Investec's Annual Secondaries Report

2021 edition

Investec

Introduction

For the past three years, Investec has conducted research looking into key trends within the secondaries market and the expected changes. This year, continuing our research, we have been looking at how activity around secondaries has changed in the past 12 months. We are again looking forward, discovering the changes that secondary fund managers expect to see in the near future.

In last year's research, we got to see some of the early impacts of Covid-19 on the secondaries market. In the second quarter of 2020, transaction volume was significantly down. Buyers were looking for larger discounts to NAV, to compensate for the additional market risk they were being asked to assume.

One year later, the wheels have begun to turn again. Although we are still in the midst of the Covid-19 pandemic, vaccination programmes are rolling out and confidence in the return to a more familiar level of market activity is rising. This optimism is evident in today's secondaries market, but our conversations with secondaries funds have identified pockets of remaining concern. For example, while the exit markets remain uncertain, tail-end portfolios have fallen somewhat out of favour. And that decline is expected to continue.

However, some areas have proven more resilient and which we expect to grow. In particular, GP-led solutions have demonstrated sufficient popularity to sustain manager interest, despite the uncertainties already discussed.

Although market uncertainty may be depressing pricing, there are also forces acting in the opposite direction. As the number of available, high-quality deals has shrunk, competition for these assets has increased. In some areas, this has led to a greater reliance on financing solutions to lift the returns on these transactions. Most secondaries managers we spoke to expressed concern that the pressure to deploy may be leading some to enter into deals that they would be better advised to leave well alone.

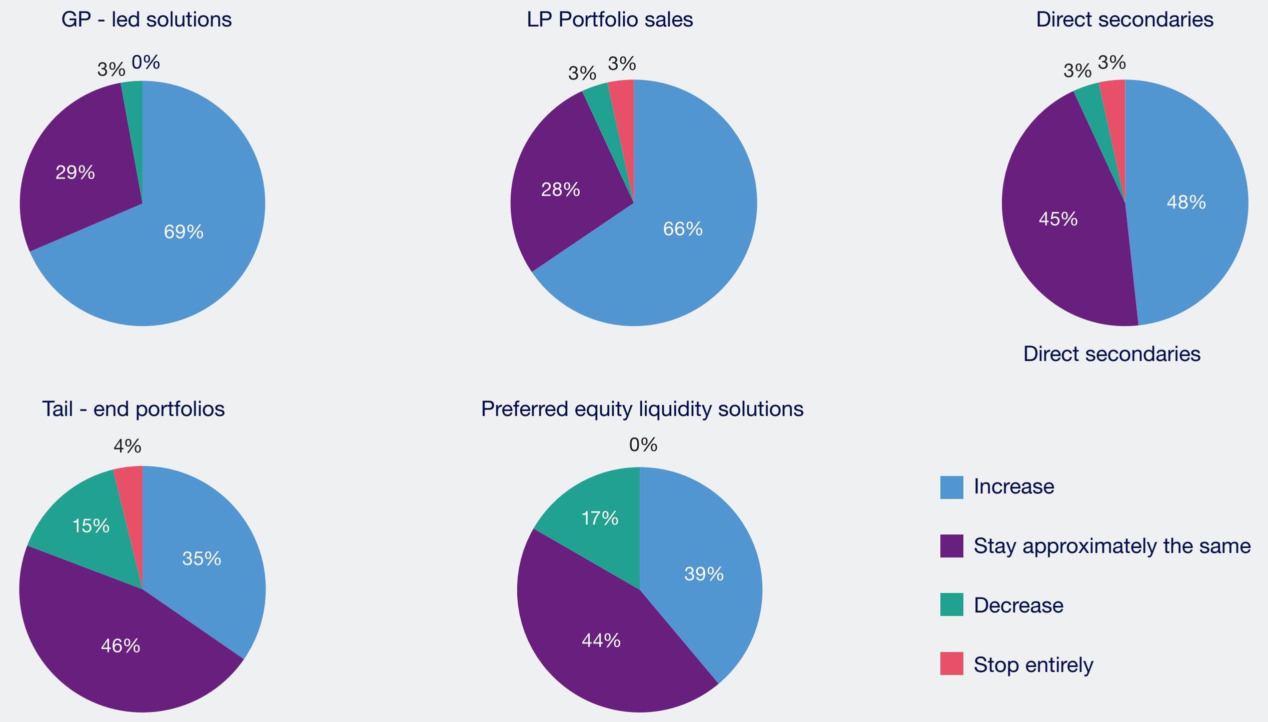
The impact of Covid-19 on secondaries

Despite an apparent slow-down in deal flow over the past 12 months, secondary fund managers have not succumbed to pessimism. There was variation across the type of secondaries transaction, but only very few managers expected to see a decrease in activity within the next 12 months (only **3%** for GP-led solutions, rising to **19%** for tail-end portfolios). Fewer still expected to stop activity entirely in any area.

Managers are confident that the market will soon recover. Indeed, the impact on activity may have been overestimated by some commentators. Megan Lau, Senior Associate at MJ Hudson, had this to say:

> *"Despite the challenges of the current environment, there has been a huge amount of interest from investors in secondary strategies. This will inevitably drive up transaction volumes and is likely to apply upward pressure to pricing."*

Chart 1: how do you expect your activity in the following areas to change in the next 12 months?



In fact, from our research, we are actually seeing growth within certain areas, particularly within GP-led solutions. Nearly all (**97%**) of those active in GP-led solutions expect their activity to increase, or at least stay the same. This area also represents a rather large part of their total activity; of those secondary managers that are active in GP-led solutions, this area represents an average of **39%** of their total activity. Additionally, **one-third** of those who don't participate in this area yet expect to be active here, within the next 12 months.

Matt Jones, Partner at Pantheon Ventures, gave his thoughts on GP-led solutions, and on single-asset deals, specifically:

> *"We will continue to invest across the spectrum, globally, but expect to see a lot of interesting deal flow in the GP-led single asset space. High-quality GPs use these types of transactions as a means of holding onto their best assets. It's really interesting and it's growing rapidly. We had been doing a significant number of single asset deals before the market really opened up and this will continue. Single-asset transactions have become more a feature of the market – and this is now the fastest-growing area of the market."*

Jones is not alone in appreciating the attractiveness of single-asset deals. **Two-thirds** of respondents indicated that they would consider deals with only one asset. This rises to **74%** (up from **50%** in 2019) when looking only at GP-led transactions, as one might expect, but the move to tighter portfolios even extends into the world of LP portfolio sales, with a good number, **68%**, saying they would consider deals representing only a single LP position.

Other areas of growth can be seen in managers who participate in LP portfolio sales and direct secondaries, with both at **93%** in terms of the number of managers looking to increase or continue their current activity, over the next 12 months. As stalled and abandoned processes from 2020 start to work their way back through the market, **66%** of managers involved in LP portfolio sales expect to increase their activity over the next year.

Ten years ago, involvement in preferred equity liquidity solutions was seen as a niche activity for managers in the secondaries market. However, this year, three managers who do not currently participate in this area indicated that they expect to be active in preferred equity liquidity solutions within the next 12 months. Lau gave her thoughts on why we may begin to see a shift into this area:

> *"Preferred equity is maybe not the cheapest option available, but it does offer flexibility. It can, in some circumstances be worth the premium, depending on the assets and the manager's situation. As secondaries funds develop their capabilities, there will probably be a few more that look at this market and the potential returns and decide to dip in a toe."*

However, as some areas grow, others may not fare so well. Managers who currently participate in tail-end portfolios have begun to back away slightly from this area, with **19%** saying that they expect their activity to decrease or stop, entirely. This could be a result of market volatility and uncertainty, with the exit environment proving difficult, forcing sellers to accept larger NAV discounts if they want to hook a buyer – and many prefer to wait if they can. The biggest discounts appear to be within tail-end portfolio transactions, with an average of **63%** of buyers requiring a discount of **30%** or more. This proportion is much higher than in other secondary areas. For instance, **69%** of buyers that participate in preferred equity liquidity solutions, and **56%** of buyers that participate in GP-led transactions, require a discount of less than 10%.

David Atterbury, Managing Director at HarbourVest, cautioned:

> *"The tail-end market is difficult, as the exit market is a little pickier at the moment meaning tail-end portfolios are likely to struggle in terms of liquidity profile. Selling lower-quality tail-end portfolios are likely to be less popular than in the past as a result."*

The depressed LP portfolio market of 2020 and the rise in activity in GP-led transactions (including single-asset deals) shows the market favouring deals that are reliant on valuations on a more concentrated portfolio of assets. After all, valuations have become more difficult and more subjective.

Jones noted the importance of understanding how the presented EBITDA of an asset has been arrived at:

> *"Run-rate pro forma adjusted EBITDA" and similar are being used more frequently to justify high valuations, including "COVID adjusted EBITDA" to remove the impact of COVID on operating performance. It's vital to understand the GP's approach to valuation throughout COVID. You want to make sure you are bidding on the true performance of the company now, rather than a smoothed valuation, built by the GP."*

However, subjective (and in some cases questionable) valuation it should be noted that GP-led activity has been increasing for some time, independent of the pandemic. In last year's research, we learnt that **75%** of respondents already participated in GP-led situations in some way or form. Now that number sits at **86%**. Whilst it's clear that there has been some acceleration, as a result of the pandemic, this is not the primary factor in the popularity of GP-led deals; the market was headed here, regardless.

Target returns and appetite for risk

All but one of the fund managers we spoke to said that, on a risk-weighted basis, the target unlevered returns of secondary funds should be greater than **12%**. **57%** of fund managers said that they'd target more than **15%**, and almost one-quarter (**22%**) of managers, in fact, targeted unlevered returns of more than **18%**. As return expectations grow, the incentive to undertake "riskier" deals will prove tempting to some, of course. One might expect to see deals getting done that might otherwise be ignored.

Despite a supposedly steady recovery from the initial strains caused by the pandemic, with deal flow starting to pick back up, many managers are concerned with some of the transacted deals they are seeing. In fact, **more than two-thirds** said that they are seeing deals being done that perhaps *shouldn't* happen.

Chart 2: On a risk-weighted basis, what should the target unlevered returns of secondary funds be (%)?

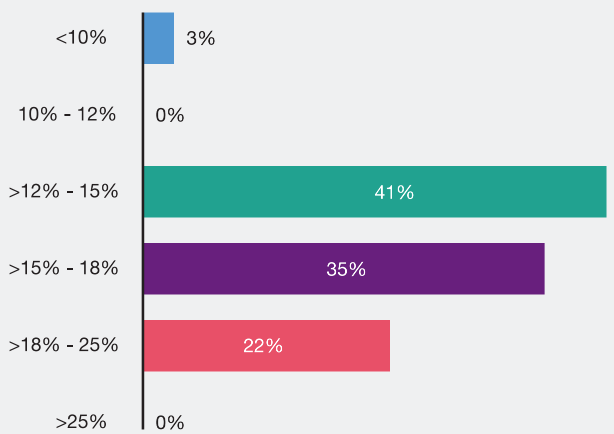
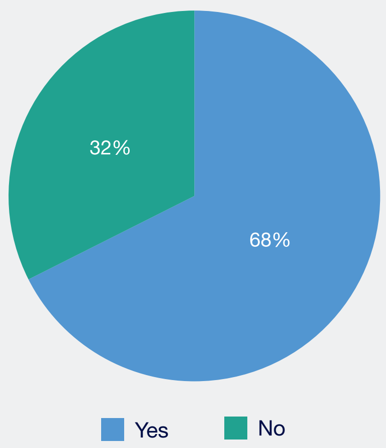


Chart 3: Are you currently seeing secondary deals done that maybe shouldn't get done?



The market environment always impacts the types of deals available and those that get transacted. When deal flow slows or even stalls, there will be increased pressure to entertain riskier deals. However, the current environment has not necessarily convinced managers to stretch too far.

As Atterbury, suggested: *"I'm not sure that it is happening more now than in the past."*

Jones agreed and was keen to point out the strength of the deals available:

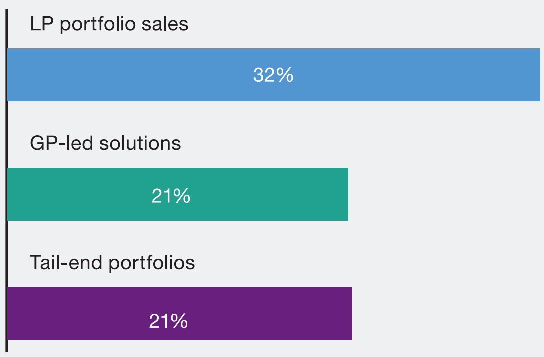
> *"Looking back over the last 20 years, this doesn't feel like a time when people are taking too much risk. In fact, the deal flow that has come to market in the last six months has been much higher quality than in recent years – there are top quality assets from top quality GPs. Competitors always like to look at deals that other firms completed and say, that wasn't a good deal to do".*

Financing at the fund and deal level

84% of secondary managers currently use financing or liquidity solutions of one kind or other, at the fund level. This is a slight decrease from what we saw in 2019, with **86%** of secondary managers using financing, which had risen from **76%** in 2018. Most popular are subscription finance/capital call facilities (used by **73%**), with asset-backed financing including hybrid facilities (for acquisitions or dividend recaps) used by **39%**.

The most common usage of deal based finance remains to support LP portfolio transactions (**32%** of managers use deal-based financing for LP portfolio transactions at anything above 20% LTV) with dividend recaps and acquisition finance also remaining relevant.

Chart 4: Managers using deal-based financing for particular types of secondary fund transactions



In 2019, of the secondary managers that participated in GP-led transactions, **33%** used specific deal-based financing. This has decreased to **21%** this year. With exits becoming more difficult in the current market environment, we may see more managers starting to use NAV financing, to provide liquidity to investors and to provide capital to their portfolio (either for defensive or opportunistic reasons). On this, Lau said:

> *"Now that subscription line facilities are ubiquitous in private funds (and more or less accepted), it is no surprise that financing against the NAV of a fund's underlying portfolio has become part of the conversation. Once commitments have been more or less called, it's just the logical next step."*

The uncertainty in valuations as well as the impact of Covid-19 on companies' performance resulted in financing solutions for dividend recaps and LP portfolios taking a bit of a back seat. In circumstances where secondary funds did utilise these, it was often at more conservative LTV levels and at a pricing premium to what was seen in 2019. Finance providers found more opportunities at primary fund level as the need for liquidity at investment level became more apparent.

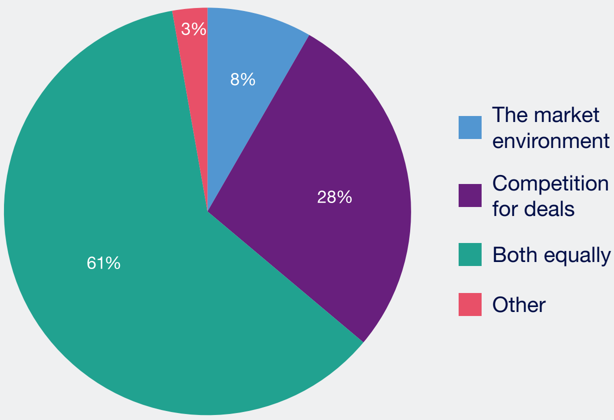
Interestingly we also saw a number of secondary funds exploring preferred equity liquidity solutions. The returns on these instruments in most instances remained prohibitive to traditional secondaries funds (even those contemplating back-leverage).

Q3/Q4 saw a significant uptick in financing requests, especially for GP-led transactions. With interest rates still at historic lows the use of financing will continue to be relevant.

Pricing pressure

Regarding the various factors impacting secondaries pricing, most managers (**61%**) felt that the two main factors (the market environment and the competition for deals) were well-balanced. However, **28%** felt that the fight for deal flow was the dominant force, compared to only **8%**, who considered the market environment to be more powerful. This lends more strength to the argument that the impact of Covid-19 on the secondaries market may be less long-lived than many have feared.

Chart 5: Which is currently having the biggest impact on secondaries pricing?

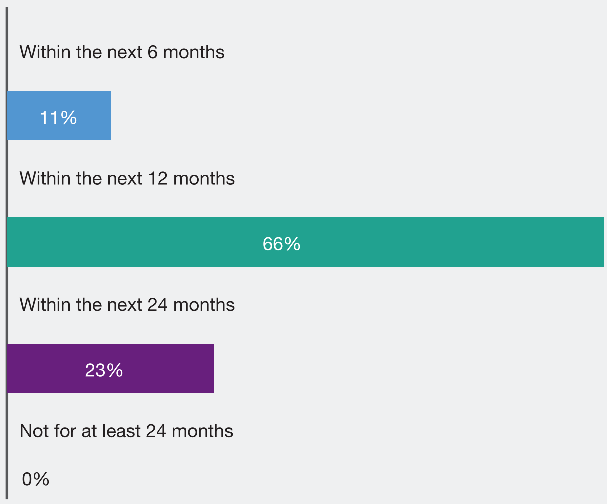


Whilst the competition for deals is fierce and exerts considerable pricing pressure, the existential threat posed to a traditional secondaries fund by open-ended fund of funds structures, preferred equity solutions or fund securitisation is not keeping many awake at night. Few of the participating managers identified any of these as a high threat. In the eyes of our respondents, the biggest threat are open-ended secondaries funds of funds, considered to be a potential problem by **18%** of managers. As innovation in secondaries and liquidity solutions continue, more significant threats may yet emerge.

The road ahead

Looking ahead at how the market may develop, the consensus among the managers we spoke to is that there are plenty of reasons to be optimistic. Dealflow may have slowed in some areas since the impact of Covid-19 began to be felt, but not a single manager we spoke to believes that it will take longer than 24 months for deal flow to return to 2018 levels. A very significant **77%** believe that we will see this improvement within the next 12 months, and some expect it to happen by the summer.

Chart 6: When do you expect secondaries dealflow to reach 2018 levels?



Atterbury concurred that things will pick up quickly:

> *"There actually wasn't as much crunch on liquidity for LPs as there was after the global financial crisis (GFC), so LPs were able to hold and wait, rather than being forced into the kind of sales we saw after the GFC. This means that there is a backlog of potential deals to come through - it will unwind through 2021."*

Final thoughts

The secondaries market continues to evolve and, whilst it has not escaped the effects of Covid-19, neither has it suffered the long-term impact perhaps feared. At Investec, we continue to work with all manner of market participants across the cycle, supporting them at the fund and transaction level. We are keeping our eyes and ears open as changes manifest and new challenges and opportunities emerge.

The trend towards hybrid and increasingly complex transactions are sure to continue, with an increased blurring between the worlds of primary and secondary funds and deals inevitable. What were once distinct and easily defined categories (traditional secondary sales of LP portfolios on the one hand and primary deal-making on the other) are no longer either of those things.

It is said that adversity can drive innovation and who are we to disagree?

Whatever this innovative market delivers next, we can be certain that it is going to be interesting.

Ian Wiese
Head of Secondaries, Investec

A word of thanks

Many thanks to all of the secondary fund managers who participated in this year's secondaries research study. In addition to those who took the time to complete our survey, we want to specifically acknowledge the senior industry professionals who took the additional time to talk to us in more detail about their own experiences and their expectations for the future. Thank you for your significant contribution to the report:

David Atterbury, Managing Director, HarbourVest

Matt Jones, Partner, Pantheon Ventures

Megan Lau, Senior Associate, MJ Hudson

About Investec

Investec partners with private, institutional and corporate clients, offering international banking, investment and wealth management services in two principal markets, South Africa and the UK, as well as certain other countries. The group was established in 1974 and currently has approximately 8 500 employees.

Investec has a dual listed company structure with listings on the London and Johannesburg Stock Exchanges. Investec's current market capitalisation is approximately £2.0 billion.

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Our Fund Solutions team is one of the sector's pioneers, providing flexible lending solutions to funds and fund management teams, at each stage of the fund cycle, as well as a treasury ad FX services.

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Innovation is at the heart of our thinking and our global team has the vision and the resources to create financing structures for unique requirements.

About the research

Research for this edition of the Secondaries report was conducted in conjunction with MJ Hudson, a leading provider of research, legal, ESG and other services to the private equity industry. 44 responses were gathered from secondary fund managers across the globe. A number of senior professionals took part in longer telephone conversations, in order to provide further colour. More information on MJ Hudson can be found at www.mjhudson.com