Secondaries & Continuations[1]

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The panelists on the "Secondaries and Continuations" panel provided an update on the market, context on recent valuations and fundraising, and predictions for the future of the market. What follows is a summary of key insights discussed by the panelists.

1) Recent History and the Current Landscape.

- In describing the past few years of the private equity secondary market, the panelists explained that the Coronavirus pandemic accelerated the demand for liquidity. Compared to 2020, 2021 was a year of major growth with a record volume of $132 billion. 2022 was the second biggest year on record at $108 billion, but secondaries did not cash flow like they were expected to, especially in the fourth quarter.

- Activity and demand have increased. Panelists noted inquiries coming from new market participants, increased interest in sponsors helping investors manage liquidity. Although there was a decrease in deal flow in the fourth quarter of 2022, it has stabilized and is expected to increase.

- Loan to value ratios were generally stable, ranging from 25-50%, with less diversified pools of assets receiving lower LTVs.

- Pricing increased, especially in the fourth quarter of 2022, even though pricing is still not consistent due to variations in structure and investor mix, but pricing has started to stabilize after the latest increases.

- Historically, banks were the exclusive lenders in the secondaries market. Recently, banks' balance sheets have not increased as expected. Consequently, insurance companies have served as lenders and private equity funds are providing secondary funding on mezzanine financings at higher-than-expected prices. However, insurance companies are more reactive than banks and the expectation is they will move to other products if pricing becomes less attractive.

- At the fund level, NAV financing is being used for cash management, strategic investments, to over-invest until fundraising is complete and for dividend recapitalizations.

- At the acquisition level, NAV financing is being used to acquire larger pools of assets or entire portfolios.

[1] Panelists included Max Forton, Head of Trading of Fund Finance & Solutions, Americas at Nomura, Brian Foster, Partner at Cadwalader, Wickersham & Taft, Martins Marnaunza, Partner at Coller Capital, Ray Meyer, Managing Director, Head of Fund Finance Advisory & Origination at Natixis Corporate & Investment Banking Americas, Linda Rowland, Managing Director, Secondaries Group at Ares Management, and Darren Schluter, Managing Director at PJT Partners.

2) Valuations of Investments

- The panelists all follow private investor holdings and the public equity markets closely to draw price comparisons and review actual cash flows over time.

- Valuations may not have decreased the same way public markets did due to the nature of the asset, with one panelist comparing valuation multiples as more analogous to smaller cap stocks and another noting that many sponsors used hedges to offset the impact of higher interest rates (although as hedges expire, cash flows and, therefore, valuations will be impacted).

- The panelists agreed that there is no consensus on valuation methods, but the key statistic is the price at which the portfolio companies are actually sold.

- Private market valuations could be 10-15% lower than what sponsors say they are, and lenders pay attention to what investors pay on the secondary market. Currently, secondaries are trading at 80% for large buyout funds.

3) Trends

- Increased demand for NAV facilities as fundraising bottlenecks create opportunities to continue holding assets.

- Increased demand for GP/management company facilities to allow for earlier distributions.

- The panelists explained that the use of a deferred purchase price can impact deal flow and allows funds to achieve their target price for an asset. Financings would be used at the end of a deferred purchase price period.

- Currently, the biggest issue for limited partners is liquidity, so a deferred purchase price is useful because it lets limited partners retain cash until the purchase price becomes due. The panelists predicted that over the next twelve to eighteen months, the deferred purchase price mechanism will be used more than ever before.

4) Hot Topic in 2023: Credit Secondaries

- Historically, there was no critical mass of private credit in the secondaries market, but limited partners are starting to increase liquidity by using private credit.

- Secondaries are already a diverse asset class so banks and non-bank lenders are analyzing how new debt would be additive.

- Because secondaries are generally expensive, they are challenging to invest in and costly to finance, so the primary challenge for credit providers will be figuring out how to lower costs to make the credit worthwhile.