Strategic Capital: Private Portfolio Financings Emerge as an Asset Class

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Key Takeaways:

- Strategic Capital portfolio financing is one of the most recent innovations in private equity investing. This innovation is primarily driven by increased demand by General Partners (GPs) and Limited Partners (LP) for more flexible solutions in fund financings, LP interest financings, and GP financings.
- The category comprises a range of portfolio financing solutions that complement existing equity-based options, including, NAV lending, preferred equity (senior and mezzanine), and structured equity.
- Informally described as the intersection of private credit and secondaries, we believe Strategic Capital is emerging as a new asset class with distinct risk-return properties and cash flow characteristics.
- AlpInvest estimates that Strategic Capital transactions in fund financings, LP interest financings and GP financings totaled around $6 billion in 2020, a doubling from the estimated volume in 2019.
- Investment opportunities are anticipated to grow significantly in the coming years as Strategic Capital continues to evolve. Based on its current trajectory, AlpInvest believes that Strategic Capital fund financings could increase to more than $30 billion by 2026.
- Market conditions are anticipated to remain investor friendly as adoption by potential issuers of Strategic Capital increases and investors respond only gradually to a growing opportunity set, consistent with comparable developments in the private equity secondary market.

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01 Introduction

Private markets have gained substantial momentum in the past few decades. This evolution has been fueled by important innovations in financial intermediation, which, in turn, has generated attractive opportunities for investors. One of the most important innovations has been the emergence of a secondary market, which allows Limited Partners (LPs) to sell their interests in private equity funds to other investors. More recently, General Partners (GPs) who have discovered the benefits of the secondary market as a portfolio management tool, have represented a growing share of transactions. At the same time, a growing number of GPs have sought outside capital to finance transformational growth and facilitate the generational transition of leadership.

While the vast majority of secondary market transactions and GP financings have been equity-based, there is increased demand for more flexible solutions across the capital structure. These solutions are provided by *Strategic Capital*, one of the most recent innovations in private equity that has the potential to revolutionize the market just as the emergence of direct lending funds did in the aftermath of the Global Financial Crisis (GFC).[1] For LPs, Strategic Capital allows asset owners to finance their interests across private equity funds as a liquidity alternative to a traditional Secondaries sale transaction. For private equity funds, Strategic Capital may enable recapitalizations, deliver needed liquidity for portfolio companies, and provide capital for growth investments and opportunistic M&A within a portfolio. For GPs, Strategic Capital may allow fund managers to recapitalize their balance sheets and provide an alternative to the permanent dilution associated with selling ownership stakes in their management companies. These different uses of Strategic Capital have in common that they represent portfolio financings, with the diversified pools of underlying assets serving to cross-collateralize NAV-based loans, preferred equity and structured equity.

We anticipate that the market for Strategic Capital will expand rapidly in the coming years, as the NAV of fully funded private equity partnerships continues to increase, with credit-based solutions enhancing asset owners' flexibility in terms of portfolio financings. As the pool of investment opportunities expands, investors are anticipated to allocate more capital to this emerging asset class, which offers risk-adjusted returns that reflects its position at the nexus between secondaries and direct lending. Given the expected supply-demand dynamics, we estimate that the market for Strategic Capital fund financings alone could increase to around $30 billion by 2026.

[1] Direct lending funds provide loans to middle-market companies that are originated and held by the lender as opposed to loans that are broadly syndicated. Direct loans, which are illiquid, are typically senior secured securities with 5-7-year maturities and floating coupon rates.

02 The Investment Universe

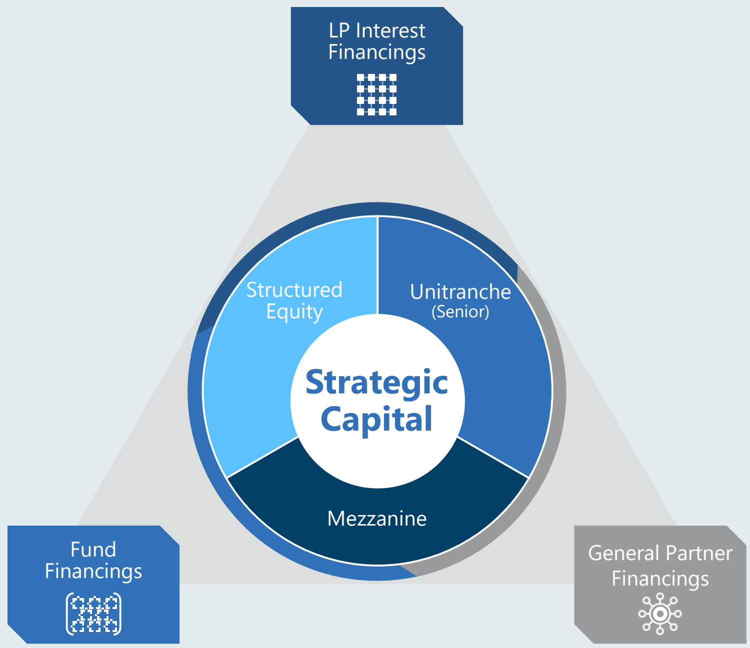
Private equity has been one of the fastest growing asset classes in the past few decades, with assets managed by primary funds having increased almost tenfold to more than $5.3 trillion between 2000 and 2020.[2] This rapid growth has been fueled by important innovations, which have generally been driven by the financing and liquidity needs of market participants. The emergence of a secondary market has allowed LPs to rebalance their private equity portfolios and generate liquidity in an otherwise illiquid asset class. While LP interest transactions continue to represent the core of the secondary market, in recent years GPs have increasingly accessed it to fund recapitalizations and continuation funds.[3] At the same time, GP organizations themselves have pursued outside capital to seed new lines of business, grow existing business lines, anchor the GP's balance sheet, and provide liquidity to existing owners addressing generational transition issues. This capital has been provided by investors acquiring stakes in private equity management companies.

In all these areas – LP interest financings, fund financings, and GP financings – transactions have generally involved the transfer of ownership. However, equity-based financings might not always be the most efficient solution, considering their cost of capital, investment horizons, liquidity preferences, and the dilutive effects of equity investments. For instance, LPs seeking liquidity for upfront cash distributions, funding future capital calls and refinancing or supplementing existing portfolio debt may not seek to reduce exposure to existing investments and prefer credit-based solutions instead of an outright sale in the secondary market.[4] More flexible capital structures may also be desirable in fund financings where funds seek to recapitalize portfolio companies, require capital for opportunistic acquisitions, wish to increase the liquidity position of their holdings or fund accelerated cash distributions to their LPs. Finally, equity-based GP financings are generally available only to larger private equity firms and run the risk that sales of GP stakes to outside investors leave too little "skin in the game" for investment professionals who aspire to become the next generation of owners.[5]

[2] Excludes funds of funds and secondary funds. Of the total amount of assets under management (AUM), around 70% represents unrealized value, with the remainder being unfunded commitments ("dry powder"). Preqin, accessed, 8/13/21.
[3] AlpInvest estimates that the (COVID-adjusted) global annual transaction volume in secondaries has grown to around $80 billion in 2018 – 2020.
[4] As an alternative, LPs might also consider a collaterialized fund obligation (CFO), which is a form of structured finance securitization that emerged in the early 2000s. In a CFO, a portfolio of private equity funds is moved to a SPV and refinanced through the issuance of various classes of notes, typically consisting of an equity tranche, a mezzanine tranche and one or more debt tranches, which can be rated by rating agencies based on expected cash flows. In these transactions, owners of private equity assets securitize a portfolio of funds as a way of generating liquidity without an outright secondary sale of the funds. However, their use has remained limited as stringent listing requirements and high costs associated with the rating and placement of senior and junior notes have generally confined securitizations to large portfolios.
[5] According to Pitchbook, the average amount of funds raised by private equity firms that received GP stake investment is $23.4 billion, compared to a non-GP stakes average of $1 billion. Pitchbook database, accessed 10/25/21.

Thus, asset owners have recently shown increased interest for a broader spectrum of financing solutions across the capital structure, ranging from unitranche financing to subordinated debt and mezzanine to structured equity. Providing LPs and GPs with the liquidity they need without giving up ownership, these financings may usefully be subsumed under the rubric Strategic Capital (Figure 1). As diverse as the use of its proceeds may be, the growing demand for Strategic Capital is generating new investment opportunities for capital providers, seeking investments with distinct risk-return properties and widening the range of sub-asset classes within private equity portfolios.

Figure 1. Investment Focus of Strategic Capital



Source: AlpInvest. For illustrative purposes only.

The growing need for Strategic Capital should be viewed in the broader context of credit-based financial innovations in private equity. In recent years, direct lending funds have gained significant market share in funding leveraged buyouts as banks have become subject to more stringent regulation in the aftermath of the GFC.[6] Rationalizing LPs' cash flows, GPs are increasingly making use of

[6] According to Pitchbook, direct lending funds raised around $200 billion worldwide in 2018 – 2020, a tenfold increase from 2010 – 2012.

subscription lines, which are available to private equity funds in the early years of their life, with loans secured against the unfunded commitments of the funds' LPs.[7] Finally, net asset value (NAV)-based credit lending for secondary market purchases of LP interests (as opposed to credit-based alternatives to sales of LP stakes) has gained considerable momentum.[8]

03 Sizing of the Market Opportunity

At the end of Q1 2021, buyout and growth funds worldwide managed assets totaling almost $3.7 trillion, encompassing their unrealized value (NAV) and unfunded commitments.[9] Around 40% of the total amount of private equity assets under management ($1.5 trillion) represents the NAV of funds that were raised between 2009 and Q1 2017 (Figure 2). These funds have drawn most or all of their LPs' commitments and generally no longer have access to subscription lines. To the extent that their liquidity is constrained, these funds may seek Strategic Capital, defining the primary investment universe for this emerging market segment.

Actual deal activity, to date, has been a fraction of the potentially addressable investment universe. While estimates of deal activity associated with GP financings and LP interest financings are notoriously difficult, we believe that the total turnover in the market for Strategic Capital could have amounted to approximately $6 billion in 2020.[10] By comparison, this represents around a tenth of the (COVID-depressed) transaction volume in the secondary market in 2020. AlpInvest estimates that fund financings that closed in 2020 amounted to around $3 billion to $4 billion, roughly half of total volume in the Strategic Capital segment. This estimate suggests that the market volume for fund financings was around one-third of one percent of the NAV of fully funded buyout and growth capital funds.

While the estimated volume of Strategic Capital transactions is still small, AlpInvest believes that the market has reached a critical stage of awareness and acceptance. We estimate that the market already saw a doubling of deal volume in 2020 compared with the previous year. The most important qualitative factor in the recent growth in Strategic Capital, particularly in fund financings, has been the improved acceptance of the underlying LPs. In the earliest stages of development, niche providers of Strategic Capital operated primarily as "lenders of last resort" often commanding punitive interest rates to compensate for stressed situations with lower quality managers. In these situations, LPs reasonably complained that they did not want to accept subordination when they had little confidence in the efficacy of deploying additional capital into underperforming investments. More recently, we have seen Strategic Capital financings embraced by established GPs in otherwise well-performing funds in

[7] AlpInvest estimates the outstanding volume of subscription lines at around $400 billion as of the end of 2020. Estimate based on private equity AUM data provided by Preqin, accessed 10/25/21.

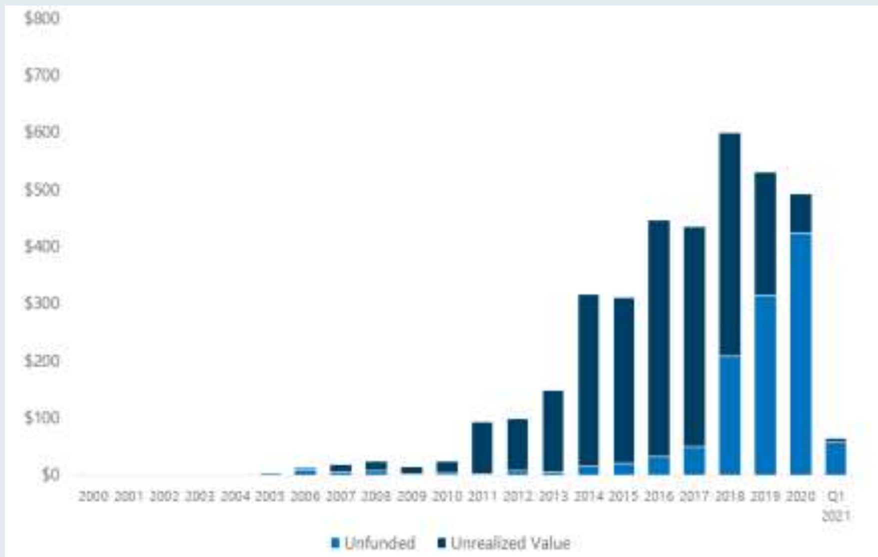
[8] We estimate that the outstanding volume of these loans, which are secured against private equity assets, totaled around $50 billion at the end of 2020, based on an estimated annual volume of issuance of around $15 billion.

[9] Preqin, accessed 10/25/21.

[10] Estimates are based on (i) AlpInvest deal flow figures; (ii) publicly available news sources (including Secondaries Investor and Preqin); (iii) market data provided to AlpInvest by select large secondary market intermediaries, which has been aggregated using AlpInvest estimates for relative market share; and (iv) market data as reported by various secondary market intermediaries.

order to enhance returns for their underlying investors. While certain LPs have continued to raise concerns around subordination, these objections are now nearly always overcome by the potentially accretive uses of proceeds and alignment between transaction stakeholders. A growing number of limited partners are beginning to appreciate the potential for Strategic Capital to provide a more LP-friendly alternative to the conflicts of interest inherent in certain continuation fund settings.

Figure 2. Private Equity Assets under Management, by Vintage Year ($B)



Source: Preqin, accessed 10/25/21. For illustrative purposes only. Trends may not continue.

To the extent that the evolution of the secondary market and direct lending provide any historical guidance, we anticipate significant growth over the next few years. In terms of investment opportunities, the two main drivers are (i) the NAV of fully funded funds that may seek liquidity solutions and (ii) the degree to which Strategic Capital is adopted by various market participants and can provide a compelling alternative to traditional equity-based solutions.

The NAV of fully funded buyout and growth capital funds, which can be used as collateral for credit-based financing solutions, has nearly tripled between 2010 and 2020 as private equity investments have gained significant momentum and valuations of underlying assets have increased (Figure 3). It is important to note that the NAV trajectory differs from the AUM trajectory of buyout and growth capital funds as the latter includes unfunded commitments and the unrealized value of funds that are still in investment mode.[11] While private equity AUM are a key determinant for the turnover in the secondary market, they also have significant predicative power for the future NAV of funds, with unfunded commitments being called over time. Given the strong momentum in the global fundraising market in recent years that has catapulted the amount of assets managed by buyout and growth capital funds to almost $3.7 trillion,[12] AlpInvest anticipates the NAV of these partnerships to continue to grow meaningfully over the next few years.

Figure 3. Private Equity Assets under Management & Net Asset Value of Fully Funded Funds, 2010 – Q1 2021 ($B)

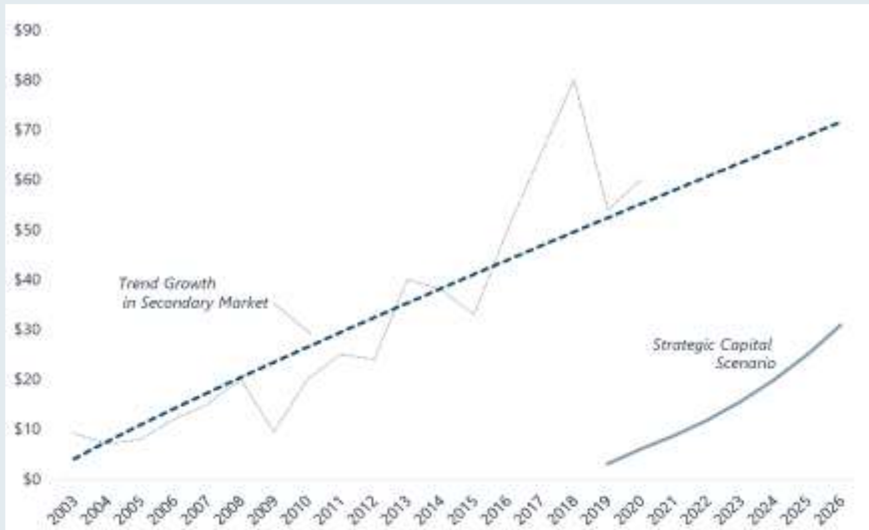
Source: Preqin, accessed 10/25/21. For illustrative purposes only. Trends may not continue.

If the NAV of fully funded private equity funds continues to grow at its compound annual growth rate during the past ten years, it could reach almost $2.5 trillion by 2026. Other things being equal, Strategic Capital transactions could reach around $11 billion by the middle of the decade. However, other things are unlikely to be equal. In our view, it is plausible to assume that Strategic Capital will play an

[11] The estimated NAV excludes unrealized value of funds that were raised in the four most recent years, as these partnerships are still in investment mode and may potentially access subscription lines to generate liquidity. For instance, the NAV at the end of 2020 excludes the unrealized value of funds that were raised in 2017 – 2020. Likewise, the NAV at the end of 2015 excludes the unrealized value of funds that were raised in 2012 – 2015. Raw data from Preqin, accessed 8/18/21.
[12] Preqin, accessed 10/26/21.

increasingly important role in LP interest financings, fund financings and GP financings, replacing to some degree traditional equity-based solutions. For simplicity reasons, suppose that Strategic Capital fund financings rose gradually to 1.25% of the NAV of fully funded partnerships over the next few years, just around one percentage point more than our estimate for 2020. In this case, the turnover could amount to around $31 billion in 2026 (Figure 4). This scenario would be broadly comparable with the long-term growth trajectory of the secondary market. To be sure, the overall market size of Strategic Capital could be even larger, by as much as an additional $15 to $20 billion, to the extent that LP interest financings and GP financings gain momentum as well.

Figure 4. Trend Growth in Secondary Market and Investment Scenario for Strategic Capital ($B)



Source: AlpInvest. For illustrative purposes only. Trends may not continue and actual results may vary from forecasts.

We believe the anticipated growth in the demand for Strategic Capital is unlikely to be linear – just as the growth in secondary transactions has been subject to significant cyclical variations. As the experience with the COVID-19 pandemic suggests, financing needs may increase rapidly in periods of financial stress, fostering the adoption of innovative solutions that help GPs support their portfolios and LPs deal with allocation and liquidity constraints. While the pandemic is likely to have been an important catalyst for the estimated doubling of market volume in 2020, the continued need for Strategic Capital in 2021 supports our belief that short-term fluctuations in volume will center around an overall rising trend.

04 Final Thoughts

The market for Strategic Capital is an emerging asset class precisely for the same reason as any financial market emerges – because asset owners and investors wish to transact. Providing NAV-based credit for portfolio financings, we are of the view that Strategic Capital is emerging to fill an important void that is not covered by existing equity-based solutions for private equity funds, general partner management companies and limited partners.

As we have argued in this paper, market volume could increase significantly over the next few years. Beyond our projected growth of fund financings, the adjacent use cases in GP financings and LP Interest financings may drive additional supply of opportunities that could increase volumes an additional 50-65% to reach a dizzying $50 billion. However, in our view, market conditions ought to remain relatively investor-friendly over the near term as investors are expected to respond to growing investment opportunities only gradually. One reason for this expectation lies in the current constraints in capital formation specifically focused on Strategic Capital. Certain secondary funds participate episodically in specific transactions, but the return profile for Strategic Capital often does not fit well with the investment focus of many existing funds. Credit asset managers occasionally invest in Strategic Capital financings but are generally not actively sourcing such opportunities. Meanwhile, niche preferred equity funds, the main incumbent players in this space, often lack a broader strategic angle in their relationships with financial sponsors.

Over time, these constraints should diminish as financial intermediaries respond to rising demand for Strategic Capital. In this respect, Strategic Capital is, roughly speaking, where secondary investments and direct lending were, respectively, in the early 2000s and the immediate aftermath of the GFC. If the development of these asset classes provides any guidance, Strategic Capital has the potential to become an integral part of investors' private capital portfolios in the next few years.

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