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PE Secondaries a Growing Liquidity Source Amid Market Dislocation

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Fitch Ratings-New York/Chicago-04 August 2022: Private equity (PE) exit activity should slow in 2H22, given the more challenging market backdrop for monetizing assets. Still, amid ongoing volatility and less accommodative public markets, the secondary market is expected to serve as a more meaningful source of liquidity for alternative investment managers (IMs), Fitch Ratings says.

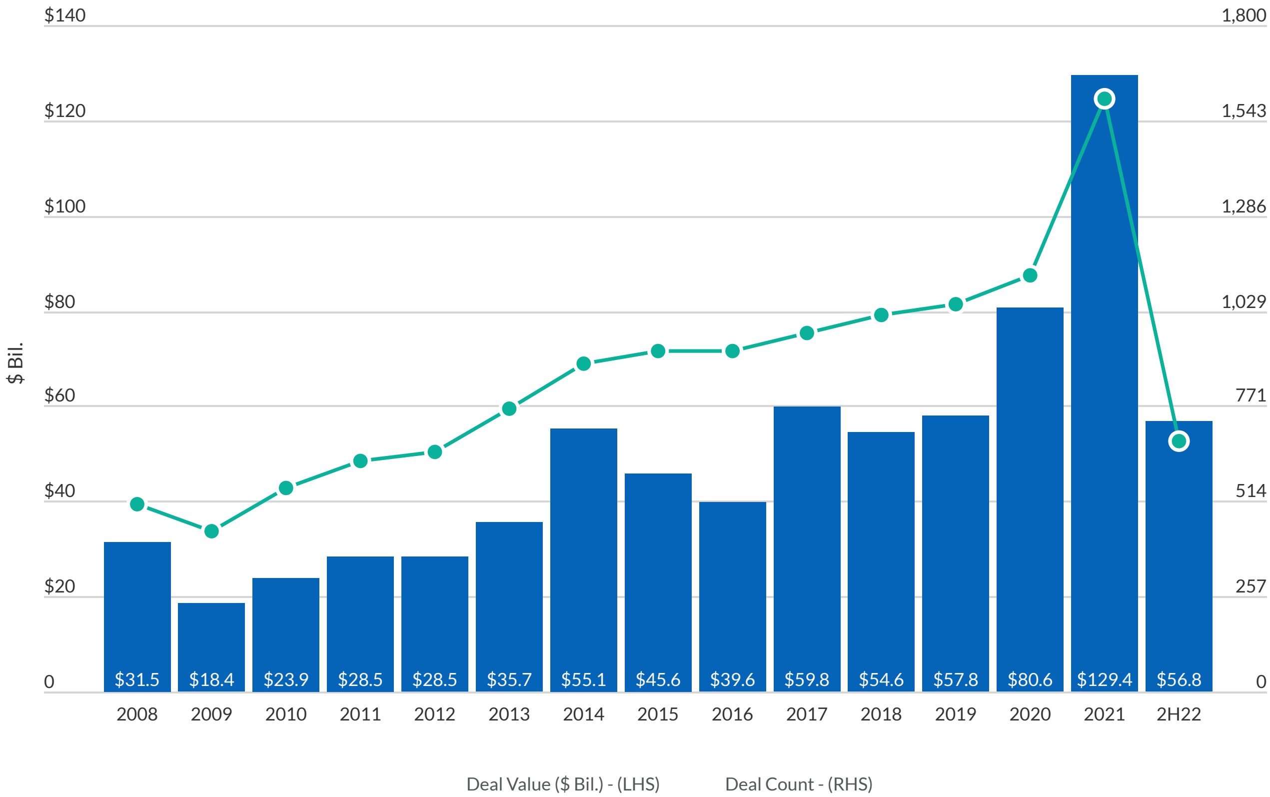
Secondary transactions, within the same general partner (GP) or between GPs, may allow alternative IMs to provide increased liquidity to limited partners (LPs), maximize the value of underlying investments and extend management fee generation capacity, which can all be incrementally positive to alternative IMs' assigned ratings. However, secondary activities can potentially create conflicts of interest between GPs and LPs and have recently begun to attract regulatory scrutiny, both of which need to be carefully managed.

Fitch defines a PE secondary transaction as the sale or financing of one or a pool of existing PE interests from one GP to another or from one fund to another managed by the same GP. These transactions allow the original GP to realize the value of the investment and to facilitate liquidity for the original investor (or fund).

A record $130 billion in U.S. secondary deals were completed in 2021, according to PitchBook. Fitch believes current market conditions could drive more secondary activity, given fewer attractive alternative channels to exit investments, as IPOs have waned and the SPAC market has nearly ground to a halt.

Market Dislocation Has Fueled Secondary Deal Flow

Secondary Market Provided Significant Liquidity in 2021



Source: Fitch Ratings, PitchBook.

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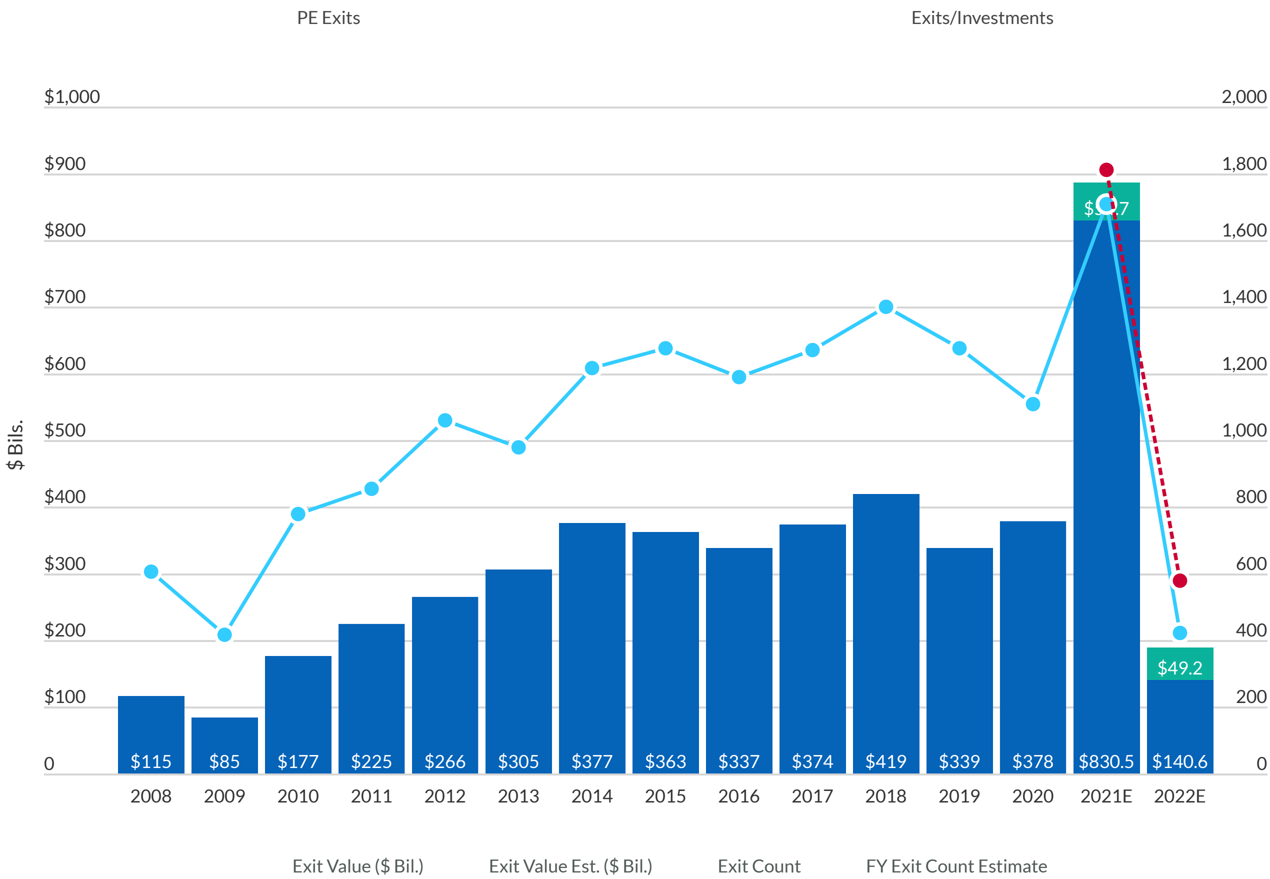
PE firms tend to hold investments through market dislocations rather than selling at depressed prices amid falling valuations. The ratio of U.S. PE exits to investments fell to 0.34x for 1H22 versus 0.48x in 2021. GP-led transactions, whereby the GP transfers existing fund interests to a new fund, accounted for over half of 2021's secondary market volume, according to a Cebile Capital report.

Market Dislocation Has Led to Longer Holding Periods

PE Exits May Fall Nearly 70% in 2022, with Valuations Down 33%



Note: 2022 actual numbers are through June 30, 2022. Exit/investment ratio excludes investment add-ons.
Source: Fitch Ratings, PitchBook.

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GPs have increasingly sought to retain ownership of strong performing assets nearing the end of the original fund's life through continuation funds, which acquire one or more assets from an existing fund. These investments are sold at a valuation mark, typically generating a gain for one fund (and likely incentive income) and establishing a new cost basis for the new fund. Continuation vehicles also allow GPs to extend fee streams for managing investments. In 2021, continuation funds accounted for 84% of GP-led transactions, and single-asset continuation vehicles represented nearly half of GP-led volume, up from 27% in 2019, according to Jefferies.

LPs in the original fund can extend their interests into the continuation fund or cash out. For new investors, acquiring interests in seasoned investments can eliminate or reduce low or negative returns typical at the onset of a traditional fund when capital has yet to be deployed and returns are outpaced by expenses and fees (J-curve effect).

In April 2022, as part of a $23 billion recapitalization, Blackstone sold its last-mile logistics platform Mileway from one of its opportunistic strategies to a new perpetual capital vehicle that it also manages, along with existing vehicles. Last month, KKR completed a $12 billion recapitalization of one of its portfolio companies, Internet Brands, selling it from existing funds to a new continuation vehicle also managed by KKR. The investment valuation has grown eight-fold since KKR's initial investment in 2014.

These deals are subject to a "go-shop" process, allowing the portfolio company, LPs and/or bankers to seek competing offers. Still, there has been increased scrutiny around valuation of these transactions and perceived price discovery and potential conflicts of interest as in-house sales often trigger realized incentive income for GPs. The SEC has proposed rules to provide greater transparency and price competition through independent fairness opinions. Fitch expects alt IMs to effectively manage these risks given the criticality of their reputation to fundraising success.

Private Equity Secondary Transactions Are on the Rise

Declining Fund Distributions, Slower Realizations Could Spur Activity as LPs Look to Rebalance, Generate Liquidity

Date	Seller	Buyer	Transaction Size ($ in Mil.)	Transaction Type
19-Jun	Norinchukin Bank	Ardian	5,000	Portfolio
20-Jul	Future Fund	AlpInvest Partners	4,294	Portfolio
21-Mar	Leonard Green & Partners	AlpInvest Partners, HarbourVest Partners	2,500	GP Restructuring
21-Jul	Intermediate Capital Group	Glendower Capital	5,102	GP Restructuring
19-Aug	Eurazeo	Adams Street Partners, Lexington Partners, StepStone	2,750	GP Restructuring
20-Oct	CPP Investment Board	GIC, Goldman Sachs Alt. Investment and Manager Selection (AIMS)	2,500	Portfolio
21-Nov	NY State Teachers' Retirement System	TBA	2,600	Portfolio
21-Dec	Clayton Dubilier & Rice	BlackRock PE Partners, GIC, Hellman & Friedman	23,891	GP Restructuring
21-Dec	Partners Group	Intermediate Capital Group	2,275	Sole Fund Interest
22-Feb	Roark Capital Group	TBA	3,000	GP Restructuring

Source: Fitch Ratings, Preqin.

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