

# In Brief

April 2020

No assurance can be given that any investment will achieve its objectives or avoid losses. Unless apparent from context, all statements herein represent GCM Grosvenor's opinion. Select risks include: risks related to the lack of a liquid, transparent market for secondary investments, performance risk, and risks related to sourcing investments.

**“We are in a unique position in the current market. We believe we will see a wave of secondaries opportunities driven by both limited partner sellers and GP-led situations”**

BRIAN SULLIVAN, MANAGING DIRECTOR,  
PRIVATE EQUITY INVESTMENTS

## Finding Opportunity in the Secondary Market Amid Dislocation

The global pandemic has touched every company, investment, and market, but in different ways. Here, we offer our perspectives on the current state of the secondary market and share ways to potentially capitalize on this once-in-a-cycle secondary opportunity.

### HOW THE PANDEMIC HAS AFFECTED SECONDARIES

As the scope of the global coronavirus pandemic became widespread in late February, public markets tumbled. Domestic large-cap indexes were down around 20% for the first quarter, while small-cap indexes averaged closer to down 30%. Private investments could suffer a similar decline, possibly even greater, depending on the specific assets and leverage involved. The continued global shutdown has continued into the second quarter, resulting in a more significant impact on operating performance. Second-quarter valuations of private equity holdings could continue the downward trend and come in lower than Q1 2020 marks in many cases.

We can characterize the market backdrop in the second quarter coming out of the first quarter's severe dislocation with a few broad strokes:

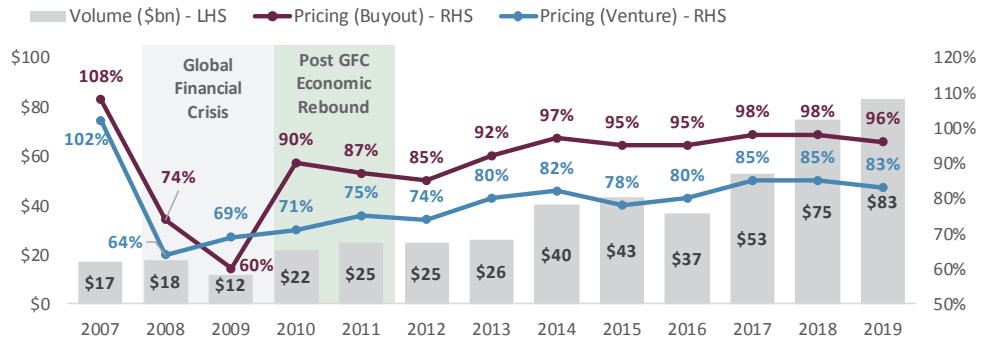
- + Large bid/ask spreads for asset transactions
- + Broad-based need for liquidity across both GPs and LPs
- + Increased structured solutions amid atypical markets

### LARGE BID/ASK SPREADS FOR ASSET TRANSACTIONS

Following the decline of asset values, a significant bid/ask spread lingers across the secondary marketplace in the interim period before or until GPs revalue their portfolios. Published year-end 2019 valuations are outdated. A seller would have to accept a 20%-40%+ discount to transact just to account for the public market movements, terms that are optically grim, even if they are economically accurate (and could generate immediate liquidity). We expect bid/ask spreads to narrow once the decline in valuations, operational performance, and outlook are reflected in PE valuations.

Besides pricing, we believe secondary transaction volumes will initially decline due to the friction caused by the pricing gaps. The pandemic puts entire industries in limbo as the next steps for public health remain in question. When we consider that a typical traditional secondary sale takes 3-6 months to complete in healthy economic environments, a backdrop of medium-term uncertainty is a major execution headwind. Given these factors, we expect traditional secondary sales will decline significantly in the first half of 2020, but are expected to pick up late this year and rebound in 2021-2022, as a result of both deferred and new liquidity considerations just as they did during and following the Global Financial Crisis.

## A Look Back at Global Financial Crisis Secondary Market Volumes and Pricing Patterns 2007-2019



While activity and pricing dropped in response to the GFC in 2009, the market rebounded well above pre-crisis levels by 2010.

Source: World Bank, Lazard Intelligence

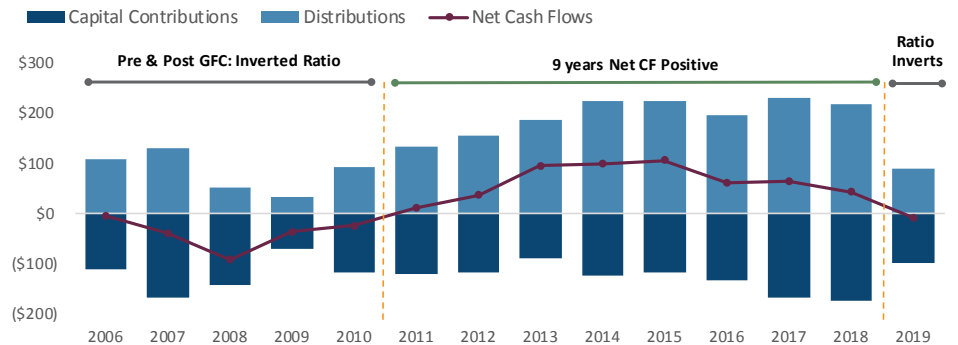
### BROAD-BASED NEED FOR LIQUIDITY AMONG BOTH GPS AND LPS

#### Pressure to Raise Liquidity for GPs and LPs

Net cash flows for LPs are expected to plummet in the short-term, and several forces are driving demand for capital at the GP level. GPs may need capital to: shore up the balance sheet of portfolio companies under pressure; fund working capital or pay off credit facilities; or to execute opportunistic follow-on acquisitions, capturing a rare buying opportunity for coveted investments. Meanwhile, exit opportunities often dry up in downturns, causing distributions to slow substantially.

#### Liquidity Needs: End of the Positive-Cash-Flow Cycle

##### Capital contributions and distributions for global buyout funds (\$ in billions)



Over the past nine years, distributions have outpaced contributions, leading some investors to use pacing strategies that rely on distributions to fund contributions. Periods when capital calls exceed distributions are likely to be catalysts for secondary sales.

Source: **BURGISS**, Global Buyout Funds

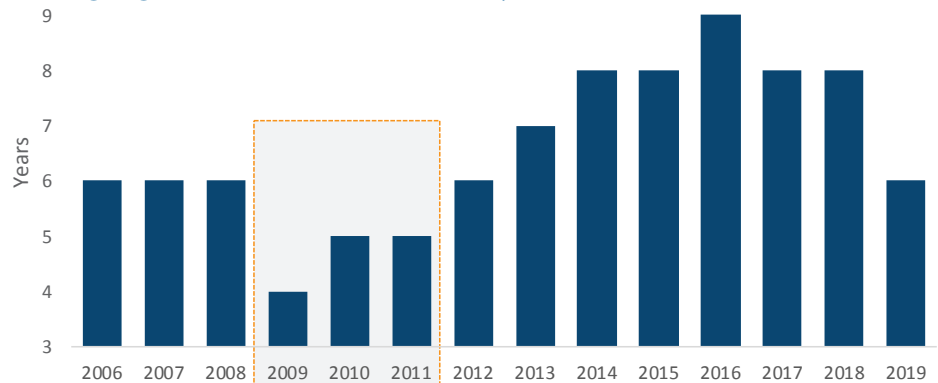
For LPs, evaporating cash flows are not the only trend. Many investors are likely to face pressure from the denominator effect – as public market values fall, but private holdings stay flat due to the normal valuation lag, private equity allocations are likely to appear bloated on a relative basis. Even for investment boards that understand the nature of the problem, the appearance is often enough to push investors to trim allocations. This effect could linger for an extended period as investment committees and boards consider their options and revise portfolio allocations and projections.

#### Opportunistic Viewpoint

All of the forces described above could create a 'perfect storm' and crystallize into specific opportunities – for instance, a limited-time entry point to acquire younger-

vintage funds with growth potential. For LPs facing liquidity pressure, the younger-vintage funds are a key stressor, given their significant unfunded capital commitments. At the same time, these assets could be particularly attractive to secondary buyers. Younger-vintage funds have an entry-point advantage in a post-shock world of lower asset valuations, suggesting that buyers could ultimately realize appealing IRRs in the full cycle. But again, such opportunities demand investors with liquidity. Funds with dry powder could be well-positioned to capture such short-term opportunities. Younger vintage funds also potentially offer the secondary buyer with a longer period of time for asset appreciation than tail-end fund interests allowing for higher multiple on invested capital.

#### Average Age of Funds Sold in the Secondary Market



During the GFC, the sale of younger-vintage funds became more prevalent as sellers considered a wider pool of assets to reduce their total PE exposure (including unfunded) and to generate liquidity at better prices through the sale of more attractive assets an attractive entry-point point.

Source: Greenhill Cogent

### INCREASED STRUCTURED SOLUTIONS AMID ATYPICAL MARKETS

In this environment, “straight” sales and traditional lending arrangements are prohibitive, both because they depend on transparent valuations and tend to take too long. In contrast, structured solutions can be an appealing substitute. While the cost of capital tends to be marginally higher than a traditional lending solution, there aren’t negative optics for the seller associated with a sale discount, and the speed and flexibility of such arrangements can outweigh the costs. Three examples of these solutions include:

#### 1. Preferred Equity

**Managers.** In a preferred equity deal, a GP can accept capital in exchange for preferred equity shares in a diversified fund. The preferred shares are “collateralized” by future distributions from the fund. In a typical arrangement, the fund funnels all or some distributions back to the new preferred shares, paying back the capital infusion plus some pre-determined return – either as a multiple of the investment or as an equivalent IRR. These arrangements can be flexible and allow for the GP to fund portfolio-company balance sheet cures, credit line payoffs, or new acquisitions. Plus, preferred equity solutions may not require LP consent, though we note that it’s still a best practice to make all investors aware of the agreement beforehand, even if formal consent is not required. While some managers may prefer to amend a fund’s recycling provisions to make additional capital available for the remaining portfolio, not every fund will have this as an option.

**Institutional investors.** The same kind of structured solution is available at the LP level, where the “collateral” is all or part of an LP’s private equity portfolio. Again, this solution provides liquidity to the institution without requiring a headline discount on asset values.

#### 2. Unfunded Joint Ventures

In some cases, the main demand for capital is to cover unfunded liabilities. For LPs

who are comfortable with their existing PE exposure, but would be above their target exposure if there were large capital calls, an unfunded joint venture with a secondary investor would be a way to shift that exposure to a third party. Similar to a preferred equity solution, the secondary investor's capital injection is repaid with future distributions from the broader portfolio. The terms are customized to each arrangement.

### 3. Annex Funds

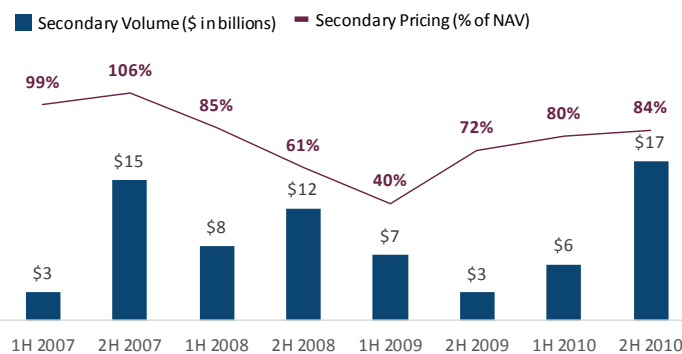
An annex fund is a third option with an even more targeted purpose. In such arrangements, a select set of portfolio companies need more capital, and the new annex fund takes a direct stake in the portfolio companies in exchange for the capital infusion. While these arrangements can be tricky in terms of navigating conflicts of interest, they are a strong solution for isolated capital needs and can meet the objectives of both the sponsors and the secondary investors.

### LOOKING AHEAD

With a period of restricted volumes, we believe the secondary market could witness a rebound above 2019 levels in 2021-2022, similar to what we saw after the Global Financial Crisis, fueled by an increase in GP-led deals, as exits are pushed further out, and fund lives lapse. We expect the current crisis will result in a return of deeply discounted secondaries. Post GFC discounts averaged 35-40% over 2008-2009 as equities reset, resulting in the highest returns for the cycle.

### We Expect the Current Crisis Will Result in a Return of Deeply Discounted Secondaries

#### Secondary market pricing and volume



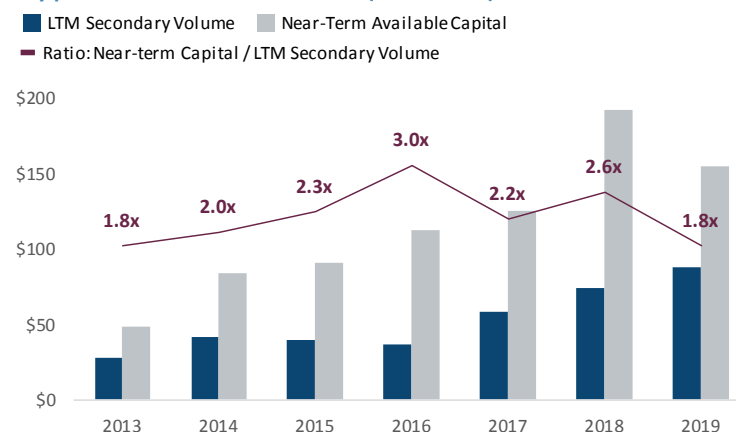
Average pricing reached 40% of NAV during the trough of the GFC in 2009.

Source: Greenhill Cogent

In addition, the dry powder-to-transactions ratio could position buyers even more strongly. Before the pandemic, we saw signs that the market was beginning to favor buyers, as the available dry powder versus annual transaction volume ratio was at its lowest since 2013.

### Declining Dry Powder as a Driver of Buyer Strength?

#### Dry powder vs. transaction volume (\$ in billions)



Ratio of dry powder to transaction volume at lowest level since 2013 going into crisis.

Source: Greenhill Cogent

**“With a global platform and expertise across a broad range of investing areas, we believe we are one of the strongest secondary solution partners in the industry.”**

FRED POLLOCK, GCM GROSVENOR  
CHIEF INVESTMENT OFFICER

## AN ENVIRONMENT THAT FAVORS BREADTH, EXPERIENCE

The pandemic is driving a new range of market dynamics distinct from other downturns of the modern era. Importantly, the way that managers and investors navigate the present private equity environment will affect their outcomes for years to come.

GCM Grosvenor’s large and unique primary fund portfolio gives us rare visibility into the GP-led market. It also provides a distinctive secondary-sourcing network, useful across all markets but even more powerful in an atypical, liquidity-demanding market. This access to a broad opportunity set is the foundation that allows us to be selective in our deals. Meanwhile, our firm has robust technology resources, enabling our disciplined and systematic approach across opportunities.

The pandemic is providing conditions typical to a traditional recession, but it’s not exactly like any prior event. As such, a unique set of opportunities are available to secondary investors. As some GPs and LPs face liquidity needs, a structured solution that facilitates a quick liquidity transfer could be the key to unlocking these near-term opportunities.

## ABOUT GCM GROSVENOR

GCM Grosvenor is a global alternative investment firm with \$57 billion in assets under management in hedge fund strategies, private equity, infrastructure, real estate, credit, and multi-asset class opportunistic investments. The firm has specialized in alternatives since 1971 and is dedicated to unlocking value for clients by leveraging its cross-asset class and flexible investment platform.

GCM Grosvenor’s experienced team of approximately 500 professionals from diverse backgrounds serves a global client base of institutional and high net worth investors. The firm is headquartered in Chicago, with offices in New York, Los Angeles, London, Tokyo, Hong Kong, and Seoul.

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