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All About Secondaries (Last of a Series)

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At a recent private markets conference in Paris, Blackstone's CEO Stephen Schwarzman said private equity "has just been too successful. Institutions have made so much money that all of a sudden they've exceeded their expected exposure." As a result, cash-constrained investors are looking to the secondary market to sell some of their exposure.

But has the secondary market reached its golden age? "Not just yet," says Nick Lawler, our head of secondaries. Buyers predict annual deal volume growth from a $100 billion market today, to $250 billion on the low end, and $1 trillion+ on the high end, depending on who you ask. Regardless of which number you believe, market participants agree there are two constraints restricting secondaries from reaching its full potential: human capital and actual capital.

The human capital element will take time to address. "It is incumbent on everyone working in private equity – buyers, advisors, GPs – to educate the next generation of talented individuals about the opportunity to build and grow careers in secondaries," Lawler says. Today, working in secondaries is very much an attractive and viable alternative to joining a direct buyout firm.

The second element is capital dedicated to the market. Evercore recently reported the top 12 largest buyers control 75% of dry powder in the market. "These funds cannot simply keep growing incrementally to meaningfully move the needle," Lawler said. "Instead, both new market entrants (traditional and non-traditional buyers) will need to enter the market, and allocations to secondaries strategies by investors will need to grow." The advent of continuation vehicles over the past several years may serve as that inflexion point, particularly as realizations demonstrate strong performance.

As we sit here today, the secondary market remains well undercapitalized, presenting, in our view, compelling opportunities for buyers and their investors. Over the last two decades, the ratio of dry powder to annual deal volume has consistently hovered between 2x and 2.5x. Today, that number hovers between 1.5x and 1.7x, meaning buyers have the luxury of being selective.

What does the future hold for secondaries? "Similar to the evolution of the broader private equity market, we expect specialization, over time, will occur," Lawler says. Akin to the evolution of various sub-strategies across private equity (buyout, venture, real estate, infrastructure) and private credit (direct lending, junior capital, distressed), we expect sub-strategies of secondaries, such as GP-Led CVs, will eventually form their own well capitalized and well understood market segments. "It will be up to buyers to differentiate themselves, and up to investors to discern the different sources of risk & return they want in their portfolio."

As we said in our third series, in baseball terms, we're probably in the second or third inning of what could be a 12-inning game.