50 SOUTH CAPITAL PRIVATE EQUITY SECONDARY MARKET OBSERVATIONS:

Pockets of Opportunity in Volatile Times

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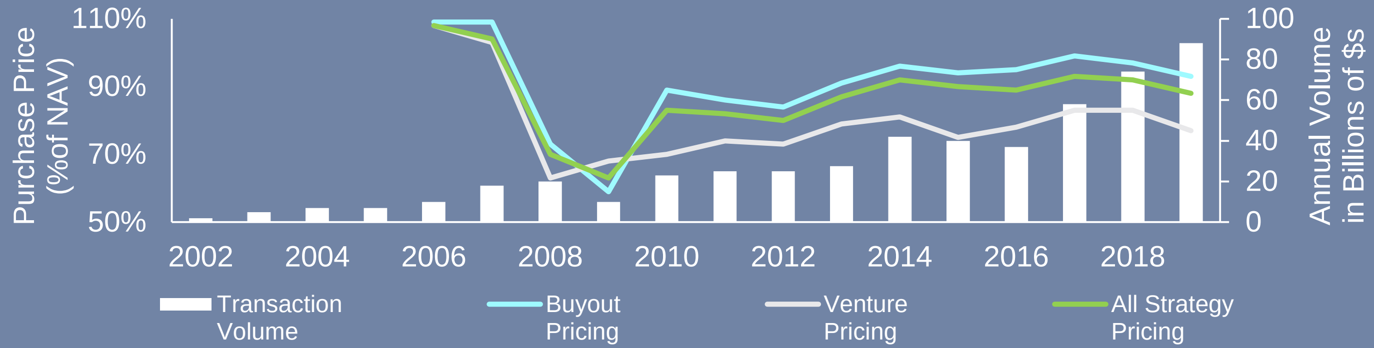
50 South Capital Advisors, LLC
50 South LaSalle Street
Chicago, Illinois 60603

50 SOUTH
CAPITAL

As COVID-19 spread across the globe, economies fell into sharp recessions and financial markets saw dramatic declines, although declines that have largely recovered as of the writing of this commentary piece. At present, while uncertainty remains high across financial markets, we see a number of attractive pockets of opportunity in the private equity secondary market.

We think: (i) the opportunity set for secondary buyers has grown and evolved dramatically since the last financial crisis; (ii) private equity investors now have more creative options to achieve both their liquidity and portfolio construction goals than ever before; and (iii) investors in secondary funds today should be cognizant of the risks to which they are being exposed, as all secondary funds are not created equal. In this commentary piece, we highlight five trends we expect to be of particular focus for buyers and sellers alike in the post-COVID-19 world.

Annual Secondary Market Transaction Volume and Pricing



Source: Campbell Lutyens Secondary Market Surveys

For context, 2019 marked another strong year of growth in the private equity secondary market, with deal volume eclipsing $88 billion – a 19% increase year over year – and more than 2011, 2012 and 2013 volume combined[1]. Numerous mega deals were completed last year, including the largest secondary transaction in history – a $5 billion private equity portfolio sold by Tokyo-based Norinchukin Bank. 2020 also appeared to be off to a strong start with a number of high profile single asset transactions coming to market, in addition to sizeable limited partner ("LP") portfolio trades that launched in late 2019.

COVID-19, however, has all but frozen the traditional secondary market, albeit temporarily. Buyers generally underwrite prospective investments with the most recently available quarterly financial information, often resulting in a three to six month lag between the valuation date and the transaction closing. During economic expansions and strong public equity markets, growth during this lag period typically accrues to the buyer. In contrast, the S&P 500 fell a staggering 34% in March and the leveraged loan market declined by more than 20%. This volatility, combined with secondary buyers still pricing deals based on September 30, 2019 valuations, created bid-ask spreads that were generally too wide to close new transactions[2]. Buyers that were already locked into purchase and sale agreements began to brace for what will likely be significant volatility in 2020. But groups with significant dry powder should be able to take advantage of an opportunity set that has both similarities and notable differences to that which was available over the course of, and in the years following the Great Financial Crisis ("GFC").

The GFC caused a dramatic decline in secondary pricing to 59% of net asset value ("NAV") for buyout fund limited partner ("LP") interests, as distressed investors were in need of liquidity, or institutional investors breached asset allocation targets as a result of the "denominator effect" (i.e., a decline in public equities driving an over-exposure to illiquid investments) and became forced sellers. Commensurately, secondary deal volume declined by 50% as those not forced to sell elected to maintain their private equity exposure, while underlying fund managers largely refrained from calling capital from LPs for new investments as they focused inwardly on managing their portfolio companies through the crisis[3].

The growth and evolution of the secondary market over the past ten years has created both a broad investment opportunity set for buyers and compelling liquidity options for private equity asset owners. In this commentary piece, we highlight five key trends that will create pockets of opportunity in the years to come.

Trend #1

Preferred equity will be an attractive alternative to outright asset sales for LPs with high quality private equity portfolios.

Preferred equity in the secondary market has become in vogue over the last several years. From being virtually non-existent a decade ago, preferred equity has grown into a market today in which a number of firms have raised $1 billion+ funds. For LPs, preferred equity can provide flexible capital that allows that LP to generate liquidity, collateralized by its illiquid assets, while retaining upside after a minimum preferred return to the preferred equity provider. This structure can be highly attractive as an alternative to an outright sale at depressed valuations, assuming the LP believes in the ultimate recovery and future growth of the underlying investments. Preferred equity can also be used by LPs seeking liquidity to meet their own capital call obligations.

While capital calls during the GFC were limited, substantial growth in the use of capital call facilities in recent years may present a different reality during the current market cycle. If an LP needs financing to meet unfunded obligations, preferred equity can be structured as a partnership between an LP and secondary buyer. The secondary buyer funds future capital calls in exchange for a negotiated sharing of future distributions generated by the private equity portfolio.

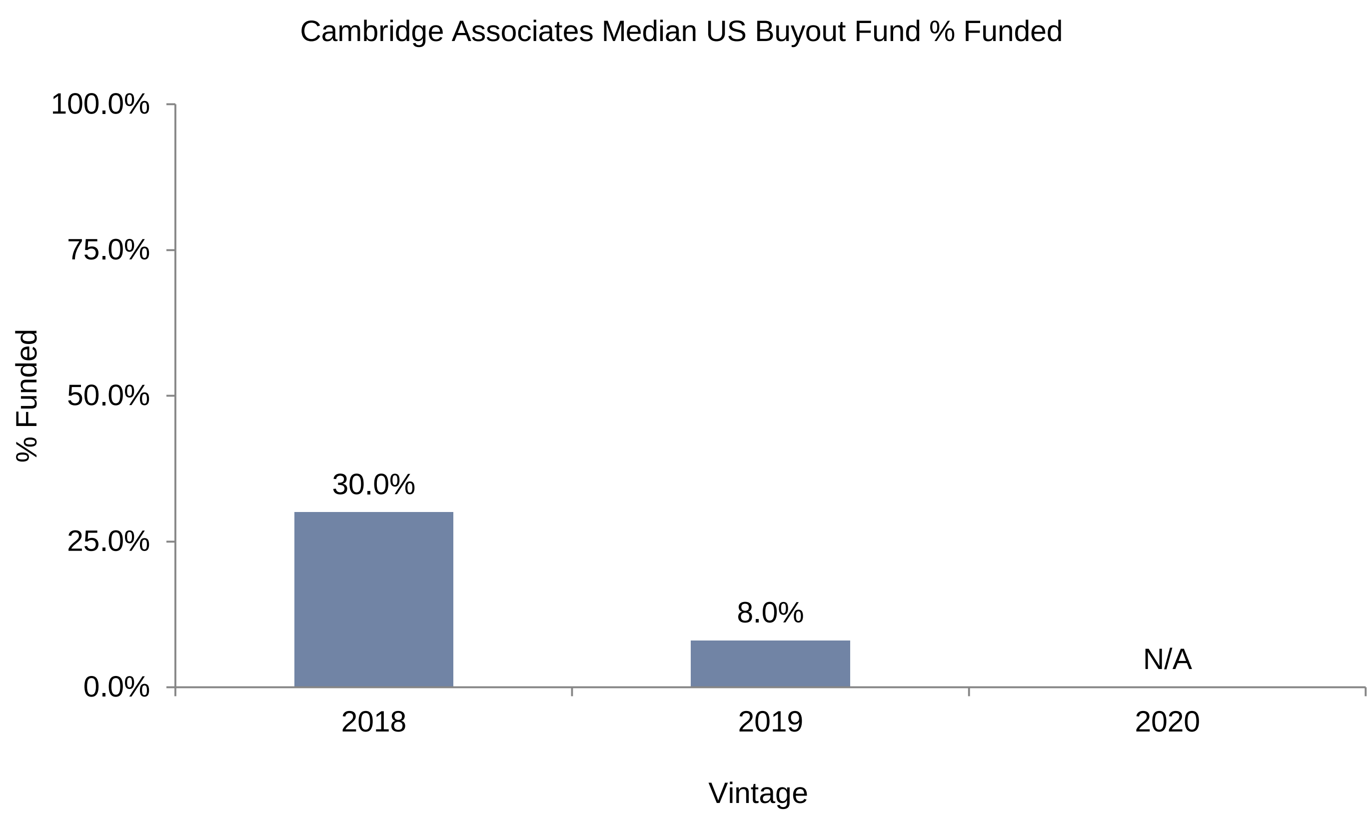
For private equity fund managers (“general partners” or “GPs”), fund level preferred equity can also be an attractive solution in the scenario where a fund is through its investment period and has limited or no remaining unfunded equity. Fund level preferred equity can be utilized to support portfolio companies, while providing more flexibility than traditional debt, and at a lower cost of capital than raising common equity.

Trend #2

The LP market will present attractive opportunities for buyers, but not yet (with one exception).

Prior to 2011, buying and selling LP interests represented almost the entirety of the secondary market. Today, given the advent of preferred equity solutions and wider institutional investor allocation ranges to various asset classes, only the most distressed sellers will likely accept discounts similar to what occurred over the course of the GFC. However, as investors have committed quite heavily to alternatives in recent years, we think there will be ample opportunities to acquire high quality fund interests at attractive pricing as LPs continue to actively manage and re-balance their portfolios in the coming quarters and years. As more information around valuation multiples and operating performance becomes available throughout 2020, the LP market should begin to re-emerge as bid-ask spreads narrow.

In the near term, we do see one pocket of opportunity in the LP market. That is, LPs in recent vintage funds (2018-2020) who may seek relief from significant unfunded commitments. Given a majority of the commitments to these vintage funds are not substantially drawn (see chart below[4]), sellers may accept a sizable discount on NAV given that their actual economic loss will be a small percentage of their total original commitment. Buyers may view unfunded capital as a positive to take advantage of what is expected to be a more attractive valuation environment to acquire companies in the coming years.



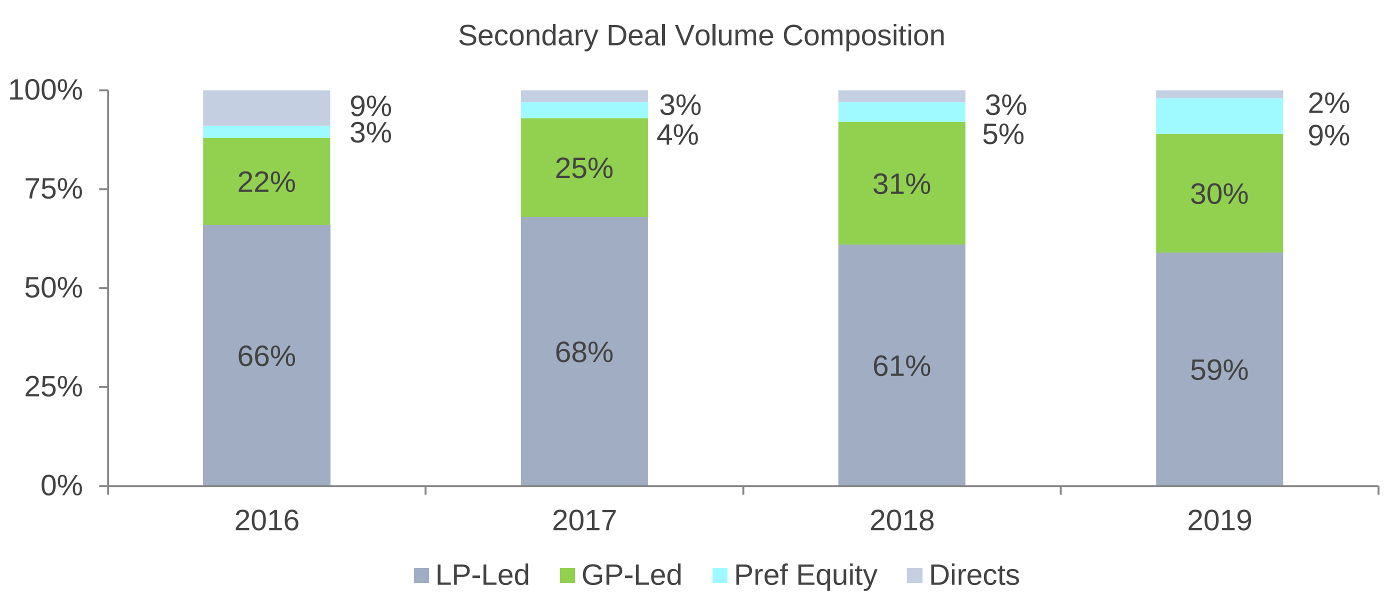
Source: Cambridge Associates Median US Buyout Benchmark as of 9/30/19

Trend #3

The growth in the GP-led market is not a fad, and will persist despite a temporary slowdown in 2020.

The GP-led market grew from a niche component of the secondary market to 30% of deal volume in 2019[5]. GP-led deals involve private equity fund managers coordinating a secondary transaction involving one or more of their existing funds or portfolio companies. These transactions come in a variety of structures ranging from restructurings of underperforming funds, to tender offers providing optional liquidity to LPs, to continuation vehicles to maintain ownership of marquee assets for longer, and numerous others. But a consistent theme is that GP-led deals are often concentrated in one or a few specific assets. These deals also demand a higher degree of diligence by secondary buyers than LP deals; often require large investor syndicates; and require asset level pricing that is amenable to existing investors, the GP and secondary investors. Notably, the GP-led market has evolved from smaller and often distressed managers tapping secondary capital, to today, where some of the most prominent GPs have accessed the market. In 2019, Warburg Pincus, TPG, Accel-KKR, NEA, and Blackstone all participated in the GP-led market, among many others.

Within the GP-led market, we think continuation vehicles will be particularly attractive solutions in the coming years for GPs. These transactions generate liquidity for one or more companies in an older fund, while enabling the GP to continue owning those assets in a new vehicle for an extended term, often with additional capital to be used for future growth. In a recessionary environment, with strategic buyers cash constrained and the IPO window tempered, continuation vehicles should present a compelling exit alternative. Fund tender offers may also experience a higher than typical seller take-up rate in the coming quarters. These transactions provide LPs with the option, but not the obligation, to sell their limited partnership interest(s) to secondary buyers. Because tenders have a “do nothing” or status quo option for LPs, the take-up rate to sell has historically been limited – 2019 tenders averaged only a 29% take-up rate[6]. In the current environment, we expect that more LPs feeling liquidity constrained will participate in these transactions. Finally, fund restructurings for private equity funds that experience significant losses as a result of the COVID-19 driven recession will need to be recapitalized in years to come. A key lesson learned by the secondary buyer universe that participated in restructurings of GFC-era funds is that GP quality and asset quality are both critically important. Secondary buyers will likely be more cautious about which GPs they engage with to finance recapitalizations of underperforming funds in the years to come.



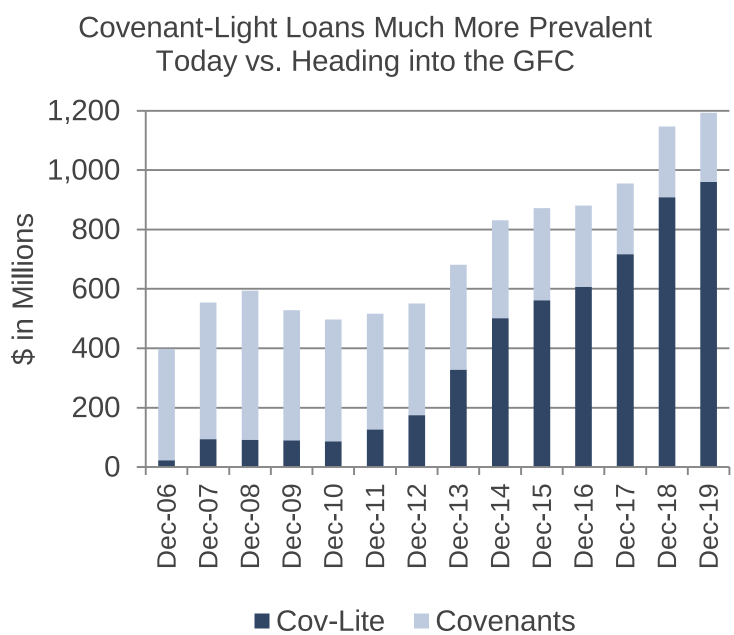
Source: Greenhill

Trend #4

Credit market dislocations will create opportunities for equity-like returns with significant downside protection, but buyers must be ready to act quickly and with conviction.

The leveraged loan markets, fueled by strong LBO activity and investor demand for yield in a prolonged low interest rate environment, have experienced remarkable growth since the GFC. As of April 2020, the U.S. leveraged credit markets represented nearly $1.2 trillion of par value, or approximately double the December 2008 amount of $594 billion. The rapid market expansion has caused some lenders to extend financing at more aggressive terms, leading to a gradual loosening in loan terms and credit quality over the past decade. Covenant-light deals represent approximately 82% of all leveraged loans outstanding today, and over 54% of borrowers are rated B/B- or worse[7]. We believe these structural differences, combined with current market conditions, have created a powder keg of potential market volatility and will offer opportunities to earn attractive risk adjusted returns not typically associated with the credit asset class.

As the COVID-19 crisis accelerated in March 2020, leveraged loan indices suffered the most rapid price dislocation in history. In an unprecedented move during a period of just three weeks spanning from February 28th to March 23rd, the S&P/LSTA Index fell from 97.3 to 75.4[8]. The selloff was indiscriminate and impacted borrowers seemingly regardless of credit quality or industry exposure. While the S&P/LSTA Index has since partially recovered to 90.4 as of June 15th, we believe there may be more volatility to come in the near term. Collateralized Loan Obligations ("CLOs"), the largest owners of leveraged loans, are closely managing their CCC rated exposures and could become forced sellers as rating agencies downgrade companies. Price levels for existing leveraged loans could also be further impacted by "Fallen Angels" – investment grade companies falling into the high yield markets.



Source: S&P LCD

Nimble secondary investors, either directly or in partnership specialist credit firms, will be able to capitalize on these dynamics in a number of ways. Credit opportunities funds, also known as "pull-to-par" strategies, can be deployed to purchase first lien leveraged loans at meaningful discounts to par value. Similarly, CLO liability and equity funds can purchase securities on the secondary market at attractive prices. These strategies generally have shorter investment horizons and offer the combined benefits of current interest income, price appreciation and the downside protection of senior secured credit. Investors must be ready to act quickly though as price dislocations and the associated buying opportunities can be very short. As the longer term financial damage caused by COVID-19 flows through the global economy, we also expect distressed credit managers to take advantage of attractive entry points into fundamentally sound businesses with over-leveraged balance sheets.

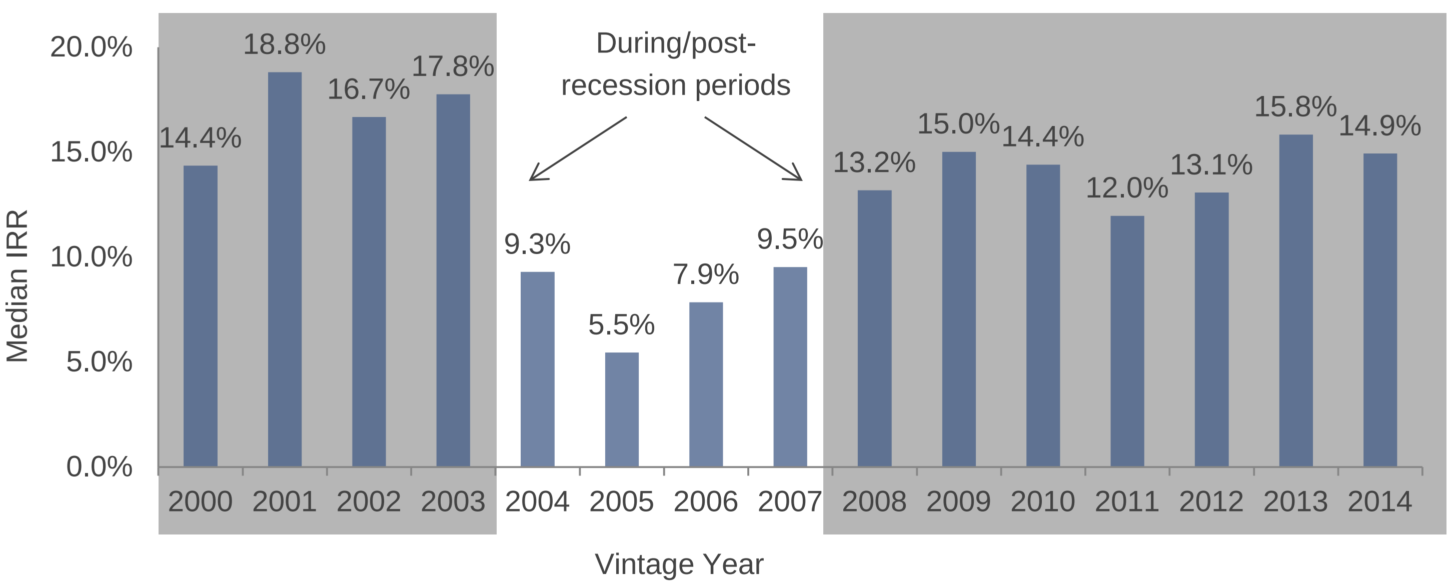
Trend #5

Specialization and leverage utilization across secondary funds will cause the benchmark returns for recent vintage funds to vary widely.

2005 and 2006 vintage secondary funds, those most exposed to the GFC, have generated a positive 5.5% and 7.9% median net IRR, respectively. Even bottom quartile 2005 and 2006 vintage funds still achieved positive 4.4% and 4.0% net IRRs, respectively[9]. Over the course of this cycle, however, we think the dispersion of returns will be significantly greater, including the possibility of bottom quartile performance being negative. The evolution and growth of the secondary market have also resulted in funds with highly niche strategies. While many secondary firms have maintained multi-strategy approaches, significant capital has been raised to focus exclusively on strategies such as tail-end secondaries (i.e., older vintage funds), direct secondaries (i.e., purchase of equity in individual companies directly from shareholders), GP-led transactions, Asia, energy, infrastructure and real estate. Each of these strategies offer significantly different risk and return profiles versus diversified secondary funds. With a few exceptions, secondary funds invested prior to the GFC were almost entirely focused on acquiring LP interests. Buyers were largely protected by both significant diversification across their portfolios and discounted entry points.

As the opportunity set for secondary buyers has evolved, so too has the risk and return profile for a given secondary fund. Secondary buyer appetite for acquisition leverage increased in recent years to both take advantage of historically low interest rates and to drive volume. In 2018, most financings had an loan-to-value of 40% or less, while in 2019, a majority of buyers surveyed reported using leverage as high as 50%[10]. While there have not been any material loan defaults in the history of the secondary market, these capital structures will be tested in the coming years. Prospective secondary investors also now need to determine whether historical secondary fund returns have been driven by leverage or deal selection.

Median Cambridge Secondary Benchmark Returns



Source: Cambridge Associates Secondary Funds returns as of 9/30/19

In summary, we think: (i) the opportunity set for secondary buyers has grown and evolved dramatically since the last financial crisis; (ii) private equity investors now have more creative options to achieve both their liquidity and portfolio construction goals than ever before; and (iii) investors in secondary funds today should be cognizant of the risks to which they are being exposed, as all secondary funds are not created equal.

Footnotes:

1. Greenhill – Global Secondary Market Trends & Outlook, Jan. 2020
2. Leveraged loan market measured by the LCP 100
3. Greenhill
4. Cambridge Associates Median US Buyout Fund as of 9/30/19
5. Campbell Lutyens Secondary Market Surveys 2016-2019
6. Evercore 2019 Secondary Survey
7. S&P LCD Index Factsheet as of April 30, 2020
8. S&P LCD U.S. Leveraged Loan Index as of June 15, 2020
9. Cambridge Associates, as of September 30, 2019
10. Campbell Lutyens 2020 Secondary Market Survey

For more information, please contact the
50 South Capital Strategic Opportunities Team:

Adam Freda
adam.freda@50southcapital.ntrs.com

Nick Lawler
nick.lawler@50southcapital.ntrs.com

Chip Davis
chip.davis@50southcapital.ntrs.com

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