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Looking beyond the 'obvious' deal: The case of PE secondary specialist Kline Hill Partners

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When founder Michael Bego launched Kline Hill Partners in 2016, he never imagined that the New York City-based private equity firm would expand rapidly enough to become an established manager with more than $6.4B in assets.

For the secondary specialist and host of the podcast "The Secondary Snapshot," setting up his own business was a natural move. "After I left my previous role at an investment firm, investors simply called me and encouraged me to start my own business," he told *Markets Group*.

However, his 25 years of veteran experience in the private equity industry may be one of the main reasons Kline Hill chose a less travelled path since the earliest start, deliberately focusing on smaller or simply less "obvious" secondary opportunities that large firms simply "don't bother with," said Bego.

"We use secondary markets to achieve better risk-adjusted exposure to private equity by executing many lower-middle and mid-market, often overlooked, transactions," he explained.

Most deals at Kline Hill are below $20M for LP- and $250M for GP-led transactions, contrasting with the industry average. "We enter niches where sellers need liquidity but large secondary players are not paying attention, often simply due to smaller transaction sizing," Bego noted.

The strategy positions the company as the "go-to" liquidity partner for investors who are not handling huge pension funds, including small- and medium-sized investors looking for liquidity solutions. "Because our underlying companies are lower middle market, we typically have more options and better liquidity than the mega-deals targeted by bigger funds."

The firm hunts profitable businesses with relatively low leverage that it can buy at reasonable valuations. “For GP-led opportunities, ideally, they have greater than 20% EBITDA margin, EBITDA growth over 20% less than three times debt, and we pay less than 10 times EBITDA for these companies,” Bego said.

Diversification is a key word in the deal-sourcing process. “We aim for sectors with lower expected AI disruptions, long-term structural growth trends and a strong history of exits,” he added.

Source and select

Needless to say, lower ticket sizes simply mean a much higher number of transactions.

“Since the firm started, we completed over 850 transactions, across more than 3,500 funds into over 1,000 private equity managers,” said Bego.

According to the founder, the firm’s approach is in contrast with the rest of the secondary industry, where deal flow has become highly concentrated among a handful of big brokers. “Evercore, Jefferies, PJT, Campbell Lutyens and a few others account for about 85% of total secondary deal volume. As a result, most large secondary funds rely on this handful or intermediaries for almost all of their deals.”

By contrast, Klint Hill has to cast a much wider net. “Last year, we had deals coming from around 550 different sources and closed transactions with 110 of them,” said Bego. “Whether we are doing tech secondaries or GP-led deals, we are plugged into a much larger set of relationships across the industry.”

The GP has exposure to a universe of about 4,000 companies. From that list, the firm narrows it down to the top 30 they actually want to focus on. “We already know these companies very well, so we are choosing from a pool where we have strong information rather than starting from scratch.”

But many transactions also come with a huge amount of information to manage. Because of that, its investment team is split into specialized teams, focused on LP interests, GP-led deals, technology and venture secondaries, in addition to separate finance and operation teams. The secondaries team alone comprises 70 people.

For each company selected, the team carefully examines the business model, the competitiveness of its products in the sector, the level of debt and the strength and reliability of cash flow.

“We aggregate this bottom-up analysis of companies to determine the overall value of the portfolio,” said Bego, noting the valuation is based on a detailed analysis at the individual company level, not just on high-level metrics related to the fund.

Technology is widely implemented in the origination process, thanks to a ticketing system that tracks every new firm and collects data from many sources to feed it into internal platforms. Bego said the firm is currently working on integrating AI solutions to better analyze and process business and transaction data.

The future is bright

The secondaries sector is buoyant, partly because of a structural liquidity problem in private equity.

“In ‘good years’ historically, investors could expect roughly 20% to 25% of a fund’s net asset value to be returned to them annually,” said Bego. “This has now dropped to about 11%, less than half, which means LPs are not getting enough cash back from their private equity portfolios.”

Because of more capital calls than distributions, LPs have effectively been cash-flow negative for about five years. As a result, they are increasingly desperate for liquidity and are turning to secondary funds as their primary solutions, Bego added.

“This is not a short-term blip: the pressure on exits and the resulting demand for secondary solutions will drive long-term, structural growth for the secondary industry.”

When looking at the future, the investor’s pipeline remains clear: “Our priorities are to keep delivering strong returns and to continue serving smaller or otherwise undeserved investors who need liquidity solutions.”