Secondaries in Session

I spend a lot of time at conferences. I guess it's just a part of the job. It's not necessarily a complaint; the networking and sharing of ideas can be incredibly useful. It's just that occasionally they can be fairly uninspiring places. Panellists regurgitate the same old mantra whilst audiences sit there, ears attuned to the speakers, eyes fixated on their iPhones, taking nothing in…. or maybe that's just me. In any case, I couldn't help but notice a bit of complacency creeping into more recent industry events. The bull run had been so strong, and the standard playbook so effective, that there was little need to innovate. The recent shake up however has breathed new life into proceedings. The uncertainty around valuations, against the backdrop of volatile public markets, has imbued discussions with an inkling of crisis, and as we all know: where there is crisis, there is opportunity. Nowhere was this more apparent than in the Secondaries section at the London SuperReturn a few weeks ago. The room was packed and not an iPhone in sight. Some of the top agents in the market had wheeled out the big guns who were all jostling for capital, and I have to say it all sounded quite compelling. Accordingly, we thought it appropriate to share a few of our findings with you to help you better understand and access this unique corner of the PE universe.

The first secondary transaction occurred in 1982 but only really became a mainstay within Private Equity in the mid to late 90s, pioneered by a few industry titans such as Jeremy Coller who now runs an eponymous global investment firm, amongst other philanthropic activities. The underlying premise here is liquidity. A market participant provides an investor in an illiquid asset class with liquidity, and therefore expects a good deal. If you are inclined to take that deal because you need cash for other things, then you should be prepared to take a haircut on the value of those investments. This is the oil which greases the engine and is particularly relevant when discussing LP-led secondaries, the original and (until recently) most popular format.

Broadly speaking, secondaries can be broken down into two types: LP-led and GP-led:

LP-Led

An LP-led secondary is the sale of an interest in an existing private market fund. The buyer takes the position(s) of the selling LP and assumes responsibility for future cash calls and distributions.

I. **Motivation.** These transactions occur when an investor needs liquidity to service other demands within their portfolio. These can range from distress to rebalancing. Experienced and sophisticated LPs have tapped the secondary market for many years to manage cashflows.

II. **Characteristics.**

- **Diversification**. As you are buying an LP's fund interest or interests within many specific funds, the underlying number of companies to which you gain exposure can be numerous. Whilst you are also gaining exposure to the winners, there are bound to be a few losers mixed into the pool.
- **Lower J-Curve.** These companies are usually quite mature in their ownership and may be distributing cash. This results in initially higher IRRs but lower TVPIs, as much of the multiple expansion could/should have already taken place. Occasionally, Secondaries GPs encounter secondary portfolios in the mid-life of a fund where there may still be some material value creation left, particularly for the assets which the GP invested in later. Today, these would be more 2018+ vintage year funds.
- **Less visibility.** LP portfolios, due to their diversification, are historically opaque and difficult/ time-consuming to diligence. Some traditional LP-transactions involve stakes in 100 funds with exposure to 1000s of companies. This makes transactions more difficult to underwrite.
- **Greater discounts**. The LP wants/ needs liquidity and that is reflected in the price.

GP-led

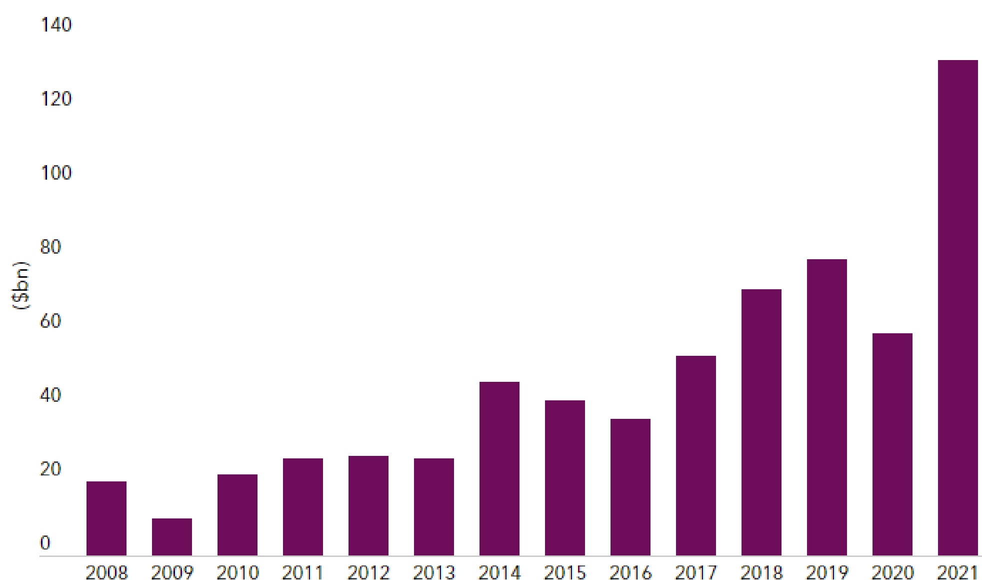
A GP-led secondary refers to a few different transaction structures most of which fall under the idea of a "continuation vehicle". These transactions allow GPs to prolong ownership of certain assets, whilst simultaneously offering their LPs a realisation or the ability to roll their stake into the new structure.

I. **Motivation.**
    - GPs are ordinarily constrained by a 10yr closed-end vehicle which implements a rigid timeframe for portfolio sales. In certain instances, it may be to the benefit of the GP (and LPs) to extend ownership in a 'prize asset' given the potential for further value-creation.
    - LPs may request the GP provide them liquidity for idiosyncratic reasons. These structures allow for this without necessitating a sale at the portfolio level.

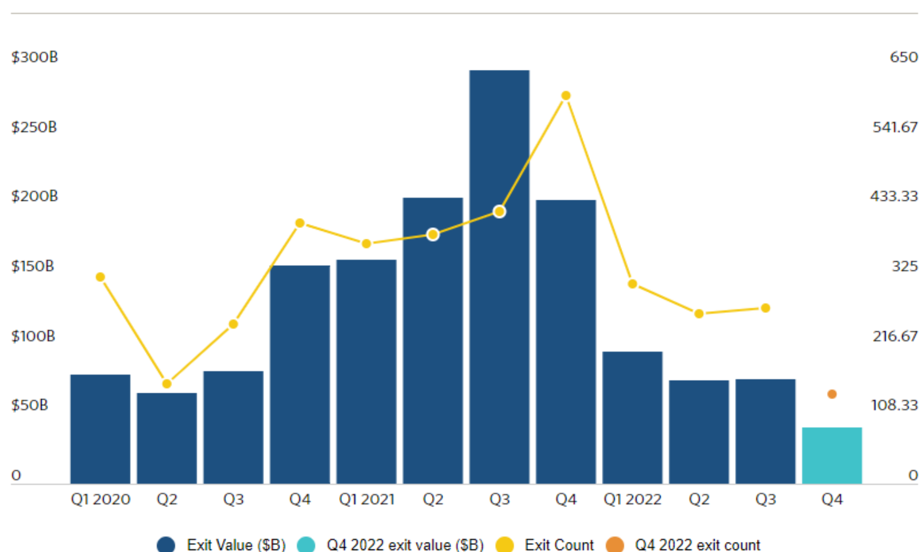
II. **Characteristics.**
    - **Concentrated.** By isolating their top-performing investments within a new structure, investors gain concentrated exposure to the GP's highest conviction success stories. These are the real alpha generators within the asset class.
    - **Lower J-Curve**. These are performing investments which should generate value and cashflow from the outset.
    - **Greater visibility**. As an investor will have to underwrite fewer assets in greater detail, the ability to effectively underwrite is enhanced.
    - **More expensive.** These are prize assets, and the GP will expect to be paid their value. Accepting discounts also calls into question their prior valuation methodology, so are seldom accepted.
    - **Alignment of interest.**

- Realisations trigger carry payments and may reduce the incentive to effectively continue managing the asset. Standard practice is to demand reinvestment of carry proceedings / a further GP commit.
- The GP owes it to their LPs to get the best price but is also the purchaser of the asset. It normally makes sense to bring in a third-party valuation.

Against the backdrop of general private equity fundraising, it is unsurprising that transaction volumes within secondaries would increase in tandem. Nevertheless, the growth has been quite staggering and certainly represents one of the highest growth areas within private markets today. This is a market which has essentially tripled in the past 5 years:



Interestingly, the 2022 figure for transaction volume came in at $103bn vs $134bn for 2021. This is still the second highest on record but seems to reflect a more general malaise within private equity: namely, a weakened exit market dampening transaction volume, as investor confidence begins to dissipate against a struggling macro backdrop.



So... what exactly is going on and how does this affect how we should be approaching Secondaries?

No prizes for recognising that a lot of the recent performance across both public and private equity has been driven by monetary policy and the idea of a Fed-put. Now we have inflation to contend with and Jay Powell has had no choice but to raise rates. Whether he continues to tinker with the foundations of this new economy remains to be seen, but what is becoming increasingly apparent is that things are starting to break. Irrespective of their idiosyncrasy or systemic relevance, the frequency with which these events are occurring is starting to dent confidence, creating a weaker exit environment for private equity sponsors/ IPOs etc... This has several knock-on effects for the secondary market, all of which influence transaction volume.

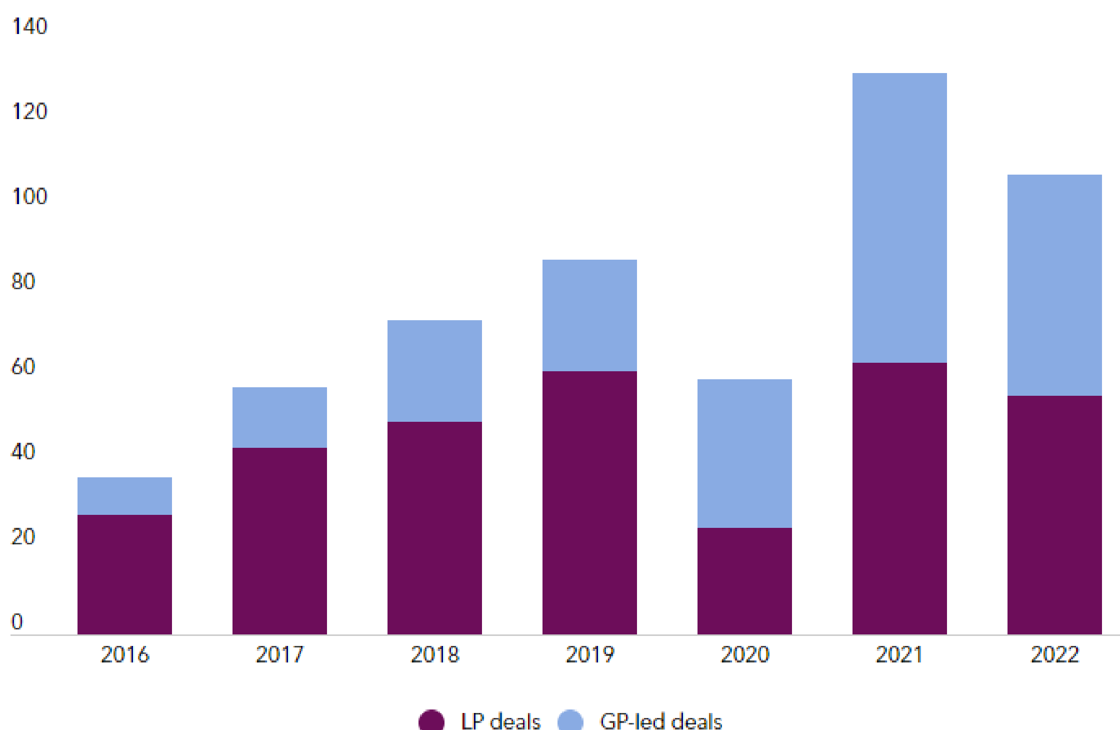
Firstly, GPs do not want to sell their prized assets in a weak environment. Pricing will be poorer than anticipated, and if the option exists to prolong ownership (and value creation), then recent evidence indicates this is the preferred option. LPs are generally happy to be given the option to extend ownership or to sell.

That said, LPs are feeling the squeeze of this weakened exit environment. Ordinarily they would receive distributions from realisations and use that cash to inject into new investments or re-ups with existing managers. Given the absence of an adequate exit market, it would make sense for LPs to start turning to secondary markets to meet their portfolio cash calls.

Rate increases have also put pressure on public equity valuations, and despite the brief rally in January, markets still find themselves in a tough spot. Normally Private Asset marks take 6 months to accurately reflect their public market comparables, and whilst there is clearly an industry wide reluctance for this to take place, the general (and sensible) consensus is that they can't continue to trend upwards. For December 2022 marks, most people are quietly crossing their fingers and hoping for something approaching par. The effect of this is that LPs have found themselves with skewed portfolios and are suffering from a **Denominator Effect**. They now have too much Private Equity as a percentage of their overall portfolio and have most likely breached some sort of internal portfolio metric. They may now have Boards and CIOs breathing down their neck and will have no choice but to turn to the secondary market to rebalance their portfolios. There should be some good discounts on offer here given the relative urgency of the task at hand and thus the opportunity set for LP-led secondary buyers should be good.

But this didn't happen in 2022. In fact, LP transaction volume slowed from $66bn to $55bn (https://www.secondariesinvestor.com/second-biggest-year-on-record-for-secondaries-market-with-103bn-in-volume-evercore/) . It was evident LPs were happy to sit on their hands and wait to see if public markets recover. This remains to be seen, but surely at this rate we will see some selling pressure as LPs look to rebalance.

In contrast, GP-leds have continued to increase in relevance and in 2020 became more common than LP-led secondaries for the first time ever. This trend has continued into 2023.



Interestingly, GP-led transactions also decreased in total transaction volume in 2022, closing on c. $50bn vs the $68bn in 2021. This is not for want of trying however, with veterans such as Pantheon's Global Head of Secondaries, Amyn Hassanally, reckoning there was demand for c. $100bn. https://www.privateequityinternational.com/how-big-is-the-gp-led-secondaries-market-today/

Therefore, secondaries find themselves in a similar predicament to their Primary brethren in suffering from a weak fundraising environment. It is hardly surprising with every man(ager) and his dog back in the market, and a poor exit environment, that investors will be strapped for cash to transact. Naturally this creates a buyers' market as secondaries investors can afford to bid lower and deals should be completed at a discount. It also means that investors are being pickier with the deals they are doing and reducing equity cheques. All in all, it takes longer and becomes more difficult to close deals and advisers may need larger syndicates to get things done. Only the very best transactions will complete and most of the top names will all find themselves in the same deals.

So, where is the opportunity?

The larger players in this field are experts with extensive track records, richly resourced teams, and fantastic relationships in the market. If and when they raise funds sufficient in scale to plug the gap in demand, the vintages should be strong in what is a ripe environment for their strategy. Alvine Capital is not in the business of disparaging market peers and deploying capital with these groups should be heavily considered.

What actually is our business is identifying strong managers who deploy 'capital off the beaten track'. Within Private Equity the argument for lower middle-market specialists has been convincing and persistent. We don't see any change here. We believe those who are able to implement original sourcing channels in a less sophisticated market, should see strong(er) returns. A few points to consider:

- LMM Sponsors have played a crucial role in driving growth and profitability from an early stage. They fundamentally understand an asset which has been unencumbered by multiple ownership, as we can observe in the large cap space.

- GP and LP-led sourcing is inherently less competitive, resulting in more meaningful discounts. This is partly a function of the number of funds in the bracket; it makes sense that some deals will not be known to everyone and fly under the radar. This is in stark contrast to the large cap space where Advisers are likely to run an auction driving up the price. These same Advisers won't typically get out of bed for deals in the $50-100m range. For this reason, LMM/MM secondary buyers are able to gain a competitive edge through proprietary deal sourcing by developing and maintaining extensive sponsor relationships. This is most often seen in private markets alternatives players who are multi-strategy, including fund investments, coinvests, secondaries, etc.

- Transactions occur at a higher velocity because they take less time to place, meaning you get more bang for your buck. I described some of the mechanics occurring in placing the large transactions above. In LMM transactions a sophisticated lead sponsor can tailor the sales process and syndicate more effectively.

- **Credit dynamics**
  - In a rising or higher-for-longer rate environment highly levered companies become harder to service and debt driven growth becomes more expensive and difficult to enact. LMM are less levered and hence less affected by rising rates.
  - Historically, large cap secondaries deals have employed more leverage to generate returns. As this gets more expensive, lower returns can surely be expected.

- Smaller companies are deemed more credit risky than their larger peers, especially in more difficult times. The net result can be a lack of service from banks/ private debt funds. We have already seen examples of smaller secondaries players benefitting by providing creative solutions such as preferred equity injections to provide growth capital whilst proving liquidity for a fund's existing LPs.

As the opportunity set becomes more advantageous for the asset class, we envisage a strong vintage for secondaries across the board. More specifically, however, we believe that sophisticated LMM players who are able to tap the above, will benefit disproportionately from a heightened need for liquidity in the system.

In any case, I expect to see attendance for Secondary specific panels increasing in the near future. You will definitely see me there, listening to the panellists, and not looking at my phone.

If you enjoyed this piece, please don't hesitate to reach out. We would be delighted to hear from you.