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Secondaries firms saddle up for a champion year

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Private equity investors have got into the habit of trading in the same way as wealthy individuals have long bought and sold stakes in racehorses. But whether the market will continue to gallop ahead is still in question.

Following the financial crisis, when many investors in private equity funds were looking to shrink their allocations to the asset class, firms raising funds to acquire second-hand private equity fund stakes – known as secondaries investments – were inundated with capital. Deals are now starting to slow but, despite this, the sector remains very much part of the financial landscape.

Funds focusing on acquisitions of fund interests – which account for the vast majority of secondaries activity – raised $14 billion across 19 funds globally last year, according to data provider Preqin. The figure included $10.2 billion raised by North America-focused funds – almost three times that raised by Europe-focused secondaries funds last year.

Such capital raising may have fallen from the $20.6 billion raised by 16 secondaries vehicles in 2012, but firms remain hungry for deals, with 28 funds currently attempting to raise $26.5 billion globally. Estimates on the total value of secondaries deals completed last year vary but a quarterly private equity report published last month by advisory firm Triago said full-year secondaries volume was set to amount to $22 billion once the complete figures came in, a 15% drop from the record $26 billion of deals carried out in 2012. The report attributed the decrease to the reluctance of “cash-rich investors to sell at anything but modest discounts”.

However, competition from a large number of buyers in the market has significantly improved pricing for sellers. Triago said in its report that average discounts remained within 8% of funds’ net asset values (NAVs) in each quarter of last year, with an average discount of 7% towards the end of the year. In fact, Triago expects secondaries volume this year to reach a record $30 billion as firms “shift their focus from bargain basement pricing to the lower risk and the shorter investment duration of secondaries, with the average discount staying near current levels or shrinking”.

Rodney Reid, head of private equity secondaries in Europe at UBS, agreed secondaries activity this year would be “robust”. He said: “Since the second half of 2013, sellers have shown an increased receptiveness to bringing secondary transactions to market.”

He added: “I would expect to see [pricing] improve even more over the next couple of quarters. There are funds pricing at low single-digit discounts and a handful even at premium levels. There has definitely been an uptick due to a significant amount of dry powder [and] fewer transactions, which is increasing competition among buyers."

The make-up of buyers and sellers in secondaries is changing. Much of the regulation-driven sales of alternative assets by banks has already taken place, and pension plans have enjoyed better cash positions than in the worst periods of the crisis, meaning they have less need to sell.

As a result, sales by financial institutions and public pension plans, which have historically accounted for a significant proportion of sellers, have dropped as a total proportion of sales from 54% in 2011 to 44% in 2012 and 25% last year, according to a secondaries report published by fund-of-funds manager Pantheon last month.

Merits of secondaries

Mathieu Dréan, managing partner at Triago, said every investor had become a potential seller as a result of narrowing discounts on pricing. He expects dealflow to come from all types of investors. He said: "There will be enough buyers this year who will recognise the merits of secondaries opportunities, even when they are priced at par or close to it, which means there will be decent pricing and that will trigger transactions.

"For very mature assets, the [discount percentages] need to be more in the teens or 20s, wider than more mainstream secondaries strategies, which focus on more recent vintage, where pricings that spark significant dealflow range between 90% and 100% of net asset value. That discount is expressed relative to a NAV that continues to progress so [pricing] will remain relatively steady."

However, rising prices mean buyers are lowering their return expectations. A London-based secondaries specialist said: "Historically, buyers target a 1.55-times multiple and high teens to low 20s [internal rates of return]."

He said that buyers could be targeting below-average return multiples, "even dipping down to 1.3-times". "It does depend on transactions and where buyers are in terms of the fundraising cycle," he added.

However, research published in September by Professor Oliver Gottschalg of HEC business school in Paris and Dr Bernd Kreuter from advisory firm Palladio Partners suggested deeper discounts did not necessarily lead to better returns. The study showed investing at a 20% premium in a top quartile fund provided better returns than investing a 20% discount in second- and third-quartile funds, suggesting that the purchase price of a fund interest may not always be reflected in the eventual return.

Nik Morandi, a partner at investor Pantheon, said: "What counts is the relative return. Most sophisticated investors in private equity understand what they are looking for is relative outperformance to listed equities. The more we can get distributions back, the better the internal rate of return [IRR] will be. It is a trade-off between the likely multiple and the IRR. The current exit market for private equity is very favourable."

What's in the pipeline?

Despite a lower post-crisis profile, there is still a lot of upcoming activity in the secondaries market.

Recent fund stake acquisitions include Lexington Partners' agreement to acquire a roughly $1 billion portfolio of US and European private equity fund investments from Ireland's National Pensions Reserve Fund, while other portfolios on the market include the spin out of One Equity Partners from JP Morgan, which could range from $4 billion to $5 billion.

Allstate Investment Management, one of America's biggest insurance companies, is also in talks to sell a private equity portfolio worth more than $500 million.

Pantheon expects sovereign wealth funds, which have been ramping up their private equity activities in recent years, to increasingly look to the secondaries market to offload some of the private equity investments they have built up.

Nik Morandi, a principal in the secondary investment team at Pantheon, said: "[Sovereign wealth funds] are moving on. They have got big ambitions to go direct, mimicking what the Canadian plans have done, and I expect some of the primary commitments they have made in the boom years to start showing up in the secondaries market."

He added that funds of funds would become a bigger source of secondaries dealflow this year, as many funds had passed the extension periods secured for their ten-year funds and were under pressure from investors to wind up and return capital.

According to Pantheon, funds of funds have accounted for 12% of all sellers in 2011, 2012 and last year.

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