Episode 113

The Takeaway with Troy Gayeski: Middle market PE secondaries

[00:00:00] Troy Gayeski: Middle market private equity is the definition of growth at a reasonable price. When we look at investor portfolios, they have very little, if any, exposure to this key area for growth going forward. Within middle market PE, as you're looking at the different choices, secondaries arguably offer the best risk-reward because you're certainly going to get some right up on the discount to NAV and you have much less risk of loss in the event that something goes sideways in the broader economy or in capital markets.

[00:01:00] Harrison Beck: Welcome Troy.

[00:01:01] Troy Gayeski: What's up, Harrison? How are you?

[00:01:03] Harrison Beck: I'm doing good. How are you?

[00:01:05] Troy Gayeski: Doing great, doing great. Focused on continuing to make sure our performance is heading in the right direction and trying to articulate all the wonderful things we're doing at FS for clients to the best of my ability.

[00:01:18] Harrison Beck: Well, your new strategy note is titled "Going for Growth, Middle Market Private Equity Secondaries," and it goes in-depth on why you believe middle market private equity secondaries offer the potential for growth at a reasonable price with unsurpassed risk-adjusted return potential. This piece does a great job of breaking this down, examining the potential advantages of the middle market, how the secondaries market works and how private equity secondaries combined with middle market private equity may help serve investor needs for growth.

Now, we're going to follow that same structure in our conversation today. So let's start with the middle market. First, there's some variation in what firms refer to as the middle market. What do you mean when you talk about middle market private equity?

[00:02:05] Troy Gayeski: Yeah, it's a great question and some of our competitors play a little loosey goosey with definitions because they want to emphasize the middle market because of all the wonderful attributes there. But there's varying definitions. One standard one is 10...a million to a billion of revenue. In that case, there's 200,000 companies.

Another definition, slightly smaller, five to $500 million of revenue; there, there's 140,000 companies. So it's a very broad environment...makes up about a-third of private sector GDP, which in case everyone forgot, we just revised up our GDP and again, our nominal GDP to an even higher number than we thought it was—29 trillion.

So a little under 9 trillion market. That's the fifth, maybe now the fourth-largest economy in the world. So a huge, huge opportunity where many investors have made their wealth from starting a business and maybe they're the second or third generation of that business, bringing in a private equity buyer or potentially selling to a larger corporate entity, but very few have access to it.

When I think of our sweet spot, I think in terms of more EBITDA—which is earnings before interest taxes, depreciation, amortization—and you think of it as the private equity way to define earnings; slightly different than a public, classic earnings definition. But there, we'll go as small as 10, but our sweet spot's 25 to 75 million EBITDA. So, real companies that are already profitable. And then it's about how we help them grow.

[00:03:45] Harrison Beck: Well, speaking about helping those companies grow, let's talk about investors seeking growth. In this strategy note, you write how of all the straightforward options available to investors for growth, middle market private equity offers significant potential opportunities for GARP—or growth at a reasonable price. Tell us why this is.

[00:04:05] Troy Gayeski: So, basically, when you think about what GARP is, GARP is a definition that's been in markets for years, decades and even longer. It really stands for growth at a reasonable price. And when you think about getting growth, what you're typically talking about is an area of markets that can generate 15% or better earnings or EBITDA growth on a consistent basis.

So, a secular growth trend, not very cyclical, certainly very different than value. And that in turn is what drives performance at the fund level. And then you have the ARP part. So the G is for growth, which is very important to clients. Tax-efficient growth, I might add, in terms of your ability to compound capital.

And then the ARP stands for at a reasonable price. And so if you think of pricing in different asset classes, the S&P right now trades at 21.3x for earnings. The Magnificent 7 minus Tesla plus Eli Lilly trade north of 35. We're typically entering co-invest positions…seven to 12 times enterprise value EBITDA.

And then the whole idea is after helping them grow by north of 15% per annum in terms of EBITDA growth—in some cases far more, in some cases slightly less—selling them for 9 to 15 or 16 times. When I think of capital markets today and opportunities for investors, this really is the definition of growth at a reasonable price.

You can find things that have growth at much higher prices or in reasonable prices. And you can find a lot of things that have no growth at maybe slightly cheaper prices, but it's really hard to find something with that growth prospects at what we consider very reasonable prices.

[00:05:53] Harrison Beck: It sounds like something that should be pretty compelling for investors. Now, you talk about in this strategy note how middle market private equity is up against three other straightforward options for growth. Market cap weighted U.S. listed equities, venture capital and large/ mega cap private equity. So let's go through these rapid fire. What is an investor likely to see if they seek growth through market cap weighted U.S. listed equities?

[00:06:19] Troy Gayeski: Yeah, so very, very different. It's almost like comparing apples to oranges from a lot of levels. One, you're always going to have far, far, far more volatility in any listed security than you are a private asset, really across any asset class. And there are a lot of reasons for this, but one of them is sentiment, one of them is flows. Another is listed equities tend to be far more impacted by Fed policy, whether they're cutting rates, raising rates, doing quantitative easing or quantitative tightening. So there's a lot more variability in valuation. So you have so much more volatility in public securities, which, in turn, means the onus is on you to time your entry and exit.

But when you think about growth at either unreasonable prices or growth at very expensive prices at best, that's really what listed equities are today. Whether you look at the S&P or you look at the NASDAQ, look at Magnificent 7. Again, I think you have to extract Tesla from there and sub in Eli Lilly, maybe, salesforce at this stage of the game.

What you're seeing is these highly, highly elevated valuations, 21.3x for the S&P, north of 35 for the Mag 7 minus Tesla plus Eli Lilly. And like we always say, valuation is a terrible indicator of short-term performance. If it was a good indicator, then you wouldn't have had a great year like 1999 after 1998. We wouldn't have had a very good year so far in 2024 after a blistering rally from October of '22 to the '23.

However, valuation tends to be a very powerful indicator for medium to long term. And typically when you start at multiples north of 20x, your compound rates of return are either very low—think a couple percent to even negative, or which obviously part of that's tied to the last decade.

So if you invest in listed equities and we're not listed equity haters—we see a lot of convoluted arguments to abandon equities altogether. We think you should own equities for growth, listed equities for growth. You're going to get your growth as long as the economy avoids a recession, which fortunately is a low risk.

You're just paying out the nose. And like I always say across a variety of our strategies, the math is the math. Starting at high valuations makes it that much harder to generate attractive returns.

[00:08:44] Harrison Beck: So if that's the landscape of seeking growth through market cap weighted U.S. listed equities, what about venture capital?

[00:08:51] Troy Gayeski: So venture capital...if you believe like we do that the U.S. is the greatest country and economy in the world by far—a very dynamic capitalistic market, a lot of great capital formation, rule of law. If you believe in that and you believe in the entrepreneurial creativity of America and its universities, you should have an attractive performance outcome in venture capital over time.

As long as we don't tax unrealized gains, which everyone assures me will never be done, never pass Congress. So I'll take them at their word. But the problem with venture capital is it's so illiquid and the cycles are so long and so volatile. The recent experience—the recent history—would really illustrate this well in that this huge run-up in valuations in 2021 and then a complete cratering in valuations in '22. And VC markets are starting to come back. But you're talking about volatility—two, three, four times what you get in public equity markets. That can be a very violent ride.

And if you can invest through the cycle, that means you can take advantage of those dislocations. But if there's any risk that you're not going to be able to invest in a cycle and add capital when markets are down, you might want to avoid it altogether. And if you participate in venture capital, you might want to do it at a smaller percentage of a fund that focuses more broadly on private equity, which is actually some of our offerings where we give people a small slice of it to help boost returns over time, but not to lead to incredibly high levels of volatility.

So think of that as growth at a hyper-elevated price because there's really no earnings at that point. The companies are all about revenue. You're all buying into an idea, more workout, enough workout to offset all the losers, but just a very, very different risk profile than you get in middle market, private equity and certainly a higher risk profile than you have in listed public equities.

[00:10:59] Harrison Beck: Okay. So then if that's the nitty gritty on venture capital, what about our third option for straightforward growth, large/mega-cap private equity?

[00:11:09] Troy Gayeski: So when you think of large mega cap private equity, there's a variety of challenges right now, and ultimately, historical performance has been materially lower than middle market private equity, precisely in an environment where you'd expect the performance thread to be tighter.

So you're already starting out, based on historical data, expecting a lower return than you get in the middle market. But the challenges right now in particular are that most of the large mega cap underlying companies are levered, let's call it six, seven, eight times at the debt level enterprise value to EBITDA or I should say senior debt to EBITDA.

As interest rates have gone up dramatically, even though the Fed has cut recently, we don't expect Fed funds rate to go below 3% anytime soon. It may take years to get there. So, much of

their EBITDA, remember EBITDA is before interest; after that you end up with free cash flow. So much of their EBITDA is being diverted to service debt that they have a lot less free cash flow left over to do exactly what you want them to do, which is invest in growth.

You need free cash flow to invest in growth. And when so much of that is being diverted to service your debt, it just makes it much, much harder. And you can't necessarily say it's a secular problem, but it's a long-cycle problem. It's going to be an issue for years. You know, secondarily, when you think about large mega cap, they really need the IPO market to be open to monetize positions and return capital to shareholders.

And there have been signs of life recently. We do expect the IPO market to gradually come back. But, in order to monetize positions, realize gains, return capital to shareholders, you really need the IPO market to be open. And then the other issue, of course, is you're always going to be paying more for a large mega cap company—which puts the onus on the sponsor to grow EBITDA even more because you can't expect that entry multiple of…call it seven to 12 and exit multiple of nine to 14. It just doesn't happen. And then lastly, even though it's not a huge difference, large mega cap valuations are materially higher than they are in the middle market.

So, it's certainly not rooting against large mega cap private equity. We just think that the forward returns, if anything, should be even less impressive relative to the middle market than they've been historically, where there's been a 500 basis point plus spread between upper middle market PE sponsors and upper middle market large mega cap sponsors.

[00:13:49] Harrison Beck: Well, it's great to see that you're already sort of a step ahead of us in terms of thinking about how these three options compare to the potential advantages you're going to see in middle market private equity. Before we get to that, just for the sake of thoroughness, how about looking for growth outside the United States?

[00:14:06] Troy Gayeski: Yeah. Look, you had the lost decade. You had the bricks. Those days are gone. They've been gone for a long time. Right. And look at a foundational level, when you look at developed markets, think Europe, Japan, as examples, they just don't have nearly the growth. And economic growth drives everything.

Innovation drives everything. And in the U.S., we fortunately have the global champions. You look at a place like Japan. Not only do they not have much economic growth, they have been in population decline for quite some time. Working age population decline. You look at Europe, not far behind.

I'm always curious why people think you're going to invest in economies like that and have meaningful growth. Not that there can't be one-off opportunities, but having a diversified exposure leading to positive outcomes for growth just doesn't make any sense. And then if you look at emerging markets, you just go through those original bricks.

So Brazil has been a train wreck since 2011—a lot of political instability, borderline socialism. And Brazil is always really an iron ore natural resource play on China.

Russia, I don't think I need to say any more words on that. Not a place you want to invest.

China is the poster child where you can get great economic growth, but you can't make any money from it. And that's just their whole model. Their whole model was always stealing IP from the West and making sure their companies got stronger and their market got stronger. But not really attentive or caring to the performance outcomes or investment outcomes for investors.

And, and that was, by the way, before Chairman Xi took over. And I often like to joke around that Chairman Xi is our Manchurian candidate. You know, he's done everything in his power to destroy that beautiful China model where you had this nice harmony between totalitarian communism and free market capitalism, most free market in the world, as long as you bow to the party, just go get rich, right. And that's how China became what it was. And then, whether

it's the crackdowns on domestic citizens, whether it's the strong army of Hong Kong, whether it's the jingoism with Taiwan.

More importantly, from an economic standpoint, the misallocation of capital away from growth industries to state-owned enterprises. And then you combine that with just taking a guillotine—not literally, but figuratively—to all their national champions, that could have competed with our tech companies. But were just brought to their knees. It's not been a great outcome for investors ever, but it looks particularly perilous going forward.

That being said, we're in the midst of a significant stimulus proposal from China. We hope for the good of global growth, they follow through on it. You're in a massive rally for Chinese shares, but this is after decades of not performing at all versus well north of 10% annualized compound returns in the U.S. So not a big fan of international investing. If you're going to do it, you better do it as a trade and you better get your timing right. And believe me, that's hard to do.

[00:17:30] Harrison Beck: Well, with that understanding of the challenges of international investing, the challenges of these other three options for growth we were talking about, large/mega cap private equity, venture capital, market cap weighted U.S. listed equities, let's get back to the middle market private equity.

You write that the potential advantages of middle market private equity include lower valuations, less startup fragility, breadth of opportunity, more actual transactions, lower corporate balance sheet leverage and a clear path to monetization. Once again, let's go through these rapid fire. How do lower valuations serve as a potential advantage for middle market private equity?

[00:18:12] Troy Gayeski: Once again, math is math, right. When you enter a position at seven to 12 times enterprise value, and you can grow EBITDA, you're certainly much less likely to suffer a valuation decline and have a much higher probability of being able to sell at a higher valuation than you bought. So that 40%—typical 40% cheaper valuations in middle market PE versus large mega cap—is a huge, huge strategic advantage, and I think should not be underestimated.

[00:18:44] Harrison Beck: How about less startup fragility? How does that function as a potential advantage of middle market PE?

[00:18:49] Troy Gayeski: Yeah, so that really is a segue or a reference to venture capital in that, you know, venture companies by definition are new ideas. They're nonprofitable. Most of them fail. The grand slams make up for all the failures and you end up having a decent outcome. And so in middle market PE, when we're entering positions, particularly through co-invests, they're already a profitable enterprise.

It's about how do we make them more profitable. How do we help them grow? It's not like this company's did its first round and now it's on its 18th round. Trust us on the 19th round, things are going to be great. So less startup fragility, very, very important comparison to venture capital.

[00:19:35] Harrison Beck: How about breadth of opportunity?

[00:19:38] Troy Gayeski: Yeah. Breadth of opportunity really goes hand in hand with transaction number. But if you think of breadth of opportunity, it's always staggering when I say the U.S. economy is now $29 trillion in size, $29 trillion dollars in size; amazing that this to scale of our magnificent economy. In private sector GDP it's about 84% of that eight…let's call it 82% to 84%. And middle market PE or private enterprises that would be defined as middle market PE make about up about a third of that. So let's call it $8.5–$9 trillion opportunity where you have 200,000 companies that meet the definition of 10 [million] to a hundred million or 10 million to a billion of revenue and 140,000 that meets the definition of five [million] to 500 million.

And another stat that's kind of mind-blowing is that 96% of the companies in America that have 100 or more employees—we're not talking about small startups or pizza shops around the corner—are privately held. And what you've also seen since Sarbanes Oxley—which has passed as a reflexive action to the dot-com bubble implosion—was this mega trend in capital markets where there's roughly 43% more private companies in the nineties. And there's about 35-ish percent less public companies. So that's one of the reasons why public markets have become more and more narrow.

The better companies that are acquired by a competitor, a larger company, or they're taken private, or there's really no motivation to go public because the whole reason you go public is to raise capital for growth. If you can get capital from private equity investors and private credit investors, you might not ever need to go public. So yeah, the breadth of the opportunity is really, really staggering.

[00:21:35] Harrison Beck: So that if we're talking about breadth of opportunity—you already alluded to this—you say there's also more actual transactions and that that's a potential advantage of middle market private equity.

[00:21:44] Troy Gayeski: Yeah, so when you think about just the transaction number, it's a great way of understanding how you can either add alpha—a lot of it, some of it, or destroy alpha. So of the approximately, let's call it four to 7,000 transactions that typically take place per annum in the U.S. and privately held companies, typically around 90% of those are in the middle market space.

Just a staggering number of transactions. Again, we don't want to imply that all of these go well and every company succeeds, but as an investment manager, you have this incredible breadth and just incredible deal flow to sift through to determine which investments meet the cut that can achieve that north of 15% EBITDA growth that you can buy at a reasonable price that you can monetize later.

[00:22:36] Harrison Beck: Going back to the underlying corporations, how about lower corporate balance sheet leverage?

[00:22:42] Troy Gayeski: Typically 35%–40% lower leverage on the operating company. This always has meant and always will mean that there's less risk on the balance sheet if something goes wrong. Because whether it's at the economic level, sector level or it's just an idiosyncratic situation a company is going through, that's really local to them, maybe poor execution, for instance; the more leverage on your balance sheet, not only the more debt service costs, but the more likely you already lose control of that company in a downturn to your creditors.

So it always has meant and always will mean less risk. But in this environment, it's arguably even more important because it means less of your precious EBITDA and cash flow is being diverted away from investing in growth. Again, the whole point of the strategy to servicing your debt. As we talked about before, so much of the wealth in large and mega cap PE is being diverted or transferred to the lender. That's really not a thing in middle market PE because of the far lower leverage levels.

[00:23:48] Harrison Beck: So then finally, talking about these potential advantages in middle market private equity, how about the clear path to monetization?

[00:23:56] Troy Gayeski: I think it comes as a surprise to many people to learn that in middle market private equity, typically 40%–50% of the exits per year are the monetization events where you finally realize the fruits of your labor over many years, or where the company's being sold to a larger cap, mega cap, LBO sponsored. And the way I think about this is, hey, we grow EBITDA from 25 [million] to 75 million, and then they take it over at 75 million and try to grow it

to 150 or 225 [million]. And that just means we have much less dependence on the IPO market. And typically 50%–60% of the exits are selling to a strategic corporate entity, a larger strategic corporate entity that's looking to boost their own growth. So those are the typical exits. This isn't like a post-pandemic thing when the IPO market's been shut, which I think it would be most people's kind of first response. Like, oh, I get it since the pandemic, since the Fed started hiking, IPO markets have been shut.

That's how you exit. It's like, nah, that's kind of how it's always been. And just as one data point, even in 2021, where we had a mini IPO boom and a little SPAC craze that was going on. Only about 7% of the monetizations were through IPO or SPACs. And that's been the highest level it's been at for the last 10 years.

So monetizing investments, being able to realize gains and then redeploy that capital and new investments is a critical, critical, critical advantage of middle market PE versus large omega cap, where again, they're much more dependent upon the IPO market reopening at some point before you and I collect social security, Harrison.

[00:25:43] Harrison Beck: Well, it's pretty fascinating to see these unique qualities and potential advantages of middle market private equity. Before we round out this conversation of the first half of this conversation, of this topic, let's go back to the underlying corporate investments, and how they relate to potential performance. What do the potential advantages of middle market private equity mean for their underlying corporate investments, as well as the kind of performance that upper quartile GPs have historically generated in this space?

[00:26:12] Troy Gayeski: Yeah. So I think there's two things to really point out that are somewhat eye-opening or mind-blowing. There was a study done—a very thoughtful long-term study done by a major asset management firm, wealth management firm—that looked at comparing middle market PE positions from entry point to exit. You enter, you help them grow and then you sell. And they compared middle market to large mega cap. And what they found is 2.9x the revenue growth in middle market versus large mega cap and 2.7x the EBITDA growth. Staggering. So again, back to growth at a reasonable price. That's clearly where we're going to get growth.

Now we're not implying that performance of the middle market PE fund is going to be 2.7x better than a large mega cap fund. Because there are more failures in smaller companies, it just shows how starkly all these advantages we've talked about in middle market PE play out leading to revenue and EBITDA growth.

The second one directly tied to performance of funds is that middle market PE funds have historically outperformed large mega cap by 542 basis points. And, and most of that history was during what we refer to as the ZIRP era, which stands for zero interest-rate policy. And in the ZIRP era, the majority of returns for large mega cap PE came from financial engineering, where they buy a company with little leverage, and then they lever up the balance sheet, they extract dividends and then they find some way to exit it, or from multiple expansion.

And the McKinsey study claims it was 70% of the returns. The Prequin study claims it was 45[%]. It's a big number. Those tools are no longer in the toolbox for large mega cap. You can't financially engineer your way into a better investment outcome. And you'd be, I think, somewhat naive to assume multiple expansion will be anything like it was from '09 through '21, right before the Fed started to hike.

So, I think those are two examples of all these wonderful attributes playing out, not only in terms of revenue and EBITDA growth, but in terms of performance outcomes for clients. Very, very important. Now I also want to touch upon another subject there. We talked about this before—the number of transactions means you can add value or detract value.

So middle market PE sponsors did better than large market cap in the lower quartile, but not much. The spread really opens up, for upper quartile where you have that 542 basis points. And

so there's more dispersion and outcomes, which is why you have to pick your partner carefully and make sure that they have a rich history in the space and have a very established institutional framework for sourcing co-invest or sourcing secondaries, doing the analysis on the underlying investments, making sure that you're compounding EBITDA at an attractive level over many years.

[00:29:21] Harrison Beck: It's always a good reminder to remember that the firm that you partner with is a very key ingredient in what you're going to see at the end of the day.

[00:29:31] Troy Gayeski: 100%.

[00:29:32] Harrison Beck: So the subject of this strategy note is middle market private equity secondaries. We've discussed the middle market. Let's switch gears and address secondaries. You write that investors can potentially improve their risk-reward profile in the current environment by combining middle market private equity with PE secondaries. Let's start with the basics. What is the private equity secondary market and how does it work?

[00:29:55] Troy Gayeski: Well, basically, as you've seen this incredible growth over the last several decades in private equity. You got to a point coming out of the global financial crisis where certain institutional investors were over-allocated. Perhaps they didn't want to make additional cash flow or cash contributions.

And so the secondary market was really born in that time of stress where you had large institutions looking to sell that interest at discounts. These are typically known as LP secondaries. And over time, the volume has really exploded. You've gone from sub-10 billion to now 120 to 150 billion per annum in the last three, four years.

This year should once again be a record year. Initially, this was caused by what we refer to as the denominator effect, where going into 2022, anyone that had public equity exposure or public bond exposure, or fixed income exposure, they took big hits. Equities are down about 20, Barclays Agg was down about 14. And so that meant their PE exposure suddenly got a lot larger than they thought it was. B

But effectively, what a secondary market is, is an area where if you have an existing stake in a fund, you can sell it down typically at a discount and an investor like ourselves steps in, buys at a discount. You can write up the asset to the net asset value. So you have a quick performance pop, but from there, it's all about will the asset that you bought at a discount continue to generate the EBITDA growth necessary to hit our return targets?

[00:31:35] Harrison Beck: So now that we understand the nature of the secondary market, let's start talking about the landscape for it that we are seeing right now. You write that we entered the second golden age of PE secondary investing back in 2020. So my question is, what was the first golden age of PE secondaries? And what about current conditions makes you say that we've entered another particularly conducive environment for PE secondary investing?

[00:32:02] Troy Gayeski: Great question, Harrison. The first golden age was really the global financial crisis period of 2008–2009. You know, for those of us that went through it, it was a horrific environment. You had a major markdown in assets. You obviously had a lot of bank failures. You had a lot of investors that needed liquidity.

And so what happened is the secondary market evolved where they would sell their interest down in some cases, 30, 40, 50% discounts. And you know, if you had liquidity provided, it almost didn't matter what you were buying. Yes, there were some assets like subprime RMBS that if you entered early '08, you probably had a problem.

But if you waited until the end of '08, you did fine. But in terms of PE, it was just a golden age where if you had liquidity, you could buy at substantial discounts, mark it up and then enjoy strong performance as the economy gradually rebounded. The current market is not nearly as

dire. It's being driven much more by overweights of private equity versus allocation targets. We were talking before about the initial cause, actually, even before we got into the denominator effect during the pandemic. You had a lot of acute stress and there was some secondary volume driven by that.

And then in '22, it was driven by the denominator effect. But today it's really still driven by the fact that when you look at all the capital that's coming to PE over the years, over the decades, over 70% of it came in the five years prior to the Fed starting to hike. And that's a huge number.

So you had massive allocation, and then you look further and what you see is many pension plans, many endowments are still overweight private equity relative to their asset allocation target. And so they have a really tough choice to make, particularly when they're in a negative cash flow position. Do you not sell and live with being over your allocation target, which sometimes is tricky with hard and fast, investment policy statements?

If you choose to not sell, you're probably not going to have the capital to invest in new vintages. And so much of the outcome for these PE drawdown vehicles is based on vintage year. So that's a very risky proposition. But if you sell, you're going to have to accept a 10%–30% NAV hit. When you see the volumes that call it 120 to 150 billion, when you see the pricing, pricing is not as cheap today as it was a year ago, and certainly not in 2008, which means it's even more important to focus on EBITDA growth after the fact.

But we are in a very rich opportunity for secondaries based on price, based on volume, based on quality of asset, and what appears to be at least a multiyear need for pensions and other institutions to reduce their private equity exposure.

[00:34:58] Harrison Beck: Let's drill down a little further into what's making this environment conducive. In this strategy note, you point out that secondaries have some key advantages, including maximizing returns after the NAV markup, avoiding the J-curve, and how secondary funds generally have lower loss rates versus primary funds. Let's discuss each. What does it mean when you say that post-NAV markup, secondaries generally have lower internal rate of returns or compound rate of returns than co-investments?

[00:35:27] Troy Gayeski: I think that's part of the reason, in some of our portfolios, we blend the two. But if you think about how a secondary works, let's say you buy it at a 20% discount to the current NAV. When you take possession of the asset, you can write it up by 25% immediately; that creates a substantial performance pop.

But then after that, assuming that a hundred percent of the assets or the underlying companies that are in your private equity fund interest are not performing incredibly well. You have to assume that. You typically have a slightly lower IRR after marking it up. At the end of the day, you also have less risk because you're certain that you're going to get that NAV markup and you're already investing in a very diversified portfolio that now has had years of exhibiting attractive attributes, or you wouldn't have bid for it in the first place.

[00:36:26] Harrison Beck: Now, how about the J-curve? What is the private equity J-curve and how do secondaries help investors avoid it?

[00:36:33] Troy Gayeski: Yeah. So the private equity J-curve is somewhat anachronistic these days. But it's an important part of understanding how institutions have historically accessed private equity. So let's assume you commit a hundred million dollars. You're paying fees on that immediately, which leads to negative performance in the first several years. Your capital is slowly drawn; in some cases only 40% will be drawn and with better asset managers closer to 65 or 70. It then takes multiple years to start realizing gains, which eventually offset your fees. Typically in years three to five, you flip positive. And then from there you enjoy positive performance.

For secondaries, particularly in the drawdown vehicle, one of the nice attributes is that you can benefit from that NAV discount, which front-loads your return, which means you'll more than likely have a very positive experience in year one—as opposed to a negative experience like you typically have in primary funds where actually the first several years, you're not only not making money, you're taking a modest NAV markdown. So when you think of ways to access PE, if you're looking at a dry-down fund or even an evergreen fund, having that reverse J-curve effect, is very, very important.

[00:37:55] Harrison Beck: These are some pretty compelling attributes of secondaries, maximizing returns after the NAV markup, avoiding the J-curve and how secondary funds generally have that lower loss rate versus primary funds. You point out some other essential reasons why investors may want to consider secondaries. Once again, let's go through these rapid fire. Why is increased diversification a potential advantage of secondaries?

[00:38:19] Troy Gayeski: Diversification is really important because you're buying into a pool. There might be 20 or 30 or 50 investments or even a hundred. So from day one, you're not putting all of your risk in one or two corporate entities. You're immediately getting a diversified portfolio and you can be diversified.

There's this fine line between diversification and diworsification, a term coined by the great Peter Lynch. But diversification always means less risk. And on top of that, that's probably the primary reason why you have lower loss rates, secondary funds, because you immediately get that NAV write-up, which goes a long way to mitigating the risk of loss. And you're in a very diversified portfolio from day one.

[00:39:06] Harrison Beck: With that in mind, how does secondaries allow investors to select vintage?

[00:39:11] Troy Gayeski: We alluded to this before. One of the biggest drivers of private equity outcomes is the vintage year. You can kind of think 2006, 2007, really, really bad, right. Because you know you're putting capital to work. Right before the Global Financial Crisis, huge markdowns, it was almost a freeze-up in total activity, so it took a lot longer for companies to realize their growth goals. The economy rebounded, but very, very slowly. Avoiding bad vintages is really, really important. And obviously when you come in through a secondary, the vintage has already been grown, so to speak. If you use the wine term, you know that year probably isn't that good of a year and you can avoid it altogether. Or if you're getting a really, really good price, then maybe you still engage in it because you know you're going to have a huge pop. But vintage selection is one of the advantages you have in PE secondaries.

[00:40:12] Harrison Beck: Going back to another key attribute of secondaries, how does secondaries facilitate faster deployment of capital?

[00:40:19] Troy Gayeski: If you compare primaries to secondaries, secondary is ultimately in a high volume environment like we're at today, means that your capital that you commit will be called faster. And that in turn will lead to higher compound rates of return or higher multiples on investment. So it's not taking you years and years and years to deploy the capital. Or let's use a realistic example. It's not taking you three to five years to deploy the capital. It might only take one to three, which means your capital will be compounded, at a much higher rate, because so much more of it is called.

[00:40:56] Harrison Beck: Finally, staying on the topic of capital, how does secondaries provide the potential for earlier liquidity?

[00:41:02] Troy Gayeski: Basically because you're buying into interests that are already seasoned by three, five, some cases as long as seven years, you're much closer to that monetization period. So typically, the length of a private equity drawdown vehicle that's focused on secondaries—meaning the time that your capital is locked up—is much shorter because you're buying in at a later date.

[00:41:23] Harrison Beck: Well, finally, as we wrap up this episode, let's bring it all together. It's the name of the show and a great way to summarize our conversation. What's the takeaway you want listeners to have about middle market private equity secondaries?

[00:41:37] Troy Gayeski: Let's start with the middle market in general. The breadth of the opportunity is vast, the depth of the opportunity is vast, the historical alpha proposition. Middle market private equity is the definition of growth at a reasonable price.

Secondaries arguably offer the best risk-reward because you're certainly going to get some right up on the discount to NAV and you have much less risk of loss in the event that something goes sideways in the broader economy or in capital markets.

So, middle market PE secondaries, as the last strategy note noted, it's very difficult if not impossible to find a better risk-reward profile. You could probably find higher returns in VC over a 10- or 15-year period. We'd certainly find higher returns in co-invest, but they have more risk. So very, very difficult to surpass the risk-reward profile of middle market private equity secondaries.

[00:42:34] Harrison Beck: Well, check out Troy's latest strategy note, "Going for Growth, Middle Market Private Equity Secondaries." You can find it on our Insights page at fsinvestments.com/insights. It does a great job of discussing how middle market private equity combined with secondaries offers the potential for growth at a reasonable price with unsurpassed risk-adjusted return potential.

That's "Going for Growth, Middle Market Private Equity Secondaries" on fsinvestments.com/insights.