Roundtable: Second chances

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Speakers:

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Joseph Marks, Capital Dynamics
Valérie Handal, HarbourVest
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Stuart Ingledew, Investec
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Moderated by: Amy Carroll, Real Deals

What is happening to LP-led secondaries deal flow in light of the profound change in macroeconomic environment that we are experiencing?

Ben Pearce: We've seen a significant increase in interest in exploring secondary sales, particularly with European pension funds and insurance companies, which started building over the summer. While there has been a lot of noise and speculation around the UK pension funds and the recent LDI turmoil, we've not seen that drive any secondaries activity – while some UK pension funds are selling, these processes have been long in the making and have typically been focused on portfolio rebalancing.

We’re seeing some reasonable pragmatism among sellers around the discounts that need to be taken in today’s market – while they’d rather not be taking discounts, they do see some justification given the market outlook and anticipated write-downs in the quarters ahead. We’re also seeing some positive selection bias for the portfolios coming to market – sellers recognising that to minimise discounts and secure attention in a busy market they need to sell better-quality, typically more-recent vintage funds.

Charlotte Morris: We are also seeing people wanting to sell $400m of value and going out with $800m portfolios to get there.

Pearce: Absolutely, the buy-side is very selective at the moment – few groups are taking a broad portfolio approach, certainly where they’re not already well covered.

Steven Nicholls: I agree that vendors seem to be selling their best assets – those that can get closest to par. But those are also the assets with the best and most predictable upside. They are giving away their crown jewels and I wonder how they reconcile that with their fiduciary responsibilities. On the buy-side we think about cash, not discounts, because we are judged on DPI at the end of the day, while sellers are judged on optics.

Joseph Marks: You have to remember that we are dealing with humans. The fear of loss is greater than the prospect of reward further down the road.

Nicholls: Although it can be acceptable to take a big loss on something that someone else has bought. A change in the cycle often leads to a change in the people at the top. We are actively hunting for firms going through that transition.

Are we are seeing genuine distressed sales?

Morris: With the possible exception of some of the UK pension plans, I don’t think we will see properly distressed sellers. But there is a sense of timing pressure. For example, there may be a house view within the seller’s organisation that the recession is going to be grim, and they therefore aren’t prepared to wait for NAVs to reset. There is also a recognition among sellers that a recession is likely to slow down distributions at a portfolio level. A secondaries sale is another way to access that liquidity.

Marks: I don’t think we are seeing a liquidity crunch yet, though. It didn’t really happen in 2009 either. There was a liquidity crunch in 2009, but even then, we didn’t see widespread defaults in private equity. Even Lehmans didn’t default. But selling unfunded positions helps with liability management, which is why we are seeing some newer vintages on the market.

Valérie Handal: I think liquidity is not the only factor driving decisions to sell. It is also about risk management (the denominator effect) and portfolio rebalancing. We are often asked to bid on both a cash and deferred basis, and even groups that initially indicate that they will never take a deferral can prefer the deferral option when they see the pricing differential. In a world of rising interest rates and uncertain exit markets, the deferral option has more value for the buyer than in the past.

Pearce: We’re seeing quite a lot of contingency planning from LPs – no need to sell yet but if they do, what sort of discounts should they plan for and what does a well-run process look like.

So, is it primarily the denominator effect that is driving transactions?

Antony Anastasiadis: An over-allocated LP has three choices. Firstly, they can stop committing to private equity, however, I think most would agree that is the wrong decision to make. They can take allocation from other parts of their portfolio, be that fixed income or equity, and transfer it to private equity, which negates the over-allocation. Lastly, they can sell. More and more groups are now moving from the first two options to the third, and that is driving the tremendous volume that we are seeing today.

Pearce: Many LPs have had a degree of latitude with private equity allocations to date but with public market valuations dropping significantly, private market valuations remaining relatively stable and currencies in Europe weakening significantly, we’re seeing increased scrutiny of over-allocations with some LPs exploring how they might bring them down.

Anastasiadis: But private markets have actually done exactly what is expected of them in a downturn. They have stayed consistent. In that sense, over-allocation is a nice problem to have. The performance of private markets over the past 18 months has been the best the industry has ever seen. Many of these portfolios are sitting on significant gains today.

Pearce: There is some cynicism around current private equity valuations, which have largely seen little adjustment year to date, certainly relative to the public markets and the anticipation of future write-downs which certainly contributes to discounts.

How is the economic environment impacting GP-led deal flow?

Handal: The IPO market is frozen, strategic buyers have their own issues to contend with and the financing markets are difficult so the trend towards continuation vehicles that we saw during Covid is accelerating. Many GPs now see this as a fourth way of exiting an investment. Capital availability for these types of transactions remains an issue, however. The buy-side is having difficulty keeping pace with supply.

Helen Griffiths: Some of these cornerstone secondaries houses have been taking very substantial positions in these assets and that concentration is something we have had to adjust to as lenders.

Nicholls: I don’t think you are seeing that anymore though. Now you get $500m deals where the lead investor is only taking $50m. We have been shown a draft term sheet by a lead investor this week, who is evaluating confidence in the market before proceeding with the transaction. They are trying to build a syndicate in advance, which is a very different process to underwriting the whole stake and then letting the market follow.

What are you seeing with regard to pricing in GP-led deals?

Anastasiadis: If you look at the first quarter of this year, all the deals on the GP side were priced at par or above. But if you look at Q2 and Q3, the data gets more interesting: more than 50% of deals were done at a discount or with some structural element. A lack of capital also means many deals are being pulled. Even with this backdrop, more GP-led deals are coming to market than ever before, and so I am confident in this market long-term; we are just experiencing some growing pains.

Handal: In GP-led deals, discounts to NAV are new and more difficult for GPs to accept given that they are selling some of their prized assets. That being said, we are starting to see deals being done at double-digit discounts to the last reported NAV.

Morris: In a GP-led deal, the price is shared with all the LPs in that fund. With an LP-led deal, no one else has to know.

As buyers, how do you get comfortable with the motivation of a GP-led sale, particularly in this more volatile environment?

Nicholls: We are seeing assets coming to market that were bought three years ago and it is hard to see what the motivation is there, other than the fact the asset is standing at 3x and the GP wants to lock in carry. Yes, they are rolling that carry over into the new vehicle, but that's now an LP interest, not a geared carry position. They haven't had time to execute on their business plan so, even at par, I struggle to see how they can justify that course of action to their LPs.

Morris: It can be difficult to accept that the GP really believes in the asset in those situations. Understanding motivations and ensuring alignment between the GP, company management and the new investors is the challenge and skill of doing these GP-led deals.

What about lenders - how are they reacting to current market conditions, and how do they approach GP-leds?

Griffiths: Debt providers are being more selective of the opportunities they want to pursue and the GPs and LPs they want to support. It's important to remember that not all debt providers source their capital in the same way and so rising interest rates will impact the market in different ways. Investec works with its institutional partners to deploy capital into GP-led solutions that have a higher yield than primary subscription finance.

When it comes to GP-led solutions, the track record of the GP and how it manages the portfolio to create value are key. Without longevity of management of a portfolio or asset, it can be challenging to buy into the strategy of the GP as it flips into a continuation vehicle.

How are LPs viewing these GP-led deals today?

Pearce: There has been some sensitivity from existing LPs around elements of some of the single-asset transactions completed, for example the use of the flagship fund to partially finance the continuation fund. Now that the fundraising markets are so challenging, I wonder whether GPs will become even more sensitive to the views of their existing LPs.
Nicholls: But LPs have the choice of selling or rolling over and I think selling LPs are aware they may have to accept a discount to a strategic sale price.

Handal: GP-leds can be good for everyone, if they are structured properly, done for the right reasons, with the right assets, at the right time. We firmly see this as a positive development for the industry. I haven’t seen many situations where LPs that wanted to sell, or LPs that wanted to roll over, couldn’t do so.

Morris: Over the past three or four years, we have really learnt what it is that makes a win-win-win deal, including a transparent process, having an adviser involved and consultation with the LPAC to ensure this is actually something that LPs want. The proof that these deals can offer a win-win-win, meanwhile, lies in the increased percentage of LPs that are selling.

And what about LPs in your own funds? How do they feel about the dramatic increase in concentrated GP-leds? How are those pandemic single-asset deals likely to perform and what does all this mean for fundraising?

Morris: While we have been doing these kinds of deals for over a decade in different forms, single-asset deals with these high-quality asset profiles have really taken off over the past two years, so it is too early to tell how they will perform on realisation. Fundraising across the market, of course, will take place on the back of unrealised returns. We raised a dedicated GP-led fund last year, alongside our flagship strategy that invests in both LP and GP-led deals, so there is definitely appetite there.

Handal: Investors in secondary funds recognise that these deals can generate alpha in a secondary portfolio but they are also focused on diversification. This explains why we are seeing dedicated pools being raised for concentrated transactions where investors who are interested in doing so can dial up their exposure to these particular assets.

Pearce: I do think that the rise of GP-leds has happened so quickly, that many LPs are struggling to weigh up the risk/return profiles of the different secondaries offerings - how do you compare the relative risk/return of a fund that is 50% weighted towards GP-leds, with one that is only 20%?

Nicholls: Secondaries managers are not cavalier. We are risk-averse and most of us have strict concentration limits, in terms of managers and individual assets. That’s another reason why you are seeing deals being so widely syndicated. LPs do end up with the diversification they are after.

How are fund finance providers responding to the economic environment? Are we seeing lenders step back?

Griffiths: Asset valuations, which were arguably toppy in recent times, are starting to come down and, as investment activity becomes more challenging, there may be some tough conversations on the horizon between debt providers and GPs. We recently closed a single-asset GP-led financing in just five weeks. Investec was uniquely placed because of our strong relationships with the cornerstone investors and asset-level lending exposure, which provided us with a detailed understanding of its performance and how it might be impacted by the macro environment and expected exit strategy. Having insight into the whole capital stack allowed us to design a financing that would support the GP and LPs as times get tougher.

Are there concerns around how much leverage is already in the system?

Morris: We have always been relatively conservative on debt but, given the benign market and cheap finance we have experienced over the past decade, leverage has undoubtedly built up in the broader secondary market. With interest rates rising so rapidly, that may be the undoing of some deals. Certainly, I don’t believe LPs have any idea just how much debt there is in typical secondary funds – and they definitely can’t compare one secondaries firm with another. We are often asked for unlevered returns and it is very difficult to unpick since there is no standardised way of calculating unlevered returns to be able to benchmark secondary firms appropriately.

Nicholls: I agree. You have leverage at a company level, leverage at the GP level and leverage at the investor level. There is also sometimes leverage at the SPV level in between. With interest rates going up and business performance coming down, that is really increasing overall risk.

Interestingly, this is an area where GP-leds come into their own. With a GP-led, we have controls over whether the new vehicle can raise capital and a lot more visibility on the underlying companies. With an LP position, the GP can raise more capital for that particular company and you may not even know about it.

To what extent are you seeing increased specialisation in the secondaries industry?

Anastasiadis: Increased specialisation is going to be one of the biggest trends in the secondaries industry going forward. We may see GP-led tech funds, for example. There are certainly enough tech deals to warrant that. We may see funds focused on healthcare or on Western Europe. There is so much deal flow in the market that buyers can pick and choose and I think it is inevitable we will see more of that differentiation. I also believe that the resulting return differentials will mean that secondaries will become a more prominent part of investors’ private equity strategies, and commitments to the industry will grow.

Pearce: The fundraising markets across private equity more broadly are so congested and challenging right now that, despite the next few vintages of secondaries funds potentially offering great returns, secondary fundraising momentum is slow because there is just so much pressure on LP time and capital.

Marks: I also think some investors still tend to think of secondaries as a tactical and market-dependent strategy. While they recognise the importance of maintaining investment pace on the primary side, they only look to secondaries when discounts are wide. As these GP-leds start to generate really interesting multiples, that could restore secondaries' image as a strategy for all weathers.

What other predictions do you have for this market?

Nicholls: I think we will see new entrants. There will be firms that lead a transaction, but then look for followers that can really add something through sector or geographical expertise, rather than just pursuing a syndication process.

Marks: Another big trend is the democratisation of private equity, which is already starting to take place. Secondaries are seen as the preferred entry point for those mass affluent investors and that could really help grow the industry.

Griffiths: With so much dry powder in the secondary market and more opportunities for investment in GP-led transactions, the next 18 months will be very active. Forming a partnership with a debt provider who has the ability to truly understand the portfolio, as well as strong relationships in the secondary market, can be the distinction that allows them to stand out in a competitive and more risk-averse market.

Pearce: While there are some short-term funding constraints, the secondaries market will continue to enjoy significant growth - 10 years ago, we saw $26bn of volume, so the market has already grown between four- and five-fold in a decade. Extrapolate that forward to 2032, and I think we could be looking at a market of half a trillion dollars.