BARINGS

PRIVATE EQUITY

Views from the LPAC: Four Trends Shaping Private Equity in 2021

BARINGS INSIGHTS

Throughout Barings' 30 years of investing in private markets, we have held hundreds of Limited Partner Advisory Committee (LPAC) seats—helping mitigate conflicts of interest and making suggestions to General Partners (GPs) and Limited Partners (LPs) on best practices. From this seat, as longstanding-LPAC members, we offer the following insights on the issues, actions and trends currently shaping private equity.

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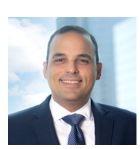

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Through recent and wide-ranging conversations with fellow LPs and LPAC members, we have found the following four trends to be among the most pronounced in the current environment. While this is not an exhaustive list, we believe LPs should take these particular factors into consideration as they manage their portfolios and allocate capital throughout the remainder of the year.

1. The Big are Going Wider

CURRENT TREND

As the industry matures, private equity GPs are showing an increasing willingness to be acquisitive, with many thinking more in terms of AUM and business growth than they may have in the past. We have recently witnessed a number of deals in which large GPs have acquired other GPs or platforms—such as smaller emerging managers, independent sponsor teams, or specialized managers with proven track records in select verticals (i.e. tech) and/or with adjacent or complementary strategies. From a strategic standpoint, these acquisitions can be advantageous in that they provide a way for GPs to buy into a trend or establish a new vertical in a relatively efficient and cost effective way. For a GP interested in secondaries, for instance, acquiring a secondary platform or proven team would likely be more efficient than building that capability in-house over a number of years. And because these GPs often have large existing distribution networks and a strong name in the market, they are typically able to leverage their wide-reaching LP base to enable supercharged growth for newly acquired strategies. These acquisitions can also benefit LPs, offering them greater exposure to new areas via a manager that they already know and trust.

OUR VIEW

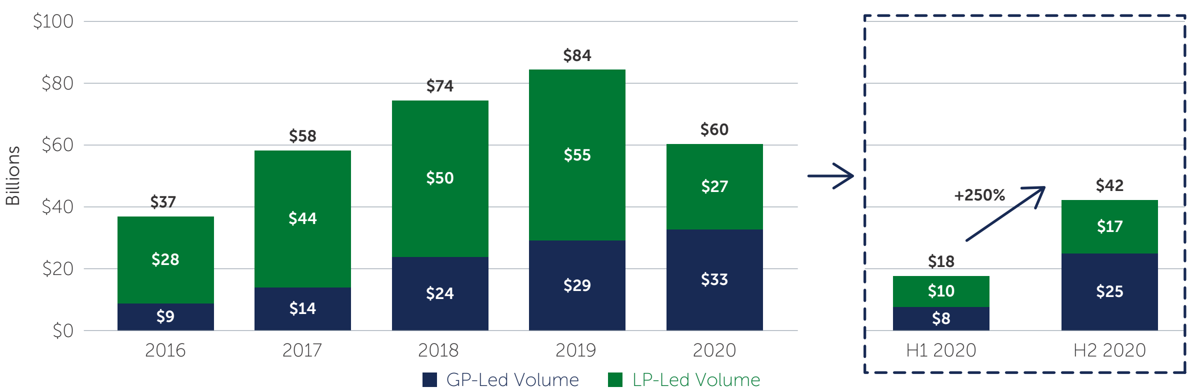
For LPs, one key question around these acquisitions is whether the key investors that made a GP successful have become more focused on business building than investing. While many of the GPs involved in these deals are large, established businesses—and may already have investment teams that are well-positioned to continue driving value at the portfolio level—there is always a question of alignment. For instance, if a GP is selling GP stakes to third parties, without giving the internal partners a chance to purchase portions and become more ingrained, it could raise longer-term misalignment questions. Another consideration is around how the new team will perform under a new ownership structure, and with less autonomy. Ultimately, for the LP, it all comes down to underwriting and conducting diligence on the new team—digging into their track record and how they have executed as a team, and how they will replicate that success under a new ownership structure.

2. The Growing Prominence of Continuation Vehicles

CURRENT TREND

In the last year, we have seen an increase in the amount of continuation funds, which allow GPs to roll an asset (or assets) from an existing fund or multiple funds into a new investment vehicle with fresh or re-start capital, rather than selling the asset to an outside buyer. These funds were historically more prominent as a means of giving one or two companies more time to deliver on expected returns. More recently, however, GPs are recapitalizing their higher-performing investments—the so-called crown jewels of their portfolios—earlier in the life of a fund as a way of holding on to the assets longer-term while providing additional capital for growth initiatives. Indeed, while continuation funds have received less headline attention than special purpose acquisition vehicles (SPACs), they are evolving into a credible mainstream exit strategy. Over the last year in particular, continuation vehicles have become an effective option for COVID-impacted assets—providing an exit path for LPs looking for clean, COVID-free portfolios, while offering other LPs interested in greater COVID-bounce back exposure an opportunity to roll with the impacted asset and potentially capture the upside as it recovers.

FIGURE 1: Secondary Market Transaction Volume



SOURCE: PJT Partners; Barings. As of March 31, 2021.

There are certainly risks involved in these deals, namely around potential conflicts of interest and GP alignment, but there can be benefits as well. GPs, in addition to holding a high-performing asset longer, often benefit from a larger fee base and the resetting of the deal carry pool, which can re-incentivize the team to execute on a known asset. For LPs, assuming that the asset has been fairly priced and that the GP's motivations are properly aligned, these vehicles can provide an attractive opportunity to deploy secondary capital into what may be perceived as a less risky investment vis-à-vis buying into a new unknown asset, with improved speed to market. Over time, there is the potential for LPs to realize strong risk-adjusted returns, particularly with GPs that know the target companies well and have delivered value creation on the assets.

OUR VIEW

Many LPs are currently not set up to participate in continuation vehicles, while others choose not to participate given structural or bandwidth constraints. Arguably, continuation vehicle transactions can force traditional fund LPs to be more involved co-investors, requiring them to undertake additional approval and monitoring processes. These dynamics ultimately cause some LPs to sell their positions instead of rolling their exposure into attractive continuation vehicle opportunities.

Alignment with the GP is of utmost importance, especially for LPs rolling their existing investment in a new continuation vehicle. Some LPs may perceive transactions as "option value," benefiting the GP disproportionately. Since a continuation vehicle, by definition, prolongs an asset's duration and fee base for the GP, LPs need to understand the upside return potential from rolling their investment. High-quality GPs typically have a strong value creation plan outlined on a particular asset or set of assets, and will often commit a considerable amount of time and capital to each deal. A reasonable proxy to measure GP alignment is the amount of carried interest that the GP has created via the platform exit and any subsequent portion they may roll into the new vehicle. Additionally, it is critical for LPs to understand the business motivations and alignment of other LPs/LPAC members. There may be questions, for instance, around whether a given asset manager—with both primary and secondary businesses—would be more likely to approve a deal that benefits its secondary arm, even if that deal is potentially less advantageous for its primary fund investors that may not be in a position to participate due to structural and/or timing limitations.

Most recently, we are observing negative dynamics driven by the relatively high dry powder levels in the secondary market and the compressed timelines to execute GP-led deals. The high level of secondary capital available and the rapid GP-led deal velocity increases the potential for cut corners and suboptimal diligence processes. Nonetheless, we believe continuation funds are an attractive area of the market for LPs and will continue to be going forward, as long as LPs and GPs are aligned in matters such as transparency, appropriate governance controls and economics.

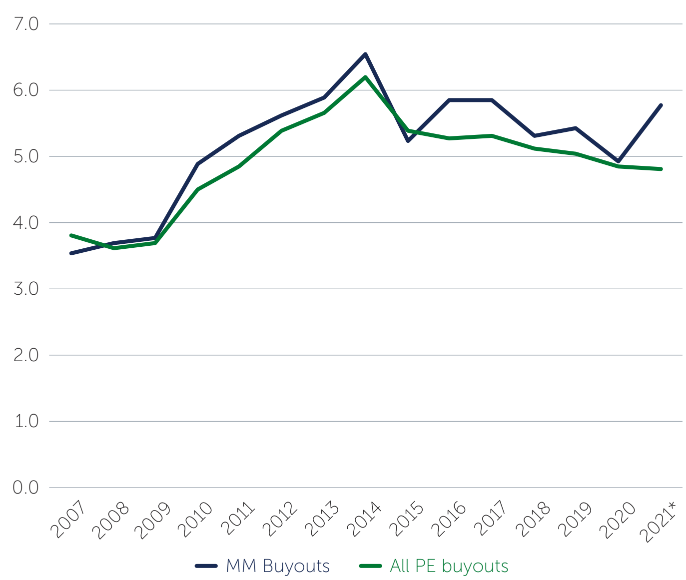
3. Rise of GP Lending

CURRENT TREND

Alternative GP financing solutions are emerging across the private equity landscape, providing GPs with additional options for holding an investment until it delivers on its expected returns. In particular, as older funds reach the end of their fund life and have additional financing needs (offensive or defensive) with little or no remaining uncalled commitments, more GPs are using the fund portfolio's net asset value (NAV) to raise additional financing. This enables the GP to provide non-equity dilutive financing to underperforming or distressed companies that otherwise face refinancing challenges, or to provide offensive firepower for accretive M&A. The lender typically charges a relatively high interest rate on the loan and seniority and priority of payment, ahead of distributions made to LPs (across any of the remaining assets securitized by the NAV loans).

There are a variety of reasons for going this route. For instance, a portfolio may include a COVID-impacted company that, while underperforming, looks poised to rebound as the economic recovery continues. This can be an attractive financing option—especially for funds that are past their investment periods and for smaller GPs or private equity firms without a large LP base to back them in a continuation fund—should this type of securitization prevent a dilutive write-off or impairment of an otherwise sound business. Going forward, we expect these types of financing solutions to draw more attention, particularly during down cycles, given the potential for future value creation via support capital and relatively low risk given the typical securitized nature of the loans.

FIGURE 2: Longer Hold Times Since the 2008/2009 Financial Crisis *(Middle Market PE Fund Rolling One-Year Horizon IRRs)*



SOURCE: Pitchbook. As of March 31, 2021.

OUR VIEW

There are risks and downside scenarios as well, so it is imperative for investors and existing LPs to understand the GPs' motivation (and portfolio), as well as how GPs have managed portfolio risk and acted in prior troubled situations. As an LP, there are a few key questions to consider when it comes to this type of alternative financing. One is whether the capital is worth risking the higher-performing assets in the portfolio against which the underperforming assets are securitized—or whether exiting those assets would be more advantageous. Another question is whether the GP has exhausted other potential financing options, such as raising outside capital or looking to its LPs to raise a specific round of financing (i.e. co-investment) for the company(ies) in question. It is also worth inquiring into how the fund ended up in a situation where it needed additional financing. For instance, were there high-risk tendencies on the part of the manager? For LPs seeking to invest here, this type of financing requires credit underwriting expertise, in addition to manager evaluation experience, to ensure the risk is being priced appropriately.

4. Fundraising in a Virtual, Low Interest Rate World

THE CURRENT TREND

As Zoom replaced in-person meetings early last year, it created both challenges and opportunities. For well-established managers with good track records and strong existing LP relationships, the virtual world enabled more frequent meetings, ultimately leading to faster fundraising and high deal volume during the second half of 2020 and into 2021. This virtual world has been more challenging for emerging managers, however, as newer funds tend to have fewer established relationships and shorter track records. In some cases, given the high frequency and velocity of deal volume, LPs have gravitated toward managers they know and trust, rather than spending the extra time and resources exploring fresh opportunities during a potentially challenging time (i.e. COVID environment/virtual relationship building). Overall, we have observed a two-speed fundraising environment, with some raising first and final close funds at their hard caps and in record speeds, and others are experiencing prolonged fundraising processes.

Further fueling activity, interest rates have remained low and private equity has continued to show resilience in terms of returns, as well as lower volatility relative to the broader markets. Against this supportive macro backdrop, LPs have looked to broaden their scope in search of more attractive returns, with many increasing their allocations to private equity. LPs have historically been focused on general fund investments, emerging managers and co-investments, but we have seen increasing interest in the secondary market, particularly in GP continuation vehicles and direct secondary deals.

OUR VIEW

There is clearly no shortage of exciting opportunities, investment areas and new managers in the market. While it can be beneficial to redeploy capital with GPs that investors have proven relationships with, it is also a good time for LPs to explore the market and learn about some of the newer managers and strategies. Given current market dynamics, LPs can begin building deep and meaningful relationships with a broader set of GPs by evaluating potential single-asset deals together and/or proposing deeper and more aligned partnership dynamics (i.e. co-investment rights) along with other like-minded LPs. As existing managers likely continue to move up market over time, it is imperative for LPs to continue mining smaller and newer managers that focus on the lower-mid market—which we view very favorably going forward.

That said, diligence and speed to close matter, and given the sheer amount of deal volume, LPs can easily become stretched when trying to cover too much at once. In this environment, we see many benefits to LPs maintaining an open dialogue with one another in order to make GP introductions and better understand a certain deal or manager.

Emerging Opportunities

As previously outlined, we believe continuation vehicles and GP-led secondaries look attractive and represent a fast-growing part of the market—particularly given that many GPs are creating these vehicles by rolling forward their top-performing investments or assets. However, the ability to efficiently underwrite deals and to discern the best transactions under tight timelines will be key.

We also continue to see strong opportunities in emerging managers, which tend to have access to smaller companies that have demonstrated greater potential for value creation—even as valuations across the market have increased over the last several years. More recently, many emerging managers have moved up market as it has become more difficult to deploy capital at the smaller end of the market given the large amount of capital raised. This has created an opportunity for LPs able to deploy capital at the sub-$250 million enterprise value end of the market, where many smaller emerging manager and independent sponsor deals are taking place. For LPs with the resources and breadth to conduct the appropriate diligence, these areas provide compelling opportunities while also allowing LPs greater influence to set appropriate parameters, economics and weigh in on processes.

From a sector and structure standpoint, structured growth investments (particularly in tech and health care) appear interesting in the near-term. These typically offer exposure to fast-growing businesses that have shown good market resilience, while also offering seniority and downside protection. Renewed focus on the technology and power infrastructure space driven by positive secular tailwinds also presents attractive risk-adjusted opportunities from a sector standpoint. We expect to see additional opportunities in this space over the long term, particularly in areas like telecommunications and renewable energy.

Given the multitude of new managers and opportunities in the emerging manager space, it is certainly a good time for LPs to take a comprehensive and proactive approach to discovering the best up-and-coming teams targeting attractive industries/markets. However, dedicated teams with experience in these areas and tight diligence processes will likely be in the best position when it comes to underwriting these opportunities going forward.

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