Behind the Growth and Maturation of the PE Secondaries Market

An interview with two private equity veterans who discuss the COVID era of secondaries, new solutions for GPs, GP-led continuation vehicles, and fund-level leverage strategies.

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Privcap: Today, we're going to learn all about the evolution of the private equity secondaries market. You both had front-row seats for the development of that asset class, so I'm fascinated to hear what you have to say about both the market in general and how Northleaf chose to structure its own secondaries business. Mike, what is behind the spectacular evolution of the private equity secondaries market to date?

Michael Flood, Northleaf Capital Partners: We have been investing in secondaries since the early 2000s, which was really the early days of what has become a fast-growing, innovative, exciting sector of the private capital markets. Sellers and CIOs saw this market as an accepted tool of portfolio management to rebalance and optimize portfolios. The last 10 years of fundamental shift in the market has been around increased volume. Within that, we've seen increased GP involvement as they have seen the secondaries market as a benefit for growing their franchises. And, within that, we've seen an emergence of innovative transactions and structures.

Finally, as the secondaries market has grown, we have seen private market asset classes other than private equity increase volumes of transactions, such as private credit and infrastructure.

Privcap: How has Northleaf structured itself to take advantage of the increasing complexity in the secondaries market?

Flood: Our broad private equity program has a middle-market focus. We really do see market inefficiencies and better return opportunities in the middle market. We have built a one-stop-shop where we've built the strategy, the team and the process to be able to execute transactions across the spectrum of deal types, from LP secondaries to more complex, single-company continuation funds, preferred and structured equity transfers.

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Privcap: The secondaries market used to be seen as a place where LPs would transact with each other, perhaps somewhat sheepishly, with the blessing of the GP looking on. Increasingly, the secondaries market has become a place where GPs can go to solve their own challenges. Matt, talk about some of the options that GPs have today from the secondaries market and why they would want to pursue them.

Matt Shafer, Northleaf Capital Partners: The secondaries market, if we step back, was an indirect way for liquidity to be achieved on an LP-to-LP basis. Now, it has become a way for GPs to organize themselves, or to organize processes, to provide liquidity to LPs in ways that weren't really there before.

I'll give you an example of a single-company continuation fund deal we did last year. We did it on a proprietary basis with a GP that we knew very well. They had an investment in a company that had really grown tremendously. It is a category-defining business: great market share, but still growing at about 30 percent a year. Very high margins, high free cash flows – all the things you look for in a great investment. So, we came in and we capitalized a new fund. The new fund bought the ownership position from the old fund. It sounds very simple. However, I assure you, it was really complicated and lawyers did well on it. It enabled us to gain exposure to a great company at a price that we felt terrific about. It also gave the sponsor the ability to continue to have exposure to this great business that they'd been working with for years. It gave the management team a lengthened horizon to realize their growth plans and it still gave great value and a great result to the LPs who sold.

Privcap: Talk about the extent to which fund level leverage is being used in secondaries transactions.

Shafer: The secondaries market has adapted some of the thinking and technology from the leveraged finance market in terms of providing solutions at the fund level. That enables the sponsor to put more capital into the company. So, if you have a portfolio company that is maxed out on leverage, you can incur debt or preferred equity at the fund level and use that capital to support the portfolio company. In today's environment, people are going to be holding companies a little longer than they thought they were going to be. And that has increased the need for innovative solutions to get capital either for offense or defense at the portfolio company level. And the secondaries market has adapted to meet that challenge.

Privcap: Northleaf Capital Partners is a global firm, a multi-asset class firm. How does that broad range of activities across the alternatives world benefit the secondaries strategy?

"I'm excited about the future and the way we can bring our platform – including our private credit capabilities, our infrastructure capabilities and our private equity capabilities—to address the deal flow that is going to come from this dislocation."

–Michael Flood, Northleaf Capital Partners

Flood: Our platform is middle market-focused across private credit and infrastructure. In private equity, we do secondaries, primaries and directs. Each of those strategies is pointed at the middle market. As the secondaries market continues to evolve, it includes assets that have credit characteristics and infrastructure characteristics that the private equity secondaries business will invest in. We can tap our investment teams and talk on a daily or weekly basis to execute on those transactions.

Privcap: In the midst of an exceptionally volatile market, what makes you most excited to be participating in the secondaries market?

Shafer: I'm excited about the flexibility that we have as a secondaries investor. This has been an unprecedented time in terms of the need for companies to be supported by capital in a variety of ways, where smart money is making a difference to businesses across the country and across the world. Private equity is a big part of that.

Flood: I'm excited about the future and the way we can bring our platform – including our private credit capabilities, our infrastructure capabilities and our private equity capabilities—to address the deal flow that is going to come from this dislocation. ■

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