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The rise of private equity secondaries financings

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Summary

The use of leverage by secondary fund managers to finance secondary transactions is not a new phenomenon. The last few years have seen a significant growth in the number of secondaries transactions supported by debt finance, the number of secondary fund managers using debt as a liquidity and portfolio management tool, and the overall complexity and variations in the facilities themselves. Like other types of fund finance products, these facilities are private and confidential in nature and therefore there is little publicly available data on the volume/size of the market.

However, based on our experience, we estimate that the size of this market in 2018 exceeded \$20bn – a \$5bn increase from last year, driven principally by a number of large portfolio sales, managers raising \$1bn+ funds, and an increasing number of facilities supporting GP-led fund restructurings. The majority of large private equity secondary acquisitions now invariably rely on some form of debt financing, and we are seeing a considerable uptick in other types of secondary transactions supported in this way. Whilst \$20bn may seem small compared to the estimated size of the global fund finance market as a whole, this figure represents a significantly larger percentage of total capital raised by secondary funds (over \$26bn by the end of Q3 in 2018 (albeit representing a near 40% drop on the record amount of capital raised for the same period in Q3 2017)) than global fund finance as a percentage of private capital raised globally.

As of November 2018, the average fund size reached almost \$843m, as once again a group of larger managers continued to dominate this space with echoes of the primary market, with annual volume on track to reach an estimated \$80bn. 2018 also saw some of the largest secondary funds ever raised and Europe's largest general partner (GP)-led secondaries transaction (with GP-led transactions accounting for more than a quarter of the \$27bn deal value in H1 2018), and 2019 shows no sign of slowing down. We have continued to see expansion of the list of primary managers using the secondaries market to implement GP-led restructurings and stapled deals on their funds, and we are increasingly seeing large-scale asset-holders such as insurance companies and pension funds take advantage of the liquidity the secondaries market can provide.

In 2016 and 2017, the largest debt financing transactions were in relation to the sales of large, diverse portfolios of limited partner (LP) interests. Purchasers able to bid on all, or a material portion, of the portfolio would typically have a stronger bargaining position with the seller, and would win over other bidders, who may have bid higher prices, but only in

relation to a portion of the target portfolio. This was particularly important for sellers prioritising certainty of execution and timing in respect of the sales process, as opposed to price maximisation for each portfolio component. This drove larger transactions which, in turn, drove a greater need for debt financing, as smaller funds were forced to bid on the entire portfolio in order to have a chance of winning a tender process.

This dynamic appears to be driving bifurcation within the secondaries market. The largest funds, which have the most capital and perhaps also the greatest time pressure to deploy funds, compete for large portfolios against medium-sized funds willing to utilise debt facilities to level the bidding process, while smaller funds appear to be abandoning these competitive processes, given the binary outcomes and relative higher pricing, and are instead focussing their efforts and capital on other opportunities. There has been a significant increase in GPs raising smaller, more specialised funds focussing on particular regions, asset classes or strategies. Buy-out funds represent the majority of stakes sold in the secondary market but as these positions consistently trade near to or, in some cases, at or above par, secondary GPs are increasingly looking to strategies offering greater discounts, including real estate, natural resources, and venture.[1]

Many of the top secondary GPs are raising and managing ancillary vehicles alongside their general secondary funds to focus on niche strategies within secondaries and are increasingly introducing a dedicated private debt strategy, in each case to provide diversification to the GP and to earn a different revenue stream from assets higher up in the capital structure. As a result, we have seen an increase in the financing of smaller secondary transactions, including the financing of direct interests and less diversified portfolios where, in some cases, the financing is of a single fund interest. Certain GPs are also introducing funds that provide financing for the acquisition by other funds (including affiliated funds) of secondaries portfolios. We anticipate a growing need for GPs to clarify potential conflicts between equity and debt holders, and between investors in equity-focused and debt-focused funds, and the various rights, obligations and information flows that will need to be managed accordingly to avoid future disputes. This will become of particular importance in situations of asset distress where decisions need to be made that will impact multiple competing investor groups.

In addition to the increase of acquisition finance debt in secondary transactions, we have also seen secondary GPs using senior debt later in the fund's life cycle to provide early liquidity for investors and, increasingly, as part of or triggered by GP restructurings. As the secondaries market matures, and financings become increasingly complex, the lender community is showing a continued willingness to extend credit in reliance on a number of different credit enhancements and protections, in particular where there may be less confidence in the robustness and "liquidity" of the underlying collateral to support the debt. The pool of lenders with credit appetite for these types of debt financings is considerably smaller than, say, the subscription credit facility market, and there are currently fewer than 15 specialised institutions globally in the market providing this type of financing on a standalone basis. Unlike the subscription credit facility market, this figure has only increased marginally year on year since the early 2000's and we estimate that this slow growth in providers will continue, in particular, given potential balance sheet constraints, regulatory capital hurdles and credit risk considerations in respect of some of the largest lenders.

The core rationale for this is that the underlying assets are illiquid and, outside of direct secondary financings, lenders are unable to directly access or influence those underlying assets. The calculation of the net asset value (NAV) of the assets against which the lender is providing finance is neither scientific (as such NAV cannot be marked to market (albeit the private equity industry has taken steps to improve valuation methodologies) nor necessarily a real indication of the potential for near-term cash generation). The primary source of repayment for a lender will be distribution proceeds resulting from realisations of the underlying assets, and there will be no clear visibility as to the timing of those realisations, which will be dependent on market factors at the relevant time. The fallback of selling assets into the market in the event of a borrower default is, however, increasingly accepted as a viable option, although the speed and pricing of such sales must be determined on a case-by-case basis, and will be highly dependent on the credit quality and desirability of the underlying assets, dry powder and breadth of potential buyers, and market conditions prevailing at the time of such sale.

In this article we examine:

- the factors behind the rapid emergence of the secondaries market and the financing opportunities this has given rise to;
- why secondary GPs and managers are increasingly looking to finance secondary transactions with debt finance and use debt as a liquidity and portfolio management tool;
- how specialised lenders are comfortable with the risk profile of these transactions;
- how secondary financing structures have evolved over the last two decades; and
- how we expect the market to develop in the future.

What are the drivers behind the rapid growth of secondary financings?

The secondaries market has rapidly emerged over the years since the global financial crisis as a mainstream alternative asset class and significant component of the private capital landscape, with volume reaching over $26bn as at November 2018. Aggregate capital raised globally by secondary funds at the end of 2017 reached $47bn – a record year for secondaries – representing an increase of over 50% from 2016. At the end of 2018, over 40 secondaries funds were in the market, targeting over $61bn. Compare that to the approximately $10bn raised by secondary fund managers 11 years ago, and you have a market which has achieved significant growth over this period of time. It is therefore not surprising that, as the secondaries market has grown, so has the popularity of financing to support the activities of secondary fund managers.

The secondaries market was historically stigmatised and regarded as a marketplace for distressed sellers forced to sell their interests out of necessity rather than as a product of active portfolio management, with the effect that sale prices achieved were at a significant discount to the reported NAV. As the secondaries market has matured and secondary market sales have become a crucial portfolio management tool for private markets managers, higher pricing has followed suit – in 2018 average pricing was approximately 90% of NAV across all strategies, with some large and mid-market buyout funds trading at par or above. So, what is behind this rapid growth?

- In the immediate aftermath of the global financial crisis, the seller market was dominated by distressed sellers such as banks and insurance companies forced by regulation to reduce their private equity positions. Now, these sellers make up a significantly smaller percentage of sellers globally.
- Sellers are now selling not out of necessity but in furtherance of active portfolio management as they seek to rebalance their portfolios across asset classes, industries and vintages and refocus their investment strategies on a smaller group of GPs. The blind pool risk associated with primaries is substantially reduced in secondaries as the

investments comprise mature, substantially funded assets.

- Buyers looking to the private markets to increase their private equity exposure are attracted to the level of diversification across strategies, vintages, managers and geographies as well as the near-term cash realisation prospects of secondary funds. In addition, expected returns in the fixed income and equities markets are not high enough to deliver the investment results required by pension funds and insurance companies, given their attendant liabilities. Alternatives, including secondaries, continue to advertise the potential for double-digit returns, which therefore continues to drive ever-larger allocations.
- Primary managers are using the secondaries market to implement GP-led restructurings.
- Via stapled transactions, secondary fund managers view the secondaries market as an opportunity to create capital for future fund-raises, as well as fresh capital for existing funds via co-investment rights.
- In the case of direct secondaries, portfolio companies are using the secondaries market to breathe life back into investments via new investors.
- Importantly, the availability of leverage for secondary transactions is driving increases in volume.

Why are secondary fund managers using debt both to finance secondary transactions and as a portfolio management tool?

- ***Enhancement of returns:*** leverage, if structured and priced correctly, can materially enhance returns for secondary fund managers by reducing the weighted average cost of capital.
- ***Filling the funding gap:*** vendor financing on secondary acquisitions has historically been a large and, in some instances, necessary part of structuring secondary transactions. Leverage facilities can, however, be used to replace the need for deferred consideration and allow the purchaser to finance the sale consideration in full at the time of completion, thus allowing the purchaser to differentiate itself from other potential purchasers in a competitive situation.
- ***Accelerated liquidity:*** whilst one of the most attractive features of secondary funds for investors is the accelerated liquidity profile these funds afford, as sellers' pricing expectations remain high, leverage facilities can provide early liquidity for secondary fund managers to crystallise returns to investors without needing to exit underlying positions. A leverage facility can be an extremely valuable option for a GP to utilise, if such provision of liquidity serves to trigger certain performance fees and/or create an incentive for such investors to reinvest such distributions in the GP's follow-on fund. Equally, the manager can use this liquidity to acquire other assets or portfolios without needing to call capital from investors.
- ***Increased firepower:*** debt financing can significantly enhance the firepower of a secondaries manager in a competitive bid situation, a tool which has become increasingly important as dry powder levels in the private equity secondaries industry continue to rise and prices remain, on average, at a slim discount to NAV.

<u>The lender's perspective</u>…

Whilst on the face of it, these transactions might not seem attractive from a credit perspective due to the illiquid nature of the underlying assets, the uncertainty around the accuracy of the NAV calculation and a lack of visibility on the timing and level of distributions flowing to the secondaries fund to repay the facility, there are a number of features of these transactions which, for specialised institutions with capacity to carry out the requisite due diligence and a sophisticated understanding of this asset class, make these transactions compelling propositions:

- ***Diversification:*** whilst we are beginning to see many transactions which are more concentrated in a few or even one single LP position, a large number of transactions are highly diversified across a number of high-quality underlying fund managers with excellent performance track records where positions are highly funded.
- ***The absence of over-leverage in the underlying portfolio:*** not every secondaries transaction will be suitable for leverage finance, and one of the key factors a lender will take into consideration in assessing whether or not leverage is appropriate is the level of leverage in the underlying portfolio for a given vintage and sector. Where leverage in the underlying portfolios is high, additional credit support may need to be provided by the investing funds, including NAV-backed fund guarantees and ring-fenced or assigned uncalled capital.
- ***Near-term cashflow generation:*** whilst there is no guarantee that market conditions will be conducive to a sale of the relevant underlying positions within the tenor of the facility, a sophisticated and experienced leverage provider to this asset class will be able to assess the likelihood of near-term cash generation and will typically look for assets which are likely to be realised within 18-24 months. Leverage facilities typically include a mandatory cash-sweep of all or a portion of distributions (depending on the LTV level and general risk profile of the transaction) and, in our experience, the operation of these sweeps frequently results in these facilities being repaid within only a couple of years. As leverage facilties have grown in complexity, borrowers have also sought greater flexibility in respect of such cash sweeps, such as one- to two-year delays before the sweep commences or, in extreme cases, no sweep at all unless certain events occur.
- ***Comparatively low-geared financing:*** current market conditions with high valuation multiples provide for low LTV (loan-to-value) and LTC (loan-to-cost) ratios which present an appealing risk profile, even when lenders apply the most vigorous stress testing on performance models, though this is slowly starting to change. Some secondaries transactions permit higher LTV ratios, but mitigate the risk to the lenders using a number of credit support features.
- ***Reduced risk of blind pool lending:*** whilst the secondaries market provides more visibility of underlying LP performance than that in the fund-of-funds financing space (which tends to rely more on statistical lending and bottom-up analysis), lenders will often place value on the historic data that a fund manager who is also an investor in the underlying portfolio can provide. While the traditional secondaries space does reduce the risk of blind pool lending, one feature we have started to see, in particular in tail-end funds, is the inclusion of mid-stage primaries in a portfolio, to allow for the potential for further growth. While the blended profile of such portfolios may make sense, some argue that the strategy is significantly different compared with traditional secondary portfolios.
- ***Experience of secondary fund management team:*** seasoned lenders will often take into account the track record and market know-how of individuals within a management team. Whilst there are a number of new funds that have come to market in recent years, longevity and expertise can often be found in the partners running the new funds' managers – which can be a compelling argument for credit committees. Spin-out funds from those with the best reputations are also starting to feature in the market.
- ***Hybrid value-add:*** to mitigate the concentration risk in transactions with few or a single LP position, some fund managers are able to offer an additional credit enhancement in

the form of a guarantee or equity commitment from the secondary fund itself, or from other fund vehicles, in support of financing to an SPV. This is a significant value-add which allows lenders to factor in the creditworthiness of the secondary fund (and often the LPs behind it) when considering pricing and risk allocation.

Secondary financing structures

The past

The shift from direct to indirect security over collateral …

Over the past two decades, we have seen the structure of secondary financings continue to evolve as the market has matured. In the early 2000s when the product was in its nascence, the closest type of mainstream financing to secondary financing was leverage/acquisition finance, and this understandably framed the mindset of lenders in structuring the terms of the financing and the collateral package. In practice, this meant that lenders expected to have direct security over each item of collateral, being each LP interest which was the subject of the acquisition financing. Invariably, this arrangement was prohibited by the terms of the underlying fund documents governing the LP interest being acquired, and required the consent of the underlying general partner or manager.

Moreover, not only was the granting of security over the interest prohibited by the terms of the underlying fund documents, but the ability of the lender to transfer the interest to a third party purchaser on an enforcement of such security also required such consent. Lenders also expected to be involved in the negotiation of the form of the consent to be given by the underlying general partner or manager in order to ensure that it adequately addressed both the proposed security and any future transfer of the interest following an enforcement. The consequence of this for secondary managers contemplating using debt finance for their transaction was that if they had not factored this into their very early-stage discussions with the seller, attempting to put this type of financing in place at a later stage would prove challenging, given the practical difficulties caused by the length of time it would take to negotiate the consents, as well as the commercial difficulties in attempting to reopen discussions with the seller on the terms of the sale and purchase.

As the market began to open up in the years leading up to the global financial crisis and as more institutions began to show credit appetite for these types of financings, the balance of power visibly began to shift to secondaries managers, who began to question the necessity and value of this financing and collateral structure. Often, these acquisitions involved multiple LP interests in various jurisdictions – in some cases exceeding 50 interests – which resulted in these transactions being costly and time-consuming to implement. Enforcing all of these security interests individually through multiple processes in multiple jurisdictions would also necessarily be more protracted and expensive.

Further, even where discussions around the form of consent required by the lender took place at an early stage in the transaction, in most cases the underlying managers were unable to give more than an upfront consent to the creation of security. Providing an upfront consent to the transfer of the interest on an enforcement to an unidentified third party was virtually impossible for a fund manager to agree to, given the secondary fund manager's obligation to its investors to ensure that the admission of an LP would not give rise to any adverse legal, regulatory or tax consequences for the fund and its existing investors, as well as the manager's duty to independently assess the creditworthiness of the LP in respect of any unfunded commitments. Secondary fund managers were therefore left questioning the real value of this collateral structure, and began a dialogue with lenders around other alternative structures.

What quickly emerged was an acceptance that, although direct security over individual interests (and obtaining the relevant consents) was the preferred collateral package for a lender, in certain situations where the secondaries manager was of a very high quality and well known to the lender, where the underlying assets were quality, highly diversified assets and, importantly, where the structure of the fund and the terms of the underlying fund documents allowed the lender to benefit from indirect security over those LP interests, the financing was still viable through an indirect collateral structure.

... Indirect collateral structures

In basic terms, indirect collateral structures involve the secondaries manager setting up a wholly owned special purpose vehicle (the SPV), which in turn acts as the purchaser of the target LP interests. The financing is entered into with the secondaries fund backed by a guarantee from the SPV (or vice versa) and secured by way of a pledge (or equivalent) over the secondary fund's interest in the SPV. Whilst this structure does not give the lender the same flexibility to directly enforce its security over individual LP interests (subject to the consent considerations outlined above), it does, if structured correctly and provided the underlying fund documents do not prohibit the same, allow the lender to sell the underlying portfolio as a whole to a third-party purchaser without the need for consent from the underlying manager via one enforcement process, and/or to take control of the SPV, thus allowing it to begin the process of liquidating the underlying positions individually if desired, working with the underlying GPs. However, there are still a number of potential issues to navigate with this structure:

- ***The requirement for consent:*** taking indirect, rather than direct, security does not necessarily obviate the need for consent from the underlying manager. Many provisions in private markets limited partnership agreements which seek to regulate the transfer of LP interests are not drafted with this type of arrangement in mind, yet in some instances the language could capture indirect security, and an enforcement thereof. These provisions need to be reviewed carefully to establish whether consent is still required and, if it is, how this can be resolved. Even if the provisions could capture indirect security and/or indirect enforcement of such security, in many cases the stated consequences of a breach of these restrictions in the relevant underlying limited partnership agreement do not adversely impact realisation of the relevant LP interests unless the transfer involves a change to the identity of the LP on the register of limited partners. If, however, it is clear that consent is required, then either:
    a) ***consent:*** consent will need to be obtained, noting that any such consent is likely to be limited, as described above, with the result that consent could be needed for the enforcement of the indirect security interest over all of the LP interests making up the portfolio; or
    b) ***hive-out:*** the affected LP interest is hived out into another SPV and either remains unsecured, and therefore outside of the qualifying collateral for the purpose of the financing, or comes into the secured portfolio at a later stage – if a clean consent can be obtained from the underlying fund manager.
- ***The nature of the indirect security:*** generally, as a result of tax considerations, the SPV cannot be formed as a limited company and must be formed as a limited partnership. Whilst taking security over the entire interest in a limited company is generally straightforward and quick to both implement and enforce in many jurisdictions that we routinely come across in these types of financings, it is significantly more challenging to achieve the same result in respect of a limited partnership. The reason for this is that, unlike with a corporate structure, the ownership and economic interests in a limited

partnership are split between the limited partners and the general partner and, in order to be able to transfer the entirety of the interests in the partnership so as to be able to deliver both the control and economics of the limited partnership and its assets, both of the interests need to be transferred. The exact issues to be navigated will be dependent on the relevant jurisdiction in which the SPV and its general partner are formed, but are likely to include:

a) ***regulation:*** taking and/or enforcing security over the shares in the general partner may require regulatory consent and/or give rise to liability issues. In some cases, this can be avoided by the interposition of an SPV above the general partner and security taken over the interests in the SPV rather than the general partner itself, but this isn't always the case and alternatives will need to be found; and
b) ***nature of security over the limited partner interest:*** when taking this type of security, a lender will be looking for the legal title of the interest to remain with the fund, and to take the benefit of an equitable charge/assignment (or equivalent) over the interest, which will allow it to transfer the interest to a third party on an enforcement. However, some jurisdictions do not recognise the concept of an equitable charge and/or, in some jurisdictions, the taking of security over the entire interest requires certain public announcements to be made. If security over the whole of the interest cannot be taken due to these or other factors, it may still be possible to take security over the economic entitlement of the limited partner – which is principally where the value lies in this interest, although this may impact the marketability of the asset on an enforcement. This may be coupled with a power of attorney to facilitate the transfer of the interest in such circumstances, although the survival of the power of attorney in an insolvency scenario will need to be taken into consideration in determining its value.

<u>The present and the future</u>…

Whilst direct and indirect collateral structures are still the most common and preferred structures employed in secondary acquisition financings, we have seen an increase in the number of secondary fund managers looking for debt financing later on in the life cycle of the fund to bridge distributions to their investors,. where the value of the underlying portfolio supports this. With this type of financing, it may be too late for the foundations of the indirect collateral structure to be put in place and the direct collateral structure may be heavily resisted where there are a large number of LP stakes forming part of the portfolio, thus potentially resulting in an expensive/time-consuming process to put the deal in place. In these situations, depending on: (i) the quality of, and relationship with, the manager; and (ii) the quality/value/diversification of the underlying assets, we have seen lenders get comfortable with alternative structures, including:

a) ***distribution account security and winding-up protection:*** relying on a pledge over the distribution accounts held by the fund, alongside the ability of the lender to wind up the fund in a default scenario. Note that this structure has only been seen with very high-quality managers and where there is a close relationship across other product lines between the lender and the secondaries manager;
b) ***custody arrangements:*** where the underlying assets are held through a custodian, an assignment of the secondary manager's interests in the custody agreement to give the lender the ability to direct the custodian in an enforcement scenario;
c) ***trust arrangement:*** where the underlying documentation permits the same and where this structure is appropriate for the relevant transaction, the creation of a trust in respect of the manager's interest in the underlying assets; and/or

d) ***hybrids:*** where lenders are less comfortable with the security provided in respect of the portfolio of assets, they will be incentivised to increase the credit quality of the overall transaction. Such credit enhancements include establishing rights over recallable capital distributions, step-in rights over ring-fenced uncalled capital, or restrictions on overall financial indebtedness, and by obtaining NAV-backed guarantees to cover not only any uncalled capital of the underlying portfolios, but also a portion or the full notional of the loan amounts outstanding.

The outlook for 2019

The secondaries market has continued to evolve at a rapid pace. Fund-raising in respect of the largest funds continues unabated, and market participants face intense competition for assets across all sectors. Steady deployment of capital can be challenging. This, in turn, has contributed to GP-led secondaries, in particular in Europe, where managers have sought to establish multi- or single-asset continuation funds allowing investors, and the GPs themselves, to hold on to quality assets which have future potential growth. Secondary funds are starting to utilise the full suite of financing tools available to them. Those with high-quality NAV in established funds, and a diverse, highly-rated LP investor base, can seek to support primary GPs in the provision of follow-on capital transactions using bespoke tranched-debt structures and preferred equity solutions.

However, there is also a sense in the market that participants should be cautious. Complexity and rapid growth may breed risks that are not fully appreciated. The overall effects of increasing underlying asset leverage is reasonably well understood. However, the multi-layering of both funds and investors which are inherent in secondaries structures can make it difficult to monitor the risks at each level. Other concerns such as rising LIBOR rates, underlying unitranche and other private debt structures, which contain variations in covenants and creditor rights compared to older vintage portfolios, can affect ultimate equity valuations in ways in which the market may not anticipate.

We also anticipate that as the market matures and the cycle eventually turns, there will be an increased focus by investors on returns and risk, and a demand for far greater transparency across structures and fees. The private equity market will likely need to justify why it continues to cling to IRR as a key metric, in particular as investors better understand its weakness and, in some cases, irrelevance to overall performance. Better data sets should mean that market leaders will seek to provide meaningful comparisons to their investor base and to the broader market. More experienced secondary players have already implemented a solid framework to detail how to provide their investors with such information, and are anticipating how to deal with conflict-of-interest issues which will arise as they participate more broadly across capital structures, strategies and asset classes.

* * *

Endnote

1. It should be noted that a number of secondary GPs dispute that the level of discount at which the assets are purchased is a prime driver of future returns. There certainly is both academic support and anecdotal evidence that demonstrates even inverse correlation between larger discounts and better performance.

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Sam has advised both financial institutions and private markets managers on the full range of fund finance products provided to secondaries funds including GP-led financings, acquisition financing, subscription and hybrid facilities to secondary funds and pref equity solutions over the past two decades. She has advised on some of the largest financings in the market, including a $2bn liquidity facility and a $2.5bn hybrid facility. In the last 12 months she has advised on over 50 new fund financings exceeding £15bn in value.

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