

FUND FINANCE FRIDAY

Fund Finance Symposium Panel Recap: Secondaries and Continuations

February 17, 2023 | Issue No. 211



By Bryan Barreras
Counsel | Fund Finance

Cadwalader's own fund finance partner Brian Foster moderated one of the four panels focused on NAV financing at this year's Global Symposium, evidencing the growing relevance of NAV products in the fund finance market. The panel, titled "Secondaries and Continuations," brought together a group of industry experts to discuss developments in the Secondaries market and the opportunities and challenges facing that market. The panelists included: Darren Schluter, Managing Director in the Secondary Advisory Group at PJT Park Hill; Linda Rowland, Managing Director in the Ares Secondaries Group; Ray Meyer, Managing Director and the Head of Fund Finance Advisory & Origination at Natixis; Max Forton – Head of Trading for Fund Financing & Solutions in the Americas at Nomura; and Martins Marnauza – Partner at Collier Capital.

The panel noted that there have been a number of developments in the past year that have significantly impacted the Secondaries market generally, and the Secondaries financing market specifically. The fundraising market has become more competitive for private funds, especially so for sponsors without a long-established track record. Increased volatility in public markets has impacted traditional realization events for private funds' holdings (IPOs and M&A transactions) and affected such funds' ability to make distributions. Regulatory capital pressure has resulted in a pull-back on balance sheet deployment by bank lenders. And the rapid rise in interest rates throughout the year has increased the overall cost of NAV financing transactions, affecting a fund's decision whether to utilize financing.

The discussion kicked off with a look at the Secondaries market over the past few years, with a particular focus on liquidity and fundraising. 2020 and COVID brought an accelerating demand for liquidity, but difficulties in valuations and underwriting diversified portfolios led to transactions involving more concentrated portfolios. More recently, there has been an increase in GP-led transactions, and transactions involving more diversified portfolios. Among the different strategies and regions, the panelists noted particular growth in infrastructure and credit during this time, with the bulk of assets in the U.S. The overall market was strong throughout

this period, and 2022 continued that trend with over \$100 billion of transactions. Fundraising has also been consistently robust, especially among the larger sponsors with proven track records, and the Secondaries market had in excess of \$100 billion of dry powder entering 2023.

The panel then turned to trends in the financing market related to Secondaries. While financing activity overall has increased over the last few years, 2022 was really three separate markets, beginning with a strong first quarter (carrying over from a strong 2021) that saw an increase of activity and new borrower inquiries. This gave way to a slowing second and third quarter, as we started to see the impact of the developments mentioned above, especially the rise in interest rates. The fourth quarter saw a decrease in new activity, although the market has stabilized so far in 2023. The panelists noted that the lender market has changed considerably over the last two years. Historically, a handful of relationship lenders provided the majority of the Secondaries market financing needs, but as banks have pulled back on their use of balance sheet there have been both (i) new lenders entering the traditional financing market, most notably insurance companies, and (ii) an increased use of new products, such as second lien and mezzanine financing, as fund lenders look for higher returns. With respect to financial terms, LTV levels were noted to be generally stable, with well diversified portfolios seeing a range of 25-50%, whereas pricing has increased “enormously” – even though spreads have not moved dramatically, the increase in the benchmark rate has greatly increased the cost of financing.

As the discussion moved to the uses of financing, and the implications of the higher cost of financing, the sponsor panelists noted that their decision whether to use financing (and at what level to use it) is not predicated solely on the financial terms. They also look to their investors’ need for liquidity, the quality of a portfolio (*i.e.*, whether it merits leverage), cash flow forecasts (including the impact of market volatility) and asset valuations/execution prices (which vary depending on strategy). The lender panelists noted that they take many of these same factors into consideration, looking for diversification across industries, stress-testing cash flows to determine whether they would support amortization of the facility, underwriting larger portions of the portfolio and analyzing the impact of continued interest rate increases. The lenders also noted that they take comfort from dealing with sponsors that have a record of achieving exit prices in line with their reported valuations.

The panel ended with a discussion of private credit secondaries, and uniformly described it as a hot topic. One panelist compared the current private credit secondaries market to where the private equity secondaries market was 10 years ago, noting the level of growth and the increasing duration of vehicles in the space. They also noted that financing in this space has its own set of challenges, from pricing to underwriting, especially if a fund can invest across all types of products (which can range from senior secured unitranche transactions to preferred equity). While noting that there has not been much financing in this space yet, as both the lenders and borrowers work to figure out the product offerings here, the panelists said this has been the source of an oversized amount of interest, with one panelist calling it the “largest, smallest portion of the market.”

