

State of the Private Equity Secondaries Opportunity

Three veterans of the PE secondaries market discuss the COVID disruption, pricing and expectations for the future.

(Based on a July 2020 Privcap webinar)

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The Panelists



Simon Ok

Principal
Lexington Partners

Simon Ok is a Principal of Lexington Partners primarily engaged in the evaluation of secondary purchases of private equity and alternative investments. Prior to rejoining Lexington in 2010, Mr. Ok was an associate in Lexington's equity co-investment program and prior to that he was an analyst in investment banking at Credit Suisse. Mr. Ok graduated from McGill University with a BCom in finance and from the Wharton School of the University of Pennsylvania with an MBA.



Matthew Pellini

Principal
Hamilton Lane

Matt is a Principal on Hamilton Lane's Secondary Investment Team, where he is responsible for due diligence and execution of secondary investments. Prior to joining Hamilton Lane in 2010, Matt spent five years at Curtis Financial Group, a Philadelphia based middle-market investment bank. At CFG Matt advised on mergers and acquisitions as well as debt and equity financings for public and private companies across a variety of industries. Matt received a B.S. in Accounting from the University of Delaware.



Meghan McAlpine

Director of Strategy and Product Marketing
SS&C Intralinks

Meghan McAlpine is the Director of Strategy and Product Marketing for Intralinks. In this role, she is responsible for the go-to-market strategy and driving the growth of the company's Alternative Investments solution, the leading communication platform for private equity and hedge fund managers and investors.

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Privcap: The secondaries market is always a fascinating topic. But because we find ourselves in interesting times, it's even more important to understand what's going on in secondaries. Simon, the private equity secondaries market has grown tremendously over the past 20 years. Why is it that secondaries have become such a huge factor in the private equity market, and do you think that the current COVID crisis in which we find ourselves is going to be an impediment to further growth?

Simon Ok, Lexington Partners: The way we view the market, there have been two traditional sources of growth for the secondaries market. First, there has been meaningful growth in terms of private equity and alternative fundraising overall. After a brief dip during the global financial crisis, global fundraising reached all-time highs in the last couple of years. If you look at 2019, fundraising volumes for alternatives broadly were around \$700 billion. And if you add up capital that's been raised since 2012 you're looking at total commitments of \$3.4 trillion into private equity and alternatives globally.

If you're a secondaries investor, that's your inventory. That is what you're going to buy in the next four to five years. Seeing this growth and this interest in private equity excites us. It is one of the reasons why the secondaries market has grown so much.

Number two, more importantly, the turnover rate that we measure has increased meaningfully over the past couple of years. The way we define turnover at Lexington is as a percentage of funds raised in a given year that gets traded on the secondary market over time. Let's say in 2010, \$1 billion dollars was raised in private equity overall. If the turnover rate was 10 percent, \$100 million of that \$1 billion turned over in the secondaries market over time.

When I first started in the industry in 2006, turnover rate was closer to 4 percent or 5 percent. Now it is reaching, according to our estimate, 9 percent or 10 percent. This speaks to a deeper secondaries market, a more widely accepted market, where people

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–Matthew Pellini, Hamilton Lane

use it not only for distress, but as a portfolio management tool. From a structural perspective we're very excited by the outlook. We do forecast meaningful growth in the secondaries market going forward.

To answer the second part of your question, what's the impact of COVID? There isn't any doubt that in the short term COVID is going to have an impact in lowering secondary deal volume. We have seen this in the past, following the internet bubble in 2000 – 2001, following the Global Financial Crisis in 2008 - 2009. Naturally, as asset values come down there is going to be an increase in the bid-ask spread.

As a secondaries buyer, if you know that as of 3/31/20 asset values are coming down, naturally your discount is going to increase, which obviously makes it harder from the seller's perspective to pull the trigger on a sale. Hopefully, volume comes back up, but it's going to be down meaningfully this year, according to our projection.

Matthew Pellini, Hamilton Lane: We think secondary market growth is just an evolution of the private markets into a mature asset class. To put this in context, the private market net asset value from 2008 to 2019 has grown from \$1 trillion dollars to over \$3.5 trillion dollars. At the same time, unfunded capital grew from just under \$1 trillion to close to \$2 trillion. So clearly as the asset class grows there's going to be more opportunities for secondary volume. Secondaries volume grew from \$20 billion in 2008 to close to \$90 billion last year.

The trough in 2009 was \$10 billion. So we're talking about huge growth, huge opportunity. And as Simon said, a lot of this is a function of seller demand. But it's also a function of how the returns within the private equity asset class have been so strong. That's going to drive a lot of the volume into the market. Also, assets are being held longer, and there's a need for alternative methods of liquidity.

The last thing I'll add is that GPs have entered the fray. Instead of selling assets to third parties after a certain period of time, they understand that there are opportunities within the secondary market to hold onto crown jewels for longer, and continue to manage them for new sets of LPs.

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Privcap: Meghan you've got a unique vantage point on the market because your company facilitates deal making and due diligence. What have you seen happen to deal making in the midst of COVID?

Meghan McAlpine, SS&C Intralinks: There is definitely a growing universe of players out there, and a broadening set of assets available for sale. The stigma associated with secondary deals has diminished significantly. We've definitely seen a huge increase in secondaries over the last several years.

Obviously we saw a bit of a pause in secondary activity when the pandemic hit. Travel bans have made in-person, company-level due diligence impossible. That has led to some stalled GP-led secondary processes. COVID brings a need for communicating better information remotely. And remote technology is even more key to connecting all the players in these transactions. It's helped people realize that technology is a requirement and should be a priority to getting these deals done.

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–Simon Ok, Lexington Partners

I do think there's an opportunity in this market environment. Secondaries were very well positioned during the Global Financial Crisis, and there were some great investment opportunities that delivered outsized returns during that time period. We are now seeing some of those same dynamics with this down market. It is possible that there will be some great secondary opportunities in the next couple of years.

Privcap: Further to the mechanics of getting these deals done , presumably the three of you are at home and presumably everyone in the market you deal with - brokers, sellers, buyers – also are at home. What's that like?

Ok: Private equity naturally is a relationship-based businesses. It is important to meet people, see their body language, assess who they are and the firm that they represent.

Most importantly, the way we monitor our investments - attending annual meetings, advisory board meetings – has definitely been impacted. I miss it. I miss meeting with folks. But the technology tools we have at our disposal have meaningfully closed the gap in terms of what we can do without meeting people face to face.

We've been incredibly productive here at Lexington. This year we've looked at around 250 transactions. We've closed on six transactions, about \$1.2 billion in value. We are getting things done.

Pellini: It really comes down to relationships and information within the secondary market. Groups that have been around for a while, that have the relationships, that have invested in technology, are able to excel in this environment. It's an exciting time. We have access to investments in hundreds of thousands of private companies with information asymmetry. You can't really imagine a better investment position to be in. However, in order to successfully prosecute that, you need to view it all from the right side of the information asymmetry. You need to have the technology to be able to analyze it efficiently and effectively. Hamilton Lane has spent a lot of money on technology over the past few years. We've really been preaching technology within the asset class. On the secondary side, we invest in less than 2 percent of the deal volume that we see. So we really have to prosecute that deal volume efficiently. In order to do that we've been using a lot of third-party tools.

Privcap: Meghan, as people are transacting remotely, how has that changed the way they use platforms like yours?

McAlpine: Technology will never take the place of relationships. But in this remote working environment, technology has become even more important. Zoom has become a way of life for everybody at this point. Using a data room for the secondaries process can really help make it more efficient. It can help automate a lot of the manual tasks and inefficiencies in traditional processes. Allowing bidders to analyze information is a key component of that. Technology can lock down sensitive information and can help accelerate the overall deal process.

Privcap: Cutting to the chase, what are all of you seeing by way of pricing in the secondaries market?

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Pellini: Part of the reason why deal volume is down is because there's a wider bid-ask spread. That's a function of uncertainty and lack of conviction. It's really important to have information and to be able to price with conviction. Yes, there are distress opportunities out there, but nobody's going to admit that. What you have to figure out first is not just price but asset quality. I don't mind paying up for a high-quality asset. I don't want to be tricked into buying something at a massive discount and then finding out later that, well, actually that discount was because I was buying a lower-quality asset.

We're seeing pricing come down a bit. We're seeing some volumes stall because of that. For volume to pick back up, that bid-ask spread is going to have to narrow. The public markets and the capital markets will need to provide more certainty around the exit environment, helping buyers and sellers understand valuation a little bit more.

Ok: We've seen discounts go in two directions. For funds or assets that are highly exposed to COVID and its economic impact, the discounts have clearly widened. We require large discounts to own some of those assets. And on the other side of the things, we see funds and assets that are much less exposed to the effects of COVID, be it technology or healthcare, where the change in discounts have not been so significant.

One of the intermediaries told me that according to their estimate, discounts have increased 8 percent to 9 percent from where they were in December. Additionally, people will notice in the coming quarters that there will be a slowdown in distribution activity from private equity funds. And based on our historical observations, we know that as distributions slow down, discounts tend to increase in our markets.

There will be a modeling bias where people who project future commitments will look at past distributions to make their commitments. And as those distributions come down, people will be over-committed to the asset class. And they will need to seek liquidity solutions.

McAlpine: The issuance of Q2 and Q3 financial statements will likely be a key metric for both buyers and sellers. Once those are out, buyers will likely re-engage and potentially drive higher optimal pricing.

Privcap: As a buyer in the current secondaries market, are you having to take a view about when the COVID crisis will subside?

Ok: It's difficult. As a firm, we are trying to take a more proactive approach in terms of how we underwrite our assets. One difference that we've noticed from the Global Financial Crisis is that the

level of distress is much less pronounced, partly because sellers are better prepared. And the government stimuli have enabled people to buy some time. But because of COVID and its uncertainty, we've become more conservative. We are pushing our exit modelling further down the road.

Privcap: Talk about the rise of GP-led transactions.

Pellini: There are a lot of different types of GP transactions. Rather than buying an LP interest from a single seller, GP transactions often offer liquidity to a group of LPs as a whole. This can be through different mechanisms like a formal tender offer, a fund restructuring, or a purchase of a strip of the underlying assets.

Hamilton Lane has become very involved in GP-led transactions. They start with educating the GPs on what type of transaction helps them achieve their objective, how to run a fair process, how to communicate the transaction to their LPs. Some of these have been very sizable transactions. They can be certainly north of \$100 million and a handful of them are north of a \$1 billion. They are also fueling a lot of the growth within the secondaries markets. Of close to \$90 billion of secondaries deal volume, probably close to 30 percent of that was in these GP transactions. To not be involved in them, you're missing out on a huge opportunity.

McAlpine: From our perspective, GP-led secondaries have really exploded over the last few years. I think we will continue to see an increase in those transactions as holding periods will likely increase. With delayed exits GPs will have to consider these types of transactions to address potential capital needs, in order to support their existing portfolios, or avoid having to sell assets at depressed valuations. The key to these types of transactions is transparency.

In many cases, LPs lack the bandwidth to get the diligence done, so it does require a lot of handholding to make sure they get information in a timely fashion. The LPs also need to understand fees, expenses, and what the structure's going to look like going forward. Using technology to help with that process definitely can help make it more streamlined.

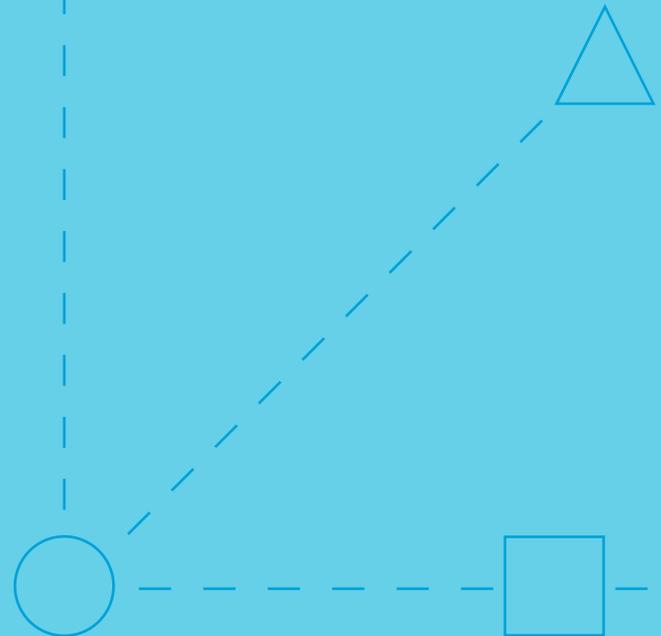
Ok: One of the questions I get a lot is, what is a GP-solutions transaction? Sometimes people confuse that with investments in the management company. A recent form of GP transaction that we've been seeing is what's called a continuation fund transaction. In this case, a GP has an older fund. It has, say, one or two assets left. One of the assets is performing great. Traditionally, there are a couple of options the GP has to sell that asset. One is they could sell it to a strategic. They could also bring it to the public markets and do an initial public offering. And now, there is a third option, and we call it the continuation fund. They sell that asset to a group of investors led by a secondary fund.

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Let's say they want to hold onto this high-quality asset a little bit longer. They see the growth potential. The fund will sell that asset to a new continuation fund that's being capitalized by a new group of buyers, typically a secondary fund a group of investors. This allows the GP to achieve liquidity, and crystallize the carry from the old private equity fund so they can move on.

The GP can continue to manage the assets, see the growth and take advantage of the future value creation potential. The sellers from the old fund typically get the option to participate in the sale, or to participate in the transaction and roll their carried interest into the new fund. If they just want to call it a day, they can sell their shares and move on.

Thirdly, the secondary buyer gets to partner with a general partner in an asset where they see a lot of upside. The secondary market used to primarily provide liquidity to limited partners. Now, general partners themselves have learned over time that the secondary market can be used to their benefit to generate liquidity or achieve other strategic purposes. ■



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