KEYNOTE INTERVIEW

Pushing back boundaries

Once the domain of private equity, the secondaries industry is now gaining momentum in infrastructure, debt and real estate, says Northleaf managing director Mike Flood

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Q How would you compare and contrast the way the secondaries market has responded to the pandemic and the way it reacted to the financial crisis?

There have been two clear stages to the secondaries market to date, and I believe, that with the covid pandemic, we are now at the beginning of a third. It is no coincidence that each stage began with a crisis – a market dislocation where the secondaries industry stepped in to provide liquidity. The first stage started with the bursting of the tech bubble and September 11 attacks in 2001. At that time, sellers were either distressed, faced regulatory challenges, or were shifting strategy and buyers were pretty limited. The imbalance of demand and supply meant that discounts were high and because there was a stigma around selling out of GP relationships, transactions were largely kept out of the news.

The second stage of the secondaries market came with the global financial crisis and in the years that have followed, deal volumes have increased by around five-fold. That is a result of some key shifts in industry dynamics. First, there has been continued growth in private markets asset classes. Secondaries are directly correlated to primary fundraising, which has exploded as investors have moved away from the volatility of the public markets. In addition, LPs are now using secondaries as a portfolio management tool – and this will only increase going forward.

GPs have become more sophisticated about managing their funds and the liquidity of their LPs. This has evolved from fund restructurings to continuation vehicles for star assets. And finally, we have seen the increased adoption of secondaries in asset classes beyond private equity, including infrastructure, private credit and real estate.

As we emerge from covid, I think we will see a new phase of growth and enhanced sophistication in the secondaries market, predicated on the continuation of those four drivers. I think the next 10 years are going to represent a very exciting period for this industry.

> *"LPs have started to recognise the different risk/return and cashflow profiles that exist with various secondaries strategies"*

Q GP-led deals and, in particular, concentrated GP-led deals, have been the big secondaries story of the past 18 months. What were the key drivers and how is that market developing now?

The GP-led market – formerly known as the fund restructuring market – has been around for close to a decade. But, yes, those deals really came into their own through the pandemic, representing around 50 percent of secondary market volume in 2020. One of the primary drivers has been greater awareness and education within the sponsor community and I think the secondaries industry can take credit for that as GPs increasingly use these tools to manage their funds and their relationships with LPs.

GPs realise now that they can hold their prized assets for longer and where these deals used to be about fund restructurings, they are now used to the benefit of all parties. I think covid will further accelerate this growth and we are excited about the future of this market, as GPs look to optimise their fund management and provide a broader set of exit options for LPs.

Q Unlike GP-leds, LP portfolio sales dropped off sharply at the start of the pandemic. Is that market now coming back?

LP portfolio sales came to an abrupt halt in April 2020. Extreme volatility and uncertainty around what the future held, meant it was difficult to value private equity assets. Most sellers decided to hold off executing on transactions as a result. Today, there is far greater visibility around the impact of covid on companies and around the value of portfolios. And there is real pent-up demand among both sellers – which held off optimising portfolio management for 18 months – and buyers, eager to put capital to work in more diversified situations. We are therefore predicting a strong second half to 2021. We expect a return to historical volumes, and probably an increase, given the need for liquidity in portfolios.

Q How would you describe the pricing environment for both GP-leds and LP portfolio deals?

Pricing has become more competitive as the market has matured. A GP-led transaction will almost always go through a process where it is truly market tested, and rightly so. However, while competition for larger GP-led deals is intense, we believe that in the mid-market space, competitive dynamics are more muted. The GPs and the underlying assets are less well understood and there are market inefficiencies that can be exploited.

The same is true of LP portfolio sales. There is greater market inefficiency when dealing with smaller portfolios, with less well-known managers and assets and therefore greater opportunity to secure attractive pricing. We think that distinction between the large market and mid-market is going to continue in the future.

Q Are you seeing many new entrants coming into the secondaries market in response to the opportunity you are describing?

It has been interesting to observe many of the big private markets asset managers entering the secondaries industry over the past year or so. They have been doing so in different ways. We have seen the acquisition of firms, team acquisitions and product launches from scratch. It seems as though there has been a new announcement almost every month and I am sure we will see more in the future.

The increase in dedicated secondaries funds that is occurring mirrors other sub-asset classes in the private markets space where a clear market opportunity emerges. These new entrants are responding to the same growth and returns potential that we see. They are probably also responding to demand from their existing investor base given both the strong performance and unique portfolio construction benefits that secondaries offer.

Q Is this increased level of competition a concern for you?

We welcome increased participation in the market. There is plenty of room for everyone. Secondaries transactions still only represent a very small fraction of the private markets asset class – at around 5 percent. And dry powder is also at a healthy level, with less than two years of capital overhang. That has created some really attractive supply/demand dynamics.

I think new entrants will accelerate the education process and drive increased adoption of the secondaries market, leading to a greater percentage of assets being traded across all private markets asset classes. And, again, we believe the majority of that competition will be focused on the larger end of the deal size spectrum. The mid-market will benefit from the enhanced exposure and improved education, but the direct impact on competition in processes will be minimal.

Q As the secondaries market matures, are we seeing greater levels of specialisation?

We are seeing the same evolution that we saw in the primary buyout and venture capital space 25 or even 30 years ago. We saw that market segment into mega, mid-market and growth. And then we saw GPs focus on specific industries and geographies. We are already starting to see the same thing happen in secondaries and I expect that to continue. That is essential from a talent perspective. We have done this ourselves, appointing a head of secondaries and head of directs within our private equity strategy. As we start to see strategies focused on GP-leds, for example, or on the credit or infrastructure asset classes, managers need to ensure they have the right specialist capabilities in place in order to be successful in a competitive market.

"I think the next 10 years are going to represent a very exciting period for this industry"

At the same time, LPs have started to recognise the different risk/return and cashflow profiles that exist with various secondaries strategies. Single company secondaries and continuation funds may offer higher returns, but with more risk and potentially a longer duration, for example, while structured credit-like secondaries offer the benefit of downside protection and stable returns. As investors increasingly appreciate these nuances, I think their allocations will become more targeted and we will see a proliferation of highly focused strategies, products and teams. It is already happening, but I think that process will only accelerate.

Q Private equity has been the dominant sector for secondaries, to date. But how much growth are you now seeing in the credit and infrastructure asset classes?

Until now, private equity has clearly been the dominant industry for secondaries, representing approximately 91 percent of transaction volume in 2020. However, we do believe that meaningful growth opportunities exist in other private markets asset classes, specifically, in relation to our own platform, private credit and infrastructure, but also in real estate. Each of these sectors offers significant white space over the coming years and we feel we have a unique angle given our global mid-market direct infrastructure and direct credit strategies and the dedicated teams behind those.

In addition to our flagship private equity secondaries strategy, we have the ability to invest across all those deal types, and many of our biggest clients are starting to ask us to target these opportunities in their mandates. I expect to see growth across all those non-private equity secondaries strategies going forward.

Q As we enter this third stage of the evolution of the secondaries market, how optimistic are you about what is to come?

I see the next five to 10 years as a period of rapid growth. We are tremendously excited about the opportunities the secondaries market presents, not only in private equity, but also infrastructure and private credit. And we believe our integrated global mid-market platform positions us perfectly to exploit those opportunities for the benefit of our investors. We are extremely excited about what the future holds. ■