

# Secondaries: What does the future hold?

As part of the BVCA Alternative Fund Strategies Conference, James Duffield, our Head of Business Development, moderated a virtual panel discussion on the outlook for the private equity secondaries market. James was joined by Matthieu Ducharme of Northleaf Capital Partners, Patrick Knechtli of Aberdeen Standard Investments and Inigo Weston of Ardian Investment.

**Moderator, James Duffield (JD):** From a secondaries perspective, 2020 was a very big year indeed for fundraising. Do you think that's a trend that will continue?

**Inigo Weston (IW):** If you look at the 15 largest funds that raised between 2006 and 2008, you won't see any secondaries funds in that list. Yet if you look at fundraisings in 2019 and 2020, you will see four or five secondaries names in the top 15. That reflects the institutionalisation of the secondaries market, as well as the movement of the market to cater for a regular supply of larger sellers, in particular public pension funds and sovereign wealth funds.

Secondaries took a larger share of the total volumes raised in 2020, but that is also a reflection of what was just a very busy year for secondary players. If you consider that, almost all the large secondaries funds finalised their fundraisings in 2020. So, yes, the market is growing, but I think it will represent a smaller portion of the market in 2021.

**Patrick Knechtli (PK):** Investor appetite for private markets generally is growing, and secondaries is one of the fastest-growing elements within that. I think it has now become a mainstream element of investor portfolios. I started in secondaries almost 20 years ago. At that point, it was about educating investors on the benefits of secondaries, talking about diversification, and getting quicker cash flows back. Today, those benefits are all well understood by investors. Now,

with that additional money coming into private markets, plus the innovation that you are seeing in deal-doing, the conditions should help drive the growth of the secondaries market.

**Matthieu Ducharme (MD):** Just putting things in perspective, the secondaries market is still a fraction of the overall private equity market of around \$3.5 trillion. And, if you look at the penetration rate of secondaries, the amount of net asset value (NAV) traded every year is still just roughly 3% to 4%, compared to the overall volume of private equity NAV available. So, still a long way to go. But the more liquidity you bring into what used to be an illiquid asset class, the more you can attract new investors into the private equity industry.

**JD: There must be a fair amount of dry powder waiting to be put to work. What are you seeing on the demand side, in terms of deals to be done?**

**IW:** Looking back to 2016, 2017 and 2018, despite increased fundraising activity and lots of dry powder, the massive increase in deals completed meant that the ratio of dry powder to secondary deals closed actually fell. They fell from around 1.8x = to 1.3x. 2020 is an exception because deal volumes have been low and, given all the fundraising, dry powder is high, but in general the growth in the number and size of transactions have been big enough to accommodate the increase in fundraising. As more deal variants have emerged, it allows for a greater portion of that dry powder to go to different forms of private equity secondaries deals – such as General Partner (GP)-led or single asset.

**PK:** The GP-led phenomenon is only just beginning. I think 50% of the deal volume last year was GP-led, which is an incredible progression from where we were back in 2018. GPs understand secondaries, and how to use them in terms of responding to liquidity needs, in ways that were not even considered ten years ago.

**JD: The secondaries market is dominated by a few large players. Do you see that continuing,**

## **given the amount of new money coming into the market, or could we see some structural changes?**

**PK:** When the secondaries market was just starting out, most of the big firms did a bit of everything. As the market has grown, it has also segmented. Of course, the really large transactions and the large players that do them dominate the headlines. But one of the features of the secondaries market is that people can focus on different niches, and play to their strengths.

We are seeing new entrants into the market with big ambitions in the GP-led space. That's partly because it is challenging to do very concentrated GP-led transactions within a secondaries fund, as you are somewhat limited by the amount of exposure you can take in a single company. The bigger players can raise capital specifically tailored towards accommodating more concentrated exposure.

**IW:** Yes, the diversification of deal type in the secondaries market leaves plenty of room for new entrants filling interesting sectors. But while the market is getting bigger, the actual volumes of capital raised is still concentrated at the top end, so it will remain, volume-wise, a large players game.

**MD:** I don't expect any big shift in the structure of the market in the coming years, given that secondary firms will continue to focus on their relevant segment: for example, we are focused on the mid-market and we want to continue doing small and mid-market deals and you cannot really do such deals if you have a much larger fund to deploy and, even if you invest in these deals, they would not move the needle in terms of performance in a larger fund.

## **JD: The next point is about innovation in the marketplace and the more complex types of deals emerging. Where do you see this trend going?**

**MD:** Preferred equity deals are definitely growing, not just at the fund level, but also at the company level. This is new, innovative and sophisticated, and is clearly filling a gap in cases where the GP needs a solution that banks simply cannot provide. The secondary market has a history of filling the gaps in terms of

liquidity needs, so I'm sure this will continue.

**PK:** We manage a number of fund of funds programmes and have a large legacy portfolio of funds and mandates, often as a result of merger and acquisition activity. Getting liquidity on a fund of funds position is often hard, and sometimes the only way to sell is by taking a big discount. So, we came up with structured programmes where we aggregate pools of assets together, aimed specifically at larger secondary buyers that can price a complex portfolio with a huge amount of diversification. This means of offering liquidity and maximising price for sellers of fund of fund interests would not have been considered five years ago, but has been well received by our investors and by secondary buyers.

Within the GP-led space, we are also now seeing the emergence of single asset deals or deals on very concentrated portfolios. Sometimes these deals involve some of the GPs' best assets - their crown jewels - but they feel they won't get best value through the traditional exit markets. So, instead they look at the secondaries space to provide a more innovative solution for them, allowing liquidity for some investors, but also the ability for other investors (and the GP) to back these best companies for the next three to five years. Each GP-led deal has its own complexities and can be challenging for all the relevant stakeholders, in terms of understanding and managing the pricing dynamics, deal structuring and the potential conflicts of interest. But the secondaries market has been innovating and adapting well to these challenges, and we are still just at a very early stage in the evolution of GP-led deals.

**IW:** It's amazing we've got this far without mentioning COVID, but both preferred equity and single asset sales have been influenced by the pandemic. There are some sectors where GPs do not know what the future is going to look like over the next two or three years, but they feel they have an asset that is robust, and they want to keep it. Similarly, with the preferred equity side, often there are single assets that require a cash injection, but the financing isn't available from LPs. So, the secondaries market is providing an opportunity for LPs to continue to share the upside, without supplying that additional cash. That has been an important development.

**JD:** One of the problems with innovation is that it

## **often comes with potential side effects. For example, how can conflicts of interest be managed?**

**MD:** That is already front of mind for people operating in this industry, and to some extent the industry has been regulating itself so far. No-one wants to be on the wrong side of these issues. For example, with a GP-led deal, having a third-party intermediary involved helps to manage potential conflict and steer the interaction between the GP and its LP. Overall, I think the secondaries market has evolved very positively on the conflict management side of things, particular in terms of transparent access to information.

**PK:** From a buyer's perspective, the key is to look at the motivations behind the GP doing the deal. As I mentioned, we have a big portfolio of fund interests and we are on the advisory boards of a number of these funds. The big question for us is whether the GP has really tested the market in terms of the valuation. People need to make sure they understand why this is a fair exit value for the existing investors. The best situations are those where there are very specific reasons why a particular business can't be sold at that point in time, and why it makes sense to buy more time for the GP.

My other point would be around advice. I think intermediaries have really stepped up in terms of the quality of advice they are giving GPs. In the past, you could argue that intermediaries tended to focus on the LPs as sellers, with GPs more of a side conversation to get the consent of the transfer of the funding interest. Today, there is now a much more engaged process, and intermediaries have upped their skill set, in terms of how they are offering advice and managing the process. That has been a welcome development in the secondaries market.