JUNE 2020

THE TRIAGO QUARTERLY

Dear Reader,

As we go to press, after the fastest plunge into bear market territory ever, that bellwether stock index, the S&P 500, has just inched into positive territory for the year, and stands only 4.5 percent below its all time high in February. Arguably, that represents the most amazing V-shaped financial market recovery in history. It's certainly a run that epitomizes the disconnect between the optimism of public markets and the anguish, angst, and sheer unpredictability unleashed by the ongoing Covid-19 Crisis.

We don't pretend to address the truly tragic elements of the current crisis, but it's evident in the commentary you'll find here that Triago believes that at a time when value is particularly hard to identify in the public markets, good private equity managers offer low-risk and imaginative paths for preserving and increasing collective and individual wealth.

As always, we hope the information found here helps you make the right business and investment decisions.

Sincerely, The Triago Team

ANALYSIS: PRIVATE EQUITY IS RARING TO GO

Its biggest challenge may be disparity between markets and the economy

ROUNDTABLE: SINGLE-ASSETS

Will Covid-19 kill single-asset secondaries?

PRIVATE EQUITY BLOG

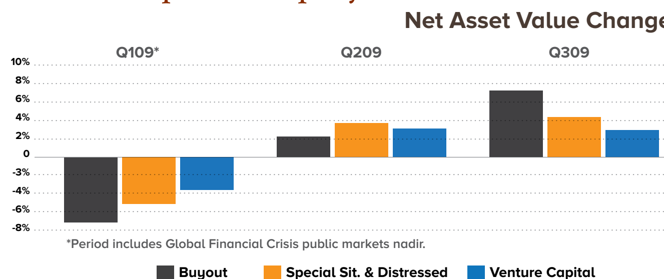
Denominator non-effect and faith in PE, Bargains despite high prices, The exit drought is an opportunity to boost returns, Opening up PE to US retirement accounts, Early secondaries rise, recycling falls

GFC AND ITS AFTERMATH

How much will PE's recovery from COVID-19 resemble this?

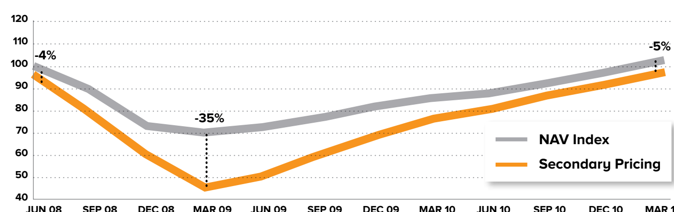
Stocks & private equity hit lows simultaneously.

Net Asset Value Change



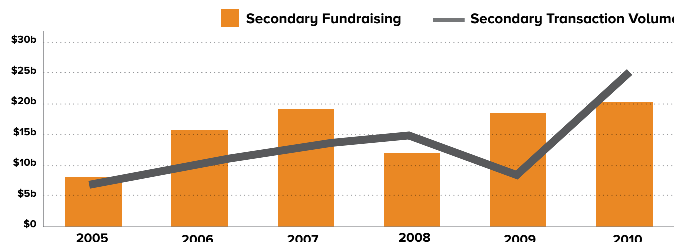
Severe dislocation rebound took 24 months…

Evolution of Fund Net Asset Value and Secondary Pricing

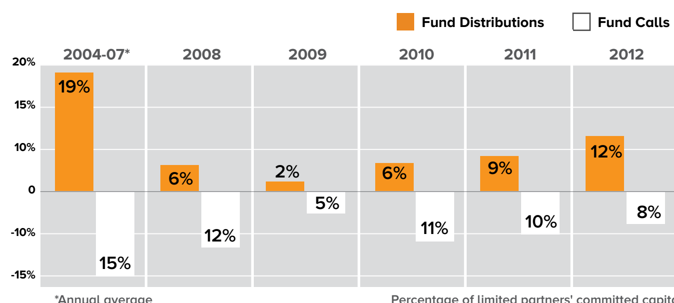


…as secondaries' secular growth resumed.

Secondary Market Growth



Yet slow exits hurt LP cash & fundraising.



Private Equity is Raring to Go

PE's biggest challenge may be the growing disparity between the bleak economy and market values.

Given that a key component of fair market value calculations for PE-backed companies are publicly-quoted comparables, we can safely assume rock bottom for PE fund value during the Covid-19 Crisis will parallel timing for public equity lows - as during the Global Financial Crisis (see first graph on p. 1). A plunge below March's nadir is a real danger. But barring an infection resurgence, the likelihood is that the Covid-19 bottom for PE and for stocks has come and gone. PE plunged less than the stock market in Q1 and any bounce back in Q2 will be muted versus the big stock gains through early June.

From the 1,300-plus conversations we've had with general partners and limited partners since early March, it's evident that the vast majority now want to invest, stoked by memories of missed opportunities during and after the GFC. But the biggest complicating factor for any recovery of PE activity may prove to be the growing disparity between bleak economic prospects and relatively high market values.

Managers began finishing Q1 reports in late-May. With a majority now in, Triago estimates net asset value fell 7.2 percent for PE broadly defined (encompassing buyout, credit, growth, real assets and venture capital, from all regions). That's considerably better than the 20 percent-plus drops most major stock market indexes suffered.

Given the ex post facto nature of PE reporting and what now looks like fire-sale pricing for many stocks at the March low, Q1 fair market value for PE assets was likely influenced by the recovery in public markets. This is hardly surprising at a time when getting a bead on discounted future cash flows is exceptionally difficult.

During the GFC, PE asset values took 24 months to bounce back from market lows (see second graph on p. 1). With companies supported by unprecedented amounts of government stimulus, PE values have fallen considerably less than during the GFC, and look set to recover more rapidly. With most investors maintaining or increasing PE allocations and with managers eager to deploy record levels of committed but unspent capital, this is liable to significantly reduce the opportunity for bargain hunting.

A highly uncertain economic outlook combined with high prices for most assets, means that more marginal forms of PE are coming to the fore, including earnouts, distressed investing (managers should really shine here, with many more GPs prepared to take the plunge than during the GFC); PIPE, or private investment in public equities (focusing on more distressed stocks); and specialized niche investing in everything from healthcare to digital infrastructure. As depressed economic conditions continue, liquidity-driven deals should also increase, including carve-outs, structured credit and preferred equity investments (often done in the form of co-investment).

Barring an infection resurgence, the impact of Covid-19 on medium and long-term corporate cash flows should be clear by the end of the third quarter. Clarity on this front - as during the GFC (see third graph on p. 1) - will enable accurate pricing and kickstart the stalled secular growth of the secondary market for closed PE funds (volume rose to $83 billion last year from $3 billion in 2002). Compared to the GFC, the secondary market is better positioned for a swift recovery - buyers hold $140 billion in dry powder, at least four times as much as in 2008 (for a debate on the future of single-asset secondaries versus traditional LP stake sales, see our roundtable on p. 3).

Feeding off momentum in the first two months of 2020, fundraising amounted to $129 billion in Q1, some 6 percent higher than in the same period last year. But following March lockdowns, most fundraisings were put on hold. Triago assumes April through June will be the worst quarter in a decade for commitments. Fundraising went into a four-year slump when the GFC hit, as a sharp drop in realized investments left PE programs short of cash (see fourth graph on p. 1). This time around a quicker return to pre-crisis pricing – foreshadowed by today's milder falls in asset values – will fuel a rapid return to strong levels of private equity capital commitment.

Will Covid-19 Kill Single-Asset Secondaries?

Access to portfolio stars may not be enough to counter concentration risk.

Before Covid-19 brought much of global deal making to a halt, single-asset secondaries were the fastest growing part of the expanding private equity secondary market. Driven by intense competition, the secondary market – formerly restricted to buying private equity fund stakes held by particular limited partners – has quickly diversified into general partner-led deals involving the collective transfer of assets from one investor group to another. Single-asset secondaries, the latest GP-led wrinkle, are the sale of a sole investment, usually a company. The best offer access to a portfolio gem, typically from an aging fund where incumbent investors want liquidity. Single-asset secondaries can generate great returns, while corporate managements thrive under exceptionally long periods of private ownership. But their Achilles' heel is elevated concentration risk. Our panelists address the pros and cons of single-asset secondaries and how they might survive in the newly risk-sensitive world.

MATT JONES
Partner and Co-Head of Global Secondaries at Pantheon Ventures

MICHAEL HACKER
Managing Director of Secondary Investments at AlpInvest Partners

RICHARD HOWELL
Partner and Head of Investment and Capital Markets Teams at PAI Partners

How is Covid-19 likely to affect the appeal of single-asset secondaries?

MATT JONES: The Covid-19 crisis won't have an impact on the long-term appeal of single-asset secondaries, in my view. Over the short term everything is being hit, but high quality single-asset secondaries should hold up better than traditional sales of limited partner stakes, transfers of entire portfolios and strip sales. As people grapple with uncertain sales and profit forecasts and with what fair pricing is, many single-asset secondaries will be easier to evaluate and price than multi-asset portfolios. Over the next six to twelve months this means we could see a proportionate increase in transactions for single assets, particularly for those relatively unaffected by the crisis. In a private equity space likely to be starved of distributions in the near term, excellent companies with significant potential that wouldn't otherwise come to market now may get partially sold through single-asset processes. This would give sellers liquidity while allowing them to keep appreciation potential.

RICHARD HOWELL: My take is a bit more negative. With the significant impact of Covid-19, we get the sense that investors are nervous about the high concentration levels and consequent higher risk associated with single-asset secondaries versus traditional LP stake portfolios. Secondaries have traditionally been about low concentration and highly diversified risk. It's also worth remembering that the early general partner-led deals were mostly done with underperforming assets requiring both capital and time just for values to reach acceptable levels. Some of these more cyclical assets could suffer an impact from the current crisis. Coupled with concentration concerns, this could cause the GP-led market to pause for a while. That's a shame - in the past few years single asset secondaries have become a valuable tool for optimizing returns and retaining upside in top-tier assets.

MICHAEL HACKER: As Richard says, there were a number of deals done in

an attractive investment opportunity to investors willing to continue the value creation journey, while crucially generating from secondary investors additional capital to drive accelerated growth. These deals offer secondary investors both the potential of an appealing time-weighted return and a relatively high multiple on investment.

MH: First of all, these transactions must be priced attractively for LPs - this will be a key issue moving into the post-Covid-19 environment. There also needs to be a clear rationale for pursuing a single-asset secondary beyond maximizing value for the GP. What commonly drives these transactions is a mismatch between the optimal exit timeline for a specific company and the life cycle of the fund in which it's held. Many GPs in these transactions are feeling pressure to generate liquidity for LPs. Yet they may be reluctant to sell a winner prematurely. In nearly all the transactions we've pursued, the rationale is clearly attributable to an exogenous factor that acts as a catalyst. Those factors include strategic acquisitions, a need for new capital, and management teams or minority shareholders seeking liquidity.

MJ: I agree that for deals to work for everyone - limited partners, the general partner and new buyers, there must be a clear rationale for why the company no longer fits the existing structure. Legitimate rationales boil down to two criteria, time and money – i.e. more time and/or cash is needed to increase company value. For example, if you've got a great company that's pushing the envelope on the investment period and there are investors who want liquidity, in most cases you'd be keen to avoid putting it on the block in today's environment - better to transfer it

the market where we had some level of concern. If they underperform it's likely to impact the popularity of single-asset secondaries even after we come out of the Covid-19 crisis. Historically, one reason capital flowed to GP-led deals, and more recently into single-asset secondaries, was because of return compression in most other areas of private equity over the past half-decade. We saw this compression in the traditional LP interest market, especially for diversified portfolios of funds. It's possible specific single-asset deals will happen as Matt describes, but I suspect that secondary buyers will be focusing their attention elsewhere. In particular, we'd expect to see more interesting opportunities in the LP interest market as assets are repriced through the course of 2020.

> We expect more interesting opportunities in the LP-interest market.
>
> *Michael Hacker, AlpInvest Partners*

Do any of you foresee buyers and sellers employing innovations to get single-asset deals done during the crisis?

MJ: I'm pretty sure we'll see investors incorporate more downside protection into these deals through greater use of structures like preferred equity. This will especially apply when GPs want to hold on to potential appreciation, but no longer have uncommitted capital for urgent cash needs. Those needs could be driven by an underfunded balance sheet or even an unexpected acquisition opportunity associated with the current market dislocation. In many instances during turbulent times you may only be able to attract secondary buyers if they have some form of protection, such as preferential rights to cash flows.

Generally speaking, when are single-asset secondary sales more attractive than a traditional portfolio exit?

RH: They can be the most attractive way to raise capital when you need to reconcile seemingly contradictory investor priorities for assets that have been held a long time. In our most recent deal, the 2019 transaction for ice cream group Froneri, we provided a great return to investors who wanted liquidity from a fund that had reached maturity. At the same time, we offered

to a continuation vehicle via a single-asset transaction and wait for improved conditions. Alternatively, a business might need growth capital not available from the fund. Selling outright could significantly undervalue potential, while transferring it to a continuation vehicle and enabling a cash injection from new investors may lead to higher returns.

To vet single-asset secondaries what questions should LPs ask and can they evade deals that they don't like?

MJ: To make sure deals are not being done for the wrong reasons a lot of questions need asking. Among them: is the GP mainly trying to prolong management fees; will the deal crystalize carry over the short term without boosting return prospects; does it just give the GP another roll of the dice on a poor performer; will the company get needed cash to drive growth; what proportion of the GP's own capital - either carry or committed capital - is being taken off the table or reinvested - this is a critical determinant of incentive. Beyond asking these questions, it's crucial that limited partner advisory committees carefully examine proposed transactions. When they don't like a deal, it usually doesn't get done.

MH: We also believe limited partner advisory committees play a critical role asking these questions. Arguably, buyers and advisors are the most important line of defense against GPs pursuing transactions that don't adhere to the high standards established in this market. We were enthusiastic supporters - along with several other buyers and advisors - of the work done by the Institutional Limited Partners Association last year to create a framework for these transactions. It is definitely in our interest to ensure that the GP-led secondary market is perceived positively by LPs. We want to make it as difficult as possible for bad deals to happen. Having clear guidance from organizations like ILPA makes it easier on advisors and buyers alike to ensure the market's long-term success.

RH: As a general partner I'd say you have to do three things to fully answer limited partner concerns about the appropriateness of a single-asset secondary, and whether it's attractive or not. You have to communicate heavily and transparently; secondly, it's critical to bring a third party advisor on board to clearly demonstrate that fair value has been established - through a process as rigorous as in a straight out sale; and finally, you've got to offer a clear strategic rationale for the deal. As Matt noted it can't just be about taking money off the table or improving carry terms. These transactions have to create a means of enhancing a company's fundamental value.

What are other parties to single-asset secondaries, namely new buyers and portfolio company managements, hoping to achieve through these transactions?

MH: As a secondary buyer moves from diversified portfolios of private fund interests with hundreds of underlying assets, to GP-led transactions involving multiple portfolio companies and on to single-asset secondaries, the motivation is the promise of progressively higher returns. Each stage brings higher concentration, so we need to be increasingly selective around the assets we buy. In a single-asset transaction, the bar is incredibly high. We focus on highly defensive companies with predictable earnings and recurring revenues, that can be sold even in challenging markets. We also need close alignment not only with GPs, but also with management. Management needs to be enthusiastic about continuing their partnership with the GP. We want them to have the right ownership and incentives in place.

MJ: I agree with Michael on the characteristics you should aim for in these deals. They also allow buyers to invest in the stars of general partners' portfolios; Froneri, mentioned by Richard, is a case in point. Zeroing in on the stars of a portfolio is not something afforded to investors in any other type of secondary. Another critical issue is general partner alignment. When the GP has an even greater stake in the restructured asset than was previously the case, these deals usually go well. If the GP takes the majority of their capital off the table, that's a deal breaker for us. For portfolio company managements, single-asset secondaries clearly offer minimal disruption compared to a full sales process. They also avoid any uncertainty or perceived risk regarding how new owners might run the company or interact with management, given that the existing GP remains in control.

> When the GP's stake increases, these deals usually go well.
>
> *Matt Jones, Pantheon Ventures*

RH: I can attest to the fact that the focus on alignment is intense in single-asset secondaries. In the Froneri deal we spent a significant amount of time explaining the importance of our overall exposure, what the economic interests were of specific PAI team members and how closely each of them was involved in the company's development. The importance of our team's ongoing investment in Froneri was key for all the investors in the deal. The alignment of management is also a critical component. We asked management to do a lot - the due diligence, Q&A sessions and presentations tied to this deal took up as much of their time as a straight-out sale would have. I'm happy to report they were enthusiastic when it came to reinvesting their capital within a familiar partnership.

PRIVATE EQUITY BLOG

A round-up of current trends and issues for general partners and limited partners

Denominator non-effect and faith in PE

The denominator effect, in which collapsing stocks mechanically push PE assets well above allocations and force PE cutbacks, looks like a non-event given surging stocks. If anything, we expect PE to emerge from this crisis with an enhanced reputation for creating value while minimizing risk - something that should lead investors to discount the denominator effect permanently. We also expect that PE will more energetically and effectively preserve and enhance the worth of investments than the passive and diffuse shareholder bases of public companies. The exceptional ability that sophisticated PE firms and their financial networks possess when it comes to tapping debt and equity even in the toughest market conditions should play a major role in what we believe will be the exceptional performance of PE during the crisis and its aftermath.

The prospect for great bargains despite high asset prices

As noted in our p. 2 market analysis, PE's biggest challenge during the Covid-19 Crisis could be the gap between a bad economy and high market values. Yet auction theory points to factors that will mute the expense of PE. Bidders overpay when everyone has the same viewpoint. Among PE professionals, there's a broader range of views today on everything from the shape of economic recovery to individual company prospects than at any time in the last decade. Surplus value is also more likely left for the winner when bidders use a wide range of yardsticks and skill sets to determine their offer. With general partners showing greater specialization than ever before, some managers will pick up incredible bargains.

When an exit drought is an opportunity to boost returns

Over the next 18 months there will be a significant uptick in fund extensions. This will be accompanied by a rise in deal structures designed to both generate liquidity for investors and give assets more time to develop. Counterintuitively, growth targets that exceed pre-crisis aims are likely to be part and parcel of these deals. Triago expects a proportionate increase in partial realizations designed to deliver liquidity to investors while also providing a longer growth runway for the assets in question, frequently paved with fresh capital from new investors (one version of these deals are single-asset secondaries, our p. 3 roundtable topic). Today's exit drought will become an opportunity for managers to conceive and execute more ambitious plans that in many cases will surprise investors, driving better investment multiples and higher annual returns.

> PE's ability to tap debt and equity stands out in crisis.

Opening up PE to US retirement accounts...and retail

It's probably no accident that the three largest managers of US target-date funds, multi-asset vehicles that gradually rebalance portfolios from aggressive growth to income preservation over decades, have all announced deals with PE. Vanguard struck a February partnership with HarbourVest, while Fidelity and T. Rowe Price bought StepStone stakes in October. Given June guidance from the US Department of Labor greenlighting PE inclusion in TDFs, without any qualifying wealth threshold, Vanguard, Fidelity and T. Rowe Price take pole position – as do Pantheon and Partners Group which sought the guidance – to tap $6.2 trillion in US defined contribution pensions. Indeed, this may be the catalyst for a new form of low-fee retail PE. PE's high fees will be diluted by the low-cost stock and bond portions of TDFs (their expense ratios are as low as 0.1 percent). Some predictions have low-cost, mixed-asset retail funds as being key to PE's success in a decade.

Early secondaries rise, recycling falls

In a repeat of what happened during the GFC, there is a relative increase today of secondary market deals involving closed PE funds that are only 5-20 percent drawn. These early secondaries account for over a third of secondary volume initiated since mid-March, up from 5 percent in a typical year like 2019. Because discounts apply only to invested capital, early secondaries can be a painless way for sellers to free up committed but uninvested capital, and to come to terms with buyers even at major markdowns to net asset value. Some primary-minded buyers (investors of all types that have historically focused on fundraisings) are also doing early secondaries to gain exposure - or increase exposure - to specific funds they like. In contrast, recycling, where purchased vehicles liquidate so rapidly (short duration investing) that proceeds can be reinvested before being distributed to secondary fund investors, is at a standstill.

OUR OFFICES

TRIAGO EUROPE
5 rue Scribe, 75009
Paris, France
Tel: +33 (0)1 47 03 01 10

TRIAGO AMERICAS
499 Park Ave.
25th FL New York, NY
10022, USA
Tel: +1 (212) 593-4994

TRIAGO UK
20 North Audley Street
London W1K 6LX, UK
Tel: +44 (0)203 196 0660

TRIAGO MIDDLE EAST AND ASIA
DIFC – Emirates Financial Towers
PO Box 506681, Dubai, UAE
Tel: +971 4 433 1009

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