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Debt and the secondaries market

How relationships have become more important than pricing

Investec explores the importance of having a strong relationship with a bank that can underpin the speed, flexibility and deliverability that GPs require.

From its humble beginnings, today's more mature secondaries market has opened up greater liquidity options not only because of the speed and efficiency with which it can process large deals, but because of the increasing array of transaction types including the use of leverage to boost returns and generate liquidity from the portfolio through recapitalisations.

As a leading provider of structured financing to the private equity market, the Investec Fund Finance team has been a close observer of, and contributor to, the development of the secondary market. We recently welcomed 140 leading GPs, investors and advisors to Investec's offices in New York and London to explore how the secondaries market has evolved and the use of debt within it.

To help inform this discussion, we invited senior private equity professionals to answer a few questions on the secondaries market, from which some interesting conclusions emerged. While the use of debt in secondaries is well established – with 73% of respondents considering it or already using it – it is still not seen as essential as 87% believe it is possible to be competitive in the market without using leverage. These statistics indicate that debt, while not a crucial part of every transaction, is necessary in some deals where leverage is used to be competitive.

While the relative importance of debt is still up for debate, what has become ever clearer, as was reinforced by our panellists in London and New York, is that when GPs choose a debt provider, a strong relationship is valued above all.

Evolution of debt in the secondary and fund of funds market

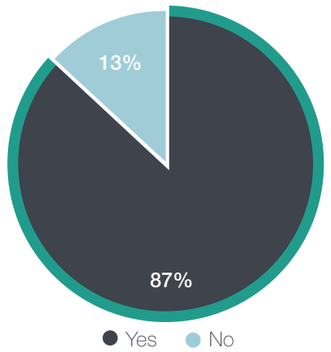
Key Points

- No single approach to financing by GPs. Some only take leverage at the fund level while others take a deal-by-deal approach.
- The 'tool box' available to GPs has grown and evolved significantly due to an increase in the innovation and sophistication in the lending market, with the whole capital structure being represented, from senior debt to preferred equity.
- The pricing of debt comes secondary to a bank's relationship with the firm. GPs value flexibility, speed and deliverability in a dynamic marketplace.

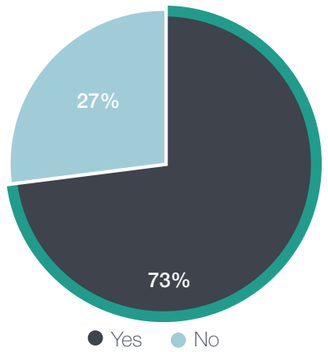
The dichotomy of 87% of GPs viewing leverage as non-essential when it comes to being competitive against the fact that 73% of GPs have or would consider using some form of financing raises an interesting potential conclusion: using finance or debt has become an almost ubiquitous tool for the private equity industry despite what market participants say. Often it is the case that debt can turn a good deal into a great one, as long as it is used prudently.

Worldwide

Can you be competitive without using some form of financing support?



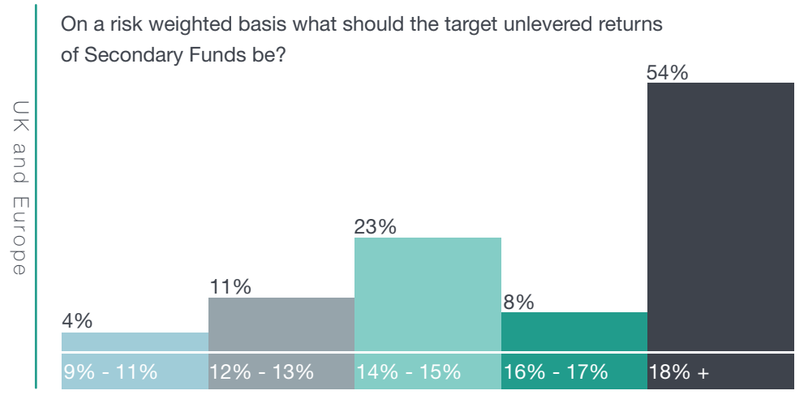
Do you use or would you consider using some form of debt?



Of course, secondaries firms operate in different ways and have different appetites for leverage, but while there is no pro forma approach to debt, the number of ways in which it can be used has increased. This was demonstrated by one of the panellists, who reported that they limited their use of financing to the SPV level, thereby isolating risks at the transaction level. Another took a far broader approach to financing allowing for debt at the fund and SPV level as well.

"To be competitive you have to have some level of debt."

In direct contradiction to the survey respondents, one GP commented: "To be competitive you have to have some level of debt". Competition for assets at the top end of the market is extremely high and this trend is trailing into the lower end. As a result, many see debt as a way to set themselves apart from that competition. For these types of transactions where the GP will often aim to achieve returns of 18%+, a large portion of the market will likely agree that some form of SPV level funding is required. However, structuring this type of financing requires an innovative approach.



There was a recognition among the panelists that there has been an exponential growth in the number and sophistication of financing products on offer.

The use of leverage as a portfolio management tool has also increased, with dividend recapitilisations recognised as a means of both delivering value by boosting IRR and also maximising investment capability.

While one panellist described the types of financing arrangements in the secondaries market as "vanilla", one area of innovation, discussed at length was the use of preferred equity which has become a viable option for many in the market. Even though there was no consensus on the definition of innovation in the use of debt, there was a recognition among the panelists that there has been an exponential growth in the number and sophistication of financing products on offer.

One point met with agreement across the panellists was that the use of debt when purchasing fund stakes in the secondaries market requires an extremely strong relationship and understanding between the bank and the GP. Without this relationship, GPs won't necessarily have the trust in the bank to deliver the financing quickly, while the banks may not have the long term understanding of the business to deliver the innovative structures that the private equity industry is looking for.

These relationships become ever more important during periods of economic uncertainty where portfolio's hit headwinds. No matter what the challenges private equity companies face, it is essential to have an established partnership with a bank that truly understands the long term nature and dynamics of the asset class.

Market Update: The flight to quality – opportunities and threats in the secondary market

Key Points

- Deal flow is being driven by opportunistic sellers who focus on price and ultimately do not need liquidity.
- The secondary market has been sheltered from recent volatility and people's expectations for future pricing shows that volatility has not impacted the secondary market.
- GP-led transactions are expected to increase as the stigma around the secondaries market lessens.

The issue of volatility is never far from the headlines and this trend shows no sign of abating following of the EU referendum and the impending election in the US. When it comes to the secondaries market, this volatility has undoubtedly had an impact on pricing. However, as one of the panels discussed, this period of introspection for the market is no bad thing. Furthermore, it is this volatility that provides opportunities for people to do deals where there is a large amount of value to potentially be extracted.

"Sellers are not distressed or even stressed."

Sellers are seen to be opportunistic in the current market, not troubled by their own lack of liquidity. As one participant noted, "sellers are not distressed or even stressed", as LPs opt to wait for the right price. While the flow of opportunities has decreased overall, Investec's panellists noted a much higher close ratio on the transactions that had made it to the market over the last six months.

Another trend noted was of sellers waiting to see how pricing will develop, on the basis that it's always easier to sell in a market that is constantly being marked up. However, with distributions down by 24% in Q1, some investors believe now is the time for LPs to consider offloading non-core portfolios that they were previously reluctant to relinquish because of the income they provided. One GP referred to a flight to quality whereby the price of assets perceived as high quality held up, while the pricing of lower quality assets softened.

Looking ahead, panellists expect to see more GP-led transactions with positive indications for this section of the secondary market. While GP-led deals began with "zombie funds" looking for a lifeline to continue managing assets, in today's rapidly changing environment we are seeing a greater proportion of high-quality GPs frequently utilise the secondary market, as the stigma surrounding it lessens.

With an estimated two thirds of LPs already using the market for portfolio construction, almost all GPs believe this is likely to continue. One GP noted that the opportunity for LP owners of private equity to quickly test the price of their invesments, while occasionally vexing for him as a potential buyer looking for genuine sellers, demonstrates the confidence felt by investors.

Finally when asked if the primary and secondary markets have yet reached equilibrium, the response from our panellists was unanimous: the two are far from a natural point of equilibrium, but the secondaries market has plenty of room to grow as the amount of secondary capital raised is currently less than 10% of the primary market and overall flow of LP positions was just a fraction of the invested capital in private equity.

The Investec View – Price ambivalent GPs value relationships above all

"It is essential that funds have reliable trusted debt providers with an in-depth understanding of the fund, its history, its strategy and how it operates."

Simon Hamilton, Global Head of Investec Fund Finance

It is easy to think that the price of debt would be the deciding factor that could make or break a lending deal in most sectors. However, as was demonstrated at Investec's Secondaries and Fund of Funds Seminar, the private equity secondaries market takes a contrarian view. On a panel consisting of leading GPs and advisors discussing the use of debt in the secondaries market, pricing was hardly mentioned.

Instead, the essential elements raised by the panellists when looking to take bank financing were speed, flexibility and deliverability, with all three of those qualities predicated on an strong working relationship with the lender. With high levels of competition in an uncertain environment, it is essential that funds have reliable trusted debt providers with an in-depth understanding of the fund, its history, its strategy and how it operates.

The GPs at our seminar also made it clear that these deep relationships are essential for deliverability, making the point that banks need to effectively manage its credit committees and provide a decision to GPs quickly. Transactions move fast and a dynamic lender is an essential part of that, particularly at the top end of the market where competition is so fierce.

"While global volatility and macro-economic headwinds create an extremely competitive environment for houses looking to deploy capital, it is also an environment that fosters significant value-creation opportunities."

The consensus that the secondaries market will continue on its growth trajectory is, of course, welcome news to the private equity industry. While global volatility and macro-economic headwinds create an extremely competitive environment for houses looking to deploy capital, it is also an environment that fosters significant value-creation opportunities.

Investec is of the view that debt is a vital resource for GPs in the secondary market, who are required to react quickly to market opportunities and maximise returns. Our extensive expertise in the secondaries market and understanding of the challenges allow us to deliver innovative solutions that support the continued growth of this market. We pride ourselves on developing long term partnerships with private equity professionals, supporting them on their journey at every stage of the fund cycle.

About Fund Finance

Investec Fund Finance is a specialist finance provider focused on lending to funds and fund management teams.

We aim to build lifelong relationships with our clients. We offer flexible finance solutions at each stage of the fund cycle, which can enhance returns maximise the efficiency of the fund's equity and increase competitiveness in an aggressive market environment.

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

Our flexible solutions for funds and fund management teams include:

- Capital call facilities – facilities to bridge investor call-downs
- GP financing – facilities enabling fund managers to fund their GP commitments or working capital requirements
- Secondary leverage – leverage against LP interests in funds including portfolio acquisitions and recapitalisations
- Portfolio lending – facilities secured against the value of the assets in the fund
- Investor financing – providing liquidity to institutional investors and family offices

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About the research

A sample of 110 senior private equity professionals in the UK, Europe and the US were surveyed in June 2016.