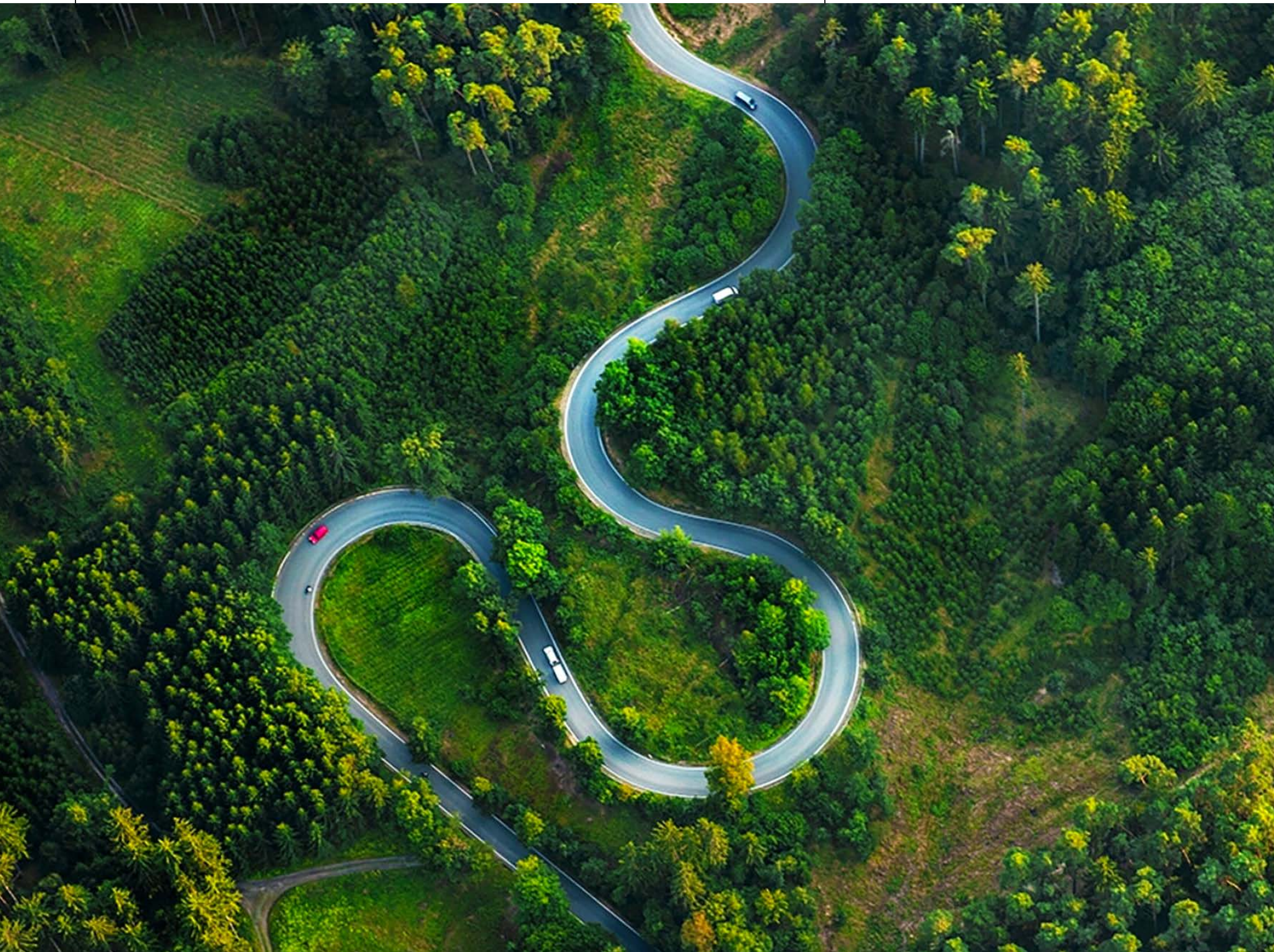
Private Capital Advisory

The Private Equity Secondary Market Continues to Create Attractive Liquidity Alternatives

In This Report



William Blair Private Capital Advisory: Secondary Market Survey Report

William Blair's Private Capital Advisory team conducted its inaugural survey of secondary investors in late 2022 and early 2023. Here, we highlight key themes that drove the secondary market in 2022—as well as areas to watch in the months ahead.

2022: Sophomore Slump or Prelude to a Banner Year?
After the private equity secondary market experienced a record year in 2021, aggregate volume was down in 2022 from $133 billion to approximately $105 billion, and the number of failed or delayed deals seemed to have increased meaningfully. But despite the slowdown, the secondary market continued to create attractive alternatives to generate liquidity.

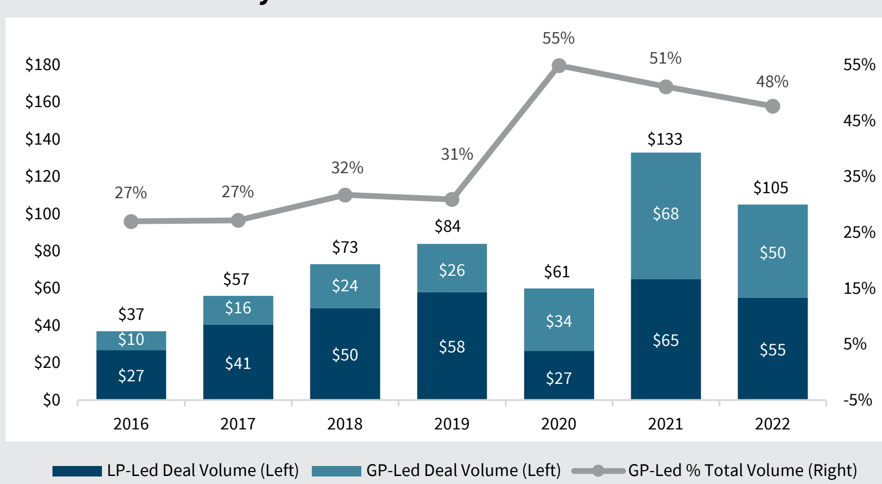
What caused the down year in secondaries?
In our view, the down year was largely driven by macroeconomic challenges and a slowdown in fundraising across private markets, rather than a decline in investors' interest in secondaries as an asset class. Challenges faced by the industry included:

- Elevated inflation, declining consumer sentiment, and other economic signals indicative of slowing economic growth and risk of a near-term recession
- Rising interest rates, and therefore, costs of capital
- Divergence among public market and private equity valuations
- Global geopolitical conflicts
- A decline in M&A activity
- A slowdown in private equity fundraising, exacerbated by the above factors

Despite headwinds, GP awareness of and interest in the secondary market continues to grow
While many general partners (GPs) have successfully executed secondary transactions over the past 12–18 months, many more have spent time educating themselves on solutions the secondary market can offer. In our estimation, a majority of financial sponsors had either contemplated or executed a secondary transaction as of the end of 2022. Additionally, our research indicates that a significant cohort of financial sponsors are actively contemplating a secondary transaction but would not launch until market conditions improve. We believe pent-up supply exists within the financial sponsor community, which could create a strong backlog for transaction volume in 2023 and 2024, as limited partner (LP) investors require liquidity amid a challenging environment for many traditional capital markets. The stage is set for secondaries to become a "mainstream" alternative—or complement—to a traditional exit.

- Based on a universe of more than 600 GPs covered by William Blair, a significant majority either have completed or are considering pursuing a GP-led secondary transaction in the future.
- Within that cohort, middle-market sponsors (defined as funds between $500 million and $5 billion) are a growing segment.

Historical Secondary Market Volume [1]



1. Sources: William Blair Estimates; William Blair Secondary Market Survey.

Areas of increasing activity have begun to emerge, notably within the LP secondary market.

- Continuation funds (CFs), and more specifically single-asset CFs, are the most common structure GPs have considered, likely because single-asset CFs most closely resemble traditional exit alternatives, as compared to other secondary market solutions.
- Today, many GPs appreciate the range of strategic objectives secondary transactions can accomplish, in particular those addressed by CFs.

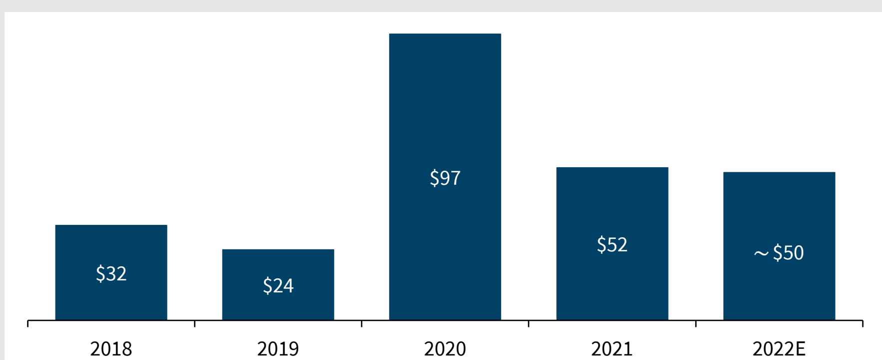
Possible green shoots emerge
Areas of increasing secondary market activity have begun to emerge, notably within the LP secondary market, which has shown signs of continued thawing in Q1 2023, following a flurry of year-end deals. After public market volatility in Q2 2022 created bid-ask spreads and a virtual standstill in Q3 market activity, buyers and sellers appear to be finding common ground, and LP-sale volume could be on track for a strong rebound by mid-2023.

Sellers, rewarded for their discipline in 2020 with a V-shaped recovery, are coming to accept a "new normal" characterized by double-digit discounts. On the buy-side, many investors are being drawn to the diversification, near-term write-ups, and liquidity profile of LP portfolios. Should Q4 2022 audited financials reveal even modest downward revisions in valuations, a backlog of potential Q3-Q4 2023 transactions may accelerate and catalyze strong LP volume during the first half of 2023.

Among concentrated GP-led transactions, CFs involving resilient assets, quality managers, and strong GP alignment continue to experience success. Some of the most attractive CF targets include companies that have maintained stable top-line performance over the past several quarters, have contractual, recurring revenue and strong visibility to 2023 performance, and provide mission-critical products or services with a clear ROI for customers and a high cost of failure. Further, in our experience, there has been a flight to quality, as buyers are prioritizing transactions with well-known GPs and those with whom they have existing relationships. Strong GP alignment is a feature of virtually all successful CFs and can be demonstrated through carry rollover, a new GP commitment, an investment from a flagship fund alongside the new vehicle, or other transaction characteristics.

More capital is on the way
Secondary fundraising slowed in 2022 after the highs of 2020 and 2021. After record deployment in 2021, many investors prepared to replenish their funds in 2022 and 2023. At the same time, similar to the broader private equity market, secondary funds faced a challenging fundraising environment as a result of slowing distribution activity, the LP "denominator effect," and an uptick in funds in the market actively raising capital. Available capital was a key constraint that drove decreased secondary transaction volume in 2022.

Annual Secondary Fundraising Volume in Billions [2]



2. Sources: Pitchbook Data Inc.; William Blair Secondary Market Survey.

However, there are signs that more capital is entering the market. Secondary investors continue to close on larger funds and raise new vehicles dedicated to concentrated transactions. Among large investors that have significantly increased their latest fund size, Blackstone Strategic Partners, Neuberger Berman, ICG, LGT, Whitehorse, and Greenspring are a few examples. Other signs of improving capital availability include:

- Alternative sources of capital, such as family offices, sovereign wealth funds, pension funds, and insurance companies, are entering the market.
- Large traditional private equity firms and asset managers continue to build out secondaries platforms.
- Investors have a substantial amount of dry powder available to invest.

William Blair Survey: Dry Powder Among Secondary Investors[3]

$126 billion

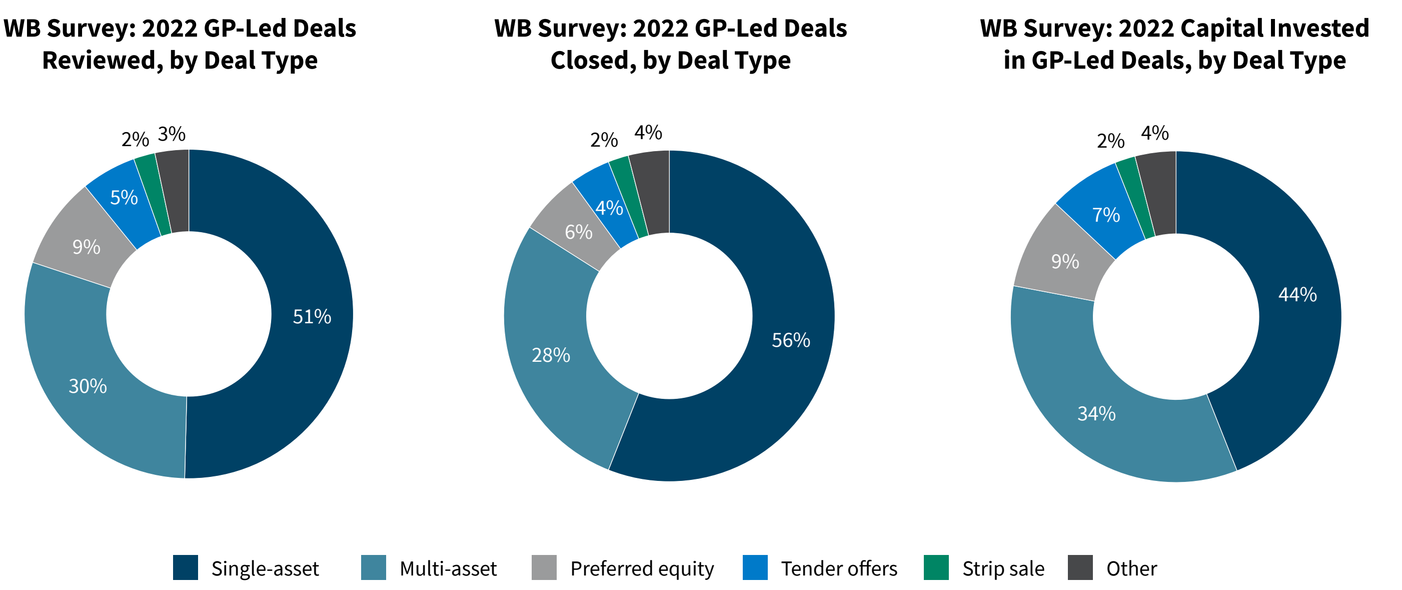
Total estimated dry powder available to participants in William Blair's survey of secondary buyers at the end of 2022

$4.0 billion

Average available dry powder among the top 30 buyers (by capital invested) in WB's survey of secondary buyers

What Happened in 2022? Highlights From Our Survey

Continuation funds dominated as a share of GP-led transaction activity. Single-asset CFs represented the majority of GP-led transactions reviewed by secondary investors in 2022, and an even larger share of closed deals. The high conversion of single-asset deals may be driven by a large supply of high-quality single-asset deals in the first half of 2022 and increased buyer focus on those structures. Additionally, single-asset CFs represented the highest percentage of capital invested in 2022, although the gap was narrower between single- and multi-assets than it was for deals reviewed or deals closed. This is likely due to the larger scale of many multi-asset transactions and buyer preferences in the second half, which seem to have shifted to diverse opportunities.



3. Excludes capacity from leverage and purchase price deferrals.

Many large single-asset deals required broad syndication of both secondary investors and traditional LP relationships. To better understand syndication trends, William Blair reviewed the survey responses and identified a subset of investors who typically play a large "lead" role, and those who primarily play a "syndicate" role in single-asset CFs.

"Lead" investors:

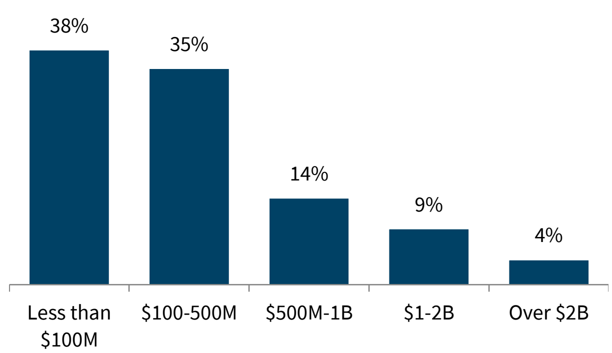
- Average reported single-asset check size for the respondents was approximately $120 million.
- Average reported conversion rate (defined as number of deals invested in, as a percentage of deals reviewed) was approximately 5%.

"Syndicate" investors:

- Average reported single-asset check size for the respondents was approximately $20 million.
- Average reported conversion rate (defined as number of deals invested in, as a percentage of deals reviewed) was approximately 9%.

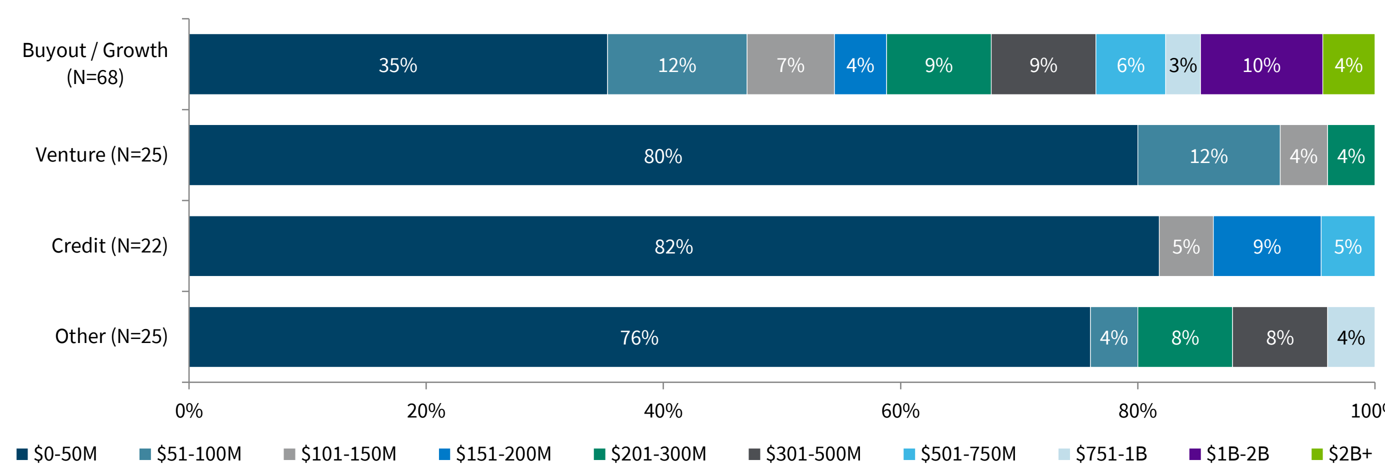
Based on the above estimates, on average every $100 million of syndicate capital raised required outreach to approximately 55 syndicate investors. This created some constraints around the viability of single-asset transactions above a certain size. Many large single-asset deals required the support of a GP's existing LP relationships and alternative sources of capital, in cases where the typical universe of secondary investors did not provide the capital required.

Average Number of Deals Completed by Size



Middle-market deals represented the majority of closed transactions. As middle-market GPs have become more educated on the benefits of secondary market transactions, they have become active users of CFs and other structures. At the same time, investor interest in middle-market GP-led secondaries has continued to grow, as value-creation plans and projected exits can be easier to underwrite, and investors can take a more meaningful role in transactions requiring smaller equity checks. The middle market's ongoing success, however, will require a continued expansion of buyer comfort in investing alongside GPs with whom they do not have an existing relationship.

Deals Completed by Strategy



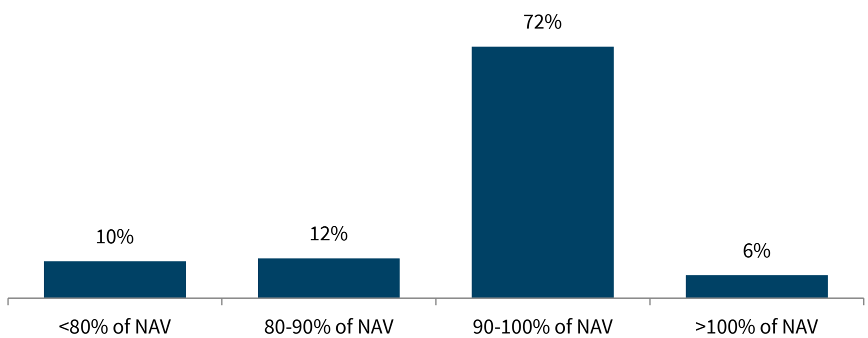
Buyout and growth remained the highest priority strategies. Two-thirds of respondents said they invested $50 million or more in buyout/growth strategies, with some investing over $2 billion. Venture and credit attracted much smaller amounts of capital in 2022.

Flexibility in Pricing

Both GPs and LPs showed flexibility on pricing. Our survey indicates that most GP-led deals priced over 90% of NAV in 2022, but more than 20% of deals priced below 90%, including 10% that priced below 80%.

Deals by Price Range (% of NAV)

For the average investor in our survey of secondary buyers, almost three-quarters of closed deals were priced between 90% and 100% of NAV.



Super carry structures declined in 2022, while unfunded capital remained significant. Super carry structures in GP-led transactions (carry above 20%) appeared less common in 2022 and seemed to decline as the year progressed, based on our experience—based on our survey, we estimate that fewer than a quarter of deals in 2022 featured super carry. Despite that trend, GPs continued to use CFs deals to raise meaningful amounts of additional dry powder to support existing portfolio companies.

William Blair Survey: Management Fee, Super Carry, and Unfunded Capital

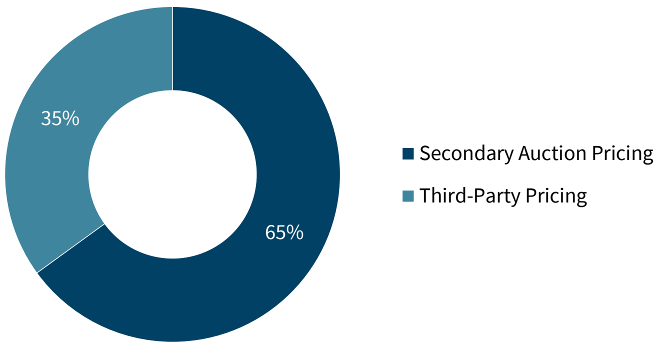
~20%	Deals including a management fee above 1%
<25%	Deals including top carried interest above 20%
~60%	Deals including unfunded capital for the existing portfolio
<20%	Deals including unfunded capital for new platform investment

William Blair Survey: GP Rollover in CF Deals

~55%	Deals including GPs investing additional capital on top of carry rollover
27%	Deals including GPs investing from flagship fund alongside a CF

GPs often invested additional capital into CFs on top of carry rollover. GPs investing incremental dollars on top of their rolled carry was fairly common, highlighted in more than 50% of deals. Some GPs also invested from a flagship fund alongside a CF, although respondents indicated that only around one-quarter of closed deals shared that feature.

Pricing: Secondary Auction and Third Party



Third-party pricing from a minority or co-control investor remained significant. The average respondent to our survey indicated that approximately 35% of their GP-led deals involved third-party pricing—for example, pricing that was set by another sponsor through a minority investment or co-control deal. Given the anticipated growth in secondary market volume, the capital constraints that exist within the secondary investor community, and the pressure felt by some GPs to explore pricing beyond the secondary market, we expect third-party pricing to remain a common feature of secondary transactions.

William Blair Survey: Re-investment Option and Status Quo Option[5]

71%	Deals offered LPs a "re-investment" option
26%	Deals offered LPs a "modified status quo" option
19%	Deals offered LPs a "status quo" option

Status quo options re-emerged in LP rollovers. Although "re-investment" [4] remained the most common type of rollover option provided to existing LPs in GP-led continuation funds, some deals are beginning to offer "status quo" options again, where LPs have the option to retain their stake under the same economic terms from the existing fund.

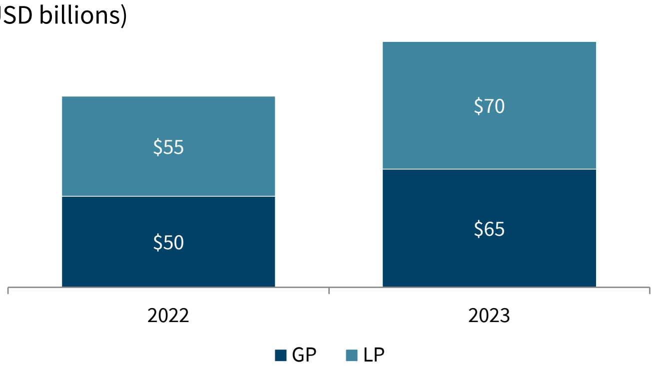
Continuation funds also provided partial liquidity to company management teams. Single-asset CFs were often used to provide liquidity to company management teams. However, in most transactions closed in 2022, management teams were expected to roll a majority of their stake. We estimate that the average management team took less than 25% liquidity in a CF transaction.

Secondaries Themes to Watch in 2023

GPs will increasingly turn to the secondary market to supplement traditional exit activity. GPs are feeling pressure to post realizations in 2023 and return capital to investors in what remains a challenging environment for both M&A and private equity fundraising. We expect any extended slowdown in liquidity to drive creativity in deal structuring, and potentially decreased valuation sensitivity among both GPs and LPs. Buyers surveyed expect a growing pipeline of GP-led opportunities in 2023, but the conversion of those opportunities into closed transactions hinges on an ability to bridge bid-ask spreads and minimize syndication risk.

William Blair Survey: Estimates of Secondary Volume, 2022–2023

Estimated Global Secondary Volume by WB Survey Participants (USD billions)



Single-asset transaction supply will continue to grow. Although secondary investors will continue to maintain a high standard for concentrated transactions, we expect to see continued growth in the number of single-asset deals brought to market. We believe growth in single-asset continuation vehicle supply will be driven primarily by GP awareness of the strategic benefits the transactions can afford all portfolio company stakeholders. Furthermore, the successful execution of new transactions will be supported by the increasing prevalence of dedicated single-asset secondary strategies among secondary investors, and buyers' desire to generate alpha amid a challenging fundraising environment.

4. "Re-investment" option refers to an option for existing LPs to re-invest their distributions from the transaction into the continuation fund, on the same terms as the new secondary investors.
5. Some deals offered multiple options.

Multi-asset deals will garner greater attention. Multi-asset transactions allow investors to write larger checks into more diversified transactions, while maintaining a focus on middle-market companies, the core market segment of interest to most secondary investors. Our survey showed that multi-asset deals constituted a significant portion of secondary deals reviewed and closed by secondary investors in 2022, and we expect that interest to continue in 2023.

Deal structures will continue to evolve. We expect key areas of market growth and evolution to include:

- **Co-control or minority recapitalizations:** Minority recapitalizations and shared governance transactions gained prevalence in the M&A market in 2021, and that trend continued into 2022, as companies sought to address capital needs (primary and secondary) amid a challenging financing environment, and GPs sought liquidity solutions for their LPs. We believe an increasing number of CF transactions will be negotiated alongside joint-ownership recapitalizations, given the improved alignment continuation vehicles create between incumbent and new sponsor-owners, and the capital "backstop" a new investor can provide to de-risk a continuation fund syndication.
- **Rollover options:** We expect "status quo" rollover options to become more commonplace in 2023, as GPs seek to provide existing LPs with improved rollover flexibility, and incentivize existing LP support for transactions, thereby reducing syndication requirements.
- **GP commitments:** GPs should continue to expect to be required to contribute and roll economics into CF transactions, demonstrating alignment with secondary investors. Yet this will need to be balanced with GPs' need for liquidity to support future funds in a tighter exit environment. We expect GP financing solutions to gain prevalence as a tool for bridging this potential gap.
- **Structuring creativity:** Amid an environment characterized by secondary buyer capital constraints and valuation bid-ask spreads, we expect secondary investors to employ a range of structures to complete attractive transactions. As an example, we expect annex funds—side-car vehicles that address portfolio company capital needs for growth and liquidity—to increase in prevalence.
- **Nontraditional participation on the buy-side:** Given the potential risk-adjusted return opportunity that some CF transactions provide, we expect direct GPs and traditional LPs to continue to increase their focus on accessing transactions from the buy-side through both existing and new dedicated pools of capital.

Asset-Level Trends by Sector

Which types of assets are in favor for GP-led secondaries? Below are some trends William Blair's industry experts have identified as we enter 2023.

Healthcare: With an end to the Federal Reserve's restrictive policy potentially in sight, healthcare is well positioned as a defensive sector. Hospitals will face labor shortages and continued pressure to be profitable, creating an opportunity for solutions that improve efficiency in administering provider organizations and managing compliance, labor, regulations, security, and critical data. Further, as consumerism continues to shape healthcare, stakeholders will likely look to improved technology, process, and delivery models to adapt to patient demands.

Business Services: In a space that has performed well despite recent economic headwinds, a higher-than-usual premium is being placed on models that demonstrate stability, predictability, and recurring revenue. Investors and buyers are especially interested in specialized and mission-critical services and are taking a wait-and-see approach to businesses tied to labor markets and perceived discretionary spending. Areas with stable and tangible underlying assets—e.g., real estate services, wealth management, IT cloud and infrastructure services—continue to outperform the broader sector.

Industrial Growth Products: Companies in this space are looking to technology to address climate change, evolving consumer behavior, ongoing labor shortages, labor rate inflation, supply chain disruption, and a heightened focus on safety and security. Simultaneously, other tailwinds for the sector are driven by the passage of the Infrastructure Investment and Jobs Act in late 2021 as well as investments being made to de-risk supply chains in the wake of pandemic-related disruptions.

Consumer & Retail: Consumer spending was resilient for most of 2022 as consumers used savings from earlier in the pandemic to weather rising costs. But belt-tightening began later in the year, which could lead to a shift from brands to private label in some categories. Consumers also shifted spending from durable goods to services and experiences that had been hit hard early in the pandemic. Increased borrowing costs will likely impede consumer spending in 2023, particularly for larger-ticket items such as homes and automobiles, and investors are focusing on sectors with consistent, nondiscretionary demand drivers. Demand for high-quality consumer services businesses remains strong as investors look to participate in large, fragmented, and growing markets.

Technology: Application software in large, durable vertical-end markets, such as legal, real estate, manufacturing, education, and government, is an area to watch. Additionally, organizations are prioritizing solutions focused on environmental health & safety (EH&S) as well as governance, risk, and compliance (GRC) issues, which should provide sustained tailwinds for businesses solving these increasingly critical and complex customer needs. Finally, vertical-specific fintech and payments solutions continue to disrupt legacy horizontal providers, in many cases demonstrating strong, sustained performance throughout 2022. Financial sponsors investing in technology are well capitalized but cautious—and technology strategics appear to be "open for business," even if they are in some cases value-constrained due to public stock price degradation.

Learn More About What's Driving the Secondary Market

William Blair's Private Capital Advisory team would welcome the opportunity to share our perspectives and discuss how these market themes affect you. Please don't hesitate to contact us if you are interested in learning more about our survey or continuing the conversation about key themes in the secondaries market.

William Blair has completed more than 1,430 advisory and financing transactions totaling over $730 billion in value for our clients.*

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* In the past five years as of December 31, 2022

Appendix: Survey Details

In December 2022 and January 2023, William Blair surveyed 76 secondaries investors. Nearly half (49%) of respondents were pure secondary investors, another 38% combined primary and secondary investing, and the balance did secondary investing on a more opportunistic basis.