Institutional investment

October 2019, 6 min read

Secondaries – 10 emerging trends

Authors: Mark Silveira

Driven by robust investor demand for alternative asset exposure, the secondaries market – the purchase and sale of existing LP commitments in private equity and other alternative asset funds – has boomed in the last decade.

> But what does the future hold? In this article we highlight 10 emerging trends in the secondaries industry:

1. Big and bigger?

The five largest secondaries funds have grown by 36% on average from predecessor to current fund, and these funds surpassed their target fund size by an average of 29%. There are also three secondaries funds ranked amongst the largest vehicles in private equity currently being raised. Around 80% of 'dry powder' currently available for secondaries is held by the top 20 specialist secondary investors.

2. Popularity with LPs

Secondaries transactions are now widely used by LPs and fully accepted in the market as a portfolio management tool, with no stigma attached. According to the Campbell Lutyens survey, 45% of institutional LPs have utilised the secondary market within the last 12 months, while 62% would consider doing so within the next 12 months.

3. Active management by GPs and LPs alike

With private equity funds traditionally being an illiquid asset class, LPs (and GPs) tended to get locked in for the long term in their fund partnerships and whatever opportunities came with those funds. But the emergence of the secondaries market means that GPs (and LPs) can proactively manage their portfolios after investments have been made. GPs are looking at how to de-risk IRR and increase their degree of control over what they are delivering to their LPs. The ability to enter and exit with relative ease is all the more important given that the average lifespan of private equity funds has been lengthening – by some counts, it is now over 16 years.

4. Prevalence of GP led transactions

GP led transactions were historically associated in the market with failed GPs, but that has become a thing of the past, and it is now commonplace for the bigger brand names to engage in such transactions. With larger GPs are utilising these types of transactions, more people are going to be affected. There are basically two ways GP led transactions come about:

- *At the level above the fund, LP to LP (an optional liquidity offering to investors in the previous fund with a conditional primary staple into an ongoing fundraise – typically without any changes to the structure of the fund).* In this type of GP-led transaction, the GP's motivations include: (i) seeking new capital to accelerate momentum for current fundraising initiatives; and (ii) refreshing an existing investor roster containing LPs that have not supported or are not expected to support future offerings but are not proactively selling themselves. For example, in 2017 Lexington Partners purchased limited partner interests from investors in BC Partners' ninth flagship buyout fund, while committing new capital to the fund's successor. This was structured as a tender offer and the transaction value was reported to be around $1 billion.
- *At the level below the fund, where assets are transferred from one fund to another fund (typically involving changes to the fund structure).* In this type of GP-led transaction, the GP's motivations include: (i) to retain control over portfolio assets that are not ready for exit via traditional routes or would benefit from the certainty of a longer hold, but which are in a fund nearing the end of its life (or whose term has already been extended) and (ii) access to follow-on capital to realise the maximum potential value of those assets. These can either be single- asset or multi-asset continuation funds. The single-asset solution works for special situations where the asset cannot be sold (for example, a joint venture with a corporate that does not want to exit). Obviously, there are conflicts here that would need to be worked through.

5. Returns under pressure?

Many market participants in secondaries funds now expect returns to fall to as low as 8% IRR. However, it is worth noting that, in the whole history of the industry, according to publicly available information, only four secondaries funds have actually lost money.

6. Deferred consideration

The use of deferred payments is on the rise in secondaries transactions and, therefore, the seller should take great care with the identity and financial strength of the buying entity. If the buyer is an SPV, the seller should check how deep its pockets are and consider if they need to get a guarantee from a substantive parent entity. This process should be managed proactively and is something to ensure is part of the negotiation from the outset.

7. GP consent cannot be assumed

Selling LPs need to carefully manage their GP relationships , as these relationships are incredibly important when it comes to secondaries transactions, not least because the GP will normally have to give consent to the transaction, and high profile GPs are increasingly refusing consent to LP transfers; common reasons include: the buyer is a pure secondaries fund, the buyer is in Europe (where the GP itself is non-European), or the buyer is a family office and there is no certainty that it will invest in the GP's future funds or it is hard to verify the true value of the family office.

8. Dry powder mounts

A recent Campbell Lutyens survey indicates that secondaries 'dry powder' in 2019 will reach around $200 billion – that includes dry powder available through leverage, which is an increasingly popular technique with secondaries fund managers. That represents approximately 2.3x current secondaries market volume (or 1.6x without leverage). Three of the four largest secondaries funds are all currently in the market fundraising (but taking longer to close their funds).

9. Fund level financing

There is extensive and growing use of subscription credit line facilities by private equity funds. With regard to its impact on secondaries, this is an unwelcome development, because the GP's lending bank may need to approve the buyer before the GP is able to give its own consent to the transaction, and in such case the bank may ask the buying secondaries fund to sign up to loan security documents. This has made the market in LP interests slightly less liquid.

10. ESG considerations on the rise

Some, but not all, secondaries buyers are taking ESG considerations into account on the asset side and undertaking a thorough review of the GP's ESG policies. For example, is the GP a UNPRI signatory, what is their ESG policy, how do they report on ESG? A challenge for secondaries funds is that some investors treat them as if they are a buyout fund from an ESG perspective and expect the same level of information and ESG measures as those making direct investments via buyout funds. There is therefore the challenge of meeting ESG requirements of investors, given secondaries funds are not normally in a control position.

Tags: funds , secondaries