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6.5.21/483
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ROUNDTABLE

The evolving secondaries market

In a recent roundtable, in association with Investec, a group of industry professionals discussed the response of the secondaries market to the pandemic, the growth of GP-led solutions, and predictions on the next big thing for secondaries.

SPEAKERS:

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By *Talya Misiri*

What was the initial response of secondary players to the pandemic and how have secondaries funds performed over the last 12 months compared to expectations?

Graham Thomas: I think the initial response to the pandemic was a fairly normal one: what's happening, what's the extent of this, and crucially, what does it do to valuations? That led to an initial hiatus in the market, but I was personally quite surprised by how quickly the [secondaries] market, certainly on the GP-led side, bounced back in the second half of the year.

In some areas, the shock of the pandemic settled pretty quickly, and in other instances it is still settling down. As a general observation looking at our portfolio, when we did our Q1 valuations in the heart of the first lockdown, we were pretty cautious about it. And, from speaking to other GPs and LPs, I think this is generally true, it wasn't as bad as we had perhaps feared.

I was personally quite surprised by how quickly the [secondaries] market, certainly on the GP-led side, bounced back in the second half of the year.

Graham Thomas

Petra Bukovec: Similar to what Graham said, dealflow significantly slowed down in Q2, especially on the traditional LP side, given the uncertainty in the market. This resulted in buyers being more cautious, but sellers not adjusting their price expectations yet.

On the GP-led market, we didn't see a significant slow-down, and as soon as the summer hit, activity picked up and deal flow remained extremely strong over the second half of 2020 and into 2021.

The traditional LP deal flow activity increased in Q3 and Q4 once valuations recovered and stabilised and we are expecting to see further recovery in traditional LP deal flow in 2021.

Our secondaries deployment was on plan and in line with 2019, although we have tilted slightly towards GP-leds and single asset transactions.

Valérie Handal: One of the singular characteristics of the secondaries market is that assets are purchased based on valuations that date back one to two quarters. Given the scale of the disruption and uncertainty that the pandemic entailed, transaction volumes were very low in Q2 and Q3 last year as secondary investors waited to see its impact on both valuation metrics and operating performance, before deal making picked up again in Q4. As a result, 2020 secondary market volume shrunk by more than a third compared to 2019.

In terms of our own experience, we also deployed more capital in Q4, but given our focus on complex transactions, we remained active throughout the year and our investment pace surpassed that of 2019.

Raj Chall: The two things that I would add is that while there was a slowdown in deal flow during Q2, we tried to play in areas that we believe would lead recovery, such as growth and technology assets. Deal flow eventually recovered in the latter half of the year and similarly, 2020 was roughly in line with 2019 in terms of deployment.

Also, immediately after the outbreak of the pandemic, around Q2, there was a lot of buzz in the market around preferred equity deals. That is something that a lot of secondary players looked at, but there is a question around how many deals were done by players who aren't necessarily focused on a preferred equity strategy.

Ian Wiese: I think everyone would agree that Q2 was a time, especially for GPs, to educate themselves on what liquidity alternatives are available in the market. In fact, I think the number of calls and discussions we had was off the charts. I would go as far to say that banks, including ourselves, generally contact primary and secondary participants, but the tables turned - we were getting the calls, so it was actually a nice position to be in!

I think the alternatives out there for primary GPs were other additional capital, certainly for portfolios that needed a bit of TLC or if there was opportunities for bolt-ons, they were looking for further capital from LPs, which could be a secondary firm.

From our perspective, it was really during Q3 that we saw a lot of discussions turning into transactions. Resonating to what Petra and Valerie said, on the single asset GP-led transaction, the number of discussions we're having on these deals that need a financing element are much greater than 12 months ago.

How can the response of the market this time round be compared to how the secondaries market responded to the GFC of 2008/09? What was the size of the market like then compared to now and in what ways has the sector matured?

Chall: If you take a step back and think about what happened last time versus this time, the big difference between them is the greater speed and size of stimulus applied by central banks, that has led to a strong recovery in markets, including the secondary market.

Market size has grown tremendously since the GFC and was probably around 20 per cent of what it is today. It has also become more complex, with GP-led structured secondaries being much more prevalent now.

Wiese: Firstly, we didn't see a lot of distressed sales. There were structural changes where banks needed to offload some of their private equity exposure, so the dynamics changes, here.

We also saw a bit more concern from large family offices, where they had investments in PE and were worried about distributions versus calls and they were looking at liquidity alternatives to effectively bridge that gap. I would probably say the private investors, who don't have the deep pockets, like some larger LPs, were certainly a bit more worried.

In terms of inquiries versus deals done, the impact wasn't as great.

Handal: The secondary market's response in 2020 was vastly different than during the GFC. Firstly, the GFC saw a wave of distressed selling; that wasn't the case this time. In addition, continued innovation and creativity in the secondary market meant that there were new types of transactions such as GP-leds and single asset deals in the spotlight last year, which have become a key part of the secondary ecosystem that virtually did not exist in 2008.

The Covid pandemic has highlighted the ability for the secondaries market to offer flexible liquidity solutions to owners of assets. The uncertain environment meant that we had a more receptive audience and were able to better educate owners about the possibilities and this translated into transaction activity even during Q2 2020 when the market was at its most nebulous point.

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>
> **Petra Bukovec**

The market has become more sophisticated with more GPs and LPs understanding the value of GP-leds and the volume of activity reflects that.

Valérie Handal

More broadly, how have fund sizes changed? Is there a bifurcation of funds in the secondaries market and do you believe smaller niche strategies will remain relevant?
Thomas: In terms of the bifurcation of funds, the secondary market is now where the buyout market was around 10 to 20 years ago. It is on an evolutionary path, and I think that, increasingly, the secondary market will evolve in the same way the buyout market has, with increased specialisation. GP-leds have seen a huge innovation and I think innovation will continue with more strategies and more niche strategies.

You are also getting more specialised secondaries funds now, whereas five years ago those didn't exist. That is proof of the natural evolution of the market.

How has pricing in the secondaries market been impacted by the pandemic-induced economic downturn? Can fair value be achieved in this economy?
Bukovec: Pricing was definitely impacted when the crisis hit, because of the overall uncertainty in the market, question marks regarding the impact and the extent of the impact on the underlying businesses, how valuations of the underlying funds would fare and that resulted into a widening pricing spread between buyers and sellers. As valuations adjusted, pricing has improved in the secondaries market, especially for high quality assets and Covid-resilient assets.

Overall, given maturity and the size of the market, I think that fair value pricing can still be achieved in the secondaries market.

Thomas: I think pricing depends completely on the nature of the company. For businesses that were not affected, it was business as usual. The difficulty is for a business that's in retail for example, where it's Ebitda has fallen off a cliff, but in theory, that's not the sustainable Ebitda of the business assuming that we'll go back to normal. In my experience, deals like this are just not happening, because the seller, not unreasonably, says the Ebitda is invalid, and the buyer says that they don't believe it yet. And so there will be some structuring required to help bridge those value gaps.

Wiese: I think the question here is what is fair value. Following on from what Graham said, when you have a fund that is reasonably mature and it has an asset that is underperforming, but the GP knows the business very well and wants to make sure that it does achieve what it believes to be is fair value, that's exactly where single-asset GP-leds could be an option. Making sure that it can continue growing and knowing the asset.

Where the market has changed, is that we are looking to understand assets and take a clearer view. More diversity doesn't always mean better because when things do come back to normal and stimulus runs out and Covid adjustments are no-longer there, how is the portfolio going to look? If you have to analyse 40 or 100 companies versus four, I think you can take a much better view on a more concentrated portfolio.

According to Investec's latest survey, 97% of respondents expect GP-led solutions to increase or stay the same. What has caused this increase in appetite for GP-leds over the past few years?
Chall: I think it's both sides of the equation, with both demand and supply increasing. GPs are clearly getting more comfortable with this idea [GP-leds], as more transactions complete in the market, more and more GPs are noticing that LPs will

consider this solution.

Going back a few years, these types of transactions may have been criticised as they were viewed as GPs being stuck with their assets. Now, however, we are seeing much more high quality GPs with high quality assets using these solutions. So I think it's now a viable option for GPs when it comes to selling their businesses.

There are also a number of traditional M&A bankers who are trying to build their expertise in doing these types of transactions. This isn't just from reading about the increase in GP-leds in the press, but also from GPs themselves stating that they want to consider this as an exit route. It seems that the more this solution becomes entrenched in the market, the more it feels like it's here to stay.

Handal: I absolutely agree that the GP-led market is here to stay and will continue to increase. The pandemic has given GPs who may have been skeptical about GP-leds, time for pause to explore all potential solutions and routes for exit. As a result, the market has become more sophisticated with more GPs and LPs understanding the value of GP-leds and the volume of activity reflects that. We're also seeing GPs who had initially tentatively completed a GP-led a couple of years ago now actively looking to do another and becoming repeat sellers. Given this, I think GP-leds are here to stay.

Ian, how have financing solutions around GP-leds changed and has this increase in appetite for GP-leds impacted the financing market?

Wiese: One thing that I would say as a theme is that we've seen some known, large secondary players stepping in to consider GP-leds and realising that some of their peers are ahead of the curve. And, one of the themes of the past couple of months has been that participants who have not normally used a financing solution in GP-leds are also dipping their toes into that part of the market.

A lot of the secondary players have inherently been conservative, however, and have said that as we are in a time of uncertainty, when these solutions are used, they will be used modestly and I think that is key. Understanding what is the rationale of using a financing solution, is it a bridge to exit, is it in relation to a specific asset, it is to assist co-invest or mandates that do not benefit from financing solutions that may be available to the main funds? On the whole, the one thing we have seen is that some secondaries funds are often not allowed to deploy more than X per cent into a single asset in certain types of transactions and we've seen side vehicles being raised for that purpose, similar to preferred equity being raised by funds as a side car vehicle. So, I think the theme of sophistication and ensuring that the financing solution is appropriate to the specific situation has been key.

What is secondary firms' appetite like for preferred equity? How has this changed and what is causing this shift?

Chall: In Q2, there was a lot of buzz around preferred equity, and some traditional secondary players took a hard look at those opportunities. A lot of those deals from the early part of the pandemic had attractive pricing, but that quickly contracted and the market is now back to a pre-pandemic state where returns from preferred equity deals are distinct from secondary private equity returns.

Are you seeing leverage solutions in the market becoming more mainstream and accepted by LPs?

Bukovec: In my opinion, leverage has played an important role in the secondaries market for a while now. It has been used widely in the market, especially the fund level facilities that are used to bridge and recycle early distributions. As such, I wouldn't say that there has been a significant change in the use of leverage in the secondaries market. Given the early distributions expected from secondary transactions, it is a very good way to efficiently use capital in the fund and improve net performance to investors and as such the secondary market has been using that for a while.

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Handal: Leverage has become a part of the secondary market. What you do find is that different players have different attitudes towards that leverage. And so, there's the LP side of the market, where some are much more aggressive than others and historically, leverage wasn't very present in more concentrated types of transactions. What we have seen as the market and players have evolved, is that their attitude towards leverage has shifted over time and people are becoming more sophisticated with their strategic use of leverage to give them a potential edge, to win an auction perhaps or to be a bit more strategic around their bids. There are many ways that you can use leverage as a tool to fine tune your bid and some players have used that more than others.

Wiese: Subscription lines were seen as a dubious tool a couple of years ago and that has become an accepted working capital management facility. Then, we moved onto more bespoke, structured transactions such as leverage of preferred equity instruments being quite attractive to some secondary players to get those returns to where they need to get them to. There's a strategic reason for using leverage. While it is in no one's interest to increase the structural risk within the system, where it makes sense and where it can be deployed, leverage is used. In 2020, we saw a step down in the use of leverage for a while as transaction volumes also decreased; because ultimately, valuations are key, for banks and secondary players.

The key to using leverage is having dialogue between banks and funds to explore options and to ensure that the option from a risk-adjusted return perspective makes sense for involved parties. This should be both from a bank's side, and also from the secondaries house.

What is the next big thing for the secondaries market? Where are we seeing a continued evolution?

Thomas: I think there has been a lot of evolution in the secondaries market over the last 3-4 years. For example, if you look at the rise in GP-led, single assets etc., which have been used for perfectly good reasons and are really sensible evolutions of the market.

I hope that there will be a little bit more specialisation, whether that's through firms like us, who are specialised in a specific area, or whether it's bigger managers who have specialist teams focusing on those specialist areas. I think we will get more of that and I think that is the natural evolution of the market as is happening in secondaries.

Chall: We could see annual transaction volume growing to $100bn. Part of that volume increase might be driven by new buyers entering the market and more traditional M&A advisors intermediating secondaries, especially GP-leds. GPs have become more comfortable with pursuing GP-leds, during 2020 they were a large driver of volume and will likely continue to be a big part of the market in the future.

There is also a question around SPACs getting involved in the secondary market. There's currently around $60bn of SPAC dry powder out there with ticking timelines of 12-18 months. They could find the secondary market as a potential avenue for deals.

Overall, I wouldn't underestimate the strength of the secondary market and its ability to innovate. Over the years it has institutionalised, generated strong returns for LPs and will remain a credible and growing part of private markets allocation for LPs.

Handal: In addition to what has been said, we forecast the return of LP portfolio transactions. As discussed, activity naturally slowed last year, and we think there are a lot of great assets waiting to come to the market when Q4 valuations are published.

We expect to see an increase in volume of both LP and GP supply due to deployment numbers, which would indicate a strong market growth in 2021.

Wiese: I think we are not out of the woods as yet. I think the need for liquidity solutions - there was a lot of talking and investigating around this last year as the market recovered quite well, or there was government stimulus to assist.

Taking a bearish view, I would say that I think there may be a second wave of liquidity needs arising and the likes of everyone on this panel will be well-positioned to assist and it will present all of us with new opportunities for the right transactions and the right assets.

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> **Ian Wiese**