50 SOUTH CAPITAL PRIVATE EQUITY
SECONDARY MARKET TRENDS

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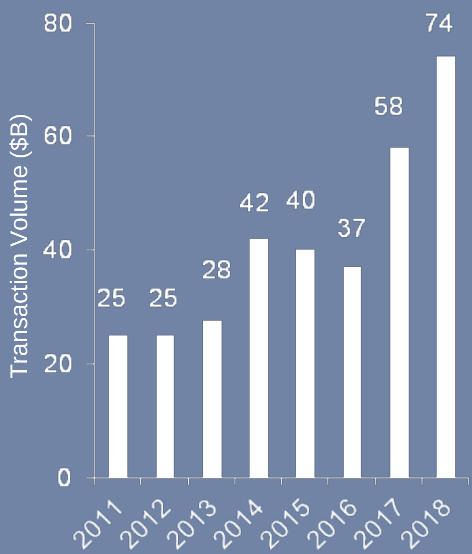
2019 PRIVATE EQUITY SECONDARY MARKET OUTLOOK

Over the last several decades, the secondary market has grown alongside the broader private equity industry and serves primarily as a solution for investors seeking liquidity on their private equity holdings. Today, it remains as one of the more esoteric, niche and opaque areas of private equity. As a result, we believe attractive return opportunities are available to secondary market participants that have the appropriate underwriting resources and structuring capabilities. Investors in many secondary funds have enjoyed outsized returns, with the median secondary fund returning a mid-teens net IRR since 1994 according to the Cambridge Associates benchmarks. Many sellers have also benefitted, as the secondary market provides investors with the opportunity to more actively manage their private equity portfolios, crystallize paper gains or dispose of underperforming funds[1].

From only $2 billion in global transaction volume in 2002 to $23 billion in 2010 and $58 billion in 2017, the secondary market has exhibited significant growth. 2018 set another record, with market volume growing to $74 billion[2]. Simultaneously, the availability of leverage and a strong fundraising environment have brought dry powder (inclusive of capital currently being raised) to an estimated $192 billion across secondary buyers, a little over two and a half years supply[3].

The secondary market today is characterized by many sellers demanding record-high pricing, buyers using ever more complex structures, general partners ("GPs") of private equity firms becoming more directly engaged in the secondary market, and many expressing concerns about being late in the market cycle. So what lies ahead for what has been one of the most niche, but strongest performing, segments of the private equity industry?

EXHIBIT 1 – SECONDARY MARKET TRANSACTION VOLUME (2012-2018)



Source: Greenhill, January 2019.

In this outlook piece, we explore five trends we believe will become increasingly important over the next several years, with potential implications for investors and other market participants.

Trend #1

Active portfolio management, not distressed selling, will continue to drive the growth of the secondary market.

In the early days of the secondary market, there was often a stigma associated with a Limited Partner ("LP") that wanted to sell an interest in a private equity fund. From both the perspective of the GP and LP, a secondary transaction was often seen as a relationship ending event. Either the GP viewed the LP as deeply distressed and not a viable investor in future funds, or the GP thought that the LP had lost faith in the GP's ability as a manager. As the secondary market has matured, perceptions have shifted, and this stigma has all but gone away. GP's are now becoming actively involved in the secondary process, and distressed sellers now represent a small portion of transaction volume. As noted in Evercore's 2018 Secondary Market Survey, distressed sellers represented only 1% of transaction volume, albeit in a strong macro-economic environment. Instead, active portfolio management of illiquid investments has been the driving force behind what was the second consecutive year of record deal volume.

2018 was marked by a number of sizable LP deals reflecting this trend, including a portfolio of nearly $2 billion sold by Alaska Permanent Fund, a $1.7 billion portfolio sold by Ontario Teachers' Pension, a $1.3 billion portfolio sold by the State of Maryland, and numerous others.

Additionally, and as discussed later in this outlook piece, GP led deals (restructurings, tenders, stapled transactions, etc.) are becoming a more meaningful component of the secondary market and contributing to these record volumes. High profile deals executed in 2018 include a $3 billion GP led deal executed by Nordic Capital in Europe, a $1 billion GP led deal involving TPG's Asia strategy, and many others. We expect the secondary market will continue to be utilized as a portfolio management tool by both LPs and GPs going forward.

Trend #2

The evaluation of private equity returns by LPs is becoming more sophisticated and the secondary market will play a key role in this evolution.

Private equity is an illiquid asset class and must generate returns in excess of more liquid public markets to justify investor interest (i.e. the illiquidity premium). Historically, private equity GPs have focused LPs on total equity dollars returned to investors divided by total equity dollars invested (variously known as ‘multiple of invested capital’ or ‘total value to paid-in capital’ or ‘cash on cash return’). However, while the return of a private equity investment may appear attractive from a multiple standpoint, this multiple cannot be evaluated in a vacuum (e.g. a 30 year bond with a 3% coupon represents 2.4x invested capital).

Other factors that take into account the time value of money, such as the duration of the investment and the opportunity cost of not pursuing other potential investments, need to be considered. A more sophisticated analysis of private equity performance should measure three key metrics – multiple of invested capital, internal rate of return (“IRR”) and a public market equivalent analysis (“PME”). Multiple of invested capital measures capital appreciation, IRR tracks how quickly invested capital is compounding and PME compares private equity returns to more liquid public market returns.

This more balanced approach to measuring private equity returns will impact both GPs and LPs, and will make the secondary market an increasingly important portfolio management tool. On the GP side, we see two emerging trends that we believe will continue to grow. First, the GP led component of the secondary market will provide optional liquidity to LPs that desire it, while simultaneously allowing GPs sufficient time to maximize exit proceeds. Second, GPs will utilize sophisticated secondary market tools such as fund level re-financings (i.e. taking a loan collateralized against all the companies in a private equity fund) and strip sales (i.e. partial sales of all the companies in a private equity fund) to crystallize gains.

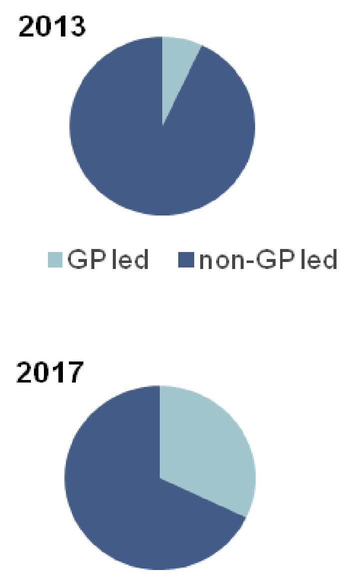
Similarly, on the LP side, we think LPs will be more active in both selling fund interests and recapping private equity portfolios with either debt or preferred equity. Thus, both GPs and LPs will be able to leverage the secondary market to make conscious trade-offs between multiple of invested capital and IRR. In particular, we believe LPs can no longer afford to be passive investors in the private equity asset class and must actively manage their illiquid portfolio as they seek to maximize returns.

Trend #3

The intermediary market will continue its expansion into GP advisory, as innovative structures and transactions continue to provide attractive liquidity options.

Our observation is that the vast majority of annual secondary transaction volume is intermediated. Secondary intermediaries typically fall within the confines of large and small investment banks, and are well positioned to identify both buyers and sellers of private equity interests and help facilitate transactions. As the secondary market and buyer demand have grown, the intermediary space has witnessed commensurate development. This growth has driven increased competition for sell-side mandates and has created fee compression for intermediaries. Simultaneously, GPs have become more engaged in the secondary market as intermediaries have shown how innovative structures and transactions with secondary funds can help generate liquidity, provide follow-on capital to assets in a GP's portfolio, and also raise primary capital. In 2018, 32% of the overall secondary market volume was GP led and we think 2019 will see continued expansion[4]. To put this in perspective, as recently as 2013 GP led volume accounted for less than 10% of overall market volume, and was virtually non-existent prior to 2011[5]. We think the trend of GPs being active in the secondary market will only continue to grow, and will provide potentially attractive investment opportunities for secondary funds given the menu of available tools GPs can utilize when tapping secondary capital, a number of which are briefly outlined below:

EXHIBIT 2
% GP LED VOLUME



Source: Greenhill, January 2019.

- **GP Tenders and Restructurings:** transactions designed to i) provide a liquidity option to LPs, ii) extend the fund term to optimize exit values, iii) provide follow-on capital, and / or iv) re-align GP/LP interests
- **Stapled Secondaries:** transactions structured to provide optional liquidity to existing investors while simultaneously providing primary capital to a GP
- **Strip Sales:** transactions structured to provide partial liquidity to LPs by selling down a portion of a GP's ownership across a portfolio of assets
- **Direct Secondaries:** transactions wherein a GP may sell all the remaining assets in a portfolio simultaneously to wind down a fund
- **Asset Sale & Continuation:** transactions wherein a GP may sell one or a number of assets from one vehicle to generate liquidity for existing LPs, and into a new vehicle financed by secondary capital therein enabling a GP to maintain control of the asset(s) for continued growth
- **Fund Level Financings and Preferred Equity:** transactions designed to i) provide growth or acquisition capital for one or more assets in a fund at a more attractive cost of capital than traditional equity, ii) provide rescue capital for underperforming assets, and / or iii) create DPI through a recapitalization at the fund level

Trend #4

The secondary market has created a "fourth exit option" for private equity firms, allowing general partners the opportunity to own assets for longer while still offering liquidity to investors.

Private equity funds are generally limited in their ability to hold even the strongest performing companies significantly beyond the life of their fund, due to both limited partner agreement restrictions and the desire from underlying investors to receive liquidity. Historically, a private equity firm looking to sell a performing asset generally has one of three options:

i) Sell the company to a financial sponsor (i.e., another private equity firm)
ii) Sell the company to a strategic corporate buyer
iii) Take the company public

The secondary market has created a fourth exit option, wherein a private equity firm can still achieve liquidity for its investors and wind down an older vehicle, while maintaining control of a performing company and continuing to grow the asset.

Secondary funds can provide the capital to buy a company out of an older fund and into a newly created vehicle that will still be managed by the same private equity firm, with a new fund term ranging typically from three to seven years. A number of transactions of this type occurred in 2018, notably a $1.9 billion vehicle raised by Lime Rock Partners to acquire its Permian Basin oil and gas producer, CrownRock, out of one of its older funds. Lime Rock was able to provide its investors a liquidity option while maintaining ownership of an attractive asset that they knew well. We think this trend will only continue in 2019 and beyond.

Trend #5

As the secondary market continues to evolve, specialization in niche strategies is leading to a wider spectrum of risk and return within the asset class.

While the largest funds in the secondary market are likely to continue to grow and remain multi-strategy, multi-sector and multi-geography, more recently a handful of secondary firms have raised pools of capital for highly niche strategies. By way of example, there has recently been significant capital raised to focus on strategies such as preferred equity, mature secondaries (i.e., older vintage funds), Asia, energy, infrastructure and real estate. This trend toward specialization is not dissimilar to the specialization that occurred in the primary private equity market. In the early days of private equity, most funds were sector agnostic, but as competition increased over time, specialization occurred such that sector and stage specific funds emerged both in buyouts and venture capital. In the secondary market, focused strategies will present different risk and return profiles versus diversified secondary funds. For example, a direct secondary focused strategy acquiring the equity of individual companies at a discount to book value offers a different risk and return profile than a fund focused on highly mature, cash flowing diversified pools of private equity fund interests. Secondary market investors will need to be cognizant of the risks to which they are being exposed when investing in specialized secondary funds.

These topics represent only a few of the trends we see happening across the private equity landscape, but there are undoubtedly many others. How the secondary market will evolve over the next several decades is uncertain, but we firmly believe that it will continue to be an increasingly important tool for private equity investors.

Footnotes:

1. Cambridge Associates, as of June 30, 2018, calculated as the average of the median performance of all secondary fund performance for vintage years 1994-2015.
2. Greenhill, January 2019.
3. Ibid.
4. Greenhill, January 2019.
5. Evercore, Q1 2014.

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