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Private markets' most undercapitalised asset class

Despite a record year for fundraising, growth in the secondaries market has been hampered by a lack of liquid capital, write Amy Carroll and Adam Le

The secondaries industry is on fire. While a rebound in public markets has, to some extent, alleviated the impact of the denominator effect, a pervasive lack of liquidity continues to drive dealflow across both LP- and GP-led strategies.

At the same time, secondaries as an asset class is chronically undercapitalised. This supply/demand dynamic is creating a truly compelling buying opportunity.

"The need for liquidity, the lack of DPI, the number of investors that are overallocated and the modest amount of dry powder that is available in the secondaries market relative to annual deal volumes – [this all means it] remains more of a buyer's market," says Ben Perl, managing director and global co-head of secondaries at Neuberger Berman, speaking on *Private Equity International's* annual secondaries roundtable.

"No matter how much money secondaries funds have raised, we still have no more than a year and half's worth of dry powder," adds Miguel Echenique, a partner at AltamarCAM Partners. "There is far more demand than supply given the lack of liquidity that investors are facing."

Indeed, M&A volumes were down by 70 percent in 2023 compared with 2021, according to Yann Robard, managing partner at Dawson Partners (formerly Whitehorse Liquidity Partners). "There were as many IPOs in the fourth quarter of 2021 alone as there were across all of 2022 and 2023," he says. "That is how little liquidity there has been in the market."

"We are seeing that managers are simply calling more capital than they are giving back, in part because they recognise that they have to start putting all the capital they have raised to work as investment periods continue to tick by," adds Jochen Mende, executive director and head of secondaries at UBS Asset Management.

Meanwhile, the fact that public markets have experienced a revival has supported secondaries dealflow, rather than dampening it. While overallocation issues are less severe, the impact on valuations – when coupled with greater stability in the macro environment – is making it easier for buyers and sellers to come together on price.

"The market is starting to feel more balanced," says Gavin Anderson, a partner at Debevoise & Plimpton. "The bid-ask spread is less acute, and the LP-led portfolios sale market is active. Both buyers and sellers are there."

"Back in 2022, we were faced with the prospect of hyperinflation," adds Robard. "We didn't know where interest rates were heading. There was a lot

Yann Robard

Managing partner, Dawson Partners

Yann Robard founded Dawson Partners, formerly Whitehorse Liquidity Partners, in 2015. The firm has over $20 billion in assets under management and a team of 175 professionals based in Toronto and London. Prior to founding Dawson, Robard spent 13 years at CPP Investments.

Ben Perl

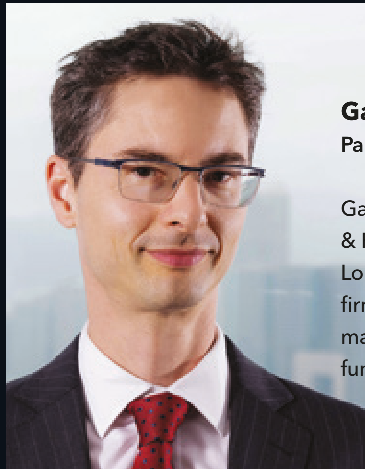
Managing director and global co-head of secondaries, Neuberger Berman

Ben Perl is a managing director of Neuberger Berman, and global co-head of NB Secondary Private Equity. He is a member of the firm's secondaries, real estate secondaries and strategic capital investment committees.

Miguel Echenique

Partner, AltamarCAM Partners

Miguel Echenique rejoined Altamar as a partner in 2013, having previously worked at the firm as an associate investment director. After his initial time with the firm, Echenique worked in the private equity division of the European Investment Fund. He has also worked at Interdin Corporate Advisory and as a lawyer in the M&A division of Garrigues.



Gavin Anderson

Partner, Debevoise & Plimpton

Gavin Anderson is a partner at Debevoise & Plimpton, based in its Hong Kong and London offices. He is a member of the firm's investment funds and investment management group, as well as its private funds transactions group.

Jochen Mende

Executive director and head of secondaries, UBS Asset Management

Jochen Mende heads the private equity multi-manage secondaries team at UBS Asset Management, a busine that forms part of the firm's real estate and private markets unit. He joined UBS in 2018.

of confusion in the market, all of which led to higher optical discounts that impacted LPs' willingness to sell. Today, those optical discounts have narrowed. Public markets are up 20 percent and private equity valuations have yet to catch up, meaning pricing is generally back in the 90s for quality portfolios and many LPs are more willing to transact."

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> **BEN PERL**
> **Neuberger Berman**

Proof of concept

While an equilibrium has been reached in the LP-led secondaries market, the balance of power in the GP-led market remains heavily skewed towards buyers. "There are more transactions being shopped around than there are deals getting done," says Anderson, "although there is more stock moving than there was this time last year."

The challenge here is that the GP-led market is even more undercapitalised than the LP-led market. Despite a phenomenal explosion in dealflow in recent years, this segment of the market is also relatively unproven: the first two reports into GP-led performance data were only released fairly recently, one conducted by Morgan Stanley and the other by Evercore. The preliminary findings are positive, but many believe it is still too early to take a definitive view.

"There just haven't been that many exits," says Mende. "We have participated in over 20 GP-led deals since 2018, and we have only seen one full realisation from a single-asset continuation fund. If you look at the data sets that have been published, the number of transactions included is very small. That said, I do think that all the ingredients are in place for the performance of these deals to be highly attractive.

"You have GPs that are familiar with the assets and are continuing with a value creation strategy that is already in play. And, most importantly, you have very strong alignment in the form of GP rollover and ideally new capital as well. There is every reason to be confident that when enough time has passed to really assess the performance of this part of the secondaries industry, it will be very good indeed."

Echenique concurs with Mende's summary: "The data is pointing us in the direction that we had all hoped for, but I agree: it is too early to tell. Track records are still immature, and the industry has not yet been proven through the cycles."

Echenique is also concerned that LPs are not always happy with how these processes are being run, particularly in terms of the pressure being exerted to sell and a lack of openness around value creation plans. "I think there is a lot more to be done in terms of transparency."

Nonetheless, there is undoubtedly cause for optimism. "The early

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>
> **YANN ROBARD**
> **Dawson Partners**

indications from [the Morgan Stanley and Evercore] reports are encouraging and are in line with what we hoped we would see given the quality of the businesses, the growth rates, the margins, the cashflows and the valuations," says Perl. "Both reports generally show lower volatility than in the buyout market and both show strong performance relative to comparable vintage returns in both the buyout and secondaries industries. While the analysis has its inherent limitations, it is certainly encouraging."

The single-asset conundrum

Despite these encouraging signals, GP-led activity – single-asset GP-led activity, in particular – has been more muted than many expected. Evercore data shows that single-asset GP-led deals represented 19 percent of the entire secondaries market in 2022. These transactions were expected to continue to grow to somewhere between $25 billion and $30 billion last year – however, only $18 billion was actually consummated.

"Single-asset continuation vehicles are now accepted as a valid exit route for GPs, and we think that will continue to be the case," says Echenique. "But the growth of this market is dependent on the availability of capital and the level of appetite for this type of deal."

"Again, this is an opportunity set that is vastly undercapitalised," adds Robard. "In our view, there is no reason why single-asset continuation vehicles shouldn't represent 10-20 percent of annual deal volume in private equity. What is constraining this is the undercapitalisation of the market. We believe there are a lot more potential deals than those that are actually coming to market."

Perl says Neuberger Berman's data supports this thesis. "If you look at the single-asset GP-led deals we have evaluated over the past two years, we estimate that there has been around 50 percent failure across the market. We believe this isn't primarily due to any fundamental issue with the assets or the processes, but probably due more to a lack of capital to support this quantum of opportunity."

Fundraising fortunes

Roundtable participants agree that this lack of capital is not a reflection of low investor appetite for the asset class. In fact, the secondaries market seems to have been largely immune to the brutal fundraising conditions that have impacted other areas within private markets over the past two years. According to data from affiliate title *Secondaries Investor*, almost $118 billion was raised across all asset classes last year, more than double the total for 2022.

However, market participants are at pains to point out that this fundraising success has done little to ease the industry's undercapitalisation issues. "The headlines highlight the fact that the secondaries market has experienced a record year for fundraising, but that must be considered in the context of how much has been deployed," says Robard. "Between 2021 and 2023, $352 billion was deployed and $208 billion was raised – that is 60 cents raised for every dollar invested. Dry powder in this market is shrinking. It is not keeping up

with deal volumes, and that is why we view this as a buyer's market."

"If you put aside fundraising and the availability of leverage," says Perl, "we believe we have somewhere between 12-18 months of actual dry powder available. I can't think of any other private market where that is the case."

Echenique agrees. "We couldn't be further from any kind of bubble, as secondaries as an asset class still represents less than 1.5 percent of total NAV out there."

One solution to secondaries' undercapitalisation problem could come in the form of democratisation. It is widely agreed upon that the inherent diversification that the asset class offers, together with its J-curve mitigation, means the secondaries industry is an ideal candidate for individual investors looking to access private equity.

"The market estimates that there is approximately $150 trillion in private wealth today. If individuals allocated 10 percent of their assets to private markets, which would be in line with institutions, there is potential for $15 trillion in private wealth to find its way into these asset classes," says Robard. "At the moment, that figure stands at just 2 percent, or $3 trillion. That would mean as much as $12 trillion in incremental capital coming to private

Regulatory scrutiny

As the secondaries market grows in popularity, it will inevitably attract the attention of rule makers

When the US Securities and Exchange Commission's new private funds rules were first proposed in 2022, there were concerns that the GP-led secondaries industry would be negatively impacted. As things currently stand, the situation looks less severe.

"When these rules were originally proposed, there were parts that looked pretty scary and people were concerned. But the version that was ultimately passed had some of the rough edges sanded off," says Debevoise & Plimpton's Gavin Anderson. "It is also worth noting that if you are a non-US manager advising a non-US fund, these rules generally won't apply to you, although they may still drive market practice. Furthermore, there is an ongoing court case trying to set aside these rules, so there is still some level of uncertainty. Although the rules have been legally passed, they have not yet come into effect."

Neuberger Berman's Ben Perl, meanwhile, is entirely sanguine about the changes being suggested. "I don't think the GP-led market will be materially impacted. In fact, as a buyer, I probably view them as net positive. There are advantages to having a clearer rule book around the right way to manage a process. It creates a better framework."

Anderson agrees. "Disclosing material preferential economic terms is something a lot of GPs will have been doing anyway, and the fact that it is being formalised and codified is probably a good thing for LPs. Likewise, a lot of continuation fund transactions already include a fairness opinion. If the rules go ahead in their current form, the impact is not going to be enormous."

Nevertheless, it is clear that as the secondaries industry grows in size and sophistication it will increasingly attracting the attention of regulators.

"There is every reason to be confident that when enough time has passed to assess the performance of [GP-leds], it will be very good indeed"

JOCHEN MENDE
UBS Asset Management

markets over the coming years from private wealth alone.

"We believe secondaries provides an interesting entry for private wealth given its highly diversified nature. Secondaries portfolios tend to be more mature and liquid than private equity, and typically mitigate the J-curve effect cashflow pattern seen in many private equity funds over time. If one assumes one quarter of the $12 trillion is allocated to secondaries, that would mean approximately $3 trillion of capital would flow to the secondaries market over the coming years, helping to capitalise it."

Mende adds that, while there is no doubt that the potential of the private wealth channel is significant, there are real challenges for these investors in terms of minimum investment thresholds and the capital call model. "We are therefore seeing momentum growing behind fully paid-in, semi-liquid structures, but we are going to need to see a significant proliferation of those funds if we are to really unlock this opportunity."

UBS is itself in the market with one of these products. "Our conversations with end customers and intermediaries tell us that everyone understands that secondaries offer diversified access in a relatively low-cost manner," Mende says. "But there is still a lot of education required. There is a real risk of misselling around liquidity features, in particular."

Perl agrees that there are still complications to be ironed out with these evergreen funds designed for private investors. "We believe secondaries can represent an attractive option for high-net-worth investors, but it will be interesting to see where things land in terms of the different structures and incentives that are put in place.

"With a traditional closed-end fund, managers are generally going to be disciplined and invest over several years, given a strong alignment through carried interest. Different structures can have different incentives. Another consideration for some structures is that new investors often do not enter at the value the secondary was purchased at, but rather at net asset value. For secondaries strategies that rely more on buying assets at a discount to NAV, as opposed to identifying assets that will appreciate in value over the long term, that can be a real consideration for later, or new, investors coming in."

Anderson points out that there is already a substantial amount of money going into banks' feeder networks. "Those high-net-worth individuals are ultimately investing in closed-end funds," he explains. "But if you want the universe of potential investors to be as big as possible, including widows and orphans [high-dividend, low-risk investments], then more liquidity may be required, ideally more like listed securities. Of course, there are already some listed vehicles out there that provide access to private markets."

"It is rare for new rules to be introduced, but regulators can apply pressure in other ways, simply by focusing more on secondaries transactions using existing rules"

GAVIN ANDERSON
Debevoise & Plimpton

Benchmarking challenges

All types of investors are having to grapple with the challenge of benchmarking secondaries managers as the asset class becomes more multi-faceted and complex.

"Back in the late 90s, the private equity industry was benchmarked as one

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> **MIGUEL ECHENIQUE**
> **AltamarCAM Partners**

[entity]. Today, it would be viewed as foolish to pitch a venture fund against a [mezzanine] fund," says Robard. "We are now going to go through that same evolution in the secondaries industry, with sub-asset classes ranging from LP secondaries to preferred equity, multi-asset continuation vehicles and single-asset deals all benchmarked against themselves. You can't compare one with another given their different risk-return profiles. LPs need to know what it is they want in their portfolio and then choose their managers based on appropriate benchmarking."

Perl, however, says all the benchmarks are relevant. "If GP-leds are going to represent half of the secondaries market, then how can you not look at the secondaries benchmark? But then, if a fund only does 10 or 15 single-asset deals, then that does look a bit like a buyout fund, so you probably want to look at that benchmark as well."

"It would be helpful, for example, if we could find a way to properly benchmark highly levered strategies against those that are not," adds Mende. "But we are not there yet in terms of that kind of granular analysis."

These are all developments that are likely to emerge as the industry continues to mature. This is, after all, a relatively nascent – and, certainly, rapidly evolving – asset class.

"We see the story of the secondaries industry as evolving over three chapters: 2001-11 was the decade of institutionalisation," explains Robard. "Pioneers in the space established themselves, track records matured and the market got validated. Institutions took notice.

"Then, from 2011-21, we had what we call the decade of innovation. A market that had previously been dominated by private equity LP secondaries branched out into credit, real estate and infrastructure secondaries, then into GP-led transactions, and then preferred equity and NAV lending. All of this innovation has led to where we are today in the secondaries market, which is long on opportunity but short on capital. So, we believe the next decade, from 2021-31, will be the decade of capitalisation, where the market continues to scale significantly as it injects liquidity in an otherwise illiquid asset class."

Perl agrees. "The growth of this market will not be limited by the number of GPs looking for partners or the number of LPs looking for liquidity solutions, but rather by a lack of capital formation."

If the secondaries market is able to address this capitalisation problem, then the sky truly could be the limit. ■