KEYNOTE INTERVIEW

'Classic' secondaries make a comeback

With LPs looking to rebalance, the future of secondaries might look more like the past, with rewards for those GPs willing and able to take a back-to-basics approach, according to Steve Costabile, global head of private funds at PineBridge Investments

SPONSOR
PINEBRIDGE INVESTMENTS

Any expansion that lasted as long as the last one is bound to reshape a market, and secondaries are no exception. Some critics may argue that the best investors stay conservative in the frothiest of times, but persistent low-cost borrowing couldn't be ignored forever, allowing an era of secondaries to be financed with growing amounts of debt, complete with remarkably favorable terms. By now, it's clear the music has stopped, and people are racing for seats. Inflation, even as it retreats, will change underwriting for years to come.

Which is why Costabile says some of the most interesting opportunities among secondaries right now require a back-to-basics approach, relying on expertise in analyzing the assets for sale, and using leverage sparingly. We spoke with him about why a throwback style of investing may be the best way to score returns among secondaries in the years ahead.

Q Let's talk today. What does the secondaries market look like in the current moment, and what kind of activity are we likely to see for the rest of the year?

With any macro change like we've seen, it takes a little while for the buyers and sellers to adjust to those changes. Sellers tend to err on the side of looking backward, by arguing this asset sold for X a year ago, so that'll inform my price, while the buyers tend to be more cautious in deploying capital, given the uncertainty ahead. Eventually, buyers and sellers come together to agree on what the current environment is, and that's where secondaries are today. The market has stabilized some, with the public side devouring some of the macro, and buyers and sellers inching closer to one another on price.

We expect to see a lot of LP-led sales in the next 18 to 24 months, as these institutional investors, endowments, foundations, high-net-worth family offices and smaller institutional investors strive to get back within policy because of the denominator effect. This isn't quite the same as the global financial crisis, which was a "catch the falling knife" scenario, but many of these institutional investors have seen their fixed income portfolios decline by double-digits in the past year.

So, they need to restore that balance in the next six to 12 months, albeit without resorting to a fire sale. Many are expecting there to be a lot of opportunity in the secondaries world from LPs who see the Federal Reserve's macro reset and act to correct perceived overallocations in alternatives. The clock is already ticking, given that 2022 was a lackluster year for exits. A lot of those alternatives fall into the category of "nice to have," not "must have," even if they promise plenty of alpha. These LPs can't control the public markets or fixed income commitments, so that leaves alternatives as a possible path towards rebalancing.

Q With LPs eager to sell, what are the kinds of opportunities GPs should be pursuing?

The more straightforward, simpler transactions involving recognizable names are essentially commodities, with most people arriving at similar valuations. But for managers looking to wade into complex portfolios that span multiple geographies and strategies, there's the chance to offer LPs a solution and a bit of liquidity that's worth the price movement.

There will be plenty of brand name opportunities, but the value will be found by getting into the weeds of these lesser known, complicated scenarios, where there might be a few buyout funds, some real estate, maybe an infrastructure deal. And at that point, a single buyer for all that can be quite attractive. They're looking to get that kind of deal done at a fair market price.

But it's worth noting that over the last few years, the cost of borrowing was essentially zero, and that impacted every alternative asset class, including secondaries. For example, there were plenty of GP-led single asset sales simply because the financing was there for them; such transactions are not expected to be prevalent anytime soon. But, with motivated sellers and plenty of inventory entering the market, buyers appear to be in a strong position.

"Secondaries buyers need to be adept equity analysts, period"

However, those buyers have to be able to underwrite such deals given the new, tougher conditions. Back in 2019, one could rely on covenant-lite financings, but those days seem to be over. Managers need upfront discounts to reflect the fact that the debt markets have contracted. If a manager can cut these deals, there's potential for disproportionate rewards for investing in secondaries. But that relies on the manager's expertise in finding the hidden gems and the ability to underwrite them.

Q As buyers get 'back to basics,' are there any blind spots they should be careful to avoid?

Buyers in the secondaries market have to be cognizant of the debt structures of whatever they're acquiring, whether it's commercial real estate, companies or funds being offered. The key question is what does the debt structure look like now? When is that debt coming due? When does it have to be rolled over? And what kind of terms can the buyer get when that happens?

Because think about how many companies have debt packages created in an environment that just doesn't exist anymore, with zero covenants, zero governance, but with a deadline. That four-year paper is going to be rolled over, and now the lender is in position to say, "Wait a minute – you're not getting the same deal anymore."

This time, there will be covenants and governance, and they'll likely be looking for 15 to 20 percent more equity into the situation. Secondaries buyers need to be aware of the underlying implications that may be prevalent in the portfolios they're acquiring right now; nothing should be taken for granted.

It's time for buyers to do their homework and understand the equity positions in those companies and consider avoiding "black boxes" where there's some Monte Carlo simulation that shows that over the last 20 years these things would have worked out. Secondaries buyers need to be adept equity analysts, period.

But, if a manager can underwrite these deals, potential attractive hidden gems should abound. That means buyers will have to be frank with sellers, explaining that their offer is based on current conditions, where 40 percent of the companies in a portfolio will have to go back to their lenders within the next year or two. So, pricing has to reflect this reality.

If a manager can navigate the complexity of these transactions, with a clear eye on the debt situation, they should be able to find tremendous upside going forward, by getting back to those basic skills. ■