Morgan Stanley

INVESTMENT MANAGEMENT

Increasing Duration Opens Up New Realms for the Private Equity Secondaries Market

PRIVATE CREDIT & EQUITY | AIP PRIVATE MARKETS TEAM | INVESTMENT INSIGHT | 2021

AUTHOR

AIP PRIVATE MARKETS SECONDARIES TEAM

Today, private equity represents 11% of the average portfolio allocation, significantly above the 4% allocation in 2005.[1] Despite this increase, one could argue this level of adoption is still below the optimal exposure given the asset class' strong performance relative to public equity.[2] Increasing duration and the associated illiquidity, in our view, are the reasons why this allocation gap persists. However, we believe that there are solutions available within the private equity industry to check or reverse this upward trend in duration and allay investors' concerns about increasing their allocation to the asset class.

Prior to the Global Financial Crisis, approximately 40% of private equity portfolio companies were sold within three years of acquisition. From 2009–2020, however, the average holding period has increased by 31%.[3] As a consequence, the median time it takes for a private equity fund to liquidate fully is now longer than 13 years, while the average term for a PE vehicle remains at 10 years.[4] Although funds can be extended, Limited Partners (LPs) have become increasingly frustrated with the

[1] Preqin Investor Outlook – Alternative Assets. Data as of 1H 2020

[2] Steve Kaplan (Chicago Booth), Burgiss Data. Data presented in 2020; data as of 2019

[3] Pitchbook Annual US PE Breakdown. Pitchbook Data as of December 31, 2020

[4] Palico Private Equity Marketplace Content

frequency at which fund durations exceed a decade. Logically, the longer hold periods for these investments have led to greater capital needs for the existing portfolio (often described as "follow on" investing). The quantum of follow on capital has increased meaningfully since 2009, with add-ons representing 72% of all private equity deal flow in 2020 compared with 57% in 2009, straining the capital reserves that exist within the PE fund structures.[5]

This mismatch of duration and capital needs has a variety of root causes. The typical private equity fund structure has not adapted to the growing and maturing private equity market. The ten-year fund life structure, which was perhaps fitting twenty-five years ago, is still the backbone of the vast majority of funds today. As the private equity market has become more competitive and, hence, more efficient, General Partners' (GPs) value creation plans often take longer to execute than expected, elongating hold periods. Thus GPs have often wanted to hold on to their 'winners' in order to maximize their potential value. These situations frequently create conflict between GPs and LPs and among the LPs themselves—some of whom want to stay on for a longer period of time, while others demand nearer term liquidity. In our view, three solutions have emerged to combat the duration dilemma while allowing the GP to continue to manage a particular investment.

One answer to this challenge has been the launch of longer duration or even evergreen private equity funds such as those introduced by a number of reputable firms such as Apollo, KKR, and Carlyle. In our opinion, while these funds are a natural solution to this issue and a laudable business extension for these private equity firms, they appear unlikely to penetrate the private equity market on a broad level. We believe only the largest private firms are able to provide investors with comfort that the governance, talent and focus required will continue to exist over these extended fund lives despite the fact that few professionals are likely to stay engaged for the full duration of the vehicles. Furthermore, few investors in private equity funds have a structure that allows them to participate in such a long-dated vehicle.

Another answer is the sale of positions held within funds that have surpassed their fund life to another fund of more recent vintage that is managed by the same private equity firm. This solution enables the manager to continue owning an asset that is viewed as attractive. However, a conflict of interest stems from the fact that a GP acts as a seller and a buyer simultaneously. In certain cases, a GP may not transfer 100% of the ownership of the asset into the more recent fund, creating misalignment of interest. In our experience, there are only a handful of situations in which these issues were examined and addressed when Limited Partner Agreements (LPAs) were in the draft stage. As such, a number of LPs have struggled with lack of transparency, information asymmetry and limited time and resources to fully diligence such transactions. Most problematic is the fact that, in most cases, there is not an independent third party responsible for pricing these transactions.

We believe the best solution to this problem has come from the private equity secondaries market. The most common transaction type within this space is the acquisition of a diversified portfolio of limited partnership interests by a dedicated secondaries fund.[7] A select number of secondary buyers, however, have abandoned this practice a number of years ago in favor of a more concentrated approach that enables them to isolate and invest in assets that they believe offer the greatest return potential. These transactions are alternatively known as "single-asset lift outs", "transformational secondaries" or "GP-led secondaries". This segment of the market has expanded significantly in the past two years; Evercore estimates the single-asset market has ballooned from $2Bn in 2018 to $14Bn in 2020.[6] Secondary buyers in these instances work with GPs to create vehicles that will hold one or more "winners" that the GP wants to continue to own and/or attractive investments that require more time to achieve their full growth potential. Single-asset lift outs may provide significant benefits to both GPs and LPs. First, they allow GPs to continue to manage certain holdings for a longer period of time and provide them with follow on capital for use when needed. Second, they offer existing LPs the option to cash out or to remain invested for a longer duration. Managers that pursue concentrated strategies benefit from the GP's deep knowledge of a specific asset and exposure to the assets with the greatest return potential within the GP's portfolio.

The magnitude of the recent evolution in the secondary market came as a surprise to many market participants, with total secondary deal volumes doubling from 2016 to 2019.[8] We believe that single-asset lift outs will serve as a catalyst for the continued growth of the secondary market and, more importantly, address the duration concerns that may be preventing asset allocators from dedicating a greater proportion of their assets to private equity.

[5] Pitchbook Annual US PE Breakdown. Add-ons (#) as proportion of total US PE Buyouts. Pitchbook Data as of December 31, 2020

[6] Evercore – 2020 Year End Secondaries Survey. Data as of December 31, 2020

[7] Diversification does not eliminate the risk of loss

[8] Evercore – 2020 Year End Secondaries Survey. Data as of December 31, 2020

IMPORTANT INFORMATION

The statements above reflect the opinions and views of the Morgan Stanley Alternative Investment Partners Private Markets ("AIP Private Markets Team") as of the date hereof and not as of any future date and will not be updated or supplemented. All forecasts are speculative, subject to change at any time and may not come to pass due to economic and market conditions.

By accepting this document, you agree that such document (including any data, analysis, conclusions or other information contained herein provided by the AIP Private Markets Team in connection herewith) may not be reproduced or otherwise shared or distributed to any other persons, in whole or in part, without the prior consent of an AIP Private Markets Team representative.

The information contained herein refers to research, but does not constitute an equity research report and is not from Morgan Stanley Equity Research. The views expressed herein are those of the AIP Private Markets Team as of August 2021 and are subject to change at any time due to changes in market and economic conditions. The views and opinions expressed herein may differ from those of other Morgan Stanley affiliates or businesses. The views and opinions expressed herein are based on matters as they exist as of the date of preparation of this piece and not as of any future date, and will not be updated or otherwise revised to reflect information that subsequently becomes available or circumstances existing, or changes occurring, after the date hereof.

These comments are not necessarily representative of the opinions and views of any other Morgan Stanley portfolio manager or of Morgan Stanley as a whole. While the information contained herein is believed to be reliable, we cannot guarantee its accuracy or completeness. **The recipient should bear in mind that past performance is not indicative of future results.** Keep in mind that forecasts are inherently limited and should not be relied upon as an indicator of future performance. The views expressed are subject to change based on market, economic and other conditions. They should not be construed as recommendations, but as an illustration of broader economic themes.

Information regarding expected market returns and market outlooks is based on the research, analysis, and opinions of the investment team of the AIP Private Markets Team. These conclusions are speculative in nature, may not come to pass, and are not intended to predict the future of any specific Morgan Stanley investment.

Certain information contained herein constitutes forward-looking statements, which can be identified by the use of forward-looking terminology such as "may," "will," "should," "expect," "anticipate," "project," "estimate," "intend," continue" or "believe" or the negatives thereof or other variations thereon or other comparable terminology. Due to various risks and uncertainties, actual events or results may differ materially from those reflected or contemplated in such forward-looking statements. No representation or warranty is made as to future performance or such forward-looking statements.

There is no guarantee that any investment strategy will work under all market conditions, and each investor should evaluate their ability to invest for the long-term, especially during periods of downturn in the market. **This piece has been prepared solely for informational purposes and is not an offer, or a solicitation of an offer, to buy or sell any security or instrument or to participate in any trading strategy. The material contained herein has not been based on a consideration of any individual recipient circumstances and is not investment advice, nor should it be construed in any way as tax, accounting, legal or regulatory advice. To that end, the recipient should seek independent legal and financial advice, including advice as to tax consequences, before making any investment decision.** Any index referred to herein is the intellectual property (including registered trademarks) of the applicable licensor. Any product based on an index is in no way sponsored, endorsed, sold or respect thereto.

Persons considering an alternative investment should refer to the specific investment's offering documentation, which will fully describe the specific risks and considerations associated with such investment.

Alternative investments typically have higher fees and expenses than other investment vehicles, and such fees and expenses will lower returns achieved by investors. Funds of funds often have a higher fee structure than single manager funds as a result of the additional layer of fees. Alternative investment funds are often unregulated, are not subject to the same regulatory requirements as mutual funds, and are not required to provide periodic pricing or valuation information to investors. The investment strategies described in the preceding pages may not be suitable for the recipient's specific circumstances; accordingly, you should consult your own tax, legal or other advisors, both at the outset of any transaction and on an ongoing basis, to determine such suitability.

Risks Relating to Private Equity Investments. Certain funds will typically invest in securities, instruments and assets that are not, and are not expected to become, publicly traded and therefore may require a substantial length of time to realize a return or fully liquidate. The respective general partners cannot provide assurance that they will be able to identify, choose, make or realize investments of the type targeted for their fund, or that such fund will be able to invest fully its committed capital. There can be no assurance that a fund will be able to generate returns for its investors or that returns will be commensurate with the risks of the investments within such fund's investment objectives. The business of identifying and structuring investments of the types contemplated by these funds is competitive and involves a high degree of uncertainty. In addition to competition from other investors, the availability of investment opportunities generally will be subject to market conditions as well as, in many cases, the prevailing regulatory or political climate. In addition, investments in infrastructure may be subject to a variety of legal risks, including environmental issues, land expropriation and other property-related claims, industrial action and legal action from special interest groups.

This is prepared for sophisticated investors who are capable of understanding the risks associated with the investments described herein and may not be appropriate for the recipient. No investment should be made without proper consideration of the risks and advice from your tax, accounting, legal or other advisors as you deem appropriate.

Morgan Stanley does not render tax advice on tax accounting matters to clients. This material was not intended or written to be used, and it cannot be used with any taxpayer, for the purpose of avoiding penalties which may be imposed on the taxpayer under U.S. federal tax laws. Federal and state tax laws are complex and constantly changing. Clients should always consult with a legal or tax advisor for information concerning their individual situation.

DISTRIBUTION

This communication is only intended for and will only be distributed to persons resident in jurisdictions where such distribution or availability would not be contrary to local laws or regulations.

United Kingdom: Morgan Stanley Investment Management Limited is authorised and regulated by the Financial Conduct Authority. Registered in England. Registered No. 1981121. Registered Office: 25 Cabot Square, Canary Wharf, London E14 4QA, authorised and regulated by the Financial Conduct Authority. **Dubai:** Morgan Stanley Investment Management Limited (Representative Office, Unit Precinct 3-7th Floor-Unit 701 and 702, Level 7, Gate Precinct Building 3, Dubai International Financial Centre, Dubai, 506501, United Arab Emirates. Telephone: +97 (0)14 709 7158). **Germany:** Morgan Stanley Investment Management Limited Niederlassung Deutschland Junghofstrasse 13-15 60311 Frankfurt Deutschland (Gattung: Zweigniederlassung (FDI) gem. § 53b KWG). **Italy:** Morgan Stanley Investment Management Limited, Milan Branch (Sede Secondaria di Milano) is a branch of Morgan Stanley Investment Management Limited, a company registered in the UK, authorised and regulated by the Financial Conduct Authority (FCA), and whose registered office is at 25 Cabot Square, Canary Wharf, London, E14 4QA. Morgan Stanley Investment Management Limited Milan Branch (Sede Secondaria di Milano) with seat in Palazzo Serbelloni Corso Venezia, 16 20121 Milano, Italy, is registered in Italy with company number and VAT number 08829360968. **The Netherlands:** Morgan Stanley Investment Management, Rembrandt Tower, 11th Floor Amstelplein 1 1096HA, Netherlands. Telephone: 31 2-0462-1300. Morgan Stanley Investment Management is a branch office of Morgan Stanley Investment Management Limited. Morgan Stanley Investment Management Limited is authorised and regulated by the Financial Conduct Authority in the United Kingdom. **Switzerland:** Morgan Stanley & Co. International plc, London, Zurich Branch Authorised and regulated by the Eidgenössische Finanzmarktaufsicht ("FINMA"). Registered with the Register of Commerce Zurich CHE-115.415.770. Registered Office: Beethovenstrasse 33, 8002 Zurich, Switzerland, Telephone +41 (0) 44 588 1000. Facsimile Fax: +41(0) 44 588 1074. **Hong Kong:** This document has been issued by Morgan Stanley Asia Limited for use in Hong Kong and shall only be made available to "professional investors" as defined under the Securities and Futures Ordinance of Hong Kong (Cap 571). The contents of this document have not been reviewed nor approved by any regulatory authority including the Securities and Futures Commission in Hong Kong. Accordingly, save where an exemption is available under the relevant law, this document shall not be issued, circulated, distributed, directed at, or made available to, the public in Hong Kong. **Singapore:** This document should not be considered to be the subject of an invitation for subscription or purchase, whether directly or indirectly, to the public or any member of the public in Singapore other than (i) to an institutional investor under section 304 of the Securities and Futures Act, Chapter 289 of Singapore ("SFA"), (ii) to a "relevant person" (which includes an accredited investor) pursuant to section 305 of the SFA, and such distribution is in accordance with the conditions specified in section 305 of the SFA; or (iii) otherwise pursuant to, and in accordance with the conditions of, any other applicable provision of the SFA. In particular, for investment funds that are not authorized or recognized by the MAS, units in such funds are not allowed to be offered to the retail public; any written material issued to persons as aforementioned in connection with an offer is not a prospectus as defined in the SFA and, accordingly, statutory liability under the SFA in relation to the content of prospectuses does not apply, and investors should consider carefully whether the investment is suitable for them. **Australia:** This publication is disseminated in Australia by Morgan Stanley Investment Management (Australia) Pty Limited ACN: 122040037, AFSL No. 314182, which accept responsibility for its contents. This publication, and any access to it, is intended only for "wholesale clients" within the meaning of the Australian Corporations Act. **Japan:** For professional investors, this document is circulated or distributed for informational purposes only. For those who are not professional investors, this document is provided in relation to Morgan Stanley Investment Management (Japan) Co., Ltd. ("MSIMJ")'s business with respect to discretionary investment management agreements ("IMA") and investment advisory agreements ("IAA"). This is not for the purpose of a recommendation or solicitation of transactions or offers any particular financial instruments. Under an IMA, with respect to management of assets of a client, the client prescribes basic management policies in advance and commissions MSIMJ to make all investment decisions based on an analysis of the value, etc. of the securities, and MSIMJ accepts such commission. The client shall delegate to MSIMJ the authorities necessary for making investment. MSIMJ exercises the delegated authorities based on investment decisions of MSIMJ, and the client shall not make individual instructions. All investment profits and losses belong to the clients; principal is not guaranteed. Please consider the investment objectives and nature of risks before investing. As an investment advisory fee for an IAA or an IMA, the amount of assets subject to the contract multiplied by a certain rate (the upper limit is 2.16% per annum (including tax)) shall be incurred in proportion to the contract period. For some strategies, a contingency fee may be incurred in addition to the fee mentioned above. Indirect charges also may be incurred, such as brokerage commissions for incorporated securities. Since these charges and expenses are different depending on a contract and other factors, MSIMJ cannot present the rates, upper limits, etc. in advance. All clients should read the Documents Provided Prior to the Conclusion of a Contract carefully before executing an agreement. This document is disseminated in Japan by MSIMJ, Registered No. 410 (Director of Kanto Local Finance Bureau (Financial Instruments Firms)), Membership: the Japan Securities Dealers Association, The Investment Trusts Association, Japan, the Japan Investment Advisers Association and the Type II Financial Instruments Firms Association.

EMEA: This marketing communication has been issued by Morgan Stanley Investment Management Ireland Limited ("MSIM Ireland"). Authorised and regulated by the Financial Conduct Authority. Registered in England No. 1981121. Registered Office: 25 Cabot Square, Canary Wharf, London E14 4QA.

There is no guarantee that any investment strategy will work under all market conditions, and each investor should evaluate their ability to invest for the long-term, especially during periods of downturn in the market. Prior to investing, investors should carefully review the strategy's/product' relevant offering document. There are important differences in how the strategy is carried out in each of the investment vehicles.

MSIM Ireland has not authorised financial intermediaries to use and to distribute this document, unless such use and distribution is made in accordance with applicable law and regulation. Additionally, financial intermediaries are required to satisfy themselves that the information in this document is suitable for any person to whom they provide this document in view of that person's circumstances and purpose. MSIM Ireland shall not be liable for, and accepts no liability for, the use or misuse of this document by any such financial intermediary.

Explore our site at **www.morganstanley.com/im**

CRC 3722069 Exp. 31/08/2022 10076962_CH_0821