The wonder years

Richer, deeper, more complex, more diverse, more granular: these could all be used to describe the evolving secondaries market. We gathered six experts to discuss the intricacies of an industry that is blooming and booming. By Isobel Markham and Marine Cole

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From left: *Anthony Shontz, Michael Pugatch, John Rife, Scott Beckelman, Daryl Li, Christophe Browne*

The secondaries market is breaking new records as it continues to firmly establish itself in the private equity landscape.

This was the consensus around the table in early April when four secondaries buyers, an advisor and a lawyer gathered at the Debevoise & Plimpton offices in midtown New York to discuss recent developments in the secondaries market.

There was $74 billion of secondaries transactions completed in 2018, according to data from Greenhill – more than three times 2008 transaction volume of $20 billion. Nearly every part of the market saw activity.

A large chunk of that record transaction volume continues to come from LP portfolios, with deals over $500 million representing 59 percent of total volume globally in 2018. In particular, very large portfolios have proliferated, including Japan's Norinchukin Bank's recent sale of $5 billion-worth of private equity fund stakes.

BELLWETHERS

"Ten years ago, $1 billion deals were bellwether and there were maybe one or two a year," says Scott Beckelman, a managing director in Greenhill's capital advisory group. Nowadays, they are much more common in the market and the multi-billion transactions are the novelties. "This won't be the last $4 billion or $5 billion portfolio that we talk about."

Existing and new factors are driving institutional investors to sell on the secondaries market, primarily active portfolio management. Sophisticated LPs may be consolidating the number of GP relationships they have or selling relationships that didn't provide them with co-investments. Some large portfolio sales of fund interests are also driven in part by investors wanting to unload risk ahead of a potential downturn.

"We're spending an increasing amount of time with CIOs who are conscious of the fact that we are 10 years into a bull »

"The proliferation of opportunities has probably grown faster than industry resources

Anthony Shontz

» market and they're starting to de-risk," Beckelman adds. "It's not something you necessarily need to do at one single point in time, and given the liquidity in the secondaries market, [LPs] are now able to de-risk via multiple sales over a one- to two-year period."

Such large transactions above several billions of dollars have new implications for secondaries buyers and the way they conduct processes. Buyers can syndicate or find other ways to tackle mega-portfolios.

"We like to bring in our co-investors, which are part of our LP base, into our secondaries transactions, especially the $1 billion-plus transactions," says Daryl Li, a managing director at Ardian.

Both in the LP portfolio space and in the GP-led arena, deals are plentiful and keeping secondaries firms busy.

"This is one of the big changes in the industry that we've seen in the past couple of years," says Anthony Shontz, co-head of Partners Group's private equity integrated investments for the Americas.

"The proliferation of opportunities has probably grown faster than industry resources. We have a large team dedicated to the strategy, and over the past couple of years, we've found we increasingly have to triage what we look at. We invest in about 2 percent of the opportunities we see. Buyers narrow the deal funnel pretty quickly and really engage on opportunities that fit their strategy and where they have an operational advantage."

Firms around the table have been hiring either to expand the universe of investments they cover or to gain specialised skills.

"We want to ensure thorough coverage of our existing database, and as our fund of funds universe grows, we need to grow our team and resources," says Li. "It was a strategic decision on our part to increase our team size to approximately 80 people by the end of 2019, hiring at the junior level in order to increase coverage."

GP-led deals also gained in importance in 2018, with GP-led activity representing about $24 billion, or 32 percent of total volume, according to Greenhill. The quality of primary GPs taking advantage of secondaries has also gone up, including high-profile firms such as Warburg Pincus, BC Partners and TH Lee Partners.

With better quality assets, the market has seen increased competition among secondaries buyers focused on GP-led deals.

"As these transactions grow in volume and in size, we're certainly seeing more participation in this part of the market, including from firms who migrated strategies to participate there," says Michael Pugatch, a managing director at HarbourVest. "It is such a vast growing part of the market that incremental participation is okay."

GPs increasingly better understand the proposition of a GP-led transaction and how it can help them unlock more time and/or more money to continue to grow an asset and reach a liquidity event.

"The contingent the secondaries market has changed the most for are actually GPs, who I think five or six years ago really looked at the secondaries market with a slight feeling of dismay," says John Rife, a partner with Debevoise & Plimpton's funds/investment management group.

"That has changed hugely. GPs today see a real symbiotic relationship with the secondaries market and real potential as the perception of the market, and the types of transactions we're doing has evolved. That relationship is turned upside down."

Not all secondaries buyers are embracing GP-led transactions. Some still find them too risky, others may not have the skills to be able to participate, or they may simply find they can produce higher returns in other parts of the market.

"We fall into the camp of not being a buyer in GP-led transactions," says Li.

"We see more value in the large LP portfolios, because of the way our business model is set up. For us, the risk/return profile of a GP-led transaction isn't the same as the risk/return profile of large LP portfolios. Very often, you do need to underwrite the GPs' case to make the required return. Very often, the exits are pushed out in these transactions as the GP needs time to »

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» create value in these underlying portfolio companies. You get less liquidity back in the early years, which for us is different from a typical secondaries transaction."

As secondaries buyers choose their sweet spot, it's undeniable that the GP-led part of the market will continue to evolve. In April, the Institutional Limited Partners Association issued its first best practice guidance on GP-led secondaries, covering LP engagement, the role of the LPAC, disclosures, fees and expenses, the role of advisors, notification periods and recommendations for LPs, among other areas.

"We're still in the early phases of the development of that asset class," Christophe Browne, a managing director at Intermediate Capital, says of GP-leds. "It was $24 billion last year and that was a big rise from approximately $2 billion in 2013. The playbook of how to execute these deals in an LP-friendly way is just now reaching a point of maturity and standardisation."

A MORE GRANULAR WORLD

Innovation also continues with the emergence of new types of transactions.

"With these fundless sponsor restructurings, you have folks raising funds on a deal-by-deal basis and then spinning those assets into a continuation vehicle, de-risking the original investor base and moving the assets into a commingled vehicle going forward," says Rife. "Those are pretty novel transactions. Argonne was the first one we saw and we've seen a few more since then."

Pugatch also notes the recent rise of single-asset secondaries, as well as transactions involving GPs looking for ways to reduce single-company exposure or where the GP owns an asset that fundamentally doesn't align with the remaining assets in the fund.

"That's a trend that only in the last 12 to 18 months we have started to see with a lot more frequency," he says. "It really resonates with the GPs as another means to be able to generate liquidity for an existing investor base."

> **I would expect a downturn to fuel the GP-led asset deal space**
>
> John Rife

The added risk attached to these transactions means there's a high bar associated to all steps of the process, as Browne explains.

"We just have to find ways to mitigate the risk of that concentration," he says. "We can do that through more intensive upfront asset-level underwriting, in terms of management meetings and site visits."

Treating such investments like buyouts, he adds that risk mitigation also takes place through active management post-transaction.

As other parts of private markets

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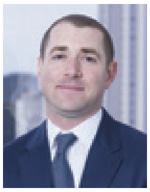
> Daryl Li

develop, such as private credit, a secondaries market is also growing around those assets, albeit with new implications as the return profile varies.

"A lot of these debt portfolios don't come through the traditional secondaries channels or intermediaries," says Shontz. "The buyer universe is also different. If you're pricing these portfolios for a private equity-oriented fund, it's probably not a good fit. But if you're pricing them out of a debt fund or a permanent capital vehicle, then it is likely to make more sense."

Soaring transaction volume and acute innovation are not the only signs that the secondaries market is doing just fine. Secondaries fundraising is also going strong »

MEET THE ROUNDTABLE



Scott Beckelman is a managing director in **Greenhill**'s capital advisory group. Based in New York, he is primarily responsible for advising LPs and sponsors on the sale and restructuring of their fund and direct company interests. He joined Cogent Partners in 2005.

Christophe Browne is a managing director at **Intermediate Capital Group** based in New York. He is part of the firm's strategy equity team and focuses on GP-led private equity transactions. He previously co-founded NewGlobe Capital Partners in 2012 before joining ICG in 2014.

Daryl Li is a managing director at **Ardian** in the firm's New York fund of funds, which makes both primary and secondaries investments and co-investments. Ardian, which he joined in 2010, focuses mainly on LP portfolio transactions, particularly at the large end of the market.

Michael Pugatch is a managing director at **HarbourVest** in Boston focusing on the origination and execution of secondaries investments from LP portfolio sales to more complex transactions including GP-led deals. He joined the firm in 2003 after serving at UBS Warburg.

John Rife is a partner in **Debevoise & Plimpton**'s funds/investment management group, advising sponsors and investors on secondaries transactions including fund restructurings and other sponsor-led liquidity transactions. He also advises sponsors, including secondaries buyers and funds of funds, on fund formation.

Anthony Shontz is co-head of **Partners Group**'s private equity integrated investments for the Americas, focusing in part on secondaries transactions. He is also head of the firm's Denver office. He joined Partners Group in 2007 and previously worked for Pacific Private Capital.

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with buyers raising mega-funds – despite a slight dip in fundraising in 2018 to $32 billion in total funds closed. It's hard to see what could derail the market and change these dynamics.

"Over the short term, obviously macro disruptions – whether it's an equities market dislocation or some significant geopolitical issues," says Shontz. "That could cause sellers to take a step back and at least pause."

In the last recession, secondaries buyers realised sellers had other options for liquidity besides the secondaries market in times of distress.

"One thing that we learned in the last downturn, when there was such a dramatic bid-ask spread and disconnect between where sellers were looking to transact and where buyers would perceive value, is that a lot of our largest clients opted to hold or otherwise shift the portfolios that they were looking to sell," says Beckelman.

Secondaries market participants also learned to adapt to market conditions and to be more creative with deal structures.

"One of the other things you've seen in past periods of volatility or dislocation is a pivot to other structures and being able to structure liquidity solutions to sellers involving portfolios of private equity assets," Pugatch says. He mentions preferred equity and structured joint ventures as examples.

> ***[GP-led deals are] such a vast growing part of the market that incremental participation is okay***
>
> **Michael Pugatch**

Overall, the participants around the table are optimistic about how a downturn in the economy would impact activity in the secondaries market.

"We certainly view a future downturn as a great opportunity for us as a buyer," says Browne. "If nothing else, most people would agree that the last three or four years have been a market awash with liquidity and almost no distress. If you believe that a downturn will increase illiquidity and increase distress, then I think it will be a great opportunity for everyone around this table."

However, the next downturn will not look the same as the last, particularly in the GP-led part of the market, which was in its infancy a decade ago and has not demonstrated yet how it would behave in a period of stress.

"I would expect a downturn to fuel the GP-led asset deal space," says Rife.

"I would think you have a market disruption that impacts business plans put in place at the time of the acquisition – that creates a natural driver to consider rolling the assets into a continuation vehicle."

One thing is for sure. Secondaries buyers are enthusiastic about the future of their market and about the prospect of further growth, particularly in volume, predicting it could reach the $100 billion mark by 2021. But who's counting. ■