KEY CHALLENGES FACING PRIVATE MARKETS IN 2015

As the New Year unfolds, Altius Associates continues to focus its efforts on assessing the global private marketplace to understand current opportunities and risks that will affect market participants, particularly General Partners (“GPs”) and the Limited Partners (“LPs”) who provide capital to the private markets industry.

While there are always tactical and strategic issues to contemplate, as 2015 begins there is certainly no shortage of complexities in global markets. Private markets, like all other asset classes, have their share of opportunities and uncertainties to consider. In this, Altius’ third annual Key Challenges article, we tackle seven issues facing the industry in 2015.

This year’s edition addresses the record level of private equity distributions and its effect on LPs, the low-growth environment in Europe, high valuations in the U.S. (and elsewhere), the dynamic investment and political environment in Asia, as well as tailwinds and headwinds affecting direct lending and other credit strategies, the secondary limited partnership market and the private energy market.

MAINTAINING INVESTMENT DISCIPLINE IN DIFFICULT PRIVATE EQUITY MARKETS

Brad Young, Co-CEO, Head of Investments

In years past, Altius has written about challenges that GPs were facing in the year ahead. The last few years have also presented many challenges to LPs, and several of these are expected to continue in 2015. One of the biggest challenges facing LPs in 2015 will be maintaining investment discipline while re-deploying the record distributions that have been received over the past two years. This sounds easy, but LPs must overcome many obstacles in order to maintain investment
discipline.

As shown in the chart on page one, 2013 was a record year for distributions, and most LPs report a similar pattern in 2014. While strong distributions and very positive public markets are both good conditions for institutional investors, together they can very quickly place a private equity portfolio into an under-allocated position (opposite version of the “denominator effect”). While this in itself is not a bad place to be, it does increase the pressure to reinvest or deploy capital at a higher rate to make up for lost allocation. Pressure to invest may also emanate from other areas, including:

- GPs are coming back to market quickly and in rapid succession;
- LPs have been trying to reduce the number of GP relationships (a flight to quality) which means more LPs are trying to place more capital with fewer GPs; and
- New LP entrants with scale exacerbate the scarcity of supply in funds managed by premier GPs. In addition, very few LPs have reduced their allocation to private equity, and in fact several recent surveys indicate an increasing number of LPs are planning to raise their private equity allocations.

Throughout different cycles, the pressure to invest has always manifested itself in a key way: the backing of marginal managers. The venture capital bubble of the late 1990s captured this tendency as LPs felt that investing with B rated managers would still outperform the benchmark; investors sometimes forget that investing with a second quartile manager does not always result in a positive return. The “pressure to invest” phenomenon also showed itself when LPs aggressively invested in mid-market buyout funds with little or no track record, under the rationalization that the addition of a new manager would be beneficial to the private equity portfolio. To further complicate this matter, a poor fund investment choice in the private equity space can take three to five years to truly come to light. As an LP, it is difficult to ignore the pressures stated above, but successful, long-standing LPs have realized the following:

- Not making an investment is an investment decision;
- Dropping in quality of investment may cause longer term problems in a portfolio; and
- Manager proliferation can lead to underperformance.

Patience and discipline are always welcome characteristics in asset allocation and portfolio management; the current private equity environment, with strong distributions and high valuations, warrants careful attention to avoid some of the mistakes that LPs have made in past market cycles.

U.S. BUYOUTS – ACHIEVING ATTRACTION RETURNS IN A HIGH PRICE ENVIRONMENT
Dr. William Charlton, Partner, Head of U.S. Investments & Catherine Mountjoy, Partner

One of the main challenges when investing in U.S. private equity today is determining which managers will be able to generate attractive returns in the current high-purchase price environment. Manager selection has always been of paramount importance to the success of private equity programs, and it is even more critical in today’s highly competitive and very expensive marketplace. LPs need to look at myriad characteristics of GPs to assess which managers are best positioned to deliver outsized returns going forward.
It is no secret that purchase price multiples have returned to, and in some segments exceeded, the peak levels of 2007. This is primarily due to the increased number of private equity firms competing for a limited number of high quality deals, the increasing efficiency of a more intermediated market, the high level of dry powder, and the current favorable access to ample debt. One positive aspect of high multiples is that GPs are able to exit portfolio companies at attractive valuations, often with a fair amount of multiple-arbitrage helping to amplify the returns; however, GPs and their LPs cannot expect this situation to continue indefinitely. Prudent GPs should plan for some degree of multiple contraction in the exit planning of companies purchased at today’s high multiples.

The opportunity still remains for GPs to pay fair multiples for companies, especially at the less intermediated, smaller end of the market. GPs with a certain “edge,” such as experience with a similar company, a well-developed relationship with management or sector expertise may also be able to “win” deals on factors other than just price. For those GPs without obvious purchasing advantages, there is still an opportunity to generate acceptable private equity returns in a high priced environment; however, GPs must be sure that their investment thesis is solid, as the higher prices leave little room for mistakes or delays in hitting milestones. Higher purchase multiples may also be justified by finding high growth companies that can grow even faster with the help of a private equity sponsor. A good GP must be able to make meaningful improvements to portfolio companies while using leverage effectively to balance risk and return. Private equity firms that have a superior ability to source companies, a good investment thesis, and the operating resources and expertise to grow those companies will still be able to outperform even in this environment.

‘PRIVATE EQUITY FIRMS THAT HAVE A SUPERIOR ABILITY TO SOURCE COMPANIES, A GOOD INVESTMENT THESIS, AND THE OPERATING RESOURCES AND EXPERTISE TO GROW THOSE COMPANIES WILL STILL BE ABLE TO OUTPERFORM EVEN IN THIS ENVIRONMENT.’
Some LPs may choose to “sit out” the private equity market under the assumption that the current vintage years are unlikely to generate commensurate risk-adjusted returns. Altius views this as potentially shortsighted in light of the long-term nature of private equity investment programs. Maintaining a steady exposure to private equity by selecting top quality managers helps to ensure that LPs have capital committed to funds that have the ability to generate returns in any market environment. Accurately predicting a market turning point is difficult, and capital deployment in private equity is almost always challenging. Maintaining commitments to quality managers can position LPs to capture value on the buy-side when the pricing environment returns to more favorable levels.

The power subsector will be virtually unaffected by falling oil prices, since very little power is generated from oil in the U.S., where the majority of private investment in power (and indeed, all energy subsectors) takes place. Power investments are affected by the prices of coal and natural gas, but not oil. Investors should expect little impact to existing power investments—or to the investment outlook for power—from volatility in oil prices.

The midstream subsector will be affected, but only to a modest extent. It’s important to remember that roughly half of midstream opportunities—pipelines, storage tanks, and processing facilities—are natural gas-related. Declining oil prices have little impact on these assets. Oil-related midstream assets, on the other hand, are vulnerable to declining oil prices. The extent of this vulnerability will vary widely, based on numerous factors, such as whether the assets are located in high cost or low cost basins, whether they are running at full capacity, the existence of take or pay contracts, or the financial strength of counterparties, to name but a few.

Oil-dominated upstream assets are, of course, directly and negatively affected by falling oil prices. Existing investments in oil-dominated properties will be marked down in value. The extent of value impairment depends on many factors, such as the amount of leverage used, the percentage of production hedged, how far into the future production is hedged, and production costs. Any portfolio companies that are now public will be most dramatically and immediately impacted. Planned near-term exits will likely be delayed until the market environment improves.

Another impact will be a widening of the bid/ask spread on upstream oil assets. Sellers will insist that recent price declines are temporary and point to 2009 when oil prices dropped to USD 34/bbl, only to rebound up to USD 80/bbl within 11 months. Buyers will claim that today’s prices are the new normal and adjust their offers accordingly. This will slow the number of transactions closed; however, this reduction will be offset somewhat by distressed sellers—those who paid full price, used lots of leverage, did little hedging—and will be forced to sell barring a quick rebound in oil prices.

**Falling Oil Prices and Private Energy Investing**

Jay Yoder, Partner, Head of Real Assets

Many clients have asked for Altius’ opinion on the impact of falling oil prices on private energy investing. This is a difficult question to answer quickly because there are so many facets to it. The impact is felt quite differently across sub-sectors and geographies, and micro-analysis is required to take an extended look at how oil price volatility affects investors in private energy.

**Impact on Different Subsectors**

Private energy is a large and broad sector comprised of several subsectors: upstream, midstream, power, and equipment and services. Each of these will be affected differently by falling oil prices.
Natural gas assets in the upstream subsector actually benefit from declining oil prices. This is a result of a reduction in the amount of associated (i.e. incidental) gas production from wells where the primary target is oil. To the extent that oil drilling and production slows, the amount of associated gas produced is reduced, thereby reducing the supply and supporting the price of natural gas.

Oilfield equipment & services is the most heavily impacted subsector. Cutbacks or slowdowns in drilling and production programs affect this subsector first and most severely. Existing companies will almost certainly be marked down in value. Those companies that have been aggressive in use of leverage, expansion efforts, adding new employees, and/or purchasing new equipment will be most severely impacted. Well-run equipment and services companies are conservatively managed and structured to survive the down cycles. Private energy fund managers must ensure that their portfolio companies take quick action to cut expenses and conserve resources. Distress in the industry will provide great deal flow to those who have capital to deploy, enabling them to expand existing platforms into related services or new geographies at distressed prices.

Impact on U.S. Shale Basins
As seen in the following chart, shale basins in the U.S. vary widely in their cost of production. The highest cost oil basins will be impacted greatly by falling oil prices (assuming no quick rebound), while activity in low-cost oil (for example Marcellus and Mississippi Lime) and natural gas-dominated (for example Haynesville and Barnett) basins will continue as before. Of course, other factors come into play, including whether a property is located in the heart of a basin or on the fringe and whose money is financing production.

**How should LPs respond to the current environment?**
First, spend very little time trying to discern where oil prices are headed. Even those who have spent their careers immersed in the energy industry cannot make accurate predictions on energy prices.

Second, invest only with quality managers. The best upstream fund managers do not get carried away by bullish views on commodity prices. They use modest leverage, hedge a significant portion of production, and position their portfolio companies to survive the inevitable down cycles.

Third, take advantage of the current market environment and make significant new commitments to quality private energy funds in the upstream and equipment & services subsectors. These are positioned to generate outsized returns in the years ahead.

Volatility in the energy markets is nothing new. Cycles, even severe ones, come with the territory. Smart investors will take advantage of today's...
Environment and invest with quality private energy managers while others wring their hands and decide to wait until things settle down—thus missing out on a classic opportunity to buy low and sell high.

**European Buyouts — Achieving Attractive Returns in a Low Growth Environment**

Rhonda Ryan, Partner, Head of EMEA Investments

Currently, the main challenge investing in Europe is how to achieve attractive returns in an environment where prices are high and leverage is plentiful, but growth is not. Manager selection has always been of paramount importance to the success of private equity programs and it is even more critical in today’s low growth environment.

*‘Prudent managers need to ensure that they are not overpaying for acquisitions today, and they should plan for a market in which exits are not so easily achieved and multiple-arbitrage is less prevalent.’*

Purchase price multiples in Europe are now approaching levels last seen in 2007/08. Leverage has increased to 5.1 times EBITDA, and although this is not as high as the 6.1x witnessed in 2007, it is at a level that has not been seen in recent years. This contrasts with European GDP growth, which is forecast by the IMF to be just 1.3% in the euro zone in 2015. In Europe, secondary deals now account for over half of all deals (in some countries such as France it is even higher), and fund managers consistently report that high quality businesses are not cheap. These factors, combined with the availability of ample debt, mean that intermediated deals are expensive. On the positive side, as in the U.S., it is a great environment for GPs to achieve exits at attractive prices – a boost for LP returns. Importantly, LPs should remember the lessons of the past; this market dynamic cannot continue indefinitely. Prudent managers need to ensure that they are not overpaying for acquisitions today, and they should plan for a market in which exits are not so easily achieved and multiple-arbitrage is less prevalent.

Given the current environment, what does this mean in terms of European private equity allocation?

LPs must look for alpha-generating opportunities. In Europe today there is a low growth environment; therefore investors cannot rely on GDP growth to drive company returns. Alpha-generating skills are more important than ever to achieve superior private equity returns. There will be opportunities within Europe, but it will take skill to uncover those opportunities. It is important to make sure that companies are not reliant on European GDP growth. Companies will need a customer base that is diversified away from low growth Europe and towards growing economies such as Asia and Latin America. Companies should have a strong market position and be defensible; for example, high barriers to entry and low influence of suppliers and customers.

Buyer beware: LPs must ask GPs the right questions when doing due diligence. For example, how much leverage is the GP comfortable with for its acquisitions, what will drive growth for its companies, and how will the GP expand its businesses in a low growth environment? Importantly, LPs must gain comfort that the GP has learned the lessons of the not too distant past.

Investors must be selective – this is true for both GPs and LPs. Competition will continue. Prices are higher, debt is plentiful, and dry powder is high and increasing. LPs must focus on the best managers...
and avoid the temptation to step down in quality. One crucial element is to identify GPs that have a different sourcing angle and know how to add value – there are still plenty of good opportunities available across Europe.

Do not stop investing in Europe - history has shown that investors shouldn’t try to market time. LPs need to allocate consistently across the cycle to produce the best long term return.

In summary, bear in mind the lessons of the past, be consistent across cycles – don’t market time, but ultimately be selective and focus on the best managers.

**MAINTAINING THE DIRECT PRIVATE LENDING YIELD PREMIUM**

Elvire Perrin, Executive Director, Partner

Private credit strategies (direct lending, mezzanine, distressed debt, special situations and venture debt) have seen a major increase in interest from institutional investors seeking viable alternatives to bolster their fixed income portfolio yields or increase the diversification of their private markets portfolios.

The Global Financial Crisis (“GFC”) triggered dramatic regulatory changes that have had a substantial positive impact on the growth of private credit strategies. Governments in the U.S. and Europe rescued several banks and other lending institutions and have pushed regulators to increase their control over excesses in the financial sector. The intention was to enact tough regulations to avoid similar GFC disasters in the future. The conditions attached to bank rescue packages in Europe and other jurisdictions have forced banks to exit or decrease their level of lending activity in certain segments of the market, such as private equity and leveraged lending. Basel III (global) and Dodd-Frank (U.S.-specific) for example, are designed to force the strengthening of banks’ balance sheets through higher capital ratios. The measures that banks must now comply with inhibit them from assuming high risk lending and, in general, reduce their lending capacity. Private credit fund managers have been able to raise funds from institutional investors to assume that risk and have been able to charge borrowers a premium for doing so.

Increased LP interest in private credit strategies has been reflected in the fundraising figures for credit funds managed by private GPs, especially direct lending funds. In the wake of bank deleveraging, large globally active GPs from both private equity and fixed income have increased their activity in the direct lending market to benefit from the increasing level of return opportunities. This increased activity is reflected in the charts shown below.
Although European banks continue to represent a much higher level of leveraged loan activity than their U.S. counterparts, these institutions are transitioning towards the U.S. bank lending level. Banks in Europe represented 54% of the leveraged loan market at the end of 2013, compared to 83% in 2011. This level is in marked contrast to the 10% bank share in the U.S. at the end of 2013. Market experts expect the European bank level to continue to decrease as a percentage of the overall market. According to Deloitte Touche Tohmatsu Limited, private direct lending GPs made 142 loans in the first nine months of 2014, compared to 85 during the same period of 2013, and this trend is also expected to continue.

With the decrease in direct lending activity by banks and the corresponding increase in the amount of capital being raised for private direct lending strategies, the question going forward for market participants is whether or not GPs will be able to maintain the substantial return premium over liquid credit markets (high yield and rated leverage loans markets), estimated to be on average between 300 and 400 basis points per annum over the past few years. Additionally, many GPs are signaling that banks are becoming more active in lending to buyout deals over a certain transaction size and where the debt is rated above B+ (based on the S&P classification). In contrast, banks generally are continuing to avoid smaller and more illiquid transactions, as illustrated by the chart to the right. Yet even in the larger loan space, banks are in aggregate lending much less than prior to the GFC.

Altius believes that the private direct lending premium will remain high enough for investors to continue deploying capital to this attractive strategy, even though the increase in fundraising will put some pressure on pricing and the available private market premium. Differentiated strategies, such as direct lending to non-sponsored deals and growth companies, should remain attractive niche spaces that are capable of providing higher expected returns than typical direct lending strategies. Finally, a focus on the small and lower-mid corporate space will be essential in maximizing the pricing/return premium.

‘ALTUIS BELIEVES THAT THE PRIVATE DIRECT LENDING PREMIUM WILL REMAIN HIGH ENOUGH FOR INVESTORS TO CONTINUE DEPLOYING CAPITAL TO THIS ATTRACTIVE STRATEGY, EVEN THOUGH THE INCREASE IN FUNDRAISING WILL PUT SOME PRESSURE ON PRICING AND THE AVAILABLE PRIVATE MARKET PREMIUM’
ACHIEVING PRIVATE EQUITY ALPHA IN ASIA’S “NEW NORMAL”
Peter Pfister, Partner, Head of Asia-Pacific Investments

In 2014, Asia entered a “New Normal”. What does this “New Normal” mean, and can private equity outperformance be generated within the context of this new environment over the next several years?

The “New Normal” refers to changing characteristics in the Asian macroeconomic and political landscapes that are expected to persist for a period of time.

- Asia is witnessing lower growth in both developing and developed markets;
- Many larger countries in the region have gone through leadership transitions, with new leaders keen to enact concrete pro-business policies backed by a strong political mandate; and
- Asia is experiencing diverging valuation dynamics, with select markets above and others below historical averages.

The impact of these changes on future private equity returns is a key question on investors’ minds. As all of these changes take place within the landscape of Asia, institutional investors are questioning if now is a good time to invest in Asia and if expected returns justify private equity investments in the region.

GDP growth has traditionally been cited as a strong supporting case for Asian private equity. Positive demographics and a large growing middle-income population in several major emerging Asian markets are often thought to be the fundamental building blocks of generating strong private equity returns. However, several studies on correlation between GDP growth and private equity returns paint a different picture. As depicted in the chart below, these studies reveal there is no real correlation between the level of GDP growth and private equity returns and suggest that private equity is ultimately a micro-business. With slower growth forecast for the region, there is a clear emerging trend for an increase in control deals in Emerging Asia, which has traditionally been a growth equity market.

Asia Annual GDP Growth and Net Median Private Equity IRR

Source: Preqin/World Bank

In a slower growth environment, entrepreneurs are more inclined to seek a financial sponsor who can add strategic insight and, more importantly, operational value-add in order to navigate a more challenging environment. In addition, growth by acquisition is a resulting strategy shift when overall growth slows down. Within the framework of such changes, LPs have an opportunity to shift their portfolio construction to include select managers who have developed in-house capabilities of taking control and possess the skill-set to add operational value. Increasingly, Altius is seeing successful managers streamlining their investment focus to specific sectors where they have direct and unique industry networks and/or knowledge.

Asia is on the cusp of a new chapter in its political history. In 2013-2014, new governments were installed in several of the key Asian markets...
including China, India and Indonesia. Additionally, political undercurrents also shifted in countries such as Japan, Thailand and Malaysia. Generally, the changes in the political landscape in Asia are a positive transformation, with new leaders generally having a historical track record of being pro-business. More importantly, in countries where political gridlock was the key factor hampering the effective implementation of policies, new governments now have strong political mandates, as in the case of India where the BJP Party has a majority for the first time in close to three decades.

There is also a greater trend towards economic integration within the region, as seen in the development of the Free Trade Area of the Asia-Pacific (“FTAAP”) agreement roadmap from the recent APEC Summit in Beijing. Further progress has also been made in the implementation of the ASEAN Economic Community (“AEC”) blueprint. These shifts and changes present opportunities for astute investors who are able to identify opportunities and have the skillset to crystallize them.

Private equity investment pace in 2014 increased significantly across Asia, reflecting the growth of attractive deals in the region related to some of the trends already discussed. The following Investment vs Fundraising Activity chart shows this.

A total of USD 80.2 billion was deployed by Asian private equity managers in 2014, almost twice the amount invested in 2013 and 2012. Investment activity in 2014 far outstripped fundraising by USD 36.0 billion. In this regard, dry powder continues to decline in the region. A decrease in competition, particularly in the middle market, has further served to fortify the market position of GPs who have demonstrated strong cash-on-cash distributions and are able to successfully fundraise and invest in a favorable environment. Obtaining full allocations to these often oversubscribed funds are proving to be increasingly difficult, and in some instances can only be guaranteed by the establishment of a long-term partnership with these managers.

Deal valuations continue to remain attractive for Asia. Although valuation cycles differ from market to market, as a whole the dynamics benefit the asset class in the region. Fund managers are continuing to close the valuation gap between buyers and sellers by building strong operational teams that have deep industry knowledge and networks to add even greater value to portfolio companies. Pricing no longer acts as the single catalyst to bring a deal to fruition. Vertical knowledge and strategic focus on origination have become integral parts of a proprietary deal-sourcing pipeline that helps GPs avoid overpaying on a deal. In 2014, some of the largest deals in the region were executed at single digit EV/EBITDA multiples.

Exits have also been an important element for Asia focused fund managers. GPs are increasingly adopting highly versatile exit mechanisms, including trade sales and M&A. In 2014, the market witnessed an even stronger and renewed focus on exits by a high number of GPs, some who established dedicated teams focusing on exits from the onset of an investment. This renewed focus has translated into a record level of disbursements by Asia private equity managers in 2014, with several markets such as Australia demonstrating strong returns. The Asia Private Equity Divestments chart on the next page shows the record levels distributed in 2014, far surpassing levels recorded in previous years.
The year was also marked by the largest trade-sale in Asia historically, when KKR and Affinity Equity Partners sold Oriental Brewery to Anheuser-Busch InBev for USD 5.8 billion, and the largest IPO in the world with the listing of Alibaba Group. Private equity exits are on a clear upward trend in Asia, and Altius expects this momentum to carry on in 2015.

The “New Normal”, with slower growth and new leadership in a large subset of Asian economies, is expected to positively impact consolidation and maturation of the Asian private equity industry. These unfolding dynamics are pushing market players to develop clearer differentiation in origination, robust operational value-add capabilities, exit strategies and building a long-term sustainable platform. More importantly, the private equity cycle is showing healthy signs of sustainable growth in the future, with record exits in 2014, increased investment activity, and less overall competition. This will very likely support an increased interest in the region by global investors, particularly considering the relatively modest valuations as compared to the U.S. and European markets. These developments bode well for the future of private equity in the region and will become the bedrock of stronger and more stable returns.

The secondary market in 2014 enjoyed another year of record transaction volume. Industry sources are expecting volume to be in the USD 30-35 billion range, representing a record and the fifth consecutive year of growth in the industry. There were a variety of factors contributing to the transaction volume including strong public and private markets, regulatory pressures (forcing financial institutions to sell or consider selling), considerable supply of capital for secondary transactions, the increasing trend of portfolio management of private markets portfolios, and strong pricing. The secondary market continues to mature and evolve at a rapid pace as buyers are continually looking at innovative structures and new sources and types of deals (versus the traditional purchase of fund interests).

One contributor to the growth in volume and strong pricing over the past few years is the increasing use of leverage. Leverage is not new to the secondary market, but it is certainly fair to say that its use has become more prevalent over the past few years as a way to enhance returns.

THE GROWING USE OF LEVERAGE IN THE SECONDARY MARKET AND ITS EFFECT ON THE INDUSTRY AND INVESTORS
Chason Baggerow, Partner
Secondary buyers have historically utilized leverage in several ways:

- Deferred payments on transactions (where the buyer will pay a portion of the purchase price 6 to 36 months post close): Vendor financing in the form of a deferred payment has been a popular tool to consummate transactions in the current market, particularly in instances where the seller might be selling for strategic or regulatory reasons and doesn’t have an immediate need for cash;

- Third party leverage on transactions: There are a growing number of financial institutions that are interested in providing leverage to fund secondary transactions. This increased supply has lowered the cost and improved the availability and terms associated with such leverage; and

- Fund-level leverage: Secondary funds have historically utilized fund level leverage to assist with the administration of capital calls and other fund level working capital issues; however, more recently, this type of financing has become less expensive with better terms, prompting some managers to contemplate expanding its use as a tool to enhance fund level returns.

Proponents of leverage in the secondary market will argue that some of the larger portfolio secondary transactions are highly diversified (by manager, geography, company, and strategy) and are well suited to appropriate levels of leverage. From what Altius has seen to date, the use of leverage by secondary buyers has largely been conservative and has not been applied to more concentrated secondary transactions. Altius is not aware of a situation where leverage has impaired an investment or where a secondary buyer has not been able to service its debt. The growing use of leverage, however, has occurred during a period of industry tailwinds, increasing public and private equity markets and historically strong distributions over the past few years. As all investors are aware, leverage can enhance returns when asset prices are going up but can also magnify losses when asset prices are going down. The secondary market has yet to endure a down market with an increased use of leverage.

As 2015 unfolds, LPs interested in the secondary market (both by investing in secondary funds as well as accessing the secondary market directly) should keep an eye on the amount of leverage in the secondary industry. Several questions to consider:

Is the growing use of leverage pushing and keeping prices in the secondary market artificially high?
A prudent approach to leverage in the secondary market would be to underwrite the transaction on an unleveraged basis and then use leverage conservatively to moderately enhance the returns. However, there is growing anecdotal evidence that the availability of leverage is pushing prices higher – being used more as a tool to allow a buyer to stretch on price to consummate a deal. Certainly, for buyers that have taken this approach there is a chance for disappointment and underperformance if/when the markets turn. Additionally, this impacts secondary buyers that do not utilize leverage as they are forced to bid higher (and take lower returns) to win a transaction.

What is the impact of leverage on the cash flow patterns of investing in secondary markets?
One of the allures for many (although not all) investors in the secondary market is the expectation for quicker and regular return of cash from a commitment compared to investing in primary funds. If there is leverage that must be paid down, some of the cash flow generated by the underlying assets must be diverted to service and pay down the debt. It is important to keep in mind that the ability of a secondary portfolio transaction to service its debt obligation comes from the distributions within the portfolio (such as through sales, recaps, and dividends). Over the past few years, the industry has had record distributions. Historically, however, the level of distributions has been cyclical and subject to downturns in capital markets and the M&A cycle. For those LPs who are primarily interested in strong returns, this may not be an issue, but it is worth watching the distribution patterns of secondary funds.
How does the increase in leverage impact the evaluation of secondary fund managers – both understanding the performance of secondary fund managers and their transactions as well as the risk taken on by the managers?

For LPs that access the secondary market through secondary fund managers, understanding a manager’s use of leverage to generate returns and the amount of risk assumed will be critical. In many ways this is no different than comparing buyout managers – some of whom may use leverage more aggressively than others – but this has not been as much of an issue historically in the secondary market.

From a risk standpoint, potential LPs for secondary funds must remember that many of the portfolios being acquired have leverage at the underlying portfolio company level, so applying leverage at the transaction level represents a second layer of debt on the transaction. As mentioned earlier, many of these transactions have not been through periods of stress, so it is difficult to predict exactly how they will react.

Ultimately, the question remains as to whether the increased use of leverage in the secondary market is savvy deal making by secondary buyers and a natural evolution of the industry, or a mechanism for driving up prices and adding risk to secondary portfolios. This is an area that Altius will be monitoring closely in 2015.