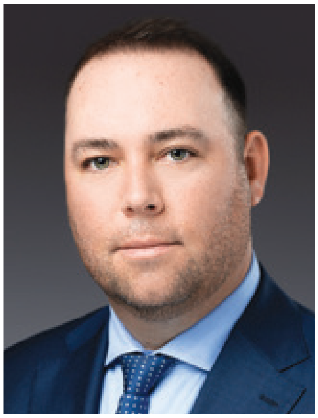
KEYNOTE INTERVIEW

Secondaries' evolving use case



Secondaries technology is increasingly proving its worth as a multi-faceted tool for GPs and LPs, says Churchill Asset Management's head of secondaries, Nick Lawler

Q How sustainable is the growth of GP-led secondaries, and continuation vehicles in particular?

It's important to remember that GP-led transactions include structures such as fund-level tenders, strip sales and minority recaps, although most transactions today – around 80 percent-plus – are continuation vehicles. We expect CVs will continue to grow and overtake LP-led secondaries for a few reasons.

First, they have proven an effective tool for sponsors to offer liquidity to LPs while doubling down on hand-picked assets. From a penetration standpoint, the large-cap market has widely adopted CVs, but from what we have observed across our mid-market sponsors, only about 40 percent have executed a CV. From our perspective, the failure rate for raising a CV is close to 50 percent, if not higher, and that is partly driven by limited appetite for a specific asset. But there is also a massive capital shortfall which means buyers are being very selective. Finally, performance trends have been very positive – single-asset CVs have higher growth rates, better margin profiles and lower leverage than the broader private equity universe.

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All that said, CVs should still be the exception to the rule. A sponsor's job is to buy, grow, optimise and sell companies over a defined period. But for special assets, CVs have the potential to be an incredible tool to keep compounding equity value while offering liquidity along the way.

Q How is the role of secondaries changing for both LPs and GPs?

The primary catalyst for LPs to sell a fund interest has typically been active portfolio management. It's a common misconception that they are only selling out-of-favour exposures. Quite often an LP is seeking to lock in a nice gain to redeploy into something they believe will compound faster. On the

GP-led side, beyond CVs, tenders can help manage the LP base and strip sales can engineer DPI. So, secondaries are a powerful tool for both LPs and GPs.

Strategically, the use case for secondaries in investors' portfolios has evolved. Historically, they helped investors establish private equity programmes with quicker cashflows, reverse vintage year exposure, immediate diversification and J-curve mitigation, among other factors.

But, as the GP-led market has expanded, the fundamental return profile and use case for secondaries has changed. Complementing the highly diversified exposure offered by the LP-led secondaries market, the GP-led market offers more concentrated access to highly curated sponsor-owned companies. Together, they offer a strong combination to potentially deliver both attractive multiples of invested capital and rates of return.

Q What differentiates secondaries managers in an increasingly crowded market?

It's a combination of factors, such as relationships, scale, sourcing and underwriting capabilities, speed of execution and structuring flexibility. Within the mid-market, there is far less syndication. You either need the scale and capability to lead and structure a deal, or you need to be an existing investor with that sponsor. That is a different dynamic to the multibillion-dollar CV market where groups can effectively stock pick their way into transactions.

Q How have pricing dynamics evolved with more entrants into the market?

Across secondaries broadly, deals for high-quality sponsors and high-quality companies are competitive. But for CVs, the concept of par is arguably irrelevant. We look at how the sponsor is valuing a company, typically on an enterprise value to EBITDA basis, and

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we look at reported EBITDA versus adjusted EBITDA. We come up with our own fundamental analysis and apply what we think is a reasonable multiple to arrive at pricing. Hopefully that coalesces with the sponsor's expectations and we're able to execute on a deal. But it doesn't always.

Q How are LP perspectives on continuation vehicles shifting?

The market hasn't completed a full 180, but it's moving in that direction. LPs recognise that CVs have a fundamentally different risk profile, with economics that are more attractive than the traditional two-and-20 structure.

Many aspects of CVs that historically have been viewed by some LPs as negatives, such as the GP being both a buyer and a seller, are in fact elements that can make these attractive investments. In that example, the GP is also the most knowledgeable party regarding that asset, and what value creation levers do or do not work.

Even more fundamentally, many LPs see that opting out of CVs could mean missing what may be the top decile of private equity-owned companies. So, there has been a shift in LP appetite.

Q What about the influence of retail and semi-liquid vehicles on secondaries?

Democratisation is good because it both enables new investors to access an asset class that has been historically hard to access, and boosts what remains a heavily undercapitalised market. Semi-liquid funds may be willing to pay more as they need to deploy capital. However, most managers of semi-liquids also have larger traditional drawdown funds. There aren't two buyers at two different prices, and the cost of capital and return profile need to meet the requirements of the drawdown fund.

Where sponsors can buy an LP interest at a discount, they immediately mark to NAV and that gain is reflected in the fund performance. Subsequent new investors into the fund will be investing in that same transaction at NAV, but will not capture the value gain of the discounted entry point. So, semi-liquids need to keep buying at discounts to support performance, which is a marked difference from traditional drawdown funds.

An increasing body of market evidence indicates that single-asset private equity strategies, including continuation vehicles and equity co-investments, combined with exposure to younger vintage LP interests, can provide a more compelling framework for long-term performance generation.

Q How is AI being used in the secondaries market?

AI is becoming increasingly more effective across the deal lifespan. That could be background research on an industry, sector or asset. AI can refine your hunting ground for optimal assets at the right place in their life cycles, with the right financial and operating metrics. You can stress test how a company might perform in a different macroeconomic or interest rate environment. Of course, AI is only as good as the quantity and quality of information you can direct it at. But it is becoming a key differentiator across the buyer universe. ■

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