50 SOUTH CAPITAL

FLEXIBLE CAPITAL COMMANDS A PREMIUM IN PERIODS OF UNCERTAINTY: *OPPORTUNITIES AND TRENDS IN THE PRIVATE EQUITY SECONDARIES MARKET*

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OPPORTUNITIES IN THE PRIVATE EQUITY SECONDARIES MARKET

The private equity secondaries market offers investors one of the most exciting opportunities in private markets today. Secondaries are a strategy where market dislocations, and, in particular, periods of heightened volatility, create significant openings to purchase high-quality assets at material discounts to their intrinsic values. The secondary market has grown from a relatively small asset class in the early 2000s to an industry with over $100 billion of transaction volume in 2022[1]. However, while the secondary industry has experienced rapid growth over the past twenty years, it remains a niche component of the overall alternatives space, representing only a small fraction of total private equity assets under management. We expect that as more investors gain awareness of the attractive investment opportunities available and observe the compelling risk-adjusted returns generated from secondary transactions, this percentage will increase.

Investors who have not allocated to secondaries in the past are now gaining awareness of the differentiated return potential from this "good in good times, great in bad times" asset class, and are doing their due diligence on the space and on secondaries managers. Sellers, including both limited partners ("LPs") and general partners ("GPs"), are looking to the secondary market as a way to manage portfolios and funds through a period of shifting market liquidity. LPs are looking to secondary markets to sell private equity holdings and rebalance their asset allocations after a difficult year for public markets generally and specifically for the "60/40" stock/bond portfolio. GPs are utilizing the secondary market to provide liquidity for legacy fund investors, while maintaining control of prized-businesses with significant value creation opportunities that require additional time and capital. The past year offered a rich opportunity set for secondary buyers, and the year ahead is setting up to be one of the best market environments for multi-strategy secondary fund managers. In this paper, we explore four key trends in the secondary market and dive into how these key trends support the potential for outsized returns.

#1 – Dislocation in Public Markets Has Led to an Outsized Opportunity in Traditional LP Secondaries

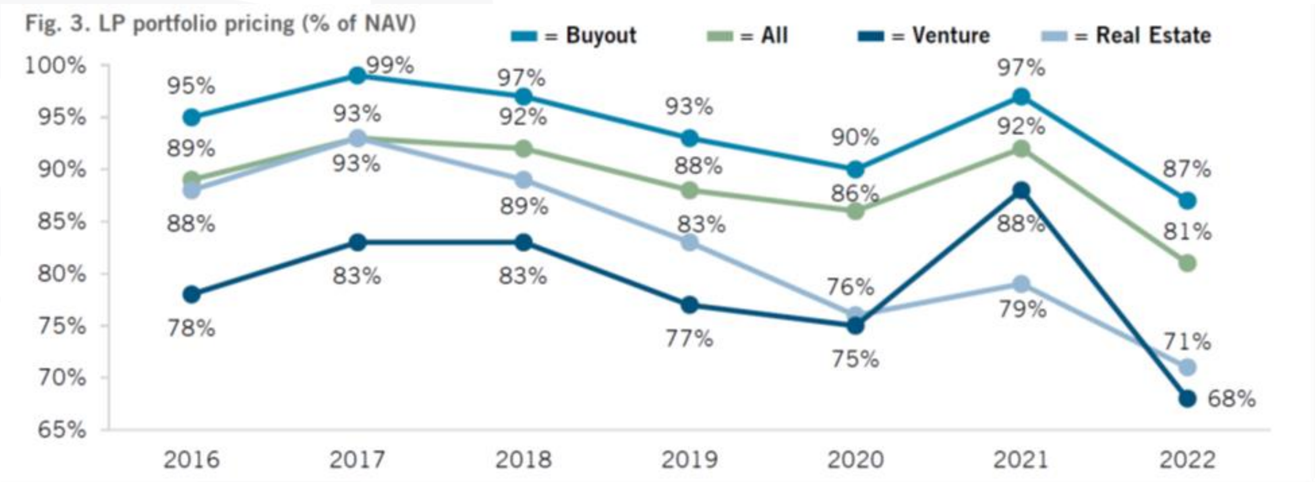
Periods of public market volatility, as we are experiencing today, have historically set the stage for rich opportunities in the private equity secondary market. Last year was a historic one for public markets, with 2022 turning out to be one of those rare periods when both bonds and equities sold off significantly. The MSCI ACWI closed the year down -18.4% and the Bloomberg U.S. Aggregate Bond Index closed down -13.0%[2], and these annual returns masked much greater volatility across global markets throughout the year. Geopolitical turmoil contributed to spikes in market volatility, with leadership changes in the U.K. and the war between Russia and the Ukraine, for example, leading to pressure on asset prices and causing pain in investors' portfolios. Given the relative stability and outperformance of private market portfolios, many investors have experienced significant shifts within their portfolios that have left asset allocations out of compliance with investment policies. Many investors are concerned about their ability to meet their unfunded obligations due to slower distributions from their private markets holdings or have limited capital available for new private market commitments they want to make due to the decline in the liquid assets in their portfolio. Absent a "V-Shaped" recovery in liquid assets, many investors are being forced to look to the secondary market to sell good private equity holdings they would have

(1) Source: Evercore, "2022 Secondary Market Synopsis", January 2023.
(2) Source: eVestment. Past performance is not indicative or a guarantee of future results. Index performance returns do not reflect any management fees, transaction costs or expenses. It is not possible to invest directly in any index.

otherwise continued to hold and to create liquidity from older vintage investments that have earned solid returns.

We expect that this backdrop, along with continued volatility and lower return expectations for traditional assets, will support a large pipeline of LP secondaries well into 2023, ranging in size and complexity. As more sellers have entered the market over the past year, prices have come down. A similar opportunity emerged in 2020, when the outbreak of COVID-19 created a sharp market sell-off and the need for liquidity. Average discounts expanded significantly by approximately 10% to 20% in the fourth quarter in 2022, as demonstrated in the graph below[3]. With sellers turning to the secondary market both for active portfolio management as well as to free up capital to make new private equity commitments, we believe the secondary market is poised for a period for outperformance.

Jeffries: Global Secondary Market Review[3]



#2 – Growth in the GP-Led Market is Expected to Improve the Overall Returns of the Secondary Industry, but Increase the Dispersion of Returns

The GP-led secondary market is a relatively new and exciting part of the private equity industry that is becoming increasingly popular with both sponsors and buyers. The GP-led market includes secondary deals where the sponsor initiates the secondary transaction and is actively involved, either running a tender offer for a fund, or creating a "continuation vehicle" ("CV"). CVs create opportunities for a specific company to be sold from an older private equity fund, providing liquidity to the original investors, by moving the company into a separate vehicle as the sponsor looks to continue to own and add value to the business.

Continuation vehicles are attractive to both buyers and GPs. For buyers, CVs may offer higher potential returns than more diversified traditional secondaries given the concentration in one asset and because GPs are hand selecting businesses with strong momentum. We believe that even top quartile GPs should only have one excellent continuation vehicle candidate every few years, so this transaction type is only intended to be used with exceptional businesses. Continuation vehicles can also increase the return potential in secondaries, as deals are typically underwritten to a premium return target of over 2.0x, well

(3) Source: Jeffries, "Global Secondary Market Review", January 2023.

above the historical 1.4x-1.7x average net TVPI of the secondary industry. Of course, the concentration risk in these transactions is quite different than for diversified portfolios of traditional LP secondary transactions, and that risk needs to be managed by secondary fund managers. Managers with deep relationships and knowledge of the GP market, who have the ability to underwrite individual assets, and with experience in this market have the opportunity for strong returns.

For GPs, continuation vehicles can offer the opportunity to continue to own their highest-performing companies beyond the traditional four-to-five year hold period, and potentially realize more value from a strong asset, while also meeting the liquidity expectations of their legacy fund investors. When a GP raises a CV to continue owning one or more of their trophy assets in a new structure, the sponsor typically rolls 100%+ of their economics related to the asset(s) into the continuation vehicle alongside new investors. As a buyer, we would not underwrite and participate in a continuation vehicle where the GP is taking their personal economics out of the deal. Alignment of interests is table stakes, and important to both sides of the transaction – it is this economic alignment that suggests that GPs will place a particular focus on CVs from a time and attention perspective. GPs also have the opportunity to allow new/younger members of their teams to participate in the carried interest of continuation vehicles that may not have had an equivalent share of the carry in the legacy funds holding these top-performing assets.

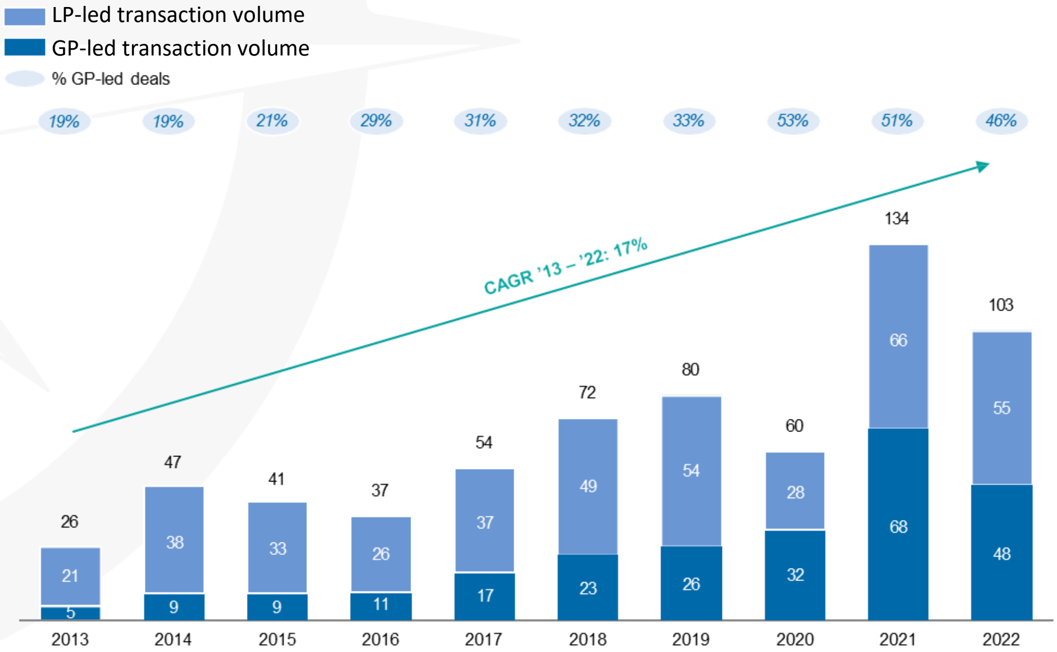
In today's under-capitalized secondaries market, the GP-led market looks compelling and investors can be discerning. Deals with any operating issue, or where the GPs lack strong alignment, are not raising sufficient capital to close. High quality deals continue to have strong interest, supporting the performance uplift that these deals should bring to the secondary market. Further, a wider range of transaction sizes has emerged. When continuation vehicles first arrived in 2019/2020, they were primarily raised by larger GPs for large portfolio companies. Today, smaller continuation vehicles are in vogue, with down market companies from middle market focused sponsors available in the market, offering more opportunities for buyers and sellers and primarily benefitting the firms who have an existing relationship with the sponsor. Secondary firms with strong relationships with top tier GPs have an advantage in this compelling investment opportunity. At 50 South Capital, our primary investment business provides us with valuable market knowledge of many sponsors and supports the detailed underwriting necessary to earn strong risk-adjusted returns from this strategy.

#3 – The Secondary Market is Currently Significantly Under-Capitalized

The secondary industry's compounded growth rate of 17% per year over the past ten years has been driven by both the increasingly active portfolio management of illiquid investments and the proliferation of GP-led transactions. However, even with the market achieving over $100 billion of transaction volume in 2022, the industry is still very much in its early years. Growth in supply of potential secondary market opportunities has generally tracked the growth in the private equity industry. Going forward, we expect the number of potential sellers to increase, supported by the long-term tailwinds for growth of the overall private equity industry. Recent annual secondary transaction volume only represents approximately ~2% of the ~$4.5 trillion in total private equity assets under management, suggesting significant room for additional growth as more investors take advantage of the secondary market with the goal to rebalance portfolios, and as the "turnover rate" continues to increase.

Secondary funds are experiencing the continued challenge of raising enough capital to support this large and growing market opportunity, while investors increasingly seek liquidity in their private equity portfolios. The same denominator-effect that is catalyzing institutional investors to sell their private equity holdings is also constraining their ability to make new capital commitments to current-vintage secondaries funds. This shortage of secondary capital has been true for much of the market's history but is especially acute today. According to 2022 market surveys, total equity dry-power in the global secondaries industry was estimated to be $103 billion[1], representing approximately only one year or less of annual secondary transaction volume, with an additional $93 billion of capital targeted to be raised by funds currently in market. With fundraising activity poised to slow down across the private equity industry, the undercapitalization of the secondary market may not be relieved any time soon. This shortage of dry powder is a key reason that secondary buyers may have an advantage in today's market and are poised to potentially outperform.

Evercore: 2022 Secondary Market Transaction Volume Over Time ($bn)[4]



With limited capital to invest, secondary buyers can be extremely selective in the transactions they pursue. Deals closing in these market conditions are likely to be only the highest quality opportunities, as limited capital will focus on the most attractive assets. Buyers have the clear advantage, and this trend supports higher returns from secondaries in the years ahead. The industry is expected to continue to grow, and there will likely be some new entrants, but the competitive moats are high. New secondary buyers are confronted with significant obstacles considering the importance of long-term relationships with sponsors and intermediaries, the required underwriting expertise and market knowledge necessary to generate strong returns, and the control that GPs hold over the industry given that consent by GPs is required for deals to close.

(4) Source: Evercore, "2022 Secondary Market Synopsis", January 2023.

#4 – Growth in Secondary Market Supply Means that Buyers Must be Increasingly Discerning on Asset Quality

As volume increases, and with a backdrop of sellers driven by dislocations in public markets, we expect a widening range in the quality of assets for sale in the secondary market. Secondary buyers have the opportunity to generate returns both by paying discounts to intrinsic value, and from the post-closing performance of the investment. The discount itself can be a meaningful driver of returns, particularly in periods such as today when discounts widen, but the go-forward returns generated by each investment can have a much bigger impact on the ultimate performance of a secondary fund. Investors are wise to consider how a secondary manager evaluates asset quality, the depth of the manager's underwriting process, the manager's relationships in the private equity industry, and the manager's ability to identify and access investments in the highest quality GPs and portfolio companies.

Data has continued to demonstrate the persistence of strong performance by the world's best private equity managers. Those managers with funds demonstrating consistent, top quartile performance tend to find a way to win through challenging economic environments, while some less experienced managers may find it more difficult to generate attractive returns through cycles, even with good portfolio companies. A secondary buyer has the opportunity to evaluate both the track record of the private equity sponsor in every transaction and also to underwrite the individual assets in the fund. It is our view that deep knowledge of the sponsor universe can lead to outperformance, as a secondary buyer with a more discerning lens into GP quality will carefully weigh both the discount to intrinsic value and the potential future growth of the investment under the GP's ownership.

Lastly, a secondary business that is paired with a primary investment business can be particularly valuable, as these secondary managers will have deeper insights and better access to restrictive GPs and over-subscribed transactions. In the current environment, sellers are offering traditional LP stakes in top quartile funds that are rarely for sale on the secondary market, and many top GPs only approve secondary funds that have primary fund programs that could support the GP's future funds. A secondary strategy that prioritizes a deep underwriting of each asset and a preference for buying assets from top GPs is likely a strategy that will demonstrate outperformance over time, with an all-weather return profile through varying market environments.

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