Investec

OUT OF THE ORDINARY

Investec's Annual Secondaries Report

2022

Introduction

For the fifth consecutive year, Investec reveals the key trends driving the secondaries market, with a focus on the use of financing. Findings show a mature and robust market where financing plays a key role, on track to break more records.

Last year's secondaries report highlighted prevailing optimism in the market despite pockets of concern – with uncertainty around timing of exits and tail-end portfolios falling out of favour. As global economies learned to live with Covid-19, this gave way to roaring levels of activity and predictions of even higher deal flow in the coming year.

Pricing rebounded to record highs, reflecting a competitive seller's market. This proved the secondaries market has matured and, with greater levels of liquidity, is much better able to withstand setbacks. After the 2008 global recession, it took the listed markets about 18 months to recover, and post-Covid pricing bounced back in about three months – whereas the private equity market weathered the storm showing much less volatility.

As a result, financing remains at the forefront of deals, with buyers relying on funding solutions to bridge the pricing gap and enhance returns. Subscription or capital call facilities have become the go-to product for most transactions, with hybrid solutions gaining in popularity and ring-fenced deal-based financing prevailing for LP portfolio sales.

The rise of GP-led solutions was accelerated by Covid-19 and they are now a well-established portfolio management tool, with almost all the GPs we spoke to participating in these transactions.

In 2022, secondary GPs indicated they would look to rebalance portfolios as they deprioritise deals that were more dependable in an uncertain environment – including single asset continuation funds and preferred equity solutions.

However, while the effects of the pandemic have now subsided, the world is inevitably facing another series of challenges – namely the conflict in Ukraine, price inflation and the threat of higher interest rates, as well as a looming recession.

This could mean another hold-up for secondaries, particularly on tail-end funds, where valuations are more mature. But with a lot of dry powder, GPs are in a strong position and can wait before actively re-entering the market.

Imprudent attitudes towards risk remain, but GP discipline seems to have somewhat improved since last year, suggesting fewer risky deals will be done.

The Covid-19 catalyst

76%

of GPs reporting openness to doing GP-led deals with one asset

67%

saying they would consider single asset preferred equity transactions.

Only a year after the onset of the Covid-19 pandemic, the global secondaries market shot up to record volumes in 2021, surpassing $130bn.

Corporate activity made headlines, with many established players in the market targeted for M&A. Notable acquisitions included PGIM's purchase of Montana Capital Partners, CVC's acquisition of Glendower, Ares's acquisition of Landmark and Springbridge and Franklin Templeton's intention to purchase Lexington.

The majority of survey respondents believe the main driver behind these corporate acquisitions has been to increase assets under management in a growing market, closely followed by a desire to forge strategic alliances and benefit from institutionalised platforms. To a lessor extent, they attributed recent activity to partners of secondary GPs wanting to crystalise value and to succession planning efforts.

The spike in activity reflects the growth of secondaries as a whole, which has become an essential part of the liquidity package for GPs, advisors and banks – a position that has been solidified over the course of Covid-19. To benefit from this trend, many investments banks have launched their own secondary advisory practices – think of Jefferies, William Blair, Rothschild's and most recently Lincoln Partners.

Richard Olson, Managing Director of Valuations and Opinions at Lincoln International, noted: "The increase in the use of continuation vehicles has had a direct impact on our transaction opinion business insofar as the number of fairness opinions being issued. This trend is expected to continue and is further catalysed by recent SEC draft guidelines."

Indeed, the rise of GP-led solutions, which was already evident pre-Covid, accelerated throughout the pandemic. Continuation vehicles are now systematically considered alongside IPOs and trade sales as a bona fide exit avenue for GPs, with all but one survey participant stating their intention to participate in this type of transactions – up from 86% last year. In fact, deployment into GP-led solutions is now almost on par with LP portfolio sales.

Olli Markkanen, Partner Buy-out fund selection – Primary & Secondary at Access Capital Partners, said: "When set up correctly with a well-managed process, a continuation or single asset vehicle can be a win-win-win, which is interesting for all parties – buyers, existing LPs and the GP."

In fact, GPs have begun to raise dedicated 'GP-led solutions' funds to specifically address the growing market opportunity within GP-led secondaries – ICG, Portfolio Advisors and Pantheon to name a few.

At the same time, when debt capital markets closed during the pandemic because banks put a pause on lending, secondary funds saw an opportunity to provide liquidity for companies that needed it through preferred equity transactions.

Over the last year, single asset deals increased in popularity in both of these areas, with 76% of GPs reporting openness to doing GP-led deals with one asset and 67% saying they would consider single asset preferred equity transactions. Markannen added: "Going forward, there is a large untapped reservoir of GP-led opportunities, as almost any current portfolio company could become a GP-led solution."

In an uncertain environment, managers felt more comfortable investing in individual companies or a small number of businesses, where they could conduct robust bottom-up analysis, than in tail-end funds or diverse portfolios, which are more heavily influenced by the macro environment.

Balance is better

However, market participants are now looking to rebalance their portfolios by prioritising traditional LP trades – how long this will take remains to be seen given the Ukrainian uncertainty.

Although there may be delays due to the macroeconomic uncertainty, the LP market looks set to take back centre stage, with 70% of participants indicating they expect to be more active in this area over the next 12 months.

This sentiment is shared by Brenlen Jinkens, Managing Director and Global Co-Head of Jefferies Private Advisory: "We expect LP secondary sale activity to continue to grow for a number of reasons. Active portfolio management remains the central driver, while a combination of de-risking and recycling liquidity from secondary sales will drive additional activity as LPs seek to keep pace with ever shorter fundraising cycles."

GP-led solutions may have also reached peak popularity. Going forward, the majority of managers (59%) believe current levels of GP-led solutions will remain approximately the same, and 28% expect a slight increase.

However, this may be impacted by current macroeconomic conditions. Francesca Paveri, Senior Managing Director at Evercore Private Capital Advisory, remarked: "The deal environment has changed in the past months. Everyone is still assessing the impact of the new world in which we live on companies and their profitability. For high-quality businesses there is still strong demand, as GP-led deals are the type of transactions secondary buyers tend to focus on in moments of uncertainty – given they can do more work and better understand the assets, especially when compared to diversified LP portfolios."

We are also seeing the use of preferred equity transactions fall back, as traditional debt providers have reopened. Only 30% of participants participated in preferred equity transactions in the last year – significantly down from 69%.

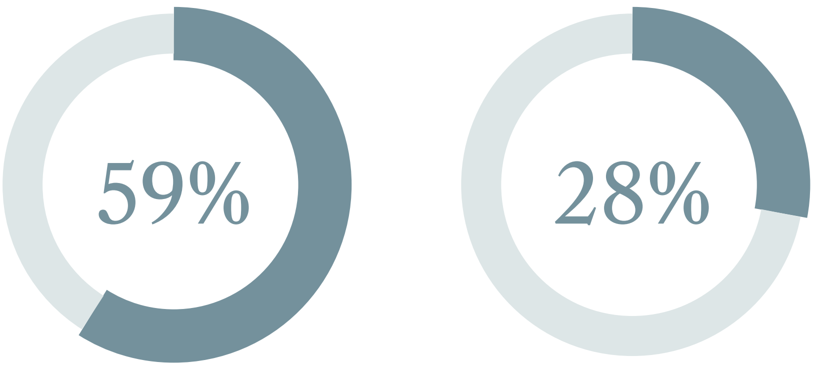
According to the survey, the most attractive vintages are 2016, chosen by 59% of participants as appealing, while a close 52% chose 2017 and 41% selected 2015.

Tail-end portfolios, which were seen to be declining in popularity during 2020-2021, have also bounced back. Respondents believe activity is either likely to remain the same this year or somewhat increase.

"For high-quality businesses there is still strong demand, as GP-led deals are the type of transactions secondary buyers tend to focus on in moments of uncertainty"

Francesca Paveri
Senior Managing Director,
Evercore Private Capital Advisory

How do you expect your activity in this area to change in the next 12months? (GP – led solutions)



STAY APPROXIMATELY THE SAME

EXPECT A SLIGHT INCREASE

Priced for perfection?

As the backlog of LP sales that were put on hold unwinds, heated competition for high-quality assets is having a direct impact on pricing. According to 48% of respondents, this competitiveness is pushing valuations ever higher, while another 21% attribute higher prices to the considerable amount of dry powder still to be deployed.

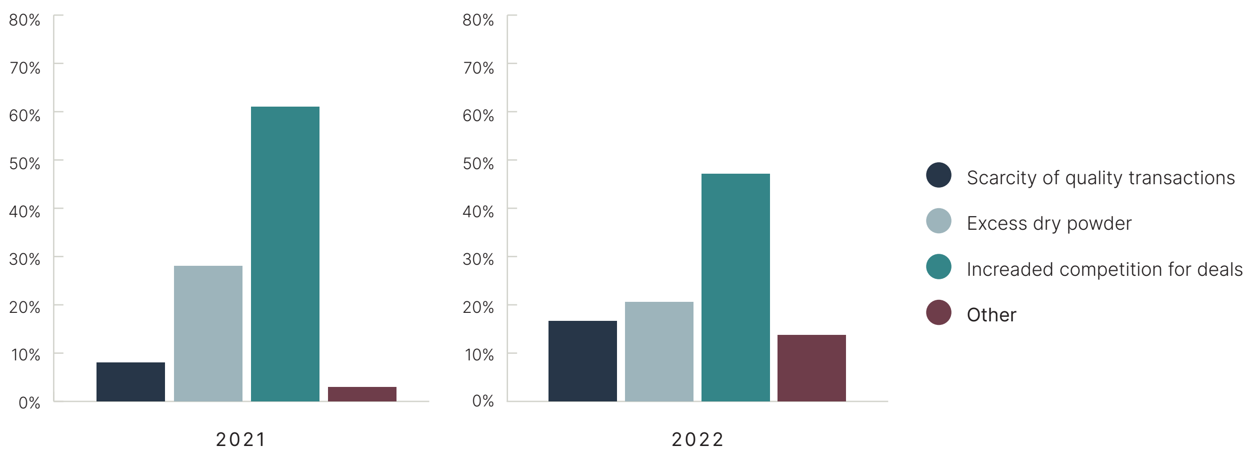
Indeed, GPs are facing pressure to deploy, but with fewer high-quality assets available, this is leading to more risks being taken – 41% of secondary GPs believe more deals are being done that should not. "With increased volumes, it is natural to see GPs being tempted to give second tier portfolio companies another go," said Markkanen.

The main reason behind this is imprudent risk appetite, according to 44% of respondents, and pressure from LPs to transact, said 31% of managers. Still, discipline seems to have improved since last year, when 68% of respondents thought more deals were being done that should not.

Although until recently it has been a seller's market, this is changing. Commenting on GP-led transactions, Paveri said: "GP-led processes are still happening, but we have seen an impact on price and on the time required to complete a deal. Secondary buyers have increased the amount of due diligence they perform. Depending on the sector, we have seen more or less pressure on price and a few deals completing at small discounts to NAV. We have seen a few buyers trying to take advantage of these volatile times to submit offers at opportunistic prices, but for now few of those trades are happening, as sellers are not in a rush to sell."

Meanwhile, Jinkens remarked on the impact of macro uncertainty on LP portfolios processes: "Rather than processes being delayed, we are seeing deals being tailored to be more attractive to specific buyers' interests. Buyers are on the whole are being more selective, resulting in the average process completing with a greater number of counterparties."

Which is currently having the biggest impact on secondaries pricing?



Portfolio valuations will depend on how rising input costs and rate hikes, as well as slowing economic growth, affect portfolio companies. With a lot of leverage in the system, particularly in the tech sector, this could put pressure on the bottom line for many businesses. Some GPs could be forced to sell as a result, and this could lead to a more favourable environment for buyers.

Jinkens said: "As we move into the second half of 2022, it's reasonable to expect that secondary pricing will adjust downwards in the wake of the public market sell-off and myriad issues affecting the macro environment. That discounts will widen is also a reflection of the lag in private valuations, as GPs reluctantly adjust their marks over the next several quarters."

Across all strategies, the average discounts achieved in 2021 were between 0-10% (41%), with a smaller number of transactions attracting discounts in excess of 20% (14%).

However, Olson reminded us of the bigger picture: "The impact of inflation and interest rates on Q1 2022 enterprise valuations and earnings in the more than 3,500 valuations we performed depended upon the underlying industry but was minimal in aggregate. There is some downside expected for Q2 2022, but so far less than what was experienced during Q1 2020 – where Lincoln's Private Market Index was down -7.5%."

This view was shared by Greg Ciesielski, Managing Director at HarbourVest: "The true impact of inflation and interest rates is not fully reflected in Q4 2021 and Q1 2022 and the market is already looking ahead to potential Q2 marks in certain sectors. We are in the fortunate position that we can invest globally across industries and sectors, which has allowed us flexibility in the current environment on a transaction-by-transaction basis."

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Brenlen Jinkens
Managing Director, Jefferies Advisory

Financing at the forefront

73%

of respondents said the primary use of financing is to enhance returns

27%

of respondents citing LP acceptance of financing as the main cause of increased financing

In order to counteract extremely high valuations, financing has become increasingly essential to transacting in private equity. The primary use of financing is to enhance returns (73%), with more than half (55%) of respondents targeting unlevered returns of between 15-25% – and nearly half of these aiming for above 18%.

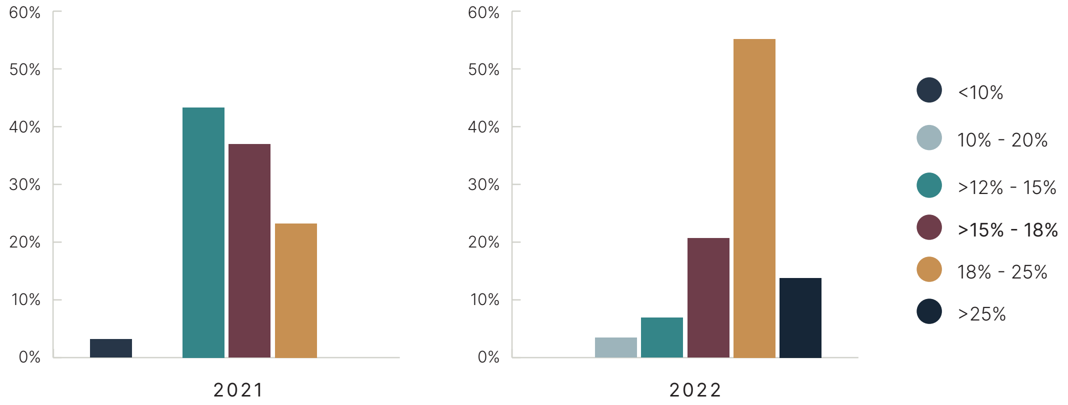
Previously perceived as risky, financing is now an accepted part of the package, reflecting the maturity of the market. An overwhelming 97% of survey participants now use some kind of financing – up from 84% in 2020-2021 and 86% in 2019- 2020.

Asked about the reasons for using financing lines, Matt Lowman, Head of Pantheon's Treasury Team, explained: "For subscription lines, the main use remains a working capital management tool and having the ability to move quickly to close transactions. Other uses include managing significant equalizations occurring for first close investors. On the deal side of things, it is particular to each deal, but financing can unlock transactions that would not have been possible without the use thereof."

Crucially, LP acceptance of financing is increasing, with 27% of respondents citing this as the main cause of increased financing in private equity. However, reticence remains, with 57% of secondary GPs listing LP sentiment as a reason for avoiding financing solutions, and 77% of respondents still believe leverage brings greater risk.

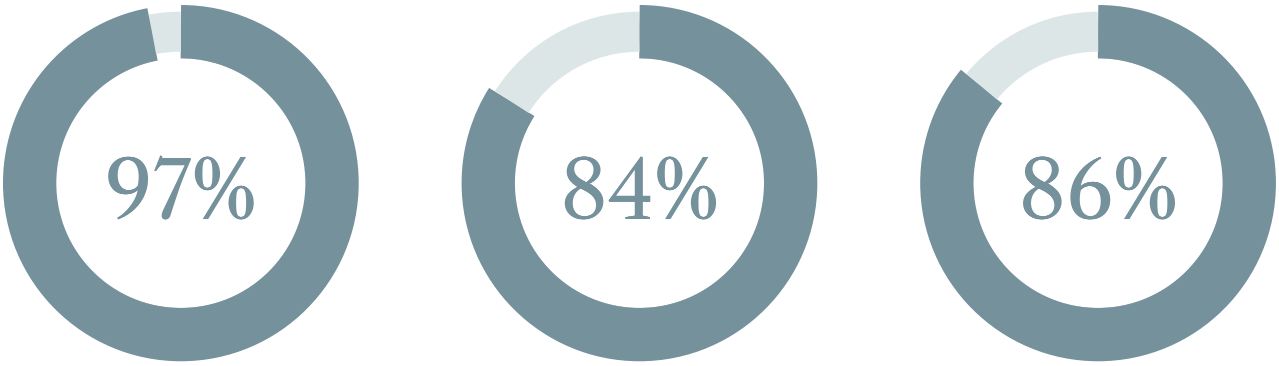
When asked about how Pantheon has adapted to the increased use of financing and risk solutions, Lowman said: "We have an in-house Treasury team that handles all aspects thereof, including managing lending relationships. Historically, that was part of our investment teams' responsibilities, but with the number of lines we have found it beneficial to control within a centralised function."

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



55% OF RESPONDENTS TARGETING UNLEVERED RETURNS OF BETWEEN 15-25% – AND NEARLY HALF OF THESE AIMING FOR ABOVE 18%.

Do you currently, or plan to, participate in GP-led solutions?

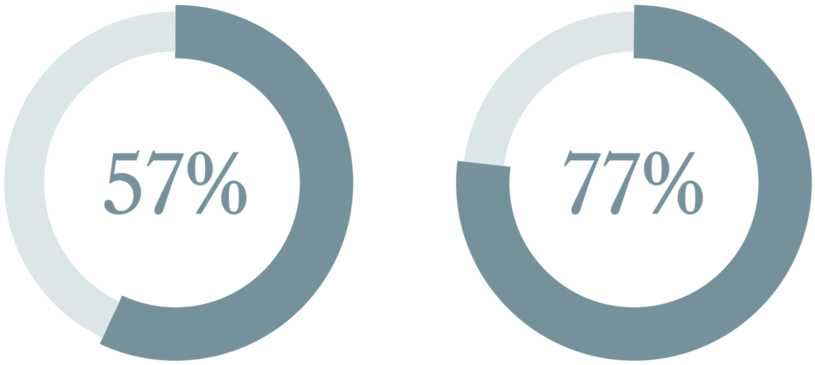


YES: 2021 - 2022

YES: 2020 - 2021

YES: 2019 - 2020

What do you ascribe as the main reason secondary GPs are not using financing solutions?



LP SENTIMENT

INCREASED RISK

Breaking it down

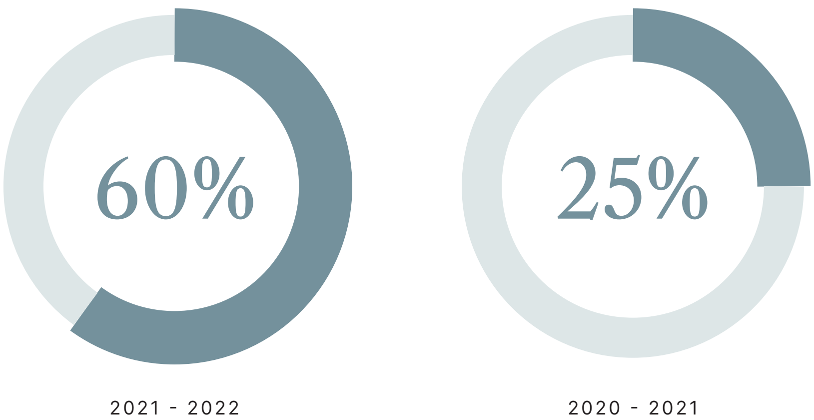
As subscription lines become more sophisticated, this remains the most popular type of financing, recording 97% use. This is has come a long way from the 25-30% of funds that used these facilities five years ago.

Lowman said: “From an investor perspective, we find that there is now a general understanding and acceptance of how subscription lines in particular are being used. On the investment side, there has also been conformity around how those lines are being used, and investors are taking a lot of comfort from that.”

“Pricing obviously is always towards the top of the list when selecting a financing partner, but flexibility of terms and a greater understanding of our business is as important,” he added.

Meanwhile, asset-backed – including hybrid – solutions are also gaining much more acceptance, with 50% of participants using these facilities – up from 39% in 2020-2021.

GPs that use subscription lines to fund LP portfolio sales



GP-led financing

For GP-led deals, the survey suggests GPs are using financing to act as a bridge – either to an exit, to a refinancing of underlying portfolio companies or to a capital call, as a form of return enhancement. Subscription lines at the continuation vehicle are the financing of choice, preferred by 62% of those surveyed. The typical loan-to-value ratio (LTV) for these is between 30-40%. Meanwhile, the 10% of GPs who use deal-based financing tend to favour hybrid facilities.

Paveri said: "While before, considering financing for GP-led transactions was an exception, it is now a topic we discuss with GPs at the onset of every process. The space is experiencing a similar evolution to what we saw for both capital call facilities for direct funds and recapitalisations or NAV financing for more mature funds. GPs see the advantage of optimising cash flows by using financing, and I believe we are getting close to 50% of GP-led deals, if not more, seeing financing solutions being applied."

Interestingly, only a small minority of GPs believe it would be appropriate to adjust the primary GP carry metrics when financing is used at the continuation vehicle. Recent discussions with LPs suggest this may become more topical as the market matures.

LP portfolio financing

The majority of GPs (60%) also use subscription lines to fund LP portfolio sales, a big jump from 25% last year, and nearly 30% of participants use ring-fenced NAV lines. As a result, the entry of non-bank lenders in this area is becoming more prevalent. For financing these deals, half of respondents request up to 30% LTV, with a top end of 50% LTV. This is lower than last year, where almost 90% were requesting more than 30% LTV.

Preferred equity

Interestingly, 33% of those playing in the preferred equity market are using back-leverage to enhance returns, compared to 18% last year. We believe this is directly attributable to preferred equity returns bouncing back over the last 12 months and back-leverage becoming more important to achieve target returns. The annualised target returns for preferred equity holders is evenly split between 13-14% and more than 15%.

Tail-end portfolios

Given the risk and uncertainty around 'zombie' assets, GPs believe tail-end portfolios are the least suited for financing, with only 12.5% using ring-fenced financing and LTVs between 20-30%. Across these strategies, the majority of respondents (62%) are achieving discounts in excess of 20%.

Looking forward

While recent geopolitical events may dampen the mood slightly, 80% of participants we surveyed believe 2022 deal flow will exceed that of 2021.

If Covid-19 has taught us anything it is that the secondaries market is stronger than ever and should have no problem withstanding further shocks. Overflowing with liquidity and equipped with more advanced means of financing than ever, this bodes well for the uncertain environment that lies ahead.

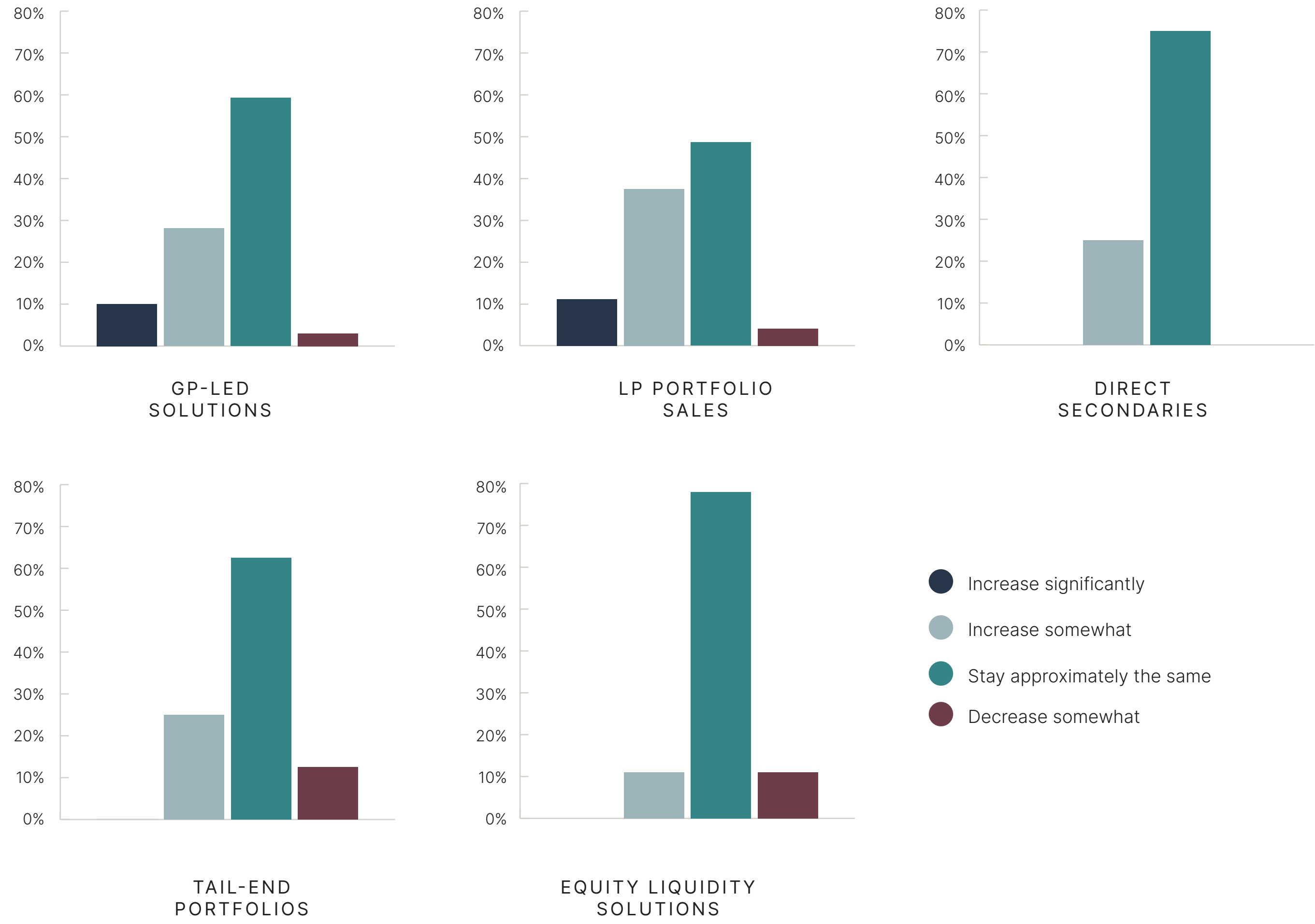
As the secondary and primary markets become increasingly indistinguishable, the ascent of GP-led solutions and the sophistication of LP portfolios may see more participants entering the market, which will undoubtedly lead to further developments on the financing side.

"With the increased use of the secondaries market as a portfolio management tool for LP stakes and the rise of GP-led solutions, there is still a lot of growth left in the market as we know it today. This being said, there will absolutely be new innovations that will add into the current opportunity set," said Markkanen.

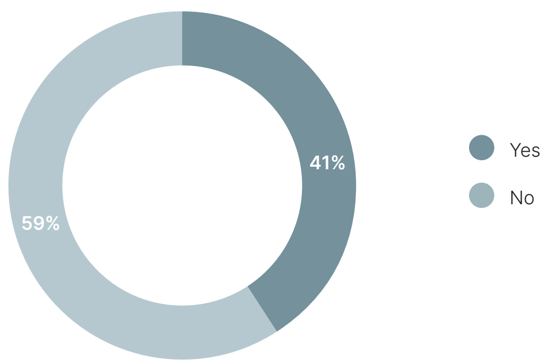
At Investec, we are committed to constantly innovating. We work closely with market participants across the cycle to come up with creative and flexible solutions that can help deliver enhanced returns.

Appendix

How do you expect your activity in the following areas to change in the next 12 months?



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



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