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Debt Mounts in Secondary Market

By **ED BALLARD**

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The market for secondhand private-equity interests is increasingly awash with debt.

Data from private-equity adviser Triago shows how much secondary investors have leveraged their deals to enhance returns.

Based on an analysis of 1,217 transactions since 2013, Triago estimated that debt accounted for 23% of the money spent on private-equity secondaries deals last year, up from 19% in 2016 and just 4% in 2013.

That would mean debt represented $10.35 billion of the record $45 billion in secondaries deal volume that Triago estimated for 2017.

In transactions that involved debt, borrowed money accounted for 49% of deal value in 2017, up from 36% the prior year and 17% five years ago, according to Triago.

Triago estimates that 65% of secondaries buyers use leverage, up from 15% in 2013. The firm's survey was based on transactions the firm had arranged and information gathered from other market participants about their deals.

Daniel Green, head of secondaries investment for Europe, the Middle East and Africa at Deutsche Bank Asset Management, said the use of leverage has become the norm among big secondaries players competing for sizable investments in hotly contested auction processes.

"It's not ubiquitous, but in a lot of the large, highly competed-for transactions, the use of leverage is almost an obligation in order for buyers to generate their returns," he said.

Debt can enhance returns on a secondary buyer's equity, much as it boosts the potential return on equity in a buyout deal. It can also give secondary buyers extra firepower to increase their bids.

Mr. Green said the market's approach to leverage has changed markedly since the mid-2000s. "In the early days nobody used leverage, because nobody needed it," he said.

As the market has become more competitive, investors have begun using various forms of debt. As well as taking out loans secured against the particular assets they are bidding on, firms may use fund-level debt secured against their investors' undrawn commitments.

Mr. Green said firms also use vendor financing, in which a chunk of the deal value is paid up front and the rest is deferred—an approach that enables firms to fund deals in part using distributions from the underlying assets, boosting returns.

Adding leverage on underlying portfolios that often are levered themselves can put those deals at a greater risk of default if the underlying portfolio companies fail to generate sufficient cash.

Some investors resist the lure of leverage. Mr. Green at Deutsche Bank said his firm plans to limit its reliance on debt by avoiding heavily mediated processes that are won on price.

"Our preference would be to create transactions in partnership with managers or investors," he said. "We believe that, although there may be more work put into structuring bespoke deals, the approach generates more attractive situations with more limited need for leverage."

Deutsche Bank is currently rebuilding its secondaries investment arm after its old investment team left to form a new firm Glendower Capital, last year. The firm announced the appointment of Mr. Green last month. His arrival followed the hire in November of Mark McDonald from Credit Suisse Group AG to run the private-equity secondaries team globally.

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