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The bigger, the better?

There is growing speculation that secondaries trading could surpass primary fundraising, as it has in the public markets, write Rod James and Amy Carroll

Though GP-led deals dominated secondaries activity during the pandemic, the LP portfolio market came back with a vengeance at the tail end of 2021. "That dealflow was largely driven by investors looking to recalibrate their private equity exposure, for example, with regards to sector, geography and strategy," says Daryl Li, senior managing director at Ardian. "GPs have also been coming back to market faster than LPs might have expected, given the strong investment pace over the past couple of years. That means LPs have been selling exposures to older funds in order to roll proceeds into new funds being raised."

Shane Feeney, managing director and global head of secondaries at Northleaf Capital Partners, agrees that a proliferation of re-ups in the primary market is helping to drive secondaries activity. "Primary teams are struggling to keep up and, given their desire to secure co-investment, it is important that they remain meaningful investors in new vintages," he says. "We will continue to see large LP-led sales to rebalance portfolio construction, as long as GPs keep coming quickly back to market with larger funds."

Meanwhile, strong quarter-on-quarter NAV growth has meant buyers have been able to meet high seller expectations on price, according to Peter Bock, managing director at Neuberger Berman. "By the fourth quarter last year, more than a full year of post-covid financial performance was available, which helped with pricing as well," he says.

Denominator effect

Some LPs are also selling as a result of recent strong performance, which has left them mechanically overallocated to the asset class. Few expect the denominator effect to really bite, however. "We were bracing ourselves to see the denominator effect come into full force at the beginning of the pandemic as well, but public markets quickly recovered, so we didn't see those allocation-driven sales," recalls John Rife, a partner at Debevoise & Plimpton. "It is too early to say one way or the other whether the same thing will happen this time around."

Of course, most GPs mark to market, so movements in public equity valuations will translate into movement in private equity valuations, albeit with a short lag.

Miguel Echenique, managing director and partner at AltamarCAM Partners, is sceptical that the denominator effect will drive significant dealflow in 2022. "In 2009 and 2010, the denominator effect drove massive portfolio sales, but the people involved in those transactions have learned their lesson about the value they left on the table. I think investors will choose to hold assets rather than react to something that is likely to be temporary with fire sales."

While the intensity of the secondaries market may have eased slightly, wider volatility – particularly for those pricing off September NAVs – means the medium-term outlook for LP secondaries sales remains strong.

"Going forward, we expect to see continued strong growth in LP sales, as LPs actively manage their portfolios and as primary funds continue to increase in size," says Li. "Over $1 trillion was raised in primary fundraises last year, and we see more and more

multibillion-dollar commitments being made to mega-funds. That naturally drives the LP sales of the future."

Single- versus multi-asset deals

The GP-led market has not taken a back seat as LP sales have re-established themselves, and the single-asset deal phenomenon has not faded away. Around half of the dealflow that Matt Wesley, co-head of private capital advisory and global head of GP-led advisory at Jefferies, sees involves single assets, while the other half involves a combination of strip sales, multi-asset continuation vehicles and tender offers.

"The most important thing with any of these transactions, but particularly single-asset deals, is that they are being done for the right reason and that there is strong alignment with the GP," Wesley says.

Echenique agrees that single-asset deals can be highly attractive, but points out that the risk profile is very different to multi-asset deals. Bock, however, says Neuberger Berman continues to be excited by the transactions it sees in the single-asset GP-led market. "We believe asset quality is high. We seek to

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> **Neuberger Berman**

Peter Bock
Managing director, Neuberger Berman

Peter Bock joined Neuberger Berman in 2005 having previously served as an associate at Lightyear Capital. He also worked at PaineWebber in both strategic investing and investment banking, advising on corporate transactions including mergers and acquisitions, restructurings, and equity and debt financings.

Shane Feeney
Managing director and global head of secondaries, Northleaf Capital Partners

Shane Feeney oversees all aspects of Northleaf's secondaries programme. He is a member of Northleaf's Private Equity Investment Committee and actively participates in investment activities across the broader private equity programme. Prior to joining Northleaf in 2021, Feeney was senior managing director and global head of private equity at CPP Investments. He has previously worked at Bridgepoint, Morgan Grenfell Private Equity and Deutsche Morgan Grenfell.

Miguel Echenique
Director and partner, AltamarCAM Partners

Miguel Echenique rejoined AltamarCAM Partners in 2013 having spent a number of years working as an investment manager in the private equity team of the European Investment Fund. Before he first joined Altamar in 2006, he was an investment analyst at Interdin Corporate Advisory.

John Rife
Partner,
Debevoise & Plimpton

John Rife is a partner in the corporate department at Debevoise & Plimpton and a member of the firm's funds group. He is also a leader in the alternative assets transactions and liquidity solutions group, and regularly advises sponsors and investors on secondaries transactions, including GP-led restructurings, LP interest portfolio sales and fundless sponsor transactions.

Daryl Li
Senior managing director,
Ardian

Daryl Li joined Ardian in 2010 and is based in New York. He is a senior managing director and investment committee member for Ardian's secondary, primary and co-investment funds and customised solution platforms. Prior to joining Ardian, Li worked at Wachovia Securities in New York, in the firm's real estate investment banking and special situations groups.

Matt Wesley
Co-head of private capital advisory,
Jefferies

Matt Wesley joined Jefferies as co-head of private capital advisory and global head of GP-led advisory in 2021. He has previously worked at Guggenheim Partners, PJT Partners and Coller Capital. He began his career at law firm Sullivan & Cromwell.

create diversification through portfolio construction."

"I think the single-asset versus multi-asset dichotomy can be overplayed," agrees Feeney. "You can build a diversified portfolio at a fund level. What we want to avoid is being pushed into multi-asset deals for the sake of diversification if those transactions are actually being priced higher. If you are paying more for four assets in a multi-asset deal than you would pay for the same four assets in a series of separate deals, that doesn't make sense."

Rife, meanwhile, adds that broadly syndicated single-asset deals are increasing – which, from a buyer perspective, can make these transactions seem more like oversubscribed fundraisings than terms-setting secondaries.

"On the other hand," he says, "it does make it easier for buyers to create diversity in their portfolio by giving them a larger number of smaller, single-asset slices."

Rife does, however, believe that we may see more multi-asset deals if the economic environment becomes more challenging. "Personally, I am bearish on the economy, particularly in Europe," he says. "I would expect that to drive more GP-leds that are not so much about retaining ownership of the crown jewels, but more about giving quality assets more time in a period of dislocation. I think that will increase the number of multi-asset deals, because it becomes a fund-wide issue."

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SHANE FEENEY
Northleaf Capital Partners

Proof of concept

If anything, the GP-led market is being limited by a mismatch in supply and demand. "The GP-led part of the market is undercapitalised," says Feeney. "But you could argue that that constraint is a good thing. It forces discipline. No one feels the pressure to do deals, which ensures you are not paying A-quality prices for B-quality investments, or doing marginal deals. As an industry, we are still pretty early in the development of the continuation vehicle market, so it's important we produce strong returns out of the gate."

Bock agrees: "Because there is not enough capital for all the GP-led transactions coming to market, we can afford to be very selective." That's important: let's not forget, the returns generated by this surge in GP-led transactions have yet to be proven.

"Almost everyone we speak to on the buy-side says their current fund is likely to be the best they have ever had," says Wesley. "Obviously, a strong macro environment has been the rising tide that has lifted all ships. But as we enter choppier waters, I expect to see clear winners, and maybe some losers, emerge."

Wesley adds that it will be interesting for investors to compare risk-adjusted returns for GP-led secondaries funds with more concentrated direct buyout investing, and to see how the two stack up.

Feeney, however, believes that the more interesting comparison for big allocators will be between net returns on single-asset deals and gross returns on co-investment.

"We often hear investors say these single-asset deals are just co-investment with carry," he adds.

"My belief is that you are getting a highly curated selection of the very best businesses with a GP-led strategy, and that, on a risk-adjusted net basis, the returns will be better. But it will take a few years before we can demonstrate that."

Echenique adds that, with co-investment, you also have entry risk, including unproven chemistry with the management team and a new business plan. "A lot of that risk comes off the table with a single-asset GP-led secondary," he says. "Having said that, full prices have been paid for these star assets, and if there is a contraction in those valuations, it remains to be seen if we will all achieve the returns we are

Special forces

The secondaries market is growing dramatically. It is also becoming increasingly specialised.

"We are already seeing some buyers focus on large LP trades, and others on smaller GP-leds," says Miguel Echenique of AltamarCAM Partners. "In time, I think we will see more firms specialising in growth and venture secondaries, for example, or in the technology and healthcare sectors."

"It is the natural direction for the market to take," agrees Jefferies' Matt Wesley.

"The first generation of specialisation is seeing firms focus on GP-leds or LP-leds, and on specific asset classes such as real estate and credit. We are also already starting to see the emergence of even more specialised strategies. I recently spoke with a dedicated VC healthcare secondaries firm that is deploying significant capital. The market is demand-side constrained, which creates the opportunity to unlock value in niche parts of the market."

"Many LPs have long-term exposure to the secondary market and are becoming more sophisticated in their allocation strategies, which is helping to drive increased specialisation," says Peter Bock of Neuberger Berman.

Debevoise & Plimpton's John Rife, meanwhile, adds that specialisation is not only being driven by commercial imperatives.

"From a legal perspective, there are certain strategies – such as real estate and credit secondaries – that have unique considerations that can be an impediment for generalist funds that don't have the structuring tool kit at their disposal," he says. "There are legal, tax and regulatory drivers in play here as well."

"We are still in the early innings," adds Northleaf's Shane Feeney, "but as the secondaries industry matures, we will start to see more product development to isolate risk, return and duration. That is not to say the flagship diversified fund will be dead, but we will start to see more pockets of specialisation grow up alongside them. I think this is a good thing for the industry."

hoping for, despite the quality of the underlying assets."

Indeed, high prices have been an undeniable characteristic of both GP- and LP-led deals in recent months. In an increasingly efficient market, pockets of value are hard to find. "Nothing feels unexploited. It is a competitive industry and nothing is cheap," says Feeney. "In particular, GP-leds don't transact at significant discounts because of conflict of interest and transparency requirements. We focus more on ensuring we buy quality, because paying A-level prices for B-level assets is where buyers have historically run into trouble."

Echenique adds: "We are long-term investors, so even in an expensive market like the one we have lived in the past couple of years, with everything priced to perfection, there is always the opportunity to look for value."

Li, meanwhile, says it isn't always about price – particularly for large LP

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> **Debevoise & Plimpton**

portfolios. "Competition is limited at this end of the market. Ten years ago, there were six transactions of over $1 billion. Last year, there were 36, and 13 of those were over $2 billion. But there are still very few players able to execute at that scale.

"Furthermore, in addition to price, sellers may prioritise certainty of execution, discretion and/or strategic goals for the stakeholders involved, such as becoming third-party asset managers. GPs also get highly involved in the transfer of $400 million or $500 million commitments in individual funds, so having a sizeable primary programme – which Ardian does, and deploys approximately $3 billion of primary capital from it annually – can be critical. Those are the types of situations we like to get involved in. We pay a fair price, of course, but we want to offer more than price as a differentiator."

Big ambitions

It remains to be seen how much of a lull the current geopolitical situation and ensuing stock market turmoil will create for the secondaries market. Though it is hard to believe that the current level of pricing can be sustained against such macroeconomic volatility, vendors may not be willing to take a hit. It is clear, however, that the long-term tailwinds for both GP- and LP-led deals are strong. But just how big could the secondaries market really become?

Previously, the founder of a large secondaries firm has said he expects the secondaries market to outstrip the primary market by 2050, in the same way that secondaries trading on the public markets dwarfs primary issuance. Echenique isn't ready to be drawn on timelines on this idea, but believes that the market will reach $200 billion sooner rather than later. Ultimately, he says, the sky is the limit.

Bock adds that the fundamentals driving the secondaries industry are compelling. "We expect to see the

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> **Jefferies**

market grow significantly," he says. "Fund sizes will increase. Deal volumes will increase. We are still in the early stages of the development of this market."

Wesley says a conservative estimate would be $350 billion, but adds that the more interesting question is how we get there. "The retail market is three times as large as the institutional market, and that represents a massive opportunity if we can figure out how to harness the capital available," he says. "That, along with continued growth on the supply side, could get us to some of these big, full-year market numbers that we are talking about today."

A key constraint on this growth is human resources – an area that is already stretched, given the huge uptick in dealflow in 2021. "When doing these single-asset deals, you try to build portfolios of smaller assets. From a transaction standpoint, you need a lot of resources to execute on that," says Echenique.

Rife adds: "From a legal perspective, these GP-led transactions really require fund formation and M&A expertise. The real challenge is finding people who have both." He notes that lawyers who specialise in GP-led deals simply did not exist 10 years ago.

Facing a limited pool of potential hires with secondaries experience, firms are looking to other areas of investment banking and beyond. "We've had success with folks who had a slightly different career out of college – maybe someone who was doing accounting or valuation work," says Wesley. "They've been willing to start at the analyst level on the basis that it's a chance for them to redirect their career. Then we've created a path to catch them up."

A lack of human resources should not be an impediment to established secondaries firms, which have a track record of retaining talent, says Feeney. "Investing is an apprenticeship model – you bring people up through experience and train them. I think if you are trying to start a new secondaries fund from scratch, that's where it's very difficult." ■