KEYNOTE INTERVIEW

Oiling the wheels of private equity

As contributions exceed distributions in the private equity asset class, the secondaries market is proving more important than ever, says Northleaf Capital Partners managing director Matthew Sparks

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Q How would you characterize secondaries dealflow?

Private equity has been plagued by a lack of liquidity in recent months, and that has driven significant secondaries dealflow across both the LP-led and GP-led markets. Many investors remain overallocated to private equity, relative to other asset classes, and are entering the secondaries market to trim their exposure. Meanwhile, market statistics show that contributions have exceeded distributions since 2018, after an extended period in which the reverse was true. Managers are holding companies for longer and returning less capital to their investors. This is providing real tailwinds for the secondaries market, which is delivering much needed liquidity to both LPs and GPs.

At the same time, we are seeing more LPs getting comfortable with using the secondaries market as a portfolio management tool. We continue to see repeat sellers that are programmatically using secondaries to manage their liquidity and private equity relationships on an annual basis. We are also seeing new sellers enter the market.

GP-led secondaries dealflow also remains robust, particularly in the mid-market, due to capital constraints on the buy side. We expect to continue to see volumes increase, given the value proposition that GP-led deals represent. The GP can continue to own a trophy asset it would rather not sell, while LPs can achieve liquidity in a challenging exit environment. Secondaries buyers, meanwhile, get the opportunity to deploy capital in attractive companies, supporting the next stage of value creation.

Q How are pricing dynamics evolving, and to what

extent are you seeing structure being used to bridge any residual gaps?

Pricing for buyout interests, which is where we primarily focus, has increased over the past 12 months. This is being driven by a robust public market as well as improved visibility on the future performance of underlying assets and on where the US Federal Reserve stands with regards to interest rates. These factors have enabled buyers to underwrite with more confidence.

This has contributed to an increase in dealflow as more sellers come to market to take advantage of higher optical pricing. Where there has been a gap in pricing expectations over the past 12 to 18 months, we have worked closely with sellers to achieve their objectives using structure.

In particular, the deferral of a portion of the purchase price has been quite common. This is a 'buy now, pay later' concept that allows the buyer to increase their optical price slightly to take advantage of later payment. We have also introduced price enhancing assets to deals – changing the composition of the portfolio that the seller was originally looking to sell to include more accretive assets that allow us to increase optical pricing. Finally, in some cases where sellers are looking for liquidity but where they have strong conviction in the assets, we have also proposed upside sharing elements to transactions.

Q How would you describe LP appetite for secondaries strategies, and what is behind the appeal?

The appetite for secondaries is substantial. Last year was a record year for secondaries fundraising, with over $100 billion amassed for an asset class that enables investors to rapidly build diversified exposure to private equity, while also providing J-curve mitigation and a compelling cash back profile. The appeal of secondaries has been enhanced by the attractive risk-adjusted returns that the asset class offers.

This strong performance has largely been driven by the inherent inefficiencies that continue to exist in the secondaries market. We believe that is particularly the case in the mid-market, where there are fewer LPs and therefore, fewer buyers with access to information. These mid-market funds also tend to have more levers for value creation with which to enhance returns.

Q How would you describe supply/demand dynamics, and how do you see that playing out going forward?

The secondaries market continues to benefit from attractive supply/demand dynamics. In 2023, there was roughly $110 billion of market volume, and we're projecting market growth in 2024. Dry powder across the market, meanwhile, sits at approximately $150 billion – in other words, roughly a ratio of 1:1. That is extremely favorable when compared to the broader buyout market, where the ratio is closer to 1:3. We would expect those dynamics to remain favorable for quite some time.

Private equity NAV is increasing due to capital inflows into the asset class. At the same time, hold periods are being stretched because exits are scarce. One of the key drivers behind the growth of the secondaries market is total NAV. The other is the turnover ratio. How much of that NAV changes hands each year? As more and more LPs use the secondaries market for portfolio management, we will see an increase in turnover. The two factors combined will create significant need for secondaries capital across both LP-led and GP-led deals.

Q How are secondaries firms differentiating themselves, and what should LPs be looking for in a manager?

There are five key elements to consider when looking for a secondaries manager. First is the existence of a platform. The secondaries market is inefficient.

> *"Appetite for secondaries is substantial"*

Dealflow and access to information is driven through relationships. Having a global platform with an active primary and private credit program provides critical outreach and coverage for a secondaries manager.

Next, I would point to market focus. The greatest inefficiencies can be found in the mid-market. There are also more opportunities for mid-market companies to create value beyond revenue growth, margin expansion and debt pay down; these levers include professionalization, for example the upgrading of a management team, the institutionalization of the sales force or the streamlining of operations, all of which can enhance the purchase price multiple at exit.

The third factor is team. Investors will benefit from a team that is experienced across multiple cycles, and which has a depth and breadth of skills and capabilities. There will always be an ebb and flow to supply/demand dynamics across LP-led and GP-led opportunities. The risk-adjusted returns on offer will shift. It is therefore important to invest with a firm able to deploy capital across both strategies, executing on those deals that represent the most attractive risk/return profile at any one point in time.

Track record is an obvious point of differentiation. Investors will want to see a manager that has proven itself over a long period of time, and that goes hand in hand with my final point – risk management. Investors should consider how managers have generated their returns – how risky the underlying assets have been and how much leverage has been used across the portfolio to generate that performance.