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PETER BOCK
Managing Director, NB Private Equity Secondaries

PHILIPP PATSCHKOWSKI
Managing Director, NB Private Equity Secondaries

BEN PERL
Global Co-Head of NB Private Equity Secondaries

Three Notable Trends in the World of Secondaries

Why we think macro uncertainty and the private equity liquidity squeeze are making secondary market conditions particularly favorable for targeted buyers.

The private equity secondary market, which initially evolved to enable limited partners (LPs) to raise cash by selling a fund or portfolio of funds before they had matured and made their final distributions, has become an increasingly important part of the private equity ecosystem since the global financial crisis. As the private markets grew from around $2 trillion to $10 trillion between 2010 and 2022, secondary market transactions went from $20 billion a year to well over $100 billion, according to Jefferies.

Alongside this growth, we see three notable trends in the world of secondaries:

- A drop in the "dry powder" available to the secondaries market relative to annual transaction volumes providing well-capitalized secondaries investors with the opportunity to invest in a less competitive environment.
- A significant rise in the proportion of secondaries transactions that are so-called mosaic transactions providing targeted secondaries investors with an enhanced opportunity to reduce risk via selectivity and a focus on quality from broader portfolios.
- The continued rise of general partner (GP)-led secondaries provides secondaries buyers who possess the requisite due diligence capabilities with the opportunity to take their selectivity to another level by transacting on *individual businesses* from individual funds.

In our view, all three of these trends are creating a landscape that is particularly attractive for well-capitalized secondary investors that don't need to use leverage and can be highly selective in targeting quality assets.

Undercapitalization

Since 2020, three waves have caused a substantial increase in demand for secondary market liquidity while also creating a shortage of dry powder.

The first wave, in 2020 – 21, was the "numerator effect." Private equity investments performed so well, and capital calls were made so rapidly, that many LPs found themselves overallocated to the asset class relative to the value of their overall investment portfolio.

The second wave, in 2022, was the "denominator effect." Public equity and bond market valuations plummeted, while there was generally a much smaller decline, if any, in investors' private equity fund portfolios. LPs were now even more severely overallocated.

Finally, through 2022 and into 2023, exit routes closed, leaving LPs still invested in funds that they had expected to mature. Furthermore, as private equity firms continued to call capital for new investments even as distributions dried up, net investor cash flows turned negative for the first time in many years. This exacerbated the overallocation problem still further.

The secondary market can provide a solution for realizing liquidity and bringing allocations back into line. The other side of that coin, however, is that the same group of investors who are overallocated to private equity are also potentially constrained in their ability to invest in private equity secondaries.

As such, we do not believe that fundraising across the secondary asset class has been able to keep pace with the potential transaction volumes. Industry data suggests that, even if we added all of the expected pipeline of secondaries fundraising and an estimate for leverage, the total dry powder in the secondaries market would still meet only two years or less of current selling demand—an exceptionally low level.

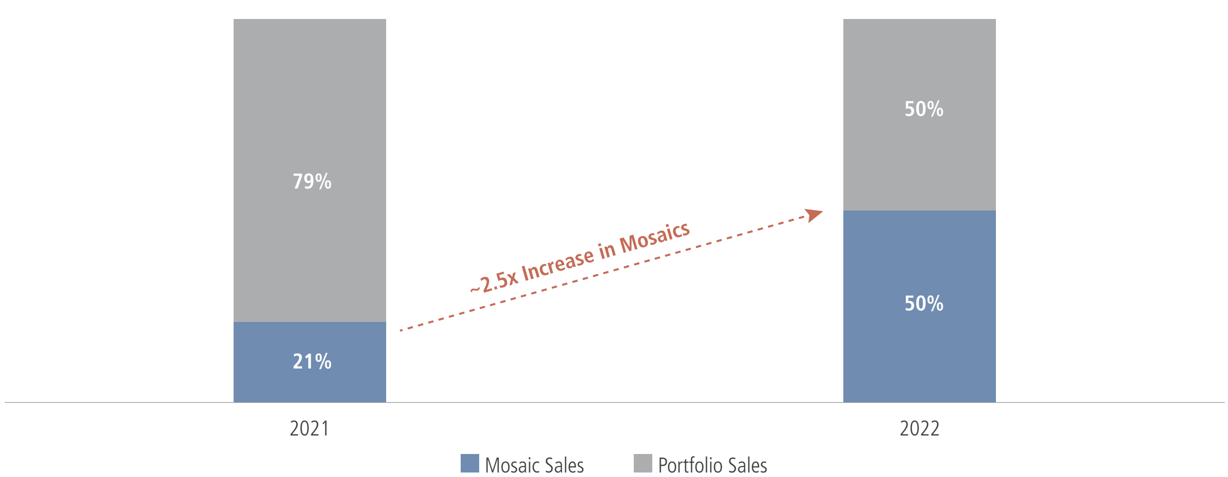
That means well-capitalized firms that are able to raise funds potentially face much less competition for assets, just as LP and GP demand for liquidity is rising.

Index Buyers vs. Targeted Buyers

What about the rise of mosaic transactions?

According to Greenhill's 2022 *Global Secondary Market Review*, mosaic transactions in specifically targeted funds amounted to 21% of a $132 billion secondaries market in 2021, rising to 50% of a $108 billion market in 2022.

TARGETED BUYING STRATEGIES CAPITALIZE ON DISLOCATION



Source: Greenhill "Global Secondary Market Review". Data as of December 2022. Neuberger Berman analysis as of April 2023.

To understand why, one can think of the market as being split between bigger "index" buyers (who bulk-buy entire portfolios of funds and apply another layer of leverage) and "targeted" buyers (who look for specific, high-quality funds with embedded value, and buy them with no additional leverage).

Index buyers acknowledge that not every fund they buy in a portfolio will be high quality, but they generally assume that they will also be sufficiently diversified to manage that risk. While we remain optimistic about private equity's long-term prospects and performance, we also suspect there may be greater dispersion in the returns of legacy portfolios, given the changes of the past two years in the economy and capital markets. Index buyers could therefore be picking up more mixed and lesser-quality assets than the classical top-down models of estimated return might indicate. Alongside the higher cost of their leverage, this is leading many to lower their estimated portfolio returns—and, in an attempt to counteract that, lower their bids for portfolios to give themselves a valuation buffer.

As a result, it is now much more difficult than it was for LPs to sell entire portfolios to leveraged index buyers at minimal discounts to NAV, and they have become more likely to consider selling select assets to more targeted buyers to realize liquidity—hence the rise in mosaic transactions.

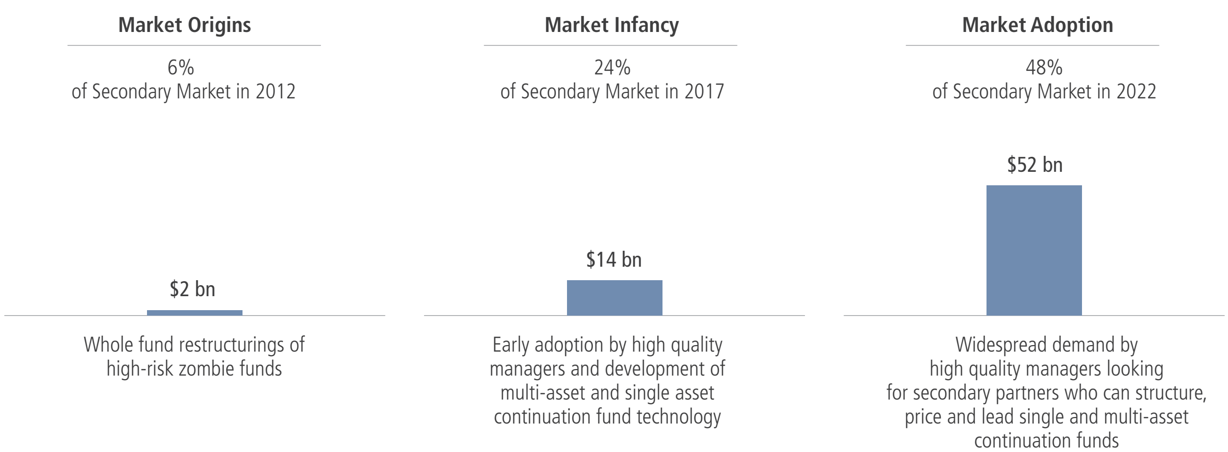
Whereas index buyers try to *mitigate* risk via diversification, targeted buyers try to *reduce* risk via selectivity and a focus on quality. As such, the rise in mosaic transactions reflects not only the expanded opportunity set for targeted secondary investors described above, but also the opportunity to be even more selective than usual, which in turn implies more potential to reduce risk and generate attractive returns.

And this is where the rise in GP-led secondaries also comes in.

The Targeted Opportunity in Complex GP-led Secondaries

GP-led secondary transactions involve placing prized mature companies into "continuation funds" that are sold to new, secondary-market investors alongside some of the existing LPs. GP-led transactions have evolved and grown rapidly to now represent approximately 50% of the secondary market.

UNDERSTANDING THE GP-LED MARKET



Source: Jefferies. Data as of December 2022. NBAA analysis as of January 2023.

These transactions solve a critical challenge that many GPs currently face. At a time when the traditional exit routes are closed, the secondary investors' capital can provide liquidity to any LPs who need it, while the continuation fund enables the rest of the LP base to stay invested as the GP continues to grow their best businesses.

On the other side of the transaction, GP-led secondaries enable targeted secondaries buyers with the requisite due diligence capabilities to take their selectivity to another level. Index buyers transact whole portfolios; targeted secondaries buyers transact individual funds; GP-led secondaries buyers transact *individual businesses* from individual funds.

Moreover, these are individual businesses in a continuation fund to which the underlying GP typically makes a substantial commitment: Investors often expect the GPs to roll substantially all their carry proceeds into the new fund and to make a meaningful additional commitment. This represents a strong vote of confidence from those who know the underlying businesses better than anyone.

In our view, this is why GP-led transactions, while operationally demanding, represent one of the clearest alignments of interest between GPs and investors in the private equity secondary market.

Conclusion

In uncertain times, as mosaic solutions rise and the need for liquidity grows, the opportunity for targeted secondary investors like Neuberger Berman expands. This is against the backdrop that secondary dry powder stands at an exceptionally low level. Thus, enabling investors like us to remain selective and target the very highest-quality private market assets at attractive prices from investors desiring liquidity. Within GP-led secondaries, as discussed above, this selectivity can extend even further, moving from the fund, down to the individual company level—providing our investors the attractive attributes of the secondaries market in an even more pronounced manner.

As a result, we regard current secondary-market conditions to be among the most favorable we have seen for targeted buyers.

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Neuberger Berman
1290 Avenue of the Americas
New York, NY 10104-0001

www.nb.com