Partners Group
REALIZING POTENTIAL IN PRIVATE MARKETS

The secondary approach: maintaining discipline during a crisis

Q&A with Anthony Shontz

Anthony Shontz, Co-Head Private Equity Integrated Investments Americas

As investors absorb the impact of the COVID-19 global health crisis, many perceive secondaries investments to be a rare bright spot in an uncertain market. Anthony Shontz, Managing Director and Co-Head Private Equity Integrated Investments Americas at global private markets investment manager Partners Group, explains how discipline, creativity and flexibility are key to successfully navigating a global private equity secondaries platform through today's unprecedented environment.

From a secondaries perspective, how has the recent crisis impacted the industry?

In the years leading up to COVID-19, people were aware of high asset valuations and expected some sort of correction. Nevertheless, the crisis ultimately took people by surprise. Investors were not ready for the lockdown or freezing of capital markets and complete halt of exit activity for private equity portfolios.

Similar to what happened during the Global Financial Crisis (GFC), there has been a steep drop in public equity valuations, but we have not seen a corresponding decline in private equity valuations. They are moving together but it is not a 100 percent correlation and public equities have declined further and faster than private equity valuations – at least that was the case in Q1. That has implications for portfolio decisions as it creates a denominator effect where investors find themselves overallocated to private equity.

"As we weather this crisis and ultimately its recovery period, institutional investors are going to be much more inclined to use secondaries as a tool to create distributions that are not happening naturally."

Does that mean we are likely to see a wave of secondaries buying opportunities stemming from this crisis, as we did with the GFC?

If we look back, the GFC led to three very specific waves of opportunities for secondaries buyers, which happened sequentially. Firstly, there were distressed sellers that needed liquidity immediately to repay a credit line or meet unfunded obligations, for example. Then, as the market settled, NAVs started to adjust downward, bid prices from secondary buyers increased a little, and there was less of a bid-ask spread. In that time period, we saw a lot of groups undergoing rebalancing exercises, changing their asset allocation models, shifting from private equity into fixed income or public equities as a portfolio management exercise.

The third phase was the rising NAV environment, where we had better visibility on growth and quarter-over-quarter NAVs increased. That created a huge opportunity for secondaries buyers to acquire assets that could benefit from that momentum and grow and appreciate over a longer-term horizon.

Today, we expect to see opportunities follow a similar pattern. Right now, we are in phase one – discussing high discount situations with institutions that need cash right now.

It is also interesting to look at how this crisis is different to the GFC. Today, the private equity market is much bigger, with assets under management by the industry about 3.5x what we saw in 2006. The secondaries market is also much more established, and institutional investors now understand the market – they know they can use it as a tool for liquidity, and secondary turnover, i.e. the percentage of assets that trade on the secondary market, is now about 4x higher than it was 10-15 years ago. So, as we weather this crisis and ultimately its recovery period, institutional investors are going to be much more inclined to use secondaries as a tool to create distributions that are not happening naturally.

What types of secondary assets have the best risk/return profile in a market like the current one?

We firmly believe that what we call 'inflection assets' have a better risk/return profile. An inflection asset, as we define it, is an asset that still has a lot of remaining upside and where you have high visibility on the performance of the underlying investments. In the private equity secondaries world, that typically means buying funds in years three to seven, when the portfolio has been constructed, you can see the assets in the fund, and there are probably some unfunded capital commitments remaining that will be used to support the portfolio in accretive add-ons and growth strategies.

We believe inflection assets perform better in bull and bear markets, and our data confirms this. What Partners Group bought in 2009 as inflection assets have significantly outperformed mature assets. We think we will see a similar phenomenon right now as there was a lot of capital raised in 2018-2019. A lot of those portfolios are going to be impacted by the corrections caused by COVID-19.

> *"Secondary transactions, both for traditional LP interests and GP-led liquidity solutions, have gone from taboo to commonplace. Over the coming decade we expect they will not just be commonplace, but also required."*

What are the core components of a successful secondaries investment strategy in a market like this?

This is a relationship-driven investment practice, so you need a robust deal-sourcing engine and that comes through relationships with GPs, intermediaries and institutional investors. Being part of a global platform with those extensive relationships is really critical; it is always important in secondary investing, but is even more so right now when nobody wants to broadcast that they are a distressed seller. If we are in front of an institution having regular conversations and come with some ideas on particular funds that we are tracking, that triggers opportunities.

The next key success factor is underwriting. Once you identify an opportunity, you need to be able to price the assets correctly and it is really critical to have GP relationships that enable you to access the information you need. Whoever has the best information wins, so it is important to have access to industry experts that know exactly how different sub-sectors are performing, where there might be red flags, and what questions to ask in due diligence. At Partners Group, we rely heavily on our Industry Value Creation team for that. It is not enough to just wait for a quarterly report from a GP that comes out after quarter-end telling you what happened six months ago. In the current environment when you are emerging from a crisis and a steep value correction, you need real-time data from companies to invest successfully.

Lastly, you need to have discipline and creativity. You cannot just jump right in and buy everything you see. In times of volatility and uncertainty, you need to balance being proactive with being patient and disciplined enough to buy assets you are convinced are leading the emergence from the downturn and return to growth. Creativity comes in the form of structuring solutions. Whether that is tax structuring, financing, or portfolio construction, it is critical to be able to listen to a seller, understand what their objectives are, and create a solution that works for them and that works for us as a buyer. That is where tapping into 20 years of experience structuring these types of transactions really helps.

How did the crisis impact existing secondaries portfolios?

The impacts will be felt on nearly all assets in some way. Some assets are going to be severely impacted and forced to close with nearly no revenues. Many businesses have benefited, too. There are some high-profile public equities that have traded up, and in our own portfolio we have seen some companies benefiting from, for example, the home-dining trend, or some e-commerce companies seeing spikes in demand and even struggling to keep up pace. So, the impacts are wide-reaching but different.

In private equity, we have also seen differences in how GPs have reacted in the crisis. In the first quarter alone, we saw GPs mark down their portfolios 10-20%. These initial valuation movements have been driven primarily by mark-to-market adjustments based on the movement in public comparables and changes in assumed exit multiples. We are yet to see the impact of lower earnings – that will likely come in the form of further valuation adjustments in Q2 and Q3. The implication for secondaries funds is similar.

Given the changes in the environment we operate in, as a buyer, we are looking for stable assets that are growing. Right now, that means there is probably a skew towards healthcare, technology, recurring revenue businesses, e-commerce and tech-enabled businesses. The portfolios that hold these types of assets are likely to be the first to trade. We are in an environment that enables us to engage in constructive dialogues with sellers that need liquidity and be selective with the types of assets we buy.

As we emerge from the crisis and look ahead, how do you anticipate the secondaries market will evolve over the next ten years?

The secondaries market has already become a commonly-used liquidity tool. The past decade has seen a proliferation of these types of transactions, and increased penetration among institutional investors. Secondary transactions, both for traditional LP interests and GP-led liquidity solutions, have gone from taboo to commonplace.

Over the coming decade we expect they will not just be commonplace, but also required. Portfolio managers will be expected to optimize their portfolios through secondary sales and GPs will be expected to provide LPs with liquidity solutions when funds near maturity. As private markets grow in assets under management, and secondary trading volume continues to grow as a percentage of private equity assets, we continue to believe that we are in an exciting growth phase for private equity secondaries.