The View From Chicago

by Marine Cole on 24 JULY 2015 in Commentary, Editor's View

Regular readers know I've been racking up the frequent flyer miles lately. This week I was in sunny Chicago for an industry conference and a number of meetings with secondaries-focused professionals around town. Here were three themes sources brought to my attention:

1. Buyers are increasingly selling

There has been talk for a while that sellers would become buyers, but it hasn't really happened yet. Most limited partners, particularly pension funds, don't have the resources and ability to have a full-time dedicated secondaries specialist able to conduct due diligence. For those that do, like the Canada Pension Plan Investment Board, it can be challenging to retain key personnel.

But what is increasingly happening is that buyers are becoming sellers. Most funds of funds involved in the secondaries market are selling, especially tail-end funds where there are only a few portfolio companies left in a multitude of funds. Secondaries firms are also increasingly selling, particularly if they want to shut down old funds.

"It tends to be a large contingent of funds but you may not have that many companies," said one market participant, pointing to the diversification in such transactions.

One consequence is that these sales are usually much more focused on the discount than other typical transfers of LP stakes. "The expected uptick in value from today is almost null," he added. "So returns are 100 percent based on the discount and timing." This is mainly because the funds and portfolio companies are old and there's very little appreciation potential left.

2. The restructuring market is growing and is here to stay

It's still unclear how much of the secondaries market GP-led restructurings comprise. I've heard as little as 10 percent for last year and as much as 25 percent for this year so far. But most people agree it is growing and becoming a more established part of the private equity market.

Someone at an advisory firm told me that even if the stock market goes through a correction, GP-led restructurings will remain robust, while the market for LP portfolio and fund stakes will be more affected because pricing is more pegged to public valuations. Pricing in restructurings, on the other hand, doesn't depend solely on public valuations.

The other good news is that the quality of GPs undergoing restructurings is going up and we're seeing fewer zombie funds.

Yet, despite the popularity of GP-led restructurings, some secondaries market participants continue to take them with a grain of salt. While the market may be moving away from being focused on zombie funds only, there's still a certain stigma attached to a lot of situations.

"Beyond zombie funds, there are situations that make sense," said a secondaries investor. "But usually restructurings stem more from a problem than an opportunity in most cases."

3. Return expectations have gone way down

Expected returns have gone down to about a 1.3x multiple, someone at a secondaries firm told me, while a year or two ago, the market was pricing at least 1.5x or 1.6x multiples. This drop has happened despite the market having entered an environment where valuations are full if not close to peak, indicating a riskier investment environment.

“The margin of safety in expected returns is very low,” he said. “I suspect we’re going to have a correction.”

As risk is increasing, secondaries firms, in theory, should slow down or even halt their investment pace and try to avoid buying assets that are likely to be overpriced. But they have raised an enormous amount of new funds in recent years, money they have to put to work or else LPs may not back their next fund.

Sure, some secondaries firms have told me that they have slowed down their investment pace this year but current activity and predictions for 2015 deal volume is indicating that they’re still a minority. Secondaries firms can’t just stop putting money to work, that’s not how it works.

“I find it a strange reality that at market highs volatility is the weakest and margins of safety are the smallest when really it should be the other way around,” that person said.