Secondary investors in Asia face China uncertainty but show rising sophistication

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Private equity (PE) and venture capital (VC) investors are increasingly looking for ways to unlock liquidity and have begun to display a growing sophistication in their understanding of secondaries.

However, the prevailing uncertainties around China's exit market and upcoming elections in over 50 countries suggest that it may take a while before we see more closed transactions across this region.

Supply is rising, driven by China

According to Jefferies's Global Secondary Market Review, Asian secondary market volume jumped from 2% in 2022 to 5% in 2023. Most of it came from China – still Asia's biggest market today – but the rise came from lower pricing due to challenging macroeconomic conditions and limited buy-side capital.

Asian portfolios generally enjoy steeper discounts compared to other geographies. North American funds generally price 2,000 basis points higher than Asian funds, with top-tier Asian GPs facing substantial discounts of over 40%, shared Jefferies.

"Every GP is considering secondaries now," echoed Soma Ghosal, founder of Candor Asia Advisors.

The pressure on GPs to return capital has also risen substantially in part because of the high-rate environment today. “With higher interest rates, every year you don’t deliver a promised exit, you’re losing money for your LP,” she said.

Global Secondary Market Review – 1H 2023

Pricing across all strategies largely moved sideways

Fig. 6. Historical secondary pricing (% of NAV)

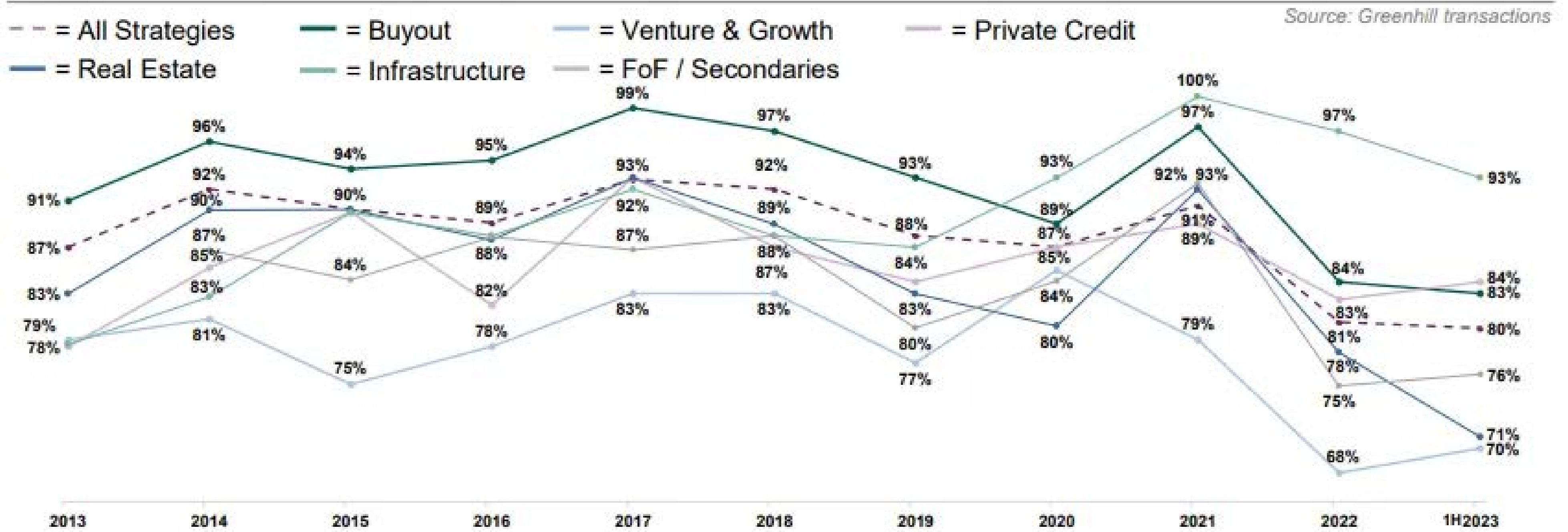
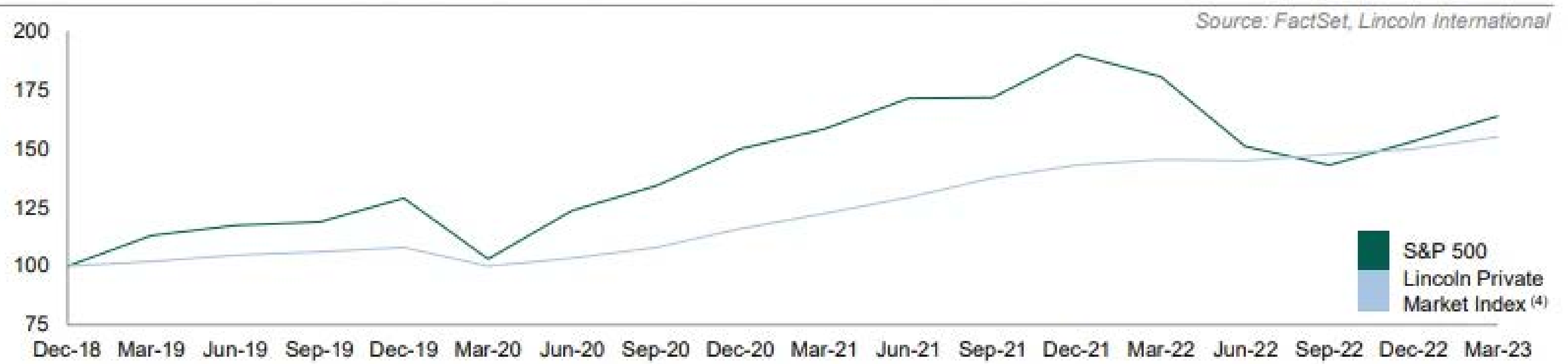


Fig. 7. Private vs. public market valuations mismatch: Lincoln PMI and S&P 500 indexed performance



Source: Greenhill

Meanwhile, LPs are still struggling to gain clarity around China’s growth prospects or exit market. China’s relatively shorter timeline and track record are giving further pause to investors who may be more sensitive to risk in this uncertain global market.

“The biggest issue for China in general is that you don’t have 20 years of companies being able to exit and investors getting their capital back. That’s probably the biggest concern, or at least one of the biggest concerns that investors have,” said Vincent Hsu, StepStone Group’s Beijing-based partner.

This is casting a wide shadow over the Asian market in the eyes of global LPs, who used to dedicate a substantial portion of their Asia allocations to China. Investors note that some institutional LPs are already choosing not to re-up in existing funds and at times are even exiting Asia altogether.

“Historically if you had a certain allocation for Asia, especially for Western institutional LPs, China would typically account for nearly 70% of that piece. With significant disarray in that part, many LPs have started to wonder whether it’s even worthwhile being in Asia at all,” explained Ghosal.

This continues to lead to a wide bid-ask gap for Chinese assets, particularly VC-backed or “politically sensitive” portfolios. Some of these discounts can go as high as 70% for a top-tier Chinese VC, observed Javad Movsoumov, who heads UBS’s private fund coverage in Asia Pacific.

What's the real price?

The bid-ask gap across Asia is narrowing but remains wide at the moment, shared secondary investors. Some of the disagreements have to do with the different ways in which assets were valued by PE and VC firms during the peak liquidity years.

PE assets are usually marked to market based on public and peer comparisons, but the VC ones were frequently marked to the valuation raised at the last round. Since US stock markets fell off a cliff in 2022, Asian investors today are still coming to terms with an asset's price versus value.

"...You (would) get into debates on what is the "real" value of the portfolio. If the selling LPs, GP, and the incoming buyers are not aligned on what the value of the portfolio is, then it's very difficult to do transactions," shared UBS's Movsoumov.

Among VCs and tech investors — who are often staring at over 50% discounts on portfolio NAV these days – Ghosal still sees a reluctance to accept the low ask prices. The other option is structured financing solutions like NAV financing, but many are still not willing to consider this.

"Fund managers are less excited by NAV financing. One factor could be that it's usually more difficult to bake in GP economics for that type of deal... also for venture funds in particular, where DPIs are low, the financing terms can be quite tough with quite low LTVs and high return expectations," shared Ghosal.

Deal structures in demand

There has been an uptick in requests for certain types of structures though.

Continuation funds in India are common these days, where transaction sizes can range very widely from $30 million to $750 million, shared Dennis Kwan, managing director, private capital advisory, at Jefferies.

Indian fund managers are also requesting for pledge funds to raise non-Indian or institutional money for their new fund vehicles, echoed Ghosal.

Staple transactions are also frequently requested by GPs who may be facing difficulty raising capital for a specific fund, noted UBS. These structures involve an incoming secondary buyer to conduct the secondary exit while requiring them to inject an additional small portion of primary capital into a new fund.

"It's an interesting concept because it introduces even more conflicts of interest into a transaction and needs to be handled very carefully. But GPs in particular, who are under a lot of pressure to raise capital, may have the incentive to execute a secondary transaction with a staple," shared UBS's Movsoumov.

One sticking point that investors tend to debate over is the staple ratio, which indicates the amount of secondary to primary dollars the transaction entails. Secondary investors usually do not like staples because they tend to be dilutive for the overall pricing of the transaction.

During the last peak liquidity cycle before the COVID pandemic, staple ratios would go at 2:1 in primary versus secondary dollars. Today, they're inching towards 4:1.

"You can have an amazing asset that everybody wants to get in from a secondary perspective and then you can utilise that competitive tension the ratio a little bit to hit 3.5 or 4:1. Everything is very detail driven (today)," said Movsoumov.

Industry experts all point out that Asian investors are increasingly sophisticated in their understanding of secondaries, which is a positive sign for Asia's emerging private markets.

"Every GP that I've spoken to in Asia has a very good understanding of continuation funds. There's no continuation fund 101 needed anymore. The question for them today now revolves around whether there is the right asset or assets that investors will be interested in," said Jefferies's Kwan.

Several major funds have been closing large secondaries funds to capture the opportunity set in this asset class in recent times.

These include the likes of Lexington Partners ($22.7 billion) and Blackstone ($22.2 billion). Well-known names like Ardian and HarbourVest are also aiming to close large corpuses of $25 billion and $12 billion for their respective global secondaries vehicles. Pantheon notched up $5.3 billion for the largest-ever secondary infrastructure fund which it closed just last month.

There, however, remain few secondary funds dedicated to Asia.

Schroders Capital partnered with Kasikornbank in October to launch a China-focused private equity fund, primarily targeting opportunities in the secondary market. **Ardian told DealStreetAsia in August** that it was earnestly considering a secondary platform for Asia.

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