Investec

2023

Investec Secondaries Report

Secondaries shine in turbulent times

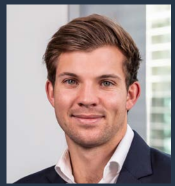
OUT OF THE ORDINARY

Foreword

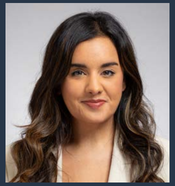
The sixth edition of the Investec Secondaries Report, 'Secondaries shine in turbulent times', is an in-depth analysis based on a comprehensive survey completed by over 30 secondary managers operating in the market.

Listening to you, we understand your concerns around the complex economic backdrop, where you are grappling with a shifting landscape. This report delves into the fundamental dynamics shaping the market, key considerations, and financing strategies adopted by secondary managers.

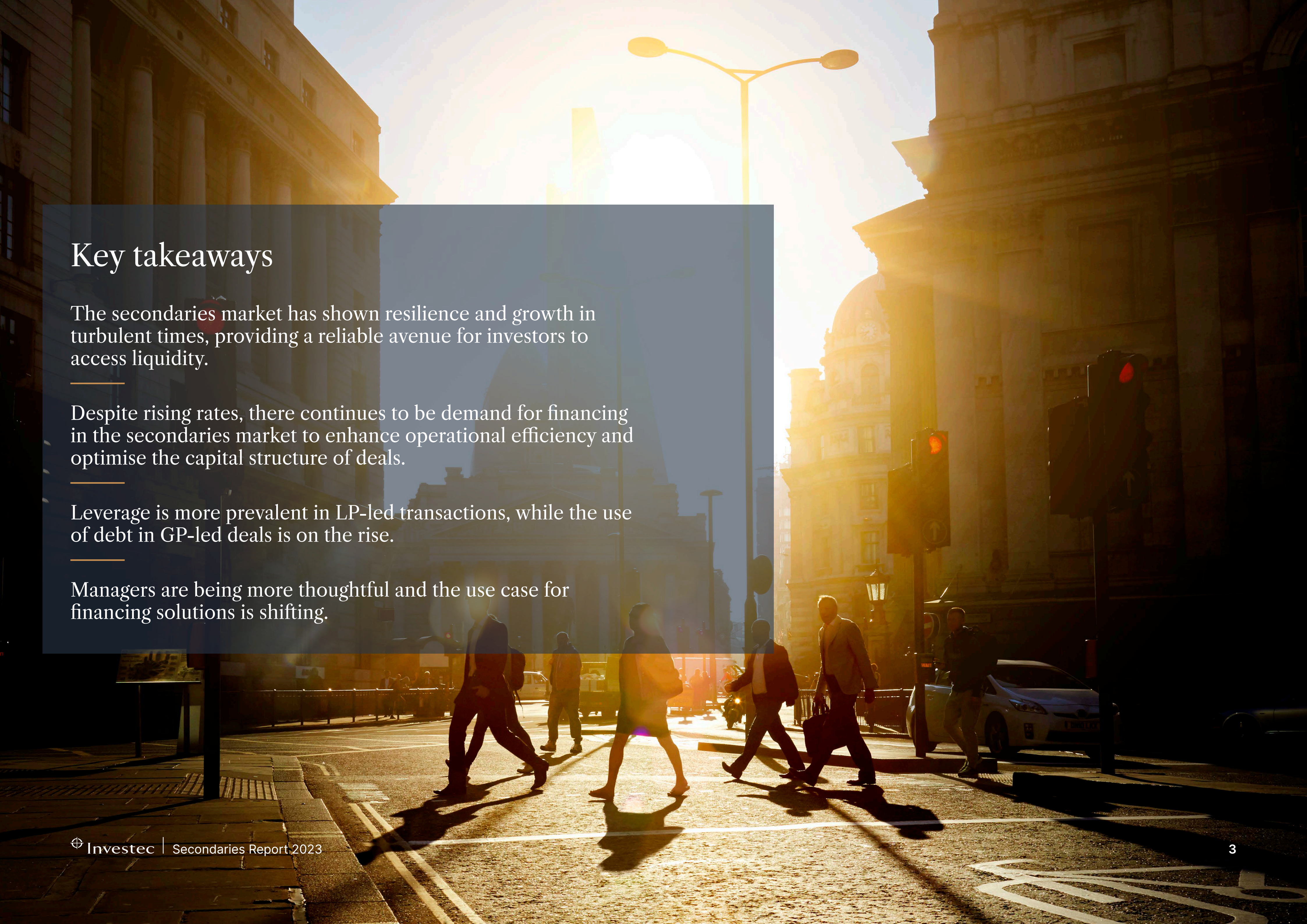
This year, we have sought to focus on how financing solutions are being used against a rising rate environment, whether at the secondary funds or at deal level; exploring trends and structures within the market. Whilst liquidity constraints remain prevalent and the supply and demand imbalance continues within the fund financing market, the report highlights the need for solution-orientated lenders with a proactive approach in providing tailored and flexible facilities to meet the evolving needs of the industry, to support the future growth of secondaries.



Stuart Ingledew
Fund Solutions



Sharon Thandi
Fund Solutions



Key takeaways

The secondaries market has shown resilience and growth in turbulent times, providing a reliable avenue for investors to access liquidity.

Despite rising rates, there continues to be demand for financing in the secondaries market to enhance operational efficiency and optimise the capital structure of deals.

Leverage is more prevalent in LP-led transactions, while the use of debt in GP-led deals is on the rise.

Managers are being more thoughtful and the use case for financing solutions is shifting.

Shifting macro winds

Over the last year, we have entered a new stage in the market cycle.

The period has been marked by runaway inflation, surging interest rates and economic and political uncertainty. All of this has exerted acute pressure on market liquidity.

Investors globally became overweight in their private equity portfolios creating a rebalancing challenge for Limited Partners (LPs). UK pension plans encountered challenges related to liability-driven investments (LDI).

While General Partners (GPs) faced a subdued exit landscape, as the equity markets witnessed a dearth of initial public offerings (IPOs) and a slowdown in mergers and acquisitions (M&A) activity.

The rate of distributions for LPs decelerated, creating a pressing need to unlock capital for new allocations. As a result, both LPs and GPs turned to the secondaries market as a route to access liquidity.

Secondaries – an all-weather strategy?

In 2022, the market showcased its strength by surpassing a transaction volume of over $100bn[1] – the second-highest level ever recorded.

Against the backdrop of challenging macroeconomics, the secondaries market has demonstrated remarkable resilience, reaffirming its role as a reliable route to generating liquidity for both LPs and GPs. In 2022, the market showcased its strength by surpassing a transaction volume of over $100bn[1] – the second-highest level ever recorded; the driver continuing to be LP-led deals ($55bn) and GP-led deals ($48bn).

“Amidst the challenging landscape for M&A and the limited availability of IPOs, secondaries have emerged as one of the few viable avenues for investors to access much-needed liquidity. And while we have not entered distressed seller territory yet, we are seeing motivated sellers indicating a buyer’s market. Interestingly, as a lender we have seen more investors exploring financing solutions to hold onto their private equity portfolios whilst generating liquidity.”

Stuart Ingledew, Investec

1. Evercore Private Capital Advisory, 2022 Secondary Market Survey Results

Fundraising: Sizing the opportunity

Indeed, while capital constraints are expected to result in a slower fundraising market across all private equity sub-asset classes, our survey showed that the fundraising market for secondaries is expected to remain buoyant.

There is plenty of cause for optimism, but throughout the course of 2023 the fundraising landscape continues to be tough for all. LPs grapple with where to deploy their new allocations, given the lack of expected distributions from older vintages – as primary managers are forced to hold on to assets for a longer period.

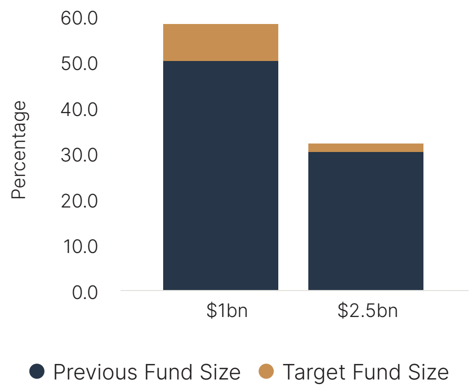
Additionally, there is the sheer number of managers in the market fundraising, competing for commitments. Many are expecting to close their funds below their initial target sizes. This raises the question of how secondaries funds will fare.

So, while capital is being raised, is this sufficient to take advantage of the opportunity in the market?

Could financing act as a tool to help complete deals where there is a shortage of capital, or is debt too expensive?

2. Private Equity International, 2023 Q1 data

Fundraising landscape



> More than 90% of secondary managers we surveyed said they are looking to fundraise in 2023 – demonstrating high expectations for the size of the opportunity in secondaries.

Sharon Thandi, Investec

Sharon Thandi, says: *"Meanwhile, when discussing their last fundraise, 30.3% said they raised large pools of capital for secondaries opportunities, over €2.5bn in fund size, meanwhile 51% raised funds of over €1bn.*

Looking ahead to their next raise, respondents predict raising a similar amount – 58% estimate over €1bn and 32% over €2.5bn. This build-up of dry powder will allow buyers to position themselves to hopefully take advantage of a rise in expected deal flow, leading to increased deployment."

According to Private Equity International[2] data, the latest 2023 Q1 figures have already shown strong attraction from LPs, as more capital is being committed to secondaries funds than to any other private market asset class.

The market has seen an expansion in dedicated funds being raised solely focused on investing in GP-led deals over the last couple of years, with the likes of ICG Strategic Equity, Blackstone Strategic Partners, TPG GP Solutions and Pantheon; more recently, Astorg bolstered their team to target continuation fund deals. This has spurred overall market growth.

One industry report has predicted secondary fundraising to reach $96bn[3] by the end of 2023.

Part of this has also been the emergence of private debt secondaries funds being raised by managers such as, Coller Capital, Pantheon, StepStone and Apollo S3.

Stuart Ingledew says: *"We expect the trend of GPs identifying the value of the secondaries market for liquidity solutions to continue. Consequently, the overall growth of the market is anticipated to align with the expansion of commitments raised in these vehicles. With record fundraising in recent years and liquidity accessible from both LP-led and GP-led transactions, we believe the secondary market is poised for significant growth."*

3. Lazard Private Capital Advisory, Secondary Report 2022

Secondaries light-up deal environment

Our survey suggested this strong deal flow is likely to continue, with almost all (93%) of our participants saying they believe 2023 deal volumes will exceed last year's levels.

The strength of volume is driven by an uncertain backdrop, as GPs grapple with current market challenges and increasingly access secondaries as multi-faceted solutions. Greater deal flow will also help to mature the entire asset class.

> Taking into consideration the market gloom, the expectation from 93% of respondents that overall deal flow will exceed 2022 levels this year is remarkable – especially given last year only 79% said the same – and, in fact, transaction volumes were lower in 2022 than in 2021.
>
> **Sharon Thandi, Investec**

Relative value

The report also showed secondary managers will look to invest more in LP-led than in GP-led transactions in 2023. This supports the prevailing view indicated by the respondents that there is more relative value in LP-led deals.

76% of managers expect to be more active in LP portfolio sales in the next 12 months.

One key driver of this is the liquidity needs of LPs, such as UK pensions schemes, which have faced LDI issues. These entities require increased liquidity, prompting them to actively seek out opportunities for generating capital through LP-Led deals.

While not appearing as comparatively enticing, GP-led deals have similarly been a core part of the secondaries market offering. In recent years, there has been an increase in their market share of the overall volume, and they have become an established route to liquidity.

Over 50% of our respondents expect to be more active in GP-led solutions over the next 12 months.

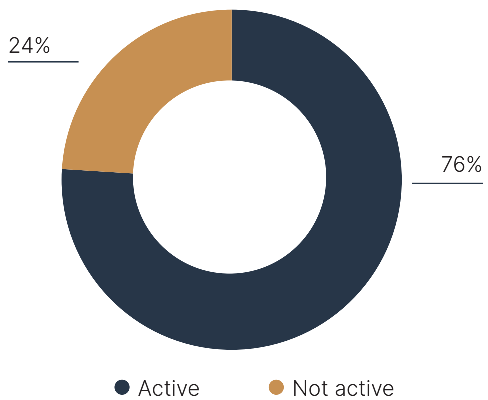
In 2022, there were capacity limitations noticed in the GP-led deals sector. Nevertheless, it is anticipated that the supply-demand disparity in this market will eventually balance out as time progresses.

Well-established participants in the secondary market are taking action by raising larger funds, while new investors are accessing additional capital sources to bolster their participation in GP-led deals.

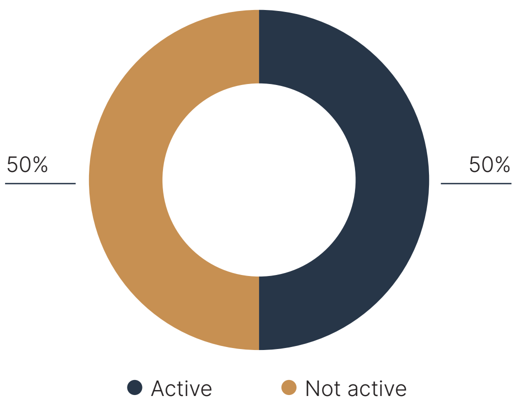
Sharon Thandi, says: *"An elevated number of deals and higher transaction volumes were witnessed by buyers in the secondary market. This was a result of a downturn in M&A activity and the denominator effect which stimulated limited partners (LPs), with outsize allocations to private equity, to actively manage their commitments and access liquidity through GP-led transactions.*

The higher demand for liquidity increased the capital that needed to be raised from secondary investors, putting pressure on available supply of capital in the market. This has created a new, complex landscape with fresh challenges for the allocation and availability of capital in the secondary market."

Activity across secondary transactions in LP-led deals



Activity across secondary transactions in GP-led deals

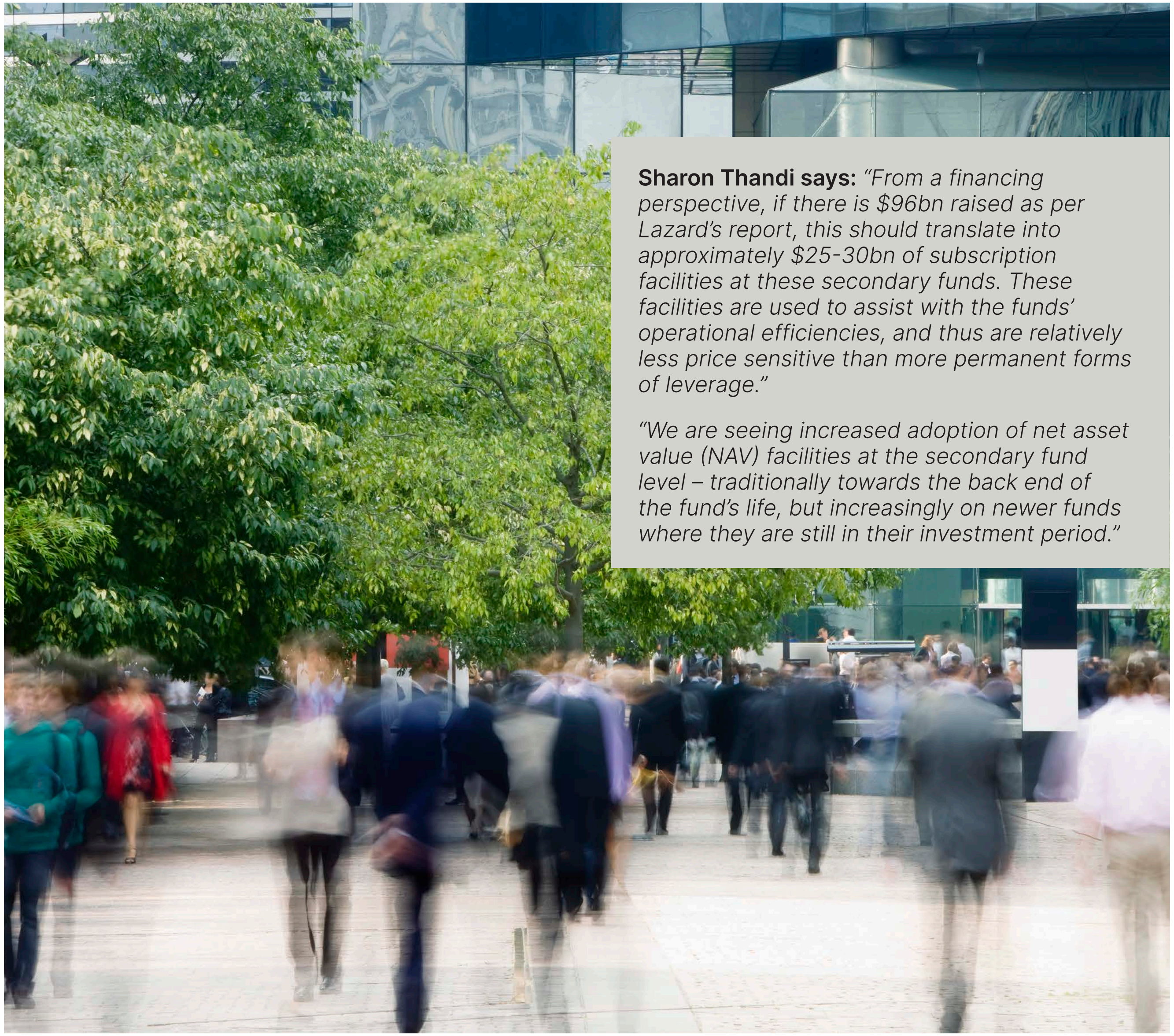


The new rate dynamic

Despite rising interest rates, our research found there is still appetite for financing in the secondaries market. More than three-quarters (77%) of managers said they expect their use of debt financing to remain the same in 2023.

In the current environment, secondary managers are employing different financing strategies, whether that be at the fund level or a combination of fund and deal level financing.

It is clear leverage continues to play an integral role in facilitating operational efficiency and the optimal capital structure for deals. Our report findings indicate the secondaries market will likely benefit from an influx of opportunities as LPs and primary managers alike seek out liquidity amid ongoing uncertainty.



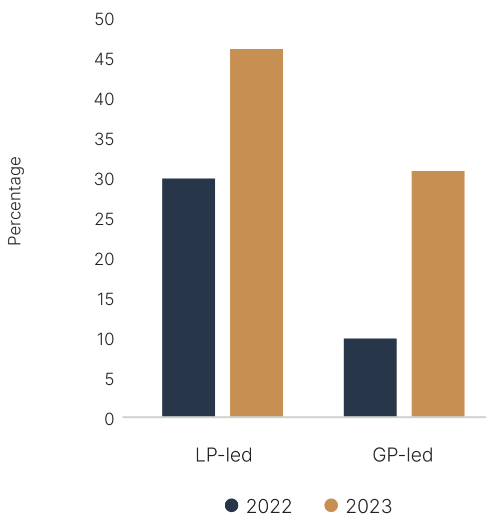
Sharon Thandi says: *"From a financing perspective, if there is $96bn raised as per Lazard's report, this should translate into approximately $25-30bn of subscription facilities at these secondary funds. These facilities are used to assist with the funds' operational efficiencies, and thus are relatively less price sensitive than more permanent forms of leverage."*

"We are seeing increased adoption of net asset value (NAV) facilities at the secondary fund level – traditionally towards the back end of the fund's life, but increasingly on newer funds where they are still in their investment period."

Shifting the use case for leverage

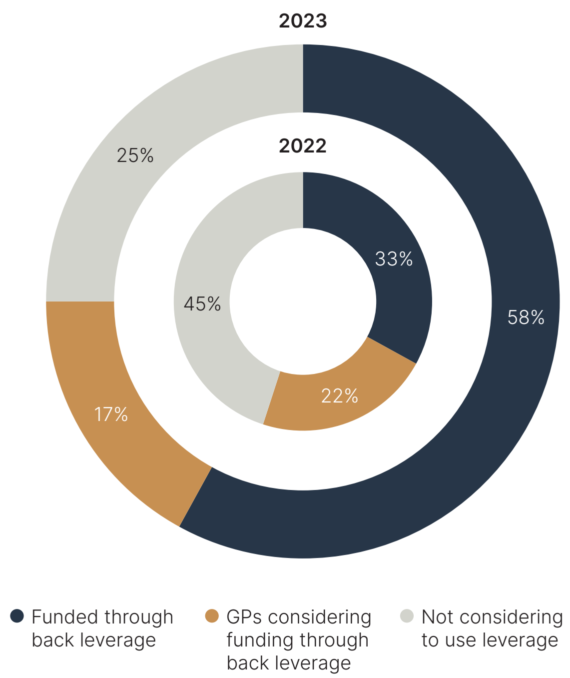
The report found that respondents using finance for LP-led deals increased to 46% compared to last year's 30%. When compared to deal-based finance for GP-led transactions, there has been a substantial jump from 10% in the previous survey to 31% in this year's report.

The use of financing for LP-led and GP-led deals



Preferred equity transactions, meanwhile, are 58% funded through back leverage, with an additional 17% of GPs considering using this form of financing. This is significantly up by 25% compared to last year, where only 33% of GPs were using back leverage and 22% were considering it.

Preferred equity transactions



Stuart Ingledew says: *"Secondary managers are generally more accepting of leverage today. The evolution has followed the same path we are seeing with NAV financing in the broader private equity market. Also, investors are becoming increasingly more comfortable with GPs using leverage to part-fund the purchase price in continuation vehicles, rather than having to fully equitise the transaction on day one."*

The data indicates that while concerns may be rising over rate hikes, leverage will continue to be deployed as the use case evolves.

Sharon Thandi explains: For example, despite rising rates and elevated volatility, GPs remain ever more thoughtful about the use case for leverage. We may increasingly see more deal leverage, where the facilities are used to support working capital requirements of the continuation vehicle, such as servicing management fees or funding bolt-on acquisitions. There has also been an increasing trend of using the leverage to bridge capital calls and create a synthetic deferred consideration.

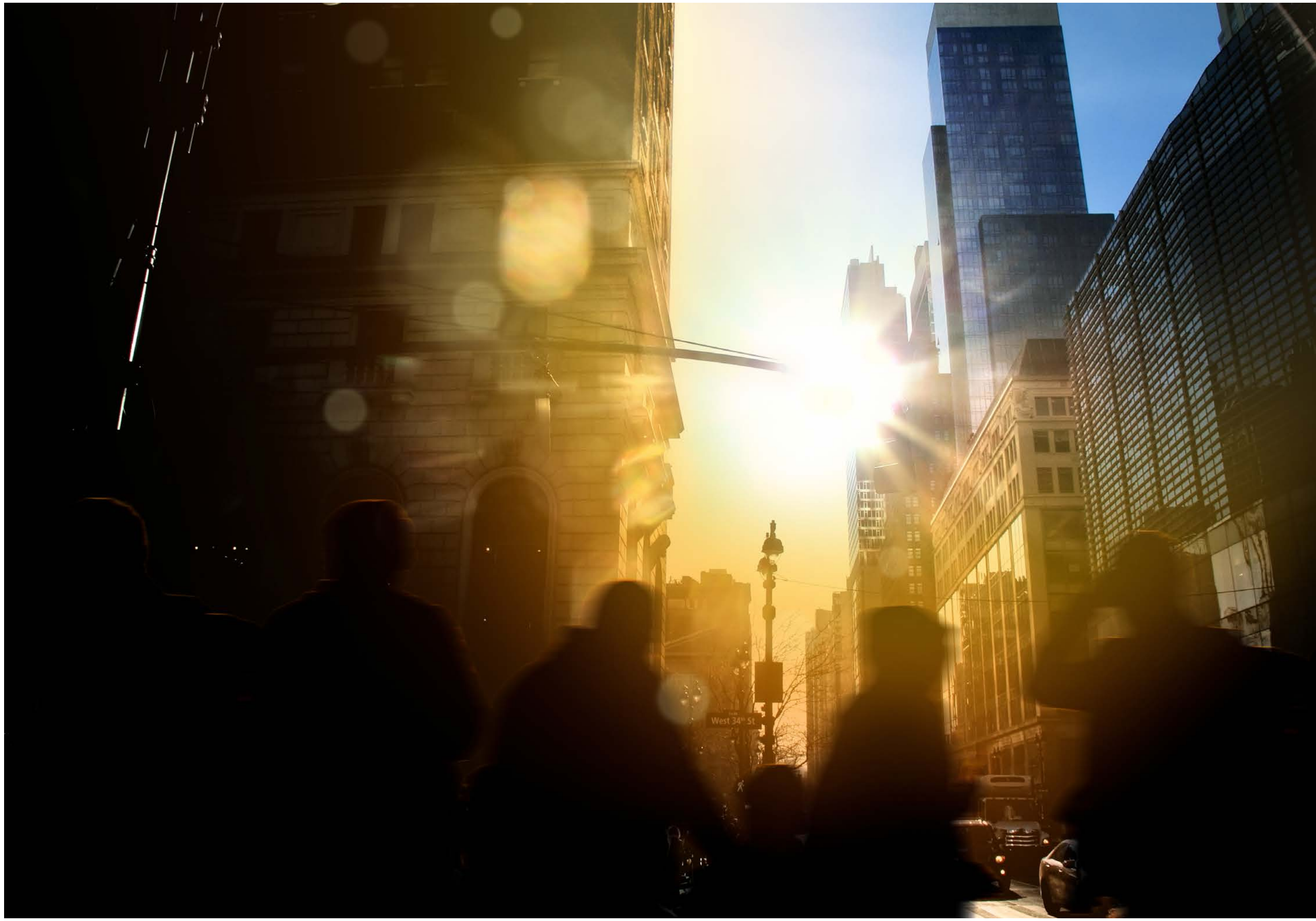
Financing: Sizing the opportunity

As was the case last year, our research showed the main use of financing is still to enhance returns.

85% of this year's respondents still cite return enhancement as the main purpose for using financing across deal types, and 48% say leverage allows them to refine pricing to win transactions.

Accordingly, target unlevered returns have increased over the last year. Most GPs (71%) said they are targeting unlevered returns of more than 15%, compared to 59% of GPs last year. GPs are now able to combine deal and fund-level leverage to significantly boost the internal rate of returns (IRR), while still achieving an optimal money multiple. To ensure that the optimal mix between the IRR and money multiple is achieved, the right amount of leverage needs to be taken on by the buyer.

GPs that are targeting unlevered returns of more than 15%



New financing landscape

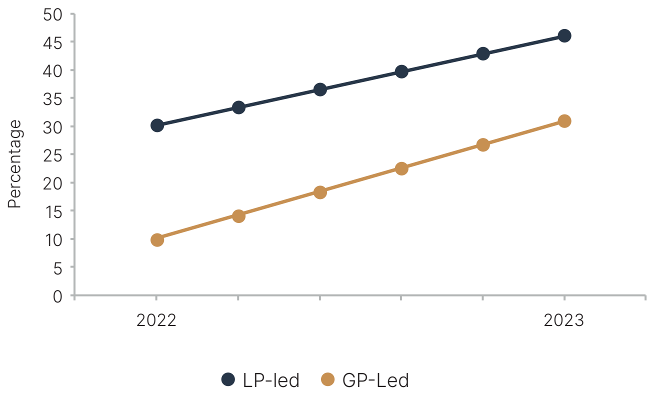
The all-in cost of financing to borrowers has increased substantially over the past few months. This has predominantly been driven by the steep increase in base rates but has been exaggerated by the widening of margins. This has led to borrowers having to be more thoughtful in how they are utilising leverage at both the fund and deal level.

Stuart Ingledew explains: The current environment and dislocation in the market has reshaped the landscape for secondary investors. Prices are now at far more attractive levels and this period could prove, in hindsight, to be an opportune time to deploy capital. Financing continues to be utilised, but any financing solution must make sense in relation to high base rates and return hurdles.

The survey results also suggest a larger usage of leverage at the deal level for LP-led versus GP-led transactions – at 46% compared with 31%. We would expect deal-level financing of GP-led transactions to be behind, as it is relatively speaking the newer segment of the secondary market. Yet 31% represents a large proportion of secondary financing and underlines a growing trend.

The survey shows that where LP-led deal finance is used, it is mainly asset backed (69%); however, solutions can be structured, where there is recourse to the secondary fund.

Usage of leverage at the deal level in 2023



Sharon Thandi says: *"Based on our discussions with the secondary managers, there has been an uptick in the number of conversations for deals to be structured with recourse to the fund, in order to help with better pricing, higher loan-to-value ratios, longer terms and more flexible cash sweeps."*

Transforming GP-led funding

Breaking down the substantial jump in the use of GP-led, deal-based finance, 66% of GPs say they use financing where the main recourse is to investor commitments, and 33% where the main recourse is to the assets.

Several GPs mentioned the primary reason they are using financing is to defer capital calls - as opposed to putting the leverage in as a permanent source of capital.

As leverage begins to be more widely adopted in GP-led transactions, most respondents (63%) expressed the importance of how the waterfall structure[4] needs to cater for leverage when it is implemented in a GP-led transaction.

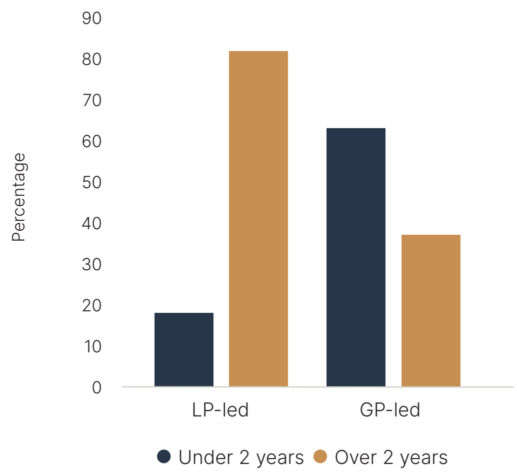
Adapting deal terms

Reflecting the environment, GP-led financing is typically structured on shorter tenors, with 63% of respondents opting for under 24 months. By contrast, only 18% of LP-led transactions are conducted on loans of less than two years. Furthermore, the survey showed that 82% of LP-led, deal-based financing was above 24 months.

As GP-led financing is increasingly being used to defer capital calls, short tenors may be required. These facilities have also been structured with shorter tenors to cater for tax legislation in certain jurisdictions.

In contrast, the average tenor of the LP-led facilities is longer, as they have tended to be put in place with the intention of repayment coming from distributions via the assets.

Average tenor for financing used for LP-led and GP-led deals



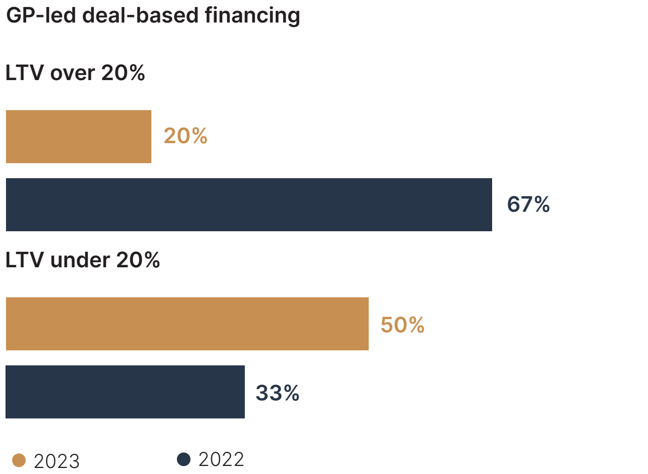
> By structuring facilities as shorter one-year terms, GPs can offer LPs more control over deployment, as the lead investor is in a position to veto an extension of the facility.
>
> **Stuart Ingledew, Investec**

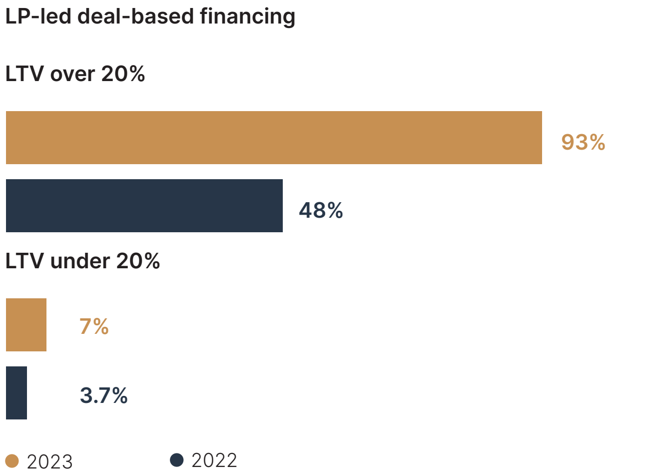
4. Waterfall structure: A structure that refers to the sequential distribution of investment returns among stakeholders in a fund. It outlines the order of payments, typically starting with the return of capital to limited partners and followed by the allocation of profits.

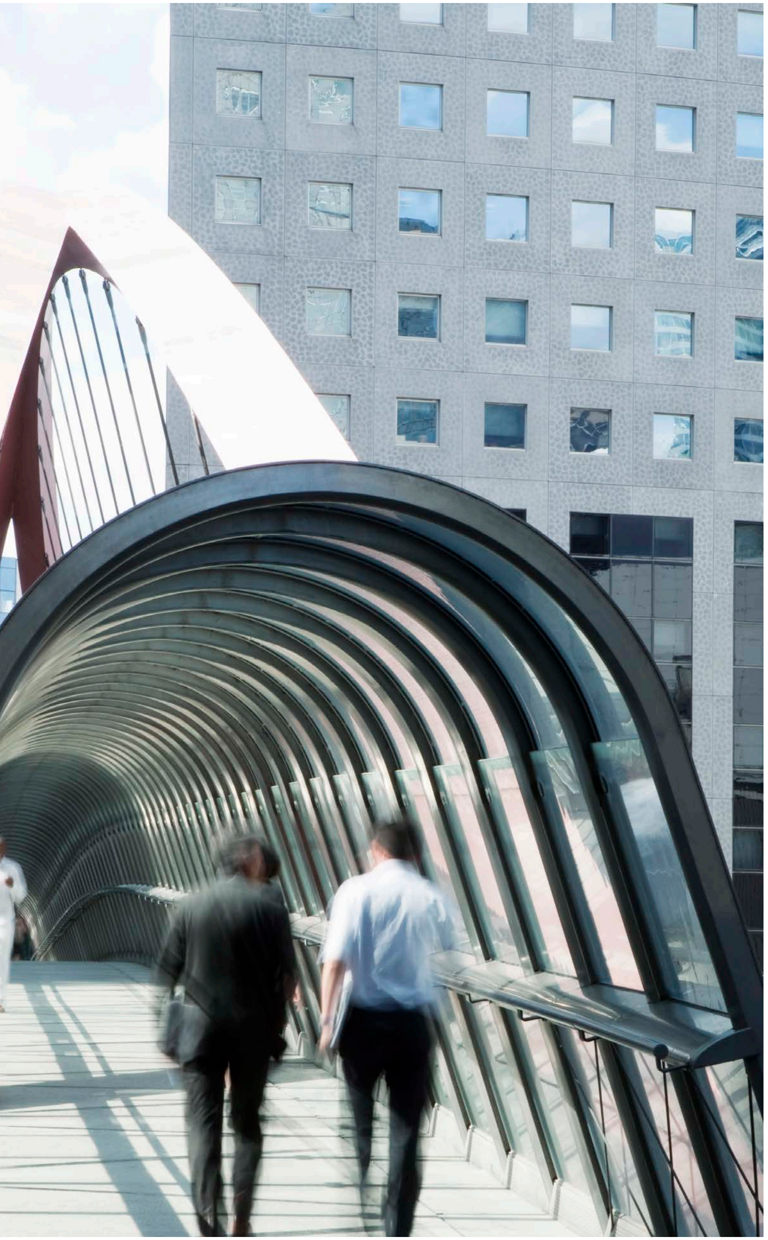
Half of respondents are requesting loan-to-values (LTVs) under 20% for GP-led, deal based financing. Compared to 2022's survey, where 33% were requesting LTVs of under 20%; and 67% asking for higher LTVs between 20-40%. In contrast, LTVs for LP transactions are much higher, with 93% of GPs requesting LTVs in excess of 20%.

Sharon Thandi explains: LP-led financing tends to have higher LTVs. From a lender perspective, the higher LTVs of LP-led transactions are easier to achieve than for a GP-led deal, due to the more diversified asset base. The survey shows that 60% of the respondents requested LTVs in excess of 30% (the same figure revealed by last year's report).

One of the key structural considerations for these facilities is whether the facility is structured as a revolving credit facility (RCF) or term loan. This is predominantly driven by the timing of the utilisation of the funds and the source and timing of the repayment of the facility. Increasingly, these facilities have been structured with a combination of both term and RCF elements.







Paths to liquidity – beyond banks

The rate dynamic is not the only factor weighing in on private equity markets. There is less liquidity in the market, as banks have pulled back from lending in the face of elevated volatility.

The survey shows that:

93%

of respondents use banks as lenders;

14%

use insurers;

7%

pension funds.

This indicates a concentration risk as liquidity shrinks among some banks.

Stuart Ingledew explains: *"The fund financing market has typically been dominated by banks. However, given recent banking failures and heightened uncertainty in the sector, we expect that borrowers will be more focused on diversifying their lender base, to avoid reliance on any one lender. Fortunately, alternative and flexible lenders, such as Investec, continue to lend through the cycle, allowing secondary investors to reach their goals.*

"While our survey revealed that 90% of respondents still find there is appetite from lenders to meet their needs, this means one in ten secondary managers doesn't see lender appetite for their financing needs – an indication of the current market."

Looking forward

While private equity secondaries are not immune to disruption, the market has yet again navigated another set of challenges – continuing its long-term growth.

The use of financing within secondaries is currently facing the biggest test of all – high interest rates – and appears to be holding strong. Until now, in an ultra-low-rate environment, growing demand for debt was almost a given. However, this year's survey results prove it has enduring appeal for GPs across the cycle.

Food for thought

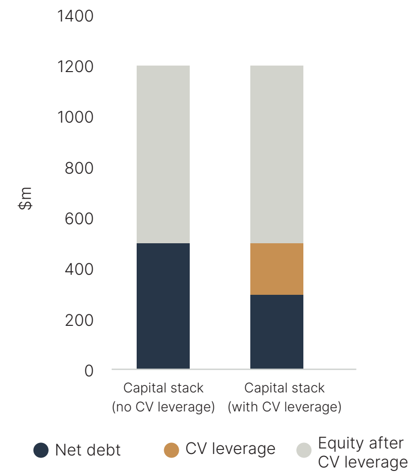
One question that comes from the report is where in the capital structure of a GP-led deal is the optimal place to take on leverage to maximise returns for all stakeholders.

Sharon Thandi explains: In GP-led transactions, we suggest if possible to take on less leverage at the portfolio company level and substituting at the continuation vehicle can result in a better return profile due to the lower cost of capital.

As more liquidity has gone out of the fund finance market, there are fewer players offering solutions.

$m	Standard GP-Led	GP-Led with leverage	Cost of Capital
LTM EBITDA	$100	$100	
EV/EBITDA	$12	$12	
TEV	$1200	$1200	
Net Debt	$500	$300	[More Expensive]
Equity Value	$700	$900	
CV Leverage	$0	$200	[Less Expensive]
Equity After CV Leverage	$700	$700	

Determining the optimal capital stack



At Investec, we pride ourselves on providing unique and flexible financing solutions that are tailored to individual needs, and firmly believe well-structured leverage can allow GPs to unlock their true fund potential.

Stuart Ingledew says: *"There is no one size that fits all, and we work with the client to seek a solution that is suitable for all parties."*

"At the end of the day, returns are always top of mind for GPs and secondaries investors – whether in a rising or a falling market. As leverage is a key driver for returns – particularly if GPs use all the tools at their disposal, including fund and deal-level financing – we expect its adoption to follow the trajectory of the booming secondaries market.

Deal flow is naturally going to drive the opportunity set for lending solutions to be bigger, especially when you overlay the insufficient capital of secondary managers, to take advantage of all the opportunities the market currently has on offer."

Sharon Thandi, Investec