KEYNOTE INTERVIEW

Motivated sellers create buyers' market



Liquidity challenges seem to be fueling secondaries dealflow, presenting compelling opportunities for buyers, say Tristram Perkins, Ben Perl and Victor Ko at Neuberger Berman

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Q What is driving secondaries volumes, particularly LP portfolio sales?

Tristram Perkins: The first thing to mention is that we have seen a complete reversal of the liquidity dynamics in private equity. Most of the last decade was characterized by record liquidity in private markets, but that started to tighten in 2021. Through 2022 and 2023 we saw fairly consistent net outflows on the part of private equity.

In our view, this reversal of cashflows is also being exacerbated by the fact that allocations to private equity have increased substantially over time. PE allocations on average now account for up to 15 percent of public institutional portfolios versus 2-3 percent a decade ago, and it is hard for distributions from prior vintages, that are now slowing, to offset larger contributions related to more recent vintages.

Those dynamics create a situation where LPs need liquidity, and that more motivated selling drives a more compelling opportunity for buyers. We know recent vintage private equity funds are lagging historical distributions and that will take time to work through, creating a longer and deeper J-curve.

Q How are those trends impacting what we are seeing in the GP-led market?

Ben Perl: We keep hearing and reading that the most important letters in private equity today are DPI (distributions to paid-in capital). This is because many investors find themselves overallocated to the private markets, and the distributions they projected would occur when they originally allocated are now materially lagging what was expected. One solution is, of course, for LPs to sell assets on the secondary market. Another, and we think increasingly common solution, is for GPs to help improve the DPI crisis by creating valuable liquidity options through continuation funds and other so-called GP-led secondaries.

It is our view that there are many sponsors with high conviction, well-performing assets, where the sponsor sees tremendous upside and is reticent to monetize in the current environment. A GP-led secondaries process provides a solution for everyone's needs in a customized manner. The sponsor can create liquidity for the fund, giving LPs the ability to monetize, and for those LPs that want to stay invested and share the conviction, there is the option to rollover.

TP: The GP-led market is probably one of the fastest-growing markets in private equity, but it is not solely driven by the need for liquidity in the current environment. GPs view the pursuit of a continuation vehicle as an attractive investment opportunity. When LPs are looking at continuation vehicles, they are looking at short-duration buyouts, and GPs see a lot of the same characteristics, with an attractive option to stay with assets for longer.

Victor Ko: The secondaries market is undercapitalized, and we believe the GP-led market is even more undercapitalized as the majority of secondaries dry powder is still earmarked for traditional LP-led deals. That means secondaries investors like us can be selective. In GP-led secondaries, there is always a focus on asset quality, but in today's climate, the deals getting done involve the highest quality assets in the market.

Q What makes a good GP-led investment? Are different skills required compared with LP-led secondaries?

BP: For groups that have grown up with a more alpha orientation, the skill sets are quite similar, but for those that grew up buying large, diversified portfolios, that is arguably a different skill set which is not as relevant for individual company underwriting.

For us, there are four parts to the GP-led scorecard.

First, and most important, is the quality of the asset. We want to buy growing, profitable and well-positioned businesses in attractive industries, which can offer high visibility into future earnings potential.

Second is valuation and capital structure. If we can access some of the best assets at valuations that are arguably below public markets and where change-of-control private equity deals are happening, and make sure that the businesses are appropriately

Q What are the key ingredients to getting LP portfolio sales over the line?

BP: There is very well-understood and very real pressure on many overallocated institutional investors to monetize through the secondaries market in the current environment. But, despite this, LP volumes were down from the peak we saw in 2021.

Why were volumes down? In our view, the primary issue was the bid/ask spread. Many investors wanted to reduce their exposure, but these same investors were in an acceptable cash position and not forced or compelled to get liquidity. As such, despite their motivation to get liquid, they were also motivated to not sell at deep discounts or take losses relative to where they had the assets marked on their books.

That having been said, there was a silver lining to this dynamic. The fact many sellers were focused on minimizing losses and choosing to sell less, meant that they were often willing to sell subsets of their assets, enabling buyers like us to cherry-pick what we wanted to own through so called mosaic sales as opposed to having to buy everything through portfolio sales. We have never been keen on buying highly diversified portfolios for a number of reasons, but we think selectivity is hugely important in the current market where we are probably not buyers of every asset.

capitalized, that is compelling – especially in a market where not all assets are appropriately valued or leveraged.

Third, and unlike in direct investing where you only need to get the right asset, in a continuation fund you also need to understand the manager and their playbook or skills.

Fourth is alignment. One thing we like about the GP-led market is we are partnering with managers and enabling them to double down on their best investments. We want GPs to be reinvesting the totality of their investment, and we are really looking for them to increase their exposure to make these deals a net investment for them. This, combined with the tiering of carried interest, shows conviction and creates a compelling alignment.

VK: GP-leds are complex, lengthy and in-depth processes that require a different type of diligence to LP-led secondaries. Having deep sector expertise, capital markets knowledge and the ability to tap into researchers in a broader platform helps a lot.

Plus, your ability to partner with a GP is important. These transactions usually involve a diversified LP base being replaced with a concentrated group, so GPs care about who they partner with. We can support GPs on a primary basis, be a lender to their companies and invest as a co-investor, putting us in a strong position as a potential buyer.

TP: LPs generally think now is a good time to be looking at secondaries because of the lack of liquidity and widening discounts. So, figuring out where the best opportunities are is key.

At one end of the opportunity set, you have the levered beta buyers of large portfolios, relying on buoyant markets and a fair amount of leverage to drive returns. Then you have our approach, which is more focused on high-quality single funds and smaller portfolios, trying to leverage access to information and GPs we have in the platform without using leverage. We think the chronic undercapitalization in the GP-led market creates interesting opportunities for investors focused on the latter approach.

Q What impact will the SEC's private fund reforms have on the secondaries market?

BP: We don't expect a material impact on GP-led transactions, or at least not in a negative way. Overall, similar to the guidance provided by the Institutional Limited Partners Association around GP-led secondaries, we actually view them as a net positive. We have always believed that a clear set of rules or a well-understood framework for how to pursue a GP-led secondary would likely facilitate more growth and provide both LPs and GPs with comfort in how to successfully approach and complete a GP-led secondary in a fair and transparent manner with the right set of options.

Q What kind of activity have you been seeing in both GP and LP-led deals of late, and where do you see the market going from here?

TP: Over the past year, the mid-market has been the most active segment for GP-leds. One reason is that the amount of capital available to underwrite GP-led deals and the number of lead investors capable of underwriting deals has been limited, whereas the mid-market requires less capital.

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VICTOR KO

A lot of what had been driving activity in the large-cap single-asset continuation vehicle space was a deep syndication market. Often the PE owner of the asset would sell a minority stake and then essentially take their residual ownership, wrap a continuation vehicle around it and take that out to five to 10 secondaries groups to invest. You needed a significant number of investors to come in on these deals and that really tightened last year, so most of the activity was in the mid-market instead.

BP: The advisers we talk to generally expect this to be a record year for secondaries, driven by the pent-up need for liquidity. The private markets have over $10 trillion of unrealized value, and annual secondaries volumes make up just around 1 percent or a little more of that, so there is a lot of runway, both near term and long term.

What is really going to limit long-term growth in our view is capital formation for the asset class.

VK: While the lion's share of the secondaries market is expected to remain in North America and Western Europe, because that is where most of that unrealized value is, Asia has been very interesting. The private equity asset base is a meaningful size, but the secondaries market is small. Now, we see more GPs and LPs in the region exploring their options and trying to replicate the GP-led transactions they have seen in the US in Japan and Korea.

We recently completed the first-ever continuation fund transaction in Japan, with J-STAR, and we now see other GPs thinking about these transactions. We expect the technology to spread as an established alternative exit route, with adoption continuing to grow around the world. ■

Tristram Perkins and Ben Perl are managing directors at Neuberger Berman and global co-heads of NB Secondary Private Equity, and Victor Ko is a senior vice-president at the firm