Getting comfortable with complexity

*As the secondaries market matures and becomes more efficient, market participants are having to be innovative when hunting for transactions, writes **Marine Cole***

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The secondaries market has remained on a healthy footing in the last 12 months, and despite heightened geopolitical uncertainty in several parts of the world – including the two main markets, the US and the UK – it's been business as usual.

That was the consensus among five top secondaries professionals *Private Equity International* brought together in the New York offices of Debevoise & Plimpton at the end of March.

"There has been a stream of auctions, intermediated processes where sellers are coming to market to rebalance their portfolios, and then in addition we've seen more creative structured deals of very different types," says Kate Ashton, a corporate partner at Debevoise. "It's been broad."

Transaction volume slightly dipped to $37 billion in 2016 from $40 billion the previous year, according to data from Greenhill Cogent, but this is no cause for concern, according to our roundtable contributors. Volume has remained in the same range during the past few years, and they anticipate it will pick up in 2017.

"I would expect volume will be up over last year if no meaningful dislocation happens this year," says Bill Murphy, a managing director at Greenhill Cogent.

Some market participants have been more worried about dwindling returns.

"We've been in a long bull run with very positive returns but you see the same assets for sale year after year," says Adam Howarth, managing director and co-head of private equity secondaries at Partners Group.

"People are buying the same assets but with another year juiced out of that lemon, if you will. There's only limited upside and with the demand that's out there, it puts pressure on pricing and then pushes down returns."

Last year was a record-breaking one for the secondaries market, with 23 vehicles amassing $33.9 billion to deploy across private equity, real estate and infrastructure, adding to the dry powder in the sub-asset class, according to PEI data.

To maintain returns, secondaries have focused on seeking more creative ways to find attractive deals in a mature market that has become quite efficient, whether it has been by sourcing and structuring their own deals or by increasing their use of leverage.

SEEKING INNOVATION

"In many cases, it's more about searching on the fringes of the return frontier to attractive opportunities that are still incremental to your portfolio returns without taking on more risk to do those," says Howarth.

"You see it in take-privates, you see it in secondaries directs. It could be in emerging markets. It could be a GP-led transaction. It's all those things where buyers are now looking to differentiate themselves in terms of how they're positioned and how they invest their clients' money."

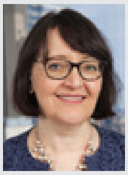
An example of that type of transaction was the headline-grabbing £1 billion ($1.25 billion; €1.17 billion) take-private acquisition of SVG Capital by HarbourVest Partners in the autumn.

HarbourVest had kept an eye on SVG for several quarters before it ultimately pursued the opportunity, allowing it to be familiar with the London-listed firm's assets. It had also closed similar transactions in the past, including the acquisition of Conversus Capital in 2012, and knew how to handle such a public transaction and to move quickly.

"SVG was a classic example of a non-traditional deal where you're not taking »

MEET THE ROUNDTABLE

VLADIMIR COLAS
managing director and co-head of Ardian US
ARDIAN
Based in Ardian's New York office, Colas joined the firm in 2003. He previously worked in Exane BNP Paribas's sellside equity research department. Ardian makes primary, secondaries and direct investment and has about $60 billion of managed or advised assets, including more than $35 billion in its fund of funds division.



KATE ASHTON
corporate partner
DEBEVOISE & PLIMPTON
Based in London, Ashton is a corporate partner focused on private equity, corporate finance, debt and equity offerings. She regularly counsels private equity funds on transactions including fund secondaries acquisitions and recapitalisations.

BILL MURPHY
managing director
GREENHILL COGENT
As a managing director in the capital advisory group of Greenhill Cogent in New York, Murphy is responsible for managing all aspects of client engagement and transaction execution. Prior to joining Cogent in 2003, he worked in Citigroup's private equity group as a senior member and previously served in Citigroup's real estate investment banking group.

JEFF KEAY
managing director
HARBOURVEST
Based in Boston, Keay focuses on global secondaries investments. Prior to joining the firm in 1999, Keay spent three years at Ernst & Young where he specialised in venture capital and financial services. He has also worked at the Financial Accounting Standards Board. HarbourVest has more than $40 billion in assets under management.

ADAM HOWARTH
managing director and co-head of private equity secondaries
PARTNERS GROUP
Adam Howarth, who co-heads the firm's private equity secondaries business, is also a member of Partners Group's global investment committee and the private equity secondaries investment committee. He joined the firm in 2007 and previously worked at HarbourVest Partners and Credit Suisse. His firm has €54.2 billion in assets under management.

» incremental risk because the assets are the same assets you've seen trade in a very traditional vanilla portfolio," says Jeff Keay, a managing director at HarbourVest. "But the way in which that transaction was put together and ultimately culminated was anything but traditional. We thought we had a technology and an experience set very differentiated from the rest of the market, and we used that to our advantage to be able to secure it."

Ashton, who worked on the transaction, says the deal was also complicated from a legal standpoint and took a lot of planning.

> ***"Sellers have been pretty flexible because they know if they want an attractive price, there will have to be some negotiation on the composition of the portfolio***
>
> **Vladimir Colas**

"It was a secondaries acquisition played out in a somewhat different way than anyone would have expected," she says. "It's not going to be often that situations like that occur."

TAKING YOUR PICK

Ardian, which focuses mainly on purchasing large portfolios of buyout fund stakes in the US and in Europe, has been taking advantage of a different set of developments in the secondaries market.

Vladimir Colas, managing director and co-head of Ardian US, notes that as sellers have become more comfortable with transacting in secondaries, there has been an increasing ability to negotiate with them, not just on pricing but also on the composition of portfolios that are for sale.

> ***There tends to be more leverage in transactions, particularly when there's capital that's going to be coming out, because why not?***
>
> **Kate Ashton**

He adds that there now seems to be more flexibility to add or remove funds in a portfolio, allowing buyers to price more attractively while keeping their return expectations intact.

"There's a lot of discussions taking place like that, which are more complicated than before, but they're necessary because today there are funds that you just can't buy anymore at an attractive price," Colas says.

"They're too old. So you're adding another fund and a lot of the discussion is around that, which is interesting for buyers because you can increase the level of upside, but it necessitates on both sides having a lot of information about a portfolio. In our experience, sellers have been pretty flexible because they know if they want an attractive price, there'll have to be some negotiation on the composition of the portfolio."

Some market participants have also focused more on GP-led transactions such as fund recapitalisations, restructurings and tender offers to squeeze more out of returns, although not all such transactions satisfy limited partners.

"We're probably seeing the most evolution on deal structures in the GP-led space," says Murphy. "I think that market has evolved to taking a sensitivity defining transactions that work for the new investors coming in, for the investors exiting and for the GPs. I think it's critical to the success of that market to finding the intersection of those."

GP-led deals tend to be more complicated, as there are more parties involved, lengthening the process compared with a more traditional LP fund portfolio sale.

"We've seen some LPs on those situations who are really willing to discuss »

» and come up with a solution, and sometimes there are investors who aren't willing to accept a solution at any level, so you really need all the participants to get on the same page to get those done," says Howarth.

DEBT EXPANSION

While some major buyers, including Ardian, Partners Group and HarbourVest, have used leverage on certain suitable transactions for years, recently the overall secondaries market has made increasing use of financing to boost returns. This comes as the number of providers has multiplied and pushed borrowing rates down.

While there were less than a handful of debt providers a few years ago, there are now at least a dozen banks that are offering leverage to secondaries buyers.

"I'm seeing far more leverage than a few years ago," says Ashton. "There tends to be more leverage in transactions, particularly when there's capital that's going to be coming out, because why not? There's also fund financing that's totally taken off and is now much more common."

Secondaries buyers have typically used debt at the deal level, rather than fund level, and continue to do so.

"We've always adopted the view that we're going to use it deal by deal to lever our transactions," says Colas.

"Each transaction has a different cash-flow profile and different underlying leverage profile at the asset level, so depending on each transaction, you decide whether you're going to put leverage or not. We also always have the leverage recourse only to that transaction. If there's an issue, which today hasn't happened but could happen, you know where your risk is and it's only in that transaction. You are also in a better negotiating position with banks than if they have full recourse to the fund and can just call the capital to pay themselves back."

At the same time, more private equity firms, on both the primary and secondaries side, have been taking advantage of subscription lines of credit to bridge capital calls and often to also boost performance, Ashton says.

Another consequence of lower borrowing rates has been that secondaries buyers are using deferrals less frequently in their transactions.

"We're seeing fewer deferrals in the market these days because the development of deferrals was largely driven by the fact that there wasn't much bank finance," says Murphy. "That's certainly grown pretty dramatically."

He explains that cases where deferrals

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> **Bill Murphy**

> ***The challenge in today's market is that you have a universe of institutional investors who don't have a lot of benefits from selling***
>
> **Jeff Keay**

occur are when sellers have a good idea of the amount of distributions they are expecting in the near term and don't need the cash immediately. They can take advantage of the pause to increase their return on capital until they develop a plan to redeploy the cash.

This brings up a larger problem in the secondaries market.

"The challenge in today's market is that you have a universe of institutional investors who don't have a lot of benefits from selling," Keay says. "Selling can create a problem for institutional investors as they're already getting so much liquidity out of their organic portfolios. Selling »

KEEPING IT REAL

Efficent pricing forces real estate buyers to look on the margins

Real estate secondaries, like private equity secondaries, have reached a certain maturity.

Post-financial crisis, when the bid-ask spread in the sector was wide, Partners Group raised its first dedicated fund to take advantage of the numerous opportunities.

"We were able to invest that in very attractive LP situations primarily, but real estate matured pretty quickly and fund interests are priced very efficiently right now," says Howarth.

Just as in private equity, this has forced buyers like Partners Group to look harder for investment opportunities on the margins.

"We've moved on to a lot of the non-standard transactions in the real estate space that build on our capabilities as a direct investor to solve a problem for investors and GPs in funds that have kind of run out of runway," says Howarth.

Despite this efficiency, Greenhill Cogent predicts that real estate volume will bounce back up in 2017 after a dip last year. ■

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Adam Howarth

will only exacerbate the 'where do I put this cash' problem."

Participants in the roundtable agree that a turn in the economic cycle and the resulting dislocation will correct that problem. Returns are then likely to increase again.

The big unknowns at this point are when the downturn will hit and how long the ensuing freeze in transaction activity will last.

Until then, some sellers will remain skittish and continue to hold, and secondaries buyers will be forced to be creative and seek non-traditional transactions. ■

BUILDING UP A SECTOR

Opportunities are on the rise in infrastructure secondaries

Infrastructure funds lend themselves to the secondaries market, and firms are taking full advantage of it.

Infrastructure initially didn't fit into more generalist secondaries, because it carried lower risk and lower returns.

"More often than not, [generalist secondaries buyers] would have to underwrite deals with general returns within the secondaries funds and there was a mismatch there," Murphy says.

Now buyers have raised funds specifically to invest in infrastructure secondaries, it's a much better fit. "By going out and raising dedicated capital from investors who want to invest in the asset class, it's a separate pocket, a separate pool that has a risk-adjusted return that's lower than the traditional secondaries return. It has made it possible for that market to develop."

Keay from HarbourVest sees another reason the sub-asset class is picking up steam. "If you look at a number of funds that were raised in the 2006-07 period, a lot of capital was raised, so, similar to private equity, there's an outsized universe of funds that are in that nine to 10 year old window."

Colas at Ardian believes there's more room to grow in the space. "When you look at the amounts that have been invested in infrastructure funds, and if you potentially assume the same proportion trading in the secondaries market, it's a market that could be $7 billion to $10 billion a year."

Greenhill Cogent's *Secondary Market Trends & Outlook* predicted infrastructure secondaries volume could double in 2017 from the previous year. ■