	Last 5-year avg.[1] vs. 2023 actual
PEC series	-2%	+5%
Global market	-44%	-42%



Source: Bain & Co. [1] 2019 – 2023 average distributions.

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[1] Bain & Company, Private Equity Outlook 2024

[2] Preqin, 2024

[3] Bain & Company, Private Equity Outlook 2024

[4] Source: Federated Hermes Private Equity. Excludes cash flows from programmes that have generated exits for original investors but that have continued to be managed on behalf of new secondary investors.

Secondaries: facilitating liquidity

Secondary transactions involve the sale or refinancing of existing private equity assets. Sales can be carried out at the fund-level (indirect) or asset-level (direct) and can be initiated by either the manager (general-partner led) or the investor(s) (limited-partner led). Secondary buyers are typically other specialist secondaries-focused private equity funds.

GPs can establish a 'continuation fund' or refinance within existing funds to generate liquidity. A continuation fund is a new vehicle created specifically to acquire a single portfolio asset or multiple assets from a predecessor fund, creating liquidity for LPs that wish to 'cash out', while the GP continues to drive value in the assets for incoming investors.

Today, secondaries play an increasingly vital role across the sector with volumes significantly up as asset owners increasingly use the secondary market as an exit route against the backdrop of difficult traditional exit markets. In 2023, the overall secondary market had its second-largest year on record, delivering $114 billion in deals.[5]

Our best-in-class approach

Despite its growing relevance, accessing liquidity via the secondaries market requires investment expertise and skills that are not currently widespread within private equity. At Federated Hermes, we endeavour to stand out in the industry for the strength of our liquidity offering, with a specialist in-house secondaries team. The team has a 12-year+ track record on the sell side, supplemented by a recently established secondary buy-side programme.

Our capability across the secondaries market includes multi- and single-asset continuation vehicles, strip sales, tender offer process and preferred equity options. We seek to be at the forefront of the industry thanks to the breadth of strategies that we can deploy to deliver outcomes to our global base of institutional clients.

Our team draws on deep industry knowledge and a strong network to manage and execute secondary market opportunities in-house. We do, however, opt to use advisors where this is deemed beneficial to our clients, for example where there may be the potential for a perceived conflict of interest.

Delivering client-focused benefits

Our commitment to maintaining an in-house liquidity function provides the following benefits to our clients:

1. Enhanced liquidity – our deep expertise and strong network across the secondary market allows us to meet the evolving needs of our clients, whether that is generating early liquidity on otherwise illiquid assets, or tailoring programmes to meet their desired holding periods.
2. Flexible exit options – we use the secondary market to broaden options and gain more control over exit strategies, when required, so we can realise assets at what we deem to be the optimal moment.
3. Avoidance of tail-end assets – it is at the end-stage of the lifecycle that portfolio risk becomes more concentrated, meaning returns typically stagnate and costs become increasingly large relative to remaining value. Our secondary capabilities can help ensure that investments are sold at the right moment.

Timing for an optimal exit

At Federated Hermes, we are not just focused on making great investments and partnering with leading GPs; we pay special attention to exits. We prepare for exits throughout the ownership period, applying a disciplined approach. In addition to supporting our partner GPs on asset-level realisations, our secondaries team monitor our funds across their lifecycle in three phases:

Tail-end phase (10 years+): mature assets that have not been exited often require deep discounts at the point of sale and will appeal to a more specialist buyer set.

Early monitoring phase (0-5 years): the fund is driven by alpha returns

Optimal liquidity phase (5-10 years): the fund switches from being alpha to beta driven with performance more heavily influenced by market factors

On a quarterly basis, our secondaries team build out a forecast for relevant funds to assess what a secondary sale would mean for investors and the likely pricing that we would achieve from possible secondary buyers based on market and asset-level factors. We assess the return that we expect to receive from continuing to hold the fund's assets in various investment and market-driven scenarios, versus the immediate liquidity we could generate from a secondary transaction.

We are particularly focused on the more mature portfolios with positions that are crossing over from alpha to beta-driven returns. Identifying the optimal time to sell, facilitated by the use of our proprietary monitoring tools, is integral to our ability to make informed liquidity decisions which will meet our client's objectives.

Conclusion

Developing a clear and bespoke exit strategy is both a science and an art. Our experienced secondaries team has developed an extensive buyer network and a strong track record in maximising and expediating returns for investors.

As one of a small number of in-house teams dedicated to unlocking liquidity via the secondary market, our aim is to provide a differentiated solution to one of private equity's biggest challenges.

[5] Evercore Private Capital Advisory – FY 2023 Secondary Market Survey Results

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Our goals are to help people invest and retire better, to help clients achieve better risk-adjusted returns and, where possible, to contribute to positive outcomes that benefit the wider world.

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