KEYNOTE INTERVIEW

A surge in secondaries

As pricing rebounds, pent-up supply is returning to the secondaries market, says Northleaf's global head of secondaries, Shane Feeney

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Q How has today's macro environment impacted secondaries dealflow?
The macroeconomic environment has impacted bid-ask spread dynamics right across the private markets. The secondaries industry is no exception.

That has led to a reduction in completed deals year-to-date. A little over $40 billion was transacted in the first half of 2023, which is roughly 20 percent down on H1 2022. We have definitely seen the secondaries community displaying caution when bidding on assets in both GP- and LP-led deals. Meanwhile, sellers are also displaying caution by not wanting to take significant market-clearing discounts.

However, benefiting from 2022 tailwinds, the first half of 2023 presented experienced buyers with the opportunity to complete attractive LP-led transactions at compelling price points. As we progress through the second half of the year, we are feeling optimistic and are observing an increase in LP secondaries dealflow.

There are two main drivers that we believe are contributing to this uptick: first, the public markets are rebounding and economic conditions have remained surprisingly resilient, at least in North America. The bid-ask spread is starting to narrow, and sellers are gaining confidence in bringing portfolios to market.

The second important factor at play is liquidity. There is close to $3 trillion of NAV controlled by buyout funds in the market, and almost half of that has been held for over four years. Given reduced exit activity, we are seeing a lot of pressure building in the buyout community when it comes to delivering distributions to investors. As a result, allocators are feeling the strain in their cashflow models, leading to an increased supply of secondaries deals.

Q What are the most attractive types of opportunities within that broad spectrum of potential supply?
It is incredibly helpful to have a flexible strategy. We look at LP-leds as well as all types of GP-led transactions, and we think it's important to have a team that is able to underwrite risk and execute across all deal types. This is particularly true in today's market where risk/return opportunities can fluctuate.

The dispersion in views on the macro side is as high as it has ever been, which makes it extremely difficult to time the market. Consistent deployment is therefore the best policy. Having said that, we are mindful of the level of uncertainty and risk in the market, so our premium to transact has gone up. We are also obviously looking to buy very high-quality earnings at this point in the cycle.

Q Are you seeing more buyer caution with GP-leds?

There is an 'only the best' mentality in the GP-led market right now. Buyers are being extremely selective and only moving on what they view as the most compelling transactions. In fact, we are seeing a very high early failure rate on deals. That is not to say that they are falling apart at the last minute – rather, deals are being shown to a select group of secondaries buyers in a pre-marketing period, at which point the decision is being made to not proceed.

Part of the reason for this is that the motivation for GP-led deals is shifting. If you go back to 2020 and 2021, the primary motivation was to extend the hold for assets that were perceived to still be mid-life in terms of their value creation period. Today, we are seeing dual motivations. Managers are also looking to GP-led secondaries deals to deliver DPI to investors and, as a result, the quality of the funnel has become more heterogeneous. Buyers, therefore, need to be highly selective as to what they choose to transact on.

Q How would you describe competitive dynamics in the secondaries space at the moment, and how are players differentiating themselves?

The secondaries market is competitive right now, but not overcrowded. We still feel that the risk/reward that can be achieved in the secondaries space is among the most attractive across private markets. It is a proven and conservative strategy, but this is a market where it is really important to select your areas of focus and know where your strengths lie. Right now, it's best to stick to your knitting and play in areas where you have had success in the past and where your underwriting capabilities are strongest. It is not the time to stray into new territories. For us, that means maintaining our focus on the middle market, where we have successfully transacted for over 20 years.

> *"This is a market where it is really important to select your areas of focus and know where your strengths lie"*

The mid-market presents particularly favourable dynamics; mid-market assets have consistently been valued on EBITDA with reasonable leverage ratios being applied. This has provided a natural hedge against the rising cost of capital and has enabled mid-market assets to build more resilient balance sheets with increasing uncertainty in the macro environment. We have been able to acquire companies at a discount to public comps and this disciplined pricing at entry has given us a cushion, even in an environment where discounts have narrowed.

Q Have you seen much evolution in the structuring of transactions and the nature of deals taking place?

We have started to see a trend towards mosaic solutions on larger portfolio sales – we think that will continue. Mosaic sales enable buyers to go through line items and pick off funds where they have real conviction, managed by GPs that they know particularly well. Certainly, we are very much focused on identifying funds where we have a relationship angle with the GP, providing a competitive edge when underwriting the transaction. At the same time, in this environment, sellers are highly receptive to mosaic solutions as well because they recognise that they can lead to better pricing.

In addition to mosaic solutions, despite the narrowing bid-ask spread, we are still seeing LP-led transactions being completed with deferrals on a portion of the purchase price. We and other secondary investors have benefitted from this structure as LPs aim to improve pricing.

Q What does LP appetite for secondaries look like today given the challenging fundraising environment?

There is good news and bad news. The bad news is that the secondaries market is not completely immune to broader fundraising challenges, and the ability to raise capital is undoubtedly the biggest issue facing the private equity industry today. The good news, however, is that secondaries is considered to be a very attractive risk/reward sub-segment within private equity, and so we are seeing a lot of interest among allocators.

Q How will supply/demand dynamics play out in secondaries in the long term?

Based on the transaction volume that we saw in the first half of the year and some of the funds that have recently closed, the capital overhang has increased marginally. Having said that, looking out over the remainder of 2023 and beyond, we feel extremely positive about the market opportunity that secondaries represents. This is a market that is still in its mid-innings, and we have no particular concerns around the amount of dry powder that exists. Furthermore, we think those attractive supply/demand dynamics will continue because there is a significant barrier to entry in secondaries: access to the high-quality teams that can underwrite these transactions. ■