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A buyer's market

Secondaries investors are anticipating a golden vintage – just so long as buyers and sellers can agree on price, write Amy Carroll and Adam Le

The secondaries industry exists to provide liquidity to an illiquid market. In the current period of high macroeconomic volatility, therefore, demand for secondaries' solutions should be through the roof.

To a certain extent, this is true. "The dealflow we are seeing today is driven by a pressing need for liquidity," says Jochen Mende, head of secondaries at UBS Asset Management.

"Investors [are] overallocated to private markets on the one hand, and in need of cash as other sources of liquidity, including distributions, dry up on the other," Mende says. "Equally, for GP-led secondaries, the IPO market is not open right now and the M&A market is challenging. So the secondaries industry represents one of the few viable routes to liquidity."

Ross Hamilton, managing director at Partners Group, agrees with this assessment. "On the LP side, we see two categories of sellers – those seeking liquidity and those overweight on private markets. GP-led transactions remain a tool for extending ownership for the best-performing assets and, increasingly, to drive distributions."

Indeed, 2022 boasted the second-largest secondaries deal volume on record, surpassed only by the year prior. However, despite undoubtedly favourable market dynamics, many deals failed to close last year for one simple reason: buyers and sellers could not agree on a price.

This is particularly true in the GP-led market, which has been booming in recent years. "The bid-ask is causing a number of GP-led processes to stall," says Hamilton. "There has been an expectation that GP-leds will trade at par, but if the valuation hasn't adjusted to economic reality, it's challenging to agree on price."

"Pricing discrepancy is the key inhibiting factor at the moment," agrees Gavin Anderson, partner at Debevoise & Plimpton. "Private markets valuations don't appear to have tracked the public markets as closely as they have in previous cycles."

Pricing paralysis

The current slowdown in GP-led secondaries is being exacerbated by the fact that many secondaries investors have become overweight to single-asset deals, impacting their portfolio construction. "Key reasons to invest in secondaries are diversification and investing later into the J-curve for early cashflows," Hamilton explains. "Too much concentration undermines this, and some buyers are looking to rebalance via increased investment in LP portfolios."

While deals in the LP-led market are taking place at sizeable discounts, there is a limit to the level of discount that LPs will accept, unless forced. "We have not yet seen widespread distressed sales," says Miguel Zurita, managing partner at AltamarCAM. "Investors are strained and nervous about overallocation and about their ability to re-up with favoured managers, but genuine

Jochen Mende

Executive director and head of secondaries, UBS Asset Management

Jochen Mende heads the multi-managers secondaries team, a business that forms part of the real estate and private markets unit within UBS Asset Management. He joined UBS in 2018, having previously worked in the secondaries division of a Swiss private asset management firm for 12 years.

Gavin Anderson

Partner, Debevoise & Plimpton

Gavin Anderson is based in Debevoise & Plimpton's London and Hong Kong offices, and is a member of the firm's investment funds, investment management and private fund transactions groups. He advises on fund formation, co-investments, fund secondaries transactions and carried interest arrangements.

Miguel Zurita

Managing partner, AltamarCAM

Miguel Zurita is managing partner and co-head of private equity at AltamarCAM, covering primary and secondaries transactions, as well as co-investments. He is also head of the ESG committee. Prior to joining AltamarCAM, he was a senior partner at Mercapital.

Ross Hamilton

Managing director, Partners Group

Ross Hamilton is part of the private equity partnership investments business at Partners Group. He has been with the firm since 2014 and has 13 years' industry experience. Hamilton previously worked at BGF Investments and Standard Life Investments.

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> **ROSS HAMILTON**
> **Partners Group**

distress and LP default has yet to be observed."

"We are seeing motivated sellers, but not distressed sellers," adds Anderson. "End-of-year marks are now coming out, and it will be interesting to see how much of a difference that makes."

Early indications, however, are that valuation movements will be muted. "We are seeing some downward adjustments as year-end marks come out, but no deep markdowns yet at this point [as of end-March]," says Mende. "In fact, some funds are taking positions up, possibly because they marked them down too aggressively in the first place."

"Marks have been measured," agrees Hamilton. "There is a downward trend, but not the big adjustments some were expecting."

Zurita, meanwhile, believes that we are still some distance from reaching a consensus on valuations. "There is still so much uncertainty. Some are optimistic that inflation will come down and interest rates will not go up further. But an equally valid scenario sees persistent inflation and interest rates staying higher for longer. Those scenarios have different implications for valuations, not just in terms of multiples but in terms of underlying portfolio performance."

"I don't think that uncertainty is anywhere near resolving, particularly with what has been happening in the banking sector," Mende agrees.

Despite the portfolio concentration issues that some secondaries investors are facing, in many ways, this kind of uncertainty should lend itself to high-quality, concentrated GP-led transactions, just as we saw throughout the covid-19 pandemic.

"In this type of environment, investment committees are generally more cautious," says Anderson, "and I think many sponsors are responding by only taking their highest-quality and most defensive companies to market in single-asset deals, rather than trying to sneak others in as part of a bundle."

Mende, meanwhile, says the alignment of interest between the secondaries buyer and GPs is far stronger in

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> **UBS Asset Management**

a concentrated GP-led, because the GP typically puts a significant amount of its own money at risk alongside the secondaries investor.

Zurita adds that an advantage of concentrated portfolio or single-asset deals is the level of analysis that can be undertaken. "We know what the capital structure is. We know how inflation is being passed through and what the supply chain challenges are, for example. Those things are far harder to assess if you are buying a large, diversified portfolio.

"The risk profile for GP-leds is even more attractive than for co-investment. When you participate in a primary direct deal, there will always be risk involved – including, for instance, how effective the management team will be. A lot of that uncertainty is eliminated once the asset has already been in a portfolio for three or four years."

Coming to terms

Despite a lack of forced sellers, supply/demand dynamics are moving in secondaries investors' favour. "Secondaries still represent a very small part of the overall market," says Zurita. "Less than 2 percent of NAV is transacted each year, and there is still only just over a year of dry powder out there, which is as good as it gets. And while there are thousands of funds doing direct deals, there are less than 100 doing secondaries. All of that means this is truly a buyer's market."

Terms are shifting accordingly, says Hamilton: "We see situations with premium carry tiers but no management fees in certain GP-led transactions. A high rollover of carried interest or participation from other funds managed by the GP are also strong signals of conviction."

"The whole conversation around management fees has become a lot more reasonable," adds Mende. "We typically now also see tiered carry ratchets with [EBITDA] multiple and IRR hurdles, which was not always the case. Super carry is still being proposed, but less frequently than before – although, from my perspective, I would be delighted to pay a GP super carry if the break points and overall alignment are right. We also observe that carry rollover plus new capital into transactions is more prevalent that it was 18 months ago."

Meanwhile, despite the attractive supply/demand dynamics, there is unlikely to be a surge of new entrants due to a scarcity of experience and talent. "You need access to data and relationships on both the GP and investor side. Building that from scratch takes a long time," says Mende, who adds that the emergence of ancillary strategies to private equity secondaries, including real estate, infrastructure and private

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Debevoise & Plimpton

credit secondaries, is also sucking up a lot of available talent.

Indeed, the market is seeing significantly more M&A than it is seeing the organic launch of new teams.

As a consequence, secondaries firms are having to be highly disciplined about where they choose to dedicate resources. "The challenge is certainly not finding dealflow, but rather deciding where to focus," Zurita says.

Hamilton explains the deal selection process for Partners Group: "For continuation vehicle opportunities, we typically identify assets and embark on conversations early to shape transactions. We maintain a shadow portfolio that we develop over time, which is closely aligned to our thematic investment approach. We are unlikely to jump on a process without an angle or specific knowledge of the underlying assets. On the LP portfolio side, we triage our pipeline, taking forward opportunities with high-quality content, which we value over discount."

Mende advocates a similar approach: "We meet once or twice a week to triage what has come through the door, allocating resources based on portfolio fit and anticipated return profile, as well as our level of familiarity with the GP and with the assets."

Regulatory creep

The SEC's private markets reform proposals, released last year, included a number of slated regulatory amends that would directly impact the continuation vehicle market.

Most notable of the US Securities and Exchange Commission's proposed reforms was the need to seek an independent fairness opinion and additional reporting requirements.

"The noise around this seems to have died down a little, but has certainly not gone away," says Debevoise & Plimpton's Gavin Anderson. "These are inherently conflicted transactions, which is something any regulator is going to focus on in order to ensure appropriate disclosure and fair processes. It is helpful, of course, that over the past few years a market standard has developed around GP-leds, typically including the involvement of an intermediary, the provision of information packs and a decision-making period of at least four weeks for LPs. This should help address the regulator's concerns."

Secondaries investors themselves also appear sanguine about the prospect of enhanced regulation. "I don't think a regulatory framework that provides clarity should be viewed as a negative," says Jochen Mende of UBS Asset Management. "On the contrary, if the rules establish clear market standards, that should help facilitate activity and allay fears of LPs who want to be sure they are not being taken advantage of. All in all, I think it can be a net positive."

"Clear rules of the road are good for everyone, so long as any regulation is workable," adds Anderson. "The requirement for a fairness opinion is probably the most debated aspect of the proposal but, in reality, fairness opinions are already quite common. This is certainly something we could live with."

Venture veto

One area that appears unlikely to make the cut is venture secondaries. The tech industry has endured a turbulent time over the past year – exacerbated, most recently, by the failure of Silicon Valley Bank. Rather than presenting an exciting opportunity for growth, this seems to be deterring secondaries investors.

"We do look at venture secondaries, but we haven't done any for a while due to market tumult and the challenges around pricing assets," says Zurita. "The impact of interest rates and a lack of liquidity on valuations is even more significant in this part of the market. We will be watching the space closely."

"On the secondaries side," adds Mende, "we are not the most avant-garde of investors – but I think in general, secondaries investors tend not to be. We don't like technology risk. We don't like business model risk, and we haven't really seen anything we really like in venture over the past 18 months. I would say, though, that by the time secondaries buyers look at venture funds, a lot of the risks typically associated with this sub asset class are already gone, because these funds tend to be seven, eight or nine years old, and so we can see which companies have made it through the initial stages."

Hamilton questions this wisdom, however, given the sheer scale of rounds that some VC-backed businesses have raised in recent years: "Several venture-backed companies that would historically run out of runway have significant cash headroom from recent rounds. Winners and losers will eventually emerge, and the cash gives time to prioritise profitable growth or potentially pivot. Typically, there is less data available for venture and growth-stage assets, making it more challenging to assess commercial prospects."

Another opportunity set that secondaries buyers appear keen to avoid in most circumstances is the stapled secondary, which has made something of a comeback in recent months due to the significantly more challenging

fundraising conditions that direct investors are experiencing.

"There has been a small resurgence in stapled secondaries, although they are not hugely prevalent," says Anderson. "They tend to invite a level of scepticism that can be challenging."

"Many sponsors contemplate stapled secondaries transactions, with a relatively small number deciding to proceed," adds Hamilton. "Those that have gone ahead experience mixed results. Success typically follows comprehensive canvassing of the investor base to understand what the tender volume might be. There can be reputational risk should a tender be associated with poor market traction, but this can be a useful tool towards the end of a fundraise. If it is key to achieving critical mass, it's not a strong signal to send."

"It is another case of demand needing to match supply," says Zurita. "Stapled secondaries are becoming more attractive to GPs today because the fundraising environment is getting tougher. But for a secondaries buyer, staples are not ideal. We are trying to deploy and distribute capital rapidly, and the staple doesn't help with that. It makes a transaction less interesting and, given, the volume of opportunities we are currently facing, it isn't going to make it to the top of the list."

Mende says he can understand why advisers are pitching stapled deals aggressively, but agrees that a stapled transaction is unlikely to be a top priority for secondaries buyers at this point in the market: "There are so many straightforward opportunities out there with strong alignment. If the fund manager is on a list of firms that you were considering a primary commitment with anyway, that is different. But otherwise, we are unlikely to spend a lot of time on these types of deals."

A golden vintage

Indeed, such is the deluge of dealflow that secondaries buyers are expecting heady optimism around the current vintage – just as soon as bid/ask discrepancies are resolved, of course. "Our experience tells us that in times of market disruption, returns tend to be higher," says Zurita. "That may be due to more cautious underwriting, or perhaps because deals are priced and structured in a way that is more favourable to buyers."

Mende is also bullish about the opportunities ahead. "The conditions for buyers are extremely good. The quality of assets and GPs coming to market is very high. I haven't seen a market as attractive as this in a very long time. The secondaries market has obviously evolved significantly, with an explosion of GP-leds, which are now characterised by trophy assets rather than what used to be called zombie funds. We are really excited about what is to come."

Hamilton agrees with this positive assessment: "Secondaries performance is strong through market cycles and tends to peak in periods immediately following dislocation. We saw this after the dotcom crash, GFC and eurozone crisis, and we are excited about the potential for strong returns as we emerge from this turbulent period. Outperformance will be driven by our thematic investment approach, acquiring high-quality portfolios and assets and cautious underwriting. The prospects for current and future vintages remains strong." ■

Structural innovation

New strategies are coming into play in order to meet the challenges brought on by difficult fundraising conditions.

Periods of economic distress often give rise to structural innovation and shifts in market norms. "It will be interesting to see what happens to the use of finance as interest rates continue to rise," says Gavin Anderson of Debevoise & Plimpton.

"We do sometimes see [the use of] continuation vehicle sub lines to delay draw downs, as well as NAV facilities to bridge a gap, and it will be interesting to see how this develops."

Anderson also points to the role that a third-party sales process has frequently played in GP-led price validation in recent years. "That may be more challenging as exits are harder to come by."

Miguel Zurita of AltamarCAM, meanwhile, says he expects to see the return of structures that allow a seller to avoid realising a loss at the point of sale.

Deferred payment mechanisms are expected to remain a rarity. "Deferred payment is something we use selectively," says Ross Hamilton of Partners Group. "As financing and bridging becomes more expensive, it may become more common, especially in situations where sellers are unable to immediately re-invest transaction proceeds."

Meanwhile, reps and warranties insurance also appears to be gaining popularity, particularly in end-of-life situations where the selling fund may be winding up, leaving question marks around recourse and credit worthiness, according to Anderson.

"To a lesser extent, we are also seeing LP insurance used for LP portfolio deals where a seller wants to draw a definite line under the deal, removing any prospect of future liability."