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Middle-market GP-leds: New 2ND Capital's Tjarko Hektor discusses market and strategy

Tjarko Hektor, founder and Partner, New 2ND Capital.

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Published: Jul 22, 2024

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The growth in middle-market GP-leds emerged as a pivotal theme in 2023 and gained further momentum in 2024.

However, secondary market veteran Tjarko Hektor foresaw the growth long ago. After 16 years as an MD in AlpInvest's secondaries team, including as the team's co-head, Hektor launched New 2ND Capital in 2016 to invest specifically in middle-market GP-leds.

Middle-market GP-led deal volume was at near-record highs in 2023, PJT said in its yearly secondary market volume report. Jefferies said that it expects the middle market to continue to be a focus area for GP-leds.

In an interview with *SecondaryLink,* Hektor said that the firm launched at the right time, seeing how the larger GP-leds market has boomed since 2016. The firm too has grown to over $1.8 billion AUM and is currently investing from its third fund.

Through these funds, New 2ND has invested in 25 deals, 23 of which it was a lead investor in.

In this interview, Hektor reflects on how the market has evolved over the span of his career of over 20 years, addresses the growing competition in the market, and shares New 2ND Capital's plans for growth and the firm's investment approach.

How has the market evolved from your time at AlpInvest to today, i.e., eight years after founding New 2ND Capital?

I have been doing secondaries for 22 years now, and when I started, it was a $2 billion market. When we started New 2ND Capital, it was a $35 billion market. At the end of 2024, the market is estimated to grow to $150 billion. So, there has been tremendous growth, not just in size but also in segmentation. The way people now segregate the market into traditional LP-leds and GP-leds is a good way to view it.

While GP-led deals have always been there, we got the timing of New 2ND Capital right because GP-leds have really taken off after we launched in 2016. Now, it is 50% of the secondary market, and that is going to continue. I am a strong believer that we still have very significant market growth ahead of us and that GP-leds will be a very meaningful part of that growth. The 50-50 market split will probably continue in the longer term and is not just temporary because there are liquidity needs.

Everybody talks about overall market volume, but I specifically also look at activity in the middle and lower middle markets where we are active. The GP-led phenomenon is stronger in the higher end of the market and is trickling down to the middle market, creating a vast number of investment opportunities. Our job is to find the most interesting opportunities from within those.

New 2ND has completed a milestone of 25 investments. What have you learned about the market while making these investments? What's your view on when New 2ND will complete the next 25 investments?

If we go back to 2016, GP-leds used to feel like missionary sales. We used to tell GPs about what we do, and how this works, and their response would largely be, "we have never heard about this, we don't think we need it". Fast forward four years later, they were likely to have heard about GP-leds and started to ask if these deals were relevant to them. Today, almost everyone knows about GP-leds, even in the middle market. So, that increase in acceptance and visibility is fantastic.

For New 2ND, as our team grows, we have more capacity to do deals. That said, most of our deals take five to six months to close in the short end. On the longer side, sometimes they take over 12 months from start to finish. So, every deal needs its own time to come to fruition and I don't think that will change. But as we invest in the team, the organization and technology, our investment bandwidth goes up.

It has grown from two deals per annum to up to six. But I don't see a massive change, these are gradual extensions. And in the beginning, we were doing smaller check sizes. Now our cheque size is increasing, but basically, the same types of deals.

The number of GP-led buyers is increasing, and competition will be much higher in the coming years. How will that impact your investment strategy? Will more buyers also mean deals being closed for slightly lower-quality assets as opposed to only the best assets currently?

Regarding the asset quality, I would say no. I am seeing the asset quality of opportunities only going up. Again, this has to do with acceptance of GP-leds and GPs' understanding of how this tool works. So, the quality of the opportunity set is increasing.

On the competition side, I'd like to say we have no competition. That is how I truly feel. New entrants are coming up in the larger end of the market with a couple of billions of fund sizes and small teams. They are looking at bigger deals.

But let me explain it this way - there is a massive ocean with thousands of fish (opportunities) out there. Within secondaries, there are maybe just 10 boats fishing for the same deals as us. So, we are sailing for days and months, or even a year, and not running into anybody. Let's say the competition increases by 20%. That is two more boats. I'm still going to be out there the whole year and not run into anybody. That is the competitive landscape and opportunity set we are seeing. So, I don't think there will be an impact on pricing and terms.

What is New 2ND Capital's investment rationale and strategy? What kind of assets do you think will be attractive going forward?

We screen for two things while initially evaluating a deal. The first thing we ask ourselves is if we like the companies. Like how you would evaluate a company if you were making a direct investment. Because ultimately, if you want to make money in the private equity asset class, it is about buying attractive companies – in our case, in the middle market.

The second layer of screening is people. So, we ask ourselves if the GP we are striking a deal with has the right skills to create value in the assets. And, do we feel aligned with them? Do we want to work with them for the next two to five years? Once it passes these two layers of screening, we put on our secondary structuring and dealmaking hats and ask if there is an interesting transaction here that we can pursue that, at the end of the day, meets the type of risk/return profile we are looking for. Also, the opportunity needs to be in the North American middle market. And, we are secondary investors, so we want to get a discount. We want to have assets that have a shorter duration, earlier cash flow, and no J-curve.

We don't really look at sectors. But when constructing deals and deciding what companies we like, we use a little bit of reverse engineering. Like, we try to assess the exit potential of a company, if it achieves certain goals in the next two to three years, will there be ample buyers for it? If the answer to that is yes, then in principle, it's an interesting company. So, we are not focused on sectors, we are focused on screening the exit. Since most of our portfolio companies are sold to larger private equity firms, we look at what they are interested in. So, companies in sectors like professional services, healthcare, education, technology and industrial companies end up in our portfolio.

The slowdown in the M&A and IPO markets aided growth in GP-leds. How will an improvement in the M&A and IPO market change the dynamics for middle-market GP-leds?

When the GP-led market was red hot in 2021, the M&A market was still very open. I would argue that a lot of people on the buy side of GP-leds have held back a bit last year because the deal flow was so tremendous. We don't want to be caught in a cycle. The secondary market has discipline.

There is so much private equity capital stuck in older funds and older structures, that the secondary market is not big enough to solve that. Even if we take the next 10 years, we will not be able to solve that. The problem is so vast that I don't think the overall supply-demand imbalance is going to change materially.

Personally, I believe the biggest constraints to the overall growth of the secondary market are twofold. One, the secondary market remains undercapitalized. There is one-and-a-half years of buying power currently. I have been in this market for 22 years, and the dry powder has always been around one and a half years. Sometimes, it has been 15 to 21 months. This is also one of the rationales for the relatively attractive performance of the secondary market vis-a-vis other alternatives in private equity. I believe the market's relative undercapitalization is not going to change.

The second biggest constraint, or potentially the biggest constraint today is that there's a lack of human capital. Everybody has tried to tackle this in their own way. We are tackling this by growing the organization largely at the junior end and promoting from within. We have grown now to 18 people. Most likely, we will add another two to four people in the next 12 months. At the same time, we are investing in people. We have significant internal training programs and we make use of external training. We use technology to make our organization more efficient and enhance our due diligence. We make use of external resources so that with the same number of people can do maybe 50% more. That is the name of the game - investing in people and technology. That's because, at the end of the day, this is a people business.

You mentioned how the secondary market is undercapitalized, that is especially true for GP-leds. By when you think capital availability will come closer to matching the GP-led opportunities?

We are still very far from that. That is what makes it interesting and allows us to be selective.

But the funny thing is that we have been seeing the same thing over the last 20 years – that the market is undercapitalized. We are still such a small piece in the bigger scheme of things. What's the secondary turnover as a percentage of the private equity asset class? 1.5% per annum? We are a little drop of liquidity in a very large and growing illiquid asset class.