

unquote”
analysis
secondaries focus

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Unearthing hidden value:

As the secondary market heats up, generating returns largely based on deep entry-point discounts is increasingly becoming a more challenging strategy – instead, secondary investors must find new ways to uncover hidden value

AS THE secondary market evolves and competition intensifies, we are witnessing the increased specialisation of funds. Secondary funds have largely split into two categories; with large funds focusing on big deals carried out on a global basis, and smaller participants targeting small-cap deals in select geographies.

Furthermore, as secondary fund sizes continue to grow, with a handful of firms currently targeting very ambitious funds, pressure to deploy capital quickly has increased. While average discounts to NAV for buyout interests dropped to record lows of 59% in 2009, according to Cogent Partners, they have steadily crept up, and in the second half of 2013 stood at 89%.

The rapid pace at which the secondary market is evolving means that to ensure success, participants must quickly adapt. And those with clear and sustainable strategies are the most likely to prosper.

Small is beautiful

At the large end of the market, secondary transactions are very well intermediated, meaning there are generally intense levels of competition involved. This naturally puts pressure on pricing, meaning the assets go to whoever is willing to pay the most.

Turning to the smaller end of the market, with deal sizes typically less than \$50m, there is far less intermediation. In



fact, the large, established intermediaries often bypass these deals because of their smaller size, which – due to smaller revenue potential – they perceive as too onerous or labour intensive. Yet, with a wealth and variety of potential deals, the small end is proving to be an attractive segment of the secondary market.

However, the majority of secondary houses active in the small end of the market tend to have only local operations. But, in order to efficiently and successfully carry out deals in this segment, a global reach is increasingly important as GPs, LPs and portfolios are often scattered around the world. To effectively cater to the needs of both GPs and LPs, feet on the ground in relevant geographies is

the practice of secondaries

a must and the real challenge lies in bridging this gap. According to Joseph Marks, managing director and head of secondaries at Capital Dynamics: “Having a global platform that spans Europe, the US, Latin America and Asia is vital for handling transactions from both the GP and LP perspective. It is also critical for uncovering other factors unrelated to pricing, including counterparty risk and local practices, and provides a much better chance to structure a deal directly.”

In order to source quality opportunities, secondary firms need to have an on-the-ground approach to the market, with team members in regular contact with LPs, GPs and the advisory community in their local regions. This typically provides a buyer with early access to deals, enabling a much more efficient process. “For example, sellers value the ability to deal with a single counterparty that can underwrite a global portfolio. Global scope is essential in order to supply a fairly firm pricing indication within a very short timeframe,” says Marks.

A focus on the small-cap secondary market, however, does not preclude a buyer from working on deals with sellers often thought to be the preserve of large funds. “There is a misconception that smaller funds are not capable of executing deals with banks or big institutions,” says Sandro Galfetti, director and member of the Capital Dynamics secondary team.

“This is a big and vibrant market and it’s not just about multi-billion dollar deals. Regulations including Volker, Basel III and Solvency II will continue to create opportunities at the small end of the market. We, for example, have completed a number of transactions with large financial institutions. Also, there is a steady supply of tail-end funds-of-funds reaching the end of their lives. These are very complex deals with multiple parties involved, which require specialised knowledge from a dedicated secondary fund.”



Primary perfection

Pure-play secondary houses are likely to have less visibility or current knowledge of stakes they are buying because they may not have an existing relationship with the GP concerned. However, firms actively involved in the primaries market benefit significantly from having already performed due diligence on management teams because they have a clear understanding of the GP’s investment strategy, value creation abilities and the market within which they operate. They also have long-term relationships with managers to which they have demonstrated a clear commitment. While secondary deals have proven popular because of the increased visibility awarded to buyers due to the maturity of the fund – enabling a much clearer view of how the fund is likely to perform – the rising level of intermediation often means that bidders are kept at a distance to the deal. “In order to price funds quickly and efficiently, you have to be in constant contact with the

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Joseph Marks, managing director, Capital Dynamics

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Joseph Marks is a managing director and head of secondaries in investment management at Capital Dynamics. He has 16 years of experience in private equity. Previously, Marks was a principal at Collier Capital in New York where he was responsible for the origination, evaluation and execution of secondary portfolio transactions. He holds a Bachelor’s degree in Economics (Honours) from Stanford University and an MBA and a Juris Doctor in Law from the University of California. Marks also holds the professional designation of Chartered Financial Analyst.

managers. Having a primary fund platform enables a buyer to price a broad array of funds very quickly because you already have access to many managers and their fund information,” says Galfetti.

Outside market cycles

Understandably, quality assets demand a premium, making it difficult for secondary funds to buy at a discount. “There are two sides to the coin when it comes to valuations. Deep discounts often mean lower-quality assets, but smaller discounts can indicate clarity over growth prospects and more tangible returns,” explains Marks.

As the bulk of capital in the secondary market chases larger transactions, commentators and some investors are increasingly questioning the sustainability of returns if prices for quality assets continue to rise. It is against this backdrop that secondary houses targeting smaller deals are becoming ever-more attractive. Not only are these participants able to transact efficiently in a less efficient environment, their ability to negotiate directly provides more control of the deal structure and terms. Concentrating on transactions where it is possible to conduct direct negotiation with the seller makes it easier



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Sandro Galfetti is a Director on the secondaries team in investment management at Capital Dynamics. He has 12 years of experience in private equity and financial services. Previously, Galfetti underwrote structured credit transactions at Swiss Re Financial Services in Zurich and London. He started his career with Swiss Re Audit Group carrying out worldwide assignments and has also worked for management consulting companies, including Horváth & Partners in Hungary. Galfetti holds a master’s degree in business administration and economics, magna cum laude, from the University of Zurich (lic.oec.publ), and also holds the professional designation of chartered alternative investment analyst (CAIA).

to address the issues of deal complexity, knowledge of assets, efficiency and confidentiality.

At the small end of the market, it is advantageous if a secondary buyer is capable of capitalising on the entire opportunity spectrum (ie differing levels of transaction complexity) throughout market cycles. The secondary participant that is versatile and able to cut through transaction complexity will have more buying opportunities as the market has become more mature and sophisticated as well as expensive. “Focusing on smaller deals enables greater selectivity in targeting opportunities to buy quality assets at good entry pricing,” explains Galfetti.

“As a result, a good strategy at the small end of the market addresses the entire spectrum of buying opportunities irrespective of market cycles,” says Marks. ■

CapitalDynamics



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Our investment history dates back to 1988. Our senior investment professionals average more than 20 years of investing experience across the private equity spectrum. We believe our experience and culture of innovation give us superior insight and help us deliver returns for our clients. We invest locally while operating globally from our London, New York, Zug, Beijing, Tokyo, Hong Kong, Silicon Valley, Sao Paulo, Munich, Birmingham, Seoul, Brisbane, Shanghai and Scottsdale offices.

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