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Private markets webinar

The case for co-investments and secondaries

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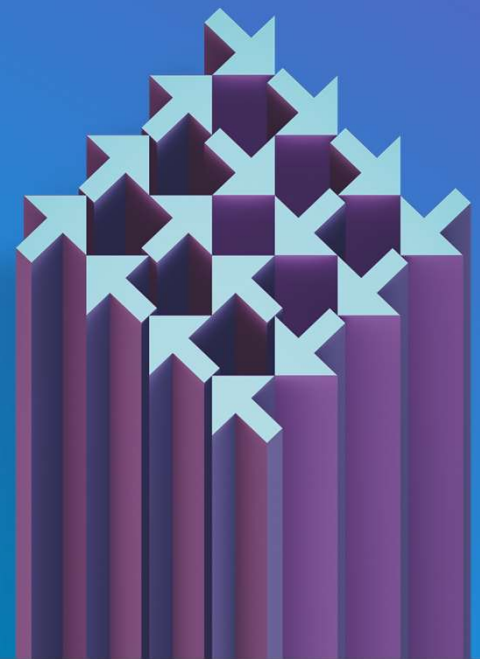

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Welcome

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Mercer's alternatives platform
Co-investment and Secondaries Team

Global Private Markets Investment Team*		
North America	Europe	Asia/Pacific
49 professionals	25 professionals	9 professionals

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*Number of private markets investment professionals as of February 28, 2021, including the six professionals named above.

Co-investments

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Co-investments: The WHAT and the WHY

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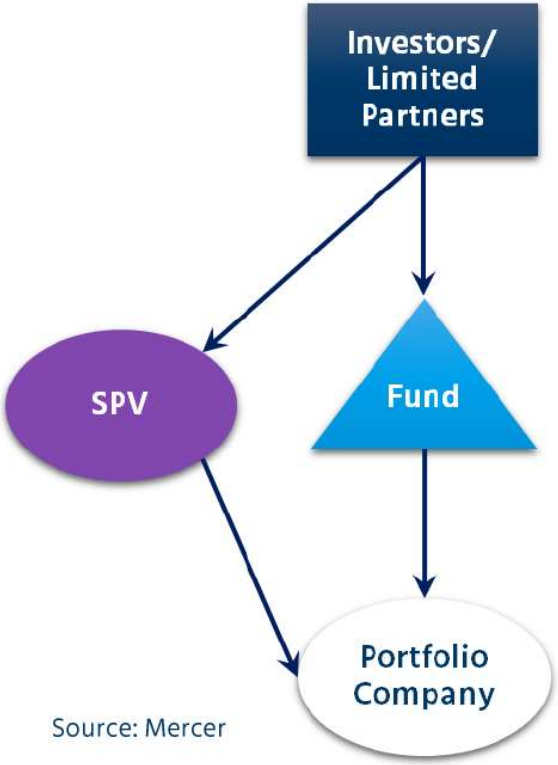
Co-investments
What are they?

Co-investments are private equity investments into a single company as opposed to a diversified blind pool portfolio such as a primary private equity fund

- Investments are made alongside a private equity fund that is also investing and exiting at the same time and price.
- Investments are made either directly into the target company or through a commingled vehicle or special purpose vehicle (SPV). The investment manager of the private equity fund sponsoring the investment is typically also the investment manager of the SPV.



Source: Mercer

Why they exist?

- Co-investment opportunities arise when a private equity manager identifies an attractive transaction that requires the private equity fund to invest more equity than its diversification or other limits allow.
- Rather than passing on an attractive opportunity or partnering with a competitor, private equity fund managers prefer to syndicate the excess equity investment required to their funds' investors or other strategic partners.

Allocations of co-investment opportunities of a specific investment managers are usually unpredictable. Therefore, for investors to be able to build a diversified pool of co-investments, a large and established network across fund managers is required.

Define j curve (Becky stiff providing disclaimer)

Reasons for considering co-investments

- Potentially lower fees
- Potentially improved net returns
- Accelerated capital deployment/ J-curve mitigation[1]
- Diversification and control
- Closer relationships with investment managers
- Knowledge transfer, transparency and alignment
- Enhanced team retention

[1]J-curve

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Co-investments: Market universe and selection

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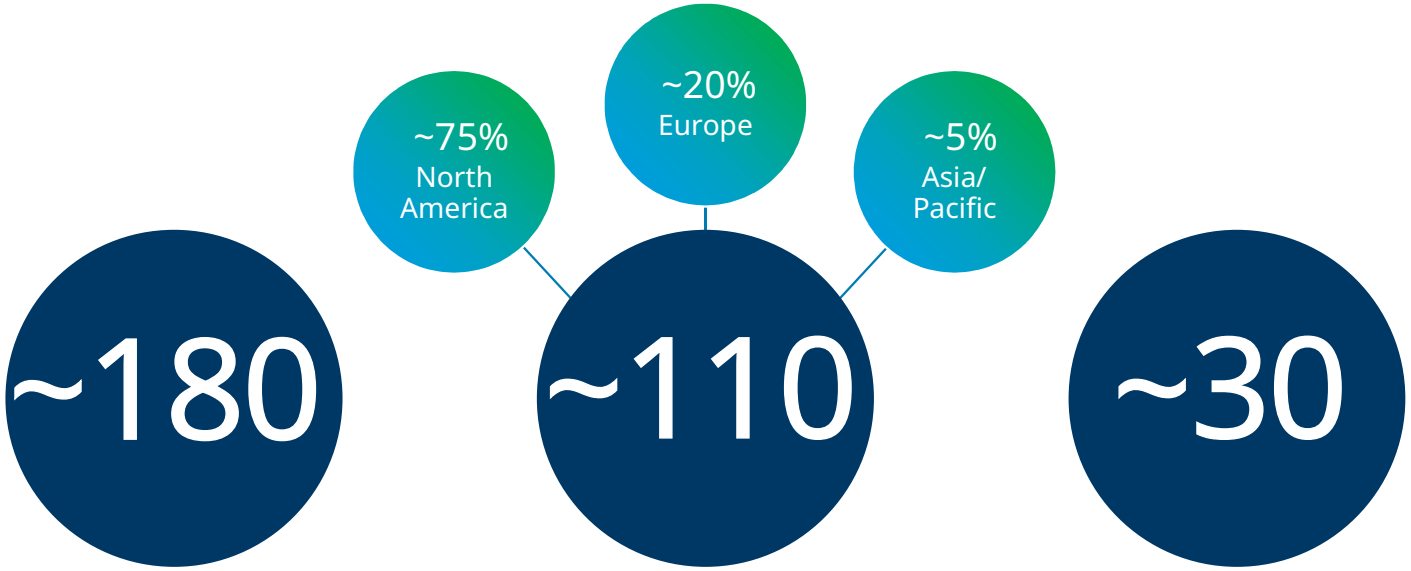
Robust co-investment deal-flow



Co-investment opportunities screened on a global basis in 2020

Co-investments sourced from more than 110 General Partners globally in 2020

Co-investments (deals and projects) completed for advisory and discretionary accounts in 2020

Note: Mercer Co-investment Pipeline Data for CY 2020 as of February 15, 2021.

Our deep experience, extensive manager relationship network and robust due diligence process are important ingredients for the success of our co-investment efforts

Due diligence: key criteria

Investment Manager

Investment Manager Quality

- Highly rated manager by Mercer
- Established organization and track record
- Team experience and turnover
- Quality deal flow

Investment Manager Fit

- Strategy, structure, sector, geography and size
- Relevant track record and experience (similar deals, co-investments)
- Deal team quality and resources to execute investment thesis

Investment Fit

Company

- Business and performance of the target company
- Leading market position
- Management team quality
- Cash flow positive

Market

- Attractiveness of the market
- Cyclicality
- Competitive landscape
- Extraneous risks (headline, geopolitical, other)

Transaction

- Sources and uses
- Investment Manager's rationale for acquisition price & transaction structure
- Use of leverage
- Fees and terms
- Alignment of interests

Valuation & Returns

- Comparable transactions
- Return modelling – projections, key assumptions and sensitivity analysis
- Potential exit routes

Client Portfolio Fit

- Fit with sector, style, geography, current exposure, ESG
- Pacing, vintage

Legal and Tax Due Diligence

- Standard legal review (SPV specific legal analysis)
- Governance rights (tag along, drag along, etc.)
- Information rights / reporting
- Client specific side letters
- Tax due diligence
- Tax-related side letter clauses

Co-investments: Implementation considerations

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Key factors for investors to consider in co-investments

Broad and deep relationships with investment managers

Efficient process and ability to execute, dedicated resources

Need for discipline and consistency

Other considerations

Recognition that it is “co-investing” not “co-leading”

Potential risks to consider

Concentration risk	• In a portfolio with a more concentrated number of investments, a single investment's returns can dominate performance, positively or negatively. • Concentration risk can happen across various dimensions (manager/industry/geography). The amount of capital invested per manager/industry/geography should be monitored. Many investors institute a maximum percentage of commitments across the entire portfolio that can be invested in any one dimension.
Resource intensiveness	• A successful active co-investment program requires dedicated investment professionals. • This can be costly and time-intensive.
Performance	• Risk characteristics differ from fund investing, and co-investments could have a greater dispersion of outcomes. • Performance can vary (based on approach or investment manager relationships, for example).
Adverse selection	• An investment manager could execute deals that are above its normal investment range. • An investor's desired investment size can limit the opportunity set. • However, some experienced co-investors view adverse selection as more of a myth than a reality.
Manager relationships	• Executed well, co-investments can enhance investment manager relationships. Executed poorly, co-investments can damage relationships and hinder future fund access and co-investment deal flow.
Headline risk	• Co-investments could expose investors to headline risk if a high-profile investment goes bad or develops public relations issues.

Common co-investment implementation options

	Pros & Cons	Resource Requirements
Third-Party Co-investment Manager	+ Simplified reporting + Potential to pool deal flow + Ability to develop more fully diversified portfolios - No discretion or ability to tailor - Additional layer of fees	• No additional resources required
Fund-of-One / Separately Managed Account	+ Simplified reporting + Ability to tailor (portfolio and involvement) + Investor owns relationships with managers - Additional layer of fees - Must rely on Investor's relationships with managers	• Depending on structure, some additional resources
Co-investment Advisor	+ Fully tailored approach + Investor is responsible for decision + Advisor assists in sourcing and diligence + Lowest cost - Must rely on Investor's relationships with managers	• Additional level of resources required • Ability to react quickly
Overage/Co-investment Vehicles with Manager	+ Fee advantages - No discretion or ability to tailor	• No additional resources required

Co-investments: Case studies

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Case study
Co-investments with highly-rated investment managers

European Buyout

- The investment manager is the global leader in the design, engineering and production of digital sound mixing consoles .
- The company combines hardware and proprietary software into mixing and processing equipment for a variety of applications including live music, television, broadcasting, theatre, corporate events, houses of worship and cruise ships.
- The investment manager has established a strong global network of 150 distributors, serving over 90 countries.
- In Q1 2020, the Company was partially realized, returning 2.7x MOIC to co-investors.

In addition to private equity, Mercer has experience executing co-investments across all private market asset classes

Fund manager shown is a sample of a firm that Mercer has performed due diligence on and it is not indicative of future recommendations or performance.

Secondaries

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Secondaries:
The WHAT and the WHY

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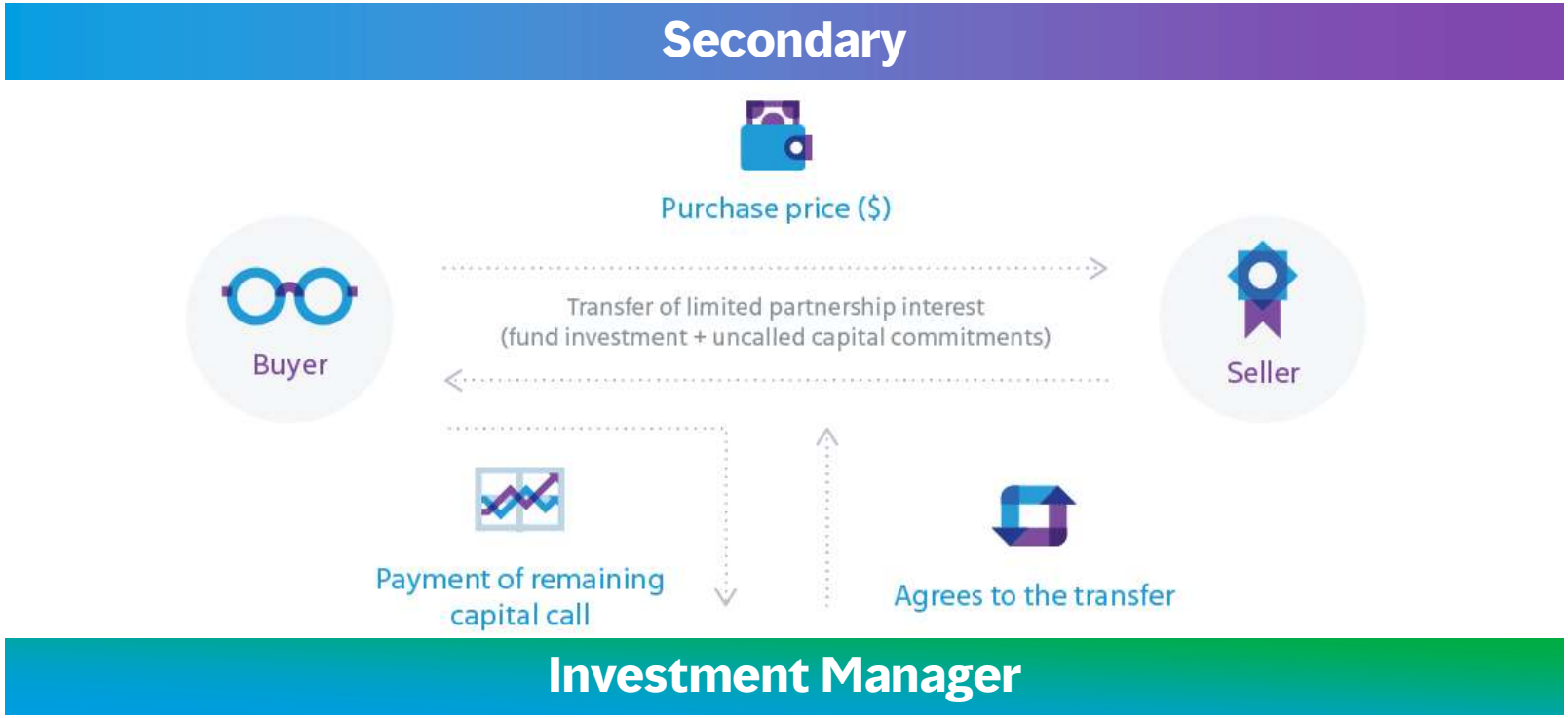
Secondaries
What are they?

A secondary private equity investment occurs when an interest in a private equity fund or position is transferred by an existing investor to another investor. They can provide liquidity to investors and investment managers in a traditionally illiquid asset class.



Motivation of secondary sellers

A broad array of factors motivate investors to actively manage their private investment portfolios

Portfolio Management

- Address asset allocation changes
- Reduce exposure to specific vintage years, investment strategies or managers
- Manage cash flows
- Desire for liquidity

Exit specific Investments

- Exit/reduce exposure to funds with
  - Poor performance
  - Higher-than-expected risk
  - Slower-than-expected liquidation
- Realize gains in strong performing funds

Administrative needs

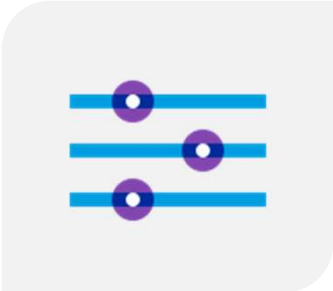
- Reduce number of asset manager relationships
- Eliminate “tail-end” fund investments
- Address merger or consolidation of plan or company

GP-Led

- Generate liquidity or access capital for an asset managers own portfolios
- Evolving transactions and structures such as manager spinouts, fund restructurings, GP-led tender offers for investor interests, continuation funds

Benefits of secondary transactions

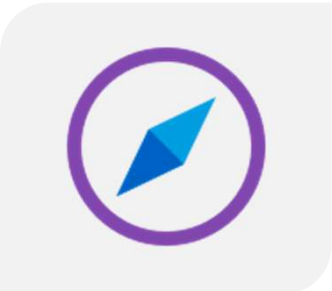
J-curve mitigation



Reduce 'blind pool' risk

Faster exposure build-up

Demonstrated Risk/Return Profile



Additional Diversification

Leverage network

Secondaries: Market

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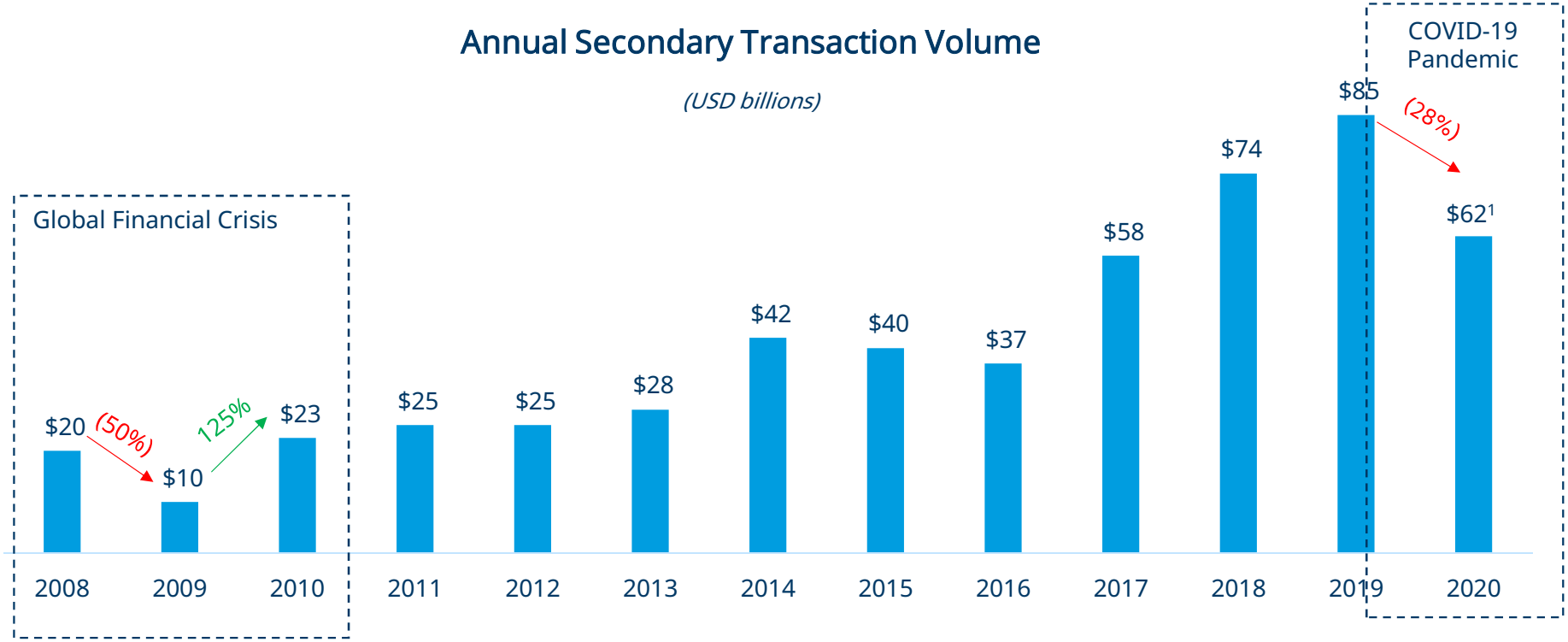
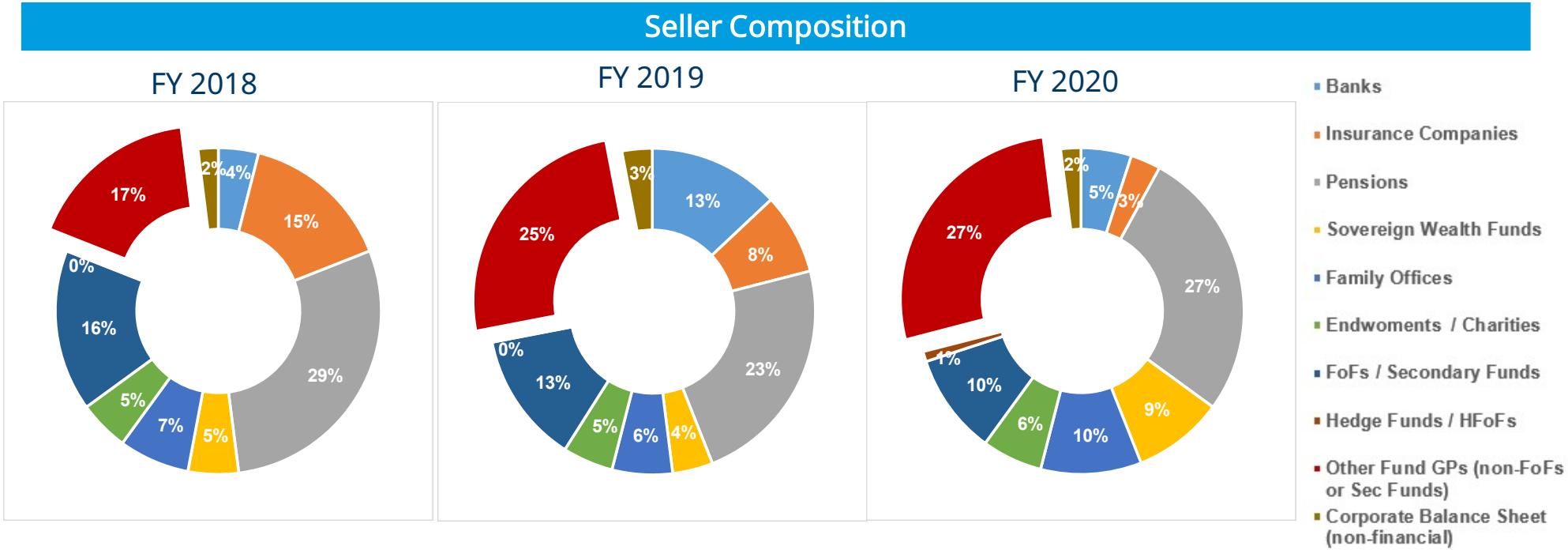
Secondary Transaction Volume



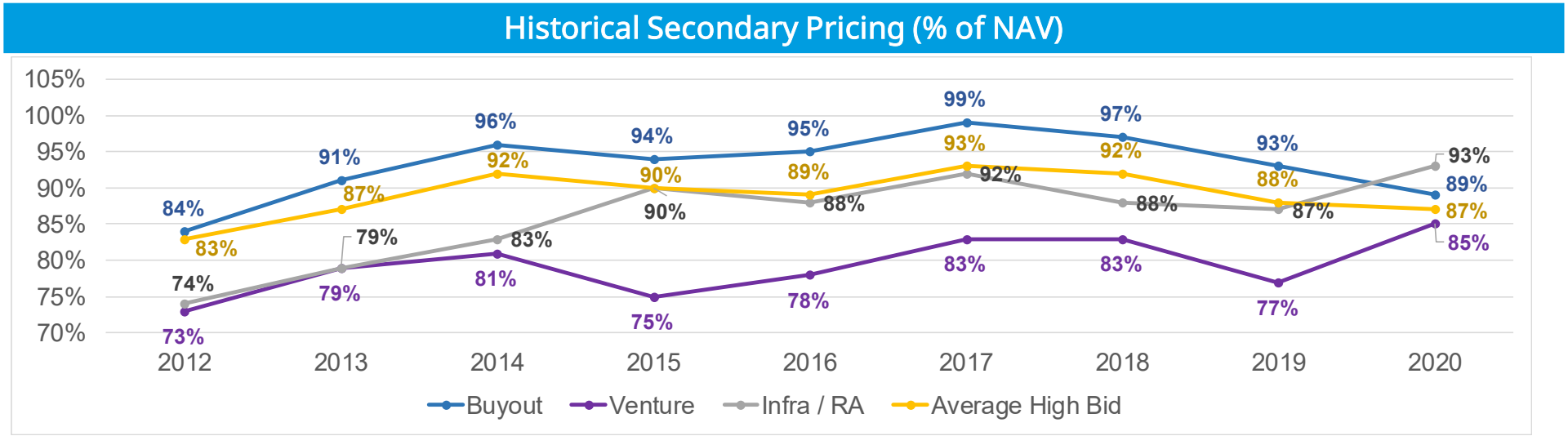
Sources: Greenhill, Setter Capital, Commonfund, Mercer Analysis.

Seller Composition



Source: Setter Capital Volume Report FY 2018, FY 2019 and FY 2020

Historical market pricing



Source: Greenhill's Global Secondary Market Review January 2021

Secondaries: Implementation considerations

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Key factors when investors considering secondaries

Dedicated resources

Data management

Access to deal flow

Structuring expertise

Effective investing into secondaries is resource intensive and requires specific skills

Secondaries: Case studies

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Case studies
Private Equity and Real Assets

US Venture Capital – investor stake

- One of the leading life science venture capital firms.
- Their core strategy is focused on building early stage drug discovery companies with potential to deliver breakthrough therapeutics.
- One of the top 10 positioned healthcare focused firms in the US.
- Position was sold as part of an auction process where Mercer had the opportunity to top the highest bid (by an Ivy League endowment).
- Position has grown substantially since acquisition with multiple value drivers remaining in the portfolio.

Structured fund portfolio

- Highly structured deal set up by this investment manager.
- Diversified, mainly global buyout portfolio, that could be acquired at considerable discount to NAV
- Mercer has a strong relationship with the investment manager on the one hand and knew the underlying fund portfolio very well, which facilitated the underwriting of the deal
- Structure entails different share classes and leads to an adjusted risk-return profile.
- Attractive opportunity to get exposure to a broadly diversified portfolio in an efficient (one-line) way.

GP-led infrastructure companies

- GP-led secondary transaction with the aim to recapitalize four portfolio assets via a continuation fund.
- The manager is one of the top-quartile infrastructure managers and provided a clearly defined growth path for the continuation fund.
- As existing investor in the fund, Mercer was approached directly by the Manager and able to enter the transaction on favorable terms.
- Opportunity to invest in a largely built out telecommunications portfolio with the goal to participate in the continued expansion of the individual assets in Europe

These case studies are for illustration purposes only, to illustrate Mercer's capabilities. Transactions shown are a sampling of firms that Mercer has underwritten and are not indicative of future recommendations or performance.

Q&A

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Thank you

For further information about our investment solutions, please visit https://www.mercer.com/what-we-do/wealth-and-investments/alternative-investments.html

Please send us any questions by email to MercerInvestmentSolutions@mercer.com

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Please see the following link for information on indexes:
https://www.mercer.com/content/dam/mercer/attachments/private/nurture-cycle/gl-2018-investment-management-index-definitions-mercer.pdf

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