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February 2018

The secondaries market

The growth of debt finance

Investec
Specialist Bank

The secondaries private equity market has grown exponentially over the past 10 years but what does increasing competition mean for players in the secondaries market?

In this report we'll cover the following topics:

Developing trends

Last year, we invited representatives from the secondaries market to our annual Secondaries and Fund of Funds debt seminar series in London and New York to discuss the fundamentals and trends shaping transactions, and to ask how greater innovation could help drive returns. In this report we discuss these conversations.

One of the talking points was the increasing role of debt and how secondaries players were using it to gain an edge on the competition.

Deal volumes and dedicated secondaries fundraising are increasing, leading to a significantly more mature market than pre-financial crisis.

According to a secondaries market report for FY 2017, published by Setter Capital, the secondaries market reached a record high of $60.74 billion in 2017 completed transactions. This is due to large investor portfolios coming to market and the emergence of bigger GP-led transactions.

The report indicates that traditional fund secondaries increased by a third, from $32 billion to $42.7 billion, in 2017 as compared to 2016.

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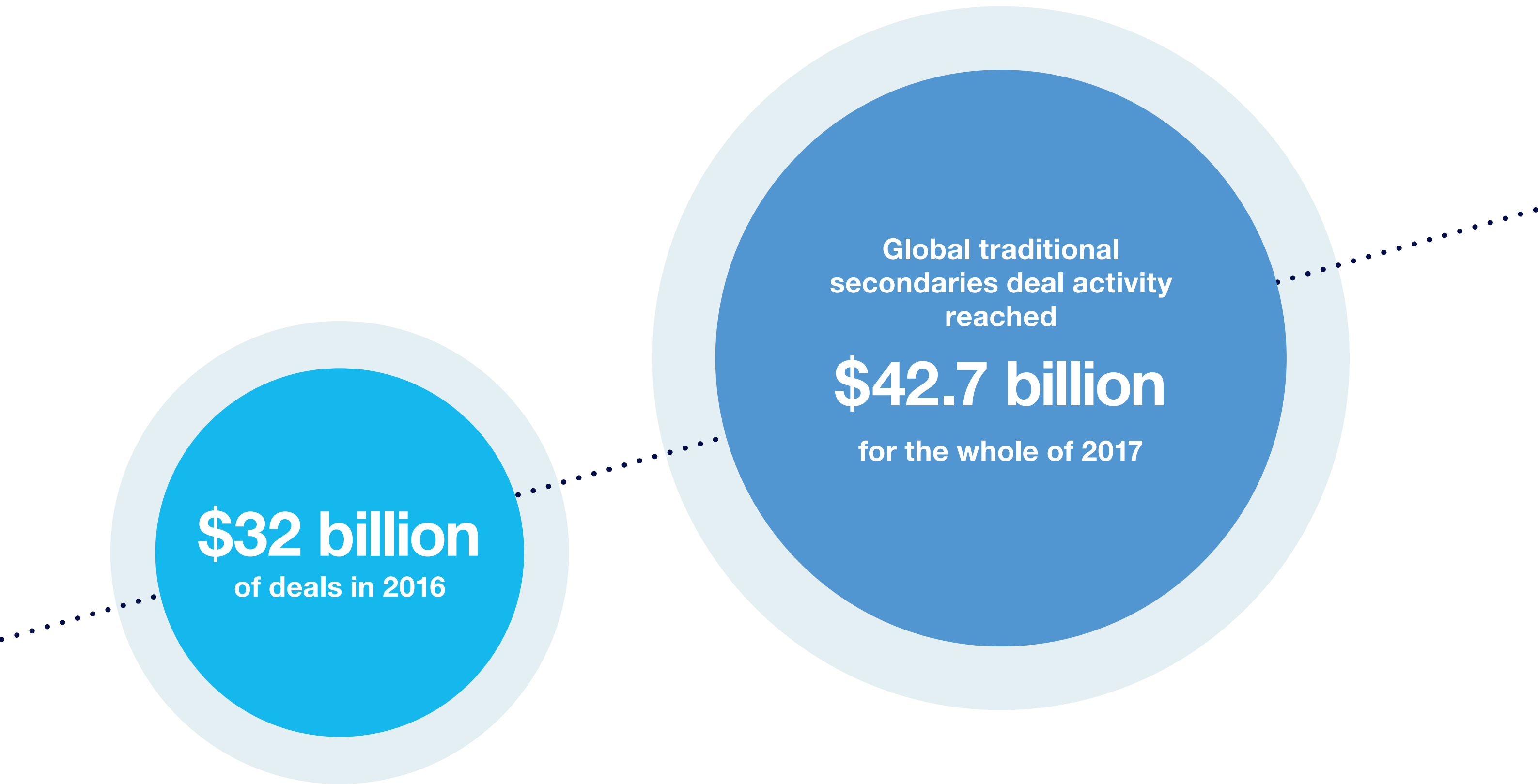
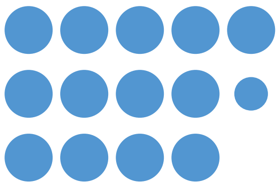


Source: Setter Capital Volume Report, FY 2017

Dedicated secondaries funds globally raised an aggregate $26.1 billion in 2016, approaching the record $26.6 billion raised in 2014 and almost double the $13.7 billion raised in 2006, according to researcher Preqin.

At the time of writing (February 2018), final fundraising for 2017 came to $37 billion, according to Preqin. As a result, the funds traded on the secondaries market have become more familiar to lenders and buyers; acceptance and understanding of debt has improved, and deal flow has grown accordingly.



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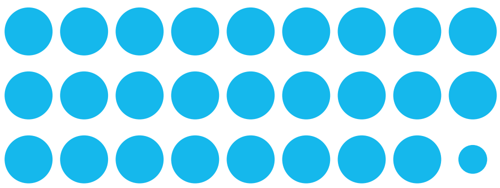

A record

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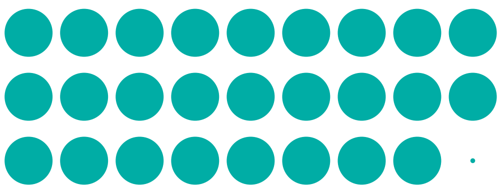

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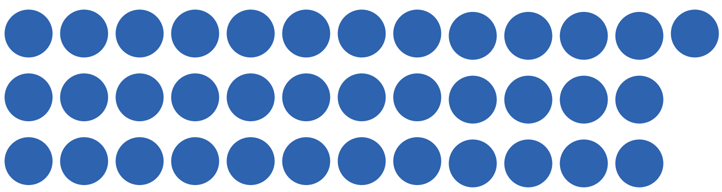


At the time of writing, such vehicles had raised a combined

$37 billion in 2017

Source: Preqin, January 2017

Increased awareness and sophistication

Widespread awareness of fund finance for secondaries deals and greater understanding of the products available means we now spend less time explaining options to clients and more time structuring and implementing debt solutions. In fact, more buyers are arranging finance post-deal, before completion – a clear sign of confidence among managers in their ability to secure favourable terms.

Gregg Kantor, Head of Fund Finance in the US at Investec, explained:

> "I'd be surprised if there were many deals without some sort of leverage at all. The market is much more comfortable with debt, the different types and aware of how it can be used to improve a transaction."

A secondaries fund finance survey we carried out in spring 2017 highlights the trends towards debt finance in the secondaries market. It found that 76% of funds were using capital call facilities and 30% of funds were using asset-backed lending on portfolios. We're now seeing acquisition facilities employed across the deal spectrum, from transactions worth tens of millions of dollars to those worth billions.

How we see finance being applied

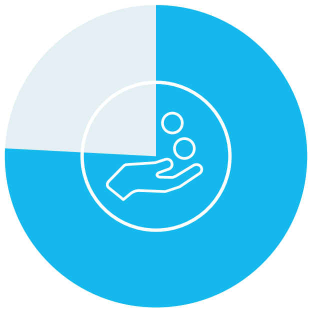
Meanwhile, more than half of respondents were considering using a dividend recapitalisation in 2017, enabling managers to actively manage secondaries positions and providing limited partners (LPs) with liquidity options during the hold period.

The market's maturation has also led to a change in mind-set among market participants, with many deals drawing on instruments traditionally used in the public markets.

2017 Investec Fund Finance secondaries survey

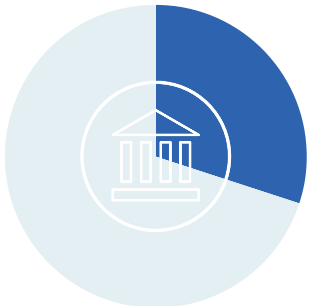
76%

of funds were using capital call facilities



30%

of funds were using asset-backed lending



Public market tools in a bank debt context

According to Mark McDonald, Head of Private Equity Secondaries at Deutsche Asset Management:

“People are more open minded in using tools that have been around in other markets for years – whether it’s securitisation or preferred equity – by applying them to a traditionally illiquid market. This is the core of the innovation we’re seeing in the market today.”

We’re seeing more investors using alternative pots of capital and securitisation to gain a non-traditional route to private equity exposure. For instance, an investor holding its instruments in private equity via rated paper rather than equity.

The complexity of securitisation means market participants have shown a preference for bank debt enhanced with key features of securitised structures. These ultimately maintain the flexibility and choice of bank finance but provide solutions for certain requirements or investment mandates.

Such tools were used in a small number of deals pre-crisis but are expected to become more popular in the coming years amid greater market volatility and changing returns expectations.

Gregg added:

“By pulling together features of bank finance products that are rated at the beginning of the deal, we can offer LPs a different way of investing in the asset class that’s more interesting from a capital and a hold perspective.”

GP-led transactions

GP-led deals are arguably driving some of the market's most interesting innovation.

GP-led deals are arguably driving some of the market's most interesting innovations, due to their complex nature and case-specific challenges. Five years after secondaries firm Vision Capital's deal to buy assets held by a mature fund managed by Willis Stein & Partners – in which existing LPs had the option to divest or roll over their commitment into a new partnership – esoteric transactions for end-of-life funds are gaining traction.

The large numbers of parties involved in GP-led deals and the varying objectives they each hold make early and transparent communication essential to success.

Mark noted:

"We derive bespoke processes based on the different elements of the investor base. Certain LPs see a clear value proposition – why assets should be moved into a new fund – while others want to ensure they are selling at the best value possible."

These nuances are creating demand for finance facilities that can provide greater certainty for buyers and vendors, particularly before agreeing a deal. Pre-attaching debt or preferred equity to a deal during negotiations can help allay buyers' concerns about securing appropriate finance, and narrow the bid-ask spread between the buyer and seller.

Concentrated portfolio

Similarly, concentrated portfolios can pose issues for lenders, who may be wary of supplying debt for assets with different objectives and varying levels of existing leverage.

Matt Hansford, Head of Fund Finance in the UK at Investec, said:

"When we're looking at these situations the real value is generated by sitting with the buyer or GP and the adviser and saying 'what are you looking to achieve?' We've provided facilities on concentrated portfolios of fund interests or underlying businesses, but it's important to truly understand the buyer's objectives so that a bespoke solution can be achieved."

Hybrid structures: the new kid on the block

Hybrid debt facilities are becoming more prevalent for situations where portfolios are concentrated, complex or require specific flexibility. Some lenders only take risk on the investors, while others only take risk on the assets.

However, Investec can consider both and offer a flexible hybrid solution in situations involving a mature, concentrated portfolio. We will base the solution on our client's goals rather than applying an off-the shelf product, filling a gap in the market.

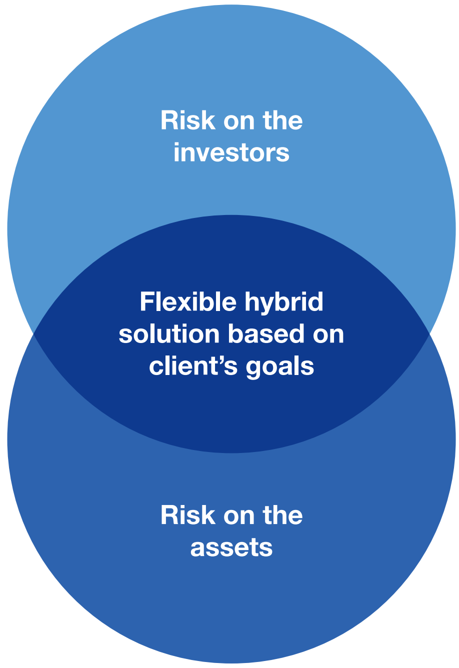
Supplementing asset security with additional commitments from LPs to the investment portfolio can be relatively straightforward and palatable to secondary GPs. This enables a financing solution the underlying asset base would not ordinarily support. It also provides more attractive pricing and flexibility of cash flow through the structure to the manager.

David Atterbury, a Managing Director at HarbourVest Partners, added:

"When we led these types of transactions – and it's often as a bridge into refinancing some of the underlying businesses because you're at the tail-end of a funds life – you can see near term cash flows and backstop it with commitments and manage that at your own fund level. The amounts are relatively small and you can manage that through a modest over commitment strategy at your own fund level."

With the growth of the secondaries market the use of specialist debt facilities has become almost standard – firms and deals of all sizes are employing debt finance to enhance returns and the ability to compete in a maturing market. Meanwhile, the tools on offer are considerably more sophisticated than in the years pre- and post-crisis.

We expect rising numbers of enquiries regarding debt finance for secondaries deals and are always innovating to find the most effective and efficient solutions for our clients.



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About us

Investec, an international specialist banking and asset management group, is dual listed on both the London and Johannesburg Stock Exchanges and is a FTSE 250 company. It has offices in 42 cities, with headquarters in London and Johannesburg, and a staff compliment of over eight thousand.

With offices in London, New York, Johannesburg and Sydney, Investec Fund Finance is a specialist finance provider focused on developing and delivering smart lending solutions for funds and fund management teams.

Working closely with our clients, we get a deep understanding of their goals and requirements so that we can offer flexible finance solutions at each stage of the fund life cycle. We aim to help clients enhance returns, maximise the efficiency of their fund's equity and increase competitiveness in an aggressive market environment.

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