

Will there be a secondaries boom?

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As any investor knows, timing is everything. And over the course of the past 12-18 months, reading the market for signs to invest has become a full-time occupation. For secondaries investors, this is particularly true. In 2007, prior to the current economic downturn secondaries prices had reached historic highs, with premiums to NAV of 40-50% not uncommon. But during 2008 the balance of power shifted and over the course of 2009, as buyers and sellers have felt their way around in this unfamiliar territory, discounts to NAV of 40% to 60% have become commonplace.

Unsurprisingly against this background sellers have been reluctant to sell and, on the whole, many have managed to find ways of avoiding having to do so. Consequently the much anticipated secondaries boom of 2009 is edging towards 2010. But might it fail to materialise at all?

Clearly a lot hangs on the level of motivation of distressed sellers choosing to take the 'elegant solution' offered by secondaries. Focusing on LPs, their main reason for selling on unfavourable terms would be to free up capital, as a matter of urgency, to repair capital adequacy ratios or over-commitment strategies. Capital calls in the recent past have been kept as infrequent as possible and almost at a 'keep the lights on' level. Where deals have required a draw they have mostly been to support small add-ons to existing portfolio companies at low multiples.

If LPs can find alternative ways to raise capital their motivation as distressed sellers goes away. (They may, however, still wish to rebalance or finesse their portfolio by exiting a portion of their private equity interests to invest in other funds.) But with current forecasts for the UK economy remaining cautious to say the least, their options for increasing returns from other sources continue to be limited. Some relief on allocation indices has been achieved by improving public market performance and much has been made recently of the intentions of larger buyout firms to create liquidity through IPOs. We are even starting to see more volume on exits to trade buyers, albeit from a low base. However, even if all of these companies achieve whole or partial exits, it is unlikely that the capital flows will be sufficient to move the needle for LPs.

Despite compelling aggregated research data that suggests LPs will continue to maintain allocation to private equity over the long term, until equity indices and bond markets achieve a sustained and significant rally LPs will continue to struggle to fund their draw down commitments and will continue to need to address allocation issues and over commitment strategies. In the short term, therefore, it remains likely that a need to reduce their allocation to the asset class, combined with a need for cash will require them to exit fund commitments over the coming year – regardless of discounts to NAV.

So if LPs and GPs have reluctantly come to accept the new market paradigm – and this has taken far longer than many commentators anticipated – what is now holding back activity? No-one disputes that potential deal flow is higher than at any point previously; yet the volume of closable deals has fallen to its lowest level for many years.

The problem is the difficulty of assessing future returns. Investment committees take a long time to reach decisions in any market but, in the current market, it is extremely hard to assess performance while factoring in the lack of visibility and taking a view on GP quality and strategic viability.

In addition, many portfolio companies began missing their forecasts earlier in the year and are struggling with debt levels well in excess of the current norm. Until the economic outlook stabilises and the exit environment improves (particularly at the large end), calculating fair value is impossible. A 'fear' discount is being built into pricing, and that is the point on which sellers and buyers are struggling to agree. Consequently we expect the total value of deals completed this year to be less than \$10 billion globally (compared with \$20-30 billion last year), despite there being an estimated \$70-\$80 billion of interests for sale. For reference, the total volume of transactions in private equity interests, for the first five months of 2009 was \$4 billion.

Once the issues of pricing and primary market activity can be resolved, the market is going to take off in earnest. The major factors influencing sellers' current motivation such as economic uncertainty, draw down requests, unbalanced asset allocations and limited returns from their investment portfolios are unlikely to be resolved overnight. And GPs that have held off from making onerous draw down requests will not continue doing so forever.

We expect 2010 to be the best buyer's market since secondaries began nearly three decades ago, both in terms of quality and quantity. Experienced secondaries investors such as Greenpark Capital, with detailed diligence models, proven expertise across multiple investment jurisdictions and firepower in reserve, will be well placed to identify and invest in the highest quality assets on offer.

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