

KEYNOTE INTERVIEW

Opportunity in a crisis



Turbulent times have typically been periods of plenty for private equity secondaries players as assets trade at a discount and limited partners seek liquidity. Yet not all opportunities are created equal, says Partners Group's Evelyn Zhang

The private equity secondaries market has grown substantially over the past few years. In 2019, \$77.82 billion of funds and direct assets changed hands, up nearly 11 percent on the previous year, according to Setter Capital figures. Much of this growth is a reflection of the industry's evolution and growing maturity as GP-led secondaries witnessed significant uptake and limited partners sought to use the market as a portfolio management tool.

The arrival of a deadly pandemic and the subsequent economic fall-out look set to create further, substantial opportunity for secondaries players as distressed sellers return to the market, liquidity needs rise and prices reduce. *Private Equity International* spoke to Evelyn Zhang, investment leader at global private markets investment

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manager Partners Group, who believes simply buying at a discount is not enough to generate strong returns, especially in a competitive market.

Q What's your view of where the market is today?

We are now seeing some very interesting opportunities emerge. There are some similarities with what we saw in the global financial crisis, which was a great time for secondaries buyers and a period where we were able to generate strong returns on behalf of our clients. We're cautiously optimistic about what's to come.

Post-Global Financial Crisis, we

were able to buy high-quality assets from recent vintages. Although the 2005-07 vintages were not great for private equity in general, we were able to secure assets in these portfolios at a discount to NAV. And more importantly, we were able to leverage our global platform to be very selective and sought to buy only the right assets – and for us that meant buying inflection assets.

Q What do you mean by 'inflection assets' and are they as attractive this time around?

Inflection assets are those that are in roughly years three to seven of a fund's life. You have visibility on the performance of the assets and, at the same time, there is still significant value creation potential as the assets have not yet

been written up. These are also portfolios that suffer from a double J-curve in crisis situations – the fund valuation reduces just as it is emerging from the expected negative returns in the early years, making these portfolios prime targets for motivated sellers. This is a real sweet spot.

By contrast, if you buy early secondaries, you are taking blind pool risk and face a steep J-curve – whereas if you focus on acquiring late and tail-end assets, for example, you are buying a squeezed lemon, as there is limited value creation potential left and the assets have already been written up.

We believe inflection assets are just as attractive as they were during the GFC, as well as during more benign periods. Targeting these assets is a proven strategy that can generate returns in good and bad times. And, similar to the GFC, the amount of private equity capital raised in the run-up to the current crisis had been rising sharply year on year. These vintages will be impacted by the corrections caused by the pandemic, creating great buying opportunities.

Q What will be different in this crisis?

There are a few differences this time around. One is that, during the GFC, a significant part of the market was driven by banks and financial institutions, whereas today, we're starting to see a real mix of different types of investor, including pension funds and asset managers. These investors have become accustomed to using secondaries transactions as a portfolio management tool over the past few years and this will remain an important driver in the market once things have stabilised a little.

Perhaps the biggest difference is the scale of the secondaries industry – it has grown significantly over the past decade. Assets under management among

Q Given the unusual nature of the crisis, how are you approaching different sectors - some of which will be badly affected while others may well have benefited?

We work closely with our industry value creation team in the due diligence phase and we can cherry-pick and focus on sectors that have been resilient through the crisis and will continue to be so in the post-crisis world. Instead of just taking a top-down approach to industries, we can really drill down into the different sub-sector dynamics and individual company circumstances. Even if there is a red flag against a sector, that does not mean that you cannot find attractive opportunities within it.

If you take two fitness businesses as an example, both will have been substantially impacted. However, one may have low leverage, cov-lite terms and no near-term maturity on its debt; the other may have 7x leverage and only three months of liquidity left on the balance sheet and so on. You really have to look at aspects such as the individual business prospects and the capital structure to determine attractiveness.

At a very big picture level, healthcare and technology, and associated sectors, are clearly attractive right now. In software, for example, you can target businesses with recurring revenues, where the solutions are mission-critical to clients and where there is a high diversification of customer base – even if they may be slow to recruit new customers in the current environment.

secondaries players have tripled since 2008 and the turnover in the secondaries market as a percentage of primary activity has also increased substantially: the transaction volume in 2019 was four times greater than that in 2008. That all suggests the opportunity today is far bigger than after the last crisis.

Q The growth of the market suggests competition is greater today. How will that play out?

Yes, there are certainly more buyers than previously and there is a lot more capital available among secondaries firms. But the market has also grown in depth and breadth, with GP-led deals in particular seeing widespread uptake and acceptance among both GPs and LPs.

So, while there is certainly competition, the market is big enough for everyone. But it does mean secondaries investors need to find their own niches and define their own USPs. For us, that means focusing on buying high-quality, diversified inflection assets, while

for others it might mean establishing a single asset continuation fund or buying tail-end portfolios, completing GP restructurings or establishing continuation funds.

Q How can secondaries players stand out in the market?

I have heard people say you can buy anything in the secondaries market and generate returns when you can buy at a discount post-crisis. I don't think I necessarily agree with that statement. The discount can certainly offer an element of protection, but there's no guarantee the assets will perform well unless you invest selectively.

To do this successfully, you need to have strong sourcing and evaluation capabilities. For us, that means leveraging our global private equity platform. We can access our funds database to provide valuable intelligence in due diligence, as well as using our industry expertise and industry value creation team – this can really assist with

transactions and portfolio construction. Our in-house transaction services team can also help us navigate complex structuring topics if needed.

Extensive and trusted relationships are also vital in sourcing deals, especially in the current environment, because no-one wants to broadcast their distress. We have multiple touchpoints with investors across our global platform, and this has generated some interesting conversations over the past few weeks and months.

Q How do you expect opportunities to develop over the coming period?

During the GFC, we saw three waves of opportunity come through sequentially and I think we'll see a similar pattern as we move through the current crisis. Back in March when the crisis became global, we saw an immediate drop in secondaries pricing and the return of liquidity-driven sellers. You only really see the most distressed sellers at this point, such as investors that had an over-commitment strategy or that were running leverage against their portfolios.

The next phase is a stabilisation of NAVs, and the bid-ask spread starts to narrow. At this point, there will still be liquidity needs among some investors, including those that have to act because of the denominator effect. Crucially, we've also already seen a general slow-down in exits and we'd expect distributions to remain low during this phase. In the meantime, GPs will still seek drawdowns for defensive purposes or to make acquisitions in what is likely to be a good environment for deals – that adds pressure on LPs that had constructed their portfolios in a cash neutral way and therefore expected regular distributions. You will see LP sellers rebalancing their portfolios and perhaps changing their allocation models as a result.

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The final stage is the recovery of market valuations, where buyers can get better visibility on growth.

All three phases can create strong dealflow for secondary buyers and, in the GFC, we saw discounts persist from 2009 right through to 2012, even as the market recovered, so there was a multi-year opportunity to generate great returns.

Q What kinds of innovation do you expect to see in the market as these phases progress?

The main point of innovation will be as we go into phase two because there will be a large bid-ask spread, certainly in the earlier parts of this. The pricing expectations between buyers and sellers always take time to adjust and so we'll see more structured options come into play. That might mean preferred solutions on the portfolio and other ways of ensuring the seller can benefit from some of the upside as the market recovers.

Q How do you see the secondaries market evolving?

The secondaries market has already become a more commonly used liquidity tool in private equity. It will develop beyond this and it is quite likely that LPs will start to use secondaries transactions to optimise the return they generate from their investment portfolios. On the GP side, there may be a requirement from their LPs to provide liquidity solutions if assets are taking time to reach exit.

The overall theme is that the private markets are growing in AUM and the turnover in secondaries is increasing its proportion of primary market value and volume. We are entering an exciting period of growth for secondaries. ■