The Growth of Private Equity Secondaries

Disruptive Forces in Investing

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Anu Rajakumar: As investors are dealing with the COVID crisis, many are wondering how this is affecting private markets. After the global financial crisis, the secondary market provided attractive investment opportunities for disciplined investors as liquidity premiums rose and investors turned to the secondary market for liquidity. My name is Anu Rajakumar, and with me today is Tristram Perkins and Ben Perl, portfolio managers in Neuberger Berman's private equity Secondaries team, to discuss this market and what we're seeing today. Tristram, Ben, thank you for joining us.

Ben Perl: It's a pleasure to be here.

Tristram Perkins: Thanks very much for having us.

Anu: Now, as I understand it, secondary markets are a bit frozen at the moment, suffering from a bit of a bid-ask spread. But before we turn to the market today, talk us through how we got here. I understand that the secondary market has actually doubled in the past four years despite strong liquidity net flows and thanks to the demand for private market alternative investments. But why is that the case? Perhaps we can start there with you, Ben.

Ben: It's a great question. I mean the secondary market has doubled over the past four years[1]. And that's against the backdrop of an incredibly, you know, liquid market overall. And I think the growth is even more impressive if you look back even further in time. I mean if we compare it to secondary levels prior to the GFC, you know, this market today is four or five-fold larger than it was. And I think the growth that sort of propelled the market is really secular. Right? It's not driven by distress or needs for liquidity. It's driven by secular drivers. And as we think about it, we've boiled it down to really three key themes. First, the size of the private markets. Second, the use of Secondaries by institutional investors. And lastly, innovation. You know, as we think about the size of the private markets, right, as more and more capital comes into the alternative asset classes every year - that sort of has taken our opportunity from fishing in a pond to fishing in an ocean. You know, as we sit here today, you know, it's against the backdrop of record fundraising over the past several years.[2] Second, as it relates to the investors used to the secondary market, if you went back 20 or 30 years ago, there was a stigma associated with selling a secondary investment. The only investors who really turned to the secondary market were those who found themselves in moments of duress, absolutely needing liquidity, or they were compelled to sell because of some sort of regulatory reason.

Anu: Interesting, and what is it like today?

Ben: Today it's almost the polar opposite. Most investors who've utilized the market over the past decade have done so for regular-weight portfolio management reasons[3]. They understand that the idea that you would sit there and make an allocation to private markets, and take no actions in your portfolio for 10 or 15 years, doesn't make any sense. And for us, the benefit is because it was always the exception not the norm, small changes in investor behavior can really drive exponential growth for us. Right? If we go from one out of 100 investors turning to secondary market, to two out of every hundred investors, that doubles the opportunity set for us. And then last thing that I mentioned was innovation. Right? Twenty years ago, the secondary market was really just a tool for LPs. It was a really plain vanilla type solution. Today the secondary market has become quite innovative. Beyond preferred and structured solutions for sellers, today it's really a tool for general partners.

Anu: That's true – and maybe correct me if I'm wrong but a decade ago GP-led Secondaries didn't exist…. How is that different from today?

Ben: So if you went back a decade ago, there was no such thing as a GP led secondary. Today GP-led Secondaries are roughly a third of the overall secondary market. And so as general partners turn to this market to create opportunities for themselves

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[1] Greenhill. Data as of January 2020.
[2] Preqin as of January 2020.
[3] Evercore PCA Secondary Market Surveys 2014 –2019

and their LPs, that's another likely growth. And when you put those all together, what we saw was sustained secular growth in an incredibly bright future heading into this year for the secondary market.

Anu: Great. So that's a helpful overview. Now the big question on everyone's mind is, of course, how is COVID impacting the market right now and what does this mean? Are these trends going to change the trajectory of the future and why do we see a bid-ask spread today? So maybe, Tristram, I can turn it over to you for that one.

Tristram: Sure. So I think in terms of where we are right now in the market, and sort of what does COVID mean for the long term growth in the secondary market, maybe taking those in reverse order – I think the growth in the market, you know, we would expect to continue. If anything, and again, not losing sight of the horrific human cost of COVID, but just looking through a very narrow secondary lens, you know, shocks to the market tend to result in a short term lull in activity in the secondary market. And I'll talk about that in a minute and what drives a little bit of the bid-ask spread.

But I think our expectation is this will drive a continuation of the long term trend in terms of growth in the market, active use of the secondary market as a portfolio management tool by an increasing universe of sellers, accessing the market with greater frequency. I think if we look pre-GFC, financial institutions were by far the biggest seller of secondary private equity, representing probably north of 80 percent of all transaction volume. You know, fast forward three or four years later and you had just an explosion in types of sellers that were utilizing the secondary market, from public pension plans to endowments, you know, groups that historically for similar reasons I think largely that Ben mentioned, had not actively resold private equity assets. You know, those groups started using Secondaries as a tool. And that has continued. So again, I think our expectation is this shock to the market will continue that trend of increasing the number of sellers and the frequency with which those sellers access the market. And we'll talk a little bit about, you know, GPs becoming an active source of supply in a few minutes.

But in terms of the, you know, the lull, I think part of what happens in the secondary market reflects just how we are bidding on assets. We typically bid off of GP-reported values for the underlying private companies. So unlike in the public markets where there's a constant flow of information and bid-asks are adjusting daily, hourly. Um, you know, in the secondary market, we're bidding off sort of frozen, stale information that's up to in some cases six months old. And if you think about just the impact of COVID, both in terms of deterioration in underlying private companies, but also some volatility in the metrics that GPs are using the value of those private companies. If we're looking at a December mark for an underlying private company and trying to value an asset off of that mark, you know, very, very hard for the secondary market today to price that asset. And what the secondary typically does is they take a big discount to reflect that uncertainty and the challenges of valuing that asset, assessing the – the impact of COVID. So right now, you know, we are in a bit of a lull in terms of transaction volume. Uh, a lot of that reflects the bid-ask spread.

Anu: Out of curiosity, how has that affected pricing in the Secondaries market?

Tristram: You know, pricing in our market has gone from I'd say, you know, mid to high 90s, through most of last year, uh, to 50 percent discounts, 30 percent discounts, almost overnight. So I think just like in prior market corrections, you know, we'll be in this lull probably for I would guess two, to three quarters as GPs start to adjust their NAVs down to reflect some of the deterioration in performance in their companies. But once those markdowns occur, I think you'll see the secondary markets start to become much more active. And we would expect, based on prior cycles for that activity, to last, you know, anywhere from two to three years. You know, secondary assets are long duration assets. It takes a while for that value creation event to occur. So we would expect to see a, you know, a fairly compelling opportunity for secondary investors over the next few years.

Anu: Okay, great. Thank you, Tristram. Interesting to get that perspective. And how does this compare with the Global Financial Crisis, Ben? Are there similarities or perhaps lessons that we can draw on?

Ben: Yeah, I think, you know, Tristan made a lot of, you know, great points, and to paraphrase Yogi Berra, it's always difficult to make predictions, especially about the future. But I think if we compare what we were looking at in March, in April, and even into May vs. the GFC, there were some eerie similarities in the way things were lining up. Right?

If we look at volatility, it spiked from, uh, record lows over many years to over 80. The market decline in the first quarter at one point over 30 percent, one of the most precipitous declines ever recorded in history. Very similar to sort of the significant declines and public market repricing that we saw during the GFC. And again, it's against the backdrop, just like we saw leading up to '08, '09, a record fundraising. Except now records are 50 percent higher than the peaks that we set in 2008[4].

And what we saw law time in terms of behavior, I'll unpack behavior in terms of both supply side, the way sellers are interacting with the market; as well as demand side, how buyers like ourselves are acting in this market. And what we saw was a couple things. You know, first, the volatility in the public market movements created portfolio balancing issues for certain LPs, the so-called denominator effect, causing people to turn to the secondary market's rebalance.

And then even more everlasting was sort of the behavior changes on the part of LPs, in response to what they were seeing from a cash flow perspective. Right? And you know, what we found, and I think what we'll see again, is the industry moves from a position of net inflows, meaning exists are outpacing contributions, to sort of the reverse. You know, all of a sudden private equity portfolios may start to consume a lot of capital for investors, right?

If we think through it intuitively, very few GPs are going to sell assets in the coming environment. Leverage markets are not as supportive of exit processes. Buyers are going to be less willing to predict out the future. And multiples may be lower than what we've seen in the past few years. And one thing that I think private equity sponsors are very good about is maximizing long term value. And it's hard for most assets to maximize long term value by selling in the midst of a crisis.

Anu: Right, so how do you think the GPs will react to this?

Ben: What we saw last time, and I think what we'll see again, is that private equity investors, the GPs that manage these portfolios, will wait out the storm. They're going to wait for their portfolios to recover, for their earnings to come back, for the macro economic environment to be better. But what that's going to do is really cause a material pull back and exits. And while exits are pulling back, we expect GPs will continue to be active. And so as a result, the compounding effect can be quite significant. And what we may find is similar to the GFC; investors are looking at significant outflows that persist in their portfolios for some period of time. And what that will hopefully do is lay the groundwork for more motivated sellers over a reasonably sustained period of time.

Anu: You mentioned buyer behavior, how will that change and potentially impact the market?

Ben: I think we've seen certain patterns that we would expect may repeat themselves again. You know, it's funny. A few months ago we were going back and looking through some old Dow Jones headlines, you know, from sort of the '07, '08, 2009 environment. And a lot of the same things that we see today, or that we had seen in 2019, we saw then. Right? There was quotes about high leverage levels in the secondary market, aggressive pricing of risk, buyers having voracious appetite for well diversified portfolios. The same themes that we've seen over the past few years in the secondary market. And I think what we saw time was buyer behavior turned on a dime. And it makes sense, right? A rising tide is no longer lifting all boats. There will be winners and losers. And so the person who is relying upon leverage to amplify the good in taking advantage of what we'll call a quality index is going to pivot.

That strategy will change. They will back away, the leverage will amplify the good and the bad. The notion that, you know, the rising tide is going to lift all boats no longer will hold true. And so that will create more rifle-shot opportunities within the market. A statistic that we, you know, like or that we enjoy as a buyer, you know, Evercore was kind enough to share with us that over the past several years, about 80 to 85 percent of the transactions they intermediated went to a single portfolio buyer.[5]

If we look at that same statistic in 2011 and '12, not during the sort of the eye of the hurricane, so to speak, but, you know, one or two years after, you know, the Great Financial Crisis, that same statistic was less than 40 percent. So you can see that, you know, buyers pivot their behaviors. And what that can do is can create attractive opportunities for folks like us to step in and solve the liquidity issues that institutional investors may need, but to do so in a very rifle-shot manner targeting what we think are high quality assets at attractive prices. And hopefully, if we're lucky, the opportunity will persist as it did in the GFC for a reasonably sustained period of time.

[4] Evercore PCA Secondary Market Surveys 2014 –2019
[5] Evercore PCA Secondary Market Surveys 2014 –2019

Anu: And what about the differences? Tristram, how are things different this time around?

Tristram: Yeah, so I think, you know, a couple important differences that we're evaluating. You know, one, just in terms of the scale of the private equity market today relative to pre-GFC, you know, if you look at primary fundraising, in the decade since the GFC, you know, nearly doubling of investor commitments into private equity relative to, you know, the decade pre-GFC.[6] So just, just a significantly bigger opportunity in private equity in general. You know, the duration of this bull market has driven investors to, increase their allocations to private equity. That's shown up in obviously primary fundraising. And that has huge knock-on effects for secondary supply. You know, the more primary capital that's raised, the bigger our opportunity set. And so we were entering 2020 with what we thought was a really strong supply outlook, you know, even pre-COVID.

From a demand perspective, you know, again, looking at the beginning of 2020, the capital available to invest in the secondary investments represented about one year of average transaction volume.[7] You know, that's a very low level, at least historically. If I look at Dry Powder in a direct buyout market, as an example, it would be multiples of that. You know, that sort of competitive dynamic, that Dry Powder, that competitive interest, in secondary purchases, being at equilibrium had already affected pricing in 2019. So we'd already seen a little bit of a softening in secondary pricing last year. And certainly heading into this year, you know, given where Dry Powder was, I think, you know, we were feeling very optimistic about the outlook for pricing this year. So, if we look at GFC, you know, we entered as a secondary market, 2008, 2009, with several years of Dry Powder. So just a very different demand equation.

Anu: Okay, so more favorable than coming out of the Global Financial Crisis due to a much larger Secondaries market as well as lower level of demand. What about from the perspectives of the various tools available?

Tristram: In terms of market sophistication, I think, you know, the secondary market today is very different in terms of sort of the types of strategies that secondary buyers are deploying, the diversification across those strategies, what's driving return for certain secondary investors. Leverage is much tougher to get access to as a secondary buyer, and so I think our expectation is you're going to start to see a real dispersion of return. I think asset quality is going to become much more important as a driver of return. Tail end risk is going to be, you know, much more apparent in some of the more diversified portfolios that we've seen trade. And then just in terms of, again, tool kit, GP led technology was not a technology that was available to GPs or LPs, coming out of the [Global] Financial Crisis.

Ben: I think in many ways, actually, our job in the next couple years is going to be even harder than in the GFC. What I mean by that is, you know, understanding COVID's impact on, you know, industries and companies on a global basis. I think it's going to be even more challenging than understanding the impacts of the Great Financial Crisis.

I mean today we're spending tremendous amounts of time with our industry resources and industry research teams at Neuberger Berman, to really understand this on a granular level. And I think that's going to be an enduring theme, where we spend a tremendous amount of time on the buy side, really trying to unpack what COVID means company by company, sector by sector, geography by geography. And I think in some ways some of the impacts are going to be less intuitive than you might think. Curious if that's something you would agree with.

Tristram: Yeah. I mean I think it's a good point. I think that, you know, one of the challenges that we see buying diversified pools of assets today is that in every portfolio we're looking at, there are companies that we expect to be impaired long term and then there are companies that with think actually may have a little bit of profitability tail wind created by some of the changes in the consumer behavior.

But I think to Ben's point, if we look at the drivers of return for our investors over a very long period of time. You know, the – the primary driver of return has been asset selection. So parsing through the private equity universe, trying to identify assets, we saw value assets, we saw near term value creation opportunities; avoiding, you know, underperforming assets, avoiding over-levered assets.

To Ben's point, I think that selectivity has become more important than ever. I think the idea of buying a diversified pool of 500 private companies right now, almost at any price, is going to be really, really challenging. So yeah, the ability to develop

[6] Preqin as of January 2020.
[7] Greenhill. Data is as of January 2020.

a view on underlying private companies get access to that information, access to the general partners that control that information, you know, will be a huge differentiator and I think a big driver of that dispersion of return that we referenced.

Anu: Great. Well, I think that'll do it for this episode. Tristram, Ben, thank you both so much for being available to join me on the podcast to share your insights on the Secondaries market today.

Tristram: Thanks, Anu. Appreciate it.

Ben: Thanks for having us.

Anu: And to our listeners as always, you can subscribe to this show via Apple Podcasts or Google Podcasts, or visit our website, www.nb.com/disruptiveforces, for previous episodes, as well as more information about our firm and offerings.