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Undercapitalization slows secondaries activity

While LPs and GPs cry out for liquidity, secondary funds are unable to recapitalize quickly, creating pent-up demand that bodes well for the future.
By Claire Coe Smith

After years of explosive growth, the global secondaries market hit a slowdown in the second half of 2022 that reflected challenges in the broader macroeconomic climate. Participants at the second annual *Buyouts* secondaries roundtable talked extensively of the challenges of undercapitalization but were unanimous in their belief that activity will soon rebound and today's slowdown bodes well for a strong uptick to address pent up demand.

"In January and February 2022, we still had a functioning secondary market," says Yann Robard, managing partner at Whitehorse Liquidity Partners. "In the first half of the year, $53 billion was traded and most of that happened in the first quarter. Remember that strong performance of private equity in 2021 left many LPs entering 2022 overallocated to private equity. Then public markets faltered in Q2 2022, compounding LPs' over-allocation to private equity, then distributions started declining and now capital call facilities are starting to get cleared, further compounding overallocation. If you wanted liquidity for your private equity portfolio, you had to start queueing in April of this year."

$85bn

The amount traded in the second half of 2021, accoring to reports cited by Yann Robard

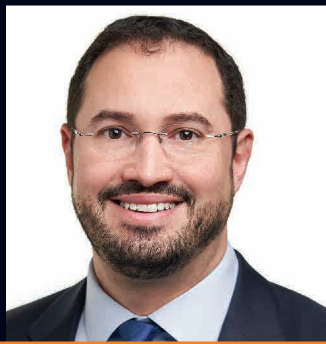
Because fundraising is difficult right now, secondaries funds have been unable to recapitalize quickly, creating undercapitalization and a backlog of demand.

"Reports suggest that the dry powder in the market stands at $93 billion before any new fundraising," says Robard. "Last year, $85 billion traded in the second half of the year. Assuming a similar deployment this year, this would suggest that most, if not all, dry powder will have been extinguished by the end of 2022. Said differently, we're entering 2023 with a lot of pent-up liquidity and little to no capital to absorb that supply."

An additional challenge is that there is a pretty meaningful bid/ask spread in the market, as the difference between what buyers are willing to pay for assets increasingly diverges from the

Gordon Appell
Managing director, PJT Park Hill

Prior to joining PJT Park Hill in 2021, Gordon Appell was a director in the Client & Partner Group at Kohlberg Kravis Roberts, where he was a product specialist responsible for the firm's North American private equity and energy real assets platforms. Previously, Appell was a director in Credit Suisse's Private Fund Group.

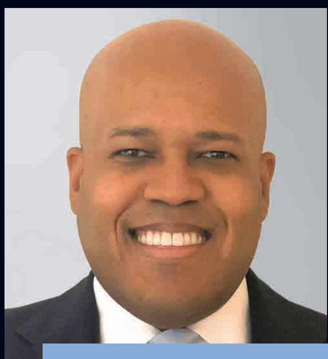


Ben Perl
Managing director, Neuberger Berman

Ben Perl is global co-head of NB Secondary Private Equity. He is a member of the secondary, real estate secondary and strategic capital investment committees. Perl joined the firm in 2001 and Neuberger Berman Private Equity in 2007. Prior to that, he worked as an associate at Lehman Brothers Venture Partners (now Tenaya Capital).

Yann Robard
Founder, Whitehorse Liquidity Partners

Yann Robard founded Whitehorse in 2015 and has over 20 years of private equity experience. Based in Toronto, Whitehorse has raised over $12 billion in commitments, deployed over $16 billion in over 185 transactions and consists of a team of over 125 individuals. Prior to Whitehorse, Robard spent a cumulative 13 years at CPPIB.



Chris Robinson
Partner, Proskauer

Christopher Robinson primarily focuses his practice on representing buyers and sellers, as well as market intermediaries, in connection with complex secondary transactions, including traditional sales and purchases of fund interests, secondary direct transactions, captive fund spin-out arrangements, fund recapitalizations and restructurings, and "stapled" secondary transactions.

Sola Adeleye
Director, Citi Private Funds Group

Sola Adeleye co-heads Citi's Private Funds group and advises private market sponsors and institutional investors on secondary market liquidity solutions, primary fundraising and LP portfolio financing. He has over 15 years of private market experience across secondary advisory, secondary investing and investor relations from KKR, Landmark Partners and UBS.

> *"In this market, buyers are laser-focused on existing GP relationships"*
>
> **SOLA ADELEYE**
> **Citi private funds group**

lowest price that sellers are willing to accept.

"Private equity NAVs tend to be a little stickier and take a little more time to adjust to market sentiment," says Robard. "People who don't need to sell are not going to sell in this market and will hold out given higher optical discounts. This should self-correct over time. As markets settle and discounts to more recently marked books narrow, the need for liquidity will drive renewed activity in the market assuming the secondary market can recapitalize to absorb this demand."

Market slowdown

For sellers in the secondaries market, the route to exit a diversified portfolio sale to a buyer using significant leverage is challenged in this environment, both by the rising cost of leverage and a recognition by buyers of the uncertain conditions.

Ben Perl, managing director at Neuberger Berman and global co-head of NB Secondary Private Equity, says: "Each business has its own potential idiosyncratic issues right now, whether those relate to inflation, supply chains,

> *"People who don't need to sell are not going to sell in this market"*
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> **YANN ROBARD**
> **Whitehorse Liquidity Partners**

energy inputs, labor costs or regulatory change. It is not an easy environment in which to operate, and it is not an environment where people want to blindly buy diversification. Buyers are going to want to be more targeted, to understand what they own, to price risk accordingly and to steer away from using a lot of leverage to amplify returns."

He adds: "There is a need for liquidity that is structural and will not go away, but there is not a ton of dry powder and buyers really want to be careful around what they own and the prices they pay. We are going to see GPs understanding that pressure for their LPs and understanding that their LPs may not have great liquidity options, so they will be trying to help manufacture liquidity for their LPs as well. We did not see that through the last downturn, when there was really no such thing as a GP-led secondary solution to help drive liquidity."

"You have to hit a bullseye across a select set of buyers"

GORDON APPELL
PJT Park Hill

Gordon Appell, managing director in PJT Park Hill's secondary advisory group, says: "The bid/ask spread that everyone is highlighting is a real issue. The Nasdaq is down around 30 per cent year-to-date, the S&P 500 is down around 20 per cent, but private equity NAV movements have been more muted so far. While this is not a surprise to see less volatility with private assets, a lot of buyers we talk to believe a downdraft is coming so they want to protect themselves from that, which is where some of the discounts come into play."

He says GPs are looking to do some really big deals in the single-asset space, because the IPO and traditional M&A markets are not there to the extent they have been in the past 12 months. "But getting a billion-dollar single-asset GP-led deal done now as opposed to 18 months ago is a very different proposition," says Appell. "You have to hit a bullseye across a select set of buyers, because the syndication market is not what it was, and then you have the pricing issue. It is going to take a lot of work to get deals done at scale. Advisers are a little more cautious and are guiding GPs towards things that are multi-asset, with tenders also coming back."

Tender offers are back in favor, allowing GPs to hold auctions to find secondaries firms willing to buy up a certain amount of fund interests from their existing LPs. Such deals had fallen out of fashion with buyers who did not like the amount of work required upfront with little certainty on the outcome.

Appell says: "Now we have a backdrop that has the right ingredients for those transactions. You have liquidity needs on the LP side and a primary fundraising market that is challenging, allowing for a rotation of LPs who can take liquidity from the transaction and use that to commit to a new fund, or to something else that is going to be core to their program going forward. The buyers that are stepping in are hopefully getting an interesting value orientation, and the sponsor is getting a little more momentum on their fundraise through some primary capital to support that.

"These tenders have elements that are relevant to all the different counterparties right now, but to be successful they need to be for the right sponsor with an attractive strategy, team and track record."

Bridging the gap

While some deals are still getting done in the secondaries space, Sola Adeleye, who heads Citi's secondary advisory team, says it has been challenging to bridge the valuation gap: "We are seeing good assets with great GPs not able to clear the market because of the bid/ask spread. It is tough as a GP to put something in front of the LP Advisory Council if there is a large headline discount. We continue to see supply on both the LP-led and GP-led side but the hit rate in terms of deals getting to the finish line has been lower than prior quarters. As audited year end NAVs get reset in Q1 2023, we expect to see an increase in transaction volume."

He points, however, to green shoots in the current market around credit and real assets. "We've seen recent pricing for some portfolios that were actually

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>
> **BEN PERL**
> **Neuberger Berman**

higher than it was in Q1 and Q2 of this year, because LPs and secondary funds are craving yield and they can get that from seasoned credit and infrastructure funds," he says. "Certain portfolios are getting bid up by both traditional secondary funds and non-traditional buyers as well.

"Given the undercapitalization on the dedicated secondary fund side, the net needs to be cast wide in order to reach a broader set of buyers, especially when it is a large transaction. Advisers' ability to access a wider pool of capital outside of dedicated secondary funds is extremely important to reduce execution risk. We are advising our sell-side clients that it is a buyers' market, and we expect that to continue over the short term. As a seller, you can influence that dynamic by being thoughtful about the size and type of asset or portfolio you bring to market."

Chris Robinson, partner in the private funds group at Proskauer, says that syndication of large deals can be challenging right now. "If large investors have marketed to their LPs that they are primarily seeking to take lead investor positions, this may cause them to pass on syndicate opportunities, thereby limiting the universe of potential buyers that can step in to help on some of these larger transactions," he says. "That is adding to the complexity in getting some of these deals to the finish line. The syndication process can become extremely difficult, depending on your closing timeline, as you start to try and line up investors that need to get up to speed pretty quickly."

There have been a few instances of pulled deals and limited examples of buyers coming back for revised pricing discussions where deals have been in the market for a while and reference dates needing to be updated.

But advisers are finding ways to bridge valuation gaps. Robinson says: "We have done a number of transactions where valuation is a concern but where GPs are confident in where a portfolio company's performance may ultimately end up, and we have been able to use alternative transaction structures, including preferred equity or performance based earnouts, to help bridge the gap. Where there continues to be a bid-ask spread, I expect to see more of these structures implemented."

Getting deals done

Adeleye says there are several factors influencing which transactions can get done, for both LP-led and GP-led deals. "Entry valuation is important in this volatile market environment," he says. "It is tough to make money when you overpay, so your entry price is probably your biggest value creation lever. While GPs are hesitant on marking down their books, buyers are maintaining price discipline as a result of the supply-demand imbalance that works in their favor."

If price can be agreed, alignment then becomes exceptionally important on GP-leds, as buyers look for the right mindset and expect GPs to double-down on the GP commit. Perl says:

> *"As bid/ask spreads reduce we will see a real rebound across the board"*
>
> **CHRIS ROBINSON**
> **Proskauer**

"Alignment isn't something you can easily summarize in one word – we sort of know it when we see it. Buyers are looking for GPs who want to re-risk, not de-risk. If the transaction is about de-risking for them, that doesn't necessarily mean buyers don't look at it, but it is typically a big negative and is likely difficult to overcome. The gold standard is the sponsor rolling over, not taking liquidity – save for maybe some exiting partners – and they are actually committing new capital."

Adeleye adds that existing relationships are also proving critical to getting transactions closed for GP-led deals: "In this market, buyers are laser-focused on existing GP relationships. The deals getting done tend to be led by one or two investors that are existing LPs of that GP and know the types of behaviors that GP exhibits in good times and bad. In most transactions, it is really about existing LPs leading and anchoring transactions."

Perl says: "Capital is precious and every deal has to stand out in this environment. If it's an average deal, there will be another deal like it in three to six months' time. Buyers today are looking for the best assets, the best risk-adjusted returns, good sponsors, good alignment and good valuations – it all needs to hang together."

What happens next

Looking forward, Robard argues that today's undercapitalization will set the secondaries market up for growth in the coming years.

"You have an undercapitalized market that is going to stay undercapitalized for a period of time," he says.

"But, as history shows, all of this resolves itself over time and over the cycle. When you look at 2009, there were lulls in the market during a period when bid/ask spreads widened, but then you had a decade of boom in secondaries, growing from $10 billion in 2009 to $134 billion in 2021. I see a similar thing happening now: in a 2022 world we could hit $100-125 billion this year, which is a bit less than last year. But I would watch this space closely as it's going to set us up for tremendous growth in 2023, 2024 and 2025 as we deal with that pent-up liquidity."

Perl says the pendulum has swung in favor of buyers right now, but it may take time for volumes to materialize. "The markets will set in, the reality of higher interest rates will set in, and we are already starting to see a realization from GPs as to the power of these GP-led solutions," he says.

"That is one of the only attractive options they have when they need to create liquidity for their LPs. No one wants to sell in a bad market, but a lot of people need liquidity, so those will tick back up and unlike other exit options, these give investors the flexibility to choose what is best for their specific needs."

Robinson predicts the last three quarters of next year will be particularly busy. "I think the first quarter will mirror what we are seeing right now with a softer market," he says. "With the number of sponsors in the market raising capital and pent-up demand on the sell side, we will likely see a race to get deals done.

"Portfolio transactions will probably come back first at a higher volume than GP-led transactions because there is an immediate need there that has to be addressed with motivated sellers and there are a number of buyers that may be a little overweighted with the flurry of GP-led transactions done over the last 12 months so those buyers will likely look to balance their investment mix with high quality LP portfolio transactions. Additionally, as bid/ask spreads reduce we will see a real rebound across the board."

It is true that 2022 has been a challenging year, but once the recapitalization starts taking shape, expect more secondaries growth to come. ■