R O U N D T A B L E

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# Secondaries gathers strength to navigate the crisis

*The sector's resiliency and innovation will allow it to weather the current storm. Six market participants discuss how with Marine Cole and Isobel Markham*

The secondaries market has been preparing for a much-anticipated economic downturn for several years, but hardly any investors predicted it would be prompted by a global pandemic.

While the financial world grappled with the new environment prompted by the spread of covid-19, four secondaries buyers, an advisor and a lawyer gathered at the end of April via video conference call.

Andrew Ahern, partner at Debevoise & Plimpton; Jeff Akers, head of secondary investments at Adams Street Partners; Briac Houtteville, managing director at Greenhill; Patrick Knechtli, head of secondaries at Aberdeen Standard Investments; Steve Lessar, managing director at BlackRock; and Tristram Perkins, managing director at Neuberger Berman, discussed the state of the market as the crisis erupted, how their teams are adjusting to the changing conditions, and what that new normal will mean for the rest of the year and the role of secondaries going forward.

The secondaries market entered the crisis in a position of strength, more relevant to private equity than it was prior to the last crisis. It is generally better understood and more widely accepted as a provider of liquidity in an asset class that is still largely illiquid.

Secondaries posted its highest volume on record in 2019, with $88 billion in transactions, compared with $20 billion in 2008, at the onset of the global financial crisis, according to data from Greenhill.

The diversity of deal types, particularly the development of GP-led transactions, is also a testimony to the creativity in the market. In 2009, GP-led transactions were few and far between and typically associated with troubled assets and struggling GPs. This is no longer the case.

"The GP-led side of the market was really not in existence in the way it is today and I think one of the big changes in the last two or three years is GPs' understanding of the solutions available, and their confidence to proactively access the market has increased dramatically," says Akers.

At the same time, for the past few years pricing has been high, especially for high-quality GPs, which has enticed many LPs to tap the market as sellers of small and large portfolios.

Market conditions changed quickly once covid-19 began to spread globally. For now, it is mostly on pause, with no new major transactions emerging. The spreads between bid and ask prices are wide, and market participants await adjustments to net asset values.

In the meantime, they are actively working the phones and video conference calls, reaching out to LPs and GPs to understand the state of portfolios and where liquidity might be needed in the coming quarters and years.

"Volume will be lower than what we had predicted six months ago," says Lessar, although he acknowledges this is only momentary.

"The market right now feels like it's treading water: above the surface not a lot appears to be happening, but people are kicking furiously below the surface. That's what's happening in the secondaries market right now – a tremendous amount of conversations, especially on the GP side of the equation. These conversations are the pre-cursor to the uptick in investment activity."

## Bracing for a restart

Most of the roundtable participants anticipate activity will pick up in the second half of the year, with the bulk of these discussions happening in the background centred around GP-led deals.

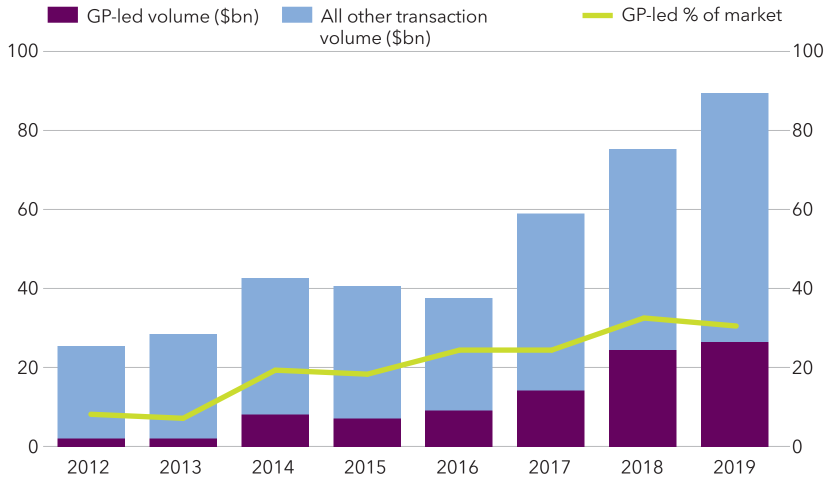
As the M&A market struggles and some troubled companies take longer to accomplish desired growth, GP-led transactions can allow capital injections into legacy assets and into funds that no longer have access to primary funding.

"We're talking with sponsors about creative ways they can access capital and whether a GP-led restructuring would make sense," says Ahern, citing single-asset transactions.

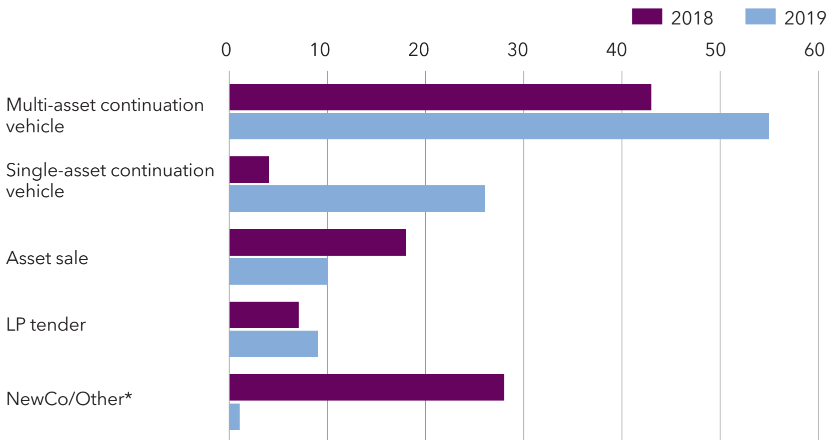
"Preferred equity transactions are also getting more attention right now, not just because they can be a tool for

> *"We'll see more customised transactions designed to deal with specific liquidity needs of specific GPs"*
>
> **ANDREW AHERN**
> **Debevoise & Plimpton**

**It was a record year for secondaries transaction volumes in 2019, although growth in GP-led deals slowed**




**Continuation vehicle transactions represented 81% of the GP-led market in 2019 (%)**




*Includes investment team spin-outs

Source: Greenhill

**Jeff Akers**

Head of secondary investments
Adams Street Partners

Akers leads the secondaries team at Adams Street Partners in Chicago. He was promoted to this role in 2016 after joining the firm in 2006. He previously worked for LEK Consulting

**Briac Houtteville**

Managing director
Greenhill & Co

Based in London, Houtteville joined Greenhill in 2015 as part of the acquisition of Cogent Partners. Prior to joining Cogent in 2009, he was a manager at Ernst & Young Transaction Advisors Services in Paris

**Patrick Knechtli**

Head of secondaries
Aberdeen Standard Investments

Knechtli is the head of secondaries at Aberdeen Standard Investments in Edinburgh, having held the same role at predecessor firm SL Capital Partners since 2009

**Andrew Ahern**

Partner
Debevoise & Plimpton

Ahern joined Debevoise in 2005. Based in New York, he focuses on advising sponsors of private investment funds and is a member of the Alternative Asset and Secondary Investment Group at the firm

**Steve Lessar**

Managing director
BlackRock

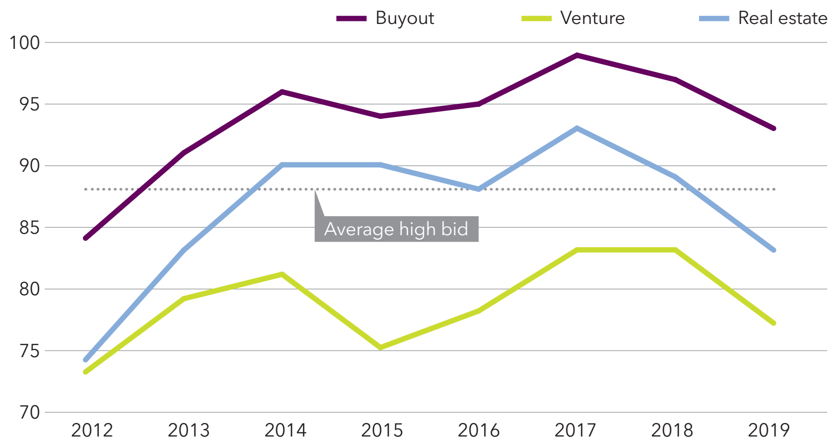
Lessar is co-head of secondaries and liquidity solutions in the private equity partners business of BlackRock Secondaries and Liquidity Solutions in New York. He joined in 2018 from Goldman Sachs & Co where he was co-head of the private equity secondaries business

**Tristram Perkins**

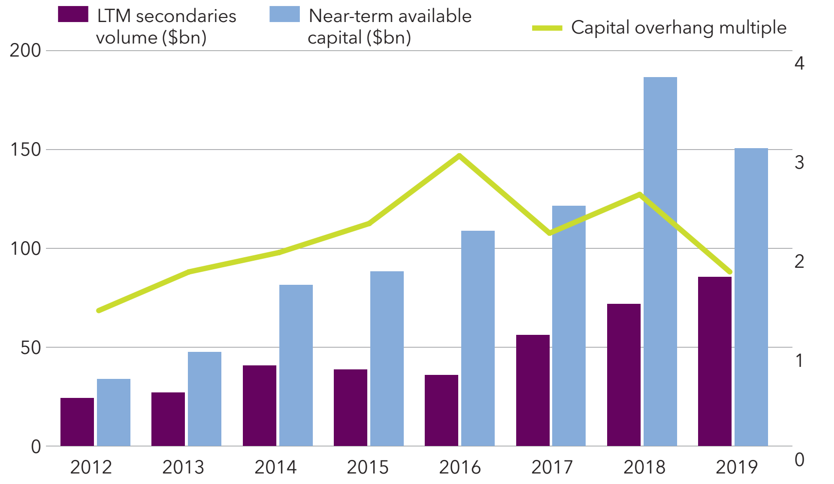
Managing director
Neuberger Berman

Based in New York, Perkins is global co-head of secondaries private equity at Neuberger Berman, overseeing origination and valuation of secondaries investments. He joined the firm in 2004 from Deutsche Bank

**Pricing had already started to drop in the last two years, but is expected to remain robust for performing managers (% of NAV)**




**The capital overhang is the lowest it's been since 2013**




Source: Greenhill

> *"I think LPs are much more educated on what secondaries funds deliver"*
>
> **PATRICK KNECHTLI**
> **Aberdeen Standard Investments**

distributing capital to LPs, but also as a potential way to access capital for underlying portfolios."

Houtteville cautions that the bar and selectivity will be higher for GP-led deals, based on a recent Greenhill survey of investors, which found most respondents will consider single-asset deals and more concentrated deals mainly with proven managers and if the assets are resilient and of good quality.

"For GP-led transactions, I think the priority will likely be given to the ones which have an element of diversification," he says. "On the single-asset deal, if I look at the recent survey we just conducted, you can see it comes in last, but I would expect that if you have a strong and resilient asset managed by a proven manager to come to market, it will be looked at very carefully."

Ahern adds: "We think we'll see more customised transactions designed to deal with specific liquidity needs of specific GPs.

"For the secondaries investors looking for creative opportunities to apply significant capital to a particular situation, as opposed to a macro-level strategy of buying portfolios, it's going to be an opportunity-rich environment. But there will also be a lot of landmines out there. It should be an interesting space to participate in over the coming quarters."

Views were more split on when and in what capacity portfolio sales will come back.

Perkins notes GPs have increased their capital calls since the beginning of the crisis, which he anticipates could in turn spur secondaries transactions, although most likely not immediately.

"Part of that is driven by a sense of opportunism and part of it is about building a defensive war chest," he says. "My sense is that a decent [part] of that capital call activity is being used to pay down subscription facilities or working capital facilities at the fund level. I think it accelerates the opportunity for secondaries buyers if net [in]flows reverse to net outflows."

Lessar thinks some LPs may take the opportunity of the crisis to reconsider their allocation to private equity, which can often be seen as resource intensive both from a time and money perspective. "Maybe there's a movement toward rebalancing and reconstructing of their portfolios," he says. "Then we think there are definitely portfolio sales that will come."

But from a buyer's perspective, the diversity inherent to large portfolio sales and the challenged access to leverage might make them more difficult to close unless LPs are willing to compromise on pricing. Perkins believes LP portfolios will take a little longer to come back and that transactions will likely take place starting in 2021 only.

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> **JEFF AKERS**
> **Adams Street Partners**

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> **STEVE LESSAR**
> **BlackRock**

"About half of the capital in our market is in the hands of the big index funds," he says. "That's a tough segment right now. I don't see that segment of the market shining. It's going to be much tougher to buy big diversified pools of private companies because there will be winners and losers and you will have to be a little bit more selective."

After the global financial crisis, many large portfolio transactions were driven by distressed sellers in dire need of liquidity. It's unclear whether it will be the case this time around, in part because the LP universe has changed since the last crisis.

"Some of the early sellers in the GFC were listed groups who had an over-commitment to private equity and really had to sell," says Knechtli. "Then the banks followed, as they were still big investors in private equity at that point. They were the most impacted by the financial crisis and many became forced sellers."

At the same time, pension funds are better equipped this time around and have learned their lessons from the financial crisis.

"I think they have a bit more leeway in their allocation targets," Knechtli says. "Trustees and boards understand better the portfolio dynamics and the potential denominator effect. But for other types

Analysis

of investors such as endowments and foundations, which have ongoing liabilities that they need to fund, there may be some distress in those areas."

While sellers may not be distressed from a portfolio liquidity perspective and the market may not see the denominator effect being a big driver of sales at first at least, the crisis may still prompt large sales for other reasons.

"We think there's going to be operating stress at many institutions, endowments, foundations and corporate pension plans that will be closely tied to the underlying operating performances of their businesses," concurs Akers. "That dealflow, that stress, may really rear its head in the second half of the year as opposed to more immediately. That's something we're keeping a close eye on."

Houtteville notes that pricing of portfolios of poorer performing managers had already begun to drop prior to the downturn, but agrees it will remain strong for performing managers.

"We started seeing higher selectivity and in some cases pricing at higher discounts already in the second half of last year," he says. "What we're hearing is that for performing funds, for high-conviction managers, we think pricing will remain high. We definitely will not go back to pricing seen in 2009. For other funds, that will be more complicated. The funds that were already trading at discounts last year, we expect discounts to increase."

## A 'dampening effect' on fundraising

The picture is a bit murkier when it comes to fundraising. The stay-at-home orders and limits surrounding in-person meetings make it difficult to conduct typical fundraising due diligence for LPs.

"At this stage, we don't expect the drop in fundraising we saw during the global financial crisis, although we do expect a dampening effect," says Ahern. "However, there may be opportunities for funds to invest in a downturn, and for secondaries funds that can show investors the benefits of putting capital to work right now."

The roundtable participants remain confident in the resiliency of the secondaries market and even of its ability to shine in times of crisis, which promise vibrant years to come in terms of renewed activity and continued innovation. And as the secondaries market continues to mature, its role within private markets and within investors' portfolios will also continue to evolve.

"There are some investors who see the value in a secondaries strategy that's part of a broader platform," says Lessar. "One of the benefits of the broader platform can be relative value discipline, recognising that secondaries play a specific role in portfolios and the manager should deploy capital in situations where secondaries are the optimal way to access the market opportunity."

The diversification of strategies within secondaries, which began in the past few years, will only become more pronounced as the market matures. At the same time, the growth of the market will come with an inevitable dispersion of returns – among secondaries funds and relative to primary funds – especially for fund vintages from 2017, 2018 and 2019, due to several factors.

"One of them is the quality of portfolios," says Akers. "Price-driven buyers are often buying portfolios that have some issues with them, which is why you are able to buy them at value. Those funds and underlying companies tend to require a benign environment to really maximise the expected value, and they may be the most impacted in the current environment."

Leverage will also be a factor as it becomes less available, impacting those typically relying on it to drive returns. Akers also cites concentration as a factor.

"Historically, secondaries funds were very well diversified, but with the advent of single-asset GP-led deals over the last few years, there have been buyers who have taken more concentration in their funds without maintaining portfolio construction discipline," he adds, which has also translated into diverging returns.

*"It's going to be much tougher to buy big diversified pools of private companies"*

**TRISTRAM PERKINS**
**Neuberger Berman**

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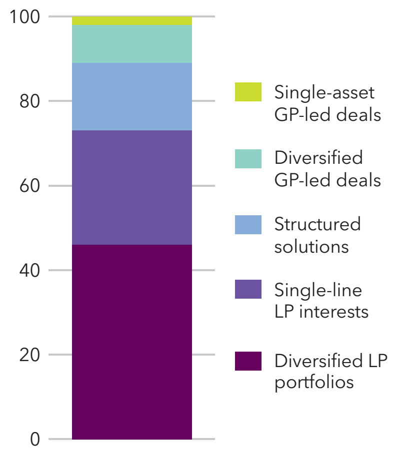
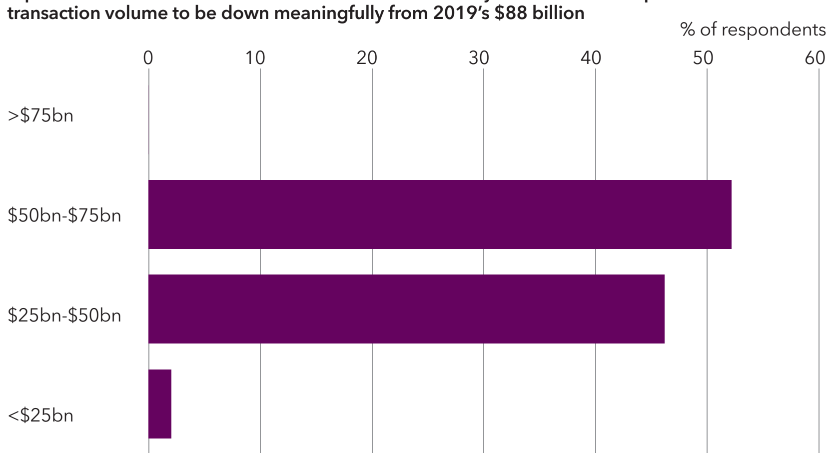
**BRIAC HOUTTEVILLE**
**Greenhill**

Buyers are returning to LP deals as a primary focus (%)

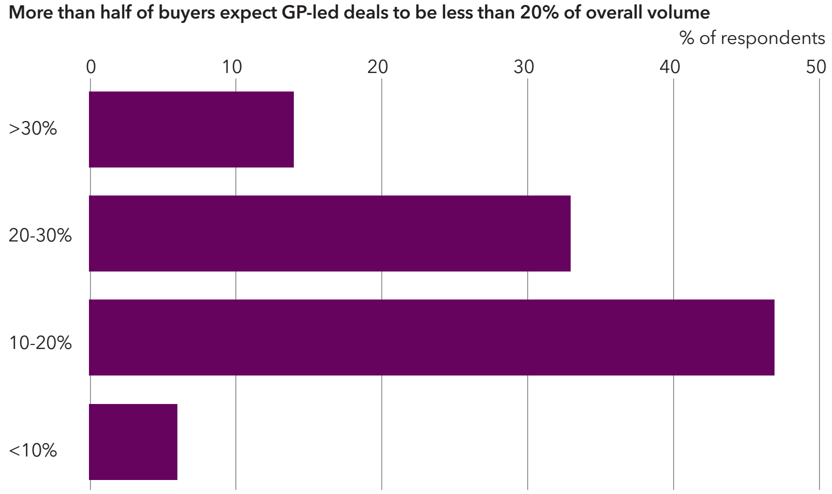



Source: Greenhill

A poll of more than 70 of the most active secondaries buyers found most expect 2020 transaction volume to be down meaningfully from 2019's $88 billion




More than half of buyers expect GP-led deals to be less than 20% of overall volume




Source: Greenhill

This diversification of sub-strategies and dispersion of returns will inevitably impact investors' portfolio construction going forward.

"In terms of what LPs are expecting from secondaries, I think that has changed hugely since the GFC," says Knechtli.

"Buyers have become more specialised and offer investors different risk-return profiles. For example, pace of deployment and the return of cash from some of the bigger funds have been skewed by the increased use of leverage. Having said that, I think LPs are much more educated on what secondaries funds deliver. They understand the roles that different secondaries funds can play within their own portfolio, whether it's one of the more mainstream firms focusing on the larger transactions, or a smaller, more opportunistic player [like us] focusing on niche areas."

Perkins adds: "We've definitely seen a bit of a shift in the use of secondaries from more of a pure tactical investment – to build diversification or early cash-flows, mute the J-curve as groups were building out their private equity portfolio – to viewing secondaries more as a core holding."

All agree one of the strengths of secondaries is it is an all-weather strategy.

"Especially in times of dislocation, it can be attractive maybe to some investors who view themselves as much more nimble and tactical and are willing to take the view that now is especially good for secondaries," says Lessar. "I think there's a wide acknowledgement out there in the market that there will be some really interesting opportunities." ■