KEYNOTE INTERVIEW

# Secondaries sees a bright future

*Activity within the secondaries market is experiencing a brief lull, but it will bounce back stronger than ever in 2023, says Shane Feeney, managing director and global head of secondaries at Northleaf*

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**Q How is the appetite for funding GP-led secondaries deals being impacted by today's challenging economic environment?**

Transactions are still getting done, but it is a very discerning market. GP-led deals have always involved higher-quality businesses, but in today's market, every box needs to be ticked in terms of asset quality, GP alignment, rationale for the transaction and the underlying portfolio company management team's rollover into the new deal.

The secondaries market is not the lowest cost of capital in the ecosystem, so the bar is very high; we are seeing more deals getting pulled, or not even getting launched. Advisers are increasingly coming to us to test our appetite on a deal before they take the mandate. In short, more caution is creeping into the market, but transactions are still being completed. It is not a total shutdown, but buyers have a 'can't miss' mindset.

**Q What about appetite for these deals from the GPs?**

GP appetite remains very strong. In fact, in many ways, appetite is increasing as traditional exit routes dry up. The IPO market is pretty much closed and accessing financing is becoming more challenging, which means GPs are very keen to explore GP-led deals as an alternative.

Historically, some LPs have been cautious about investing in GP-led deals due to the potential conflicts of interest, but I think that tide is turning, with distributions to paid-in declining. I believe that LPs will become more accepting of these transactions if they deliver liquidity back to investors in an environment where exit activity and distributions are down.

**Q There have been a number of new entrants to the GP-led space. How is that likely to impact competitive dynamics?**

I don't think we would say that this market isn't competitive, but it doesn't feel overcrowded either. There remains a fundamental disconnect between supply and demand, despite some larger mega-fund managers launching GP-led strategies.

In terms of dealflow, the LP-led market has slowed significantly. Unlike the GP-led market, where it is possible to conduct extensive due diligence on underlying assets to assess resiliency and ability to withstand a downturn, it is far more difficult to do a deep dive on every asset in a large, diversified portfolio. Although buyers get the benefit of more diversification with LP deals, discounts tend to be applied.

Furthermore, buyers are pricing based on stale reference dates, which works to their advantage in a rising market but causes bid-ask spreads to widen in a falling market. All in all, the LP-led side of the market is pretty challenging right now in terms of buyer and seller expectations.

**Q What is driving those LP-led deals that are taking place? Which LPs are proving happy to transact?**

Broadly speaking, you can bifurcate LPs who would like to sell into two categories. Some LPs are very focused on net asset value and don't want to sell at a significant optical discount. Then, there are other LPs for whom NAV is certainly instructive, but cashflow modelling is the real focus. These LPs will do more detailed cashflow modelling on the portfolio and sensitivity analysis on the expected distributions in order to work out the forgone return at different sales prices. They compare that to the return they would earn by reinvesting the capital elsewhere within PE or the broader fund, and then decide whether or not they want to sell based on that equation.

**Q Do you expect to see genuine distressed sales creeping into the market?**

We haven't seen distressed sales at this point, and I expect that the market will continue to be pretty rational. I don't think we will see sales being made at any price. Most investors now have conviction in the asset class and, as an industry, we are better positioned to withstand a downturn.

Having said that, different investors have different portfolio objectives, and I think that once NAVs do adjust, whether based on a June or possibly a September reference date, then we will see more selling.

The other trend that we are seeing playing out in real time is that private equity distributions were down close to 40 percent in the first half of this year. LPs are no longer getting capital back at the rate they are used to, and I think that will potentially play into their decision to sell NAV going forward, particularly if they are overcommitted.

**Q What are the challenges involved in having GP- and LP-led secondaries deals in the same portfolio?**

At Northleaf, we don't have firm targets regarding the split of GP- and LP-led exposure in the portfolio, but we do have some general guidelines. Every time we put a transaction into our fund, we model out the impact on the cashflow profile of the fund. This is something we are very sensitive to and actively monitor. Ultimately, we are trying to optimise the risk/return profile of the fund and believe having a mix of GP- and LP-led deals will do that.

It is true, of course, that the cashflow profile of a concentrated GP-led deal is going to be different compared with a highly diversified LP-led deal where you start getting money back almost immediately. GP-leds are going to involve more of a bullet exit when the individual company or companies get sold. Having said that, I believe that the holding period on these GP-leds is going to be shorter than many people think. We don't have enough data on this yet, but I don't think these will all end up being four- or five-year holds. The exit window will be shorter, and that will help in terms of some of these cashflow implications.

**Q What role do you expect preferred equity to play going forward?**

I expect to see preferred equity and NAV-based lending solutions gain strength over the remainder of this year. If sellers feel that pricing is too low, these solutions provide a way to resolve that bid-ask spread. This applies to both LP portfolios and to GP-led deals, where we may see GPs using portfolio financing solutions to offer investors liquidity or to support portfolio companies. Given the more conservative secondaries and traditional credit markets, I believe that preferred equity and other creative portfolio financing will gain market share over the next six to 12 months.

**Q What do you believe the future holds for secondaries over next 10 years?**

We are bullish on the size of the secondaries market going forward. We think it will continue to evolve and will increasingly become a mainstream tool for institutional investors. It is no longer seen as a sign of weakness to turn to the secondaries market to rebalance a PE portfolio. There could possibly be a slowdown in volumes this year, but we expect the market to bounce back strongly in 2023.

Ten years is a long timeline to predict, but we certainly expect to see strong growth and increased specialisation over the next four to five years. We expect to see continued innovation. We also expect the secondaries market in credit and infrastructure to continue to mature. Finally, we see Asia as a big growth opportunity as well. Overall, we are extremely optimistic about what the future holds for secondaries. ■