COVID-19 Puts Private Equity Secondaries Back in the Starting Blocks

By Mathieu Drean (guest column for Private Equity International), April 14, 2020

On March 31, 2020, we closed multiple transfers for several private equity secondary transactions, all put in motion prior to the COVID-19 market dislocation. While it's clear that over the past month the broader secondary market has come to a brutal halt, the odds are that we'll be closing several more secondary transfers at the next quarterly window on June 30.

Mathieu Drean is managing partner in charge of global secondaries at private equity fund advisory Triago. He closed his first secondary transactions in the late 90s using faxes and surrounded by boxes of xeroxed financials.

In our conversations with secondary buyers, they explain that they remain open for business. That's well and good, but concretely, what will it take for buyers to actively underwrite transactions and offer solid, reliable pricing? Of course, all are waiting for "better visibility," i.e. guidance from general partners concerning revised valuations of portfolio companies. But even more importantly, buyers and their investment committees will need a serene mindset - an ability to engage in clearheaded analyses of the appreciation potential of portfolios, despite the temporary chaos tied to COVID-19.

There will be markdowns in the first quarter and second quarter of this year. The most significant losses are likely in the latter period, when GPs hopefully will have a clearer view of Covid-19's impact on portfolio company operations. When Q1 figures come out in a few weeks, net asset value losses are expected to be all over the map, with writedowns ranging from the modest single-digits to 25 percent or more. Indeed, net asset value markdowns in Q1 and Q2 will be an interesting test of how subjective valuation policies remain for GPs.

But an historically high-level of dry powder - committed, but uninvested capital - stands ready for deployment from secondary players. Whether we end up witnessing a V-shaped or U-shaped recovery, many buyers will be eager to get transactions done prior to the rebound. A lot of them will aim to capture above average appreciation by taking advantage of larger than average discounts to net asset value - possibly during a very short window of opportunity.

A lesson from the global financial crisis is that that those who dared to buy in the secondary market during the GFC and in its immediate aftermath (late 2008 to 2010) achieved stellar results, whether measured by annual returns or, even more notably, when measured as a multiple of invested cash. Groups that aggressively and successfully bought during this period saw huge demand for subsequent fundraising campaigns, boosting the development of their secondary platforms.

Presuming that coordinated public healthcare policies are effective in ending COVID-19 lockdowns, professionals in all secondary firms are readying themselves for a wave of transactions starting in the fall. That's when transaction processes abruptly shut down by the crisis are likely to restart. But between now and then we can expect some smart players to proactively find new opportunities, with a select number of transactions closing before summer.

In the short-term, savvy buyers are likely to focus on less mature assets. Up until recently, the vast bulk of market activity revolved around relatively mature funds (including tail-end assets). Prior to the COVID-19 crisis, frequently the goal was to underwrite fund portfolios that would liquidate so rapidly (short duration investing) that proceeds could be reinvested at least once before being distributed to investors. Known as recycling, the practice is in abeyance due to the crisis.

In a resurgence of what we saw in 2009, we expect many transfers to clear between sellers and buyers for relatively unfunded positions (only 5%-20% drawn, with the bulk of fund commitments still uninvested). Because discounts in the secondary market only apply to invested capital, these so-called early secondaries can be a fairly painless way for sellers to free up committed but uninvested capital, and for buyers and sellers to arrive at mutually satisfactory pricing - even at significant discount to net asset values. The cash thus generated can be used for either short-term needs or redeployment into new investments. Early secondaries can also be attractive opportunities for primary-minded buyers (investors of all types who have historically focused on primary investing) to gain exposure - or dial-up existing exposure - to specific fund vintages of GPs they like.

We believe there are critical differences between how the GFC impacted the secondary market and how today's market dislocation will evolve. The GFC led secondary players to be more cautious in a marketplace that was smaller; this resulted in volume growth that lagged well behind the pace of economic expansion in the post-crisis era.

Compared to 2008, the secondary market is better positioned for a swift recovery (this is why the window for securing significant discounts to net asset value may prove especially short-lived). Substantial growth in recent years has propelled the institutionalization of market dynamics. Buyers today hold at least four times the amount of dry powder they did in 2008 (approximately $140 billion today), and sellers are notably more accustomed to using the secondary market. The larger, more robust marketplace is likely to generate greater competition and higher pricing than what we witnessed during the GFC.

Liquidity needs are expected to rise in a marketplace characterized by extreme gaps in price expectations between sellers and buyers (a result of valuation uncertainty and wishful thinking by both groups). In this context, many buyers are promoting preferred structures as a means of bridging differences and getting capital to GPs who need it. Preferred equity is a step down the chain from traditional ownership and gives the capital provider first right to early cash flows, with returns capped at an annualized rate (typically in the low teens). We question, however, the extent to which preferred equity will prove a magic bullet for GPs seeking liquidity to support their investments. LPs who sit on GP advisory boards will need to consent to the use of preferred equity or similar top-up vehicles. They may block such dilution or elect to provide the capital themselves.

In terms of long-term significance for the performance of secondary managers, and more broadly for all private equity managers, the COVID-19 crisis will prove exactly like the GFC in one critical aspect. It will determine who the best managers are in tough times. Managers who excel regardless of cycles and in spite of crises are the cream of the crop. It's top-flight investment managers who will - however modestly - help people rebuild in the wake of COVID-19.