Liquidity Risk in the Alternatives World
CFA Institute Private Markets Webinar (Sponsored by PGIM)
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Speakers

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Background

The second in a series of three CFA Institute Private Markets webinars sponsored by PGIM addressed liquidity risk in the alternative investments space in general and in private equity in particular from both the asset manager and investor perspective.

The discussion covered a broad range of topics, several of which are highlighted in this research note along with suggestions for further reading. The full webinar is available at https://players.brightcove.net/1183701590001/experience_60253026dad74c0022e520ae/share.html.

Alternatives Liquidity Risk in the Current Market Environment

The panelists discussed the market dynamics that gave rise to recent private market liquidity concerns among investors and the role of secondaries in the private markets. The current liquidity concerns began about 18 months ago, as banks pulled back from the market and raised pricing. This move was accompanied by weaker public markets, which led to price compression and downward pressure on private companies. The cost of financing has increased from around 500 bps a year and a half ago to more than 1000 bps, with far fewer transactions completed.

The rise in secondaries trading among private markets investments is not necessarily the result of downward pricing pressure but rather of a need for liquidity among investors provided by the secondary market. Many investors, such as CalPERS last year, have argued their trading of private assets was for strategic repositioning, borne out by an annual investor survey suggesting portfolio repositioning was the number one reason for trading secondaries in both 2021 and 2022. In the same survey, however, liquidity needs were the second most mentioned reason in 2022 for investors to sell their private assets.

Existing Positions vs. Capital Commitments

The so-called "denominator effect" (or overweight to private markets as public market valuations decline) led to a discussion about adequate liquidity to meet unfunded capital calls and spending requirements. Investment committees and boards may be less comfortable with breaching tolerance bands for private markets allocations or require that an investment team reduce its position.

This effect is likely to be temporary—either public markets will come back or private valuations will fall. The second-order effect of not meeting capital calls, however, as seen during the 2008 global financial crisis, is important and places strains on spending for endowments and pensions. Simple metrics are important, such as a commitment pacing plan conducted annually that considers the denominator effect as a factor. Such planning helps avoid funding stress and allows investors to take advantage of markets and put capital to work in what often turn out to be attractive vintage years.

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Secondary Market Behavior

Although the "denominator effect" impacts valuations, it is also important to consider not only unrealized valuations but also how much capital is called and how much is being distributed. These considerations are fairly simple in public equity but require significantly more data in private equity. based on a stochastic model of commitments, calls, and distributions, both capital calls and distributions are now both close to two standard deviations from the mean. That is, capital calls are historically *high* while distributions are very *low*. In many instances, capital calls funded in a lower rate environment by general partners (GPs) using credit lines are now being called from investors. Distributions, however, have slowed since the start of 2023, so investors who lack commitment pacing models are unprepared and more likely to face liquidity constraints as a result.

Valuation

Participants raised the issue of valuation and variation in valuation policies used by different GPs. For example, valuations of a single company held by multiple GPs have shown valuation differences as high as 40%, and the use of methodologies ranged from public market comparisons to discounted cash flow analysis or transaction-based comparisons, to venture capital valuations held at the last round of financing. Based on market feedback, it seems that down rounds will become the new normal.

Potential conflicts of interest in valuation include GPs changing their approach depending on whether they are fundraising or not, because better performance will increase their hiring prospects. In other cases, limited partners (LPs) may exert pressure on GP marks given their own incentives to have higher internal rates of return and multiples. It is important to understand the rigor and periodic review of valuation policies, and Institutional Limited Partners Association has guidelines regarding GP-led deals that are important to know when investing in secondaries.

An additional question was raised regarding GP- and LP-led secondaries and the behavior of GPs. Although some managers may inflate reported returns during fundraising, it has been observed that well-performing GPs are more likely to show those valuations at a discount, even for assets that perform well. More-conservative valuations are the norm among these GPs because they create a buffer to minimize the discount offered to LPs when purchasing an asset in the secondary market.

The Role of Private Debt

Given restrictions on traditional banks, the role of private debt has increased dramatically in private markets, particularly in the areas of direct lending but also for special situation or workout debt and bridge financing. That said, private debt remains untested under a significant recession scenario, so although it is true that investors may earn double the yield and income on private versus public debt, portfolio companies must be able to meet interest payments.

For some GPs, a time of reckoning may come if their portfolio companies simply have the cash flow to service debt without adequately considering the firm's equity value. In other cases, private debt managers are proactively taking steps to mitigate risks, including smaller loan positions and club deals for diversification as well as other measures to avoid surprises in an untested market under adverse economic conditions.

In the area of secondaries, the private debt component boils down to analyzing the leverage of the underlying private companies and their debt burden, because interest rate costs have essentially doubled in a very short time.

Suggestions for Further Reading:

Gregory W. Brown, Oleg B. Gredil, and Steven N. Kaplan, "Do Private Equity Funds Manipulate Reported Returns?" *Journal of Financial Economics* 132 (May 2019): 267–297. https://www.sciencedirect.com/science/article/abs/pii/S0304405X18303015

The following is a link to the annual PGIM investor survey mentioned in the webinar.

PGIM Real Estate, "Annual Investor Survey," (2022) https://www.pgim.com/real-estate/private-equity-annual-investor-survey

The following are links to a three-part blog series recently published by NEPC's Sarah Samuels regarding liquidity in private markets.

Sarah Samuels, "Taking Stock: Private Markets (Part One): Today's Market Dynamics," NEPC (9 November 2022) https://www.nepc.com/taking-stock-private-markets-todays-market-dynamics-part-one/

Sarah Samuels, "Taking Stock: Private Markets (Part Two): The Art of Commitment Pacing and Liquidity Management," NEPC (29 November 2022) https://www.nepc.com/taking-stock-private-markets-part-two-the-art-of-commitment-pacing-and-liquidity-management/

Sarah Samuels, "Taking Stock: Private Markets (Part Three): Finding the Opportunities in Volatility," NEPC (19 December 2022) https://www.nepc.com/taking-stock-private-markets-part-three-finding-the-opportunities-in-volatility/