W Capital Partners

Secondaries Have Become Primary

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by David Wachter

Direct secondaries have become a valuable resource for private equity investors, opening new liquidity options for general partners, other shareholders and private companies. Direct secondaries span from the buying of shares in private companies from existing shareholders, to GP-led and structured solutions. Many leading GPs are now using direct secondaries to manage returns, improve fund level cash flow and increase holding period flexibility for their portfolio companies.

The direct secondaries market has exploded in phases, driven by the GFC and then truly opening up over the last few years with top GPs pursuing GP-led secondaries and growth equity share sales. The economic disruption caused by COVID-19 will likely create liquidity challenges for the PE industry. Data suggests that GPs today have sizable late-in-the-cycle funds that are fully invested and under-reserved, much like VCs and corporate VCs in 2001 and financial institutions in 2009. This will only increase the value of direct secondaries for GPs as a way to have more control over assets and manage fund liquidity and reserves. I believe direct secondaries will be an exciting market for both sellers and buyers. All private equity investors should recognize and appreciate the new tools that are provided by the secondary market.

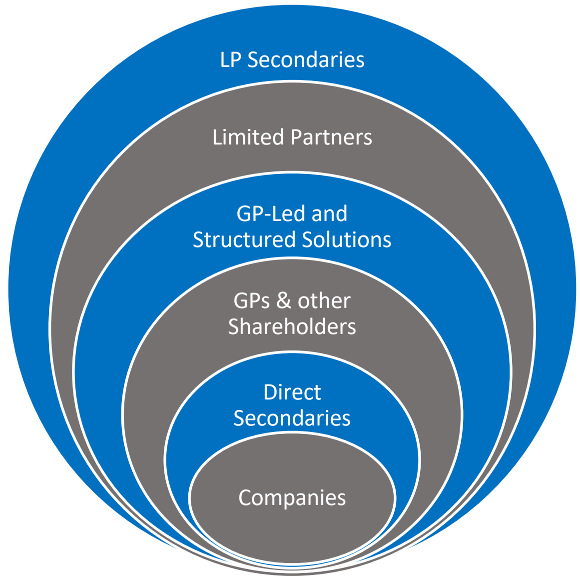
Embracing Direct Secondaries

The private equity market is highly complex. Private equity assets have no fixed duration, no yield and subjective carrying values. Exit timing for private equity investments is inherently volatile and difficult to predict. The 10-year standard limited partnership term has little correlation to the actual cash flow cycle of funds today. Furthermore, a diverse set of investors in a single company must often work together to collaborate on decisions regarding growth, profitability and capitalization. They include GPs managing third-party capital, banks, corporate venture capital programs ("CVCs"), sovereign wealth funds ("SWFs"), family offices, co-investors, employees and founders. Each investor has their own risk tolerances and return objectives, only exacerbated in a time of crisis like today.

These complexities have led to the rise of specialized secondary capital providers providing targeted solutions to market needs. By offering liquidity alternatives to optimize performance, manage duration, generate cash flow and improve long-term investor alignment many market leading GPs have embraced direct secondaries, firmly validating the market. Over the past two years, trade press has referenced transactions by highly regarded firms including 3i, Accel-KKR, Ares, Bain, Blackstone, Bridgepoint, Carlyle, Hellman & Friedman, Insight, Investcorp, Lime Rock, NEA, Nordic, Oaktree, PAI, Permira, TA, TH Lee, TPG and Warburg Pincus.

This paper (1) discusses the evolution and establishment of the direct secondary market, (2) describes the solutions and structures, (3) outlines certain drivers of growth, (4) provides a data snapshot of today's private equity market and (5) explains how the direct secondary market can provide solutions to some of these challenges.

Direct secondaries can have a positive impact on investment outcomes by improving investor liquidity between companies and their shareholders and between GPs and their limited partners.



A Brief History of Direct Secondaries.

Direct secondaries have been an emerging asset class for many years. At W Capital, we closed our first direct secondary transactions in 2002 in the wake of the dot.com bubble. We purchased technology portfolios from CVCs and financial institutions that decided venture capital investments were too volatile and risky for their balance sheets.

When the global financial crisis caused stagnation in buyout exits during 2009 through 2012, we completed direct secondaries with a range of sponsors and financial institutions in private equity and credit. Counterparties included overextended mid-market buyout funds seeking to reduce asset exposure and recycle proceeds, funds with a low level of distributions (DPI) seeking to generate LP cash flow before coming back to market, credit funds holding a larger-than-budgeted equity co-investment basket, and sponsors executing on buy and builds but running low on fund reserves and dry powder.

Once markets normalized, well performing companies with strong investor bases were also pursuing direct secondaries[1] in order to extend a company's growth opportunity without the pressure of IPO timing and to realign shareholder duration. When shares in highly regarded, late-stage growth companies such as Facebook started changing hands in the secondary market, we stopped hearing, "Why would anyone sell secondary shares in a good company?" The dated venture capital philosophy of "no-one exits until we all exit" had disappeared.

Buyout firms as well as venture funds were tapping into new liquidity transaction structures. These included private shareholder tenders, structured solutions, sponsor sell-downs, strip sales, primary/secondaries and GP-led solutions.

GP-led solutions are a way for fund managers to achieve liquidity for their LPs without reducing assets under management. In these deals, GPs that own coveted companies inside of maturing funds bring in outside secondary investors to fund the re-purchase of those companies out of the mature fund. As these GPs recognized, why sell a well-performing company to another sponsor when you can monetize your existing fund, raise new capital and re-invest into an asset you already know and like?

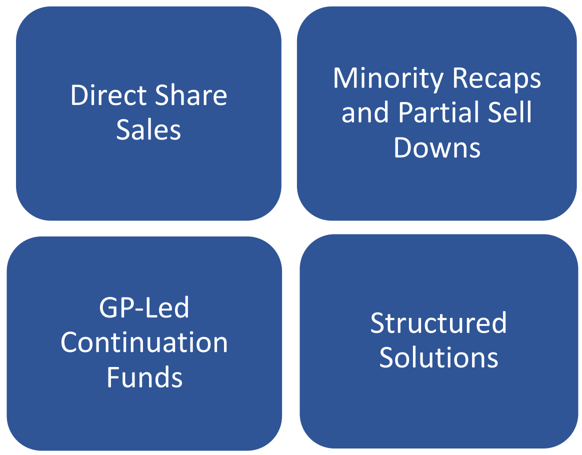
Also driving market adoption has been LPs prioritizing net IRR and DPI over MOIC and benchmarking GPs accordingly. At the same time, companies are staying private longer, leading to fund level cash flows flattening and becoming more back ended. RVPI (remaining fund value over paid-in-capital) for an average 10-year-old fund doubled from 0.33x in 2011 to 0.65x in 2019[2]. Direct secondaries give GPs the flexibility to bring forward liquidity and improve net IRR and DPI even if full exits are extended.

Direct Secondaries Market Segments.

As the market has grown, direct secondary providers have formalized structures and strategies targeted at the specific objectives of selling shareholders. Outlined below are the principal structures in the market today.

Direct Secondary Market Segments

Direct secondaries span from the buying and selling of direct shares in private companies to GP-led and structured solutions



Direct Share Sales

If you are a minority shareholder, founder or VC, a direct share secondary is the selling of your shares in the company to a new shareholder. Due to companies staying private longer, the shrinking public market and the proliferation of co-investing, direct share sale secondaries have become a large market. This has become a particularly active strategy in growth equity given the fragmented shareholder bases and investors motivated to realize some of the significant increase in value generated over the past several years. Companies themselves are embracing secondaries by running private market tender offers to provide interim liquidity prior to an IPO, which validates private market value and reduces post-lockup overhang.

It is difficult to estimate the total market size of direct share sales because most transactions are undisclosed, and many are comingled with primary growth equity transactions. Specialist secondary advisors tallied $17 billion of known transactions in 2018, up from $4 billion in 2016[3]. NASDAQ disclosed that its private markets platform alone processed 87 direct secondary transactions for $5 billion in 2019[4]. Market leading companies with exceptional institutional investor backing such as Credit Karma, Klarna, LegalZoom, Roblox, TransferWise and Workfront have publicly disclosed direct secondaries ranging from $100 million to $500 million. There have been highly publicized Softbank transactions in Flipkart, Uber and WeWork totaling more than $10 billion. While sizable, these disclosed deals are a small fraction of the overall direct share sale market.

Minority Recaps, Partial Sell Downs and Co-Investment Secondaries

While control sales are the vast majority of exits for sponsor GPs, direct secondaries have opened up interim liquidity options for buyout assets. Minority equity recaps, partial sell-downs, portfolio strip sales and rollover equity sales generate asset liquidity without a GP having to fully sell or relinquishing control of a company. Co-investment secondaries offer fund LPs the ability to exit their co-investment exposure in an asset before or after the controlling sponsor decides to sell. Historically, a sponsor seeking to sell down exposure in a company was considered a sign of a GP's lack of confidence in their investment.

Today, sentiment has shifted, and partial liquidity sales are seen as an endorsement of a GP's long-term commitment to the asset. In today's liquidity challenged environment, sponsors can pursue partial sell-downs or portfolio strip sales to generate LP liquidity or replenish funds with limited reserves. This is a way to bring forward cash flow without having to exit a strong investment in a challenging environment.

GP-Led Continuation Funds

GP-led continuation funds have grown rapidly over the past few years and represent a large secondary market segment. Surveys by the leading secondary advisors estimate that GP-led transactions reached $27 billion in 2019, having grown 70% in the past two years[5]. These transactions allow GPs with prized assets in mature funds to generate liquidity for the mature fund's limited partners without the GP having to sell the assets today. The GP forms a new special purpose vehicle which is funded by secondary investors for the purposes of buying one or more assets out of an existing fund. The existing fund exits the investment, crystalizing cash on cash returns and the LPs get cash distributions. The new fund provides the GP with new economics and an opportunity to continue to grow an investment they already know and like for a longer hold period.

Single asset GP-led transactions have gained significant traction because they allow a GP to selectively roll a desirable asset into a new dedicated fund while leaving the rest of the runoff portfolio in the old fund. Single asset transactions grew to an estimated 36% of the GP-led market in 2019, up from 14% in 2018[6]. Given the valuation and structuring work required, investors in these single asset opportunities must possess primary investment experience, deep resources and have an interest in concentrated investment exposure.

Over the past few years, best practices have been established with several dedicated and experienced advisors focused on GP-led transactions. As part of the process, a GP must navigate conflicts between its responsibility to price the assets properly in order to provide a fair return to exiting LPs while also setting up the new SPV for success. To mitigate this conflict, today's standard practice is offering existing LPs a 'status quo' option allowing them to roll into the SPV and remain invested in that asset.

With many prominent GPs successfully closing GP-led continuation funds the market has been validated and opened with substantial growth expected over the coming years.

Structured Solutions

Fund level structured solutions include capital call lines, NAV based lending and fund-level preferred equity. These structures provide fund level leverage thereby reducing LP capital calls and freeing up capital for recycling, reinvestment or distributions. Capital call lines have become an efficient way to delay capital calls, materially improving net IRR, but are only effective in the early years of a fund when there is sizable uncalled capital to use as collateral. NAV lending and preferred equity utilize the fund's investment portfolio as collateral, making them effective in the mid- to later-stage of a fund's life.

With the sudden market disruption caused by COVID-19, structured solutions have garnered significant attention. With fund level borrowing secured by multiple portfolio investments, GPs can raise capital to support portfolio companies without needing to mark-to-market or sell investments. Multiple asset portfolios provide a diversified collateral base for lenders and preferred equity investors, making this an attractive risk adjusted investment. Whereas, debt structures have a set maturity schedule and lower cost of capital, preferred equity is more flexible given it is redeemed based upon a pre-negotiated waterfall with the preferred first getting a return on capital and then shared upside based upon the long-term performance of the fund.

Current State of PE Market Liquidity and the Timing of COVID-19.

Data regarding the current state of the PE market shows an industry that has thrived and rapidly grown AUM over the past decade but also holds assets at high valuations and leverage levels in funds that have limited remaining reserves. The onset of the COVID-19 pandemic has struck at a time when the private equity and venture capital markets were pacing at peak levels. Total PE deal volume was $1.47 trillion in 2019 relative to $590 billion in 2010[7]. Total US VC investment was $133 billion in 2019 relative to $32 billion in 2010[8]. The private equity market has grown to $6.5 trillion in AUM[9] over the past decade.

With faster pacing and significantly more AUM, firms have invested larger funds over shorter timeframes and have come back to market and raised new funds sooner. This has resulted today in many funds being fully invested, holding large portfolios of relatively young and unseasoned assets, and having limited remaining reserves.

Leverage and valuations have also risen, requiring GPs to dedicate considerable time and resources to protect their portfolio company balance sheets and maximize portfolio company value against a more challenging economic backdrop. In addition to higher leverage at portfolio companies, the use of capital call lines and fund level leverage collateralized by portfolios with highly marked NAVs will compound the volatility and liquidity challenges likely to face funds throughout this crisis.

The cause of this crisis is entirely different than either 2001 or 2008. However, private equity investors will likely face the same difficult decisions regarding portfolio triage, capital reserve budgeting, reducing risk, protecting IRR and maximizing returns. We anticipate that the rebalancing, recycling and flexible liquidity available from direct secondaries will be a valuable tool for investors managing through today’s market challenges.

Outlined below is a table of various metrics regarding the current state of PE market liquidity.

The Current State of PE Market Liquidity

Trend	Data
Funds today have more unrealized value later in the life of the fund	The median 8-year-old fund has an RVPI (remaining value/paid in capital) of 0.97x today, materially higher than median RVPI of 0.67x in 2011 (Cambridge Associates U.S. PE and VC[10]). *More remaining value will likely mean more reserves and resources required to properly support and manage unrealized portfolios.*
Despite being larger, funds are getting invested over shorter timeframes	As of mid-2019, the typical 3-year-old venture fund was 67 percent called. From 2006 through 2008, the typical 3-year-old venture fund at the time was 50 percent called[11]. *This suggests that funds today have gotten called and deployed faster than pre-GFC. This leaves funds today more invested with less dry powder than during the prior financial crisis. In addition, with the increased use of capital call lines, pacing may be even faster.*
Firms have been coming back to market faster for new funds	Buyout funds in 2019 came back to market 3.6 years after their predecessor fund. This is down from 5.2 years in 2013[12]. The average time between funds in venture capital came down to under 3 years[13]. *This suggests that recent vintage predecessor funds have younger and less seasoned portfolios that may need more time and capital reserves to manage to exit.*
Despite record fundraising, fully invested funds have less dry powder than prior to the GFC	Industry dry powder today is $2.5 trillion relative to $1.2 trillion in 2008[14]. However, only a fraction of it is available for supporting existing portfolios. • Andrea Auerbach from Cambridge Associates recently said, "We estimate those older vintages are down to "fumes," as in 15 percent or less in remaining available commitments, and so they may not have the wherewithal on hand to fully support those companies and protect the fund return"[15]. • In buyouts, only 30 percent of today's dry powder sits in funds more than 2 years old. In 2010, 80 percent of dry powder was in funds more than 2 years old[16]. • In venture, three-quarters of global dry powder is in 2017 to 2019 vintage funds[17], not in the earlier fully invested funds. *Most of the industry's dry powder is in young funds meant for new investments, not to support existing predecessor fund portfolios.*
More participation in deals from CVCs, other non-traditional PE investors and newly formed firms	Corporate VC activity has also grown with CVCs participating in more than 1,200 financings or 24% of all venture rounds[18]. Furthermore, according to SVB, 61% of all active VC firms today never experienced a recession, 16% were founded between the dot com bust and GFC and 23% were founded before the dot com bust[19]. *In prior downward cycles, non-traditional investors were more inclined to exit private investing and less motivated to continue to support portfolio investments.*
Higher valuations for late stage venture deals	In late stage venture capital, median pre-money valuations since 2010 have grown by 4.1x for Series C rounds and 5.7x for Series D+ rounds[20]. *With entry valuations for later stage investors materially higher, it will likely take more time and possibly additional capital to generate positive returns.*
Higher leverage in buyout deals	In 2019, more than 75% of US buyout deals had leverage multiples over 6x EBITDA. Following the global financial crisis in 2009 through 2011, less than 25% of deals had leverage of more than 6x EBITDA[21]. *There is materially more financial leverage in buyout assets today than following the GFC.*

Direct Secondaries Can Be an Effective GP Tool to Manage Up and Down.

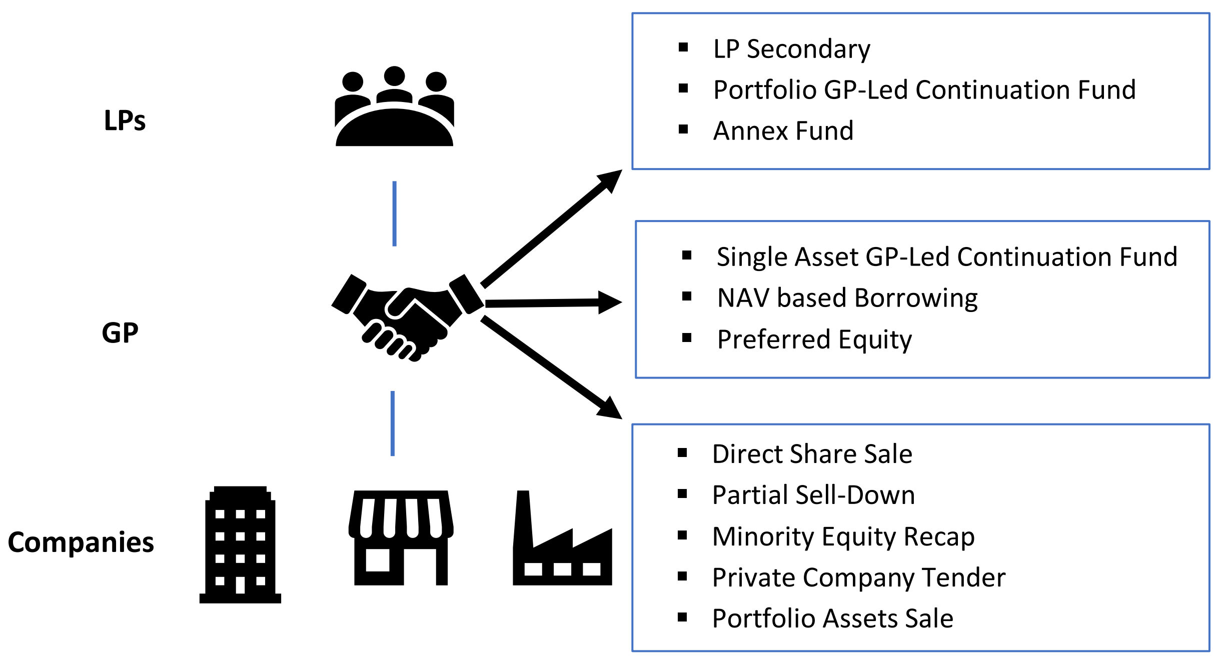
The PE industry is very different today than it was 10 years ago. With more assets, capital, co-investors and leverage, GPs have become more proactive in managing liquidity and net returns. Secondary strategies have become a key tool helping them do so.

Capitalizing on these strategies, GPs can more effectively manage-up, gaining more control over net cash flow, distributions and remaining value for their funds and LPs. GPs can also manage-down by having more tools to control asset by asset liquidity timing.

Whether managing up or down, secondary transactions open up enormous flexibility for GPs to shorten or extend duration and grow or defer liquidity.

GP Options to Manage Up or Manage Down to Enhance Performance

GPs are using secondaries to manage up-by providing LPs with liquidity options and manage down-by providing shareholders with liquidity options.



What is Next?

Direct secondaries used strategically can reduce risk, improve IRR and optimize return multiple. We expect the market for direct secondaries to continue to grow and has the potential to have a wide-ranging impact on the PE asset class including the primary GP market, the primary LP market and the secondary LP market.

Direct secondaries have already allowed companies to stay private longer and extend their runways, thereby expanding the asset class. These transactions can lower average duration for investors seeking liquidity and extend duration for investors who want to continue to hold. Will direct secondaries alleviate liquidity pressures from limited partners in harvesting late stage funds, resulting in less need for LP secondaries?

If the current crisis stimulates more secondary market activity on a sustained basis during both down and up cycles, it will become a further engrained component of the private equity ecosystem.

While there are many unknowns today, one certainty is that with this growth, opportunity and market demand, secondaries are certainly becoming primary.

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David Wachter is Managing Partner and Co-Founder of W Capital Partners and has been discussing the merits and growth opportunity in direct secondaries since 2001. W Capital Partners is a private equity firm focused on direct secondaries, providing GPs and other shareholders with secondary liquidity for their portfolio investments. W Capital Partners has invested more than $2.5 billion in over 50 direct secondary transactions, seeking to provide GPs and shareholders with a range of flexible capital liquidity solutions.

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[2] Cambridge Associates Global PE and VC RVPI. Record dates of Q3 2019 and Q3 2011.

[3] Scenic Advisement Market Perspective. February 2020.

[4] Nasdaq Private Market Secondary Market 2019 Retrospective. February 2020.

[5] Campbell Lutyens, Evercore, Greenhill, Lazard.

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