MEET THE ROUNDTABLE

JOSEPH MARKS
CAPITAL DYNAMICS
Marks is a managing director and head of secondaries in investment management in New York. He has 17 years of experience in private equity and was previously a principal at Coller Capital, where he was responsible for secondary portfolio transactions.

BRIAN MOONEY
GREENHILL COGENT
Mooney is a managing director in the capital advisory group in Dallas. He has more than 15 years of experience in the secondaries market. Prior to co-founding Greenhill Cogent he was a member of the investment team at The Crossroads Group, which is now part of NB Private Equity Partners/Neuberger Berman.

SECONDARIES ROUNDTABLE

'NAV is just a number'

Private Equity International sat down with six industry experts in New York to discuss whether the easy money has already been made in the secondaries market, how liquidity is affecting the market, and to examine what the remainder of 2015 has in store for the sector. Amanda Janis and Chelsea Stevenson report

Navigating full pricing, the rise of restructurings and the use of seller financing in today's booming secondaries market were among the topics debated recently by a panel of market experts.

There's no denying the secondaries market is thriving. Estimates for last year's closed deals were around the $50 billion-mark, with pricing at an all-time high and an increasing number of buyers and sellers entering the market.

PEI recently hosted a roundtable in New York with some of the industry's thought leaders and veterans to discuss the market's latest trends and challenges.

PEI: All the easy money's already been made in secondaries, according to a

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***Financial Times* column last month. Fighting words or bang-on?**

Barry Miller: 'Easy money' is a broad-based term. There is probably more competition today . . . but the reality is there is a lot more opportunity as evidenced by unprecedented volumes of assets brought to market. That means we can be more selective in the transactions we pursue.

Rudy Scarpa: There are still inefficiencies in the secondary market. We need to remember that we're buying limited partnership interests in private funds that are in turn invested in private companies. While eventually general partners sell those companies at their market value to generate good returns, a portfolio company's current net asset value (NAV) doesn't always equate to current fair market value and that translates into market inefficiencies. As long as inefficiencies persist, there are opportunities for secondary buyers to generate attractive returns.

Joseph Marks: Rudy refers to inefficiency; another term might be 'pockets of value' and I think that whether it's a deal's complexity that it gives you an opportunity or a smaller without as much fanfare transaction, there are always pockets of value in the marketplace. There is a certain degree of randomness in every transaction and not everybody can focus on every deal at the same time.

***PEI:* But what about today's full pricing environment? Surely that's a challenge.**

Adam Howarth: It's really about selecting the right assets where you see real future value potential. We buy LP interests but really what drives value is the underlying cash flows.

You also have a lot of liquidity in the markets today that you maybe didn't five years ago, when there was a lot more uncertainty. So [with] a combination of visible exits plus being able to project [underlying assets'] future value, I think you can really [take your] pick in today's market and find things that appreciate. And as I look across returns in the [secondaries] industry the last five years, there is a pretty strong track record and that's been in a high-priced environment.

Brian Mooney: Pricing has never been higher in terms of percent of NAV, but that's too easy a number to focus on. It's rarely the right way to think about the assets you're buying or selling. When we're advising someone on the sell side we try to get them away from focusing on 'what percent of NAV am I getting' toward 'what percent of the future value discounted to today does the offer price represent?'

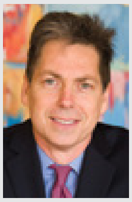
Miller: It's a starting point. NAV is just a number and you start from there – you move forward and you figure out mathematically what kind of rate of return you'll get.

Patrick Knechtli: Headline secondary pricing reflects mostly the bigger transactions – the larger portfolios of well-known, brand name buyout funds that are being sold. They are often priced fully and in some cases have leverage applied to them, which again boosts that headline price. [We tend to focus on smaller transactions or lesser-known managers.]

Howarth: I still think the term 'full price' is irrelevant because it goes down to the cash flows. And if I buy something at what seemed a premium to the reference date, I can generate cash flows over a whole period – which may be three or four years – that are well in excess of what that cash purchase price was. »

MEET THE ROUNDTABLE

BARRY MILLER
LANDMARK PARTNERS
Miller is a partner in the private equity group. He opened Landmark's New York office in 2013 after working as the head of private equity at the New York City Retirement Systems. He has also worked as a partner at Pomona Capital and spent seven years as a senior investment manager at AXA Private Equity.



RUDY SCARPA
PANTHEON
Scarpa is a partner on the secondary investment team, having joined the firm in 2007 to open its New York office. He was previously a partner on Coller Capital's deal-sourcing team and has also worked at TH Lee Putnam Ventures, Merrill Lynch and Skadden Arps.

ADAM HOWARTH
PARTNERS GROUP
Howarth is a managing director who co-heads the firm's global private equity secondaries. He spent several years in Partners Group's Singapore offices before moving back to New York in 2014. He also spent five years as an associate at HarbourVest Partners.

PATRICK KNECHTLI
SL CAPITAL PARTNERS
Knechtli is a partner who leads SL's secondaries investment programme in Edinburgh. He joined the firm in 2009 after spending nearly eight years focusing on private equity secondaries at Coller Capital in London. He has also worked in the M&A and capital markets advisory group at Dutch bank ABN AMRO Group.

> ***Not all LPs or capital commitments are created equally. LPs bring different things to franchises and to sponsors***
>
> **Adam Howarth**

» So we are not as concerned about what the price is vis-a-vis the NAV because that's so fungible – is it reference date, is it closing date? Historically it's always been around that reference date NAV that people have benchmarked to, but you can kind of use anything you want to.

Mooney: I don't think all the easy money has been made, but return expectations are just different. Years ago the substantial majority of what was transacting were sellers who needed liquidity or were getting out of private equity. There was a price, the buy side was fairly limited and buyers were targeting returns, for a lower risk asset, well above what primary investors were targeting. That's changed now, at least in my opinion, where secondaries are less risky than primaries and now are generally underwritten to a lower return expectation than primaries.

***PEI:* What should return expectations be?**

Howarth: I think it's really tough to define. There are so many different strategies, so many different groups focused on different assets, different types of transactions, different structures, different risk profile underneath there. But clients that we talk to are looking for some sort of premium over the public markets – whether that's 300 or 500 basis points net, I don't know.

Miller: That's the key: they're looking for premium that is a liquidity premium. The challenge [when talking about returns] is people always talk about 'private equity', but it is asset dependent. If you look at private equity it is buyout, mezzanine, venture, growth, U.S., Europe – it is important to define what people are talking about.

***PEI:* Let's go back to this notion of 'pockets of value'; what types of deals are you finding most attractive?**

Knechtli: Secondary players tend to focus on where they have good knowledge and insights. So for us, we target smaller-cap funds that don't typically trade on the secondary market very frequently. When they do come up, we are usually in a favoured position, usually both because of the information we have on the underlying portfolio, but also the relationship we have with the manager as well. We are trying to use our primary and co-investment platform to position ourselves well in secondary deals.

Marks: In our case, we focus on the small-end of the market where there are better pockets of value than the larger or broader auction channel. That provides interesting options that are often off the radar of larger funds. We also leverage our primary platform.

***PEI:* A year or two ago, it seemed everyone was talking about 'zombie' funds and how secondaries capital could help solve the issue for investors. Today it seems the focus is less on poorly performing managers unlikely to raise another fund, and more on GPs with decent track records expected to raise subsequent funds. Whether you want to talk about 'sunset funds', 'liquidity solutions' or GP-led fund restructurings and recaps, are your firms focused on this secondaries opportunity?** »

» **Scarpa:** GP recapitalisations are going to be a large opportunity. It's already grown a lot over the last several years. One of the drivers for this growth is the lengthening hold periods for portfolio companies. Last year, the median hold period for a buyout was roughly 5.7 years. In 2008 it was closer to 3.4 years. As a result, we'll see an increasing number of mature private equity funds entering into their extension periods that are candidates for this type of solution.

So why is a GP recapitalisation a potential solution? If the recap is structured properly it could be a 'win, win, win'. It could be a win for a fatigued LP that has been in the fund for potentially close to a decade or longer and would welcome liquidity for their interest. The GP could win if it resets its economics, including management fee which will help keep its team intact or carried interest which properly aligns them with the new investors. And, lastly, this type of transaction could be a win for a secondary buyer if they are able to purchase the assets at a fair price.

Mooney: These deals have certainly become more prevalent – in 2011 there were basically none and that changed in 2012. Since then we've probably seen approximately $15 billion-worth of GP-led transactions. Still, there is often adverse selection with these deals. You've got to spend a lot of time upfront vetting potential transactions and figuring out how the deal might fit with the objectives of the LPs, the GP and potential new investors. They are very complex and time consuming and tend to be fairly binary: they either get done or they don't.

There is generally a lot of inherent conflict which must be managed very carefully. But to the extent you can create a situation where the LPs have a more attractive set of options than they would otherwise have, that's where you find support for the transaction from the LP base. And, the GP can benefit from the deal either in terms of their franchise or their economics or alignment with existing LPs or new LPs in terms of buyers.

It's a trend that we expect to continue and there a lot of different forms of deals so it's hard to generalise, but I do think as long as we're in a fairly robust pricing environment, these deals will continue to happen. Once you see things pricing at 15, 20, 30 percent discounts that's where it gets more difficult because the LPs will be much less supportive.

Miller: There is an enormous amount of opportunity out there, but I think the key here we've all alluded to is alignment of interest. It has to be a win for everyone. There has to be an opportunity set that makes sense, and more importantly, the biggest challenge is the adverse selection. There are some interesting opportunities to restructure legacy funds of good managers. For example, you might work with a GP that has successfully raised fund VI to »

> ***Secondaries is somewhere in the agenda of every institutional LP, especially in this pricing environment***
>
> **Brian Mooney**

» provide a liquidity solution to for their fund III investors, so it's not a true 'zombie'.

Knechtli: A lot of things have developed from when we began looking at these [secondary direct/fund restructuring] deals eight or nine years ago and lessons have been learned. Managers and investors are being more realistic about the transaction terms. I also think the pricing environment helps a huge amount, so LPs don't feel as though they are taking as much pain and are not being forced to accept deep discounts to secure liquidity. Allied to this, you've got a decent supply of funds with fatigued LPs, ones where the Global Financial Crisis has impacted performance and stretched out holding periods. So I think we've got a bit of a sweet spot for the next couple of years working through these types of situations.

Howarth: Buyers have to be very selective in undertaking these transactions and making sure they're getting compensated. You take on a lot more risk but you're not getting outsize returns. [Consider] the pricing environment and selection bias – you have to pay 'full price' to get in on one of these situations, then go through all of the restructure work to try to get the alignment there. Or, you can invest in high quality assets with a fully functioning team for the same returns. I'd rather buy the LP interests.

Scarpa: That's an important point because GP recapitalisations are drawing the attention of a lot more buyers. It was an overlooked area for years and now secondary groups, many of which claim they have the relevant structuring expertise to complete these deals, are competing for these transactions. With the increased competition, returns for GP recaps have come down.

A key question for a buyer is whether you are getting compensated for all the additional risk in these transactions. There's franchise risk, for example, but a portfolio may also have company concentration risk. As a buyer, you really need to ensure you are getting properly compensated for that risk. And with the increased competition for these deals, oftentimes, you're not.

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>
> **Barry Miller**

Knechtli: One of the year-end surveys that came out actually asked people about that, return requirements for LP deals and direct deals, and I was pretty surprised at how much the returns had come down on some of the direct deals. Traditionally you were trying to get 2x-plus and mid-twenties internal rates of return, but it looks as though that's no longer always the case. In the end, it's all about the due diligence, really being able to dig into the underlying companies and get comfortable.

One of the big risks in secondary direct deals is that there is often a higher degree of portfolio concentration, with one or two investments making up the bulk of the value and the potential returns – this risk element had sometimes been under-appreciated in the past both by secondary players and their investors.

PEI: Are there other 'lessons learnt' or particular risks/red flags you look out for when evaluating these types of transactions?

Howarth: Our approach is pretty simple. It is quality assets and quality managers. If that's not there it's easy for us to filter out the deal flow.

Knechtli: It's difficult to say you're just going to focus on quality situations, because quite often the better opportunities in terms of returns are the more complex or less obvious ones. In these cases, you need to get your hands dirty to find out the potential within the underlying portfolio and the motivating factors behind the GP.

Miller: The first thing you have to do is make sure there is true alignment of interests. Ensure the GP has skin in the game. You have to go in 'eyes wide open' because as noted earlier, there can be adverse selection.

Howarth: It's not a question of if I can be aligned with the GP it doesn't matter if the asset quality isn't there. In that case, what's going to generate the returns for me? So we got the deal done, but we are not paid to just do the deals; we are paid to generate performance for our clients.

Miller: The primary considerations are the alignment of interests, the quality of the GP, and the quality of the assets and ultimately what one buyer thinks is a good transaction may be different from another buyer. I would define that as healthy competition.

> ***We focus on the small-end of the market where there are better pockets of value***
>
> **Joseph Marks**

Marks: We're on the other side of some of these GP restructuring transactions as an LP and talking about this risk-adjusted return, it looks, more often than not, that with some of the pricing we're seeing, the selling side is the better risk in the trade.

PEI: How are large LPs like sovereign wealth funds impacting competition between buyers?

Knechtli: The larger institutional investors and sovereign wealth funds tend to focus on the plain vanilla part of the market. They focus on buying secondaries in the funds and managers they like and know well, typically the larger buyout funds and some of the higher quality venture capital funds. When interests in those types of funds come to market, these »

» investors are ready to provide pricing and to transact. Other institutional investors are trying to backfill their portfolios with particular geographical or strategic exposures, so when they see an opportunity that matches their criteria they'll go for it, often at a full price.

Scarpa: The buyer universe needs to be separated into its constituent parts. With respect to sovereign wealth funds, for example, many believe that they will be a significant threat to secondary buyers. I don't see them as a big part of the market for several reasons. They often times have a rigid mandate where they only want to acquire certain funds managed by certain GPs. Secondaries tend to be a bit more opportunistic. The secondaries market also

"You need to get your hands dirty to find out the potential within the underlying portfolio and the motivating factors behind the GP"

Patrick Knechtli

moves at speed and many sovereign wealth funds just don't have the resources or the streamlined internal decision making process required to analyse, negotiate and close a secondary transaction in a compressed time table.

Mooney: Most institutional investors that are active directly on the buy side in secondaries today started by committing to secondaries funds. At some point they grew comfortable enough to buy directly into funds and GPs they know well. Eventually they started adding resources in terms of in-house expertise. But even those groups will still mostly focus on what they know well. They'll try to pick those managers out of larger deals.

Miller: They also have a different cost of capital and different models. Many LPs do not have the dedicated depth and breadth that all of our teams have.

Knechtli: The competition from these types of buyers can be unpredictable. There was a portfolio in the Nordics where everyone was thinking 'this is a fantastic quality portfolio' and was lining up to bid. But it happened to be a perfect fit for a sovereign wealth fund that wanted to backfill its exposure to all the best Nordic buyout managers. In the end, none of the traditional secondary buyers was really able to compete with a buyer who placed a strategic premium on securing the portfolio.

***PEI:* What about sellers – are there changes of note there?**

Knechtli: One of the biggest changes is how many different types of sellers have come to the market.

Howarth: There's more active portfolio management. Investors are asking themselves: 'Do I need 10 different large-cap

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>
> **Rudy Scarpa**

buyout managers when three will give me sufficient diversification? That way I can focus on those three relationships and extract better terms.' As a result LPs pick the three GPs they like and sell off the other seven. That creates opportunity for everyone around this table because we may each like one of the seven differently.

Mooney: If you look at the pie chart of who is selling, it's extremely diverse. If you move that pie chart backward in time, for any two- or three-year period you would see very large concentrations. Today, secondaries is somewhere in the agenda of every institutional LP, especially in this pricing environment and with the amount of attention the market's getting, regardless if they're selling or buying, or both.

Marks: I am also seeing a generational shift from maybe not the biggest brand name pension plans or endowments but the second or third tier LPs that are behind the others and are now looking at having these types of conversations. Types and profiles of LPs within those pie charts are also changing.

***PEI:* One topic everyone seems keen to know more about is how leverage is being used in today's secondaries market.**

Mooney: Leverage in the market is not a new phenomenon, it's just there wasn't any credit available for several years and now it's available again. It comes in different forms: banks providing financing against transactions or against portfolios; funds using credit lines against their LP commitments and sellers providing financing, which in the simplest form is a deferral of the purchase price or similar structure.

From our perspective there are buyers who use leverage aggressively, there are buyers who won't use it at all and plenty of buyers in between. From a seller's perspective, seller financing via a deferral of the purchase price, when used the right way, can tick a lot of boxes to help facilitate a transaction but it's not for everyone and you've got to make sure you structure the collateral the right way. In our experience some form of financing is used in 7 out of 10 deals.

Miller: Seller financing is really a 'win, win' for both sides. Sellers are getting an equity-like return and it's a way to bridge the pricing gap. The challenge is getting a seller comfortable with the concept. Deferred payments work well in this market.

Scarpa: Deferrals are attractive from a buyer's perspective. Instead of paying 100 percent upfront, why not pay 50 percent upfront and 50 percent two years later interest-free and receive the IRR boost? »

» However, sellers are also expecting a higher price when they offer a deferral and buyers need to properly balance the benefit of a deferral with its cost.

Knechtli: Another big change is the cash flow profile that some of the larger secondary funds provide to their investors. Historically, investing in secondaries was all about a shorter investment horizon, that is to say a quicker deployment of capital as well as a quicker return of capital. If funds are using leverage or deferrals, capital is being drawn down from investors more slowly and portfolio proceeds are having to be prioritised for the repayment of leverage or deferrals rather than being distributed to investors.

Marks: And you are deferring the early distributions back as well on the other side – so it's bidirectional.

Miller: But it is the headline price, right? If someone says well headline pricing has moved up, right? People are paying par, people are paying 98, but I would be happy to pay 95, 96, 97 if I could pay in two years. It's a lot different than paying 95, 96, 97 today.

Knechtli: Eight to 10 years ago banks were the only sellers who tended to agree to deferred consideration because they had the mechanisms and credit committees to be able to look at counterparty risk. I think it is interesting that there are now all sorts of sellers, not just financial institutions, who are actually or at least considering transacting with deferred consideration.

Marks: Maybe on counter-party risk, sellers will be looking for different types of secured financing versus the simple attraction of the counter-party, so it may show up in that form one day. But, so far the deferred deals we've seen have been pretty light in terms of the security required, often times just a counter-party signature so I think we'll see if that shifts. I agree deferred deals have been quite common and that's an intelligent tool but it shouldn't be the only thing driving your deal. You need fundamentally good assets and good managers – a deferred can help bridge but only to a point.

***PEI:* What's your view on staples – are they standard deal components or controversial?**

Knechtli: We get a lot of people approaching us about stapled deals because of our primary platform. There is a degree of adverse selection in these situations. Why would a GP come to you to do a staple in the first place? Either it's because their performance hasn't been great or there is some specific reason why they cannot raise capital through a more standard primary process. We tend to look at these situations on a case-by-case basis and dig into the motivations within the manager. It is helpful that managers are becoming a bit more realistic about the terms they are proposing, compared to seven or eight years ago when GPs were asking for rich terms and large amounts of fresh capital.

Knechtli: A lot of small-cap managers have realised that the priorities for some of their larger LPs have changed massively since the last fundraise. Particularly in Europe, the emphasis in the LP world has shifted away from certain investor types, such as banks. These managers therefore have to find a solution for these non-returning investors well in advance of the next fundraise. This means they are not really in position to contractually bind secondary buyers into a stapled primary commitment to the next fund. We tend to like situations where we can get to know a manager better through buying a secondary interest before considering a primary commitment.

Marks: We have worked on similar situations where a GP is raising a fund. Although it's technically not a staple the GP asked us to be included on the secondary because we are currently looking to evaluate their fund.

Miller: It is an evolution of the market. Ten years ago GPs were not paying as much attention to the secondaries market as they are now, nor were they involved to the extent they are now.

Howarth: The thing is, not all LPs or capital commitments are created equally. LPs bring different things to franchises and to sponsors. GPs can make the argument they don't want to bring in new parties or they have select partners who they work with.

Marks: I think that's one of the biggest moving factors over the last year or two is this whole GP-access area. Successful ingredients for private equity are generally sourcing good transactions, what information advantage do you have and lastly this access point, which is unique to secondaries because of the transfer issue. The GP-access point is one that I think is changing the most.

Miller: We perform alpha analysis on the GPs to get a better understanding of what the unfunded is going to do. In the end when you look at a staple and the assets you're buying you want the assets to be the driver of the returns not the unfunded. Its finding that mix where you're being compensated for your risk and more importantly, its assets in the ground not heavily weighted towards unfunded.

Mooney: It tends to be that secondary pricing is lower if the GP is requiring a staple. Buyers would prefer not to have that staple component as part of the transaction so they effectively discount the price they are willing to pay for the secondary component because they can't get a discount on the primary commitment. LPs selling have to carefully evaluate the impact a staple has on pricing.

Scarpa: We model out the impact of a staple or unfunded and it's oftentimes dilutive to the overall returns of the secondary transaction. However, going forward we're going to see an increasing number of GPs seeking to manage their LP base more proactively. That includes controlling which LPs come into their funds on a secondary basis.

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» On the LP-side I recently saw a survey where the number one reason why LPs are looking for secondaries is to access good quality managers. People are starting to look at secondaries more closely to see whether a secondaries manager can give them access advantages.

PEI: Do you think GPs will create more liquidity programmes for LPs? In some cases we've seen built-in programmes with chosen buyers.

Knechtli: Managing the flow of secondaries via a platform or matching service may become a fact of life for some of the bigger managers with large and increasing LP bases. However, trading platforms have struggled to gain sufficient critical mass with buyers and sellers to be really effective and so they are unlikely to secure a material share of the broader secondary market in the short-term.

Miller: Liquidity solutions for the larger funds will definitely be something we will see going forward. The question is though how effective are they or how much deal flow will they generate? But, it is another way for GPs to offer LPs a solution. It is this notion of being flexible and nimble.

Scarpa: I also understand the marketing benefits for GPs to have this liquidity solution for their LPs. I just don't know how effective those programs will be in attracting sellers. If you are a seller, for example, do you really want the sale of your LP interest to be shepherded to a limited number of buyers hand-picked by the GP?

Howarth: Still, as a seller you would at least have the option of knowing there's a solution and maybe you wouldn't have to engage [an advisory firm] and run a large process that's time-consuming. If a seller can determine two bids are enough, then it doesn't need a platform to access four bids.

PEI: One last question. Are emerging markets secondaries finally happening?

Howarth: Emerging market secondaries are already there, but it's obvious there's less capital that has been raised compared to North America or Europe. Emerging markets are such a large area to cover though and there is no secondaries firm that does all emerging markets well. There are very distinct pockets to look into and where you can access information is by being local. It's possible to have more, or better, information than the seller and that imbalance creates opportunities.

Marks: We've done a number of transactions in Asia and some of them have been our best deals. They either tend to be smaller or off-the-run from the broader processes. There have been cases where a GP invites us in to participate. It's still a small part of what we do, but we have teams in Hong Kong and Tokyo. It's turned out to be a lucrative area for us.

Scarpa: We see most of the emerging markets secondary opportunities in Asia. We have a large Hong Kong office that's proactively looking for secondaries transactions. The trick is being on the ground to sift through all of the deals to uncover the quality transactions. It takes a lot of work.

Howarth: There are secondaries in Latin American and African funds but in terms of volume and number of trades it's fairly small.

Miller: We receive questions from LPs about secondaries trades in emerging markets. The volume in secondaries tracks the seasoned private equity capital in these markets. The opportunity is still relatively small, but we do see gradual growth as the primary commitments in those markets continue to mature. ■