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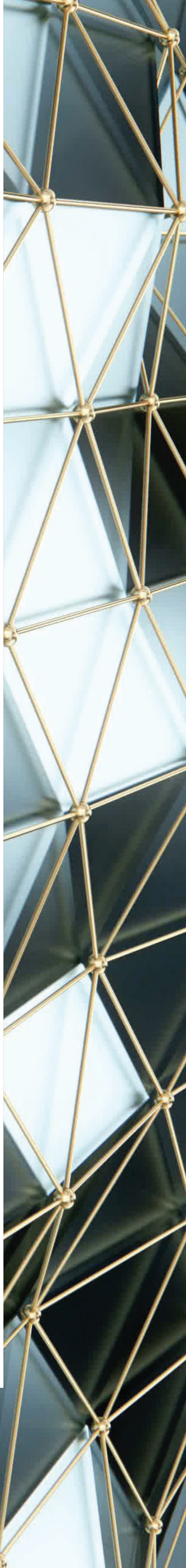

Secondaries v2.0: The Era of Transformation

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In 2017, a general partner ("GP") approached Morgan Stanley Alternative Investment Partners Private Markets team ("AIP") looking for a solution to an issue faced by an increasing number of GPs. The GP managed a 2004 vintage year fund that was reaching the end of its statutory life and held an unrealized investment with meaningful growth prospects. However, the 2004 fund had no remaining capital to invest in the company and the GP needed more time to fully capitalize on the growth potential of the business. The lead partner remarked, "I have more upside and lower risk with this asset than anything else I can buy in the market right now. Why would I sell it?"

In the secondaries market today, a compelling solution exists for GPs who encounter these situations. AIP refers to these transactions as "transformational secondaries." This form of GP-led secondary now comprises more than a third of the $90 billion secondary market.[1]

[1] Source: Greenhill Secondary Market Trends and Outlook (Data as of July 2019)

Transformational secondaries, particularly transactions involving single assets, are compelling because we believe they can potentially provide key benefits beyond those typically associated with traditional limited partner ("LP") secondaries. In addition to providing a shorter duration, mitigated blind pool risk and purchase price discounts, transformational secondaries seek to maximize the value of unrealized assets by providing opportunistic growth capital, additional time and enhanced alignment with the GP.

Single-asset transactions with high quality GPs, in our view, enable the secondary market investor to more effectively leverage the GP's intimate knowledge of the underlying asset, to collaborate with the GP in enhancing the value of the asset in its next phase of value creation and to negotiate deal terms that closely align the interests of the GP and the investor. Outside of transformational secondaries, we believe that it is difficult to find transactions with this combination of potential benefits in the secondary markets today.

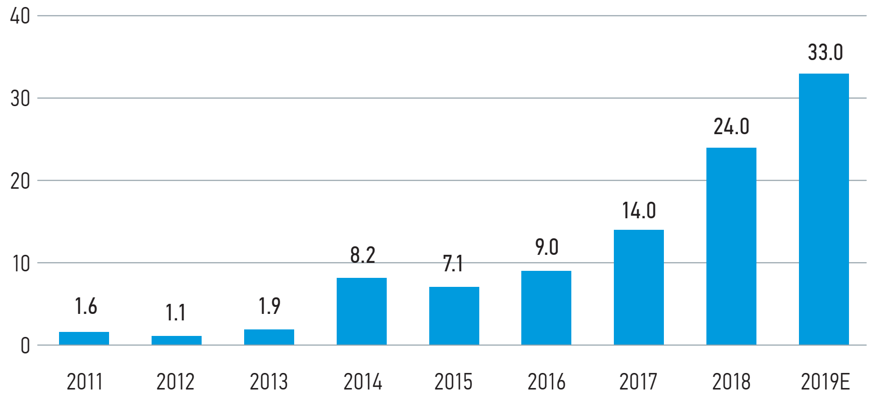
What are transformational secondaries and why are they attractive?

GPs of private equity funds often find themselves having to manage a multitude of structural obstacles that inhibit their ability to unlock value in certain assets. In our experience, common obstacles include:

- Unrealized assets with untapped value potential in a fund that is approaching end of term with existing investors desiring liquidity
- Lack of tactical growth equity capital required to enhance value in select companies
- Co-investors with different outlooks on certain assets and who are seeking liquidity on a different timeline

DISPLAY 1

GP-Led Transaction Volume By Year ($B)



- Teams being spun-out from captive sources of capital
- Need for re-alignment in economic terms between GP and LPs

A challenge that consistently arises for GPs in all of these situations is providing an outcome that works for all stakeholders involved. We believe that transformational secondaries can be a winning solution for the GP of the fund, existing fund LPs and for the new investor.

Transformational secondaries come in many forms, including: fund restructurings, fund recapitalizations, portfolio strip purchases, single-asset solutions and GP spinouts. Some transactions facilitate ways for GPs to hold onto a promising asset while allowing certain LPs to cash out; others allow the GPs to maintain control of assets where additional capital is required. The constant across all of these transaction types is providing LPs with optionality. Structurally, the asset or assets would be moved to a new special purpose vehicle with an extended term that enables these assets to reach harvest maturity. Existing investors would typically have the option to participate in the next phase of value creation of the asset or assets at no change in the economics, and those who desire liquidity can potentially cash out at a fair market price.

The transformational segment of the secondary market has gained significant traction in recent years, as shown in *Display 1*,[2] as a result of its attractiveness in offering a solution to all stakeholders.

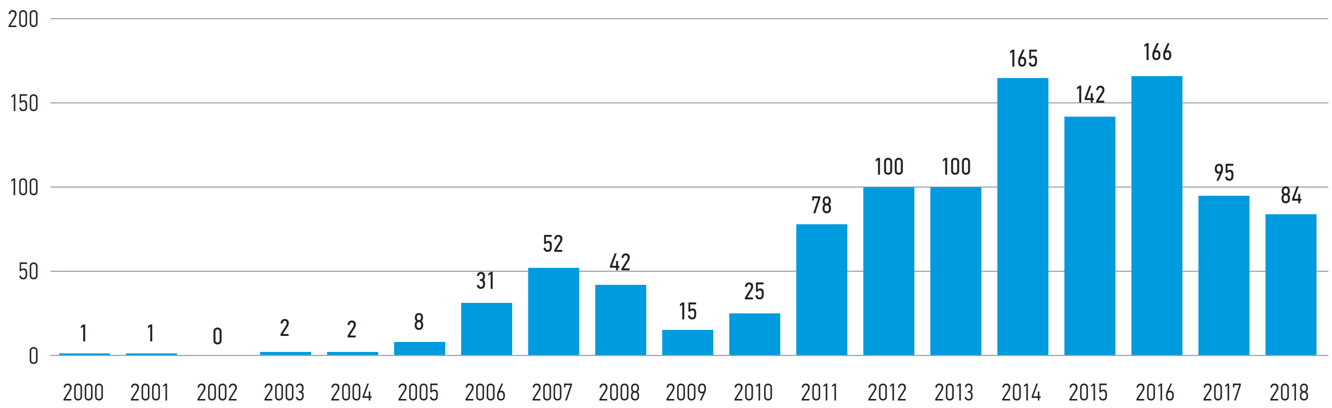
Key perceived benefits to investors, particularly as it relates to single asset solutions, may include:

- **HIGH DEGREE OF TRANSPARENCY:** Buyers may typically benefit from better access to a GP, company management teams and key company data, allowing for deeper due diligence and improved transparency. This additional access to company management as well as to comprehensive company data is often crucial in providing the buyers with the necessary comfort and confidence to offer the most competitive price to existing investors.
- **IMPROVED MANAGER ALIGNMENT:** Transformational secondaries provide an opportunity to invest with high quality GPs who are well-aligned with new investors through a modification

[2] Source: Greenhill Global Secondary Market Trends & Outlook, January 2019; Greenhill Secondary Market Trends & Outlook, January 2018; and Dow Jones Private Equity Analyst Guide to the Secondary Market, June 2017. **Past Performance is not indicative of future results.** All forecasts are speculative, subject to change at any time and may not come to pass due to economic and market conditions.

DISPLAY 2

Unrealized NAV ($B)



of fund economics and a meaningful commitment of GP capital. Alignment may be improved via one or more of the following mechanisms:

– New and larger than average manager commitments to the restructured fund,

– Re-investment of any accrued carry proceeds,

– Budgeted management fees and/or,

– Higher than average hurdle rates before the manager participates in additional carried interest

We believe it is important to carefully assess a GP's intent and seek to ensure that GPs are not pursing transformational solutions for short-term gains, but instead because they believe in the long-term potential of the assets.

- **LIMITED COMPETITION DUE TO COMPLEXITY:** Transformational secondaries are highly complex transactions requiring specialized skills and experience to successfully participate in the market. In our view, only a small number of players have the necessary resources and capabilities to pursue these transactions which may result in more attractive pricing and terms.

Where do transformational secondaries exist?

Transformational secondary opportunities exist across the entire spectrum of vintage years. Older vintage funds may hold one or more unrealized companies that are currently performing well, but may have taken longer than expected to create value. The initial investment may have been made during a period of cyclically high valuations or with leverage levels that may have impacted the company's ability to use cash for growth initiatives. For these reasons and others, assets purchased over the last decade are facing longer holds to achieve a return target. This longer time frame often results in older vintage funds holding assets that need more time to drive a good outcome, but reside within funds which need a structural solution prior to the end of their initial or extended term.

As shown in *Display 2*,[3] there is approximately $178 billion of unrealized NAV in funds that are at least a decade old. Many LPs who invested in these funds are seeking a partial or full liquidity solution for their investment. This already large and diverse market opportunity, which is set against a backdrop of a favorable distribution environment, we believe, is well-positioned for further growth in less benign distribution environments. Transformational secondaries will likely continue to expand as liquidity issues prompt GPs to consider these transaction types as a solution to structural challenges that are likely to become more pronounced.

The opportunity set also exists in newer vintage vehicles. Within the newer vintages, GP spinout transactions have been a common type of transformational solution. In these transactions, a subset of a team leaves an existing asset manager with their assets or the prior captive backer no longer supports the growth of the private equity organization. These spinouts should continue to provide a source of transformational deals in the foreseeable future. Lastly, transformational deals may provide additional growth or acquisition capital to businesses held within a portfolio that is outside its investment period. This dynamic typically did not exist prior to the advent of transformational secondaries and is proving to be an effective tool for newer vintage funds.

[3] Source: Preqin data, as of January 2020. The underlying data used to calculate unrealized NAVs by VY. Includes only balanced, buyout, growth, turnaround, and special situations funds that report performance and are managed by GPs based in North America/Europe with geographic focus in those regions. **Past Performance is not indicative of future results.**

AIP's approach to this opportunity is unique

The emphasis on single-asset solutions and the application of a multidimensional investment framework to seek to build a resilient portfolio is, in our view, a distinguishing characteristic of an approach to transformational secondaries.

It is important to build a core focus around single-asset solutions with single fund managers as we believe these opportunities allow for greater transparency and due diligence on the underlying portfolio companies as well as providing potentially stronger partnership with the GPs. More importantly, there is often a positive selection bias on the part of the GP in identifying the strongest asset in their remaining portfolio where a transformational secondary opportunity may exist. As buyers, this bias can provide comfort regarding the GP's level of conviction around the growth prospect for that company. Furthermore, there is a growing prevalence of single-asset transactions in the market from tail-end funds where there may be a dominant unrealized asset within a portfolio, to younger, more recent vintages with an identified single asset requiring a specific solution.

As discussed in the team's previous whitepaper *Where to Next: A Framework for Resilience*, AIP has developed a three-pronged investment philosophy centered on selecting assets that seeks to withstand challenging economic environments. The core tenets of this philosophy are (i) identifying efficiency producing businesses with exposure to stable end markets (ii) partnering with highly aligned and specialized investment partners; and (iii) seeking value on the buy with businesses exhibiting high cash flow generation and conservative leverage.

In conclusion, we believe that transformational secondaries are likely to be an increasingly important component of the secondaries market in the future. The opportunity set for transformational secondaries continues to grow and take on various forms as these transactions are used to achieve a widening range of objectives. It is driven by a fundamental need to solve structural limitations that exist in private equity in a way that seeks to be beneficial for all stakeholders. AIP believes that successful navigation of the issues related to single-asset transformational secondaries can offer significant upside potential for investors who take the time and have the patience to complete these structurally complex transactions.

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