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Have your private equity cake and eat it

Up until now, investors in private equity had to choose between the superior alpha of direct buy-outs or a secondary market that offered more liquidity and less risk. Not anymore. A new approach to private equity – what we call Partnership Solutions – aims to achieve the best of both strategies.

Introduction

Thanks to strong performance over many decades, global private equity (PE) assets have grown to about $3tn under management.[1] Investors in PE mostly gain exposure to underlying companies either via funds, which own them directly, or funds of funds (collectively known as the primary market). Investors can also co-invest alongside PE funds into companies, or even go direct.

The so-called secondary market is another route. It is smaller – less than two per cent of private equity assets are estimated to trade hands each year – but growing fast due to structural changes in the market. Rather than committing money at the outset, secondary capital joins the party several years later, providing liquidity to sellers and creating an active and more transparent market place.

Secondary investing is theoretically attractive because capital can be deployed quickly and diversely, historical fees are avoided, underlying assets are more mature and better funded, and cash is distributed sooner. Returns in secondary funds over the past ten years support the theory.

Traditionally there has been a trade-off when investing via the secondary market. Cash returns have tended to be lower because of less risk, shorter holding periods, reduced scope for valuation anomalies and the fact that often secondary sales are of portfolios that include assets of varying quality. In buying a whole fund position, you get the good with the bad.

However, we believe there is a way to get the best of both direct and secondary investing – to have your PE cake and eat it. What we call Partnership Solutions is a hybrid strategy targeting the alpha of direct PE with the more attractive liquidity and risk profile of the secondary market.

Partnership Solutions focuses on later stage investments within an existing PE fund portfolio. The strategy leverages a dynamic and collaborative approach to satisfy every stakeholder: the incumbent investors, PE fund managers, as well as the underlying portfolio companies. Alpha and superior returns can be created by:

- Maintaining the key tenets of a secondary transaction while tactically identifying individual, attractive assets within an existing PE fund portfolio.
- Prioritising deal creation versus deal sourcing by leveraging strong relationships. This also reduces information asymmetries leading to better underwriting and greater access to managers and underlying portfolio management teams.
- Utilising a bottom-up, asset-by-asset underwriting standard. Such an approach is unrealistic from a time and skill standpoint when assessing large secondary portfolio sales in a minimally invasive manner.

This paper explains why a partnership approach could be attractive to PE investors given recent trends in the private equity market. The value proposition as well as the risks of traditional secondary investing is described in the appendix.

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[1] McKinsey Global Private Markets Review 2018

September 2018

Secondary market landscape

In the past three decades, the PE secondary market has evolved from a niche, semi-illiquid investment class characterised by motivated sellers and a handful of buyers, into a more active and transparent marketplace. The benefit is that investors and managers now have the opportunity to structurally alter their private equity portfolios more easily.[2]

The secondary market has expanded in conjunction with the rapid growth of the primary market, helped by an increased acceptance of traditional and complex secondary transactions among the managers and investors. Transaction volumes have increased from $9bn in 2009 to around $75bn today. Despite this growth – which we expect to continue – secondary transactions remain under-represented as a portion of the broader private equity market, with annual volumes accounting for only around two per cent of the $3tn supply base of private equity assets.[3]

Secondary capital providers are now integral players in the PE industry. They boost liquidity and provide a solution to some of the challenges investors are likely to face. Secondary transactions come in three broad categories: portfolio sales, direct sales and manager-led sales.

1) Portfolio sales

- The most common type of secondary deal is known as a limited partner transaction (LPs are the investors in the fund). These accounted for three quarters of transaction volumes in 2017. A fund investor sells an interest, or a portfolio of interests, to another investor (a purchasing investor) based on a negotiated price, usually as a percentage of net asset value. The purchasing investor assumes the legal and financial obligations to the underlying fund(s). Such transactions arise from three main seller motivations: portfolio management, strategic and regulatory reasons, or due to liquidity-driven situations.

  Over the past several years, for example, large pension and sovereign wealth funds have begun to use a more liquid secondary market in order re-balance exposures and reduce the number of private equity relationships – effectively adopting traditional asset management techniques in managing their illiquid PE portfolios.

  Such transactions have been a key growth driver for the market. After the global financial crisis, increased scrutiny and regulation of large financial institutions, namely banks, led to strategic portfolio sales of directly held private equity assets and underlying private equity fund commitments. While this part of the market has historically generated attractive opportunities, its prevalence has waned in recent years as banks have reduced their balance sheets and exposure to directly and indirectly held private equity assets. Liquidity-driven or distressed situations can also still occur today, but are less common.

2) Direct secondaries

- This involves the sale of direct investments in a private portfolio of companies (which are also sometimes publicly traded) typically owned by financial institutions or large corporations. Such direct investments are sold either to the current team (for example in a spin-out situation) or to a new manager taking over portfolio management from the incumbent team.

3) Manager-led transactions

- An increasingly important segment of the market, so-called general partner-led (GP-led) transactions are where managers seek liquidity options for investors while potentially securing additional time (and sometimes capital) for a portfolio of assets to mature and be primed for sale. Structuring or re-structuring these types of transactions can be complex and time consuming – perhaps requiring bespoke solutions around the composition of the underlying portfolio, the price to sellers, and the alignment between old and new investors, as well as the manager.

  GP-led deals, as well as other non-traditional secondary transactions such as preferred equity purchases, already account for between a quarter and a third of deal volume (Figure 1). We expect such deals to play an increasingly important role in future.[4]

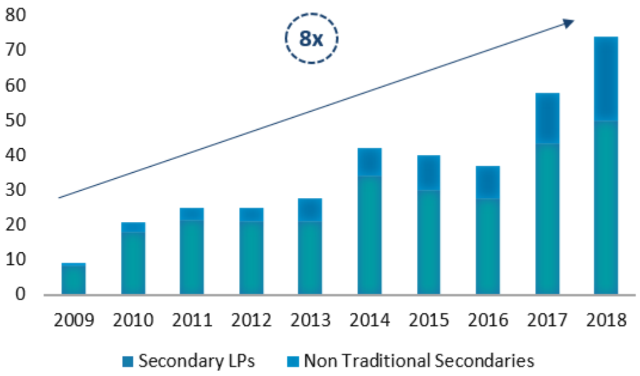
[2] Past performance information contained herein is provided for illustrative purposes only and is not indicative or a guarantee of the Program's future results. The views presented are solely those of the DWS Private Equity Team and not those of any other part of DWS.

[3] DWS PE based on Greenhill Cogent Secondary Market Trends & Outlook, Jan-2019.

[4] DWS PE based on Greenhill Cogent Secondary Market Trends & Outlook, Jan-2019.

Forecasts are based on assumptions, estimates, views and hypothetical models or analyses, which might prove inaccurate or incorrect.

FIGURE 1: SECONDARY VOLUMES AT RECORD ($BN)

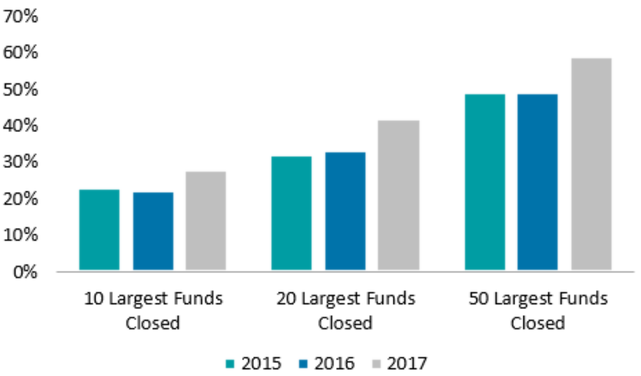


Source: Greenhill Secondary Market Trends & Outlook, January 2018; Greenhill Cogent Secondary Pricing Trends & Analysis, January 2017

Market developments create an opportunity

In recent years, there has been a shift in the private equity landscape, where a greater concentration of capital has been committed to larger, high profile firms, with many investors doubling down on a core group of fewer, better managers.[5] (Figure 2) This consolidation of investor capital has led to the average private equity fund size jumping from $400m in 2016 to $540m a year later, despite fewer funds coming to the market.[6]

FIGURE 2: PROPORTION OF CAPITAL RAISED BY THE LARGEST PE FUNDS



Source: 2018 Preqin Global Private Equity & Venture Capital Report

Because of this shift towards a more focused portfolio of managers, we believe the impact on low-to-mid market managers will lead to an increase in demand for a variety of secondary solutions. A strong pipeline of opportunities suggest such a funding gap exists in this space, as the growing dislocation between private equity tiers leads to an underserved and undercapitalised middle market.[7]

The growing need for solutions

The private equity market is an inherently long-term, illiquid asset class with structural inefficiencies. Some funds take almost 20 years to liquidate[8], as can be seen in Figure 3. This can lead to misalignments between investors, managers and underlying portfolio companies. The imbedded duration of the asset class makes it hard to calibrate the risk underwriting of all parties over such a prolonged period.

Despite embarking on a long-term partnership, prerogatives between investors, fund managers and portfolio company bosses can diverge and become untenable. However, the emergence of flexible, solutions-oriented capital has helped to ameliorate some of the inevitable issues arising through the lifecycle of an investment. Tangible examples of such issues we are currently seeing include:

- Investments in high quality portfolio companies needing more capital and taking more time to exit than initially envisaged at purchase.
- A company or a portfolio of companies requiring additional flexibility in order to be sold at the optimal time for the maximum value.
- Certain assets lacking patient capital, with founder-led businesses needing additional equity to grow and achieve business model catalysts, despite being in a portfolio for a number of years.
- A fund manager having limited capital to fund needed initiatives or targeted deals within their portfolio, which will ultimately lead to more attractive exits – particularly post the PE fund's investment period, where follow-on capital is more restrictive.
- A high quality firm struggling from overall underperformance and fundraising issues based on early investments, despite holding some very attractive and high performing assets.

5 Past performance is not indicative of future results. The views presented are solely those of the DWS Private Equity Team and not those of any other part of DWS.

6 Preqin Global Private Equity and Venture Capital Report, 2018.

7 Past performance is not indicative of future results. The views presented are solely those of the DWS Private Equity Team and not those of any other part of DWS.

8 Data presented at Invest Europe Investors Forum, March 2018.

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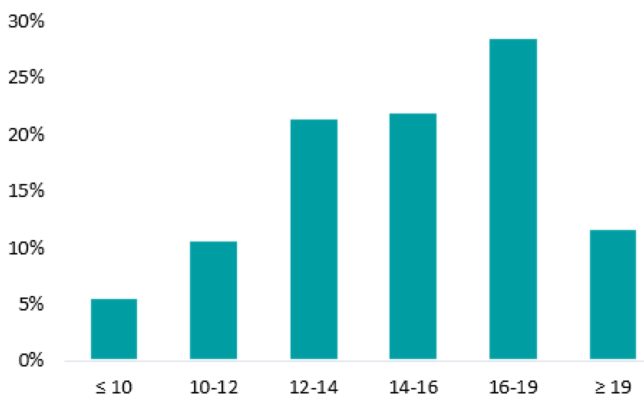
- A fund manager being pressured by investors to liquidate a fund vehicle and willing to sell near-to-medium term contractual earn-outs, with easily reachable thresholds, at a steep discount.
- A fund manager with limited strategic options for a company because they have reached their fund's concentration limit.
- A management team declining a good acquisition because it would result in an excessive debt burden.
- A relationship-driven transaction with a less price sensitive – but reputation wary – investor base wanting to create liquidity as a means of recycling proceeds into the next manager fund.

FIGURE 3: YEARS TO LIQUIDATION AS % OF FUNDS



Source: Invest Europe Investors Forum, March 2018

Capitalising on these recent market developments affords investors a unique market opportunity. Only non-traditional secondary approaches can take full advantage. Our solutions-based strategy is explained in the next section.

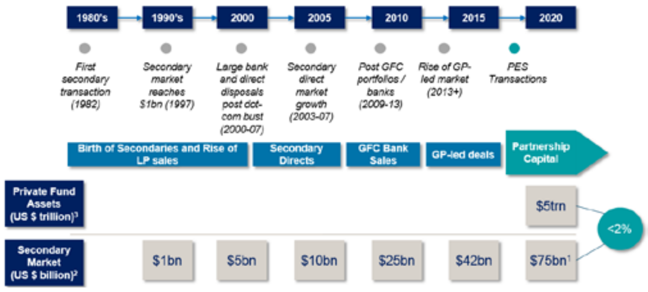
Partnership solutions

As described above, the rise in GP-led and other non-traditional secondary transactions is due to the convergence between buyers, sellers and fund managers. Each player in the market is bringing more innovation and creativity to the way capital is utilised and flows between them.[9]

Our approach to taking advantage of this evolution in secondary transactions (see Figure 4) is called Partnership Solutions. This is essentially a hybrid strategy that targets the alpha of direct private equity investing with the liquidity and risk profile of the secondary market.

Partnership Solutions focuses on later stage investments within a pre-existing portfolio of companies. The strategy employs a dynamic and collaborative approach to solving one or several issues within a portfolio while harmonising the interests of all stakeholders: the incumbent investors, the manager and the underlying portfolio companies.

FIGURE 4: THE SECONDARY MARKET'S PROGRESSION HAS TAKEN PLACE OVER DECADES



Source: DWS Private Equity, 2018 (1) Greenhill Cogent mid-case estimate of 2020 secondary market transaction volume. (2) Greenhill Cogent, Lazard and Credit Suisse (3) McKinsey & Co (2018) (4) Please note this is for illustrative purposes

While the secondary market has provided attractive returns to investors via large portfolio transactions consisting of multiple private equity interests, Partnership Solutions employs a unique approach to driving alpha by focusing on:

- Maintaining the key value-creating elements of a traditional secondary transaction, such as:
  - Reduced cost: no historical fees and future fees are discounted from the transaction price
  - Mitigation of blind pool risk: buying into funded assets at a more mature stage
  - J-curve mitigation: shorter duration and earlier cash distributions (Figure 5)

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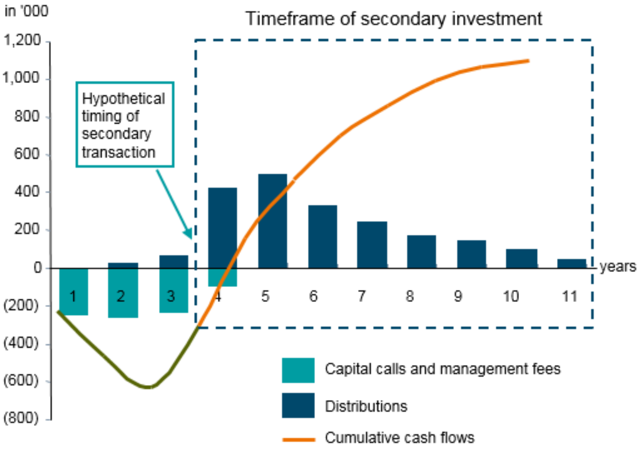
FIGURE 5: SECONDARIES CAN RESULT IN EARLIER CASHFLOWS

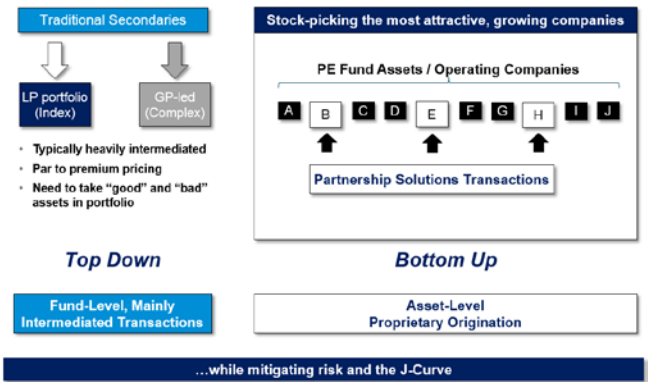


Source: Greenhill Secondary Market Trends & Outlook, January 2018; Greenhill Cogent Secondary Pricing Trends & Analysis, January 2017

- o Portfolio management: accelerated deployment of capital with potential to diversify across vintage, strategy, industry and geography
- o Pricing flexibility: benefit from the re-pricing of existing funded assets while capitalising on pricing inefficiencies

- Tactically identifying attractive assets within a portfolio that conform to specific risk/return parameters, as opposed to transacting on a 'take it or leave it' portfolio. Rather than relying on beta and leverage, Partnership Solutions delivers superior alpha via careful asset section and deep due diligence (Figure 6).

FIGURE 6: PICKING THE MOST ATTRACTIVE ASSETS



Source: DWS as at January 2019. For indicative purposes only. There is no assurance that any forecast strategy will materialise. Actual results may vary.

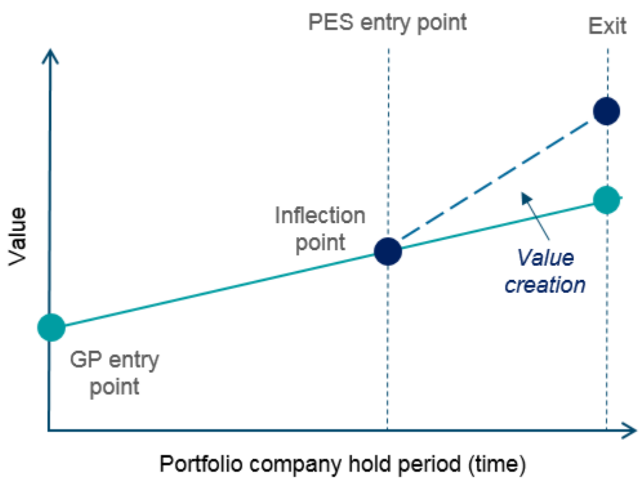
- Providing additional capital to enhance value creation by funding follow-on investments, providing working capital for new product launches or funding other strategic initiatives, such as add-on acquisitions (Figure 7).

- Deal creation versus deal sourcing through harvesting longstanding direct relationships with private equity firms and portfolio company chief executives, among others. The team acts as a trusted counterparty to all stakeholders, which supports the generation of proprietary deal flow. Direct access to both managers and underlying portfolio companies also helps lower information asymmetries.

- Cherry-picking assets allows for a superior, bottom-up, asset-by-asset underwriting standard. This would otherwise be impossible from a time and skill standpoint when assessing large portfolio sales in a minimally invasive manner.

- Finally, alpha comes from leveraging the skills of a specialised and complimentary team. Key abilities include sourcing off-market transactions, creating structures that consider the interests of all parties, identifying attractive business models and markets, and remaining disciplined in terms of capital deployment and underwriting standards

FIGURE 7: EXAMPLE OF A TYPICAL TRANSACTION



Source: DWS Private Equity Team as at February 2019. For illustrative purposes only. The information herein reflects our current views only, is subject to change, and is not intended to be promissory or relied upon by the reader. There can be no certainty that events will turn out as we have opined herein. There is no assurance that any forecast strategy will materialise. Actual results may vary.

APPENDIX

Value proposition of secondary investing

As an investment class, secondaries offer many attractive qualitative and quantitative benefits:

Qualitative

- **Enhanced build-up of private equity exposure:** By acquiring interests on a secondary basis, an investor has the ability to scale their private equity portfolio sooner than would be otherwise feasible. Typically speaking, entering the private equity market in a meaningful way – and ultimately reaching a critical mass of exposure – requires prudent capital deployment to primary commitments or single asset co-investments (many times a by-product of a primary commitment) across several vintage years.

- **Greater visibility/reduced blind pool risk:** An attractive aspect of acquiring a partially or fully funded portfolio of assets is that investors have further visibility into underlying operational performance and valuation, therefore meaningfully reducing blind pool risk.

- **J-curve mitigating qualities:** Early in a primary fund's life, the net internal rate of return to investors will typically be negative, considering the absence of portfolio-level value accretion coupled with the application of fees and expenses. However, acquiring secondary interests at a later stage can partially or entirely mitigate the impact of the J-curve. At this stage, there is typically a lower fee load, with assets potentially being acquired at a discount to NAV, thereby creating an arbitrage for new investors versus those that entered on a primary basis.

- **Smoother cash flow profile and NAV acceleration:** Complimenting an existing private equity portfolio with secondaries can lead to the smoothing of the cash flow profile across the broader portfolio, while offering the ancillary benefit of NAV acceleration for investors requiring specific portfolio value targets.

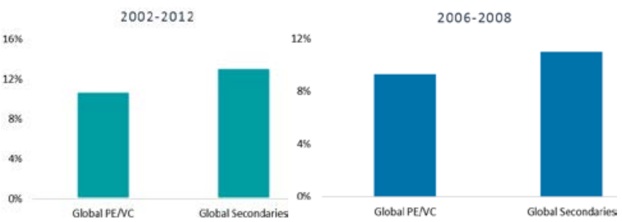
- **Back-ended diversification:** By adding exposure to secondaries, an existing private equity portfolio can benefit from increased diversification across vintage years, sectors, geographies/regions, strategies and managers.

Quantitative

- **Outperformance versus single fund exposure:** When comparing the performance of global secondaries and global private equity and venture capital across multiple economic cycles (2002-2015), secondaries have outperformed on an IRR basis by 230 basis points (580bps when including the most recent three vintage years), generating weighted median net returns of 13 per cent versus 11 per cent for private equity and venture capital funds.[10]

  When looking deeper at recession vintages (2006-2008), global secondaries continued to outperform private equity and venture capital by 170 basis points, with returns of 11 per cent and nine per cent respectively.[11] (Figure 8)

FIGURE 8: WEIGHTED AVERAGE MEDIAN RETURNS BY VINTAGE YEAR



Note: Calculation methodology utilizes median returns per vintage year weighted by the universe of funds reporting in each year. Source: Cambridge Associates, FOF, Buyout & Growth, and Secondary Funds Index and Benchmark Statistics, June 30, 2017. Past performance not a reliable indicator of future returns.

- **Low historical return volatility:** The dispersion and implied volatility between quartile returns has been greater in the private equity and venture capital investment universe than secondary transactions. Despite being a function of the private equity market, secondaries have historically offered lower dispersion of returns between the top and bottom performers, which we believe points to the consistency of this investment class over a prolonged period.

[10] Cambridge Associates, FOF, Buyout & Growth, and Secondary Funds Index and Benchmark Statistics, June 30, 2017. Past performance is not indicative of future results.

[11] Cambridge Associates, FOF, Buyout & Growth, and Secondary Funds Index and Benchmark Statistics, June 30, 2017. Past performance is not indicative of future results.

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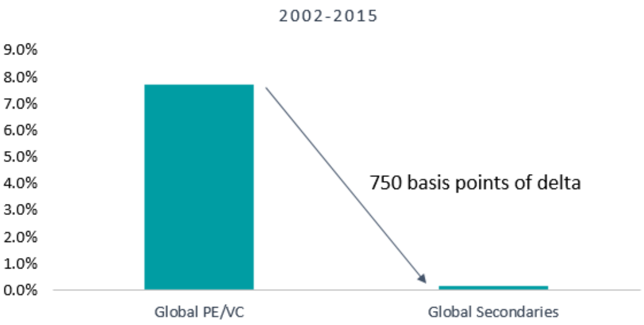
- **Low loss ratios:** In conjunction with the lower dispersion of returns, secondary funds have also enjoyed low loss ratios, evidenced by only 22 basis points of total drawn capital returning less than cost over a 13 year span, compared with 780 basis points for global private equity and venture capital over the same period.[12] (Figure 9)

  When comparing the number of firms that have returned less than cost over the same period, the number jumps to a fifth for global private equity and venture capital while remaining muted for global secondaries at 1.3 per cent.[13] We believe that the margin of safety in returns can be largely attributed to greater diversification, near-to-medium term cash flow visibility, reduced blind pool risk and acquiring positions at a historical discount to NAV.

FIGURE 9: LOSS RATIO (AS A % OF DRAWN CAPITAL)



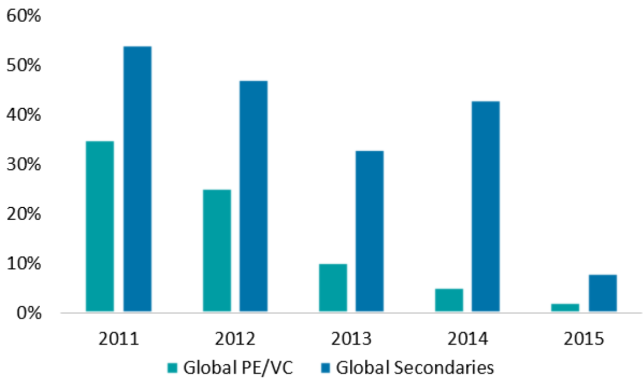
Note: Based on capital losses as a convention of aggregate drawn capital (e.g. total value that is valued less than drawn). Source: Preqin, May 2018. Past performance is not indicative of future results.

- **Earlier liquidity:** Secondary investors have historically purchased mature private equity interests that are between 50 and 80 per cent funded[14] and are usually focused on seasoned assets that have the potential to be exited over a shorter horizon. As a result, near-to-medium term liquidity has been a focal point when underwriting a transaction (Figure 10).

- Liquidity events will typically be returned to investors as a distribution – or utilised to offset capital calls for fees and/or follow-on investments. This distinct attribute can be attractive to investors of varying sizes, setups and preferences for the following reasons:

  - Early distributions can be beneficial when capital planning a broader private equity or alternatives program, providing cash flow flexibility to fund other commitments or near-term liabilities, while also aiding in the achievement of self-funding
  - The recycling of distributions to fund follow-on investments and management fees can reduce the administrative and financial burden on investors to process numerous capital calls, which often arrive on short notice and require funding within a limited timeframe
  - Recycling capital also enables a manager that has realised early returns to re-deploy capital in the maximum number of investments, potentially generating greater net returns. We believe the attractiveness of increased net return generation and liquidity has been further supported by the current low yield environment as investors have fewer options with similar characteristics

FIGURE 10: DPI LAST FIVE VINTAGE YEARS, DISTRIBUTED AS A % OF CALLED CAPITAL



Source: Preqin, 2018

And as seen in Figure 11, secondary funds typically take under seven years to reach a distributed to paid-in capital multiple of one times, with 40 per cent of that capital distributed in the first five years alone. This is unusual for most private equity strategies and desirable for investors pairing a secondaries strategy with other longer-term private equity investments.[15]

[12] Preqin, May 2018. Past performance is not indicative of future results.

[13] Preqin, May 2018. Past performance is not indicative of future results.

[14] Cambridge Associates, June 30, 2016.

[15] Cambridge Associates, "When Secondaries Should Come First" August 2017.

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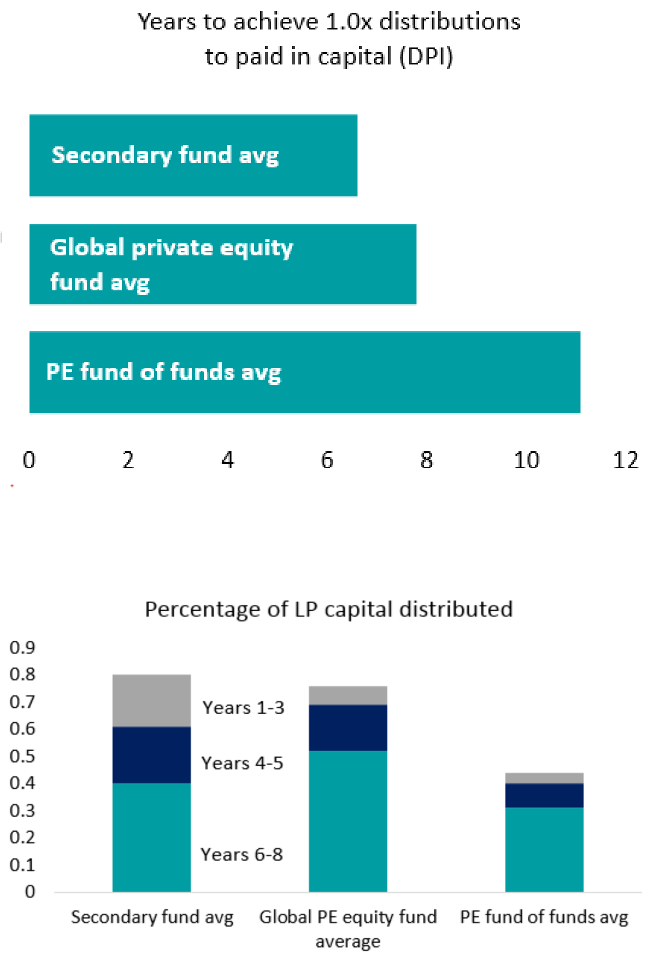
FIGURE 11: DPI HORIZON BY PE INVESTMENT CLASSES



Cambridge Associates, "When Secondaries Should Come First" August 2017

Secondary investing risks

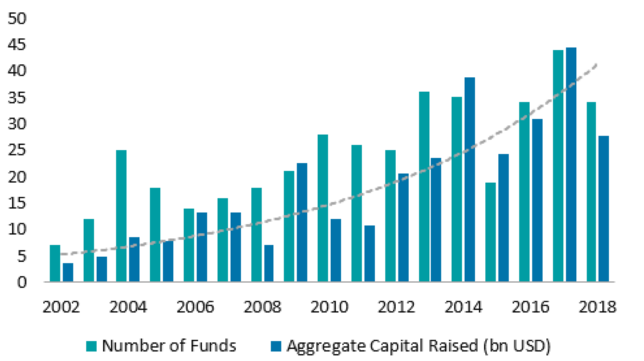
As a reflection of the broader private equity market, the secondaries universe has enjoyed buoyant and consistent growth in the current market cycle, which we believe has been largely supported by increased awareness and acceptance of traditional and complex secondary transactions among managers and investors. However, despite the continued strong fundamentals that we see on the supply and demand side, the proliferation of the market both in terms of the number of firms operating and capital being raised in recent years has led to further competition, increased pricing, and returns compression.

Competition

Since 2011, the secondary fundraising market has grown every year with the exception of 2015, generating an annualised growth rate of nearly 25 per cent.[16] (Figure 12) The number of funds raising capital over the same period grew at a modest annual rate of seven per cent, pointing to the thematic consolidation of capital flows towards larger, well-established players that typically operate in the upper end of the market.[17] (Figure 13) Also reflecting this theme, the average fund size has also increased over the same period at 17 per cent annum.[18]

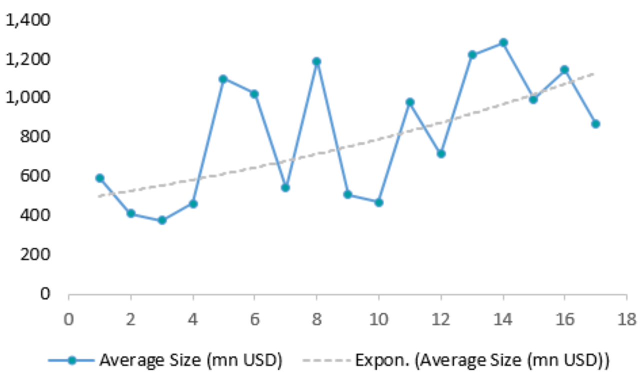
The secondaries market has experienced record fundraising, with dry powder now at 2.6 times the supply of deal flow, more than double what it was six years ago. As a result, the whole secondaries market has become far more competitive, making returns harder to generate.

FIGURE 12: SECONDARIES MARKET FUNDRAISING HISTORY (NUMBER OF FUNDS AND RAISED CAPITAL)



Source: Data has been sourced from the 2018 Preqin Global Private Equity & Venture Capital Report

FIGURE 13: SECONDARIES MARKET FUNDRAISING HISTORY (AVERAGE SECONDARY FUND SIZE)



Source: Data has been sourced from the 2018 Preqin Global Private Equity & Venture Capital Report

16 2018 Preqin Global Private Equity & Venture Capital Report

17 2018 Preqin Global Private Equity & Venture Capital Report

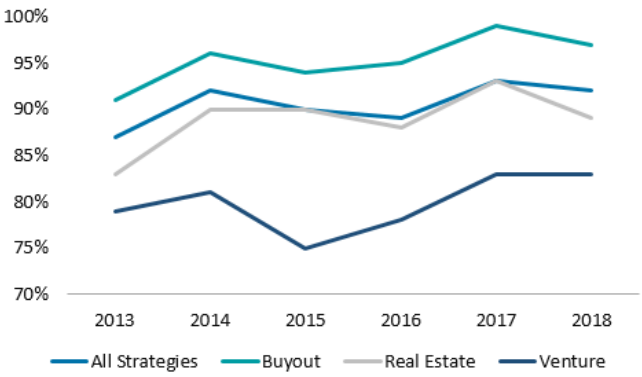
18 2018 Preqin Global Private Equity & Venture Capital Report

Valuations continue to rise

We believe that a confluence of factors has led to an increased pricing environment for secondary opportunities, which we believe to have reached peak levels in 2017 and precipitated a transition from a buyer's market to a seller's market of investor positions.[19]

For example, Greenhill, a secondaries advisor, has witnessed aggregate pricing of 93 per cent of net asset value for 2017, a 400 basis point increase versus the year before and a 100 basis points above the prior record set in 2014.[20]

FIGURE 14: YEARLY PRICING DEVELOPMENT



Source: Greenhill Secondary Market Trends & Outlook, 2017 and January 2018

A by-product of the current market cycle can be seen in the higher valuations across all asset classes. Investors flush with capital and strong company balance sheets are contributing to deals at rich valuations, while loose monetary policy has raised risk appetites. (Figure 14)

With a strong historical correlation between public market volatility and growth and pricing in the secondaries market, investors looking for entry points will likely face similar dynamics to public markets. Moreover, rising listed equity markets (Figure 15), a strong macro backdrop in the US and steadier eurozone economies have led to more optimistic underwritings at the asset level, thereby validating current pricing levels.

FIGURE 15: SUPPORTIVE GLOBAL EQUITY MARKETS

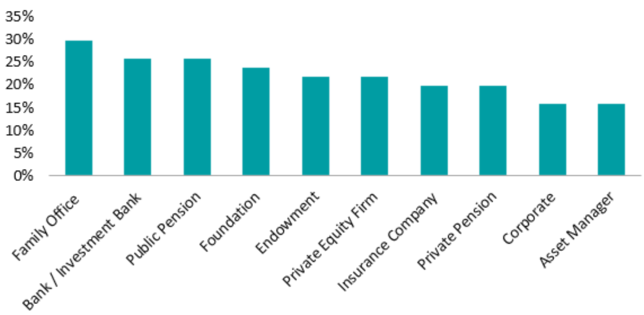
Source: Capital IQ, May 10, 2018

Role of intermediaries

The increased presence of secondary market advisory firms has also played a contributing role in the evolution of seller liquidity and pricing development. We estimate that nearly 90 per cent of the investor portfolio market is intermediated. More complex manager-led deals are generally less intermediated, more bespoke and make up a smaller but growing portion of the overall market.

On the portfolio side of the market in particular, intermediaries play a natural and critical role for investors, by alleviating the time and energy required to run an efficient and structured process with a broad universe of buyers. In a position between buyers and sellers, an intermediary is effectively playing the role of a market maker, negotiating structure, securing optimal pricing and increasing the likelihood of a transaction being consummated. (Figure 16)

FIGURE 16: INVESTOR TYPES REPRESENTED BY SECONDARY MARKET INTERMEDIARIES



Source: 2018 Preqin Global Private Equity & Venture Capital Report

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20 Greenhill Cogent Secondary Market Trends & Outlook, 2018

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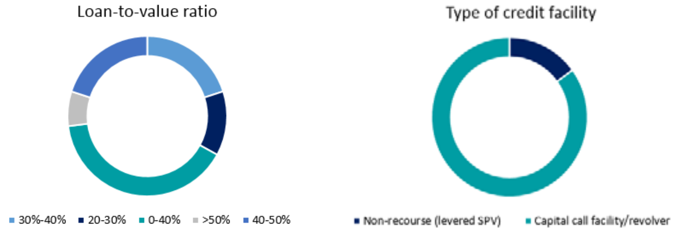
State of leverage

The use of leverage continues to play an integral role in pricing and return generation for secondary investors.[21] Particularly in the LP portfolio sale market – where the fundraising renaissance of recent years has left players with pressure to deploy – the use of debt has become ubiquitous when underwriting transactions at competitive pricing. Consequently, in order to achieve consistent return targets, investors have had to develop creative deferral and leverage structures, representing almost a quarter of the market's 2017 total volume.[22] (Figure 17)

Although largely non-existent a decade ago, leverage is now seen an essential tool when attempting to win deals and maintain double digit returns at the larger end of the market. Investors are expected to continue to utilise deferral and leverage structures. In a survey last year, a quarter of respondents said they planned to increase their use of leverage.[23] However, despite greater market sentiment towards the use of financing facilities, secondary buyers have demonstrated prudence with relatively low loan-to-value ratios.

FIGURE 17: LEVERAGE LEVELS



Source: Campbell Lutyens, 2018 Secondary Market Overview Report

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[22] Triago Quarterly Report, December 2017.

[23] Campbell Lutyens, 2018 Secondary Market Overview Report.

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