Q&A with Jeff Akers: Top 5 Questions in Today's Secondary Market

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KEY TAKEAWAYS

- Deal volume in LP-led transactions for the remainder of 2022 will likely be driven by the speed that GPs mark down the value of assets and the willingness of sellers to take discounts. Additionally, the use of continuation vehicles may rise in the GP-led sector, especially for those GPs who don't want to fully exit a position.
- We expect particularly strong activity from October through December across both traditional LP and GP-led secondary transactions, once second-quarter marks have been digested and market conditions have been fully accepted by sellers.
- We believe volatility can create attractive opportunities for select secondary buyers with conviction and the ability to be targeted in their approach to market downturns.
- As the secondaries market has matured, buyers have become more segmented, leading to deep inefficiencies in pockets such as transactions of less than $200 million, where we think many compelling opportunities can still be found.
- Determining price can be challenging, making it a source of both market inefficiency and opportunity.

Q: How do you expect secondary market volume to evolve in the second half of 2022?

After robust deal volume in the first quarter of 2022, bid-ask spreads widened, lowering volume from April through June. Today's transactions are typically pricing off valuation marks from March 31, 2022, which most buyers would view as heightened, given subsequent public market selloffs. As a result, we have seen many sellers being forced to accept discounts to net asset value (NAV).

Some LPs have recently found themselves seeking to sell private market assets in an attempt to correct for the "denominator effect" — which is created when declines in public markets cause LPs to appear over-allocated to private assets. This has helped drive up the supply of assets for sale, and we believe the unlocking of traditional LP deal volume in the second half of this year will depend on two key factors.

The first factor is the speed that GPs mark down assets to reflect market valuations, and the second is the willingness and/or need for sellers to accept discounts to achieve their portfolio construction objectives.

We expect many GPs to be slow to take markdowns, meaning the volume we anticipate seeing in the second half of the year is more likely to be driven by the willingness and/or the need of sellers to accept discounts.

As for GP-led transactions, volatile markets may heighten the number and/or desire of GPs to use continuation vehicles. Continuation vehicles can be an elegant solution for GPs who don't want to fully exit companies during periods of volatility, while still providing a liquidity opportunity for certain LPs. A potential factor which could reduce the ability of GPs to engage in continuation vehicles is the amount of capital available to complete concentrated continuation vehicles. Again, the attractiveness of these deals is likely to be heavily influenced by the degree to which GPs have marked their assets to an appropriate market value.

Overall, across both traditional LP and GP-led secondary transactions, we expect to see robust market volume in the second half of the year, with particularly strong activity from October through December once second-quarter marks have been digested and market conditions are more likely to have been fully accepted by sellers.

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2. Where do you see competitive advantages in the GP-led market?

While there is a perception that it is hard for secondary buyers to distinguish themselves within the GP-led market, we believe select buyers generally have significant competitive advantages and can differentiate themselves through deal sourcing and access, transaction selection and due diligence, and portfolio construction.

In a continuation vehicle, GPs frequently seek to work with long-term partners of their firm. Having a significant primary relationship, including advisory board seats on a GP's funds, increases the potential that certain secondary buyers will receive access to some of the most attractive oversubscribed or invitation-only opportunities. Over the past several years, buyers have had the opportunity to review hundreds of GP-led transactions, not all of which will perform to expectations. Manager and company quality, duration, risk, and GP/LP alignment differ in each transaction. Buyers with a strong relationship with the continuation vehicle sponsor are more likely to be afforded benefits in selecting among the most attractive transactions. Notably, buyers can create a "moral alignment" with the GPs who will share a long-term goal of success and are equally invested in the transactions performing well.

Finally, prudent construction is critical when putting together a portfolio of potentially more concentrated GP-led transactions. We believe the best buyers of GP-led secondary deals are imposing meaningful concentration constraints at the fund level.

3. How can secondary buyers take advantage of market volatility?

Market volatility can create very attractive opportunities for select secondary buyers. We believe two critical success factors when buying secondaries during market downturns are conviction and the ability to be targeted. A targeted approach allows buyers to isolate the most attractive companies, managers, and sectors from broader sales processes. As previously mentioned, during periods of volatility the transactions buyers review have many characteristics — some better and some worse. In our experience, a targeted buyer can benefit by seeking out specific, durable, and actionable features with the potential to produce strong returns rather than buying an index.

We believe deal conviction is built through GP relationships that enhance the ability of select buyers to perform deep, consistent, and timely due diligence on the underlying portfolios. Participating on fund advisory boards and having access to specific deal leads at the underlying GPs is access that only a select group of secondary buyers possess.

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4. With all of the capital raised in the secondary market over the past couple of years, has it become too competitive?

We believe the secondary market remains significantly undercapitalized relative to other private equity sub classes. The current overhang of capital in the secondary market is estimated to be 1.6x[1] (defined as dedicated capital / LTM secondary transaction volume). Recent deal activity suggests that brokers have been challenged to complete syndications in the market, specifically within large-scale, single-asset, GP-led transactions, due to a lack of dedicated capital and buyers' desire for diversification.

But as the market has matured, we have seen many buyers become more segmented, leading to the emergence of even deeper inefficiencies in pockets of the secondary market.

Perhaps the greatest inefficiency we see today is in transactions of less than $200 million. A majority of the capital raised over the past several years has been in funds greater than $5 billion in size.[2] Many of these are necessarily pursuing larger transactions that allow them to more efficiently deploy funds. However, we continue to believe that some of the most attractive transactions are in smaller funds with more variable valuation policies and therefore feel that the inefficiencies that have emerged in transactions below $200 million are very compelling.

5. Where is pricing in today's market, and how does it differ between venture capital (VC) and leveraged buyout (LBO) interests?

Determining a baseline for pricing in today's environment is particularly challenging, making it a source of both market inefficiency and opportunity. We continue to see the highest quality LBO funds with limited public exposure, conservative to fair valuation policies, and attractive, recession resistant businesses with upside trading above 90% of their March 31, 2022, NAV.[3] At the same time, when any of those characteristics are absent, our data show that it puts significant pressure on pricing below 90%, which we believe is representative of anticipated future markdowns. The depth of bidding for these LBO assets seems to have declined in recent months, evidenced by wider bid dispersion and fewer bids on many processes we are engaged in.

On the venture side, given the magnitude of declines in public markets, a gap between holding values and perceived intrinsic value, and a stalled financing / initial public offering market, we are seeing little demand for venture funds from secondary buyers. Even higher quality venture or pre-IPO growth funds are, in many of the processes we have been involved in, receiving bids below 50% of their March 31, 2022, NAV, making transactions difficult to complete as sellers do not want to take such large discounts.

Finally, we continue to believe that most GP-led transactions need to take place somewhere near 100% of NAV for a GP to bring them to their LPs. So while pricing has not materially changed, we have seen an increase in hung deals and expect that trend to persist for the balance of the year, depending on the quality of the assets brought to market. ■

1. Jefferies “1H 2022 Global Secondary Market Review,” July 2022.
2. Preqin fundraising database as of April 2022.
3. Jefferies “1H 2022 Global Secondary Market Review,” July 2022.

YEARS

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