Private Equity: Navigating the Illiquidity Premium

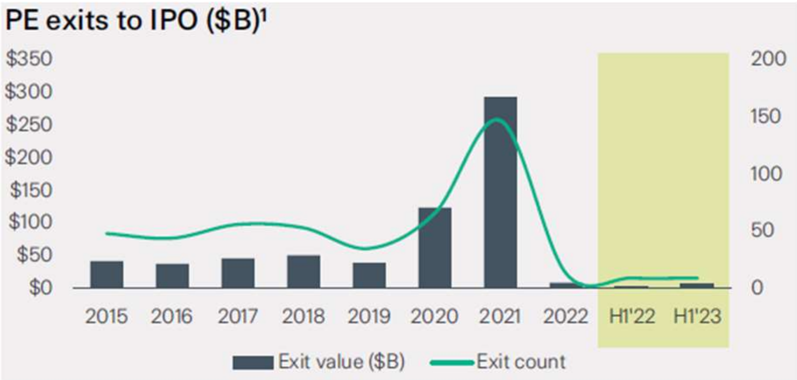
WYOMING STATE
TREASURER'S OFFICE

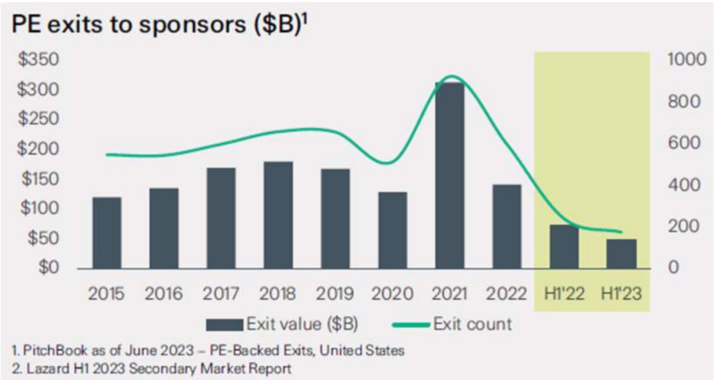
What is the Illiquidity Premium ?

The incremental return that compensates an investor for owning an asset that is not highly liquid.

	Highly liquid	Highly illiquid
Asset:	 Listed Company	 Unlisted Company
Time to Trade:	Milliseconds	Weeks to Months
Hold Period:	Milliseconds to Years	Months to Years

The Three Traditional Modes of Liquidity:

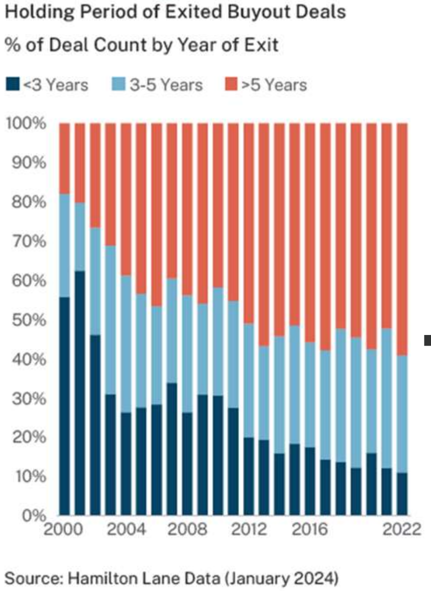




(Source: Stepstone, June 2023)

…are not functioning as they have in the past. The result of which is:

Highly Illiquid…Illiquid Markets



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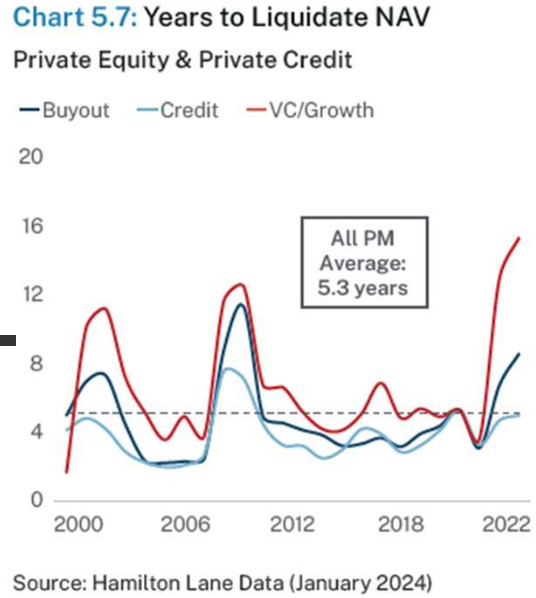

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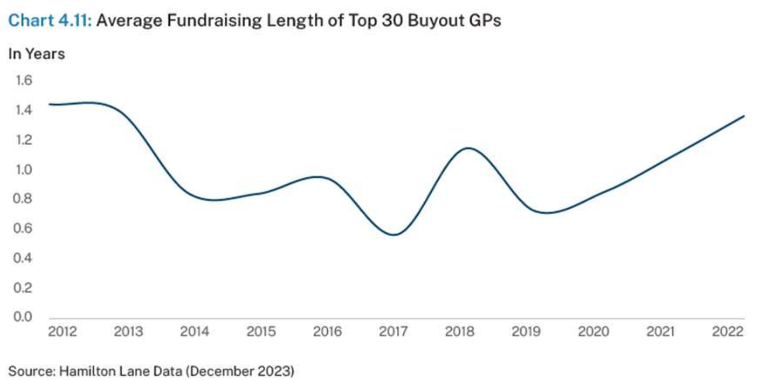


As funds are not selling deals, they are not distributing cash to investors, and hence investors have less cash to commit to new funds. So…Cui Bono?

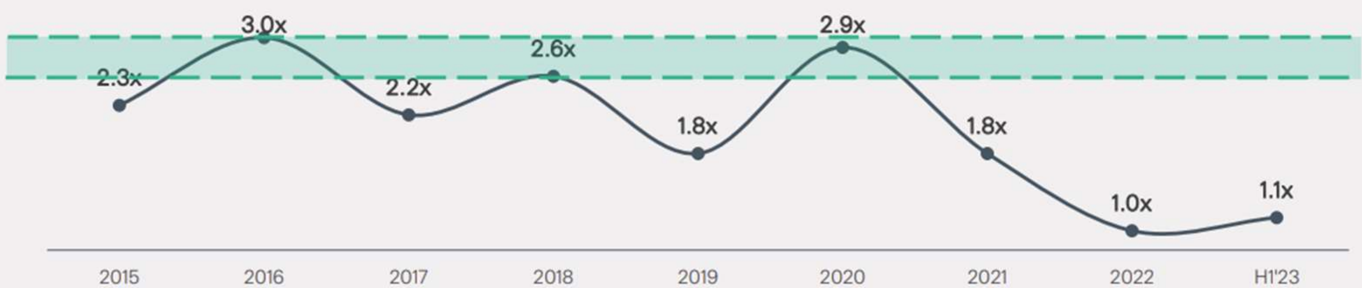
Beneficiaries of Less Liquid Markets (1/3): Secondaries

Buyers have upper hand in undercapitalized market

Given the supply-demand imbalance of the secondary market, buyers currently have the upper hand on price discussions, terms negotiations, and overall deal selectivity

Secondary market capital overhang[1,2]

Relative equilibrium (2.5x-3x)



- ✓ Supply / demand imbalance leads to a buyer friendly environment
- ✓ Taking into account available equity dry powder only, the capital overhang multiple reduces to 1.1x
- ✓ This makes secondaries one of the most undercapitalized segments of private equity markets overall

Improved Selectivity

Lower Pricing Pressure

Better Returns

1. Source: Jefferies (July 2023) and StepStone Group proprietary data.
2. Capital overhang defined as dedicated available secondaries capital divided by LTM secondary volume. Dedicated secondary capital includes equity dry powder, new fundraising capital and available leverage.

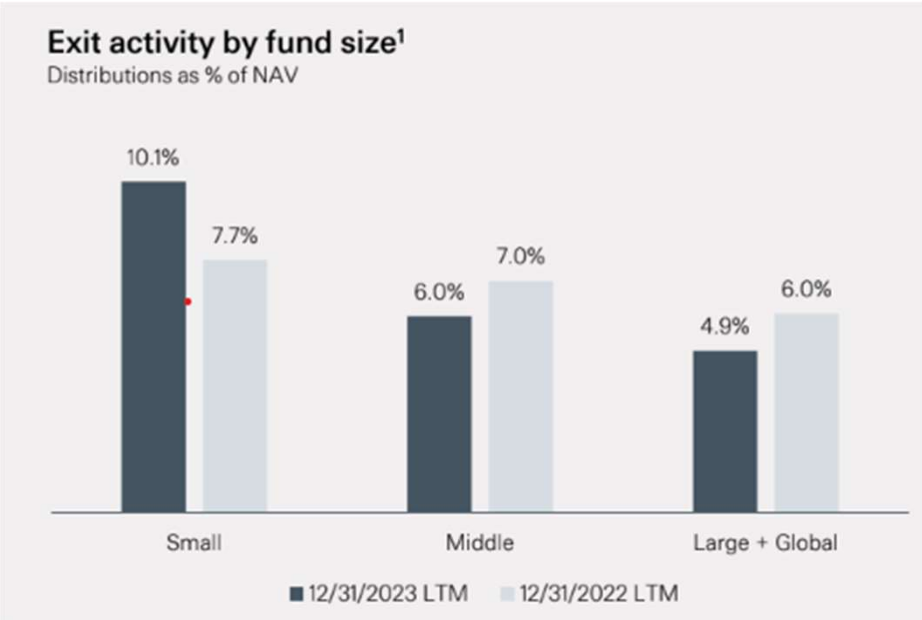
Beneficiaries of Less Liquid Markets (2/3): Co-Investments

(Yes, the second time I show this chart)

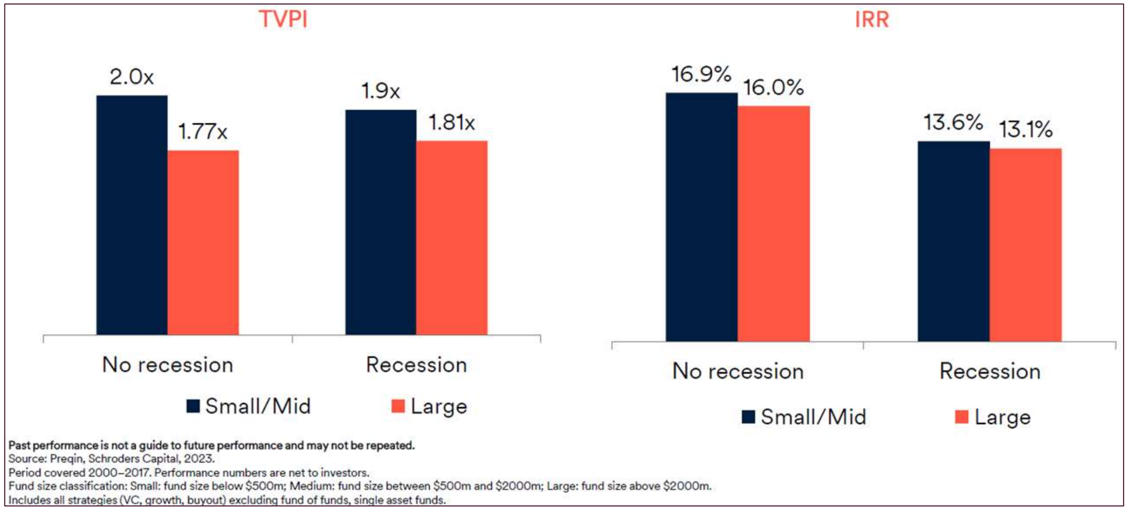
If Investors have less cash to invest in funds, then they have less cash to invest in co-investments (as these co-investments come from the funds they (don't) invest in).

Beneficiaries of Less Liquid Markets (3/3): Small Cap Funds

Small cap funds don’t need M&A or IPO’s to exit, they can sell to Large and Mega cap funds. Additionally to that, they tend to outperform over most time periods.

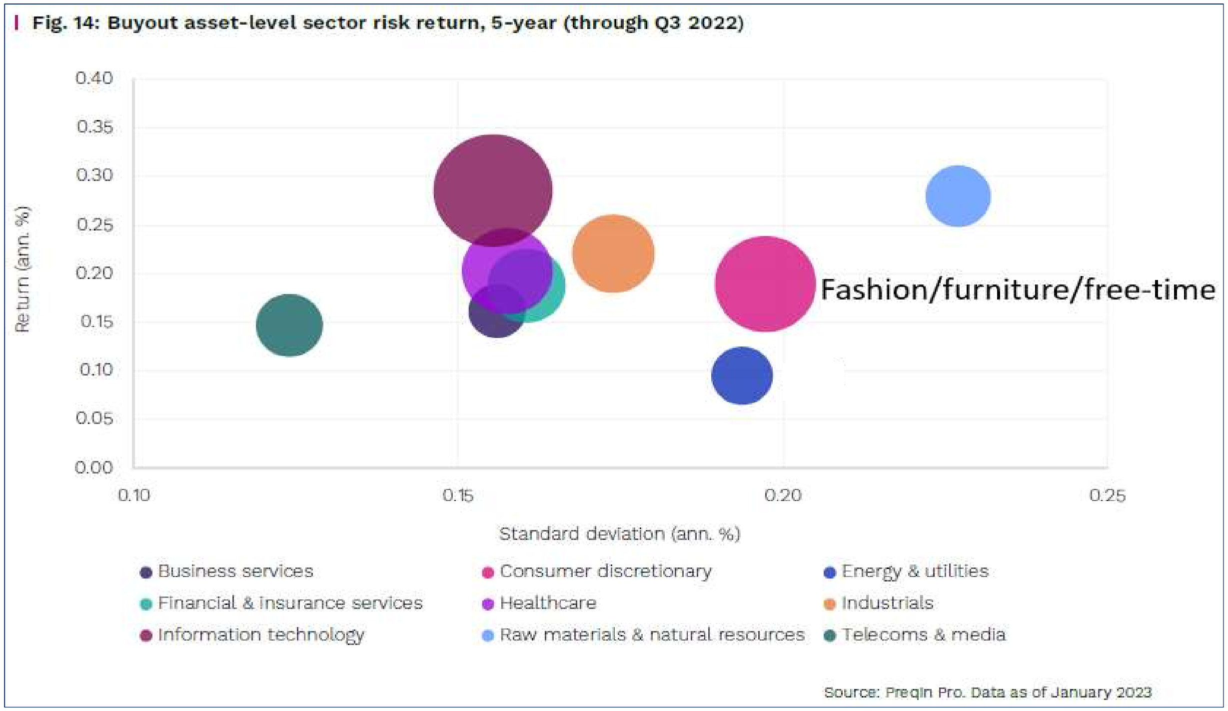


Source: Stepstone



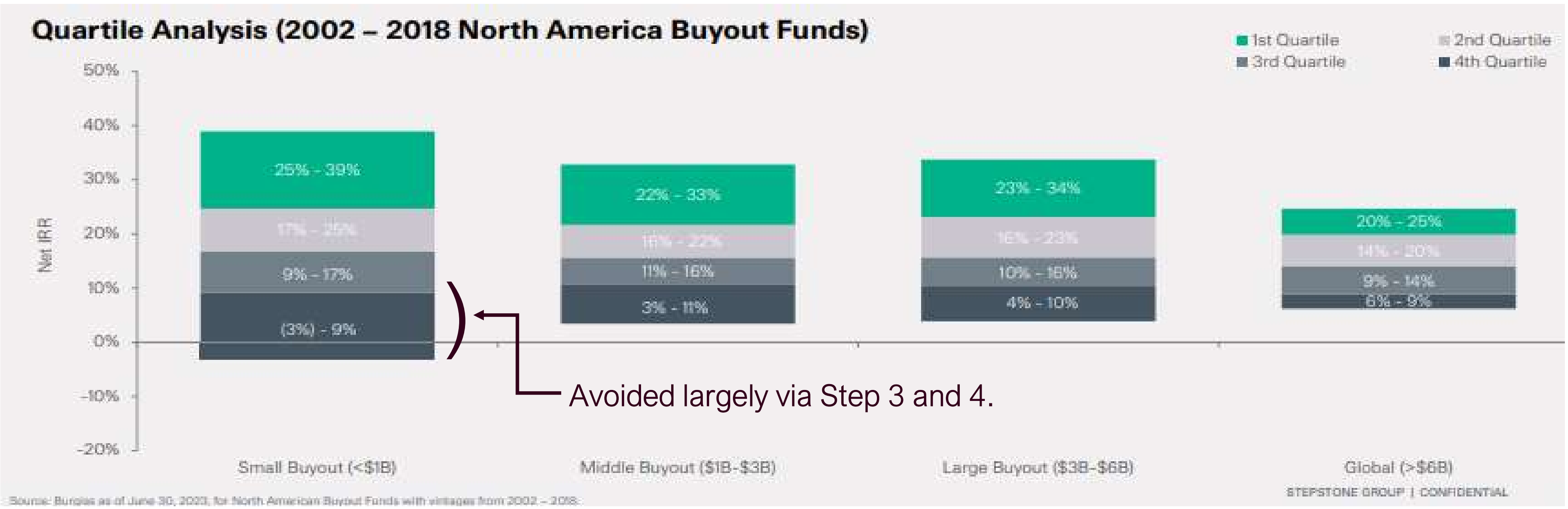
How do we create alpha? (1/3)

Step 1: Avoid sectors that historically don't offer the highest risk-adjusted return



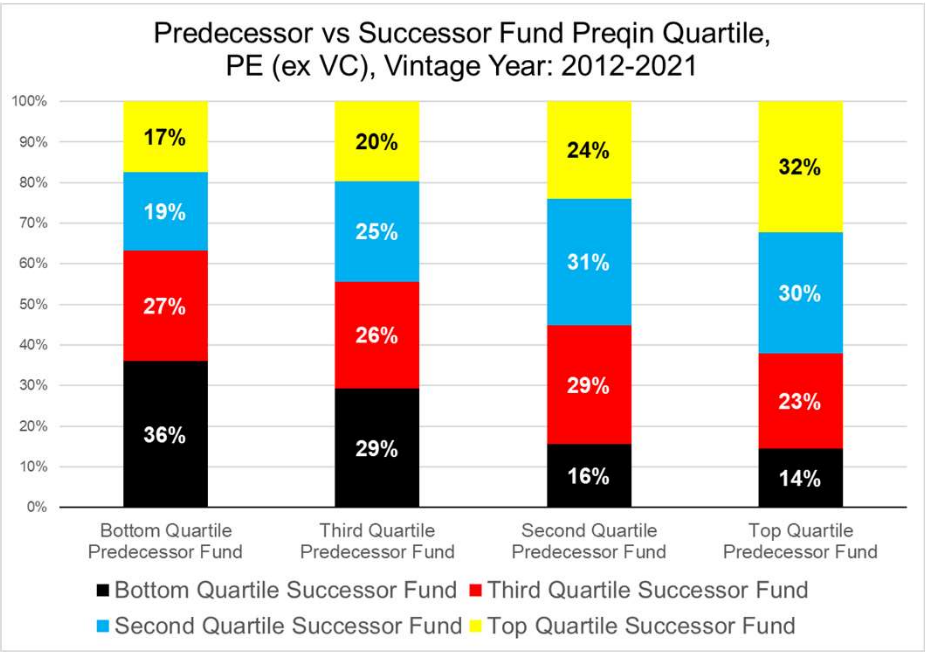
How do we create Alpha? (2/3)

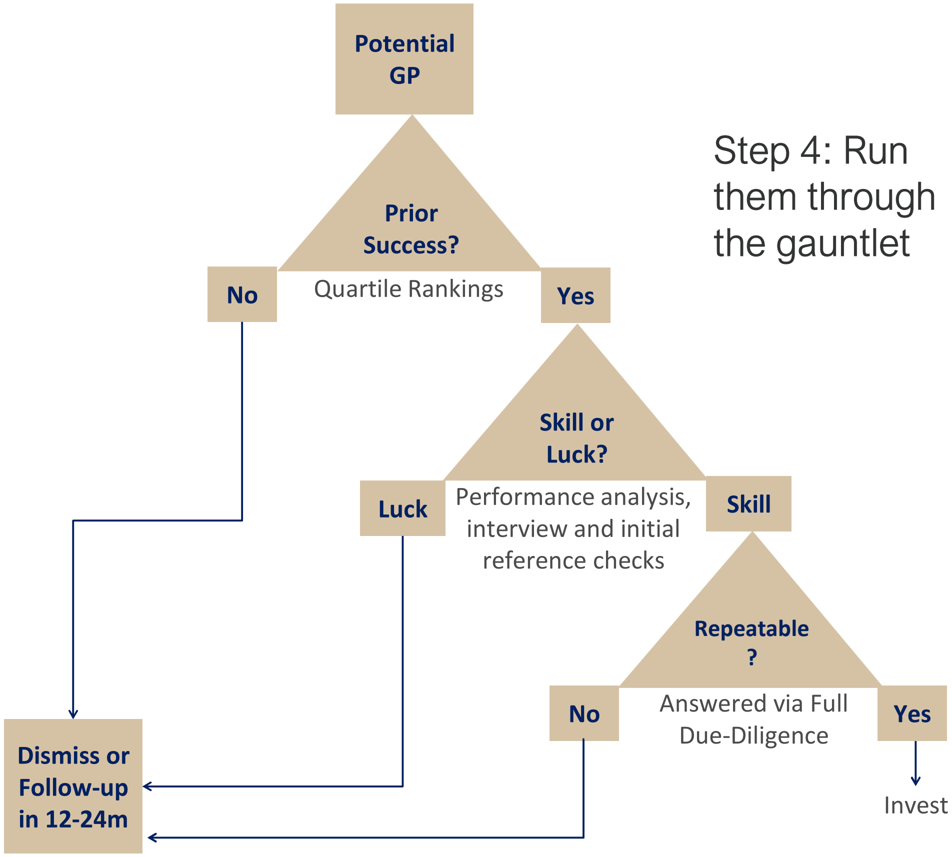
Step 2: Concentrate on the Small / Mid-Cap Segment



How do we create Alpha? (3/3)

Step 3: Source GPs that have historically outperformed





Step 4: Run them through the gauntlet