Proskauer

Secondary Nature

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GP-led deals may have attracted a lot of attention recently, but activity in the LP-led segment of the secondaries market remains robust. How are public markets corrections and the denominator effect playing out in these transactions and what types of private market portfolios are changing hands? We asked a panel of experts.

Private markets secondary deals have been booming over recent years, with 2021 volumes reaching a record $132 billion, according to Jefferies figures. This is well above the previous high of $88 billion in 2019, and while some of this growth has come from increasing numbers of GP-led deals (they accounted for 58% of the market in 2020), LP portfolio sales have continued apace as investors have continued to use secondary sales. In H1 2022, LP-led deals accounted for $33 billion of the $57 billion value of the secondary market, including the largest ever LP portfolio sale, worth $6 billion.

Perhaps unsurprisingly, much of the H1 2022 activity took place in the first three months, with deals slowing considerably following steep corrections to the public markets and the invasion of Ukraine. Yet times of dislocation often spell significant opportunity for secondaries players. So what is happening in the market now that LPs have had time to reflect on the changed environment they confront?

Dealing with the denominator effect

Many LPs are clearly facing private markets over-allocation challenges as their public markets portfolios have reduced in value materially (known as the denominator effect) – and this is causing some to sell portfolios. ““European LP secondaries activity has historically been slower than in the US,” says Ben Pearce, Partner at Campbell Lutyens. “But we’re now seeing significant activity in Europe, driven principally by pension funds and insurance companies. Many LPs are heavily over allocated to alternatives in a way that we haven’t seen before, even during the GFC – and whilst some have had a degree of latitude with over allocations to date, with public market valuations dropping significantly, private market valuations remaining relatively stable and currencies in Europe weakening significantly, we’re seeing increased scrutiny of over-allocations with some LPs exploring how they might bring them down through sales. Others, having enjoyed strong private market returns in recent years are looking to de-risk, particularly more mature pension funds, by locking in private markets returns through sales.”

Yet unlike in previous difficult periods, the market is not characterised by fire-sales of portfolios. As Erwin Roex, Managing Partner of Bex Capital, explains: “The denominator effect drove a lot of sales in the past, such as during the GFC. Yet many LPs today are less prepared to sell at the discounts they face, so they are holding even though they still need to somehow deal with the denominator effect.”

Finding ways through

Where LPs are trading fund positions, buyers and sellers are increasingly turning to deal structuring to help bridge the bid-ask gap that stems from higher discounts to NAVs and from valuations generally trending lower following public markets corrections. In 2021, approximately 10% of LP-led deals featured deferred payments; in H1 2022, an estimated 40% used these, according to Jefferies.

Payments are also being deferred for longer, says Mike Suppappola, Proskauer Partner. “We’re seeing some deals get done with $0 down at closing and the full price paid up to two years later – you didn’t see this three or four years ago. They suit the buyers because they can effectively pay for the deal using recycled proceeds, while for sellers, this can reduce the headline discount compared with what they would achieve if the full price was paid upfront - this can really matter for some LPs.”

Preferred equity deals have also been on the rise since the pandemic, and particularly since the economic outlook started to cloud in the early part of 2022. These transactions see secondaries buyers offer liquidity to LPs or GPs in exchange for capital in priority to other LPs, plus a preferred return. They can offer LPs liquidity without having to sell their fund position and they are increasingly becoming part of the secondary market's toolkit for meeting LP and GP needs. "Preferred equity has historically been a niche strategy," says Suppappola. "But that's changing as more secondary buyers structure products that can accommodate different return profiles."

The other type of deal becoming more prevalent is the LP tender offer. These differ from traditional LP portfolio stake sales in that they are usually initiated by the GP and they frequently include a staple – a commitment by the buyers to the GP's new fund. This is an attractive proposition as raising capital becomes more challenging: private equity fundraising fell by 50.2% to $119 billion in Q2 2022 versus the same period a year earlier, according to Preqin figures.

"Tender offers are on the rise," says Wilfred Small, Senior Managing Director at Ardian. "Increased allocation pressure is leading to LPs seeking liquidity and some GPs may use a tender offer to facilitate that." However, they are not always straightforward. "When they are successful, you get proper alignment via a sell and roll option, yet still meaningful selling volume and everyone is happy," adds Small. "But they can go wrong if selling volume is overestimated or where secondary market pricing is below the GP and sellers' expectations. Given the number of counterparties involved in the transaction with differing sets of priorities, alignment is key."

Broadening pool

The variety of deal types and structure, combined with the increased maturity of different areas and access points of private markets, mean that the LP-led secondaries deal universe is broadening out.

Private equity secondaries in the US and Europe may have led the charge, but we are now seeing deals done across a wider spectrum of geographic areas. “From a deal sourcing perspective Asia will be an increasing contributor to deal sourcing. The region has attracted a lot of private capital funding and some of this will change hands” says Guillaume Caulier, Principal, Lexington Partners. “Asia is now starting to be a big contributor to deal flow and sourcing,” says Guillaume Caulier, Principal, Lexington Partners.

“If you look at the 2017-2021 vintages little has been sold to the secondary market. These vintages add up to $3.7 trillion of inventory, therefore assuming an average turnover of 11.5% which is the historical rate that roughly implies $400bn and that enough for 3.5-4 years of secondary dealflow at current levels”

“Asia can be a compelling market, but you need to be extremely selective and with the right pocket of capital,” agrees Small. “Perhaps more interestingly, private equity portfolios have reached a level of maturity there where active management via secondary transactions is now a compelling proposition – not necessarily involving Asian assets. We’ve seen more activity here and we expect a lot more to come.”

The type of underlying asset available for trade is also diversifying. “We’re seeing a lot of activity in private credit,” says Pearce. “It has been slow to build, but there is now a large base of European direct lending strategies starting to churn. The question is whether there is enough buyside capital for what is out there – fortunately, there are several new entrants coming online”

“Private credit has become a trillion dollar-plus industry,” agrees Bruno Bertrand-Delfau, Partner at Proskauer. “It’s a mature market. We have recently seen secondary managers joining large asset management platform including in particular the private debt component. This may boost private debt secondaries.”

Infrastructure is another growth area, as Small notes: “In both private equity and infrastructure, the limiting factor to secondary deal volume is dry powder raised. But in infrastructure you have a more recently developing secondary market with very few dedicated funds. It’s early innings and so there are some really compelling transactions to be done.”

Looking ahead

As this broadening and deepening pool of opportunities suggests, the weight of capital going into the primary market drives activity in secondaries, albeit with a lag. The rise in private equity allocations and increased numbers of investors committed to private markets funds over recent years suggests the period to come will offer a healthy and expanding deal pipeline for secondaries players.“In the years since the financial global crisis and possibly for longer than that we are currently at the lowest level of dry powder for the secondary market. We approximately have one year of dry powder in the entire secondary industry at the current level and that compares to 1.7 years on average over the past several years and at least three-five years of dry powder for the primary market” says Caulier.

“It is probably a good time to be cautious especially in the early part of the cycle. We are looking for resilient portfolios where we have both diversification and especially discount. We are using our information advantage to make the best analysis and do the right deals, but what’s critical is how we leverage the experience and judgement of our team that has invested together over many cycles”.

Bertrand-Delfau agrees. “The volume of capital that has been raised in the primary market is substantial, and coupled with an increase in turnover, there’s potential for a lot of upside,” he says. “Which means that the existing secondary funds will need to get ever bigger and there is also room for new entrants. I think we’ll see more specialisation in secondaries players, which will need very well defined positioning in the market.”

For Roex, this latter point is vital. His firm specialises in secondary deals involving fund-of-fund interests and he points to newer, but related, opportunities on the horizon. “Fund-of-funds secondaries will keep on ticking over as they have been for a while,” he says. “This part of the secondary market is younger, although increasingly maturing, and we are even starting to see GP-led secondaries on funds-of-funds funds.”

Overall, the market looks set to be active over the next few years and beyond, with more evolutions coming down the line. As Small says: “Not only will there be more volume, but there’ll be more specialization, more innovation and more capacity for differentiation in years to come. It’s an exciting place to be within the private markets industry.”

Dialogues is a private equity publication bringing together leading market voices and influencers to discuss the key issues affecting private equity.

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