EXPERT COMMENTARY

Record deployment and fundraising headwinds are leading to limited dry powder, says Whitehorse Liquidity Partners managing partner Yann Robard

Secondaries: An undercapitalized market

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Over the years, market participants mused at the significant growth in the fund sizes of secondaries GPs. On the surface, this growth begged the question – could the secondaries market absorb all the capital that was being raised?

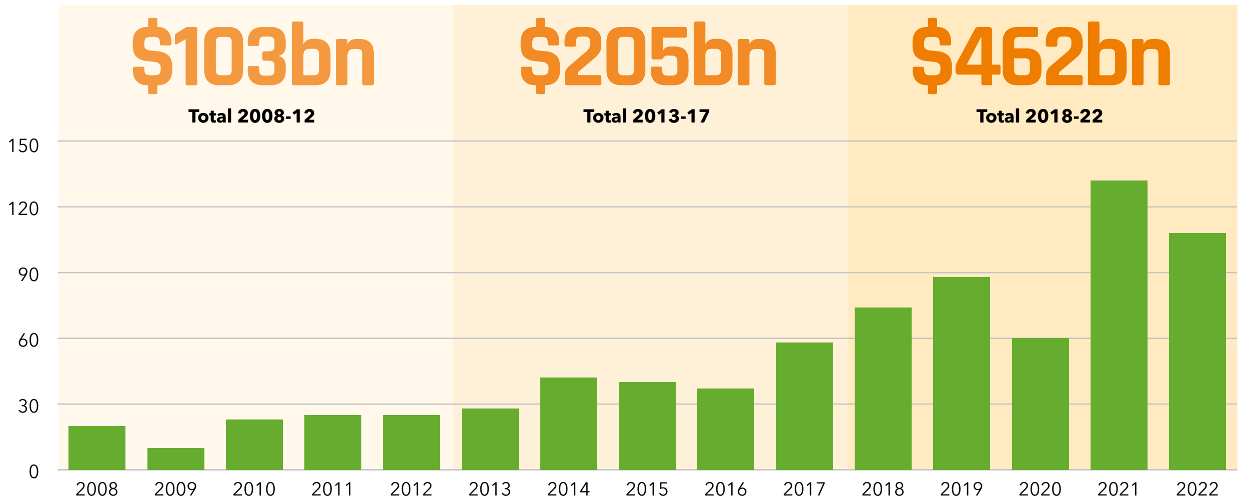
In reality, the opposite has proven to be true. Secondaries fundraising has not kept pace with the growth in transaction volume. This issue is only being exacerbated by the fundraising headwinds GPs are experiencing today. As we look at the state of the secondaries market, we believe it is vastly undercapitalized, with less than one year of dry powder remaining. A combination of record secondaries deployment over the past five years paired with a decline in fundraising over the same period has helped lead us to this point.

Today, demand for secondaries transactions is high. A combination of public market volatility and limited distributions have left LPs overallocated and seeking a means to tactically rebalance their private equity exposures. As a result, many LPs have turned, or are expecting to turn, toward the secondaries market for liquidity. Once perceived as a more niche market, secondaries are now recognized as a necessary tool to actively manage a portfolio's private equity exposure. This is true in all market environments and is exacerbated in times of volatility.

The attractiveness of the secondaries market is not limited to LPs, as GPs are increasingly tapping the secondaries market for GP-led continuation vehicles. As traditional exit routes slow down, GPs are turning to the secondaries market as a new alternative way of generating distributions for LPs while still allowing GPs to retain ownership of their prized portfolio companies through their next stage of growth. With an increased demand for liquidity and not enough capital to absorb it, we believe the secondaries market is undercapitalized, resulting in a buyer's market.

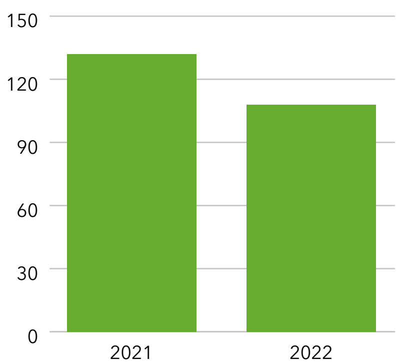
There are three key factors that led us here, each of which has meaningful implications on the outlook for the

Secondaries transaction volume ($bn)



Source: Jefferies: Global Secondary Market, January 2023

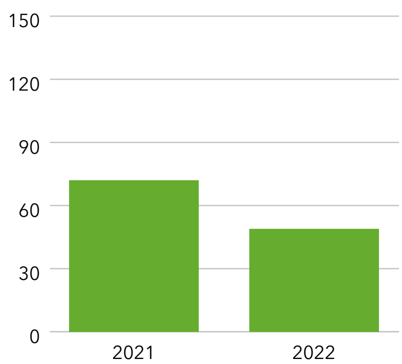
Secondaries transaction volume ($bn)



$240bn

Total secondaries transaction volume

Secondaries fundraising ($bn)



$121bn

Total secondaries fundraising

secondaries market for 2023.

Five years of record deployment...

We believe the secondaries market is no longer merely being used by LPs reactively to solve for liquidity requirements, but by all types of private equity investors to actively manage their portfolios. The breadth of solutions available to LPs and GPs alike to solve their bespoke portfolio needs has underpinned the consistent growth in the market. And this growth has been explosive.

Over the past five years, the secondaries market has generated aggregate deal volume of $462 billion, exceeding the total deployment of $308 billion over the preceding decade. Said differently, the secondaries market has consistently doubled over five-year periods, from $103 billion in 2008-2012 to $205 billion in 2013-2017 to $462 billion in 2018-2022. More recently, focusing on the past two years, secondaries market volume hit $240 billion, representing over 30 percent of the cumulative transaction volume generated in the past 15 years.

Coupled with declining fundraising...

Despite this strong growth in volume, more recently secondaries fundraising has not kept up with the pace of deployment. Case in point, over the past five years, secondary funds have raised $309 billion versus the $462 billion deployed. Fundraising momentum has waned whereas volumes have increased substantially.

We believe overallocation of LPs to private equity combined with the macroeconomic headwinds of the past ~18 months have stalled fundraises, elongated fundraising timelines, and decelerated the pace at which GPs were able to recapitalize. As a result of stalled fundraising, capital available to absorb the pent-up demand for liquidity has dried up. And the market finds itself long opportunity, short capital.

Leading to waning dry powder

The fundraising activity and deployment over the past two years in particular highlight how undercapitalized the market truly is. With total deployment of $240 billion in 2021 and 2022, and fundraising of only $121 billion over the same period, the secondaries market raised approximately $0.50 for every dollar deployed. Jefferies' 2023 *Global Secondary Market Review* estimated that there was only $103 billion of dry powder available heading into 2023 before any net new fundraising.

Meanwhile upwards of $150 billion in expected 2023 deal volume is predicted by multiple secondaries advisers, including Greenhill and PJT Park Hill. If these predictions prove true, the market would have approximately 8 months of dry powder remaining assuming no additional fundraising.

Accelerating liquidity needs

As a result of the confluence of strong deployment and declining fundraising, we believe the secondaries market is now significantly undercapitalized. This comes at a time when LPs and GPs are expected to turn more frequently to the secondary market for solutions to solve their portfolio requirements. But what exactly is driving the strong supply of deals in the secondary market? In our view it is a combination of both LPs and GPs seeking to generate liquidity in a low liquidity environment and seeing the secondary market as an enabler.

To better understand why LPs are overallocated heading into 2023, one needs to turn the clock back two years. 2021 was a banner year for private equity, according to Pitchbook's Q3 2022 benchmarks, with many investors experiencing returns not experienced in the asset class in recent memory. LPs did well – almost too well – and became a victim of their own success. Investors found themselves entering 2022 already overallocated to private equity.

Not long thereafter, public markets were shaken by macroeconomic and geopolitical uncertainty, and amidst this volatility, the S&P 500 declined by 19 percent in 2022, according to S&P Capital IQ, further compounding overallocation. To add to this, distributions started to dry up mid-way through 2022. With private equity M&A activity down approximately 39 percent in 2022 as compared to 2021, according to Bloomberg Law's *How Private Equity Fared in 2022* report, the IPO windows seemingly closed, and the rising cost of debt, realization activity decreased.

Many LPs, in turn, have generally received fewer distributions from their private equity portfolios over the past 12 months. Add to this that many GPs have doubled down their fundraising efforts and LPs are struggling to find the allocation for the commitment in order to not miss out on a potentially attractive vintage. The result of all of this – LPs are increasingly turning to the secondaries market to help manage their exposure, reduce overallocation and unlock capital to support their high conviction managers in their next fundraise.

Against this backdrop, the secondaries market has also become attractive for GPs as the macroeconomic environment has limited the exit routes available to sponsors. With the IPO window narrowed and M&A hindered given a lack of leverage, GPs are increasingly looking to a third option, continuation vehicles, to provide LPs with the option for liquidity.

This third option allows GPs to drive liquidity in their portfolio, all whilst retaining ownership of their crown jewel assets. According to Jefferies' *2023 Global Secondary Market* report, GP-led activity made up nearly half the volume of all secondaries transactions in 2022, totalling $52 billion. Of that, nearly 85 percent of GP-led volume was via continuation vehicles. With exit paths reduced and a higher interest rate environment, we believe that the secondaries market becomes an even more attractive source of liquidity for GPs.

We believe the conditions that have converged to cause an undercapitalized secondaries market to persist today – significant demand for secondaries solutions, a challenging fundraising environment, and limited dry powder. We also believe many investors who need liquidity have not yet come to market. With GPs limited in their exit routes through limited leverage availability, continuation vehicles should become an increasingly attractive option. As a result, demand should remain high for the foreseeable future.

However, it remains to be seen if secondaries fundraising activity can keep pace with deployment. How soon can the secondaries market recapitalize? Until that picture becomes clearer, we believe it will remain a buyer's market. ■