Primary focus on the secondary market

GPs and LPs tap surging private equity market as portfolio management tool

2019

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A surging PE secondary market creates a powerful portfolio management tool

Private equity (PE) general partners (GPs) and limited partners (LPs) are increasingly leveraging the PE secondary market as a multiuse portfolio management tool in a way that not long ago simply did not exist.

Whether the aim is to provide quicker liquidity, an avenue to rebalance a fund, realize healthy risk-adjusted returns, opportunities for diversification, or other purposes, the secondary market is surging—and more of the same is expected in 2019.

In the 2013–2018 period, annual deal volume **(see Figure 1)** in the secondary market has grown 163 percent, from $28 billion to $74 billion, and has produced a compounded annual growth rate of 21 percent.[1] KPMG and and other industry participants expect deal volume in 2019 to increase by at least 25 percent, compared to the 2018 level.

As an indicator of the evolution of the secondary market, one needs to look no further than the size of secondary transactions over time. The average deal size of a secondary transaction in 2018 was $250 million,[2] more than two times the size of an average deal just prior to the financial crisis of 2008.

PE secondary market deal volume ($B)

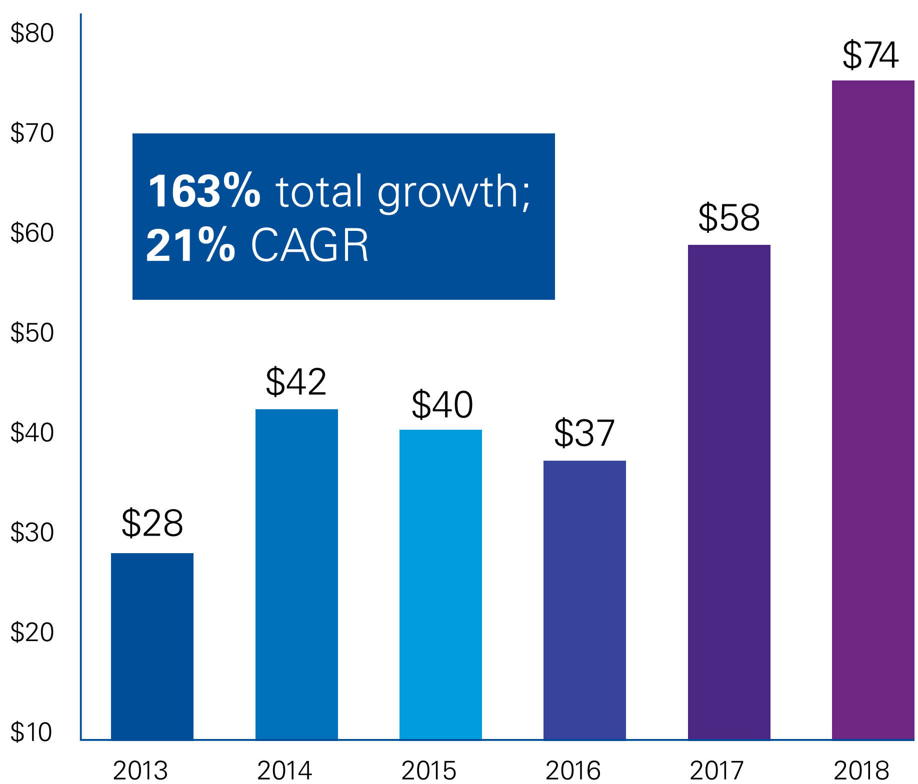

Figure 1: PE secondary market deal volume
(Greenhill & Co LLC)

[1] "Global Secondary Market Trends & Outlook," Greenhill & Co. LLC, January 2019 (used with permission)

[2] "From Niche to Normal: The Global Secondaries Market Commands Attention," PitchBook, October 2, 2018

The attraction of the secondary market

Unlike committing to a blind pool of capital at the inception of a private equity fund and subsequently relying upon the skills of a portfolio management team to make sound investment decisions, "a secondary investment allows for the ability to evaluate and commit capital to a more mature investment portfolio," says James Suglia, KPMG's National Practice Leader—Alternative Investments.

In general, secondaries are transacted between four and nine years into a fund's lifecycle, which provides the secondary buyer the ability to research prior to committing capital.

This inherent advantage of looking under the hood lends itself to mitigating the risk of committing capital to a portfolio of nonperforming investments, and it provides critical insight into how and when capital will be returned.

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>
> **— James Suglia**
> KPMG's National Practice Leader – Alternative Investments

The secondary strategy's impact on the J Curve

As secondary interests are generally purchased at a discount to net asset value (NAV), the ability to generate timely cash inflows increases. Known as the J Curve effect, newly launched private equity funds experience a period of negative cash flows during the initial investment period as capital is deployed to early-stage investments without receiving distribution inflows **(see Figure 2).**

By their nature, secondaries mitigate the J Curve impact by transacting at a later stage in the fund's lifecycle, accelerating the time it takes to return invested capital and reduce capital at risk. A study performed by Cambridge Associates revealed that on average, secondary funds take 6.6 years to achieve a 1.0X realization multiple (calculated as a measure of cumulative investment returned relative to invested capital) as compared to 7.8 years for the broader private equity market.[3]

The private equity J-curve

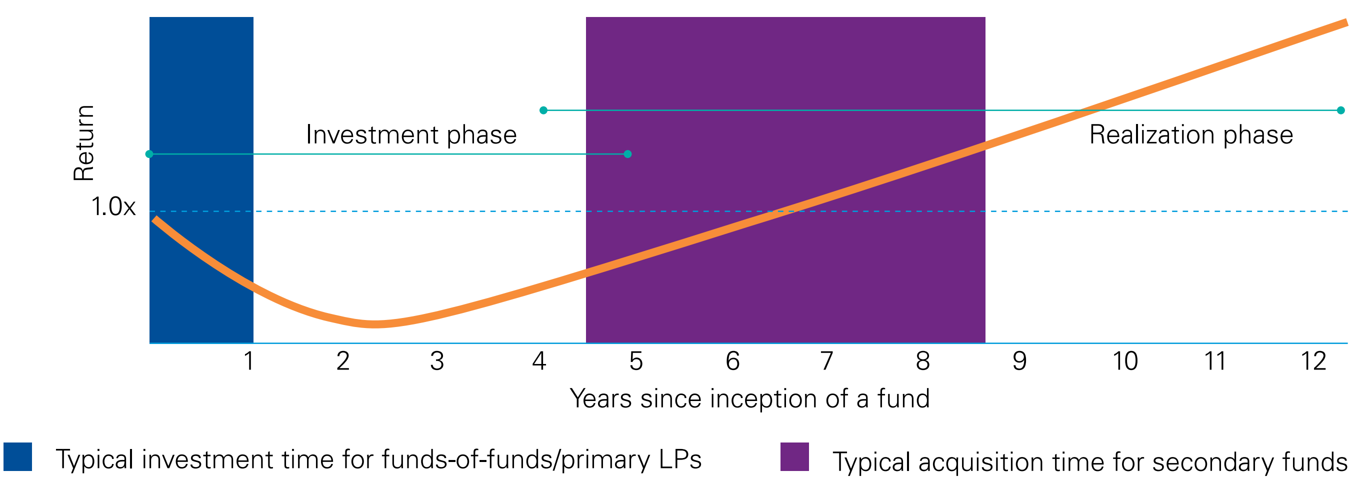


Figure 2: Source: "The Private Equity Secondary Market," Coller Capital (used with permission)

[3] "When Secondaries Come First," Cambridge Associates, November 2017

The evolving secondary market

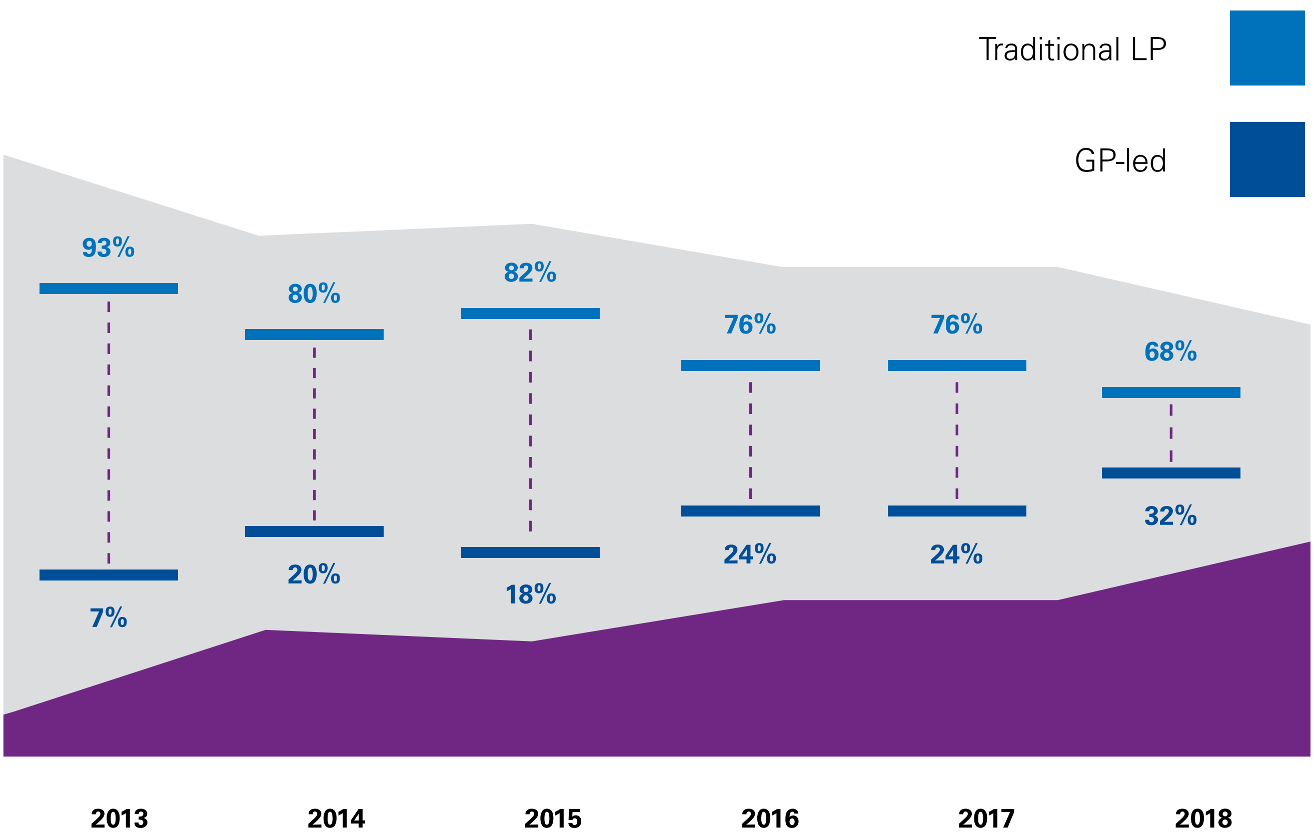
Originating from a way for LPs to cash out of funds that had exceeded their 10-year lifecycle, the number of GP-led transactions has increased significantly in the past six years, providing a mechanism to package late-stage portfolio investments for sale in the secondary market. This current activity is a marked departure from traditional LP-led transactions to an evolution led by GPs that effectively are creating an entirely new—and trusted—asset class.

We view GP-led secondary-market transactions as an opportunity for LPs to more quickly cash-out or roll investments into new fund structures to capitalize on the upside of portfolio investments that have not yet matured into their full potential. For some, cashing out and adding to dry powder may be a prime strategy driver.

GPs, we believe, also can realize several significant benefits in utilizing the GP-led strategy by:

- Fulfilling a GP's fiduciary duty to satisfy the interests of the LPs (and liquidate mature funds)
- Creating time and space to launch new funds
- Recapitalizing the existing fund to amend management fees, carried interest, and governance terms.

According to investment bank Greenhill & Co., GP-led transactions comprised 32 percent of all secondary transaction deals during 2018 **(see Figure 3)**, accounting for approximately $24 billion in deal value. The 2018 GP-led volume represents a 71 percent increase as compared to 2017, which at the time was a record high in total GP-led transactions.[4]



[4] "Global Secondary Market Trends & Outlook," Greenhill & Co. LLC, January 2019 (used with permission)

With volume comes transparency… and pricing impacts

A contributing factor to the rise of the GP-led transaction in recent years is the increase in secondary players entering the market.

As secondary market entrants crowd the field of potential buyers, a more efficient market has emerged, allowing for greater transparency into the auction process. The effects of a more efficient market translate into increased pressure on pricing and portfolio returns.

These market dynamics have helped pave the way for innovative offerings, such as GP-led transactions, to emerge in a less-efficient area of the secondary market. GP-led transactions present a unique set of challenges and requires resources with a sophisticated skill-set that certain new market entrants do not possess.

Aligning the interests of GPs and LPs; negotiating pricing; restructuring fund terms; and navigating legal, tax, and accounting matters are all heavy lifts that make these transactions labor intensive and create barriers to executing a successful deal.

As the objectives to create liquidity and generate value intersect with a good-faith solution offered to LPs, we expect GP-led transactions will continue to experience growth for years to come. Further, we believe LPs will continue to embrace this strategy if they believe the deal terms are fair, transparent, and provide an option to maintain status quo, exit, or roll into the newly capitalized fund.

"GP-led secondaries are expected to be adopted by top-tier private equity firms as an embedded investment strategy within a fund's governance documents," says Glen Benson, a KPMG Audit partner serving the investment management industry.

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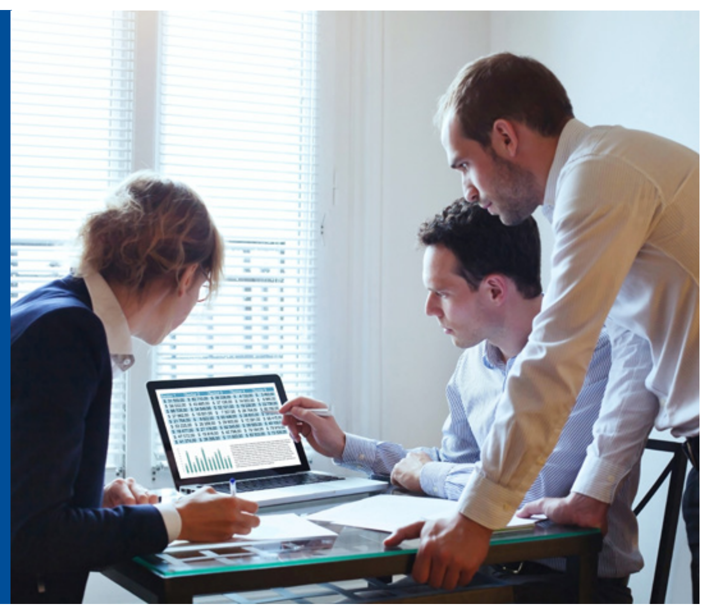
KPMG Audit Partner



3 P's to a successful GP-led transaction

While no deal is the same, and each presents its own set of challenges, we subscribe to the notion that the keys to a successful deal lie in three Ps: People, Product, and Price. A successful GP-led transaction will require the threading of a needle to create a win-win-win scenario for the GP, existing LPs, and the secondary buyer.

1 | People

The cornerstone to any successful transaction, we believe, must include parties that are well-intentioned, transparent, talented, and share common goals.

The interests of the GPs (financial or otherwise) must be aligned with those of the LPs if any deal is to be made. Oftentimes, the motivation of the GP will be a key indicator in determining goodwill intentions: Is there a groundswell of support by LPs to create a liquidity event, lock in current gains, and bring new products to the market? Or is the GP going through personal strife and looking to the secondary market to create a personal liquidity event?

Increasingly, LPs want a seat at the table and have their voice heard—not being force fed deal terms after-the-fact that are inconsistent with the initial investment thesis or heavily favor the GP's interest.

In almost all transactions, once the seeds of discord are sown and the perceived (or actual) lack of transparency sets in, the likelihood of deal consummation plummets.

Similarly, the good intentions of the secondary buyer with a reasonable entry price to the transaction is of equal importance, as no two parties can exist without the other. Up-front planning, communication, and coordinated transparency will go a long way in solidifying the win-win-win scenario needed to close the deal.

2 | Product

As a prerequisite to pricing any transaction, deal teams wrestle with the age-old question of "what are we getting ourselves into?" GP-led transactions involve exhaustive due diligence to not only evaluate the basket of portfolio investments included in the deal (giving proportionate weightings to home-run investments as well as underperformers that come along for the ride), but also to evaluate what lies beneath.

Significant legal, pass-through tax consequences and operational challenges may exist within the fund's governance structure that can prove to be significant hurdles in negotiating deal terms. The navigation of these obstacles will require the identification of prenegotiated terms of the primary fund and their impact on the new fund structure.

In recent years, Securities and Exchange Commission (SEC) oversight has increased as the secondary market has expanded its footprint within the PE world. Recent regulatory actions brought forward by the SEC have cited certain conflict-of-interest issues regarding the terms of certain GP-led deals, particularly in the valuation of portfolio investments.

GPs have a fiduciary responsibility to ensure that the LPs are not disenfranchised by the terms of the deal and the SEC is taking note. This oversight trend will continue as the secondary market gains greater market share and GP-led transactions continue to be an integral component of the secondary market. Selecting a team of professionals with the requisite skill-set is of paramount importance—know what you don't know.

3 | Price

Arguably the most important aspect of a secondary transaction, pricing has evolved much in the way the secondary market has evolved. According to multiple studies of postcrisis pricing for secondary transactions, there has been a steady increase in NAV pricing in the past 10 years, from about 70 percent of NAV to slightly more than 90 percent, a pricing trend that provides strong evidence of the popularity of the strategy and deals transacting in newer fund vintages at smaller discounts to NAV.

The parallel between price and vintage is a key indicator in the ongoing evolution of the secondary market and its ability to innovate new product offerings.

As the economy clawed its way out of the financial crisis, the utility of the secondary transaction evolved from one of mainly providing liquidity (transacting in older vintages), to a "vintage-agnostic" asset class used to seek out deals that generate the highest returns, a direct result of its continued acceptance.

Today, both LP-led and GP-led transactions are occurring with greater frequency in newer fund vintages at smaller discounts to NAV, even premiums to NAVs where substantial upside return is projected.

It should be noted that qualitative aspects surrounding seller/buyer motivation, complexity, management team quality, and information transparency, among other aspects, are of equal importance to the quantitative valuation metrics.

No matter the upward or downward pressures placed on price, the common thread among all deals is the ability to negotiate equitable pricing terms between the GP, LPs, and the secondary buyer if there is any chance of achieving the win-win-win scenario and ensuring deal success.

How KPMG can help

By maintaining relentless focus on quality and outstanding service, and a passionate focus on you and your business, our skilled, experienced professionals can:

— Anticipate new challenges and opportunities in light of economic, market, regulatory, and technological developments.

— Offer deep insights into your business and provide innovative options and customized strategies that allow you to respond to opportunities with speed and agility.

— Utilize KPMG's global, multidisciplinary resources and coordinate them into broad solutions that address your needs.

— Share leading practices gleaned from working across a variety of relevant industries.

— Offer leading networks of finance and transaction professionals who bring specific industry knowledge and experience to each engagement.

— Provide restructuring and operational efficiencies that focus on value enhancement and performance improvement resulting in added value.

— Perform highly tailored financial statement assurance services and annual tax compliance and tax return preparation.

Fund life cycle

Fund structuring

— Investor structuring and liaison

— Management structure

— Carried interest and remuneration planning

— GAAP analysis

— Track record

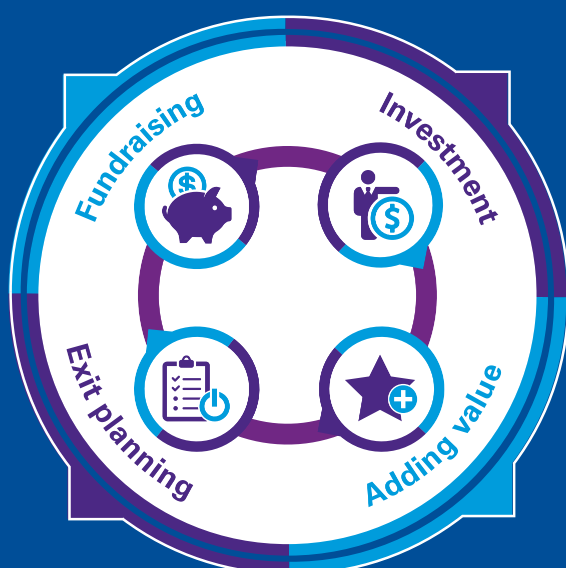
Investment planning

— Target identification

— Deal advisory

— Tax advantage structuring

— Due diligence competitive advantage



Divestiture

— GP allocation modelling

— Sell-side services

— Vendor due diligence

— Complex transaction structuring

— IPO readiness

— Pass-through tax modeling (IRC Sec 754 election)

Portfolio and fund operations

— CFO advisory

— Strategy

— Data and analytics

— Fund reporting

— Working capital optimization

— Transformation

— Cyber security

— SEC reporting

— Portfolio valuation

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