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Private Equity: New Value in Secondaries

The supply of secondary transactions initiated by private equity managers has been outstripping the capital available for such transactions—which we believe is good news for secondary investors.

Many private equity investors entered 2022 with a major challenge: Their private investments performed better, and were drawn down faster, than anticipated. Later, economic headwinds roiled public markets and limited exit doors, leaving many investors overallocated to private equity.

Against this backdrop, the secondary market is one of the few options within private equity for liquidity—which is in greater demand than at any other time in recent years. However, available capital in the secondary markets generally hasn't kept pace with deal volume, thereby creating an attractive supply and demand imbalance that we believe will persist for a period of time.

To adapt, general partners (GPs) of private equity funds have increasingly led secondary transactions, in contrast to the sales typically initiated by limited partners (LPs). In the pages that follow, we briefly explore the rise of GP-led secondaries and why we believe they offer attractive opportunities for discerning investors.

Key Terms

General partner (GP): The portfolio manager of a private equity fund.

Limited partner (LP): An investor in a private equity fund.

Primary fund: A private equity fund that makes investments across multiple companies; the fund's timeframe may be up to 10 years, with investors making commitments upfront and capital calls taking place gradually to put those commitments to work as investments are made.

Secondary market transactions ("secondaries"): Buying and selling of preexisting investor commitments to primary private equity funds, typically initiated by LPs, as well as investing in GP-led secondary transactions.

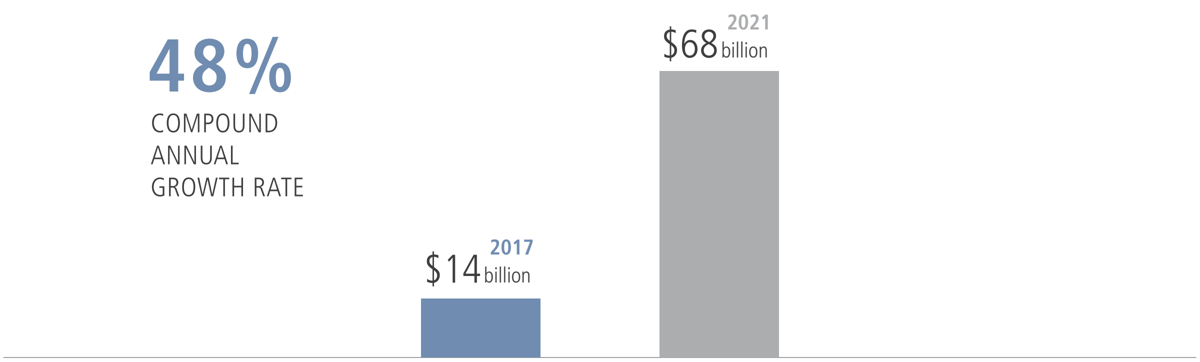
Secondary fund: A private equity fund dedicated to secondary market transactions, focused on the purchase of more mature or seasoned limited partnership stakes, historically from other limited partners, but now more frequently as part of GP-led transactions.

GP-led secondary: A secondary market transaction initiated by the general partner. The most common form of a GP-led secondary is a **continuation fund,** which allows the GP to transfer one or more of its portfolio companies to a new fund formed by the same GP and a new set of LPs.

GP-Led Deals Take Center Stage

Today, GP-led secondaries are among the fastest-growing alternative asset classes. Transaction volumes have roughly quintupled over the past five years as traditional primary private equity fund managers seek to hold onto portfolio companies to continue creating value while offering greater liquidity to their LPs.

GP-LED SECONDARY TRANSACTION VOLUMES



Source: Jefferies Global Secondary Market Review. Data as of October 2022.

So-called "continuation funds" account for a vast majority (about 80%) of GP-led transactions. In this structure, a GP decides to sell one or more portfolio companies from a typical, 10-year primary fund to a new investment vehicle—the continuation fund—managed by the same GP and set up in negotiation with secondary investors. We believe that GPs are increasingly turning to the secondary market to structure continuation funds because of several important benefits relative to traditional exit options (i.e., a sale to another private equity firm, an initial public offering or a sale to a strategic buyer):

- LPs in the primary fund can either cash out their current stakes or roll them into the new fund to extract additional value from select, high-conviction assets, allowing the individual LP to manage its specific duration and cash flow objectives.

- GPs get extra time and capital to create more value in some of their most successful portfolio companies. Historically, the best performers were often sold to competing private equity firms, often generating strong results for the acquirer. Today, rather than choosing to sell their best holdings, GPs are increasingly partnering with investors in the secondary market to create liquidity.

Secondaries: Key Benefits

In addition to providing the advantages noted above to legacy investors and a fund's GP, we believe that GP-led secondary transactions can be appealing to secondary investors for a variety of reasons. Broadly speaking, they can provide a competitive potential return profile combined with lower risk potential than traditional primary funds, driven by these characteristics:

- **Reduced execution risk.** Unlike primary funds that commit capital with limited visibility as to how it will ultimately be put to work, secondary partnerships can analyze a portfolio's existing holdings and make more informed investment decisions. The GPs that secondary investors partner with often have a deep, hands-on knowledge of the company, industry and management teams, given they already own the asset.
- **Shorter investment hold periods and quicker potential for the return of capital.** Secondary investors often access mature investments already held by GPs for some time and therefore may be closer to exit.
- **Greater diversification.** A secondary private equity fund might contain 50 to 100+ underlying holdings, compared with 10 to 20 in a primary fund.
- **Alignment of interests.** In more traditional funds, the seller is typically focused on maximizing price. In GP-led transactions, the seller is also a purchaser alongside limited partners, encouraging fair and transparent price discovery.
- **Limited leverage.** Portfolio companies within GP-led funds often have reduced leverage from previous levels, benefiting the new buyers.

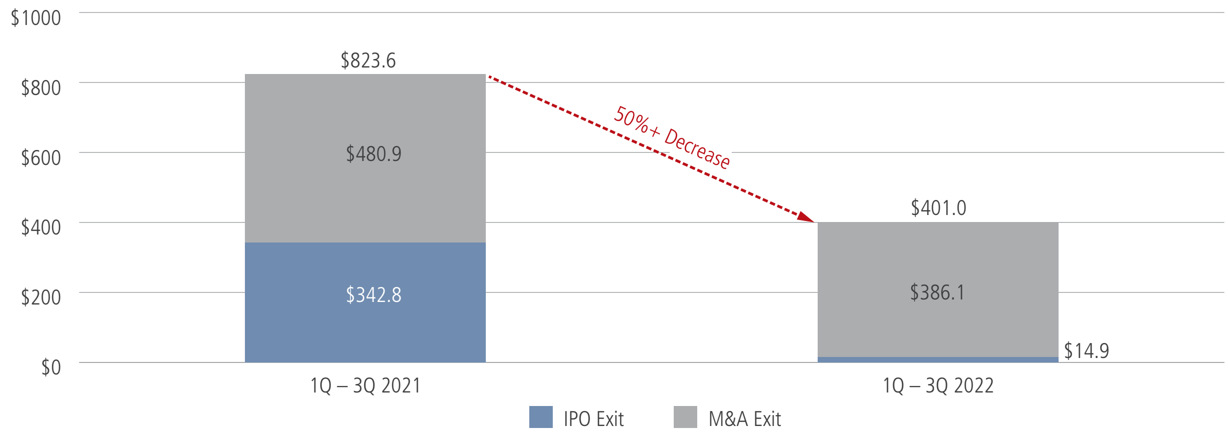
These risk-mitigating attributes may be particularly compelling in today's challenging investing environment. We believe we are also entering a compelling tactical opportunity in the space as the conditions for a buyer-friendly secondary market are taking shape.

A Buyer-Friendly Market

With that in mind, despite the rapid growth of GP-led transactions, we believe this market has plenty of additional runway as more GPs and LPs desire alternative liquidity solutions. We also believe current market conditions will likely accelerate the above-mentioned long-term growth trend and create even more attractive opportunities for experienced secondary investors as there remains a limited supply of capital to meet the increased demand for liquidity.

- **Fewer exit routes resulting in demand for liquidity.** The combination of private equity's strong performance in 2021 and the recent public market downturn has left many primary-fund LPs overallocated to private markets. Meanwhile, the economic headwinds—including persistent inflation, spiking interest rates and geopolitical turmoil—has limited off-ramps for many PE investors, resulting in an estimated 50% drop in private equity exits through Q3 2022 (see display on the next page). Continuation funds are helping GPs balance conflicting investor demand for liquidity and their desire for more value creation from portfolio investments.

EXIT PROCEEDS FOR GLOBAL PRIVATE EQUITY-BACKED ASSETS
($ Billions)



Source: PitchBook, as of Q3 2022. Exits reflect U.S. and Europe only.

- **Dearth of dry powder.** Slow fundraising by secondaries funds continues to lag the surging supply of assets.
- **Talent deficit.** Growth of the GP-led secondary market has outpaced the investment talent pool, in our view. New entrants to the GP-led market often need to hire staff that can take years to train.

As deal supply continues to outpace available capital, we believe experienced secondary investors will have a good chance to be highly selective in building attractive portfolios of high-quality assets managed by blue-chip GPs at reasonable valuations.

Making the Most of the Opportunity

In our view, market dynamics and the acceleration of GP-led secondaries deals are creating a meaningful opportunity for investors that can allow for the allocation of capital to private equity in a risk-managed framework. Secondaries generally have what we consider compelling attributes for investors interested in exposure to more mature private equity investments, resulting in earlier distributions and more clarity as to underlying company risk and opportunity. Still, the area can be complex, requiring meaningful expertise and experience from secondary managers to help capitalize on this important trend in private equity, as well as current scarcity of capital and market volatility.

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