

Firm/Strategy Update: Lexington | Lexington Middle Market Investor III



Le, Son
Analyst


 Home

Categories

 Meeting Recap

 DD Updates

 Manager Overview

 Apogem Capital (fka Private Advisors)

 abrdn

 Adams Street

 AEA

 American Realty

Son Le and Pat Burkett met with Emily Elliot on a video call on March 6, 2023.

1.Key Takeaways:

- **Firm:** Lexington Partners was acquired by Franklin Templeton, a global investment management organization, for \$1.75 billion. One year after the

acquisition, the acquisition hasn't had any material issues; and both companies are on track to realize the expected synergy.

- **Strategy:** Lexington Middle Market Investors III ("LMMI III"), a 2013 vintage secondary acquisition fund with total capital of \$1.070 billion, was formed primarily to acquire a diversified portfolio of U.S. growth capital and small and middle market buyout interests through negotiated secondary market purchases. LMMI III completed its investment program in the fourth quarter of 2016.
- **Team:** The acquisition hasn't had any impact on the investment team. Seven principals were promoted to partners: five in secondary and two in co-investment.
- **Performance:** LMMI III: As of September 30, 2022, LMMI III generated 1.9x/1.8x gross/net MOIC and 19.5%/18.7% gross/net IRR.
- **Current/Upcoming Fundraises:** Middle Market secondaries Fund V ("LMMI V") and Co-Investment Fund VI ("CIP VI").

2. Firm Update

- Since its founding in 1994, Lexington has established itself as one of the world's largest independent managers of secondary private equity and co-investment funds. Lexington has raised more than \$70 billion in aggregate commitments from more than 1,000 institutional investors, deploying capital across more than 4,700+ secondary, co-investment, and primary interests. Lexington is investing from its \$14 billion flagship global secondary fund, its \$2.7 billion middle market secondary fund, and its \$3.2 billion co-investment vehicle.
- Lexington Partners was acquired by Franklin Templeton, a global investment management organization, for \$1.75 billion. The transaction, closed on April 1, 2022, is expected to enable Lexington to access an extensive investor relationship network and operational resources from Franklin Templeton. Lexington continues to keep its brand and offices and has operations overseen by an operating committee that Lexington's President manages. Lexington uses iCapital as the backend for their feeder vehicle while utilizing Franklin's network of RAs and banks to raise capital. One year after the acquisition, the acquisition hasn't had any material issues; and both companies are on track to realize the expected synergy.

3. Strategy Update

- LMMI III, a 2013 vintage secondary acquisition fund with total capital of \$1.070 billion, was formed primarily to acquire a diversified portfolio of U.S. growth capital and small and middle market buyout interests through negotiated secondary market purchases.
- LMMI III completed its investment program in the fourth quarter of 2016. LMMI III committed to a net amount of \$1,157 million to acquire 26 secondary transactions and 92 middle market interests managed by 45 sponsors, negotiating an aggregate purchase discount of \$107 million, or 17% to market value.
- LMMI III committed \$105.7 million to 26 primary funds (10% of the total commitment). The Manager believes that primary investments generated secondary opportunities and enhanced ongoing relationships with leading middle market sponsors, which is crucial for due diligence and valuation review with general partners. The Manager also expects primary investments to increase the cash return multiple for LMMI III modestly. The Manager receives no carried interest on LMMI III's primary investments.
- As of September 30, 2022, the LMMI III partnership portfolio is 72% middle market buyout, 27% growth capital, and 1% small buyout. 90% of LMMI III's exposure is based in the United States, with 10% in Europe and the U.K. The Partnership has entered into Euro and Sterling forward currency contracts to manage foreign currency exchange risk on some non-U.S. Dollar-denominated assets.
- CAPTRUST clients committed \$10 million to LMMI III.

4. Team

- Two senior partners transitioned to senior advisors when the transaction closed: Lee Tesconi and Duncan Chapman (Boston and NYC offices, respectively). Lee has been advising Wil Warren and Pål Ristvedt, the co-chairs of the Investment Committee. Duncan advises on investor relationships and the operating committee. The acquisition hasn't had any impact on the investment team. Seven principals were promoted to partners: five in secondary and two in co-investment. The firm plans to hire two or three investment offices at different offices and continues to build out fund administration, investor relations, and compliance teams.

- Each investment team member is responsible for 25 – 30 GPs throughout their career. They develop relationships at different levels of seniority at these GPs, having different touch points depending on the size of the managers. They also underwrite the deals and build valuation models once a purchase opportunity occurs. A deal team includes three to four investment professionals: a senior partner, a principal/VP, and one or two associates. The team does bottoms-up underwriting on 80% of value drivers for a set of portfolio companies in a given deal.
- Franklin acquired 100% of Lexington but gave back 25% ownership to the investment team with a reserve for future partners, which broadened the ownership amongst the partner group.

5. Performance

- As of September 30, 2022, LMMI III had a Reported Value of \$619.6 million plus distributions of \$1,366.7 million for a total value of \$1,986.3 million, or 1.88x invested capital of \$1,055.8 million. The annualized gross internal rate of return ("IRR") to the Partnership was 19.5%. The IRR and multiple, net to the Limited Partners, is 18.7% and 1.8x, respectively.
- During the quarter, LMMI III made three distributions totaling \$32 million, bringing total distributions as of September 30, 2022, to \$1,083.0 million. LMMI III called \$3 million (December 29), increasing total contributed capital to \$917.7 million. LMMI III also distributed \$9 million (October 28) and \$51.8 million (December 29), bringing total distributions to the partners to \$1,143.8 million, or 124.6% of the current contributed capital of \$917.7 million.
- As of September 30, 2022, LMMI III, with a weighted average age of invested capital of 6.1 years, had a Reported Value of \$619.6 million and remaining net unfunded commitments of \$80.8 million.
- New/Follow-on investments:
 - During the quarter, the secondary interests called \$3.9 million for new and follow-on investments. As of September 30, 2022, LMMI III's secondary interests had been called \$540.4 million, excluding SPV Distributions Applied to SPV Obligations.
 - During the quarter, the primary interest was called \$0.4 million for new and follow-on investments. As of September 30, 2022, LMMI III's primary interests had been called \$111.1 million.
- Distributions received:

- During the quarter, LMMI III received secondary distributions totaling \$27.6 million and applied \$0.6 million to SPV Obligations. As of September 30, 2022, LMMI III had received secondary distributions totaling \$1,339.0 million, of which \$347.1 million was applied to Partnership Obligations.
- During the quarter, LMMI III received primary distributions totaling \$10.3 million. As of September 30, 2022, LMMI III had received distributions of \$108.0 million from primary interests.

6. Fund Raising | New Products

- Middle Market secondaries Fund V ("LMMI V"):
 - LMMI V will start raising in the 2H half of 2023. Lexington typically would have started raising earlier, but they needed capital for LCP X, and they don't like to raise both at the same time; thus, they have waited until LCP X completes the process.
 - LMM V targets approximately \$3 billion (TBD final amount) and focuses on acquiring interests from portfolios less than 50% funded in the U.S. middle market. It took more work to invest in Fund IV, but with the current denominator effect, they think should be more supply.
- Co-Investment Fund VI ("CIP VI"):
 - The Fund is currently in the market. The Fund focuses on a diversified portfolio of co-investments, mostly in buyout deals, from small to mega, with an average check size of 10-20M. The Fund plans to invest in 30-40 deals a year over four years across U.S. and Europe markets.
 - CIP V was raised from 13 large institutional investors who aggregate their co-investment deal flows and LCP's relationships. The average commitment was \$250M per client. However, this amount will be reduced to \$20M for CIP VI, which will be marketed broadly.