STATE *of the* MARKET 2020

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IX

Apples and Oranges: Comparing Strategies in the Secondary Market 2.0

by Charles Smith, Glendower Capital

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INTRODUCTION

We are now firmly in the Secondary Market 2.0 — a larger and more complex marketplace than the secondary market of old. Deal volume continues to break records year after year, with market participants expecting over $100 billion for 2019. This growth is no longer driven only by reactive LPs responding to regulatory changes, CIO pressures, or simply active portfolio management. Today, GPs themselves have become important contributors to the current record levels of deal flow, generating an ever-growing share of it. The emergence of 'GP-led' deals has also widened the scope and complexity of the market, providing an umbrella for new transaction types and investment strategies. In its simplest form, a GP-led transaction sees a fund manager approach the secondary market to offer a liquidity option to existing LPs in a fund; this is done by transferring some or all of the remaining assets in that fund to a new vehicle which is capitalised by a new investor base yet continues to be managed by the same GP. Of particular note are transactions providing exposure to one portfolio company alone, or 'single-asset' deals, which are also GP-led in essence. These have now become commonplace, as private equity managers add a recapitalisation to their standard exit toolkit alongside an IPO or trade sale.

With this development of the market, secondary firms have sought to differentiate themselves by specialising in different types of transactions. One axis of differentiation is the level of focus on these rapidly growing areas of GP-led and single-asset transactions, which offer the prospect of higher returns than traditional LP secondary deals. This specialism in different types of transactions has implications both for the risk-return characteristics of a fund, and for the cashflow and performance profiles, which have traditionally been a key attraction of secondary funds for investors.

There has never been a more exciting environment for investors considering investing in secondary private equity, but nor has there ever been a greater need to understand a secondary manager's underlying investment strategy and target transaction types.

TYPES OF SECONDARY TRANSACTION

Today, we see three broad categories of secondary transaction:

(a) LP secondary deals

The traditional purchase of an LP interest in an existing fund is the 'bread and butter' transaction of the secondary market. The purchase of a diversified portfolio of mature funds results in a steady stream of cashflows starting immediately after the purchase of the LP interests.

(b) GP-led deals

An increasing proportion (now 30-40%) of the secondary market is accounted for by GP-led transactions. These transactions typically involve the purchase of a number of assets — often the last assets in a fund — in order for the GP to accelerate the return of capital to its investors, with the incumbent GP continuing to manage the assets on behalf of the secondary investor.

This approach enables a secondary fund to get more concentrated exposure to a group of assets and to do deeper levels of due diligence than would be typical for an LP secondary deal, and also to underwrite to higher returns. However, the cash return profile is uneven, or 'lumpy', and returns tend to be more delayed, as any assets close to realisation will often be excluded from the secondary sale portfolio.

GP-led transactions also require considerably greater transactional expertise involving extensive due diligence, fund formation, M&A processes, structuring, and an understanding of the true alignment and incentives of the manager.

(c) Single-asset deals

One extreme form of GP-led deal is the single-asset deal, which is essentially a GP-led transaction involving one underlying asset. Obviously, this results in the most concentrated portfolio and the lumpiest cashflow profile.

SECONDARY FUND PORTFOLIO CONSTRUCTION AND RETURNS

Secondary managers building portfolios need to consider how they wish to deploy their capital amongst these three deal types, and the implications this has for the return profile they can deliver to their investors.

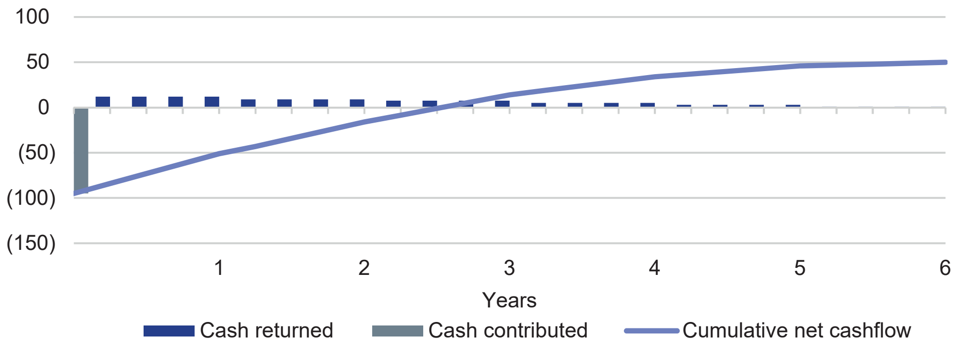
We consider three types of secondary funds:

(a) LP secondaries only — a fund which only invests in LP secondary deals;
(b) GP-led only — a fund which only invests in GP-led (80%) and single-asset (20%) deals;
(c) Diversified — a fund which invests in all three of the above deal types, with an allocation of 50% LP secondary purchases, 40% GP-led, and 10% single-asset deals.

In each case, we have modelled a fund which commits its capital evenly over a three-year period, reaching a total drawn down of 90%, with a 1.25% fee and 12.5% carried interest, which are typical for secondary funds.

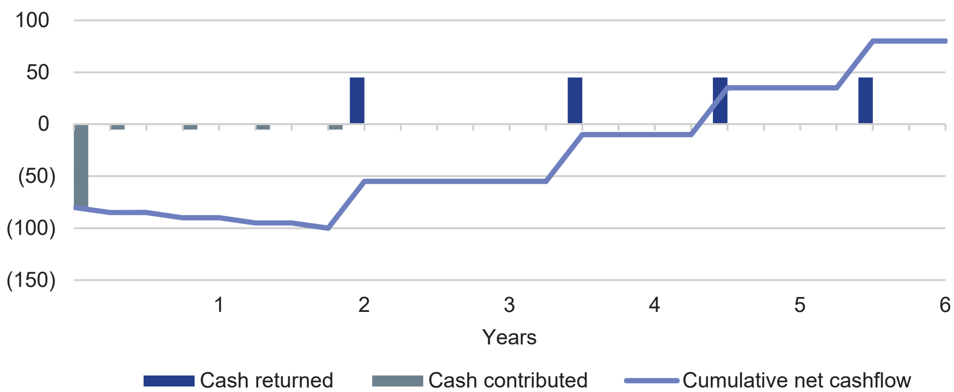
The three fund strategies result in somewhat different cashflow and return metrics. In particular, we see distinct differences in how these metrics evolve over the life of the fund.

Figure 1: LP secondary deals

Key features	Cashflow profile
▪ Acquisition of a portfolio of mature private equity funds ▪ Assumed returns: ▸ TVPI of 1.5x ▸ IRR of 24% ▪ Few drawdowns after purchase ▪ Discount at purchase providing immediate write-up	

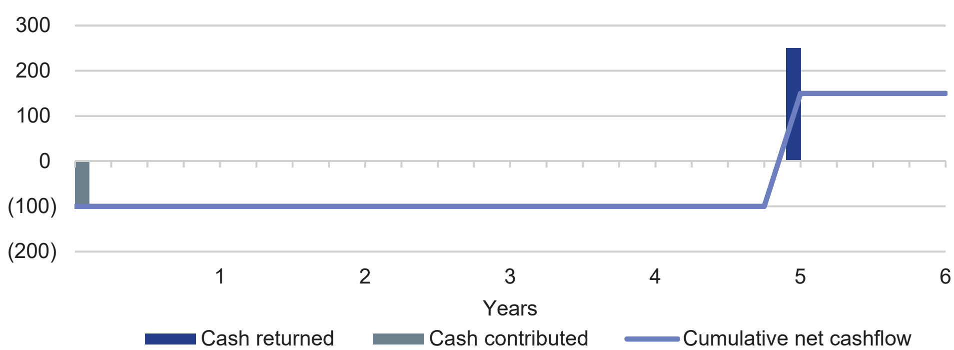
Source: Glendower Capital.

Figure 2: GP-led deals

Key features	Cashflow profile
▪ Acquisition of a number of private equity assets, usually in a single fund structure managed by the existing GP ▪ Assumed returns: ▸ TVPI of 2.25x ▸ IRR of 23% ▪ Lumpy cashflow profile due to fewer underlying assets ▪ Deals typically occurring at +/-10% of NAV	

Source: Glendower Capital.

Figure 3: Single-asset deals

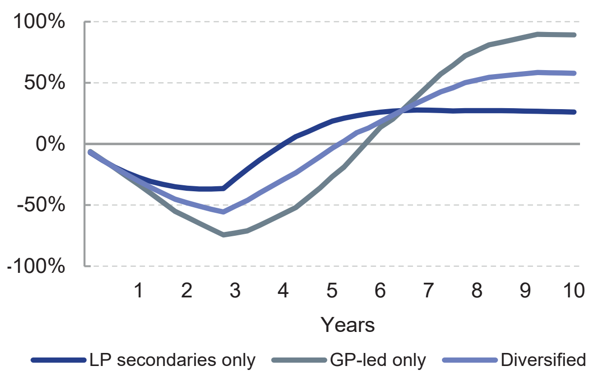
Key features	Cashflow profile
▪ Acquisition of a single asset managed by the existing GP ▪ Assumed returns: ▸ TVPI of 2.5x ▸ IRR 20% ▪ Generally only two cashflows: one contribution upon purchase and one receipt upon sale ▪ Deals typically occur at +/-10% of NAV	

Source: Glendower Capital.

(a) Cashflows

The 'LP secondaries only' fund has a much shallower cashflow curve, as the rapid return of distributions (even during the investment period) means that by the time the fund reaches peak net deployment by the end of year 3, it has already returned considerable cash, such that the net out-of-pocket amount peaks at less than 40% of the fund size. Such a fund achieves cash breakeven, or a 1.0x DPI, towards the end of year 4, and an eventual net multiple to investors of 1.3-1.4x.

Figure 4: Net cashflow as % of fund size

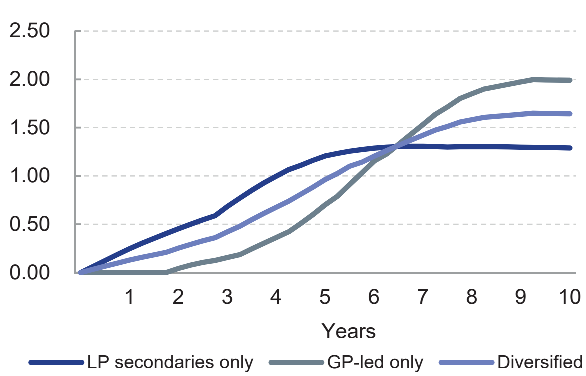


Source: Glendower Capital.

Conversely, the 'GP-led only' fund does not receive such strong early cashflows, so the cashflow curve is deeper, with the net out-of-pocket amount peaking at 70-80% and cashflow breaking even in year 6. However, the final multiple — at around 2.0x — is higher, due to the longer average hold period of this fund's assets.

Unsurprisingly, the 'diversified' fund lies somewhere in the middle, with net out-of-pocket peaking at 50-60%, cash payback around the end of year 5, and a final multiple of 1.6-1.7x.

Figure 5: DPI

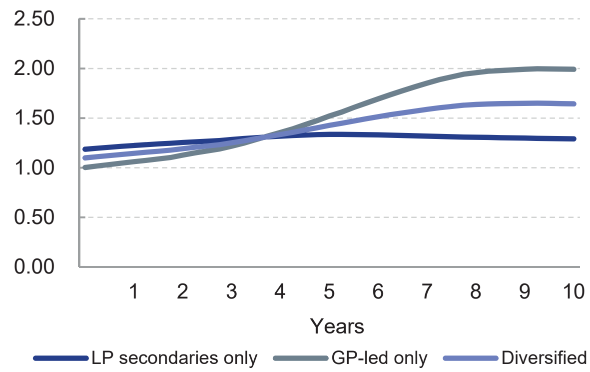


Source: Glendower Capital.

(b) Returns

The key performance metrics, total value to paid-in (TVPI) and internal rate of return (IRR), also develop differently for the different types of fund. Because (a) LP secondary transactions typically occur at a discount to the reported NAV and (b) secondary funds then write up the acquired assets to reported NAV, funds focusing on these deals benefit from an initial boost in multiple

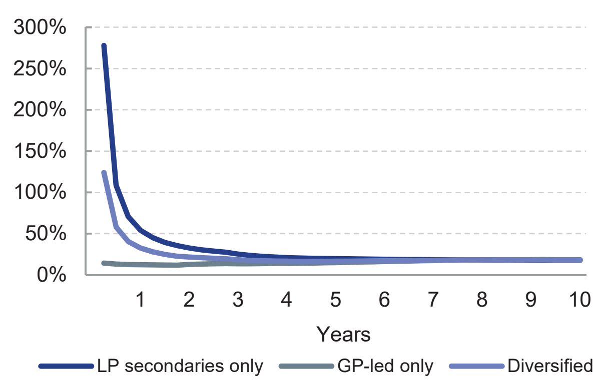
Figure 6: TVPI



Source: Glendower Capital.

and very high initial IRRs. For the 'LP secondaries only' fund this means that the reported TVPI remains fairly flat over the fund life, whilst reported IRR declines from its initial high levels. The 'GP-led only' fund has a profile much more similar to a direct buy-out fund, with both TVPI and IRR developing over time. The 'diversified' fund again lies somewhere between the two, but bears many of the high-level characteristics of the 'LP secondaries only' fund.

Figure 7: IRR



Source: Glendower Capital.

CONCLUSIONS

Many investors in secondary funds have often been attracted by the rapid deployment and return of capital exhibited by traditional secondary funds, which have generally focused on LP secondary transactions.

The development of new varieties of secondary transactions and the evolving strategies of secondary fund managers are having a major impact on their ability to deliver those historically characteristic cashflow profiles. They have also made it very difficult to compare the performance of different managers during the life of their funds unless their strategies are clearly understood.

Additionally, secondary fund performance is impacted by other decisions made by fund managers regarding, for example, the use of deal structuring or leverage, the extent of recycling of proceeds used, and the use of subscription financing lines. These tactical decisions by secondary managers impact both the risk–return characteristics of the fund and how its performance metrics develop over its lifetime.

Commitments to secondary private equity funds fit neatly into an investment programme, and investors choose the secondary market for a variety of reasons: different risk-return profiles, earlier cashflows, diversification across vintages, or J-curve mitigation. Before making any commitments, however, investors should be clear about their goals and make sure that their manager's strategy is well suited to achieve them.