Navigating Secondaries Amid Choppy Markets

Disruptive Forces in Investing **January 24, 2023**

Anu Rajakumar: The private secondaries market, a robust sector that focuses on the buying and selling of pre-existing investor commitments to private equity and other alternatives, has considerably evolved in the last decade. But with the challenging macroeconomic backdrop and slower growth on the horizon, investors are grappling with the slower pace of private market distributions, alongside the need to address the denominator effect in their portfolios following 2022's dramatic declines in public markets.

While many investors reset their expectations for reasonable portfolio returns going forward, qualified investors have taken an interest in the secondaries market, where attractive discounts appear to exist due to forced sales by limited partners. So what do volumes look like in the secondaries market from an LP and GP perspective, and why should qualified investors consider an allocation to the secondaries market?

My name is Anu Rajakumar, and to help me answer those questions and much more, I'm delighted to bring back Ben Perl, global co-head of secondary private equity, and welcome managing director in European secondary investments, Philipp Patschkowski, to the show. Gentlemen, thank you for coming on.

Ben Perl: Thank you for having us, Anu. It's great to be back.

Philipp Patschkowski: Excited to be here.

Anu: So, Ben, we had you on the show back in June 2020, which kind of feels like a lifetime ago. Um, and in that episode, you were discussing the market amid the COVID pandemic backdrop. And that was obviously an interesting time because the secondaries market really grew massively during the pandemic. So talk to us about some of your observations over the last two-ish years, and also tell us how did your predictions turn out?

Ben: [chuckles] But it's funny you ask because we went back and listened to ourselves, which-which is always an awkward thing to do, to begin with. But, um, I remember quoting Yogi Berra and saying, "It's always difficult to make predictions, especially about the future." Um, and I will say, while that's challenging, I think we got a lot right when we sat down in June of 2020. If you may recall, at the time, there was a really significant pullback in market activity. As we call it, the bid-ask spread was quite pervasive. Sellers really weren't willing to transact. And we've seen that play out before many times. And we knew to be patient. We had a view that volumes would absolutely return, that the pressures to sell would be very real. And then in some senses, what causes the bid-ask spread, is a lag in private equity values that can self-correct. And in that regard, I think we got it pretty right. Volumes came back. We ended up, last year, or not last year, I guess now in '21, we experienced record volumes. And those record volumes, uh, you know, by a decent margin. And that was driven by both LP and GP-led activity.

So I think, you know, overall I'd give ourselves pretty high marks. The one thing that was different than we expected, was really, I think, a little bit of the pace of the recovery. When we looked at the GFC, it really felt like some of the impact on the economy, that volatility, stung a little bit more, that it reverberated a little bit longer. And so, I think we were surprised by how quickly things stabilized, in the public markets, in the capital markets, and indeed the economy as well.

What I would say, though, I think if we look at it on a longer perspective, maybe we're not done dealing with COVID. And in some senses, I think some of the challenges that we've seen with inflation and supply chains, and, you know, where we are today with market volatility, perhaps it's sort of the next chapter in that story.

Anu: Great. Thank you, Ben. That's a very good overview, and excellent job on that scorecard from a couple of years ago. Now, let's talk about 2022's repricing of the public markets, which has obviously led to an imbalance in many investors' portfolios. And certainly in my role on the Multi-Asset team, you know, we've been hearing from clients over the last few months who've been forced to sell private equity to meet their liquidity needs. I'm curious, Ben, do you think that the selling pressure that investors are dealing with today is even greater than what we saw during COVID?

Ben: Yeah, I think we do. And I hesitate to use hyperbole and say it's a perfect storm. But as we entered '22, we were starting to see what I'll call a numerator challenge, which is many investors experienced outperformance in their private market portfolios. Their commitments got drawn down or invested faster than they anticipated. And so they began the year with more private market exposure than they had anticipated. And that was already beginning to put pressure on people to sort of deal with that challenge or begin thinking about how do I rebalance my portfolio? And then, as we all know, public markets start to correct and correct quite meaningfully. And that starts to create what we call a denominator challenge. So you had the numerator challenge exacerbated by the denominator challenge. And by the time we got to the end of the year, what we saw was a cash flow challenge. Not a cash flow challenge in terms of an inability to necessarily meet capital calls, but a cash flow challenge as it relates to the way people thought about their portfolios and how they'd fund those investments.

The private markets for a long period of time have been self-funding, meaning more distributions come off the asset class than get contributed. And for the first time in many years, that is inverted, meaning capital is being consumed by the private markets, not returned to the capital markets. And as we all know, that's a pretty interesting combination of facts. So as a provider of liquidity, we do look at this market and say it has the potential to be a lot better than prior cycles.

Anu: Excellent. Thank you. And I know so many folks are dealing with numerator/denominator challenges, as you said now, a cash flow challenge as well. Philipp, let me draw you into the conversation here and just ask you, across the pond in Europe where you are, obviously very challenging market conditions and also that increased pressure for liquidity. How are investor viewing secondaries in Europe?

Philipp: I would say in a pretty similar way than in the US. We really think that the secondary market is a global market. The outperformance of private equity was a global theme in 2020, 2021. The changes in the denominator effect with the drawdown in the public markets, that was a global theme as well. And then also the cash flow profile, that's equally a global theme as IPO markets are equally frozen in Europe and North America and Asia as well. And financing markets are more difficult on a global level as well.

Clearly on the investing side and the due diligence side, you want to take local specificalities into account when you're analyzing the investments, but the investors are facing the same challenges on both sides. And it's also a result of the fact that they are using similar models that account for valuations, or forecasts that are sort of within certain boundaries. And what we're experiencing at the moment is something that I would characterize as a tail-end event. And as a result, people are overallocated and face the cash flow issues that Ben referenced. And what we're also seeing is, and that's quite interesting and different to the global financial crisis, is that back then, investors were just putting everything on hold. They were just sitting this out and seeing what happens, and then we start investing again when we have a clearer view of what's happening.

And as a result, people missed out on some of the best vintages over the last one, one and a half decades. And I think that's still in everybody's mind. So investors are trying to think about how they can utilize the secondary market to create that strategic flexibility, create liquidity to continue investing in the current environment.

Anu: Yeah, absolutely. And you've hit on some really important points, including, you know, folks have probably learned from their experience in post GFC, they don't want to miss out on those vintage years. You know, Philipp, we've spoken a lot about the LP side of this equation. So let's pivot to the GP side. How do you think the current environment will impact GP-led volumes?

Philipp: So, the GP-led market has been the fastest growing segment of private equity, I think the alternatives market in general, over the last few years. What we are seeing late last year was a certain pullback in volumes of closed transactions. I think there is a lot of opportunities that are coming to the market. GPs are very interested in pursuing GP-led transactions for a number of reasons, which we can talk about. But what we're also seeing is a certain bid-ask spread still in the market, where sellers may be aiming for valuations that were fair a year or two ago, while pricing has adjusted in the secondary market given the new macroeconomic environment, inflation realities, and as a result of that, valuations have adjusted. But also because of an acute undercapitalization in the GP-led market. And I think that just creates a huge ability to be selective which opportunities to pursue in a limited competitive environment. And as a result, one can achieve interesting valuations. But on the other hand, not every attractive transaction, is finding the right partner to close. So as a result, I think there is a limited pullback in transactions closed, but the opportunities that are coming to the market are growing and I would expect them to continue to grow even further.

Ben: That's such a great point that Philipp makes. I think, you know, as we look at the GP-led market, it really does feel similar to what we've seen in the LP market over many, many years, which is, when volatility first gets introduced, there is a temporary pullback in activity, right? There's a bid-ask spread. In this case, there's also the undercapitalization challenge. And so, as a result, close transaction volumes often will take one step back in order to take two steps forward. But it really does feel like this environment should actually be a tailwind for GP-led.

Anu: So, just on that note, tell us more about this tailwind that you expect to see.

Philipp: Sure. So, with LPs being overallocated, they are also turning to the GPs and asking for liquidity to increase the DPI in their funds. And as we discussed, the exit markets on a global scale are less liquid at the moment. And GP-led transactions do provide a very real liquidity option, and option for LPs to choose to take liquidity or to stay invested. And at the same time, that it also provides the GP to retain control of the assets and continue the further value creation of these assets and participate in the value creation of that going forward as well. So it-it sort of solves two- the two problems at the same time, and sort of a-a nice middle way where the LPs and the GP can optimize the situation they're in.

Anu: Terrific. You know, you both have made a-a really good case here today and talked about some of the tailwinds, um, in this area of the investment opportunity set. You know, many of our listeners will be wondering, how do I think about, a potential GP-led investment during a time like this? What would you say to them?

Ben: It's a wonderful question. And I think one of the things that we really appreciate about GP-led investing is the ability to curate the risk that you're taking. This is not a market, as a generalization, where you want to blindly buy diversification. It's not a market where you want to rely just on a discount to reported value or financial engineering and leverage to drive returns. It's a market, in our view, where you want to drive returns through asset selection, through buying the right businesses with the right alignment at the right valuation.

And one drawback to looking at LP portfolios is you sort of “get what you get, and you don't get upset.” Of course, as a buyer you can try and price in that risk, but you're competing with seller reservation prices. And it's not always effective or easy to be able to cherry-pick the assets you want to own. And in GP-led investing, by definition, you really are selecting just the assets you want to own, whether it's a whole fund, or increasingly even, a subset of the portfolio or just a single asset. And that ability to drive returns through asset selection, that ability to navigate what we think is a very choppy, challenging market, we think is a real advantage to GP-led.

Anu: Yeah, I just want to underscore some of those comments that you made. You know, curate the risk that we're taking, don't buy diversification blindly, and isolate the companies that you want to own. And I also love that phrase, the alternative is to get what you get, you don't get upset. That's one that I use I know with my young children a lot [chuckles]. But that's a very, very good point. So what does the other side look like? What does the supply side of capital and buyer appetite look like going forward?

Philipp: So what we are experiencing in the secondary market is a good undercapitalization of-of the market. Entering the second half of last year, we had dry powder, actual dry powder of around $100 billion USD. And near-term, expected capital raises of, you know, call it $80 billion, that was planned at that point in time. You add a bit of leverage, call it $40 to $50 million on top of that for a total of around $200 to $230 billion of near-term dry powder.

Now, what we are also experiencing is that the fundraising market is slowing down a little bit, and also, as we discussed, the leverage market is also less liquid as it used to be. So out of this near-term capital formation and the additional leverage, we expect a good chunk of that to go away. Certainly, the majority of the leverage and probably half of the fundraising being pushed out into this year, later this year, potentially the year after. So overall, dry powder, we expect at the moment to be around, call it $120 to $140 billion. And if you put that into context with the expected, transaction volume for this year, then you're probably just-just above one times, so dry powder as a relation to transaction volume. Just above- just above one times, one-year run rate dry powder, which is low even in the context for the secondary market, where historically we've been more hovering around the 2X, which we already thought was very, very low.

So if you compare it to the buyout market, you're historically over the last 10 years, you've been running between three and four years of dry powder. So we feel there is a significant undercapitalization in the market. And we are seeing that sort of coming through in the competitive situations, that we're looking at where there is a lack of competition.

Ben: Yeah, I think, you know, to Philipp's point, while, you know, every day when we come to work, it probably feels like we have one more competitor than we'd like on each transaction. When you step back at a macro level, that dynamic's quite encouraging. And I think, you know, as you look at the pullback in pricing, part of it definitely reflects, you know, what we're seeing in the public markets and just a general repricing of risk and changes in interest rates. But I also think today, there's a greater liquidity premium. And that's driven not just by the need or the desire to rebalance and get liquidity, but also, as Philipp was saying, because there's not a lot of capital available to meet that need for liquidity. And again, you know, we don't think that that's something that changes dramatically overnight. It's going to take time to form capital across the asset class.

Anu: Well, actually, just on that point, on real estate, we'd love for you to just dig into that just a little bit more. I know it's something that we've been speaking to a lot of clients about is the potential for real estate secondaries. Any more to add there, Philipp?

Philipp: Sure. So when you drill in the-the primary market on the private equity side is about six times as large as the real estate market. The private equity secondary market is about 12 times as large as the real estate market. And then when you think about the recent secondary fundraisings, there you see a factor of 15. So the-the more you drill down, the more you see how that part of the market is undercapitalized.

Anu: Perfect. All right. Well, as we start to wrap up this episode, you know, you both have spoken a lot about the value proposition and the opportunity set ahead. Let's just finish by asking each of you to share some thoughts on the long-term outlook for the secondaries market and some final thoughts that you'd like to leave our listeners with.

Ben: I think the long-term outlook is really encouraging, and in many ways, it's what Philipp and I care about and think about most, not to take away from what we think is a really, you know, great temporal climate in the secondary market. But we know what drives our success is really the long term, and never just the short term. You know, Brian Talbot, who's the chair of our business began the secondary program at Neuberger. He's been doing this since 1991. And if we go back and look over many decades almost like clockwork, this is a market that doubles every three to five years. And as we look forward, we see no reason that that doesn't have the potential to continue to double, or maybe even the potential to accelerate meaningfully.

And if you think about why this is a market that's growing exponentially, it's actually quite easy. The private markets are growing. The need to balance portfolios is growing. I mean, if you think about it, you know, these are long-lived assets, 10, 14, 15-plus years in some circumstances. And the notion that you should, you know, set it and forget it, to never revisit those decisions you make, isn't a great idea. In fact, some might even say it's imprudent.

I'd posture that the average private equity fund may last longer than the average marriage in North America. Uh, and so the, um, concept that you should manage your portfolio has gained steam. I think the stigma associated with selling has faded. So you have increasing turnover against a market that's growing meaningfully, and then you layer on the fact that you have new technology like GP-led, and it really leads to, we think, the potential for continued outsized growth. And to underscore what Philipp mentioned, that's against the backdrop of a secondary market that really cannot form capital in line with the pace of the need for liquidity.

Philipp: There's not a lot to add. What I would say, though, is that there is over $7 trillion of unrealized value in private equity, and the record year in secondary volume represented just about 1% of that $7 trillion. So a very small amount, and every increase of that will just have a tremendous impact on the future growth of the market.

Anu: All right. Terrific. Thank you very much both of you. Uh, I can't let you go without asking one final bonus question. We're recording this episode in January 2023. It's a new year. I'd love to ask each of you if you could share a personal or professional goal or something that you'd like to accomplish in this year.

Ben: Wow. Um, thinking about that for one second here. In fairness, I think this was actually something that I started to think about probably at the end of last year. but I was reading, someone's writing about the concept of grit versus quit, and people talk about, you know, quitters never win. And that may be true, you know, if you're down in a football game and it's the fourth quarter and you're trying to come back. But I think one of the things that I've realized is as an investor, we need to constantly factor in all the information that we're learning. This is the type of an environment where we may spend time looking at an opportunity. We may like it at first, but we shouldn't be wedded to our initial views. We should constantly factor in what we're learning. And to some that may feel like quitting, we've looked at an investment for two months or three months and ultimately we're not getting there. And I want people to understand, and I want myself to understand that that's not quitting, that's not failure. That's the right thing in this type of an environment. And so I hope we can continue to create that sort of a culture on our team that people understand that.

Anu: Great. I love that concept. Grit versus quit. I will write that down. Thank you very much. Philipp, what about you? A goal or something you'd like to accomplish this year?

Philipp: Yes. So on the more personal side, I've got two boys. They're seven and five years old, and their-their big dream is learning how to surf. So the three of us set us the challenge that we will learn surfing this year, which-which I think will be more challenging for me than for them.

Ben: I've already limited myself to just bodyboarding

Anu: [laughs] Both are very admirable. So good luck to both of you in those endeavors. Thank you so much for sharing. It's been great to get your perspectives on this very exciting part of the private market opportunity set. You know, I think investors are well aware that secondaries have evolved dramatically. They're no longer just a way for investors to offload their distressed assets at steep discounts. And as you've described today, when you look at the opportunity ahead, you know, does appear that the vintage years, that we're seeing could be very attractive.

I'll also make one mention for a terrific white paper that Ben and Philipp wrote in December 2022 titled, *The Rise of GP-Led Secondaries*, that's available on the nb.com website. Once again, Ben, Philipp, thank you so much for taking the time to speak with me today.

Ben: Thank you for having us back.

Philipp: It was fun.

Anu: And to our listeners, if you've enjoyed what you've heard today on *Disruptive Forces*, you can subscribe to the show via Apple Podcast, Google Podcast, or Spotify, or you can visit our website, www.nb.com/disruptiveforces for previous episodes, as well as more information about our firm and offerings.