ROUNDTABLE

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Signs of a 'banner year' ahead

The last 12 months have seen more ups and downs in the secondaries market than ever before. With GPs and LPs chasing liquidity against an uncertain macro backdrop, activity looks set to unlock in 2024. By Claire Coe Smith and Chris Witkowsky

After an upward trajectory that has been building for years, the global secondaries market hit the buffers in 2022 and has been navigating a choppy course ever since. While mid-market GP-led deals continue to build momentum, participants at the third annual *Buyouts* secondaries roundtable discussed a rollercoaster year for pricing, the extent to which undercapitalization remains a challenge and the outlook for secondaries in 2024.

The last 12 months have been unpredictable for market participants. "In my 20-plus years of investing in the secondaries market, the LP secondaries market is more fluid than I have ever seen," says Yann Robard, managing partner at Whitehorse Liquidity Partners. "It shifts so much with market sentiment. The Silicon Valley Bank crisis in the early part of the year created market chaos, followed by a period of calm, and now things have shifted again. Pricing can change rapidly and that is confusing for sellers who hear things and act on them. They ultimately find a different price to what they were expecting because the market moved during the process of bringing those portfolios to market."

For LPs, it has been quite a ride since 2021 when they found themselves over-allocated as portfolios outperformed.

"In 2022, public markets declined, compounding LP overallocation to private equity," says Robard. "Then in 2023, distributions dried up so LPs were faced with negative cashflow on top of their overallocation. Many LPs needed to do something with their portfolios and were trying to find the right window in which to do that.

"Some are more willing than others to transact at discounts, and some are more willing to think about LP financings to tactically reallocate. But there is a ton of pent-up liquidity in the LP market and the question is when does that get released. Every time we think we are getting to a point where buyer and seller expectations are matching, something happens to widen that gap again."

Richard Chow, managing director at PJT Park Hill, says some relief came from buyout funds with publicly-held shares that made distributions, but there is a long way to go. "If you extrapolate forward into 2024, where you don't have a deep IPO window and the M&A market remains light, we are not going to be down in terms of secondaries market volumes. If you ask buyers whether they are underwriting to a lot of 2024 exits, the answer is probably not. That means on both the LP side and the GP side, there has to be some other mechanism to achieve exits on those companies."

On the GP-led side, strong drivers have been challenging M&A markets, limited availability of debt finance and a need for cashflow. Jason Morris,

Mike Suppappola

Partner, Proskauer
Mike Suppappola is a partner in the private funds group at Proskauer, representing asset managers across the globe in all aspects of their business and operations, with a particular focus on fund formation and the structuring and execution of secondaries transactions.

Jason Morris

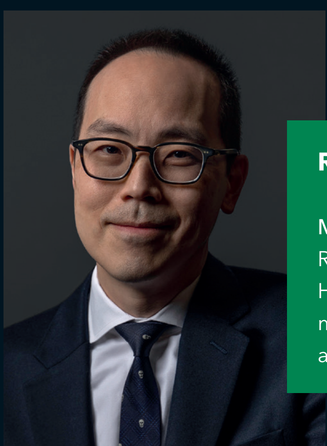
Managing director, Private Capital Advisory, Jefferies
Jason Morris is an experienced managing director at Jefferies, focused on advising financial sponsors on private equity secondaries solutions. Prior to joining Jefferies in 2021, he worked as a principal in the secondaries capital advisory team at Greenhill & Co, formerly known as Cogent Partners. Over his secondaries career, he has advised on around $20 billion of transaction volume across both LP-led and GP-led secondaries transactions.

Benjamin Wilson

Managing director, global head of secondaries, HQ Capital
Benjamin Wilson joined HQ Capital in 2019 as managing director and global head of secondaries, having worked in finance for more than 20 years with firms including Pantheon, PEI Funds, FBR Capital Markets and Deutsche Bank.

Yann Robard

Managing partner, Whitehorse Liquidity Partners
Yann Robard founded Whitehorse – a firm that provides innovative structured liquidity solutions for private market investors – in 2015. Since its inception, Whitehorse has raised $14.8 billion, deployed $18.7 billion and distributed $5.7 billion to its investors. Prior to Whitehorse, Robard spent 13 years at CPPIB, most recently as managing director, head of secondaries and co-investments.



Richard Chow

Managing director, PJT Park Hill
Richard Chow is a managing director at PJT Park Hill and a member of the PJT Park Hill private capital solutions group, based in New York. He was previously a portfolio manager on the secondaries investment team at the Abu Dhabi Investment Authority and worked as a principal at Paul Capital.

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> **YANN ROBARD**
> **Whitehorse Liquidity Partners**

managing director in private capital advisory at Jefferies, says: “There was a window in the middle of this year where a deal a day was coming to market, and buyers were able to be incredibly selective on which sectors they focused. It was possible to create a diversified portfolio by doing five or six single-asset deals.”

With new entrants coming in and a strong fundraising environment for secondaries, plus increasingly supportive LPs, the GP-led now looks set to continue to proliferate on the demand side, too.

An undercapitalized market

At last year’s roundtable, the talk was unanimously about undercapitalization across the secondaries market standing in the way of further growth. In 2023, given the bullish predictions on the GP-led side, that looks more nuanced.

Robard says: “Since 2021 to the second half of 2023, there has been 56 cents raised for every dollar deployed in this market; $283 billion was deployed in the secondary market while only $158 billion was raised in the same timeframe. In just the first half of 2023, $42 billion was deployed and $37 billion raised. That means we are continuing to eat into dry powder – we have 12 months’ worth of dry powder in the secondaries market compared to three or four years’ in the primary market. I believe the secondary market is operating under capital constraints and resource constraints and that is holding back growth.”

Mike Suppappola, partner in the private funds group at Proskauer, says: “I agree there is not enough capital out there to chase the opportunity set. The industry as a whole is still very undercapitalized, but there is more capitalization coming to market from secondaries fundraising this year than in some prior years. There is more capital in the credit secondaries space than there ever has been, for example, as people have recognized the opportunity in the growth of sectors like private credit and structured capital.”

Benjamin Wilson, managing director and global head of secondaries at HQ Capital, says: “From a return perspective, one of the best things we have going in the secondaries market is that we never seem to be able to keep up with supply. While pricing will ebb and flow over time, a huge supply backlog will help create pricing that will be in our favor more often than not.”

Our roundtable members agreed that undercapitalization remains an issue for large-cap GP-leds, even if things are more open in the mid-market. Morris says: “Certainly, where we sit today, large deals struggle to get done. The mid-market we have seen be highly functional, because there are a lot of ways to get to the finish line. You don’t need a long syndication process or to believe that numerous sizable buyers will come in to capitalize those transactions. Investors will remain wary of large- and mega-cap deals until the market becomes better capitalized and able to invest more sizably in concentrated transactions.”

How long might that recapitalization take? Robard says: “There is always a lag between where the opportunity set is and when the industry gets capitalized. Right now, if you talk to LPs, the two places they want to put capital are in private credit and secondaries. Plus, there are other pockets of retail and high-net-worth capital coming in. I don’t worry about capitalization over the medium term – just over the next 12-18 months.”

Streamlining the GP-led

Morris says continuation vehicles are likely to become much more widespread. “In the past few years, continuation vehicles have accounted for 5-9 percent of total sponsor-backed, sell-side volume. If you talk to most sponsors out there, especially those that have done a continuation vehicle transaction, they say that in any given fund they'll likely have one to three assets circled for a continuation vehicle. If you assume there are an average of eight to 10 assets in a buyout fund, that implies approximately 20-30 percent of any given fund could go through a continuation vehicle at some point in the fund cycle."

Processes will likely evolve over time to get easier. "Processes have slowly arrived at a place where there is an order to these deals," says Suppappola. "There is a process – GPs know they need to talk to the LP advisory committee, they know what the documentation should look like, and so on. But every continuation vehicle deal is different, so there is never going to be a plug-and-play way to do these. What we are going to see is continued refinements amongst attorneys and GPs such that LPs know what to expect, they are educated on the process, they understand the timing and they can see a reasonable end goal."

GP-led secondaries are often more complex than M&A processes or IPOs, not least because in an M&A context the sole objective is to maximize price, whereas here it is about achieving reasonable value with LPs that are going to be supportive to a franchise going forward. In multi-asset deals there will also be negotiations with different buyers about which assets they are interested in, with an evolution around terms and composition of the deal.

"If you are looking at a traditional M&A or other capital markets exit, there are levels of complexity but you are not typically dealing with a whole class of LPs all with their own priorities, working out where the conflicts lie," says Suppappola. "There are some GP-led processes that ultimately hit a wall due to the complexities – that's a lot of wasted time, money and headaches."

LP appetite is also more forthcoming, albeit mixed views remain, and sentiment can shift from deal to deal. Chow says: "Every LP needs to look at their own portfolio construction, how they think about cashflow in the first place, and how actively they like to manage the portfolio. An LP's specific circumstances drive what discount tolerance they are willing to accept and the quality of the assets they are willing to sell. Our role is to prioritize those competing objectives to construct the portfolio we bring to market."

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> **MIKE SUPPAPPOLA**
> **Proskauer**

Pricing volatility abounds

On Blackstone's third-quarter earnings call, president Jonathan Gray pointed to a strong secondaries opportunity as discounts on LP portfolios are poised to widen. But pricing has been volatile throughout 2023.

"We saw pricing of LP secondaries transactions in the low to mid-80s at the start of the year," says Robard. "Right before the SVB crisis it had climbed to mid-80s, touching maybe 90, then SVB happened and it fell down to the low-80s. Over the summer it crept up and in September a few deals hit the mid-90s. Today, geopolitical friction means it will become more muted again. This market really is moving much more quickly than it used to."

Wilson says: "During the first half of the year pricing ended up a little higher than people were expecting, with buyers nudging pricing upwards. That dynamic appears to have shifted in the second half as supply has increased. We have seen more dealflow in the last quarter than we have in a long time."

It is clear sellers need to bring high-quality, recent vintage LP interests to market if they are going to achieve the best pricing. Chow says: "With respect to credit secondaries, senior lending funds at the top of the stack trade very strongly, because you have rising interest rates in your favor and the intrinsic yield on those assets is now in the double digits. The concern one might have is you don't really have a precedent for the loss ratio or the recovery rates for those loans in a recession case."

In special situations, there is a much wider tail of potential outcomes that impacts pricing, and the same is true across buyouts. With more volatility in the system as well, assets priced today might look very different in four months' time.

Suppappola says there are tools available to help bridge that gap. "Obviously deferrals are now commonplace on the LP side," he says, "and they are creeping into the GP side. You can't bridge a gap that is too wide, but if things are close, tools like deferrals can make a difference, and that is why they have become popular as a way to get deals done."

A bullish mid-market

Moving into 2024, there is growing momentum around mid-market GP-leds. Morris says: "We have seen this move, even from some of the largest secondary funds out there, of gravitating towards the lower end of the market. It is a lot easier to drive returns by taking a $30 million EBITDA business and growing it to $60 million, where M&A is still highly strategic and accretive, you can generally underwrite scaled, multiple expansion and you don't have to believe capital markets or the IPO window are absolutely perfect to exit the company. You are always going to have a financial sponsor or a strategic investor community willing to absorb a $60 million EBITDA business, while that is more challenging if you have a $200 million business."

Mid-market GPs are also more likely to take an LP-friendly approach, rolling over all their capital into a transaction and appreciating the value to their franchise of that support. By offering more alignment, buyers are also more willing to deploy capital.

Chow says: "If you're an investment committee, you have more value creation levers in those deals, so you don't have to price everything to perfection – it is just more defensible to underwrite."

Wilson says mid-market continuation vehicle deals can look more LP-friendly yet attract more flexibility around rollover. "If it is a deal with a mid-market manager, and it is the team's first substantial carry distribution, there can be more understanding from an LP perspective if the GP cannot put 100 percent of what they make on the deal into the new vehicle," he says. "For larger GPs, there is usually less understanding from LPs because they expect the GP to be able to meaningfully commit to the continuation vehicle."

Morris says: "In this undercapitalized market, it is about the right process, the right structure and the right mindset. All these continuation vehicles need to happen for the right reason, and if they're not happening for the right reason, they shouldn't happen. If you are a GP trying to do these

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for the wrong reasons, then secondary buyers will see through that."

Looking forward

All of our roundtable participants expect next year to be a bigger one for secondaries deals, though some predictions are more measured than others.

Robard says: "I still think 2024 is going to be a big, big year for secondaries. Should markets be a little turmoiled for another year, that may push back to midway through 2024 or 2025, but at some point all these lulls in market volume will create a big boom for the secondaries market. People are now a lot more educated about the liquidity tools in their toolkits, for good times and bad, so the market has huge growth ahead of it."

Wilson is also looking forward to more activity in 2024. "It is hard to tell where this year will end up – which deals will close and what will get pushed into next year – but the prevailing winds are moving in the direction of a strong finish that carries into next year. In our view, pricing has been a little more attractive over the last quarter and we expect that to continue into 2024."

Chow says next year, if we see continued economic volatility and fundraising challenges, may see some flatness in LP volume but will probably deliver slight growth on the GP-led deals as buyers see more value.

"It will be a tough year, and pricing will still be modestly higher relative to historic numbers, because buyers will have a choice," he says. "There is going to be a constraint on how much capital they can pull from their LPs, and supply is going to be relatively high quality, so they can be a lot more selective."

Suppappola says: "I do think this year will end up decent given the increase in Q3 and Q4 dealflow and, as we head into 2024, the trajectory will continue. 2024 will be a better year than 2023 but the early part of the year may well go in fits and starts."

Morris adds: "All the signs are for a banner year next year. The demand is there, you have new entrants, and there is enough capital availability for the right transactions, meaning we could see both the LP and the GP markets each reaching $70 billion-plus." ■