The Liquidity Squeeze in Secondaries

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Anu Rajakumar: Private equity secondaries are an investment category that have fascinated many in the financial industry. It's a market with supply and demand characteristics that offer compelling returns at a time when many asset owners continue to suffer from the overall allocation and forced divestiture from private equity. But some may be wondering whether these attractive dynamics for secondaries will continue going forward and if so, how will these deals be structured in the future? And importantly, what risks and opportunities lie ahead?

My name is Anu Rajakumar, and today I'm delighted to welcome back to the show a couple of crowd favorites here on *Disruptive Forces*. Ben Perl, Co-Head of Secondary Private Equity at Neuberger Berman, and Philipp Patschkowski, member of the Secondary and Strategic Capital Investment Committees to discuss the investment opportunity set in private equity secondaries. Gentlemen, great to have you back on the show.

Ben Perl: It's great to be back on the show. Thanks for having us.

Philipp Patschkowski: Great to be here.

Anu Rajakumar: Ben and Philipp, we had you on the show here back at the beginning of the year. Now as we approach the end of 2023, I want to hear about some of the major themes that you've been observing. I know you've been on the conference circuit and speaking to a lot of clients recently. What have you been discussing and hearing about over the last 11 months?

Philipp: So generally speaking, what we see in the conversations that we are having in the market is that investors continue to actively think about their private equity exposure and portfolios and whether and how they want to rebalance that. On the one hand, of course, the theme of over-allocation remains very true today, as it was at the beginning of the year.

In addition, what we've seen is that many investors are thinking about their strategic asset allocations, and given the changes in the interest rate environment, private equity allocations tend to remain either stable or go down. As a result, what we're seeing is investors are proactively seeking liquidity in the secondary market by selling certain parts of their private equity portfolios and to regain liquidity on the one hand, but also strategic flexibility on shaping the overall portfolios.

However, as much as LPs want to sell, there's just not a very deep secondary market in the current environment. The undercapitalization is and remains quite dramatic. And we don't expect these dynamics to change anytime soon.

Anu Rajakumar: Great. Thanks very much, Philipp. Ben, anything else to add there?

Ben: I think Philipp hit on all the right themes. The one other item that keeps getting brought up are cash flows. Private equity has seen a tremendous change in exit activity over a short period of time. I think it was about two weeks ago, the *Financial Times* had a headline that read, "Private equity firms face worst year for exiting investments in a decade." The punchline was in 2021 if I remember correctly. There's about $1.4 trillion of estimated exit exactly. As we sit here today, that's down by about 60% to 70%. That is rather significant. And for a lot of investors, when they made these commitments, one of the key variables that they were forecasting was the duration and how long they'd be in the investments, and how much liquidity they'd be having come back to them. And those assumptions that they were relying on are being challenged in this sort of an environment. And it is far from certain when that changes. A lot of firms don't want to monetize in this environment. It's a tough challenging environment to maximize long-term value. And so when we think about our role and where we sit in the ecosystem, being able to help LPs drive liquidity when exit activities have dried up is incredibly valuable. And equally valuable is the ability to partner with general partners who have assets that they're not quite ready to sell, but they want to help their LPs get liquidity or give their LPs options for liquidity. And through GP-led continuation funds, you can partner with them to create exit options when they otherwise wouldn't exist. That's another powerful theme that we're talking about In this environment.

Anu: Those are some great points. Ben, with the need for liquidity being an all-time high what I'm a little bit stumped about is why secondary volumes have been shrinking. I would've thought the opposite that we would've been at all-time peak by now. But how do you think about that? How do you address that elephant in the room?

Ben: Yeah. Well, first it's not terribly surprising. If you look at the pattern or what happened after the GFC, volumes initially shrunk; and then they came back and they came back much greater than before. So when we think about the need for liquidity, the over-allocation, the macro picture, I think we have a tremendous conviction that we will reach new highs in the secondary market that investors will need to address these challenges.

But, in the interim, in the short term, things are a little bit different. Investors, simply put, don't like selling at losses. I always say it's behavioral economics. When we transact with sellers, very rarely do they say, "What multiple of earnings are you buying my portfolio." Everyone asks, "What's the bid as a percentage of my NAV." Saying it differently. Can I sell my portfolio at no loss? 5%, 10%, 20% loss?

And that, unfortunately, is the psychology of a lot of investors. An environment where bids widen and investors who need liquidity have to suffer additional losses versus where it's on their books, it's almost reflexive, human nature. Folks choose to sell less. They want to minimize the amount of liquidity they need to take at a point of time where discounts are wider. Now, that can't go on forever. Obviously, there are ways that that bid ask spread can narrow if the economy improves, if marks changed underlying portfolios, but it's not surprising and it doesn't change our excitement around the opportunity in either the short term or the long term.

Anu: Well, those are some great points, Ben. Philipp, let me turn it to you and just ask the question. Given this pullback in volumes, do you find that as a challenge? Is that something that you're concerned about as an investor?

Philipp: As a secondary investor, that's, of course, not a great thing. However, it's also a bit of a blessing in disguise. Let me explain what I mean by that. As Ben mentioned already, sellers do not like to sell at losses or a discount to NAV. However, what we're seeing in the market is that there is just a prevailing discount that can be achieved by buyers. So what we're seeing is a trend that sellers identify their highest quality assets or assets with embedded value and try to sell those to minimize that headline discount. For targeted buyers that do understand the quality of the underlying assets and do the due diligence, that can offer a really attractive opportunity to buy assets that in a more buoyant environment may not have come to the market in the same fashion and at the same pricing dynamics.

Ben: To maybe sort of put it in different terms, two years ago, maybe someone could sell a whole portfolio if they had a liquidity need for, pick a number, 95% of NAV, and they would've transacted on a whole portfolio. But in this market where there are discounts, investors often want to sell the bare minimum that they need to. And so what that means is rather than transacting on a larger, more diversified portfolio at a lower price, they often will choose to sell better assets, a smaller portfolio at a slightly better price. And if you're a focused buyer who doesn't want to buy everything, and you just want to buy those targeted assets, even though the headline volumes may be declining, that may not be a bad thing for where you're situated. I think that's what we've seen a little bit over the past year or two.

Anu: Yes, it really allows you to be more selective and have higher-quality assets in your portfolio in the end.

Ben: In a funny way, counterintuitively. Yes.

Anu: [laughs] Exactly. You spoke a little bit about GP-led secondaries and these liquidity solutions that you're able to provide. Is that the same dynamic in contrast to traditional LP transactions? And any examples that you can share to maybe illustrate that point.

Ben: I wish it were a simple answer. I think in many ways, it's similar, but in other ways, it's importantly different. And so, let me try and explain what I mean by that. What's similar? The need for liquidity. Investors across the asset class are clamoring for exits, they're clamoring for cash flows. One way that they deal with that is approaching secondary investors directly. The other way that they deal with that is turning to their general partners to ask for exit activities.

And one of the reasons why exit activity declines is general partners don't feel comfortable always selling in this environment. One of the wonderful things about a GP-led secondary, unlike another mode of exit, is it can give LPs choices or optionality. So let's just say fund managers made a terrific investment. They're sitting on a three-times game to wonderful success for the investors in the fund, the general partner has tremendous conviction that this business is going to continue to grow. And that it's going to be worth a lot more than three times in another year, or two or three.

Well, in this environment, they're probably unlikely to choose to sell that today. Doesn't mean the investors in the fund don't want to de-risk. Doesn't mean the investors in the fund don't need or deserve that capital back. And unlike a one-size-fits-all approach of either extend duration and do not sell, which is largely what's happening across asset class. This enables a fund manager or a GP to give their LPs optionality. If they share the vision and the patience for that additional upside, they can roll over and remain invested. If they want or need liquidity, it's served up on a silver platter. That is very value creative for a lot of market participants today and one of the things that we're really excited about.

The other thing about GP-led, is the ability to target the right assets at the right values. I mentioned before that psychology around not wanting to sell at a loss. Well, often, when as a buyer, we're paying 80%, or 90%, or 70% for an asset. It's not because every company in that portfolio, that could be 10, 15 companies, is underperforming or needs a discount. It's usually because it's a little bit of a mixed bag. There's some assets performing well with tremendous upside, but there may be other assets that are challenged. Maybe they have debt problems, maybe they're in an industry facing headwinds. As a result to the buyer, when you write-off that asset or impair its value, it requires an overall discount.

And in GP-led, because you're not always buying everything, you're cherry-picking the one asset or the subset of assets that you're trying to create liquidity from, you can often avoid the need for that discount or the need for a substantial discount. For a lot of LPs, that's really exciting. Well, now I can have liquidity and I get liquidity without needing to suffer an additional loss or without needing to take a material loss to where it's on our books. As a buyer, that's a dynamic in this environment as well.

Anu: Yes. I think that those choices, the optionality, being able to target the right assets at the right values creates incredible opportunities for investors. Philipp, let me turn it back to you. Have you seen changes in the way that deals are being structured as a result of some of these changes that you both have been commenting on over the last number of months?

Philipp: Yes, we have. I think it's more an evolution than a revolution. There are changes and I think the biggest change, of course, is the one that we've already spoken about—the ability for buyers to target and isolate those assets that they have conviction in, assets of highest quality. What we've seen is that portfolio transactions are being broken down into mosaic solutions for multiple buyers by those funds that they have the highest conviction in, and that allows buyers to really target and focus the quality assets that they would like to own.

Another theme is that leverage has generally gone down in the market. Leverage isn't as abundant anymore but also it's much more expensive than it used to be two years ago. That's a theme that—especially on the portfolio and transaction level leverage basis—has reverted quite a bit. However, on the other side of the spectrum one area that has picked up again is the return of the deferred payment. What we're seeing is that buyers often pay a certain part of their purchase price, one, two, three, four quarters after they made the investment. In the current environment that allows buyers to bridge the bid-ask spread to some degree. It's interesting in the sense that that is a theme that we've also experienced after the GFC. It's quite expected that this came back as interest rates have increased.

Anu: Philipp, is that a phenomenon that you expect to continue to see for the intermediate term, or is that typically short-lived? How long after GFC did you see those deferred transactions happening? Is it interest rate sensitive or what are your thoughts there?

Philipp: I think one area, of course, is the interest rates. Right? I think if interest rates were close to zero deferring payments did not help much in changing the absolute purchase price. Now, there with interest rates, if you defer a certain part of the purchase price for a year, there is some interest that can be earned and can be baked into the overall pricing. So I would expect that to stay for a while, certainly for the next two to three years, but also it depends of course on the interest rate environment and how that evolves.

Anu: Great. Thank you very much. As we wrap up here, I'd love to hear a little bit more about your outlook going forward. And one thing on everyone's mind is recession and whether we have a hard landing, soft landing, (laughs) no landing. When you think about those potential outcomes, how did those bode for secondary markets? How should investors be thinking about what this investment might do, particularly if it's a hard landing?

Ben: It's a fair question. We've had a lot of things working in our favor as a liquidity provider over the past year or two, a lot of the themes that Philipp and I have touched on, but one thing that we've not had working in our favor are real challenges. Investors have actually had a nominally decent time. The economy's been humming along for the most part, and as a result, you've not had a lot of real pressure to sell, you've not had liquidity challenges, you've not had investors find themselves turned upside down. You have people over their benchmark or over their targeted allocation. I want a 10% of private equity, I have 12%, or I have 14%. That's a challenge people want to deal with it, but it doesn't always lend itself to the same motivation as, "I can't fund a capital call," or, "I have to get liquidity from my private equity portfolio to deal with another challenge."

The other thing that I would say is just, psychologically, when things are nominally decent and the economy is performing, the stock market's holding its own, there's a greater willingness often on the part of investors to play another card. So if I show up and say, "Hey, I want you to take a 10% or 20% loss to get liquidity." They may be bold and say, "I'm willing to wait and see what happens in 6 or 12 months."

Now, if there are a lot of speed bumps in the economy and a lot of uncertainty, and things could get a lot worse tomorrow before they get a lot better, that changes that dynamic. Now investors potentially are more willing to say, "Hey, this is the market price for liquidity. I need it. If I hold off, maybe it's better, but maybe it's worse."

And so, while a change in the macroeconomic picture presents complications to the buyer, and it's certainly naive to just think it would be all good, it does create some interesting dynamics for us as a liquidity provider.

Anu: Absolutely. That's a great point. Let's wrap it up here with a final question for each of you. Where do you think things will go for secondaries in the future?

Ben: Do you remember the movie *Groundhog's Day*?

Anu: Bill Murray? Where he wakes up over and over again, same day experiences the same thing. Yes, love it. It's a great one.

Ben: I always feel as a secondary market investor, it always feels like Groundhog's Day. The market reaches new highs, more capital is raised. Investors say, "what will their future be? Is there too much capital? Will people really want to sell?" You wake up three, four years down the road and what do you see? The market's doubled. The market's tripled. There wasn't enough capital. Returns were decent for investors who were willing to participate.

And I think as I look out there today, it certainly feels like it should be Groundhog's Day again. I think I read a day or two ago in Bloomberg, one of our peers out there saying he believes this is going to be a trillion-dollar market by 2030. My crystal ball is neither precise enough to give you an exact number, nor probably quite as optimistic as to think it'll be a trillion-dollar market.

Anu: Would be nice though.

Ben: It would be nice, but I do think it would be to some extent defying a law of gravity for this market to not continue to grow robustly. The private markets are $12 trillion in size and growing. Liquidity is slowing. There is an increasing demand and need for secondary solutions. How those solutions are provided continues to expand from LP to GP, to NAV loans, and lots of other interesting evolutions on the margin.

When we look forward we're incredibly optimistic, there's a real growing need for secondary liquidity solutions and there are not a lot of or there's not a lot of capital available today in the market. I think if you overlay that long-term outlook with some of the near-term temporal factors, it's even more exciting. Over the next year or two it's going to be a challenging time for a lot of investors to be able to provide liquidity to help alleviate those challenges is terrific. If you think about the way we think about secondaries with this targeted precise manner, we think now is really the time. We do believe there can be a divergence of outcomes out there. We do think that mistakes could have been made over the past few years, and so navigating this environment in a very targeted manner and providing liquidity, we think is going to be a good thing, not just over the next year or two but hopefully between now and 2030.

Anu: Excellent, thank you. Philipp, any closing comments from you?

Philipp: I don't disagree with any of the comments made so far. In fact, I very much agree. However, it always appears when we talk about it that's an easy task we're up to right? The providing the liquidity, generating attractive returns. However, for every time we do invest, we do analyze a lot of assets and not a lot of opportunities. We say no, a lot, many, many times. It is hard work, and it always feels like there's one competitor more than we would like to see. However on the flip side, I think, in a market where illiquidity is an issue, generally speaking in private equity and especially in the current environment where investors are looking for liquidity, being the liquidity provider is a great place to be.

Anu: Terrific. Thank you both for those great comments. Of course, I will not let you go today without answering a quick bonus question. Ben, because you mentioned *Groundhog Day*, which is a terrific movie. I'd love to hear what is a film that each of you love to watch over and over again every year, never gets old, one of your favorite movies.

Ben: Philipp, what's your favorite movie? I'm curious.

Philipp: I don't watch much TV.

[laughter]

Philipp: I guess it's not a movie, but I really enjoy the Marvel movies because they just have the superheroes where everything is possible, and I feel that's very much the theme that we're seeing in secondaries too.

Ben: I guess my challenge is I have three young kids and I'm happily married, which means I don't get to choose what I watch on the TV. There are a lot of things I watch on repeat although I don't know if it's by choice always.

Anu: Which Disney movie have you seen the most then? [chuckles]

Ben: I think we've started to outgrow some of the Disney movies, but I've definitely seen *The Lorax* a number of times.

Anu: Maybe too many times to count. Maybe it's time to watch *Groundhog Day* again in a few months.

Ben: Yes, exactly.

Anu: Well. Ben, Philipp, thank you again for joining me on the show. We covered a lot of really important topics from the dramatic undercapitalization in secondaries, clients rebalancing their portfolios, their strategic asset allocations sometimes to decrease their private equity exposures, given other liquidity issues that they have. But one of the themes that you both touched on a number of times was as investors, the ability in this market to be selective, to choose higher quality assets that you have high conviction in. And I think that's an important takeaway, particularly in this environment where supply and demand is a two-for-one deal right now, and those who, as Philipp, I think you said those who are able to be liquidity providers have some really interesting and unique opportunities going forward. Again, thank you for the recap. We hope to have you again in a few more months to get the latest update. Once again, Ben, Philipp, thank you for being here today.

Ben: Thank you for having us.

Philipp: Thank you.

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