

INVESTMENT STRATEGY

Picker's approach

As uncertainty has heightened in the market, Adam Howarth, co-head of private equity secondaries at Partners Group, explains how it is impacting activity at the firm and gives his view on why secondaries returns will become increasingly mixed



Howarth: informational advantage

Q How would you describe the secondaries market so far this year?

The market in general is a little behind where it was last year – on dealflow and even more so on the volume of transactions completed. If you look at the numbers, the first quarter was especially slow.

Market volatility contributed to some hesitation in terms of bringing portfolios to the market because of the uncertainty regarding year-end valuations. A lot of groups decided to wait until they saw the December net asset values before taking a decision as to whether they were going to approach the market. Certainly, we saw fewer large portfolios in the market this year so in terms of transaction volume, that's also going to impact how much gets done.

From the buy-side, if you don't think the NAVs are going to keep rising and you don't think the stock market is going to continue to go up, then you can't keep offering the same prices that you were offering before, unless you want to cut your underwriting returns. NAVs were flattish at the end of December. March NAVs are flat to up, but we're not getting that 5 percent increase per quarter you were getting for several quarters last year, so that also had an impact on pricing. And although we always believe that NAVs are not the most important number, it's obviously important to sellers.

Q How has this environment affected Partners Group's secondaries activity?

We have 19 offices across the globe and we're out there sourcing more deals than we've ever had before, turning over

more rocks looking for the assets that we want to own on behalf of our clients, and looking for people that hold the funds that we want to buy into.

We're out there looking for deals where other people are not, so we can generate a big opportunity set. What that allows us to do is to be very picky about what we want to work on.

We're not at a point in the cycle where you'd want to buy everything. If you go back to 2010, you could buy almost anything and it would probably be sitting in positive territory right now. The market doesn't lend itself to that right now; it's a market where you need to have an angle. You want to be very particular in terms of what you buy and we like to buy what we know. Across our platform, we have an informational advantage from our primary and direct investing arms. It generally allows us to be an informed buyer and to take informed decisions. It's really a picker's environment.

Dealflow is still strong though and we're still seeing a lot of opportunities out there but we're more selective than we've ever been in terms of the opportunities that we pursue because not everything is right for us.

Q Which part of the market do you find attractive?

We want to buy in high-quality managers, but we also want to buy high-quality assets, because ultimately it's the underlying companies that drive the cashflows that generate the returns we're able to deliver to our investors. We want to buy funds where we think there's future value appreciation and

where we can capture the upside of those high-quality assets. If the assets are already peaked out or at maximum value, it's very hard for us to generate further returns. It's not just about buying the right assets but it's also about buying them at the right time in their life cycle.

Q With the secondaries market maturing, we're seeing more specialised strategies; how is that evolution impacting limited partners?

Specialisation is a phenomenon that has been going on in subtle ways for several years. It used to be more pronounced by transaction sizes. If you have a bigger fund you can pursue larger deals, while if you have a smaller fund you're probably going to pursue smaller deals. The groups that focus on large diversified portfolios want to buy market beta.

But I think recently we've seen specialisation even beyond that. There are groups that focus on secondaries directs and there are groups that focus on tail-end transactions. Some buyers focus on certain geographies, such as Asia or Europe only.

As an investor, you really need to consider what the content of a secondaries fund is going to look like, and then really compare the risk-adjusted returns that are underneath.

They may have very similar track records but how they generate that track record may look very different. But investors are seeing the value of having a secondaries exposure in their portfolio, not just for j-curve mitigation, but also for the absolute returns that they generate within a portfolio.

Q What are some of the consequences of this specialisation on returns?

Secondaries returns are going to be more bifurcated in the market. Historically, most secondaries buyers were buying a lot of the same content in the same types of transaction structures. So over time you were expecting the outcomes to be pretty similar for first- to second-quartile funds.

Now that people are focused on different sub-segments of the market, you should start to see more differentiated returns because the content for each of the funds is going to look very different. If you have a more secondary direct-focused portfolio, because it's less diversified, you should be earning a higher return for the risk that you're taking on. If you're buying a large diversified portfolio, you'd expect you would get more of an average return because you're buying the average. Some groups may be able to differentiate their returns through the use of leverage or seller financing, so depending on what the manager's view is on financing, the performance might be different. But on a cash on cash basis, those returns will be similar.

That's one of the nice things about having a deep market on the buy-side. Investors can choose what kind of strategy they want. But it's important that investors understand how the returns are generated by their fund managers because it's not always like-for-like. ■

Adam Howarth is head of Partners Group's New York office and co-head of its private equity secondaries business unit. He is also a member of the global investment committee and the private equity secondaries investment committee at the firm, which he joined in 2007.

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