

With debt markets tightening, what is the likely impact on the primary PE / secondaries market?

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The 'credit crunch' that many commentators are predicting is potentially one of the greatest threats to the private equity industry for many years. Private equity thrives on access to cheap debt, and so the assumption goes, if the supply of it contracts the industry will be left with a raft of highly geared and highly exposed investments, wondering how to make its model work. If the private equity market is put under pressure to achieve its double digit returns, will investors simply switch into better performing asset classes, and if so, will secondaries be the main beneficiaries?

The secondaries market is booming: from complex direct transactions to plain vanilla portfolio deals, every type of institution investor now trades in private equity secondaries. In addition, value-added strategies such as those with a structured element are providing specialist operators with an opportunity to make money. It is estimated that secondaries funds currently have around \$20bn to invest, excluding capital available from private equity fund of funds and other pension fund allocations. If that is included, the total figure could be as much as \$40bn.

Active portfolio management is driving volumes, allowing LPs to free up capital for redeployment elsewhere. But also, because competition for assets is so intense they can achieve strong premiums on non-core investments. Some quality LBO funds have been trading at a 30-40% premium, and double digit premiums are now commonplace for secondaries assets. As recently as two years ago, by comparison, discounting was standard.

Increasing demand for private equity means LPs that are new to the asset class and are looking to build portfolios and relationships with GPs relatively quickly are less reluctant to pay a significant premium for secondaries. Portfolios of partnership interests in buyout funds, pre-leverage, are currently being priced at IRRs in the low teens. At the same time, as sellers become less 'distressed' and more active, the solid but less exciting returns offered by mature secondaries are less appealing to buyers. Newer, less fully funded secondaries are commanding higher prices, partly due to sellers becoming more active earlier in the J-curve and looking to maximise returns.

The key factor driving the secondaries market, indeed with any market is a ready supply of buyers and sellers looking to do deals. After several years of economic growth across Europe and the US, there are signs that a slowdown, or even a full blown downturn are on their way. How will the secondaries market react, if and when that happens?

In the crisis of 2001, LPs under pressure began liquidating private equity positions at any price, discounting heavily in order to achieve a sale. But the market has changed dramatically since then, rising from \$1.9bn in 2002 to an estimated \$15bn in 2007. Private equity is now an established asset class for every type of institutional investor, and it is likely that LPs today would be much more reluctant to exit their investments. In addition, given that they have grown used to achieving strong premiums, selling at a discount might be a bitter pill to swallow. For sellers to start discounting heavily as happened in 2001, any economic downturn would need to be even more severe.

Already the difficulties being experienced in leveraged finance are making it prudent for secondaries to be even more cautious when pricing new investments. Investors need to incorporate views on the operational performance and exit scenarios for underlying companies, mindful of the volatility and uncertainty in the credit markets. The best way to do this is to have a clear view of the outlook for the capital markets, and apply it to each company individually.

If the credit crunch broadens to the wider economy, private equity firms could find themselves exposed to higher than expected risk and returns could start to fall. In addition, the reluctance of banks to lend at such heady multiples, coupled with the rising cost of borrowing could make it harder for GPs to do deals. That, in turn, could make the asset class less desirable. In that scenario we could see a number of LPs, not to mention GPs, wanting to sell their underperforming assets. But in a bear market, sellers might find it wiser to hold on to these investments rather than sell at a knock-down price. In addition, after the fundraising bonanza of recent years GPs are awash with cash – unlike in 2001.

Given the desirability of private equity and the wide range of investors it attracts, any fall in asset prices could potentially reignite the market. The use of secondaries as an active portfolio management tool might potentially take a back seat, causing volumes to dip, but as long as there are buyers and sellers in equal measure, prices will remain stable.

