Second act: the role of secondaries in the evolution of private markets

Q&A with Andres Small, Managing Director, Private Equity Partnership Investments

Andres Small, Managing Director

The secondaries market has grown significantly in recent years, in many ways supporting the evolution of private markets into a more versatile and liquid asset class. Transaction volumes by secondaries funds increased from just USD 37 billion in 2016 to USD 108 billion in 2022[1], with around half of these investments now stemming from general partners (GPs) seeking more flexibility in holding periods by launching continuation funds. The sale of limited partner (LP) portfolios – the other stream of secondaries investing – is also growing in popularity, with around half of 2022 sellers using this liquidity tool for the first time.

Andres Small, Managing Director at Partners Group, outlines the long-term factors underpinning this growth and explains how a thematic and integrated approach to the asset class – especially in a period of market dislocation – makes secondaries a compelling strategy within private markets now.

[1] Source: Jefferies, "Global Secondary Market Review, January 2023".

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Why has secondaries activity increased so dramatically over the past few years?

Secondaries are no longer just a by-product of the relentless growth in private markets activity. Rather, secondaries will be a key driver for private markets to penetrate the large opportunity set in the private wealth segment, much like index funds helped popularize public markets in the 1970s. With the growing demand for private equity's historically attractive returns, there is a fundamental rethink of what the right duration is for the asset class as an investment. Investors in private markets wish to evolve beyond the ten-year period arbitrarily selected decades ago.

LPs want the option of seeing their capital returned earlier than the ten years or more that it can take to fully liquidate a private equity fund, and that's partly because today they are managing their portfolios much more proactively. Secondaries are key to providing this optionality. For example, LPs can create liquidity by monetizing their existing participation in private equity funds or rebalance existing portfolios to achieve their desired exposure to the asset class.

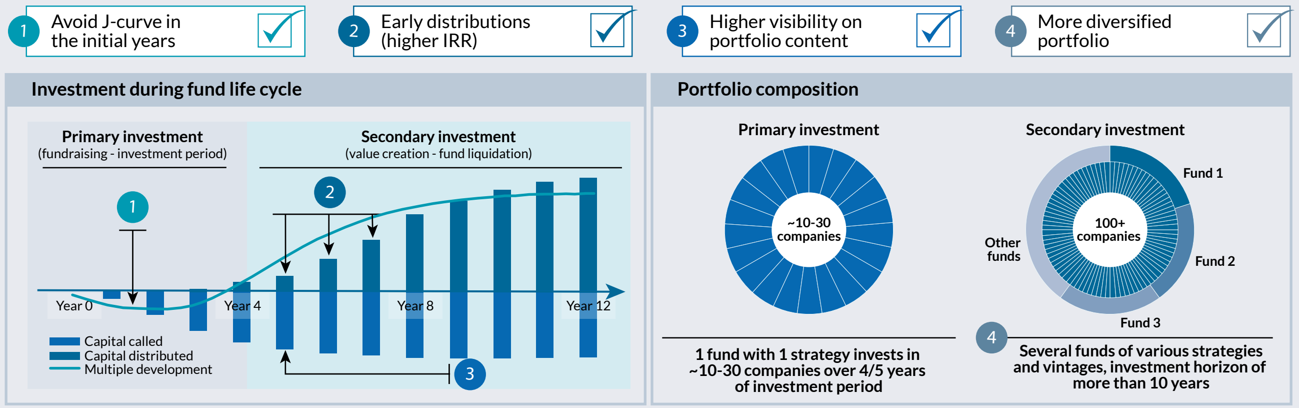
At the same time, private equity managers have recognised that the secondaries market can offer them a way to extend their hold on prized assets with a long runway of value creation and growth potential. Moving high-quality portfolio companies into continuation vehicles has become an alternative exit route to a sales process or an IPO. These extension secondaries allow managers to keep compounding returns on their trophy assets while also offering potential liquidity to LPs that want it.

And what about shorter-term trends? How is the current, more challenging macro backdrop affecting the secondaries market?

It is creating some very interesting opportunities. As with the private equity market more generally, investments in secondaries completed in the wake of a market dislocation period have historically been among the best vintages, and so we expect 2023 and 2024 to provide strong returns. With hindsight, the current secondary environment may feel like the buying opportunities that became available in 2009 and 2010 that make many of us wistful.

Smoothing the curve

The advantages of an allocation to private equity secondaries



For illustrative purposes only. Source: Partners Group (2023). Diversification does not ensure a profit or protect against loss.

We find the current market for LP portfolios to be very attractive. We continue to see high-quality portfolios coming up for sale at double-digit discounts. Many sellers may be eager to rebalance their exposure to private markets due to volatility in public markets or generate liquidity to overcome lower distribution activity. What makes this environment especially interesting is the fact that at the end of 2022, there was only around a year's worth of dry powder in the secondaries market – compared with almost 20 months of capital overhang excluding leverage for global buyouts[2]. The strong supply of opportunities, combined with a relative scarcity of capital, bodes well for an experienced secondaries investor.

[2] Source: Bain & Company, "Global Private Equity Report 2023".

We also expect to see more high-quality extension secondary transactions coming to market as the traditional private equity exit markets remain challenging. The IPO market could remain fickle, and recent sale processes have stumbled with buyers and sellers unable to bridge a wide valuation gap, a factor aggravated by higher financing costs. Yet, GPs are pressured to show meaningful distributions to limited partners, especially ahead of a fundraising effort that requests a commitment for their next fund.

If secondaries are defined by what is available in the market, how strategic can buyers be in what they target?

We remain highly selective about what we buy with our executed transactions representing less than

3% of the total flow of secondary opportunities generated across our platform. Many people tend to overlook this characteristic, but one of the attractive features of the secondary market – with LP portfolios in particular – is the potential to carve out a select exposure to fit your investment focus.

A buyout typically awards a single 'gold-medal' to the winning bidder. In secondaries, by contrast, there are lots of ways to 'place on the podium'. We see many LPs putting large portfolios of assets on the market to attract a range of buyers and sometimes to validate the price they can achieve. That frequently results in different players buying up parts of the portfolio through mosaic solutions. They can pick the parts that appeal more to them based on what they want exposure to and what they have high conviction in.

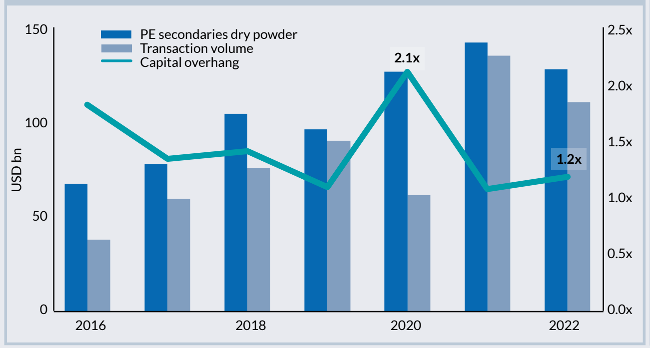
Buyers can differentiate themselves clearly through strategy. Some, for example, focus on buying multi-fund exposures to ensure diversification, while others take a more concentrated approach by looking more to single-asset continuation vehicles on the extension secondary market.

Many secondary players focus on buying more mature assets left in the tail-end of a fund. These offer the potential for larger discounts and quicker distributions if the fund can monetize their remaining assets. There are others, such as Partners Group, with a bias for inflection portfolios that are earlier in their fund lives and still in growth mode.

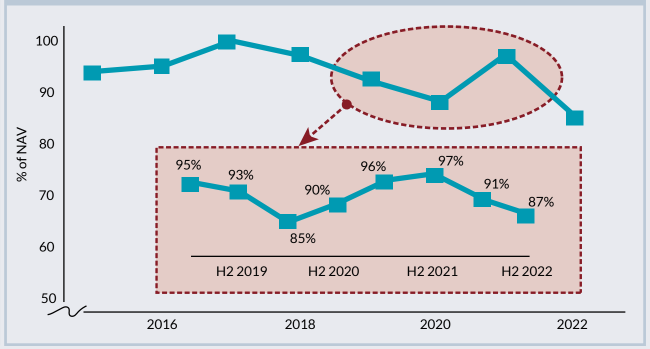
Window of opportunity

High supply combined with relative capital scarcity has pushed the price of LP portfolios down

Limited capital overhang[1]



LP portfolio prices[1]



For illustrative purposes only. Source: Partners Group (2023). [1] Source PE secondaries transaction volume: Jefferies, Global Secondary Market Review, January 2023. Source PE secondaries dry powder: Preqin, data exported 25 May 2023. Capital overhang multiple represents the ratio of dedicated available dry powder to LTM transaction volume.

Why do you tend to focus more on inflection portfolios?

You can, of course, often buy at larger discounts on the tail-end portfolios, but there is more likely a ceiling on the value of those assets. Also, it may be more difficult to exit them, especially in challenging market conditions, and you are not necessarily well aligned with the GP, which could be more incentivized to quickly monetize and move on to new opportunities.

With inflection portfolios, on the other hand, there is a higher potential on future upside, and you are better aligned with the GP, which is still motivated to create value. Our focus on inflection assets also allows us to utilize our firm's thematic approach to developing conviction in specific industries and companies across our investment platform.

What is needed to target thematic investments in secondaries?

We think scale and direct investing capabilities are important ingredients. At Partners Group, we have nearly 70 people worldwide in our team to pursue secondary opportunities, and we can lean on our direct investment colleagues to provide insights from more than 200 global investment professionals as we conduct bottom-up underwriting analysis on each asset. Our firm is fully integrated – our direct investing team has grown alongside us. We have the resources and knowledge for our secondaries investments to be aligned with the giga themes that we have identified as being transformational over the coming decades – Digitization & Automation, New Living, and Decarbonization & Sustainability.

Partners Group also benefits from understanding the capabilities of individual GPs. Our secondaries team underwrites primary commitments and manages our relationships with other GPs. This integrated approach helps us to follow their fund development and portfolio prospects. Accordingly, we can move quickly and price appropriately when a relevant opportunity becomes actionable. Overall, this allows us to buy assets we understand well, managed by people we know and trust. This consistency and focus on quality have helped us achieve strong returns and avoid capital losses since our first secondary investment in the 1990s.

How important are discounts in secondaries?

Discounts are very attractive in the current environment. We see a lot of relative value and we're certainly taking advantage of the opportunity. Our internal analysis shows that 16% of the increase in value in our secondaries portfolio can be attributed to discounts; the rest is from fundamental value creation. That discount figure may grow to 25% or more in the current market. But, ultimately, buying high-quality assets will drive our returns. It's worth noting that some of our best performing secondary transactions have been those with the highest premiums as well as those with the steepest discounts. That's because rigorous underwriting of quality assets with the greatest value creation potential provides multiple ways to win.

So, what is the process for correctly underwriting these assets?

In secondaries, correctly underwriting the portfolio will likely have a bigger impact on your investment return than the magnitude of an entry discount (or premium). At Partners Group, our scale and systems allow us to conduct granular underwriting on every asset in a portfolio, even when that involves dozens and even hundreds of companies. That requires a comprehensive approach to due diligence and a clear understanding of the underlying content and its value creation potential. For every opportunity, we access our proprietary database with information on more than 36,000 private companies and hundreds of GPs. As mentioned before, we can access our direct investment team's knowledge in an industry as well as our team's insights from monitoring a GP's evolution. For the most important value drivers in a portfolio, we will even conduct bottom-up underwriting that resembles our buyout colleagues' approach to due diligence for a single asset and discuss the opportunity multiple times with our investment committee. Over time, this process helps us to develop conviction in the assets that we want to own.

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When does an allocation to secondaries make sense?

Secondaries are a great tool for LPs at any stage of their portfolio construction in private markets. For investors who are new to private equity, multi-fund secondaries offer the opportunity to quickly gain diversification across vintage years, managers, assets and, potentially, geographies, while also enabling earlier distributions. More seasoned secondary investors could benefit from the consistently strong returns generated after a market dislocation. All will need to consider the growing supply of secondary transactions that will be generated on the heels of recent private equity fundraising records.

The diversification made possible by secondaries also helps to compress the deviation of historically attractive returns achieved by private equity. Executed well, an allocation to secondaries can provide compelling returns throughout the cycle and help investors obtain their desired exposure to the asset class.