A bison stands in a golden field, with snow-capped mountains in the background. The text is overlaid on the image.

Private Equity: Navigating the Illiquidity Premium



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What is the Illiquidity Premium ?

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

Asset:

Highly liquid



Listed Company

Highly illiquid



Unlisted Company

Time to Trade:

Milliseconds

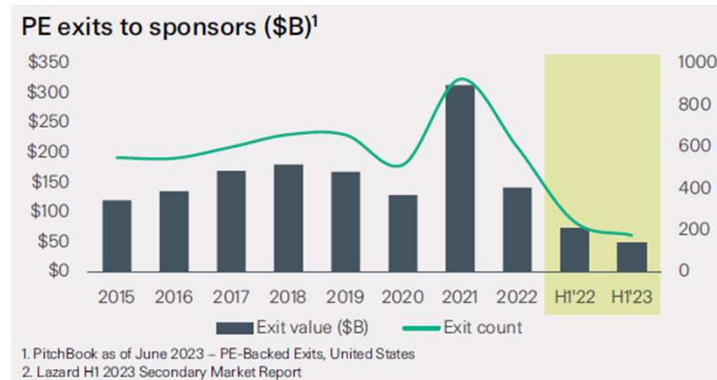
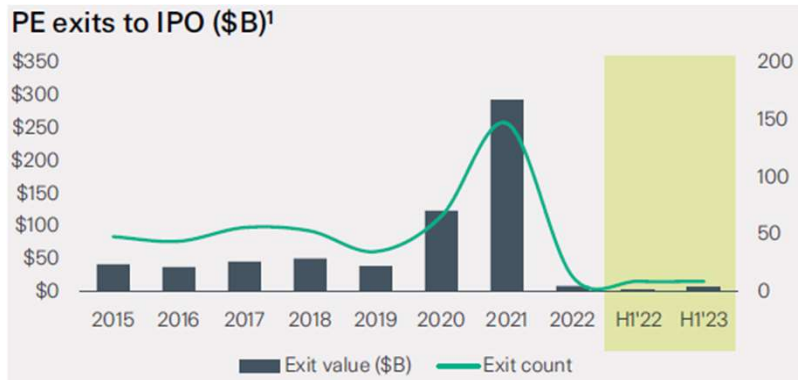
Weeks to Months

Hold Period:

Milliseconds to Years

Months to Years

The Three Traditional Modes of Liquidity:

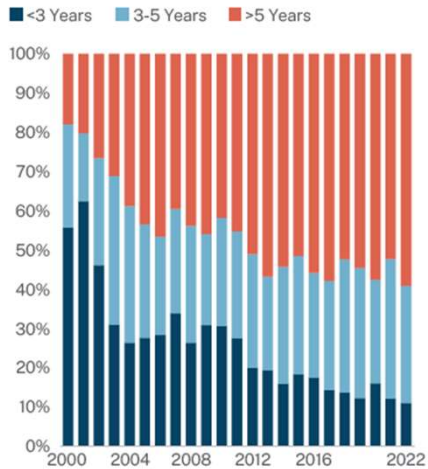


(Source: Stepstone, June 2023)

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

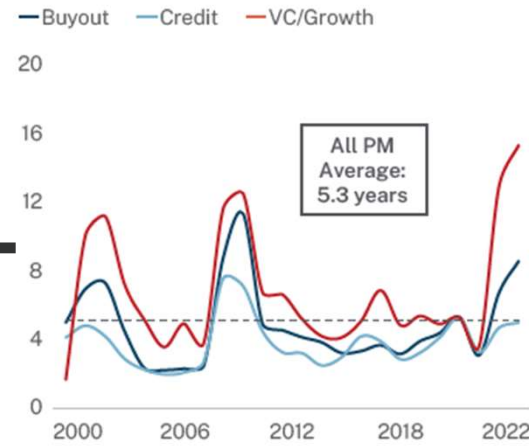
Highly Illiquid... Illiquid Markets

Holding Period of Exited Buyout Deals
% of Deal Count by Year of Exit



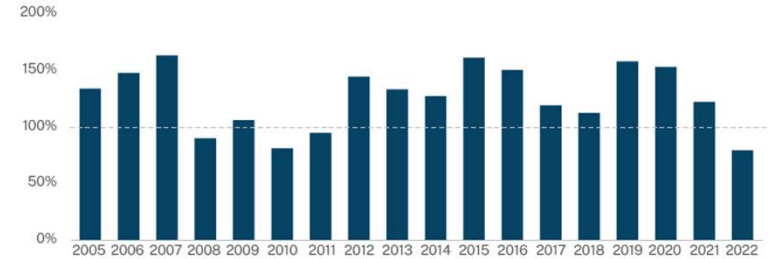
Source: Hamilton Lane Data (January 2024)

Chart 5.7: Years to Liquidate NAV
Private Equity & Private Credit



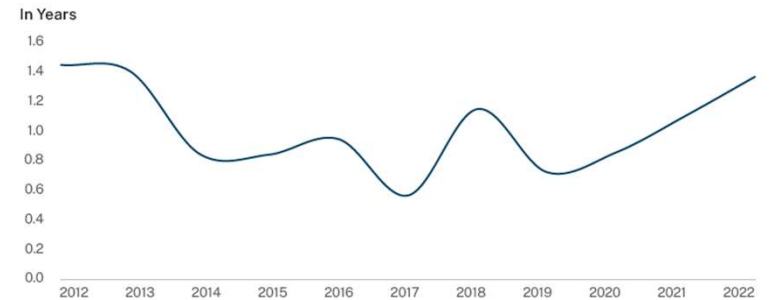
Source: Hamilton Lane Data (January 2024)

Chart 4.8: Buyout Fund Size as Percentage of Target Fund Size



Source: Hamilton Lane Data (December 2023)

Chart 4.11: Average Fundraising Length of Top 30 Buyout GPs



Source: Hamilton Lane Data (December 2023)

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?

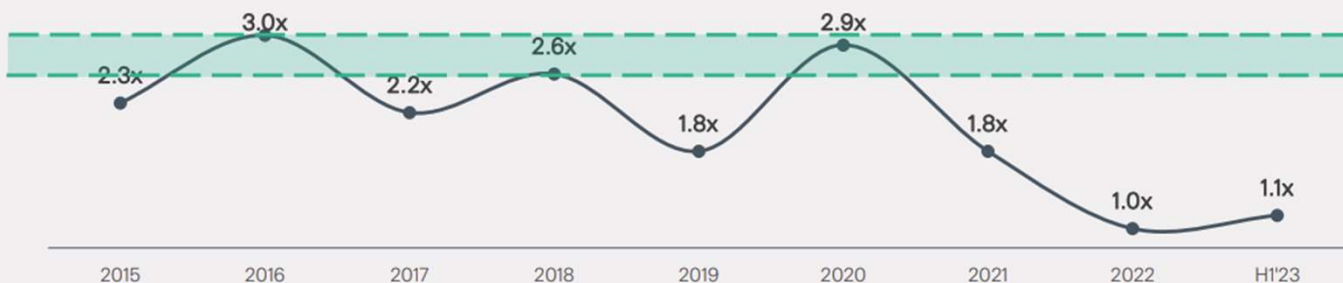
Beneficiaries of Less Liquid Markets (1/3): Secondaries

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

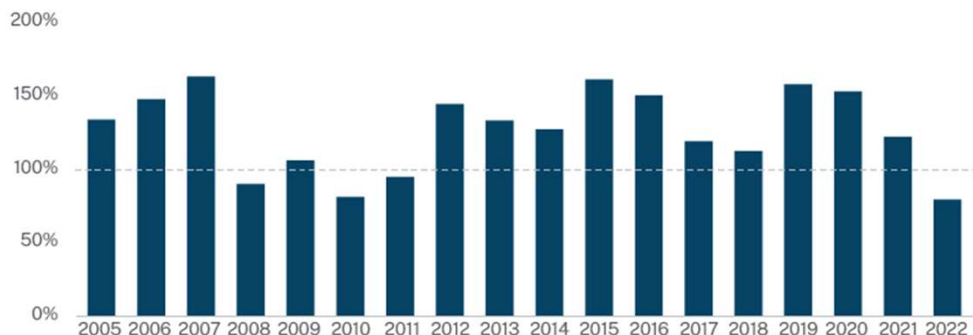
-  Improved Selectivity
-  Lower Pricing Pressure
-  Better Returns

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

Chart 4.8: Buyout Fund Size as Percentage of Target Fund Size



Source: Hamilton Lane Data (December 2023)

(Yes, the second time I show this chart)

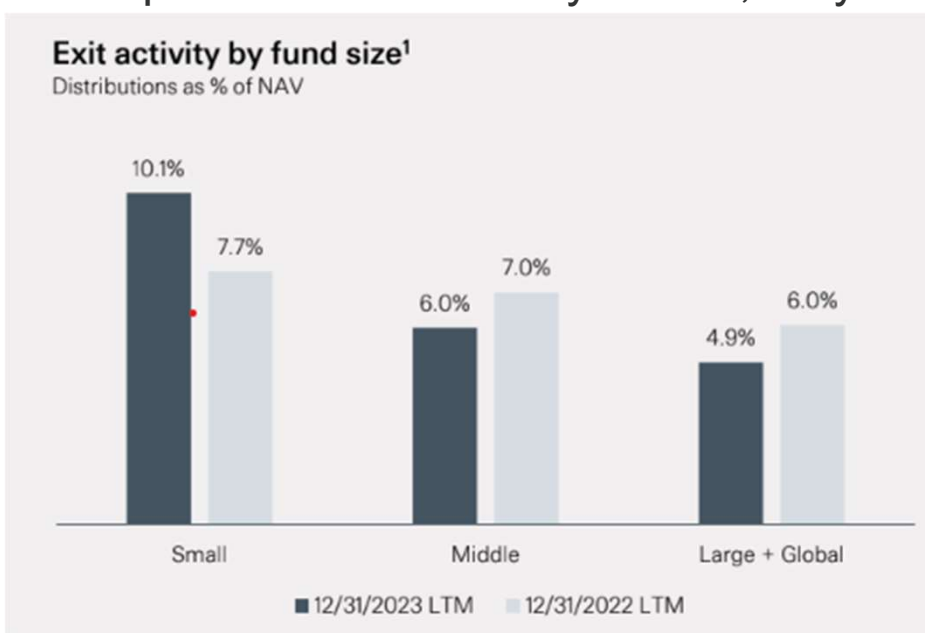
If Investors have less cash to invest in funds, then they have less cash to invest in co-investments (as these co-investments come from the funds they (don't) invest in).



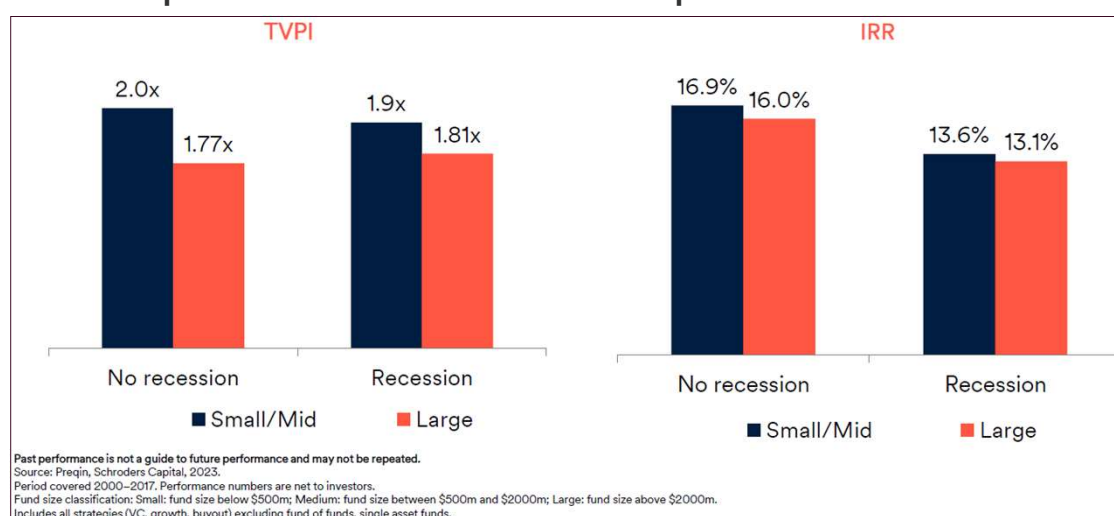
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Beneficiaries of Less Liquid Markets (3/3): Small Cap Funds

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.

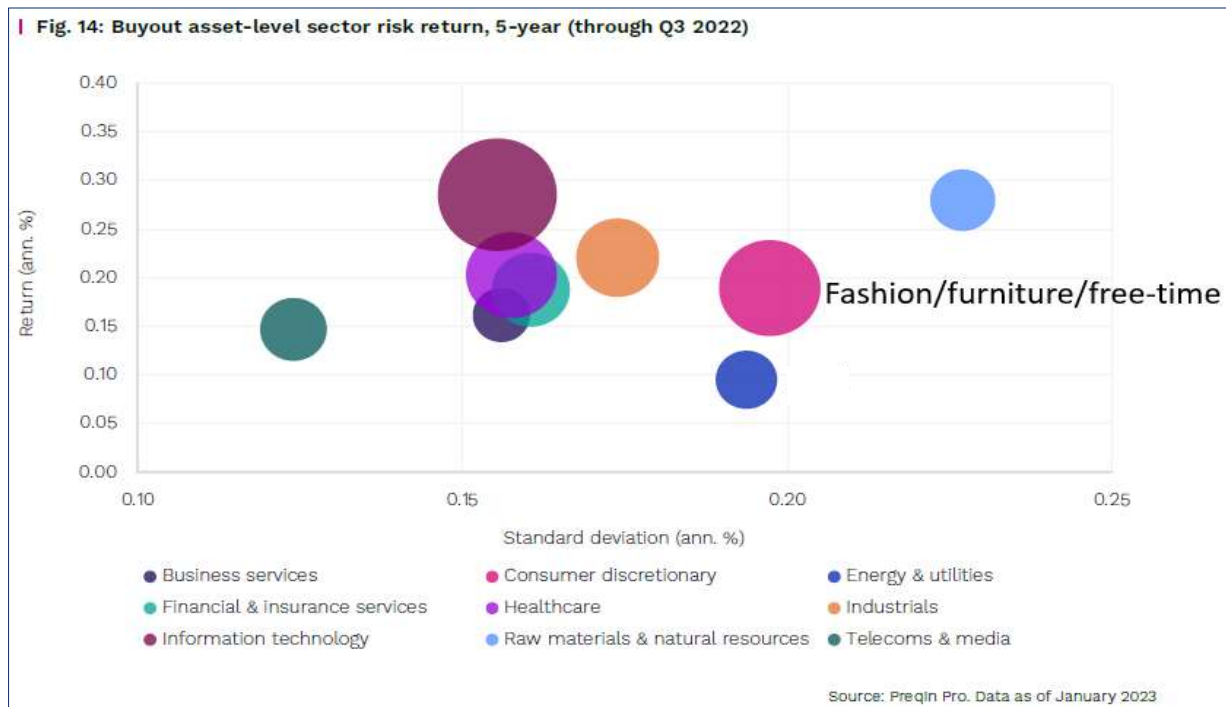


Source: Stepstone



How do we create alpha? (1/3)

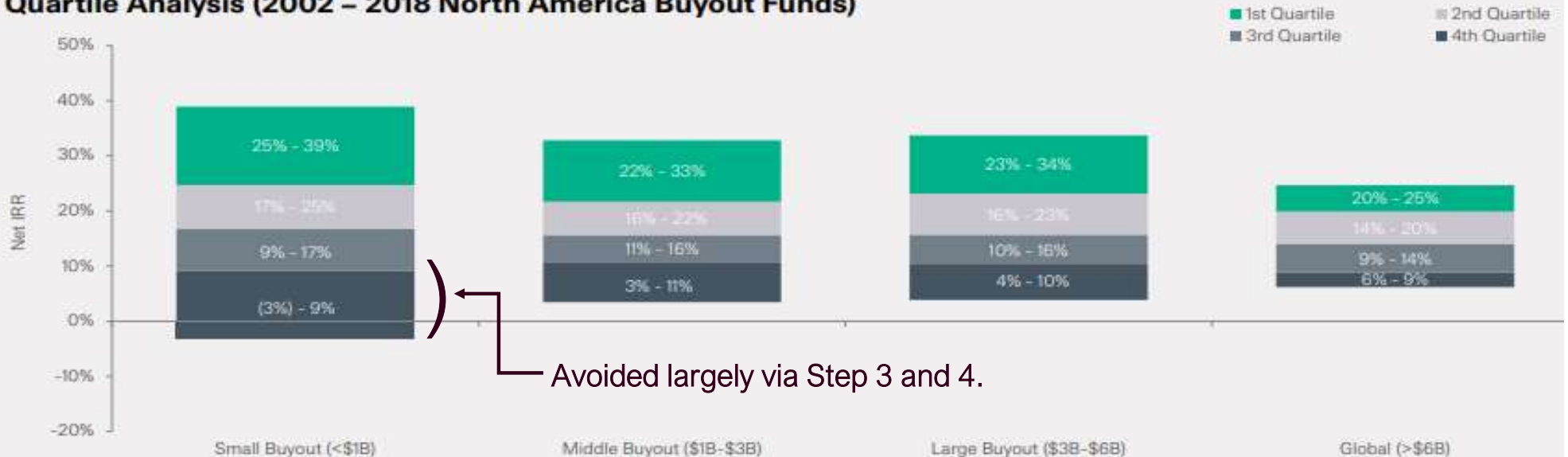
Step 1: Avoid sectors that historically don't offer the highest risk-adjusted return



How do we create Alpha? (2/3)

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

Quartile Analysis (2002 – 2018 North America Buyout Funds)



Avoided largely via Step 3 and 4.

Source: Burgiss as of June 30, 2023, for North American Buyout Funds with vintages from 2002 - 2018.

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How do we create Alpha? (3/3)

Step 3: Source GPs that have historically outperformed

