

Impact of the credit crunch on the secondaries market

Posted: July 2008

As the primary private equity market has grown, the secondaries market has expanded and evolved to meet the needs of a fundamentally illiquid industry. Investors in private equity are typically committed to the funds for a ten year period. Secondaries allow limited partners requiring cash before the end of the fund's life to buy and sell long-term capital commitments and generate liquidity. It is estimated that \$20bn in new funds was raised by secondaries investors during 2007 and this figure looks set to increase with the impact of the credit crunch.

Catherine Craig in her article for Private Equity News (11.2.08) titled 'Contrarian secondaries firms harvest golden opportunities' quotes Marleen Groen of Greenpark Capital: "Secondaries are counter-cyclical and we're likely to see a good vintage year in 2008." Craig then discusses the losses in the sub-prime and property markets sustained by the banks along with the increased capital cost of holding private equity assets. The Basel II Accord increases private equity capital costs of banks by around two to three times. This combined with a decrease in distributions and profits from the asset class means that many financial institutions are facing liquidity issues.

Angela Sormani writing in EVCJ (1.3.08) 'Trading around the balance sheets' quotes Groen: "Going forward we expect to see seriously struggling banks selling off their private equity interests to generate liquidity. If they still have significant holdings that is, many have already sold part or all of their private equity portfolio because of Basel II so there is limited stock coming from the banks. Even so, the credit crunch could still result in significant secondaries dealflow." Sormani writes that "cash-needy banks look set to provide a boost in deal flow for the private equity secondaries market". She reports that credit crunch related writedowns are estimated to be approaching \$150bn. She cites Private Equity Intelligence which names banks as the biggest contributors to private equity funds, with an average allocation of 12.7%. Although this amount is smaller than the 17.2% and 14.8% average allocation of asset managers and family offices/foundations respectively, it amounts to significantly more funding when the size of assets are considered.

In Private Equity News, Craig discusses the offloading of about \$1bn in direct private equity investments by Citigroup. Also, she writes that: "Last week the California Public Employees' Retirement System sold the largest portfolio of private equity fund commitments to be divested by a pension fund." Alongside banks, pension funds are the biggest contributors to individual private equity funds. The vast amounts invested in private equity since 2003 (\$400bn-plus raised in 2007) and the increasing liquidity pressures could create a buoyant secondaries market. However, this potential for the market brings with it the requirement to navigate its increasing complexities. Craig quotes Groen: "The market has become substantially trickier, with a lot of sellers looking for customised solutions, but not all sellers have been able to accept adjustments to pricing relative to the changes in market conditions since the credit crunch.