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Private Equity Secondaries: How the Pandemic Has Changed the Market—Again

It is our view that the uncertainty of the coronavirus pandemic has led to a flight to quality in the private equity secondary market, as many buyers have focused on transactions where they are able to conduct thorough due diligence on underlying companies in pursuit of resilient, growing businesses at attractive valuations.

To some extent, we think this flight to quality is evident in the recent shift away from the sale of large, diversified portfolios of Limited Partner (LP) interests, or so-called "index trades," in favor of smaller, often single fund sales, referred to as "mosaics."

More importantly, and we believe more sustainably, this focus on quality is being facilitated by the increasing number of what we consider to be best-in-class General Partners (GPs) entering the secondary market. We see that many GPs have concluded that some of the most attractive assets they could own are those high-quality assets already in their portfolios, even if they were due to be exited. A GP-led transaction provides them with the potential for strategic optionality, offering liquidity for LPs who need it while others retain exposure in a continuation fund, with the same GP controlling and managing the asset.

GP-led transactions are increasing the overall size of the market as well as, in our view, enhancing its quality. However, secondary market dry powder has not kept pace with that growth, and we believe that is leading to attractive pricing dynamics.

During the pandemic, the private equity secondary market has proven one of the most dynamic segments of the private equity industry. Already over the last decade, it had exhibited continued innovation and strong growth, going from $10 billion in 2009 to $80 billion in 2019, according to figures from Greenhill & Co. That upward trend was interrupted in the first half of 2020, as the huge uncertainty of the pandemic led most buyers to demand discounts that most sellers were not prepared to meet. It had resumed by the end of the year, however, and in 2021 we believe the secondary market is on track to reach $100 billion worth of transactions for the first time ever.

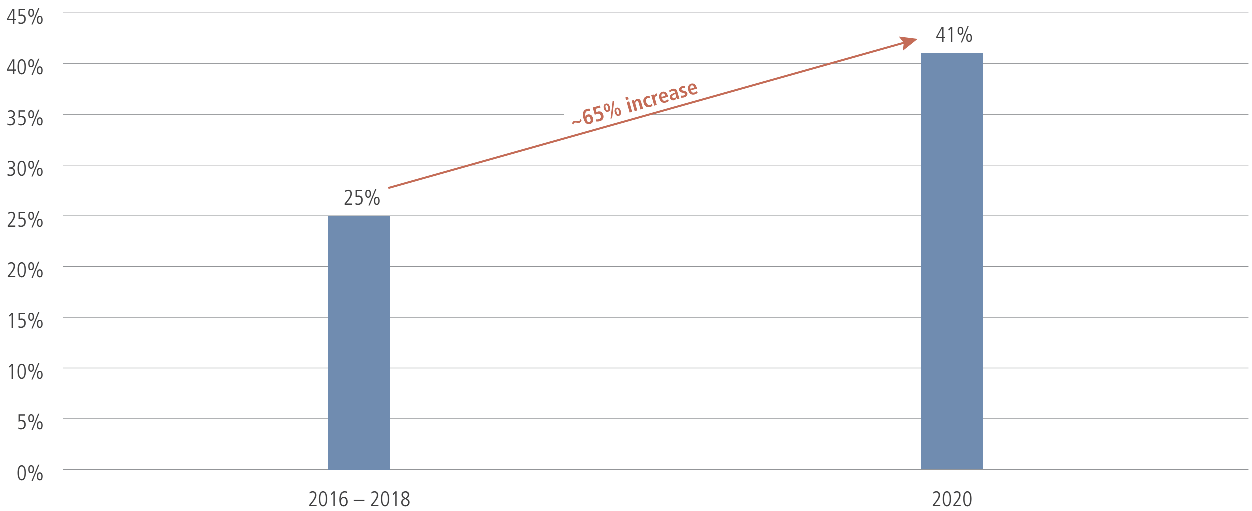
Just as notable, that resumption of growth has coincided with many buyers focusing on quality, seeking out transactions where they are able to conduct thorough, company-level due diligence to build conviction on the underlying assets and their future performance prospects. That trend has supported a recent shift toward "mosaic" sales in the LP-led market, and it is also being facilitated by an increasing number of best-in-class GPs entering the GP-led market.

LP-Led Transactions

The focus of many secondaries buyers in 2020 on fundamental underwriting and asset-level due diligence (as opposed to using leverage and modelling portfolios' expected returns with top down approaches) has, in our view, led to diversified portfolios of LP interests, or so-called "index trades," being broken up into smaller, often single fund sales, referred to as "mosaics." In 2020, mosaics represented approximately 41% of the total secondary market, up from around 25% during 2016 – 2018

FIGURE 1. SURGE IN MOSAICS

Mosaic transactions as a proportion of total secondary market deals



Source: Greenhill & Co, *Secondary Market Update, February 2021.* The figure for 2016 – 18 represents the average for those years. Data as of January 2021.

Index trades appear to be far from dead, however—indeed, they are experiencing something of a comeback, as we see some buyers begin to price for smooth economic re-opening and continued stability in public markets. While we think the LP-led market is likely to come back into balance between index and mosaic trades over the rest of this year, we remain confident that the market will continue to provide attractive opportunities for more cautious investors to select funds where they can build conviction on the future performance prospects and valuations of the underlying assets.

In our view, however, the more important and sustainable trend is observable in the GP-led market.

GP-Led Transactions

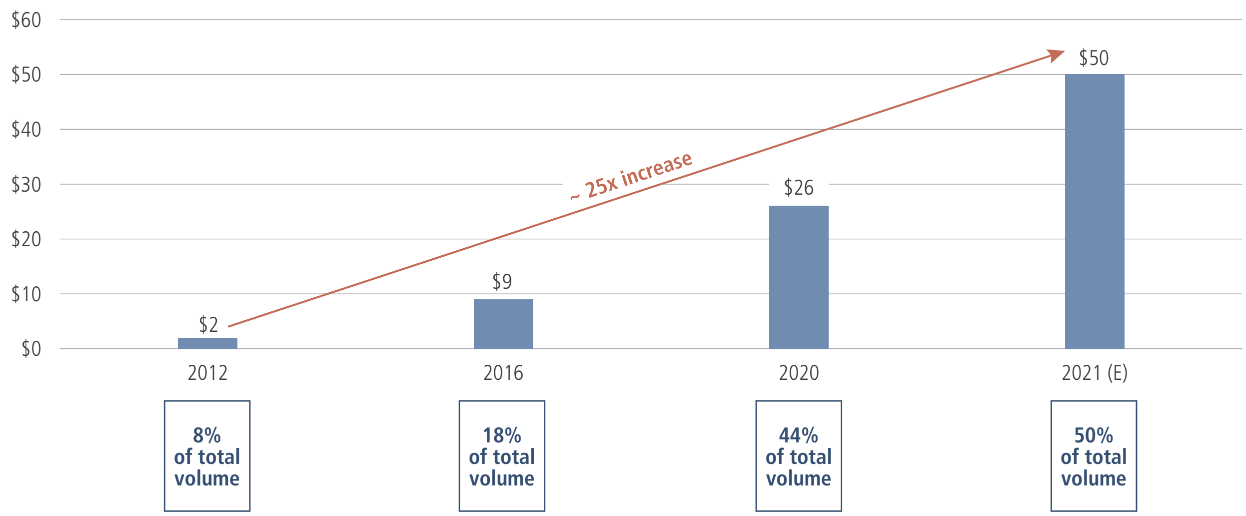
When private equity managers use the secondary market, they move some or all of their current funds' assets into new, so-called "continuation funds" that are typically structured and negotiated with secondary market buyers but are also open to the legacy-fund LPs that want to retain exposure.

GP-led transactions have been the fastest growing segment of the secondary market for several years. Having barely existed a decade ago, forecasts from investment banks PJT Partners and Greenhill & Co suggest they could account for half of the total market for the first time this year (figure 2). Moreover, GP-led secondaries are not only becoming more common, but, in our view, also rising in quality.

Much as LP-led transactions changed from liquidity-seeking to active portfolio management a decade ago, these GP-led transactions have evolved from their origins as a tool for restructuring old, poorly performing zombie funds to a way for blue-chip GPs to hold onto some of their best-in-class portfolio companies longer and also give them potentially enhanced access to capital.

FIGURE 2. GP-LED TRANSACTIONS MAY ACCOUNT FOR HALF OF THE SECONDARY MARKET THIS YEAR

GP-led transaction volumes (USD billions)



Source: PJT Partners, *Secondary Market Update, January 2021;* Greenhill & Co, *Secondary Market Update, February 2021.* Data as of January 2021. **Past performance is not necessarily indicative of future results.** These figures are based on expectations, estimates, and projections and no party provides any guarantee or assurance that these projections are accurate. Actual events or results may vary significantly from those reflected or contemplated.

We believe a confluence of factors has been reshaping this segment of the market.

First, with the economic environment highly uncertain and valuations high, many GPs appear to have concluded that some of the most attractive assets they could own were those high-quality assets already in their portfolios, even if they were due to be exited. Right now, in particular, re-investing in a well-known company with a proven management team and an attractive growth trajectory is likely to represent much lower execution and investment risk than a new buyout, in our view.

Second, as the universe of primary investors has expanded, duration and liquidity expectations have broadened and diversified, and this has also made the hold-or-sell decision more complex for many GPs.

Around half of exits from private equity holdings are made to other private equity funds, according to figures from Pitchbook's U.S. PE Breakdown Q2 2021. Many GPs are instead deciding to hold onto positions and capture the next leg of value creation for themselves and their investors. For their part, the LPs would often be clients of both the selling fund and the buying fund, and they appear amenable to GP-led secondary arrangements that enable them to hold onto assets without these frictional GP-to-GP transaction costs. The average holding period for private equity has increased by 52% since 2008, according to the Preqin *Quarterly Update: Private Equity & Venture Capital Q1 2021.*

That said, as GP-led transactions have established themselves as an alternative to traditional IPOs and M&A exits, and not just a way to deal with mature assets, some GPs have begun to tap the market earlier in the life of their funds. Our experience suggests that the average age of assets in single asset continuation fund transactions has shortened to four to six years. That is in line with the 4.8-year median holding time for private equity assets broadly, according to Pitchbook data published in its research note, "Exploring Long-Dated PE Funds," as of May 2020. As sponsors have come to market with younger assets, the opportunity set has continued to expand and diversify.

The substantial increase in GP-led transactions last year has resulted, in our view, in a marked rise in the quality of the assets in the secondary market. For buyers, that represents more and more opportunities to own a share in these high-quality companies, at relatively attractive valuations.

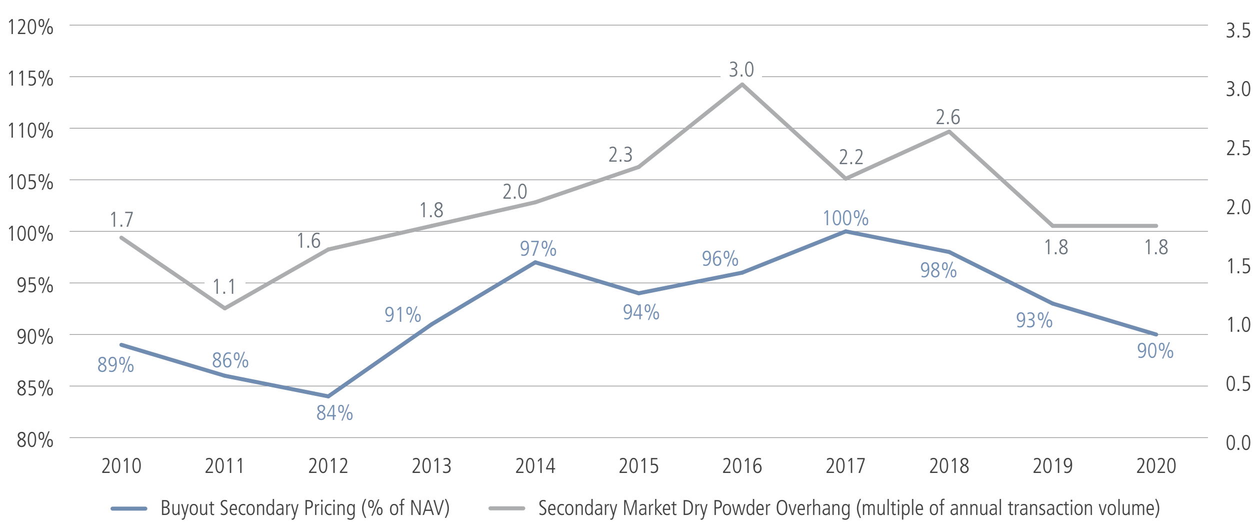
Supply and Demand: Dry Powder Is Scarce

Despite this increase in quality, particularly of GP-led transactions, secondary market valuations remain attractive due to favorable supply and demand dynamics.

As we have seen, GP-led transactions are on the threshold of becoming the largest segment of the overall secondary market, despite sell-side estimates that only around 2% of GPs have executed a transaction. The GP-led trend is still in its infancy and we believe its growth potential is significant.

Already, overall growth in transaction volume has outpaced the strong growth in secondaries fundraising, resulting in total dry powder that is less than two times the annual transaction volume. That is below the five-year average and below the 2.5 – 3.0 years' worth of dry powder that we estimate is required to bring the market into equilibrium. It is also well below the 3.5 – 4.0 years' worth of dry powder currently sitting in the buyout market, as reported by Preqin in the first quarter of 2021. In our view, we are far from a situation of too much money chasing too few transactions. Figure 3 suggests that, at the macro level, pricing has tracked this dry-powder ratio, peaking in 2017 and steadily declining since.

FIGURE 3. MARKET PRICING HAS FOLLOWED DRY POWDER LEVELS



Source: Evercore PCA, *LP Capital Advisory Report;* PJT Partners, *Secondary Market Update, January 2021;* Greenhill & Co, *Secondary Market Update, February 2021.* Data as of January 2021. Pricing data represents the average of Greenhill and PJT. There can be no assurance that any trends depicted above will continue or will not reverse. **Past performance is not necessarily indicative of future results.**

Even so, we believe this macro pricing is only part of the current story in private equity secondaries.

As we described above, the disruption of the financial crisis over a decade ago initiated waves of secondary market segmentation and innovation which means that, today, there is no longer a single macro pricing dynamic. Different segments generally have different supply and demand, different levels of efficiency and different return expectations. Consequently, we think investors in secondary funds increasingly must consider the profiles of individual market segments to draw an accurate picture.

We believe the dynamics for GP-led transactions, where only a relatively small group of investors currently lead these highly complex, long lead time transactions, are particularly attractive. Indeed, we hear anecdotally that secondary sell-side advisors are increasingly concerned about a lack of capital to support the rising volume of GP-led transactions. With our broad network across private markets, we believe Neuberger Berman has good insight into these dynamics, and into how GPs are thinking about the liquidity solutions they and their LPs need.

In our view, supply and pricing in the secondary private equity market in general, and the GP-led market in particular, remain attractive for experienced secondary investors.

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