KEYNOTE INTERVIEW

Poised for growth

Secondaries transaction volumes remain relatively low in the context of overall private equity AUM. The potential for growth and innovation is tremendous, says head of secondaries at UBS Asset Management, Jochen Mende

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Q What has been driving secondaries dealflow over the past 12 months, and how do you see it evolving?
We have focused more on GP-led transactions in the last 12 months, because we can do a more granular analysis on the underlying assets and value creation plans. In our view, this is particularly important right now, given the macroeconomic outlook.

These transactions are driven primarily by GPs that, on the one hand, want to offer liquidity options to their investors. On the other hand, they want to be able to continue working with select assets for longer and with the additional capital that the secondaries market can provide.

Meanwhile, the LP-led secondaries deals that have taken place seem to be driven either by LPs' need to generate liquidity or by the fact that LPs are rebalancing their portfolios in order to comply with strategic asset allocation parameters in the wake of declines in public equity and debt markets, particularly since early 2022.

However, some of that pressure has been reduced, as at least some of the main public equity markets have recovered since the start of this year. Private equity valuations are also being adjusted, further reducing the impact of the denominator effect. Nonetheless, LPs are using the secondaries market as a tool to actively manage their allocations and relationships.

Q Has the bid-ask spread that prevented many transactions from completing been bridged now that valuations are finally being marked down?
Because there was a great deal of uncertainty around the robustness of private equity valuations starting in the second quarter of last year, there was a disconnect between what sellers thought they could get for their assets and what buyers were willing to pay.

It appears that this dynamic eased up a little in the second quarter of this year and that the bid-ask spread has now narrowed.

Pricing for buyout funds, at least, seems to have stabilised, albeit at lower levels than before the most recent correction. It you look at the numbers

from brokers in 2022, the average discount on buyout funds was estimated at around 16 percent. This has now come down to an average of around 10 percent. However, huge differences remain depending on vintage year and perceived GP and asset quality.

GP-led deals, on the other hand, used to price at NAV or above prior to the most recent correction. Pricing in that segment of the market has become more buyer friendly. On the whole, transactions now involve good assets, are priced at discounts and involve very reputable GPs with strong incentive and alignment mechanisms. In our view, that segment of the market is offering very attractive buying opportunities at the moment.

Q Buyers are seeking greater diversification across their portfolios. What impact is this having on dealmaking?

Diversification is built into LP-led secondaries strategies because you are typically buying mature fund portfolios that already have significant amounts of capital invested in diversified portfolios.

On the GP-led side, however, we see fewer single-asset deals in the market and more multi-asset continuation vehicles. We also see buyers taking smaller bites per transaction, and more transactions with several co-leads, which results in a longer book-building process. We believe this is, in part, a function of a lack of dedicated capital for single-asset GP-led deals. It also seems to be the result of secondaries fund LPs putting pressure on their managers to deliver on the promise of broadly diversified private markets exposure.

Q What are the challenges of having both GP- and LP-led deals within the same fund? How do you approach portfolio construction as a result?

LP-led deals typically have lower absolute returns but higher diversification and shorter residual holdings periods, which result in earlier cashback. We think GP-led transactions, which tend to be more concentrated and exhibit longer residual holding periods, can provide complementary exposure with higher absolute returns.

In our view, blending the two in a portfolio can improve the overall return profile of a fund, provided that the resulting portfolio still offers an appropriate amount of diversification.

To achieve that, we look through to the individual assets and manage concentration on a company-by-company basis in such a way that no individual business exceeds a defined percentage of cost or net asset value at any point in time. We are not alone in that approach – however, we believe we are on the more prudent end of the spectrum. Some managers would tell you that no individual company should represent more than 5 percent of a fund or mandate; we are targeting an exposure of up to 2 percent for mature portfolios.

Q Why are secondaries a logical starting point for the democratisation of PE?

When entering a new asset class, we think investors should ensure that they do so in a diversified way while being mindful of fees and expenses.

Secondaries-focused strategies can achieve accelerated, broadly diversified exposure to a mix of strategies, geographies and managers. To reach comparable levels of diversification would take far longer with any other route into the asset class. As far as fees and expenses are concerned, private equity can be a very costly asset class, especially compared with public market alternatives. However, if executed and structured properly, secondaries can offer a lower cost entrance point compared with other private equity sub-strategies.

"Secondaries offers accelerated, broadly diversified exposure to a mix of strategies, geographies and managers"

Q Why do secondaries transactions still represent a relatively small proportion of PE as a whole, and how can market participants encourage further growth?

I agree that secondaries transaction volume relative to overall assets under management in private equity is much smaller than it potentially could be. Given the influx of capital that we have seen coming into private markets over past years, and the growth in transaction types and use cases, I think market transaction volumes will increase markedly going forward.

There are restricting factors, however: the amount of dedicated secondaries dry powder is one, but there are also only so many experienced investment professionals in the market.

Q How is the use of leverage developing in secondaries more broadly, particularly in this high interest rate environment?

The changed interest rate environment will, in my opinion inevitably dampen the use of leverage in the secondaries market. However, it will also spur further innovation – for example, in the NAV-based lending space or on preferred structures.

Using capital lines secured by investors' unfunded commitments or deal-level leverage – or a combination of both – to temporarily finance transactions is a lot less interesting for GPs today than it used to be. We think that will translate into increased paid-in ratios for secondaries funds, assuming that interest rates remain elevated for some time. ■