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Jera Capital Insights

The private equity secondary market in the new regime of 2023 – high activity and large discounts

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By many measures, 2022 was a challenging year, with the resurgence of inflation, the end of easy monetary policy, the war in Ukraine, and disruptions to many globally integrated supply chains. These events caused financial markets to trend downward and many of these challenges continue as we enter 2023.

Throughout 2022, the private equity market also faced these issues, leading to significantly lower transaction volumes, performance, and fundraising activity compared to 2021, which was a record year. As we begin 2023, the market is still in an adjustment period, which means that overall activity is likely to remain subdued in the coming year.

The secondary private equity market has on the other hand been a crucial source of liquidity in this environment, and secondary investors have thrived with an increase in the quantity and quality of transactions available.

Are private equity valuations an escape from reality?

Valuations of private equity assets have been a contentious issue in 2022, with many in the industry voicing their concern because private equity valuations have generally decreased by a few percent, whereas valuations of most liquid assets have dropped significantly more. This has led some financial commentators to describe the situation as an "escape from reality."

Most private equity firms use the recommendations from the IPEV (International Private Equity and Venture Capital) as the basis for their valuation methodology. These recommendations state that the valuation of a privately held company should be based on an identified peer group of listed comparables, with a discount applied to account for factors such as illiquidity and size differences. As a result, private equity-held companies typically show an "implied discount" to their peer group, which should be consistently applied to valuations going forward. In theory, this methodology implies that valuations should move strictly in line with public market valuations but in practice, managers are allowed to exercise some level of discretion.

In 2022, some managers have argued that the growth prospects of a specific portfolio company should offset the decrease in multiple, resulting in stable or even increasing valuations. Given that private companies are often acquired at a discount to the multiple of their public peers, some other managers have argued that it was the public markets that were "catching up" to private valuations and thus, no adjustments were necessary. The argument was also heard this year that private valuations can only be considered accurate at the time of acquisition and at exit, because a private company's value is validated by a transaction only on those occasions. As a result, the conclusion was made that interim valuations should be viewed as indicative and conservative guidance.

Regardless of the reasoning, the widening gap between public and private market valuations has led to significant pressure on prices in the secondary market, as secondary buyers price the underlying companies independently of the underlying fund managers. Discounts to net asset value increased dramatically in 2022 to reach levels not seen in years (e.g. 15-20% discounts for top quality assets) and are expected to remain significant at least in the first half of 2023, creating many attractive opportunities for secondary buyers.

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Is the secondary market going to reach the sky?

In 2022, many institutional investors found themselves over-allocated to private equity because valuations in the private market did not adjust as quickly to the changing market conditions as those in the public market. This led many investors to seek liquidity by selling some of their private equity fund investments in the secondary market and also increased the incentive for fund managers to return capital to their investors. However, with the slowing down of the IPO and M&A markets, many fund managers turned to GP-led secondaries as a way to return capital to their investors while still managing their best portfolio companies and capturing additional upside.

After a record-breaking volume of secondary transactions in 2021, the secondary market has been a strategic source of liquidity and portfolio management tool for both LPs and GPs in 2022 and is expected to continue its rapid expansion in 2023. However, the main bottleneck for the market in 2023 will be the limited capital available for secondary transactions, as the current levels of dry powder will be insufficient to meet the expected influx of deal flow. In this market secondary firms will be increasingly selective as to what deals they allocate the capital – and only the best deals with the highest quality assets will make it to the "finish line".

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