CapitalDynamics
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COVID-19: SECONDARIES MARKET OPPORTUNITY

KEY COMMENTARY

COVID-19 HAS HAD AN UNPRECEDENTED AND NOT YET FULLY UNDERSTOOD IMPACT ON THE GLOBAL FINANCIAL MARKETS. WHILE THE FINANCIAL IMPACT OF THIS PANDEMIC PRESENTS UNIQUE CHALLENGES, DISCIPLINED INVESTORS HAVE BEEN ACUTELY AWARE OF ELEVATED MARKET VALUATIONS FOR SOME TIME AND HAVE BEEN PREPARING (AND INVESTING) ACCORDINGLY.

Historically, crises and volatility have generated some of the most attractive buying opportunities, especially for experienced secondary buyers with both fundamental underwriting capabilities and deep negotiation/structuring capabilities. Secondaries funds demonstrated resilience during previous periods of market dislocation and can offer an attractive investment opportunity for Limited Partners ("LPs") looking to take advantage of these dynamics. Below, we discuss some of the main themes expected to dominate the secondary landscape in the coming quarters.

"SECONDARIES FUNDS DEMONSTRATED RESILIENCE DURING PREVIOUS PERIODS OF MARKET DISLOCATION."

MARKET OVERVIEW

The secondary market has seen rapid growth in recent years – both in terms of market participants and deal volumes – reaching its current peak of USD 88 billion in 2019.[1] Transaction volume has more than tripled over the last decade, while the public markets experienced the longest bull market run in history. While volumes were driven mostly by large transactions, including the largest secondary transaction ever completed of approximately USD 5 billion and an estimated 23 transactions of over USD 1 billion, the growth in the secondary market has been driven by an increase in active portfolio management, persistent strong pricing, a growing supply of General Partner ("GP")-led deals (roughly a third of overall deal volume) and an increase in both the number and types of sellers.

As growth slowed in H2 2019, buyer-seller dynamics were already beginning to change prior to the spread of COVID-19, as evidenced by widening bid-ask spreads and stalled deals.

These changes were driven primarily by buyers demonstrating higher selectivity and increased caution around private valuations and aggressive deployment of capital.

In recent weeks, as the COVID-19 crisis has escalated these trends and imbalances have accelerated. As public markets have experienced rapid, steep declines, secondary deal flow has slowed dramatically as buyers and sellers both try to take stock of the situation. This has resulted in deals being repriced or falling apart entirely. On that basis, the COVID-19 crisis will likely lead to fewer deals (by both count and value) being completed during 2020. However, over the coming quarters we expect to see a rebound in activity driven by an increase in acute liquidity needs of sellers, declining fund net asset values ("NAVs"), and distress at both the fund and company level resulting in restructuring opportunities.

OPPORTUNITIES

The small end of the secondary market is under-served due to the concentration of dry powder in the hands of much larger funds that need to deploy significant pools of capital. It is possible that this effect will be even more pronounced in the coming quarters as secondary buyers look to deploy aggressively in what could be a once-in-a-lifetime opportunity. At the end of 2019, the top 18 secondary buyers represented approximately 84% of total dry powder in the secondary market. Of these top 18 buyers, 12 are in some stage of fundraising, which will result in a further concentration of dry powder in a handful of large buyers.[2]

Clearly, this supports the expectation of intense competition in the large end of the market in the coming quarters. Buyers are well positioned to avoid this heightened competition by focusing on the small-end of the market, where there is a far larger opportunity set of deals (by count) and an increased need for leadership, especially for more complex deals, such as fund restructurings and preferred securities.

> **"DRY POWDER CONCENTRATION SUPPORTS THE EXPECTATION OF INTENSE COMPETITION IN THE LARGE END OF THE MARKET IN THE COMING QUARTERS."**

1 GREENHILL "GLOBAL SECONDARY MARKET TRENDS & OUTLOOK" JANUARY 2020.
2 UBS "2020 SECONDARY MARKET SURVEY AND OUTLOOK".

We expect to see a sharp increase in the number of motivated/distressed sellers coming to market driven primarily by what is known as the "denominator effect." That is, LPs that adhere to strict allocation guidelines between their public and private investments may be forced to liquidate a portion of their private market investments/ commitments to rebalance their portfolio, as their public investments decline. Additionally, we expect an increase in deals with higher unfunded commitments, as LPs unable to meet future capital calls choose to sell funds from younger vintages.

These funds are attractive to secondary buyers in two ways:

> **(i)** the existing assets will be less impacted by the near-term exit implications of the downturn and have multiple years of operational value creation ahead of them, and
> **(ii)** the unfunded commitment will be used to buy assets cheaply at this point in the cycle.

It is important to note the unique opportunity secondary buyers have in this crisis environment – they are strongly positioned to gain access to underlying companies at heavily discounted prices due to LPs facing mounting pressures to sell. These companies would likely never be directly offered for purchase on the market in such conditions unless absolutely necessary.

While some GPs will need to run fund-restructuring processes to support well-performing businesses until market conditions normalize and the exit window for assets re-emerges, we expect a sharp slowdown in GP-led processes in the next few quarters as secondary buyers will likely require deep discounts to accept exposure to such concentrated, unsystematic risk. By the same token, we also expect this to usher in a wave of structured/preferred deals and other types of liquidity facilities that are designed to offer buyers downside protection in the case of concentrated exposures, while allowing the seller or GP to maintain upside value beyond the preferred threshold. This also meaningfully reduces the risk of a deal falling apart due to a gap in pricing expectations because the precise value of the portfolio is less important than an acceptable level of "Loan or Preferred Equity to Value."

> **"SECONDARY BUYERS ARE STRONGLY POSITIONED IN THE CURRENT ENVIRONMENT TO GAIN ACCESS TO UNDERLYING COMPANIES AT HEAVILY DISCOUNTED PRICES."**

Of course, these investment opportunities will have the inherent risk of adverse selection and will require expertise in secondary valuation to price properly, but this effect will create a strong flow of motivated sellers, which will turn the market in favor of secondary buyers. Firms with proprietary sourcing capabilities will be better positioned to take advantage of such opportunities, as sellers in distressed processes often wish to remain discreet and prefer confidentiality – potentially bypassing the auction channel altogether.

PRICING OUTLOOK

We anticipate a sharp decline in secondary pricing in the coming quarters, both on a headline basis (percent of NAV), but also in terms of valuations of the underlying assets, driven by anticipated markdowns, company fundamentals, public market volatility, and a lack of visibility on the exit environment. In previous downturns, we have seen average pricing drop quickly and substantially, down to as low as 40-50% of NAV during the Global Financial Crisis ("GFC").

However, prices also recovered quickly, returning to normal levels in about four quarters. Clearly, secondary buyers with sufficient dry powder to deploy during this period will be able to reap the greatest benefits from this advantageous pricing window. That said, we do expect a temporary lull in secondary buying activity until first quarter NAVs are reported (30-60 days after the quarter ends) and sellers adjust their expectations to the new market realities.

In this distressed environment, we also expect the balance of pricing versus other deal considerations to shift in determining whether or not deals are consummated. Whereas pricing was by far the biggest decision factor for sellers in the recent bull market (to the point where it was not uncommon to lose a deal by several basis points on pricing), we expect that in the coming quarters, confidentiality, perceived counterparty risk, knowledge of the assets and speed of execution will become equally important factors for sellers. An important lesson from the GFC, however, is to not become too fixated on optical pricing and always prioritize fundamental underwriting. In the aftermath of the GFC, sellers were also willing to accept meaningful discounts, but buyers often pressed too hard for further discounts. This resulted in many failed transactions that, in retrospect, would have been highly accretive for buyers.

LEVERAGE

In our view, secondary groups that have remained conservative with leverage will be in pole position coming out of the crisis. The high levels of leverage in private markets is well documented, but as underlying portfolios are strapped for cash and liquidity events are postponed, secondary funds with high levels of leverage will be the most exposed to increased volatility in their NAVs and accelerated capital calls to maintain LTV (loan-to-value) covenants are expected.

MARKET OPPORTUNITIES

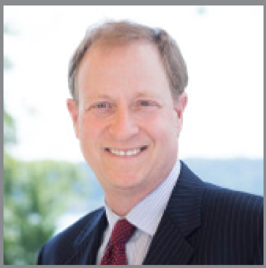
In the aftermath of this market dislocation, market opportunities are likely to materialize. It is difficult to predict the exact shape of those opportunities today, but below are some examples we are monitoring:

- **(i)** younger assets that are less impacted by near-term exit implications and have multiple years of operational value creation ahead;
- **(ii)** deeper discount opportunities with a greater embedded margin of safety;
- **(iii)** preferred securities deals with downside protection, including inbound requests for top -off capital to supply urgently needed liquidity to protect their portfolio positions;
- **(iv)** companies with resilient capital structures and overall lower levels of leverage and plenty of covenant room;
- **(v)** LP stakes that are less funded and positioned to acquire new assets at lower valuations; and
- **(vi)** opportunities with sellers who are under pressure due to the denominator effect and/or are facing liquidity requirements.

CONCLUSION

In the aftermath of the market dislocation created by COVID-19, we believe that a significant opportunity will emerge for disciplined secondary investors. The benefits of this buying opportunity are likely to accrue to those investors who can focus on the lower end of the market, can take a leadership role in structuring and fundamentally underwriting transactions, and have the benefit of a global sourcing network and private equity platform.

AUTHORS



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In 2019, Capital Dynamics was awarded the highest corporate rating (A+) from the UN-supported Principles for Responsible Investment, while the firm's clean energy infrastructure platform received top rankings from GRESB (the ESG benchmark for real assets) for commitment to sustainability. For more information, please visit: www.capdyn.com

[1]As of December 31, 2019.

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