APOLLO | S3 Sponsor & Secondary Solutions

PE Secondaries: Evolving Landscape Can Expand Opportunities

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KEY TAKEAWAYS

- Secondaries are now a core allocation for sophisticated private markets investors.
- General Partner (GP)-led secondaries and continued private markets maturation will likely continue to drive overall secondary market growth and innovation particularly given the different return profile of GP-leds than traditional Limited Partner (LP) LP-led secondaries. We believe the market will double or triple in size in the next five years.
- Distinctive attributes that drive differentiation for secondaries as a strategy—and differentiation among managers—will likely continue to persist.

Juxtaposed against the rapid growth of the broader private capital markets, the secondary market has developed into a core allocation for many sophisticated investors driven by: the growth of sub-markets in the secondary space; continued adoption of secondary sales as a tool for proactive portfolio management rather than a tool of last resort accelerating liquidity during periods of distress; and the expectation (well founded in our view) of future growth of the GP-led market.

We believe the GP-led portion of the secondary market will continue to grow due to the slowing exit environment experienced in the past five years. As GPs continue to receive pressure from their Limited Partners (LPs) to monetize investments and drive distributed to paid-in capital (DPI), GPs are increasingly turning to the secondary market as a creative and innovative route to liquidity. Even when traditional exit avenues (M&A, IPO) reaccelerate for sponsors, we believe GP-leds are now part of their "exit toolkit" given the ability to hold on to trophy assets for longer and as an attractive portfolio management tool for GPs.

Secondaries have generated strong historical performance relative to other alternative strategies on both an absolute and risk-adjusted basis, with the strategy generating a narrower dispersion of returns without giving up significant upside performance.

During periods of dislocation, such as during and after the Great Financial Crisis and the European Debt Crisis, secondaries added resilience to private market portfolios by capitalizing on market volatility to acquire assets at attractive pricing.

We believe future secondaries investors will continue to experience excess return per unit of risk when compared to other private market strategies due to a variety of factors including:

- The supply of investable opportunities is greater than available secondary capital.
- Availability and magnitude of discounts.
- Market inefficiencies create attractive transaction dynamics.
- Rapid deployment pace of capital particularly in times of dislocations enables outperformance through favorable entry points.
- Immediate diversification in most secondary strategies providing a ballast against idiosyncratic risk.
- Increasing ability for investors and secondary fund managers to modulate risk through accessing a broad range of opportunities across the cost of capital spectrum.

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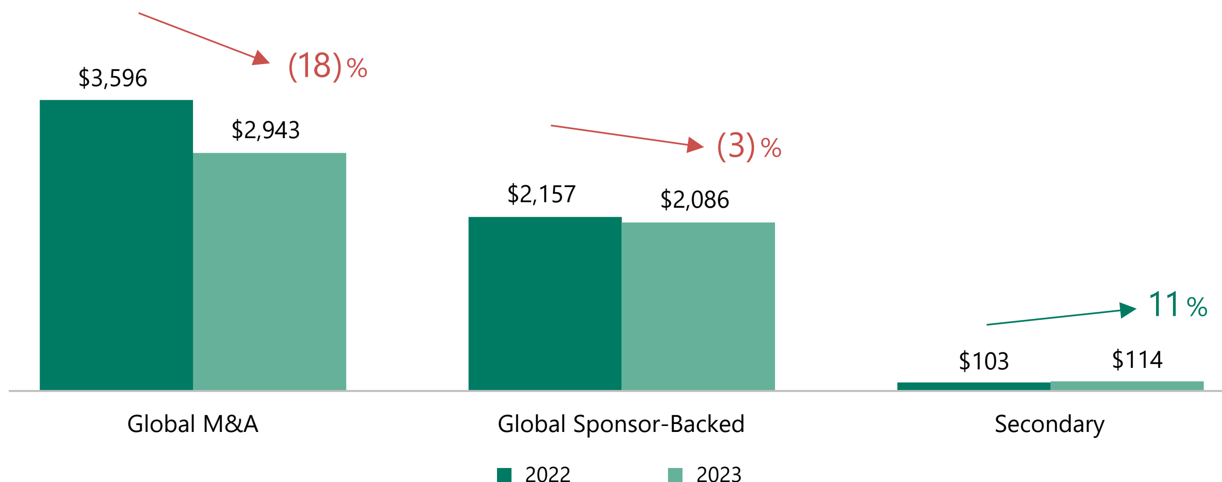
Section I 2023: Secondary Market Year in Review

Despite significant financial market and geopolitical volatility, last year delivered the second busiest year on record for the secondary market with $114 billion of closed transaction volume.[1] This represents an 11% increase from 2022 volume of $103 billion compared to the Global M&A market and the sponsor-backed M&A market, which fell 18% and 3% respectively.[2] We are seeing the effects of investors accessing the secondaries market as a means to generate liquidity amidst a tepid distribution environment. We believe well in excess of $200+ billion of potential sale volumes tested the market in 2023, relative to the $114 billion of closed transactions.

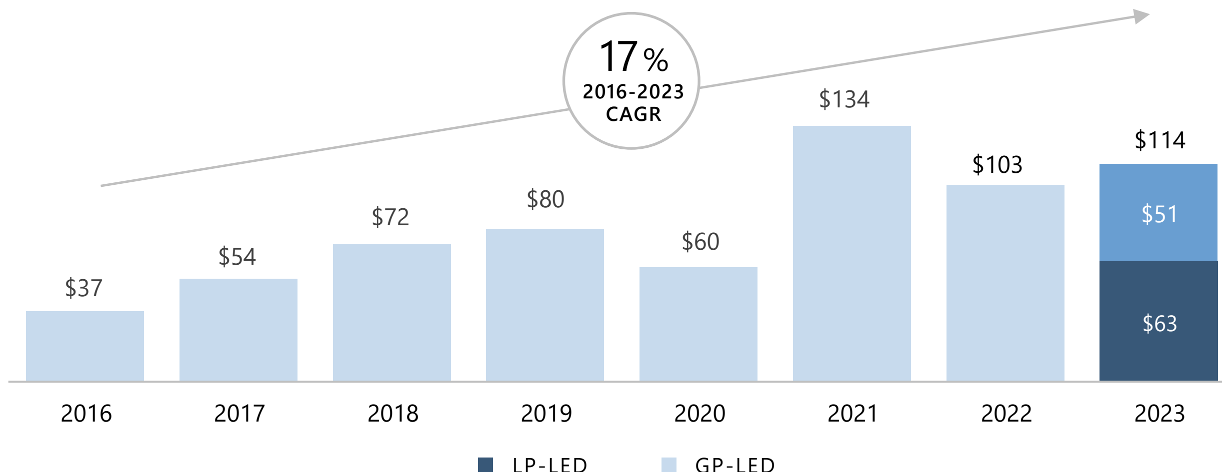
Over a longer time horizon, the secondary market has demonstrated significant and consistent growth, compounding at 19% annually since 2016. Importantly, the market has demonstrated resilience in years following declines, as seen in 2021 when the market more than doubled following a 25% decline in 2020.

Closed Transaction Volume: Global M&A, Sponsor-Backed and Secondaries ($ billions)



Source: Paul Weiss, "M&A at a Glance: 2023 Year End."

Secondary Market Growth ($ billions)



Source: FY 2023 Evercore Secondary Market Survey Results.

[1] Source: FY 2023 Evercore Secondary Market Survey Results.

[2] Source: Paul Weiss "M&A at a Glance (2023 Year End)".

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At 55% of transaction volumes, LP portfolio sales accounted for the majority of transaction volumes in 2023 (vs. 54% in 2022), although activity in the second half of the year was more balanced ($41 billion in 1H 2023 vs $73 billion in 2H 2023). The sustained levels in LP volumes were primarily driven by the desire for liquidity and a narrowing bid-ask spread. On the GP-led side, the split was fairly balanced with single-asset deals and multi-asset transactions. We believe asset quality and GP alignment were the key factors in successfully closing GP-led transactions in 2023.

Several recent secondary market trends continued to gain importance in 2023. The first is the growth of sub-markets within the secondary space, with various firms raising dedicated pools of capital to invest across the risk-return spectrum of secondary assets. From fund finance lending at relatively low loan-to-values, to credit secondaries to preferred and hybrid equity to private equity and venture capital, a growing and evolving asset class continued to raise funds with differentiated investment mandates and costs of capital. We observe that rising awareness of the flexibility and creativity of secondary capital is increasing demand among both LPs and GPs for secondary solutions, especially in an environment where more traditional exit options are challenging.

Secondary managers are raising capital with different return profiles in response. We cover this phenomenon further in Section III.

Another key trend is the continued adoption of direct private equity "tools" by secondary market participants. The use of consultant studies, quality of earnings reports, fairness opinions and reps and warranty insurance all continued to become more prevalent, especially in concentrated GP-led transactions where the asset underwrite is as important as direct GP skill and alignment.

A third key trend is the continued belief in the future growth of the GP-led market. For reasons we will discuss further in the next section, there is a strong case for secondary volumes in general, and GP-led transactions in particular, to grow significantly over the next several years. This growth can and is (as further contemplated in Section IV) creating an attractive investment opportunity for well-resourced secondary managers with expertise underwriting single assets and concentrated portfolios. As a result, a number of well-established M&A advisors have created or expanded secondary practices to focus primarily on GP-led transactions.[3] Virtually all M&A advisors now include secondary market transactions alongside more traditional exit strategies such as IPO and "trade sales."

> Last year delivered the second busiest year on record for the secondary market with $114 billion of closed transaction volume.

[3] Examples include but not limited to Baird, Goldman Sachs, Morgan Stanley, Raymond James, UBS and William Blair. Source: Apollo Analysts.

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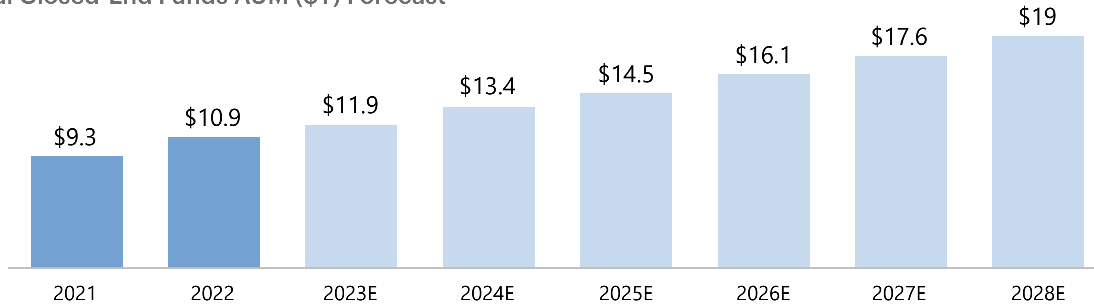
Section II The Secondary Market: A Five-Year Forecast

Looking forward to 2024 and beyond, we forecast strong secondary market growth for several reasons. First is the current size and forecasted growth of the primary market. Preqin recently published a forecast for private capital closed-end fund assets under management (AUM) through 2028.[4] Their projections show total AUM growing to $19 trillion in 2028.

Private Capital Closed-End Funds AUM ($T) Forecast

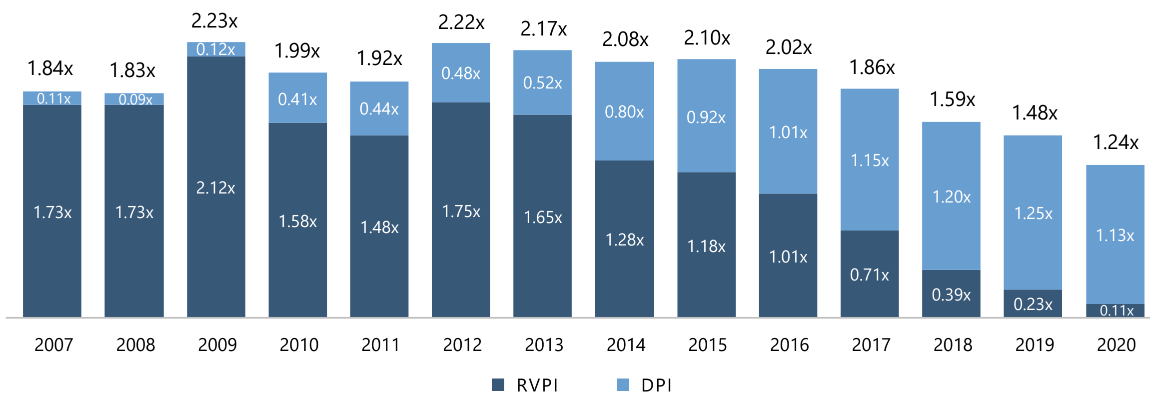


Source: Preqin as of October 2023.

Historically 1–2% of private markets AUM has traded in the secondary market.[5] Given increasing familiarity and acceptance of secondary "technology" by both LPs and GPs, it is not an unreasonable expectation that future transaction volume is at the high end of that range.

In addition to the expected growth in private market assets, another potential driver of secondary deal flow is the fact that distributions have been meaningfully less over the last few years compared to prior years. Per the chart below, Goldman Sachs estimates that funds raised in 2018 have, on average, distributed just 39% of paid in capital as of year-end 2023.[6] Compare that figure with 2014 vintage year funds after four years' duration (i.e., in 2018) when distributions were 58%. The 19% difference applied to $500 billion of capital invested in 2018,[7] implies an "extra" $95 billion of AUM that might have already achieved liquidity in a more normal exit environment. Extending this analysis to the 2019 and 2020 vintage years suggests at least an incremental $300 billion of NAV where secondary capital could be a solution. Even when traditional exit avenues normalize, we believe GP-led secondaries have become a key component of the exit toolkit given the ability for GPs to create liquidity for investors while holding on to trophy assets for longer in alignment with secondary market partners.

North American Buyout RVPI & DPI (2007-2020)[8]



Source: Goldman Sachs Secondary Advisory 2023 Secondary Market Review (February 2024).

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4 Source: Preqin Future of Alternatives 2028. Private capital is defined as private equity, venture capital, private debt, hedge funds, real estate,infrastructure and natural resources.

5 Apollo Analysts.

6 Source: Goldman Sachs Secondary Advisory 2023 Secondary Market Review (February 2024).

7 Bain Global Private Equity Report 2023.

8 RVPI stands for remaining value to paid-in capital. TVPI stands for total value to paid-in capital.

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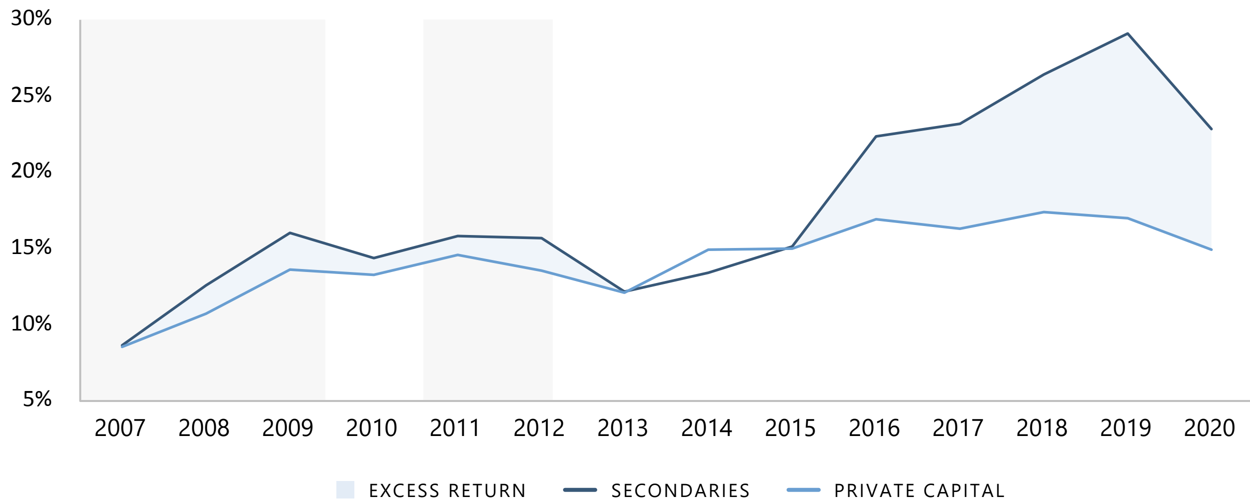
Section III The (Continuing) Case for Secondaries in a Private Markets Portfolio

With all the historical and forecasted growth of the market, it is sensible to query whether secondaries as an asset class can continue to deliver excess return per unit of risk. In this section, we will share our reasons for why we strongly believe the answer is "yes."

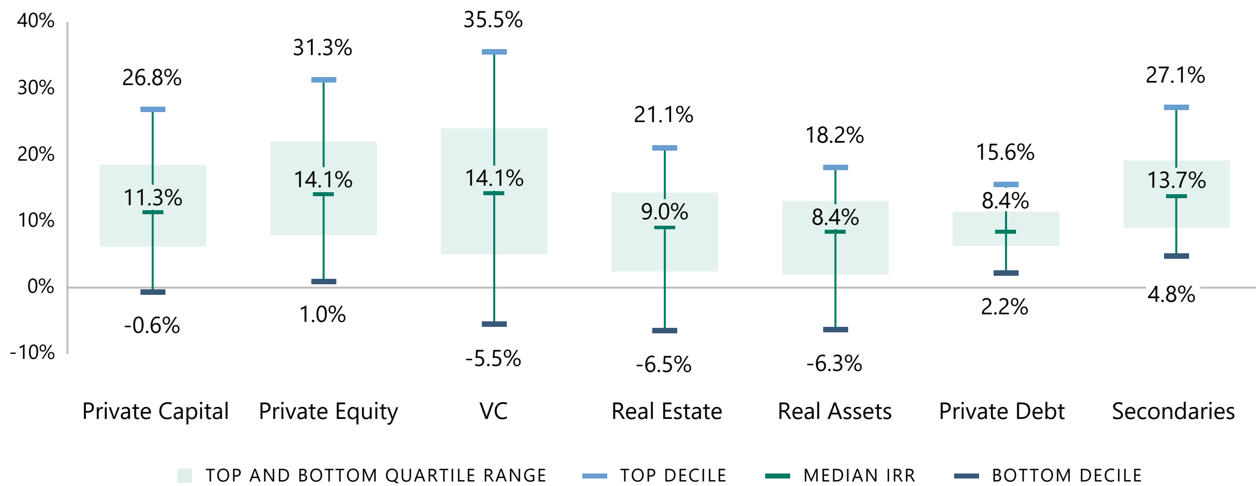
First, we will provide a reminder of secondaries' historical performance relative to other alternative strategies. As shown below, secondaries have generated excess return as measured by internal rate of return (IRR) over an extended period of time and especially during periods of volatility such as the Great Financial Crisis and the European Debt Crisis.[9]

Median Net IRR by Vintage Year[10]



Source: Preqin as of August 2023.

Dispersion of Net IRRs by Private Capital Strategy[11]



Source: Pitchbook as of 3/31/2023 (Vintages 2005-2018).

[9] Preqin as of August 2023.

[10] Gray shaded area represents Great Financial Crisis and the European Debt Crisis.

[11] Source: Jefferies—Secondary Market Trends/Outlook (January 2024).

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Most important for prospective investors is the question: will the factors that have made secondary strategies successful historically remain in place over the next several years? We believe the answer is "yes" for the following reasons:

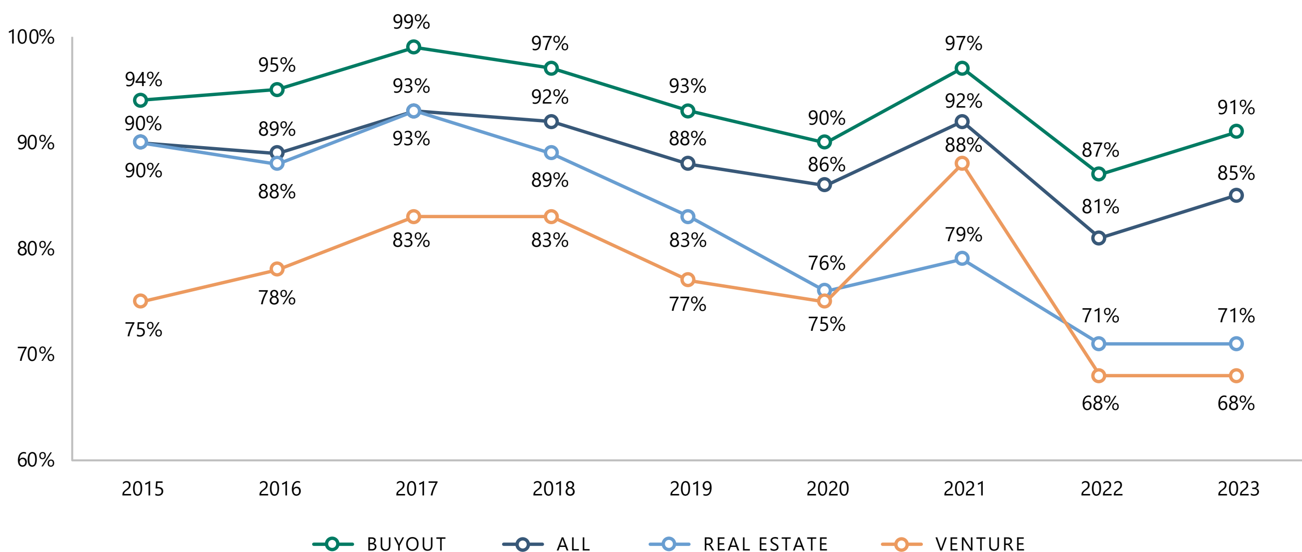
1. Supply / demand dynamics favor secondary buyers. While $114 billion worth of transactions closed last year, meaningfully more than double that amount "came to market." In many cases LPs bring to market larger portfolios than they need to sell, expecting to sell just a portion of the portfolio. This dynamic can create significant optionality for secondary buyers to create high conviction, customized portfolios to pursue. The sell-side advisor Jefferies estimates that entering 2024, there is approximately $255 billion of available secondary capital which we estimate is less than 1x the volume of available transactions and approximately 2.2x the volume of closed transactions.[12] We believe these ratios of secondary market dry powder relative to actionable investment opportunities have been and continue to be very attractive relative to most other private market strategies.

2. Secondaries remain a relatively inefficient investment strategy, characterized by complimentary objectives for buyers and sellers. While pricing is generally rational in the secondary market, it is still a market characterized by the opportunity for buyers to arbitrage time and information to help generate attractive risk-adjusted returns, while allowing sellers to actively manage their private markets portfolio and generate liquidity to recycle into new investment opportunities. Secondary LP transactions often offer very limited point in time information to secondary buyers and have short transaction timelines. As a result, well-informed buyers who can leverage the expertise across their platforms to underwrite portfolios of assets efficiently and accurately are well positioned to identify opportunities with attractive entry points.

3. Discounts are meaningful and widely available. As can be seen below, discounts widened materially in 2022 and were in fact more than twice as wide as the average of the preceding six years. In our view, wider discounts reflect several market dynamics including favorable buyer supply/demand factors as mentioned above along with buyer caution regarding the macroeconomic outlook and the belief, in certain situations, that GP valuations have not declined to levels where single digit discounts make for attractive entry points. Unless and until any of these factors change, we would expect higher-than-typical discounts to remain available.

4. Secondaries can be an effective way to capitalize on dislocation. Secondary strategies tend to have faster investment timelines than direct private equity, allowing secondary funds to deploy more rapidly in times of dislocation. Many of the factors that cause LPs to seek early liquidity, such as regulatory requirements, leadership / CIO / strategy shifts and asset allocation ("denominator effect") issues are more prevalent reasons for seeking accelerated liquidity compared to direct private equity. The ability of secondary funds to deploy quickly in times of dislocation can be a way for private equity investors to be comfortable that capital will be deployed during times of stress and distress, achieving attractive entry valuations at the "low points" in the cycle.

LP Portfolio Pricing (% of NAV)



Source: Jefferies—Secondary Market Trends/Outlook (January 2024).

[12] Source: Jefferies—Secondary Market Trends/Outlook (January 2024).

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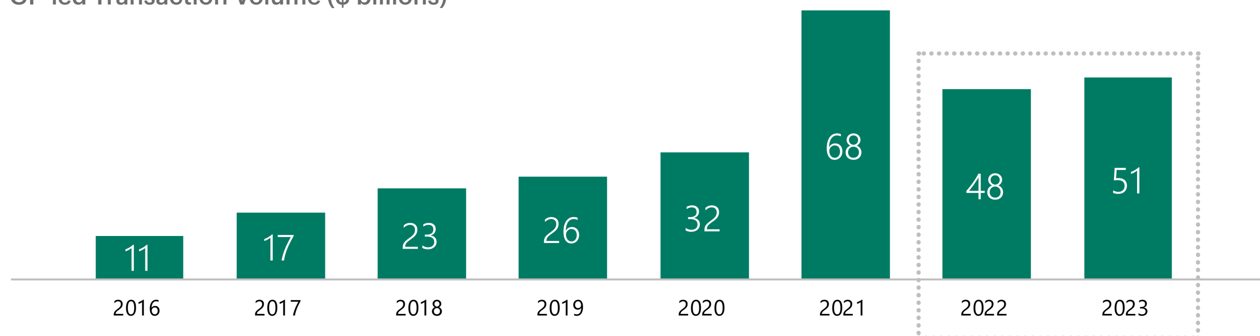
Section IV The Rise of GP-leds

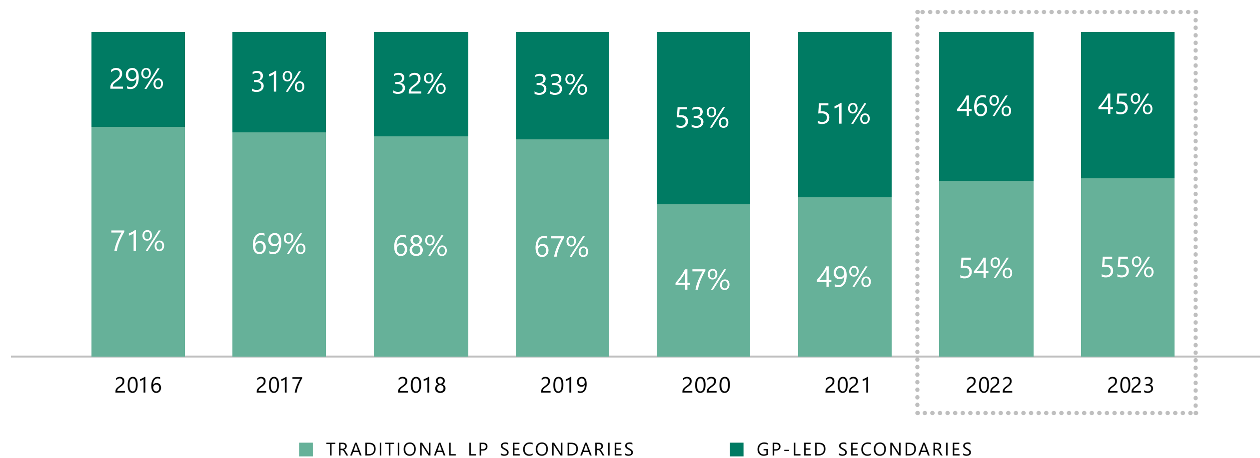
The secondaries market has kept pace with the continued evolution of private markets by being a liquidity provider to a growing set of needs as investors have continued to access private markets in search of strong returns. In the previous section we note the increased adoption of the secondaries market by GPs which has led to the rise of GP-led deals. GP-led deals differ from traditional secondary deals (LP deals), where LPs sell their current interests in partnerships, often involving multiple managers and companies. In contrast, GP-led transactions are instigated by the manager of a private equity fund, typically aimed at restructuring one or more funds (where the number of underlying companies is typically much smaller) and providing liquidity to existing LPs. Historically, market participants had a negative view of GP-led transactions as managers used these transactions as a strategy to prolong their franchise's lifespan. However, these transactions have since evolved significantly and are now widely embraced by reputable GPs as a flexible approach to retaining "trophy assets," thereby allowing them more time and capital to create additional value in these assets. Furthermore, these transactions can enable GPs to offer existing LPs the choice to either aim to lock in performance associated with legacy assets and receive liquidity or maintain their existing exposure by reinvesting in a newly established vehicle formed as part of the transaction. Since 2018, GP-led deals have represented the fastest-growing segment of the secondary market and, in recent years, GP-led deals have accounted for nearly half of annual deal volume in the secondary market. Essentially, GP-led transactions have developed to seek to provide all parties with a solution for a variety of challenges while directly addressing the liquidity needs of existing LPs.

GP-led Transaction Volume ($ billions)



Source: FY 2023 Evercore Secondary Market Survey Results.

GP-led Deals as % of Total Transaction Volume



Source: FY 2023 Evercore Secondary Market Survey Results.

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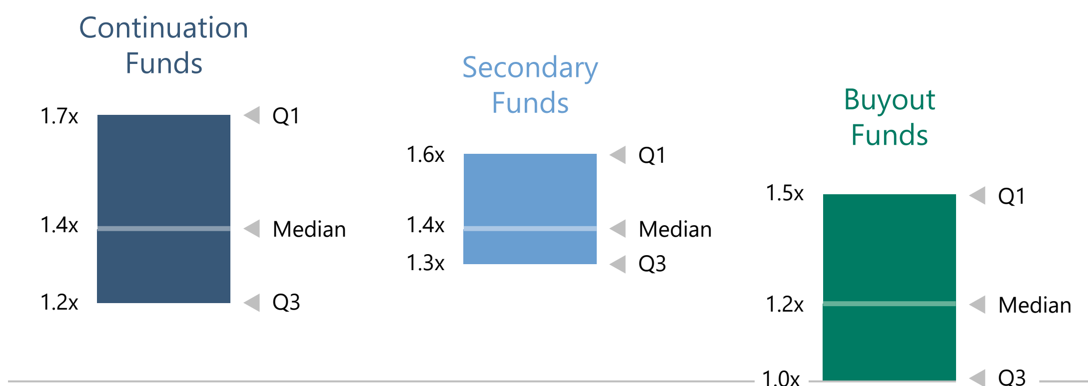
In addition to providing liquidity to current investors, buyers of GP-led deals can have the opportunity to access the positive investment attributes of both traditional secondary and buyout transactions. By investing in pre-identified assets, investors in GP-led deals can access the positive attributes of the secondary market by minimizing blind pool risk along with mitigating some of the effects of the J-curve. Similarly, investors in GP-led transactions can also access the attributes found in buyout transactions by accessing a comparable cost of capital and investment concentration.

While the prevalence of GP-led deals is a relatively new trend, the returns observed since 2018 have provided investors with conviction that the strategy can deliver attractive and differentiated risk-adjusted returns. In one of the most recent studies by Morgan Stanley, they estimate that GP-led deals have achieved a net MOIC of 1.4x along with a top quartile of 1.7x net MOIC on an absolute basis since the prevalence of GP-led deals in 2018. While the median net MOIC for general secondary funds is on par, both the median and top quartile of GP-led deals are approximately 0.2x higher compared to Buyout strategies in the same time span. In addition to outperforming on a net median basis, GP-led deals have achieved a meaningfully lower principal loss ratio when compared to buyout strategies given investors' ability to pre-identify assets in GP-led deals.

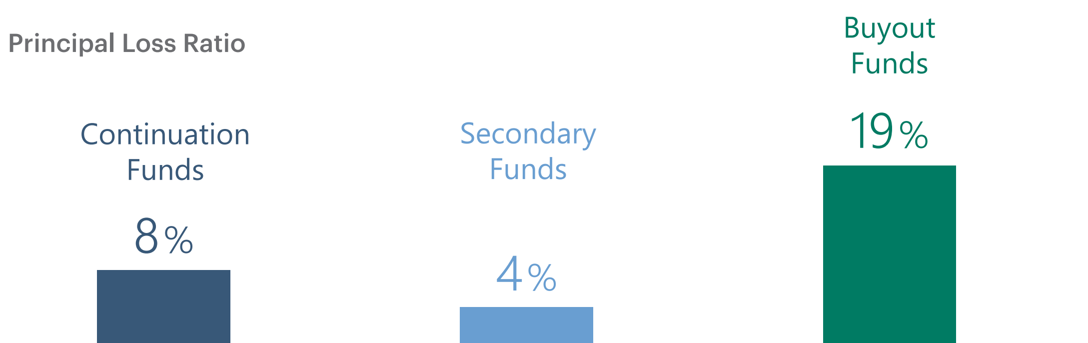
Another way to understand the performance of GP-led deals compared to other similar strategies is by not only analyzing the performance of the strategy on an absolute basis but also on a vintage year basis. By analyzing the data over time, we can account for any discrepancies in the data such as the immediate discount recapture typically found in secondaries or outsized returns during any given period in time due to factors like upward momentum in broader financial markets. When we dissect the data over time, we observe that the median, 1st quartile and 3rd quartile returns for GP-led deals are higher than the corresponding return quartiles for buyout funds in each year since 2018.

Net MOIC by Fund Strategy



Dataset represents 71 continuation funds with vintages between 2018 and 2023.[13]
Source: Morgan Stanley PCA—Continuation Fund Performance (January 2024), Prequin as of December 2023 and publicly available information
Past performance is not necessarily indicative of future results.

Principal Loss Ratio



Dataset represents 71 continuation funds with vintages between 2018 and 2023.[13]
Source: Morgan Stanley PCA—Continuation Fund Performance (January 2024), Prequin as of December 2023 and publicly available information
Past performance is not necessarily indicative of future results.

[13] 1st quartile boundary ("Q1"), median and 3rd quartile boundary ("Q3") return benchmarks are calculated using performance data from Preqin's database comprised of 107 secondary and 696 buyout funds with vintages between 2018 and 2023. Principal loss as referenced herein is defined as funds with <1.0x reported net MOIC.

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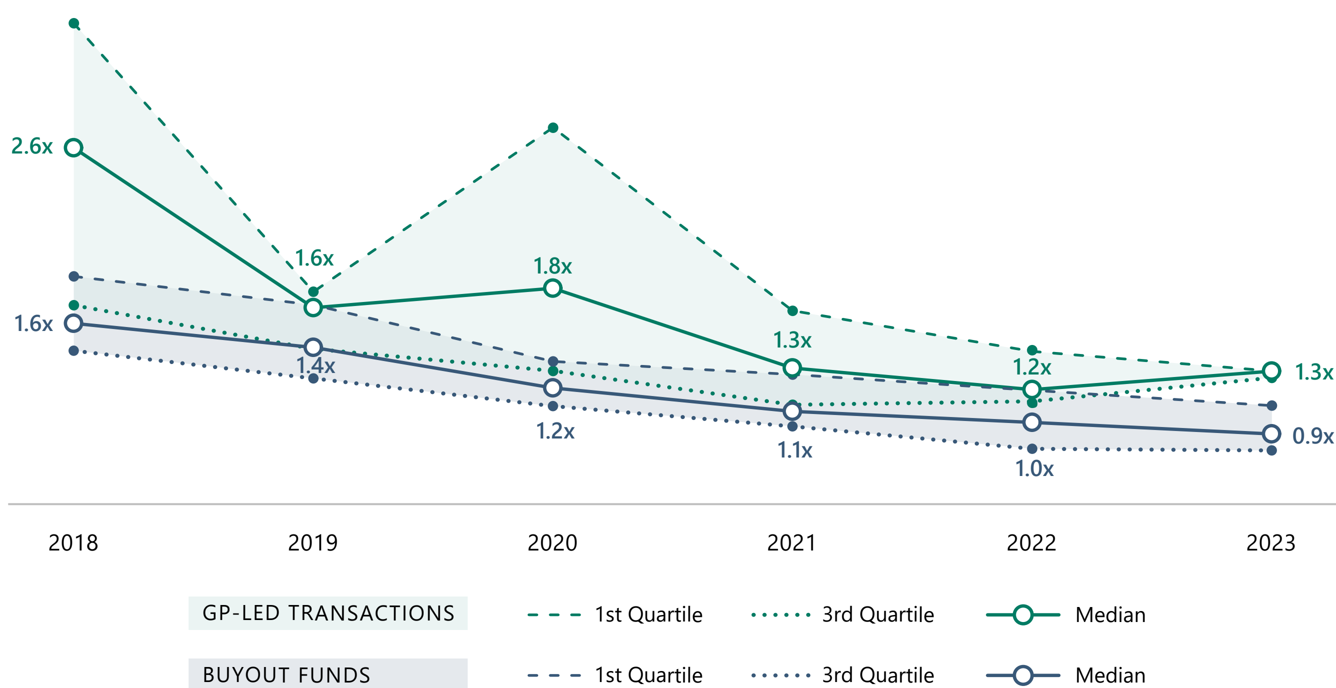
Additionally, given the nature of secondary transactions coupled with the fact that secondary buyers are purchasing existing portfolio companies, GP-led transactions can outperform buyout funds in the most recent vintage years. However, the data indicates that GP-led transactions have actually outperformed across the time spectrum including more mature vintage periods where the companies are farther along in their development paths.

As the momentum behind GP-led transactions continues to grow, investors participating in these deals are underwriting to higher expected returns. According to a recent market survey conducted by Evercore, a secondary advisor, buyers of these assets are expressing heightened confidence in the ability of GP-led deals to deliver attractive returns compared to previous years in a similar survey.

While some of the upward adjustment in target returns may be attributed to prevailing higher interest rates and inflationary pressures, the combination of historical performance data and the elevated return expectations articulated by buyers, as well as the performance reporting provided by advisors, can indicate that the underlying thesis supporting this era of quality-driven GP-led transactions is being validated.

Net MOIC by Vintage Year



Source: Morgan Stanley PCA—Continuation Fund Performance (January 2024)
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Section V A Few Words on New Entrants and Differentiation

Despite robust historical and forecasted growth, the secondary market has seen relatively few new entrants at scale over the last decade. For the most part, the investor universe remains relatively concentrated with the top 3 and top 16 secondary buyers accounting for 35% and 77% of secondary market dry powder at year end.[14] Interestingly the composition of these large funds has not changed significantly over the past decade. We believe the key reason for the dearth of new entrants comes down to the challenge of offering a differentiated value proposition to all stakeholders and most importantly to investors. New buy-side competitors perceived to lack differentiation may struggle to raise capital. Prospective new entrants considering launching a fund or firm, but without key differentiators, may ultimately choose not to enter the market. The concept of differentiation can be evaluated across several vectors including platform, data, investment strategy and team.

Platform capabilities that stand-alone secondary firms do not enjoy may create sustainable advantages. Wide-ranging and established LP relationships help with efficient capital formation and deal sourcing on the LP portfolio side. Secondary teams that can leverage platform-level investment judgment, specifically macroeconomic, industry, geography and asset-level underwriting views, may enjoy both broader and deeper perspectives compared to stand-alone secondary peers. Relationships with GPs, either as investors in their funds or as lenders to their portfolio companies, can provide advantages in sourcing and being viewed as preferred partners in GP-led transactions.

Data differentiation is related to platform but deserves separate mention. Differentiated data may come in several forms. Some secondary managers highlight access to historical LP reporting as a source of "edge." Such data is certainly helpful and can provide insight into how underlying assets have performed over time. We note, though, that during more dynamic and volatile market periods (such as 2022), real-time judgment and ability to access in-depth current and forward-looking perspectives becomes critical in assessing quality of underlying net asset value and determining appropriate purchase price. Further, such historical information is less differentiated in GP-led transactions where investors are typically provided data rooms full of company-level information, access to management and time-lines allowing for proprietary due diligence.

Other examples of differentiated data could include the platform being invested in and/or having evaluated investing in a wide swath of PE-backed companies across the capital structure (debt and equity) combined with the ability of the secondary team to have access to investment professionals responsible for these investments.

Investment strategy can be a differentiator to the extent the secondary manager is capable of executing transactions that are not "middle of the fairway" deals. An investment culture that embraces complexity, resulting in less competitive situations and more attractive entry valuations is one example. Another example would be a platform that provides a wide range of cost of capital, allowing for the secondary investment team to approach every GP and LP with a range of capital solutions rather than trying to "square peg—round hole" an investment into a fund with a narrower investment mandate. The ability to provide capital at scale and reduce or eliminate syndication risk could be another strategy differentiator, one that also overlaps with platform differentiation to the extent the platform can efficiently raise syndicate capital.

Finally, the **investment team** itself can be a differentiator. Platform, data and strategy are only helpful if the investment professionals exercise good judgment in how best to apply these differentiators to construct a portfolio that delivers attractive risk-adjusted returns. In certain respects, the secondary market has grown so quickly that the number of senior investment professionals with cycle-tested experience managing large secondary programs has not kept pace. While it is not impossible to recruit experienced investment professionals to new platforms, it is extremely rare to find a team of seasoned professionals who have a proven track record of working together and demonstrated investment judgment, such that the "first time team" risk is reduced or eliminated.

Taken together all the above factors help explain why there have been relatively few new entrants historically and why we would expect there to be even fewer in the years ahead.

[14] Source: FY 2023 Evercore Secondary Market Survey Results.

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Conclusion

In summary, we believe the secondary market to double or even triple in size by 2027. We expect much of that growth to be fueled simply by the growth of private market AUM. Two other factors could accelerate market growth. First, the amount of NAV "trapped" in 2018–2020 vintage funds creates additional secondary supply, mainly driven by GPs seeking ways to return capital to LPs. Second, investor demand (both LP and GP) for liquidity solutions with bespoke structuring and targeted cost of capital provided by specialist secondary managers can also contribute to market growth. For example, as credit strategies become a larger part of private market AUM, credit secondary managers with lower cost of capital compared to secondary private equity buyers can transact at lower discounts, unlock attractive investment opportunities and grow the overall secondary market.

We believe that secondary platforms that offer a variety of liquidity solutions can create differentiated deal flow because they allow the secondary platform to engage with GPs and LPs with a solutions mindset, seeking to supply capital priced commensurate with the risk. We believe secondary managers whose toolkit includes fund finance loans, private credit, preferred equity and all manner of private equity including single asset transactions, means they can offer GPs and LPs capital solutions ranging in cost of capital from approximately 6% to 25%+. Other important sources of differentiation include platform capabilities, investment strategy, data and, most critically, investment team judgment.

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