HYMANS ROBERTSON

Investment Perspectives

Summer 2020

In this issue:

Capital markets update 3
Special Situations Financing 8
Distressed Debt 11
Fund Secondaries 16
Market returns to 30 June 2020 19

Welcome

Welcome to our 2020 Summer edition of Investment Perspectives.

In the last edition of Investment Perspectives, we commented that at some stage there would be opportunities to be sought in the wake of the coronavirus and its impact on markets. Over the last couple of months we have been working with managers to understand which opportunities are most likely to provide genuine accessible investments for investors. As markets and economies tentatively recover, focus can now move to the implementation of these new investment opportunities.

There remain significant dislocations between fundamental value and market pricing in a number of markets, which we believe long-term investors with adequate capital and limited liquidity constraints can access. The window for each opportunity is dependent on valuations and each opportunity's persistence will largely depend on how fast markets normalise and the level of efficiency within that market. This may not be linear as there are likely to be bumps in the road, for example due to localised or more broadly felt second waves of the virus; any further deterioration in the economic outlook will create fresh opportunities and attractive entry points for investors.

In this edition of Investment Perspectives we focus on three of the opportunities that we consider most attractive;

- **The Special Situations Financing strategy** focuses on how investors can exploit borrowers' needs for timely and flexible financing solutions and consequently generate attractive risk-adjusted yields.
- **The Distressed Debt strategy** focuses on how investors can exploit opportunities when a borrower's debt burdens have become unsustainable.
- **The Fund Secondaries strategy** focuses on how secondary market trading of interests in closed-end, private funds can provide investors with attractive entry points and enhanced returns in asset classes such as private equity, private debt and infrastructure.

We welcome the opportunity to discuss any of these investment opportunities and how they may fit within your investment strategy and current portfolio.

Lastly, we take this opportunity to note a change in roles within our team. From 1 July David took on the role of Chief Investment Officer. Andy will be focusing more of his time on chairing the HR Investment Services Investment Committee, which provides investment solutions to the retail market. Although Investment Perspectives is very much a collaborative publication, as part of this change, and after editing 25 editions, Andy has passed on editorial responsibilities for Investment Perspectives to David.

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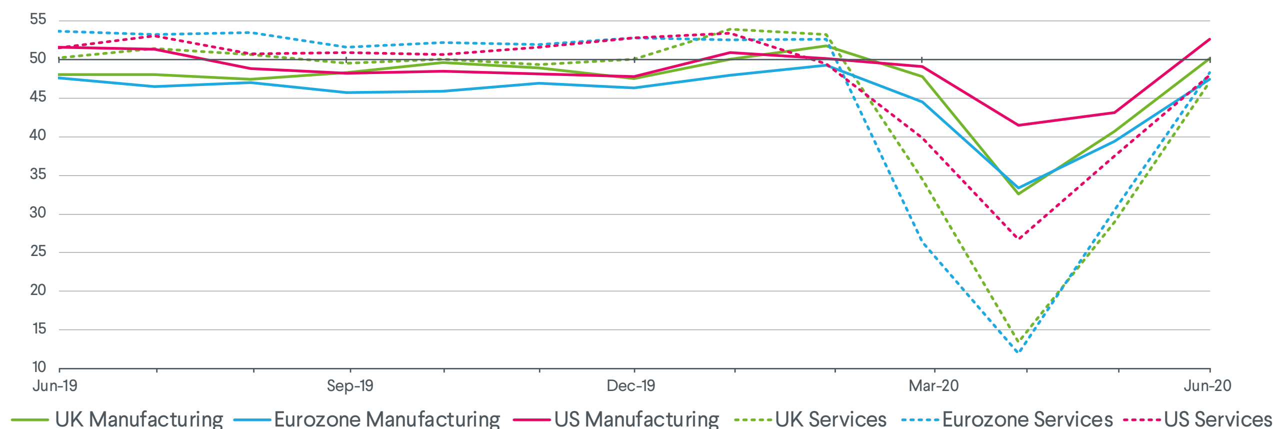
Capital markets update

It was a strong quarter for equity and credit markets as governments provided unprecedented levels of support, central banks implemented substantial monetary easing announced in the first quarter, and economies began to re-open. However, the global Covid-19 pandemic worsened as it accelerated in the Americas and southern Asia. In northern Asia and Europe, new infections declined sharply; any resurgences have been local and, so far, quickly contained. Of the major developed economies, only the US has so far failed to contain the spread of the disease, resulting in a retightening of lockdown conditions in some states. Some lingering uncertainty about the economic recovery may be evident in a 10.6% rise in the dollar price of gold.

Although Europe, the UK and the US – broadly in that order – went into lockdown only during March, all recorded falls in GDP in the first quarter. Initial releases in second-quarter GDP show Euro area and US GDP fell by 12.1% and 9.5% respectively in the second quarter, compared with the first. In line with a later and longer lockdown, UK GDP fell 20.4% quarter-on-quarter in Q2, though the economy did return to month-on-month expansion in May and June. Having entered and exited lockdown earlier, Chinese GDP increased by 11.5% quarter-on-quarter in Q2.

After plunging to unprecedented lows in April, Purchasing Managers' Index (PMI) numbers for the US, Eurozone and UK rebounded in May and June (Chart 1). Although composite indices, which combine manufacturing and services data, remain below the neutral 50 level, most commentators suggested the sharp rise in the last two months provide a better guide to month-on-month growth in output. It seems likely that April marked the low point of the downturn.

Chart 1: Manufacturing and services purchasing managers' indices (PMIs)

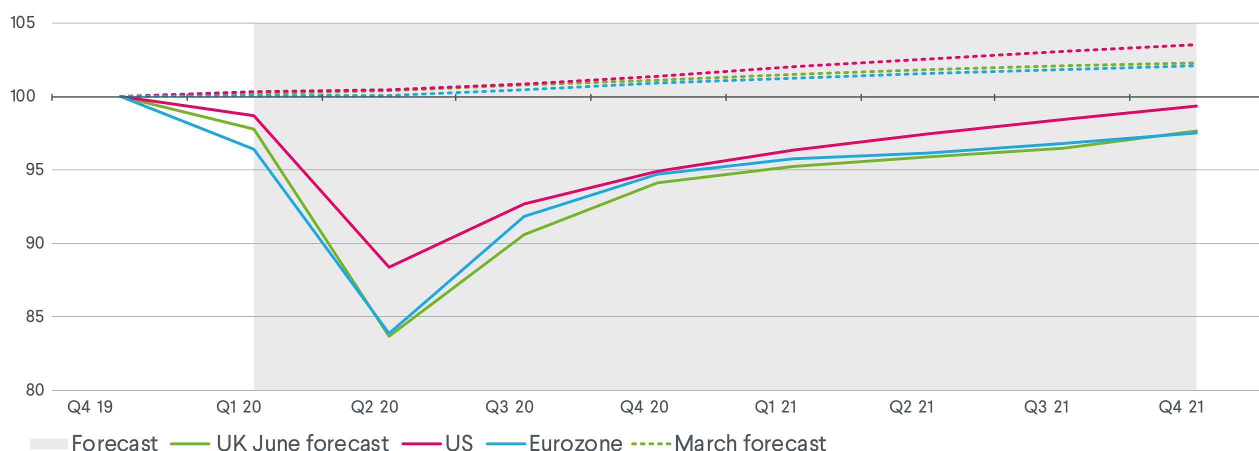


Source: Bloomberg

Given the extent of economic shutdowns, a rapid rise in near-term activity is almost certain as lockdowns ease. However, the absolute level of activity in most sectors still looks well below the level seen before the crisis and the longer-term recovery remains highly uncertain. Many restrictions will have to remain in place until effective treatment or a vaccine is available. Uncertainty over the recovery and job prospects will also likely weigh on demand for goods and services. Potential further waves of virus infection also suggest the balance of risks remains skewed to the downside.

Forecasts for global GDP growth in 2020 have fallen significantly since the end of the first quarter. June's survey by Consensus Economics showed an average fall of 4.7%, compared to a 2.1% expansion forecast in March. However, there has been some moderation in the pace of downgrades recently. The forecast level of GDP in 2021 has fallen across the world and is substantially below 2019 levels in the US, Eurozone, Japan and the UK, and even further below previous forecasts (Chart 2); only the secular momentum of the Chinese economy pushes the forecast two-year growth in global aggregate GDP marginally above zero.

Chart 2: Real GDP level – June versus March Consensus Forecasts (2019 = 100)



Source: Consensus Economics and Datastream

The huge government stimulus packages launched across the major economies will lead to a dramatic increase in bond issuance. However, the effect on financial markets will be considerably diluted by the asset purchase programmes of the major central banks. In many cases, including the US Federal Reserve, the European Central Bank and the Bank of Japan, the scale of the announced purchases surpasses the level of those delivered during the global financial crisis. The actions of central banks have prevented an excessive tightening of financial conditions and the risk of an economic and health crisis becoming a financial one has subsided.

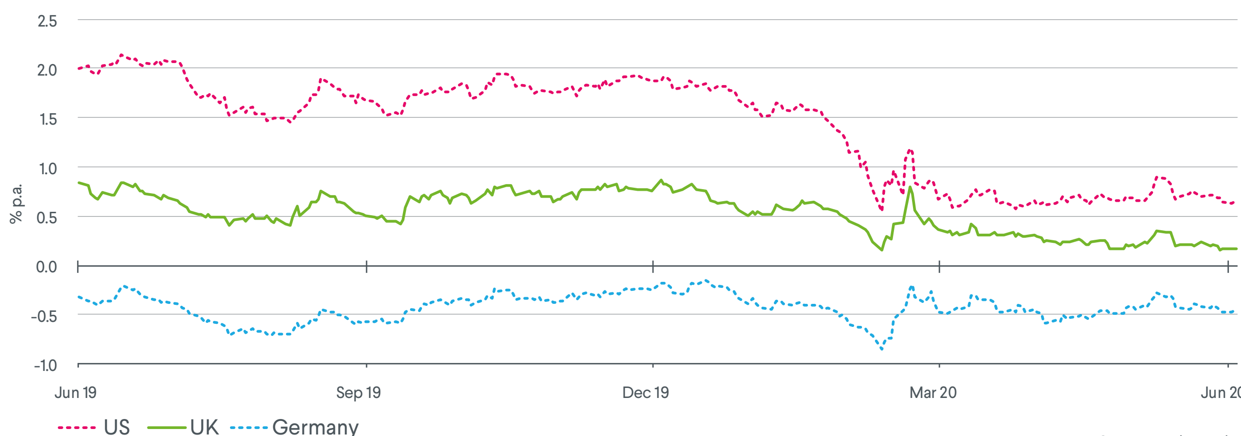
UK CPI inflation fell from 1.5% in March to 0.6% in June. Lower energy prices made a big contribution to the fall but core inflation (excluding food and energy) has also fallen from 1.6% to 1.4%. While there has been some renewed talk about the risk of deflation, most forecasters assume that a fall in inflation this year will be followed by a modest increase in 2021.

Government bonds

Near-term disinflationary pressures may help to explain the resilience of government bonds – US and German yields were little changed, and UK yields drifted lower – even as investors flocked back to equity and credit markets. Central bank policy did remain supportive – the European Central Bank announced a further €600bn of QE and the Bank of England raised its QE programme from £645bn to £745bn – but the major policy shifts had been announced by the end of March.

Notwithstanding the fall in current inflation, the recent relative performance of conventional and index-linked gilts suggests little concern about deflation: 10-year gilt implied inflation drifted up to 3.2% p.a., as high as it has been for three months and only 0.1% p.a. lower than end-2019 levels. The ongoing consultation on the use of RPI as an inflation measure remains an upside risk for real yields.

Chart 3: 10-year government bond yields



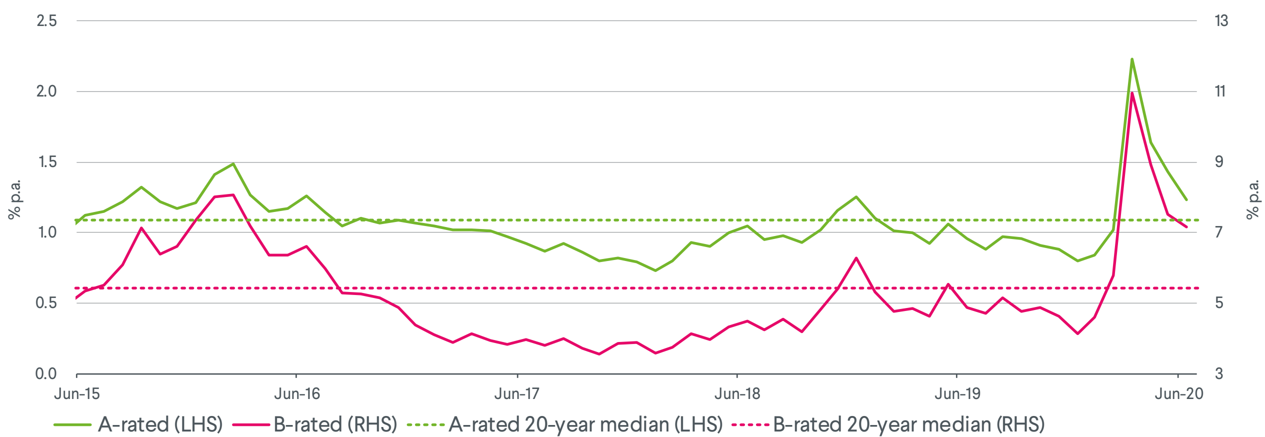
Source: Bloomberg

Credit

In April, the Fed significantly expanded the size and scope of the corporate credit purchase programmes it had announced in March to include, for the first time, some areas of speculative-grade debt. Reflecting the expansion of central bank support and broader improvement in sentiment, global credit spreads have fallen sharply since the peak of market stress in March – investment-grade spreads are now nearing long-term median levels, while speculative-grade spreads remain above long-term medians (Chart 4).

Given the improvement in financial conditions, investors are less pessimistic about the scale of defaults than they were in March, albeit not as optimistic as they were at the start of the year. In stark contrast to the experience of the global financial crisis, and in part a result of central bank support, markets have remained open. Issuance is running at record levels in corporate credit markets, particularly US investment-grade, where year-to-date issuance is already higher than for any previous year's total.

Charts 4: Global investment- and speculative-grade corporate bond yield spreads



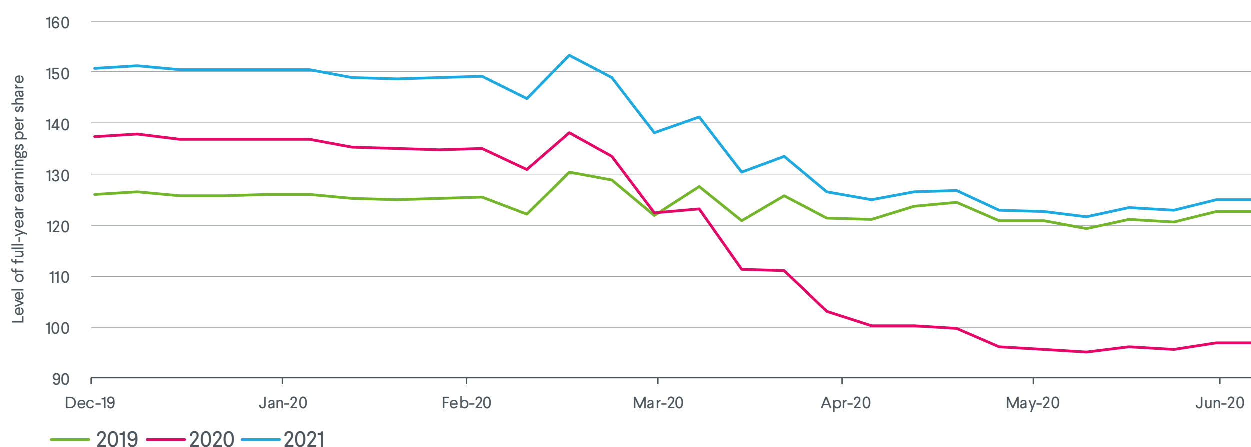
Source: ICE Index Platform

Global equity markets

Global equity markets had risen 35% above their 23 March nadir by the end of the second quarter and volatility had fallen substantially, though it remains well above levels at the start of the year. After a poor first quarter, cyclical sectors have fared better in the second: basic materials, industrials and consumer services, have outperformed the market; oil & gas has been broadly in line. But financials have fallen further behind. Technology is again at the head of the global performance rankings and, after a relatively resilient first quarter, defensive sectors, such as utilities, telecoms and healthcare, have lagged.

Global earnings forecasts for 2020 have been cut significantly since the end of March; earnings on the MSCI World index are expected to be 21% lower than in 2019. But the pace of downgrades has eased and forecasts for 2021 earnings are also showing signs of stabilising at a level just above earnings in 2019 (Chart 5). While a prolonged period of extraordinarily low government bond yields implies a higher present value of a future stream of earnings, these forecasts seem optimistic and current equity valuations may imply an even faster rebound in earnings.

Chart 5: MSCI World forecast earnings growth

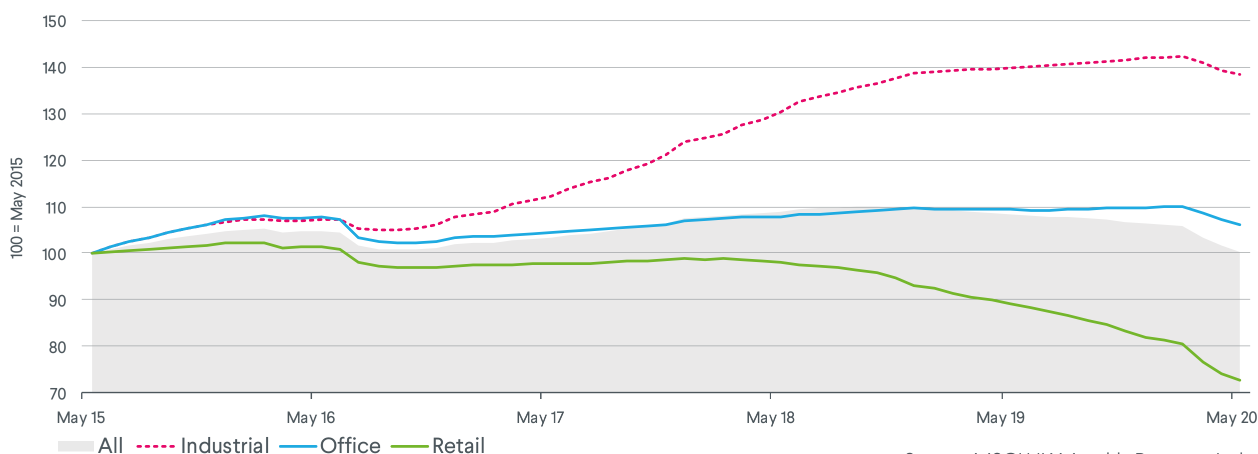


Source: IBES, Datastream. Note: 2019 forecast line continues to change after year-end as final accounts are prepared and published.

Property

The pandemic has added pressure to an already fragile UK commercial property market and its impact is increasingly evident in the MSCI UK Monthly Property Index – capital values in May were 7.4% lower over one year (Chart 6) and rents are now falling month-on-month in all sectors. Anecdotal evidence suggests rent collection has been deteriorating – according to one estimate, receipts at the June quarter collection day in England and Wales were only 18% of amounts due, compared to 25% in March. We would, however, expect rent collection figures for the main institutional funds to be markedly better than this given higher office and industrial allocations, although rent collections across all sectors are likely to be lower than in March.

Chart 6: UK property capital values



Source: MSCI UK Monthly Property Index

In current circumstances, index data may still be a poor indicator of market levels, but there are signs of a tentative return to normality. There has been an uptick in transaction activity, although it is likely to remain low while physical distancing guidelines are in place. Surveyors have also started to lift the material uncertainty clauses that qualified valuations, starting in the safest parts of the market, such as supermarkets, medical facilities and properties with long-dated leases to government tenants. However, most core balanced funds remain gated and likely will be until the material uncertainty clauses on office and retail properties are lifted.

Conclusion

Sentiment has improved dramatically in the second quarter as investors look through dismal expectations for Q2 data and focus on a near-term rebound that has outpaced the worst fears in recent weeks. Nevertheless, the outlook for corporate earnings and defaults remains uncertain and the potential for further waves of infection remains a risk.

Recent market moves have reduced the apparent cheapness of global equity and credit markets and they may be vulnerable to disappointment in respect of the scale and speed of the post-lockdown recovery. This leads us to retain a degree of caution and advocate holding more cash than usual. For those reluctant to hold cash, non-directional strategies and strategies with a genuine absolute return focus, may offer an attractive alternative to outright equity exposure in growth portfolios. In developed markets, we continue to prefer investment-grade over speculative-grade credit, although private debt markets may offer opportunities to originate new deals with better terms in certain areas. Emerging market debt, particularly hard currency debt, potentially still offers some attractive relative value.

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Special Situations Financing

The coronavirus pandemic not only affected the existing debt of many businesses, it also generated new borrowing requirements. Some of these requirements will be met in due course by commercial banks and other mainstream direct lenders, but other borrowers need a more timely and flexible response from their lenders either because of the nature of the specific challenges or opportunities they face or because their businesses have unusual characteristics. The Special Situations Financing strategy aims to capture this opportunity to generate an attractive risk-adjusted yield with a material premium over core direct lending.

What constitutes a special situation, and what are the implications for lenders?

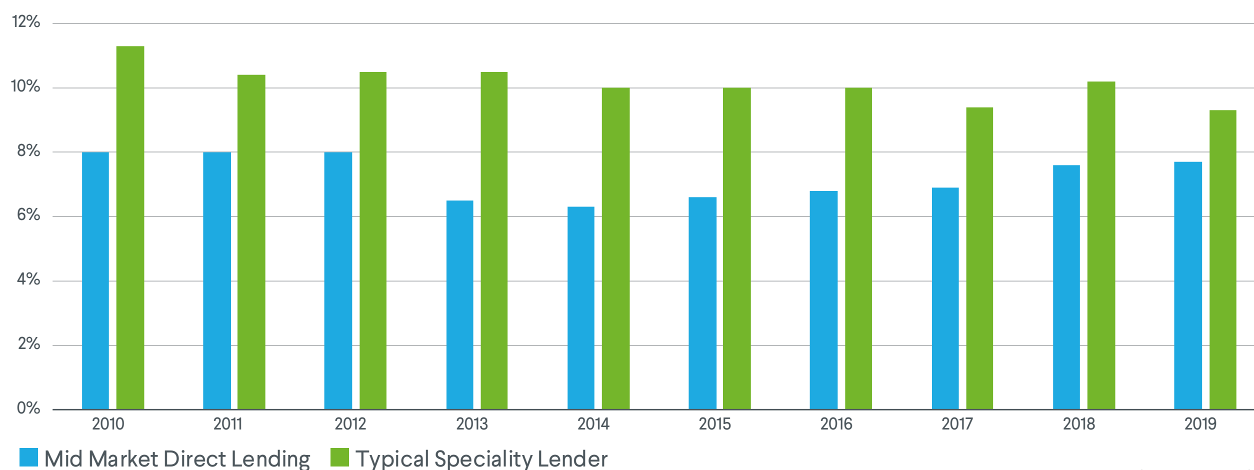
Special Situations Financing is an extension of core direct lending rather than a distinct asset class. The focus is on providing fundamentally strong mid-market corporate borrowers with financing solutions designed to help them tackle specific challenges or opportunities created by the pandemic. The two types of financing share many common characteristics; the differences arise due to the circumstances in which the financing is provided and/or the characteristics of the borrower. So, for example, a financing would likely be considered a special situation if it was:

- Provided to a borrower involved in lines of business considered by most lenders to be unfamiliar and/or too challenging to underwrite;
- Secured against highly specialised collateral including intangible and/or hard-to-value assets;
- Arranged for borrowers facing time-critical challenges and opportunities, such as liquidity events, near-term refinancings or acquisition opportunities.

As a result, Special Situations Financings tend to be bespoke, bilateral facilities, often unsuitable for broad syndication. This makes them less attractive to commercial bank lenders with highly centralised, standardised underwriting processes, particularly in cases where capital requirements are also higher.

The returns on Special Situations Financings are generated by lending margins and fees for arranging the transactions, varying the terms during the life of the loan and for early repayment. All these charges are higher than would be typical for core direct lending, but borrowers accept them because they require a rapid response and certainty of funding, and value the flexibility shown by the lender. The return premium over core direct lending is typically 2-4% per annum (Chart 7), and this advantage is expected to persist beyond the crisis.

Chart 7: Special Situations Financing vs core direct lending gross yields, calender years 2010-19



Source: Typical Direct Lender

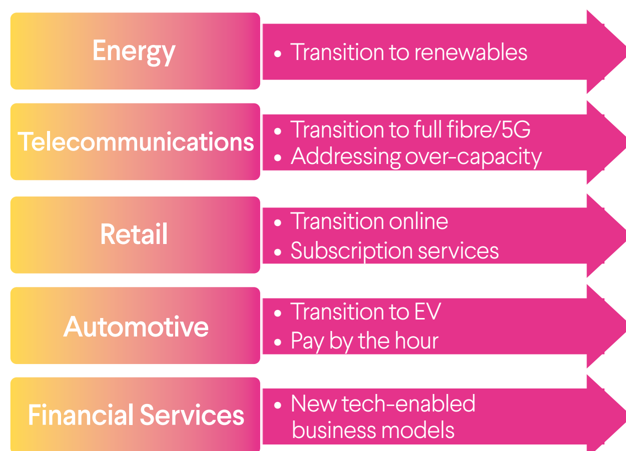
Special Situations Financings are typically structured as private loan facilities because they provide the flexibility needed to tailor the solutions to borrowers' specific circumstances. Term loans or shorter-term revolving credit facilities are the two most common forms. They share many of the characteristics of core direct loans: they are typically structured as senior, secured loan facilities, they have similar loan-to-values and are provided only to fundamentally strong borrowers. Consequently, Special Situations Financings have a risk profile only modestly higher than core direct loans. Super-senior, subordinated debt and preferred equity opportunities also exist and, subject to mandate restrictions, are used by managers to enhance returns or manage risk.

Conducive market environment

A strong flow of opportunities for Special Situations Financing is expected over the next 12-24 months as the pandemic eases and economies begin to recover. The initial focus is likely to involve liquidity support for businesses which are no longer eligible for government support but do not have access to mainstream lenders or the capital markets. Thereafter we would expect more deals to involve refinancing existing debt and acquisition finance.

The supply of opportunities is expected to be strongest in sectors that have been directly impacted by the pandemic, such as traditional discretionary retail, leisure, hospitality, consumer services and public transportation, and sectors that were facing transformational change before the crisis began, as illustrated in Diagram 1 below.

Diagram 1: Financing transformational change



Lenders into this market are expected to face less competition than before the crisis. Commercial banks have been reducing their share of the market for many years, especially in the US, and that trend is expected to continue. Activity in the capital markets, on which large corporates and the upper end of the mid-market depend, is also likely to remain subdued for some time.

Weaker competition has already led to an improvement in the underwriting terms available to special situations lenders. Market participants are seeing senior lending transactions with less leverage (1xEBITDA lower), improved lending margins (1.5-2% higher) and stronger financing covenants than before the pandemic. The pre-crisis trends towards greater leverage, compressed margins and covenant-lite loans have now been reversed.

Investment rationale

Market participants expect the annual net return from the strategy over the next few years to be in the range 10-12%, with the cash yield accounting for a high proportion of this return.

Credit risk is the primary concern, but the risk can be mitigated by the focus on fundamentally strong borrowers, thorough due diligence by the manager, conservative loan structures and the superior control that comes with being sole or majority lender. Residual credit risk is not significantly greater than it is with core direct lending.

Liquidity risk is also a key consideration. The bespoke nature of these financings make them inherently illiquid and lenders generally retain their positions through to the scheduled maturity or pre-payment of the loan.

As with the other opportunities in this edition of Investment Perspectives, responsible investment is a key consideration for this strategy. Supporting businesses with strong governance that are more focused on maximising social and enviornmental benefits such as increased employment, innovation and decarbonisation is more likely to deliver sustainable financial returns to investors. Borrowers in this space expect and need flexibility from their lender because of the dynamic business environment in which they are operating, so a high degree of engagement with borrowers is both essential and something which the best managers in this area do as a matter of course.

Implementation considerations

The Special Situations Financing strategy is typically implemented via closed-end pooled funds with a moderate life (eg 7 years). The strategy may be implemented as a specialist fund or alongside other private credit opportunities such as core direct lending or Distressed Debt. A multi-strategy fund enables managers to adjust their focus as the market evolves, and may be convenient for some investors planning an initial allocation to private credit. Specialist funds are better suited to investors who wish to target a specific opportunity set and risk profile. Management fees for specialist funds are typically in the range 1.25-1.5% p.a. plus incentive fees of c15% over a hurdle rate of 5%.

Summary

The Special Situations Financing strategy aims to provide mid-market corporate borrowers with bespoke financing solutions designed to help them tackle specific challenges or opportunities created by the pandemic. Lenders earn an attractive risk-adjusted yield in return for their willingness to provide bespoke, flexible financing solutions. Special Situations Financing is now a permanent feature of the mid-market direct lending landscape, but market participants expect the opportunity set to remain particularly attractive for the next 18-24 months.

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Distressed Debt

Many businesses that were already in difficulty before the pandemic, and those with business models that have been fundamentally compromised by it, will be finding that their existing debt has become unsustainable. This is the domain of the Distressed Debt investor. This article looks at the diverse range of Distressed Debt opportunities that become available in the wake of economic crises and what it takes to exploit them effectively.

Distressed Debt opportunities usually require active intervention

Distressed Debt strategies invest across a broad range of opportunities, but they are all concerned with the debt of inherently viable businesses or assets which have become unsustainable and require active intervention by the lender. The businesses involved will typically have exhibited significant operational and financial under-performance, but still have a strong commercial rationale. Lenders typically purchase the debt at a significant discount, enforce their security to take control of the business and then restructure and refinance it. Successful exits are usually via trade sale or IPO, generating significant capital gains for investors, although this is not always the case and lighter forms of intervention may also be appropriate.

A diverse opportunity set

The Distressed Debt market can be segmented in many ways including:

- **Public vs private debt:** public debt transactions are generally easier to research and it can be easier to build controlling positions, but they tend to be more heavily competed. Private debt transactions are typically more opaque, demand a more consensual approach, and usually require smaller capital commitments. Relative value between the two varies over the cycle, so it is beneficial to consider both opportunity sets.

- **Corporate vs asset-backed:** corporate transactions involve acquiring debt issued by operating businesses. The lender may or may not have recourse to the assets owned by the business. Asset-backed transactions involve buying loans secured against specific assets such as real estate or securities such as Collateralised Loan Obligations ("CLO") or Asset-Backed Securities ("ABS") issued to finance specific asset pools.

- **Geography:** the specifics of a Distressed Debt transaction are highly dependent on the local legal and regulatory framework, notably the provisions regarding the enforcement of security interests, insolvency/administration and operational restructuring, so jurisdiction is a critical factor.

- **Control vs non-control:** investors often acquire the debt with the intention of taking control of the underlying business; these are referred to as "control" transactions. In "non-control" transactions, investors work with the existing owners to restructure the debt.

The debt acquired is normally in the form of public bonds, private loans or debt securities. The debt will usually have a short term to maturity because, in normal circumstances at least, credit stress tends to build up as the refinancing date approaches. The debt will often be non-performing (i.e. not meeting interest or principal repayment obligations).

The debt acquired may continue to be held in the same form. More commonly it will be swapped for equity to enable the manager to exercise control over the company or asset portfolio.

Portfolios tend to be more concentrated than "normal" credit portfolios with typical position sizes in the private corporate market being c$30m, c$50m in public corporate deals and often much larger in asset-backed transactions. There may be 30-50 positions in a large, well diversified distressed corporate debt fund which is more concentrated than an equivalent performing debt portfolio, increasing the impact of individual transactions which ultimately fail.

Strong flow of opportunities expected

The volume of Distressed Debt opportunities fluctuates significantly over the economic cycle. It tends to be higher when a long period of credit expansion is interrupted by a severe economic shock. But because the strategy often depends on refinancing the restructured business and then selling it, the best returns are achieved when equity and credit markets recover robustly after the initial crisis.

The economic crisis induced by the pandemic exhibits many of the characteristics required to generate a strong flow of Distressed Debt opportunities, as illustrated in Diagram 2.

Diagram 2: Precursors for a Distressed Debt boom

Credit issuance had certainly been strong in the run up to the pandemic. In the corporate sector, $6.1trn of new bonds/loans rated BBB or below were issued in the 5 years to 2019 (compared with $2.5trn in the 5 years to 2007[1]). Leverage levels, particularly in the corporate mid-market, had also risen – by 1.0x and 0.5x EBITDA in the leveraged loan and high yield bond markets respectively since 2007[2]. Covenant protection had also weakened materially; this is negative for debt sustainability because it allows credit stresses to build up before lenders can intervene to resolve problems. Alternative lenders with structurally fragile investment vehicles were also playing a greater role in the market in the years preceding the pandemic. CLOs, for example, held over 50% of outstanding leveraged loans at the end of 2019[3]. They were quickly forced to sell assets to address covenant breaches on the securities they had issued or to meet collateral calls on hedging transactions.

The supply of opportunities is expected to be strongest in sectors that have been directly impacted by the pandemic and those that were facing transformational change before the crisis began.

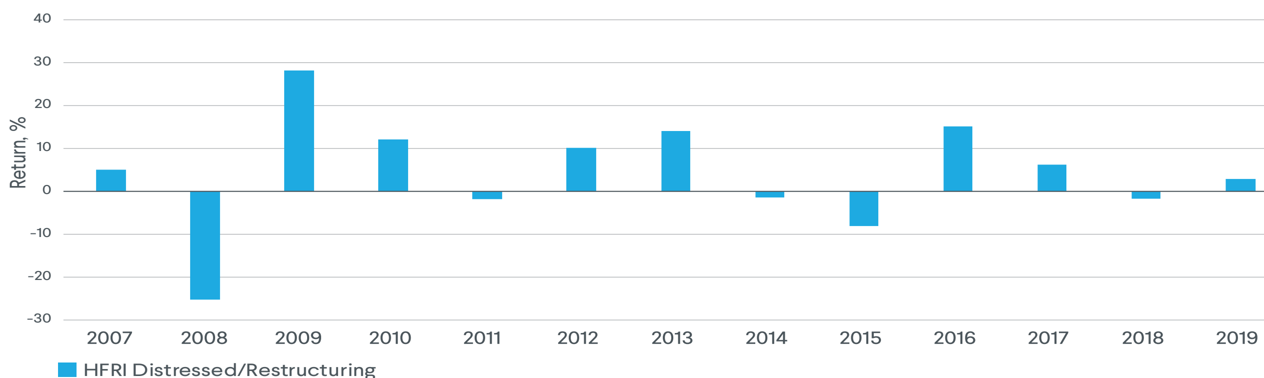
Market participants expect the opportunity to persist for several years, particularly given the severity and likely prolonged duration of the current economic contraction. Unlike some of the other post-crisis opportunities, it may be some months before the best Distressed Debt opportunities emerge, so clients have time to consider properly an allocation to this strategy.

[1] Source: Cerberus Capital
[2] Source: Cerberus Capital.
[3] Source: PIMCO

Higher returns, higher risks

Return expectations depend on the quality of the underlying business, the amount of leverage applied and the nature and timing of the transaction. Managers typically target net returns in excess of 15% per annum, but returns can be 5-10 percentage points higher than this when market conditions are most favourable. The strategy does however have lean periods at other points in the cycle as shown in Chart 8 below, which is why it is often combined with other credit opportunities.

Chart 8: Global Distressed Debt calendar year returns, 2007-2019



Source: Bloomberg

It is important to note that Distressed Debt strategies involve significant risk: capital losses can be substantial when portfolio companies cannot be transformed successfully. Distressed Debt investors face high levels of credit, equity and liquidity risk which need to be properly understood and carefully managed. Credit risks tend to be magnified by the concentrated nature of Distressed Debt portfolios which is a consequence of the need to build controlling stakes in the target companies. They must be mitigated by in-depth due diligence and robust planning, and lenders must have sufficient financial resources to support and protect the businesses during the restructuring process.

As a trade sale or IPO are the most common exit routes for corporate assets, lenders are also exposed to equity risks. It is important they have flexibility on the timing of each exit, in case restructuring takes longer than expected or market conditions are unfavourable, and have considered alternative exit routes.

Distressed Debt positions tend to be highly illiquid during both the restructuring and subsequent stabilisation period, so must be held in a structure which has the capacity and resources to hold them for significant periods. For these reasons, Distressed Debt strategies are typically implemented via closed-end, pooled funds with a long investment period (typically 3-4 years) reflecting the challenge of originating the right transactions. Funds also have a moderate ultimate life (typically 5-7 years) allowing time for the manager to take control, implement the necessary restructuring, demonstrate this has been effective and then arrange the sale of the asset. Management fees are typically c1.5% p.a plus an incentive fee of 15-20% over a hurdle rate of 6-8%.

Responsible investors in this space tend to be very patient and selective in their approach. They are looking for businesses which have experienced operational and/or financial underperformance but are intrinsically viable; this requires a longer-term outlook. It also involves careful consideration of risks, including ESG risks, and the mitigants that have been or can be implemented. They are typically also very hands-on investors. Their interventions will often involve operational restructuring with the aim of improving operational efficiency, product innovation and standards of governance, thereby creating more profitable and sustainable businesses.

A complex but well-rewarded strategy

Distressed Debt is a highly complex strategy requiring a wide range of specialist skills to execute well. Competent managers need to demonstrate an extensive origination network, strong relationships with target companies and their advisors, the ability and willingness to intervene as highly active investors and a strong track record across the entire economic cycle. Managers must also have proven expertise across the wide range of disciplines needed to evaluate, structure and manage successful transactions; legal, corporate finance, operational management and risk management are particularly critical.

Portfolio considerations

The Distressed Debt strategy is suitable for clients seeking significant capital growth over the medium term (5-7 years) with a high tolerance for market and liquidity risk. We recommend clients consider the strategy as part of their opportunistic growth allocations. High potential returns mean that relatively small capital commitments to the strategy can make a material difference at portfolio level.

Summary

The Distressed Debt strategy focuses on debt issued by inherently viable businesses which have become unsustainable, usually after a period of significant operational and financial under-performance. The strategy aims to generate a high return largely through capital growth, typically involves restructuring of either the business and/or its capital structure and often requires a highly active intervention by the debt holder. It is a highly complex strategy to execute well, but the potential rewards are substantial; net returns over 15% per annum are typically targeted but can be much higher in the right circumstances. The volume of opportunities fluctuates significant over the market cycle, but deal-flow is expected to be particularly strong as the pandemic subsides and economies begin to recover.

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Fund Secondaries

Investing in Fund Secondaries involves acquiring interests in existing primary funds which in turn are invested in asset classes such as Private Equity, Private Debt and Infrastructure. They can provide immediate exposure to well seasoned portfolios from a range of primary managers thus accelerating capital deployment and increasing diversification. The pandemic has forced investors and fund managers to restructure their portfolios which will provide a real boost to the Fund Secondaries market and an opportunity to acquire assets at deeper discounts. This article looks at how the market has developed and what options are available to investors today.

Market growing in scale and scope

The Fund Secondaries market has developed over the last 20 years as the universe of primary funds has matured. It remains a relatively small market, but one which is growing both in terms of scale and scope. It now provides the opportunity to gain immediate exposure to seasoned portfolios of Private Equity, Private Debt, and Infrastructure investments as well as other asset classes (see Table 1 and Chart 9 below):

Fund Secondaries may take various forms including:

- Interests in existing primary funds which may be structured as investment companies or (more usually) limited partnerships;
- Preferred equity in existing funds seeking additional capital;
- Co-investments in primary funds' underlying portfolio companies or assets.

Fund Secondaries transactions may be initiated both by primary fund managers (typically referred to as General Partners or "GPs") and their existing investors (Limited Partners or "LPs"). Since the financial crisis in 2008, the secondaries market has deepened and matured to provide optionality, liquidity and flexibility to LPs and GPs alike.

Table 1: Segmentation of Fund Secondaries market, 2019

2019	Primary Market	Secondary Market Annual Turnover	
	AUM $bn	$bn	% Primary AUM
Private Equity	4,100[4]	88[5]	2.1%
Private Debt	500[5]	5-10[5]	1-2%
Infrastructure	300[6]	7[5]	3%

[4] Source: Prequin [5] Source: Pantheon [6] Source: Setter Capital/Campbell Lutyens

Chart 9: Growth in Private Equity Secondaries market by transaction volume, calendar years, 2002-2019

Source: Greenhill Cogent

Market participants expect dealflow to be strong in the next couple of years as LPs and GPs deal with the consequences of the recent disruption to markets. LP-led deal-flow may be subdued right now, while investors take stock, but is expected to recover very strongly from Q4 2020. GP-led transaction activity is already very strong, especially in Private Equity and Private Debt.

An excess of un-invested capital is an issue in primary markets but less of a concern in the secondaries market. This is partly because of the anticipated uptick in transactions, but also because banks are withdrawing financing for secondaries transactions which means that buyers will be forced to use more cash.

Strong investment rationale

Investing in Fund Secondaries, particularly in the aftermath of the current crisis, can provide:

- Immediate exposure to mature portfolios which accelerates the deployment of capital and the subsequent realisation of returns while largely eliminating the risk of primary managers investing in assets that are not consistent with investors' expectations (referred to as "blind pool" risk);
- Greater diversification through exposure to a wider range of underlying portfolio companies;
- Exposure to underlying funds from the best primary managers that would normally be hard to access;
- Opportunity to acquire interests at a discount to the net asset value of the underlying primary funds, which is essentially a premium for providing liquidity to the market. Discounts are already larger than was typical pre-crisis.

The rationale for investing in funds of Fund Secondaries, rather than directly in primary funds, varies between asset classes. Secondaries funds are particularly helpful in accelerating the deployment of capital in the Infrastructure market given the challenges of sourcing quality deals in that asset class. By providing access to seasoned portfolios, they also facilitate the faster realisation of returns, particularly in Private Equity funds which typically do not distribute much regular income.

A large secondaries fund may invest in up to 50 transactions thus providing exposure to 100s of underlying portfolio companies and ensuring a high level of portfolio diversification. This advantage is perhaps more relevant to Private Equity and Infrastructure than to Private Debt where primary fund portfolios tend to be already well diversified.

Secondaries funds may also provide exposure to primary funds which in normal circumstances are hard to access. They are particularly helpful in Private Equity and Infrastructure where capacity constraints have a greater impact on the volume of capital primary managers will accept.

Fund Secondaries are typically acquired at a material discount to the net asset value of the underlying funds. The average in 2019 was 12% and 8% for Private Equity and Private Debt secondaries respectively[7]. Discounts in the range 0-10% were typical for Infrastructure secondaries[7]. Market participants report that these discounts have widened materially since the crisis began.

The annual net returns managers would normally expect to generate are c15% for Private Equity and Infrastructure Secondaries and c8-10% for Private Debt Secondaries. Market participants are expecting investments made in the aftermath of the pandemic to earn a premium of 5-10 percentage points above these levels. This would be consistent with the experience of investors in the aftermath of the Global Financial Crisis. Investors in secondaries funds expect to earn higher returns than investments in primary funds, reflecting the discounts at which the assets are acquired. There is some evidence that this is the case, even after allowing for the additional layer of costs.

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[7] Source: Pantheon

Key risks mitigated by diversification and additional due diligence

The risks of the strategy include those relating to the underlying assets, albeit these are mitigated by diversification and the additional layer of due diligence undertaken by the secondaries fund manager. There are two additional risks specific to the strategy: valuation risk and adverse selection. Valuation risk arises because it is notoriously hard to establish a true market value for underlying portfolio companies except at the point they are sold. Experienced secondaries fund managers seek to mitigate this risk by negotiating purchase prices based on their own independent assessments of the fair value of the underlying assets. Adverse selection risk arises where the vendor selects its weakest funds or assets to sell. This risk must be mitigated by rigorous due diligence, exploiting the close relationships secondaries fund managers have with primary funds (such as advisory board representation) to build a comprehensive picture of each underlying asset. Rigorous due diligence will be especially critical now given the disproportionate and devasting impact the pandemic has had on certain sectors and businesses.

Responsible investment principles are more challenging to implement for the Fund Secondaries strategy, but no less important. The challenges are the result of investing in well established portfolios of businesses; the fund secondaries manager has no direct contact with the underlying businesses and must accept the terms already negotiated with them. The challenges must be overcome though because the positions are relatively illiquid, early divestment is not an easy option, and unmitigated ESG risks in the underlying assets are unlikely to be well rewarded. The best managers do so by having invested heavily in their relationships with primary managers and in the processes and systems which allow them to identify and monitor key risks. This allows them to be highly selective in their investment process, to price risk effectively, and to work with primary managers to ensure that key risks are being effectively managed.

Specialist skills required

The number of managers specialising in this area is small. Most belong to the larger fund-of-fund firms who offer secondaries exposure either as a discrete product or as part of a multi-strategy solution. Some manage secondaries across all asset classes; most focus on a subset. It is important to select a manager who has a track record in secondaries because the skills required are subtly different from those needed in the primary funds market.

An attractive solution for growth or enhanced income allocations

The Fund Secondaries strategy is suitable for clients aiming to generate capital growth or an enhanced income yield over shorter timescales than would normally be possible in the relevant asset class. We view the strategy as an attractive option for both existing investors looking to increase rapidly their exposure to the underlying asset class(es) and for clients looking to establish an initial position quickly. Fund Secondaries are now considered to be a permanent feature of the private funds market, but we believe that the next 12-24 months will be a particularly good time to invest because of the strong deal-flow and the higher discounts available on primary fund interests.

Summary

The Fund Secondaries market remains relatively small compared with the underlying asset markets, but it is growing both in terms of scale and scope. The pandemic is expected to give the market a real boost by increasing deal-flow and stimulating more competitive pricing. Investing in Fund Secondaries can provide a number of benefits including faster deployment and subsequent realisation of capital, increased diversification, exposure to hard-to-access primary managers and a premium over the returns expected on underlying primary funds. We believe both existing and new investors in the main asset classes of Private Equity, Private Debt and Infrastructure should give secondaries investing serious consideration.

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	Yield % p.a.		Returns to 30 June 2020 (sterling, % p.a.)		
	31-March	30-June	1 year	3 years	5 years
Equities					
Global	3.0	2.5	5.7	8.4	12.3
UK	5.5	4.7	-13.0	-1.6	2.9
Developed markets ex UK	2.8	2.3	7.7	9.5	13.4
Emerging markets	3.5	2.9	-0.4	4.6	8.0
Bonds					
Conventional gilts	0.7	0.5	11.2	5.9	6.0
Index-linked gilts	-1.9	-2.4	10.6	6.9	8.4
Sterling corporate bonds	3.1	2.1	6.5	4.5	5.9
High yield (US) *	9.3	7.0	-1.1	2.9	4.6
Emerging market debt *+	7.0	5.5	0.5	3.6	5.3
UK PROPERTY	-	-	-2.3	4.3	5.5
HEDGE FUNDS *	-	-	0.1	1.6	1.0
COMMODITIES *	-	-	-11.2	-1.5	0.9

* Return in $ + Hard currency

Source Datastream:
FTSE All Share
FTSE World Developed ex UK
FTSE All World
FTA Govt All Stocks
FTA Govt Index Linked All Stocks
iBoxx Corporate All Maturities
BofA ML US High Yield Master II
JPM EMBI Global Diversified
UK IPD Monthly
Credit Suisse Hedge Fund
S&P GSCI Light Energy

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