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GP-Led Secondaries: Private Equity's Most Underserved Market?

Consistent with our experience in prior market corrections, current macroeconomic and capital market conditions appear to be creating attractive investment opportunities for secondary buyers.

Over the last 12 to 18 months, we have witnessed a meaningful decline in private equity (PE) exits, which triggered an estimated $106 billion of net cash outflows for PE investors in 2022 alone.[1] In our view, this dynamic—combined with the denominator effect and generally elongating holding periods—is opening attractive opportunities for providers of liquidity to the private markets.

We believe GP-orchestrated "continuation funds" can help ameliorate this liquidity challenge and also offer a compelling way for investors to gain exposure to private markets at a potentially attractive point in the cycle and in a targeted, highly selective manner.

In this paper—the latest installment in our ongoing secondaries series—we discuss potentially favorable trends for GP-led investors in the current environment, including:

- **Demand for liquidity across the PE industry:** The pressure remains high on both LPs and GPs to generate liquidity from PE holdings as investors remain overallocated and aggregate capital calls outstrip aggregate capital distributions.
- **Desirable liquidity optionality from GP-led transactions:** GP-led transactions can help GPs offer needed liquidity for their LPs in the current environment. GPs also get extra time and capital to continue expanding some of their most successful portfolio companies rather than selling them to other PE sponsors.
- **Attractive supply-demand imbalance for investors in GP-led transactions:** We believe the competitive dynamics in the secondary market remain attractive as the volume of marketed secondary opportunities was at an all-time high in 2022,[2] even as the market experienced an ongoing undercapitalization, especially for GP-led transactions.
- **High barriers to entry in the GP-led market:** We believe success in the GP-led market requires a unique combination of skillsets. Investors must combine direct underwriting and transaction structuring capabilities with the ability to work with GPs as a limited partner.
- **Risk mitigation by targeting quality assets:** We believe that targeting quality assets can reduce risk by avoiding much of the underlying return dispersion that often comes with buying large, diversified portfolios which were invested in the boom years leading up to 2022.
- **Buyout returns with potentially lower risk:** We believe GP-led transactions can generate buyout returns at a superior risk profile due to structural differences versus new buyout investments, including strong alignment with the underlying GPs, lower execution risk, shorter duration, lower entry valuations and safer capital structures.

For additional context, see The Rise of GP-Led Secondaries.

[1] Burgiss Global Private Capital Performance Report 2022 Q4.
[2] PJT Park Hill Secondary Market Insight Investor Roadmap 2023 Q1.

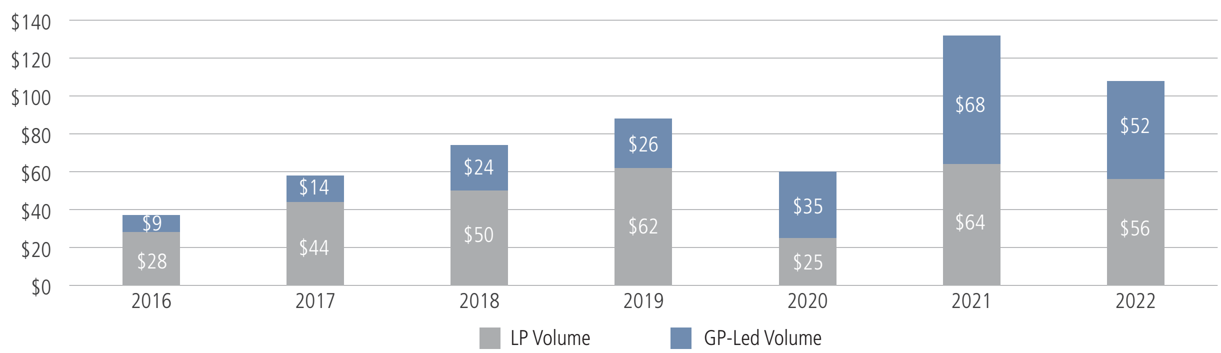
Demand for Liquidity Across the PE Industry

As we discussed in our previous paper, many PE investors remain overallocated as their private investments outperformed while other asset classes underperformed over the last few years. Exacerbating the situation, closed exit markets caused liquidity to dry up and PE investors to suffer an estimated $106 billion of net cash outflows in 2022 alone.

Against this backdrop, the secondaries market—one of the few ways for GPs and LPs to generate much-needed liquidity—recently marked the second-highest volume of closed transactions in history, down from their record-setting year in 2021 (see figure 1). Indeed, in 2022, the volume of *marketed* transactions—both for LP- and GP-led transactions—was at all-time highs, according to PJT Park Hill, a secondaries advisory firm.[3]

FIGURE1: GP-LED SECONDARY TRANSACTION VOLUME SLIGHTLY DECLINED IN 2022[4]

Annual Transaction Volume ($B)



Source: Jefferies, "2023 Secondary Market Update". Data is as of January 2023.

Desirable Liquidity Optionality from GP-Led Transactions

In continuation funds, a GP sells one or more portfolio companies from a typical, 10-year primary fund to a new investment vehicle—the continuation fund—managed by the same GP and structured in negotiation with secondary investors.

We believe continuation funds can meet the liquidity needs of primary fund LPs and GPs, while also generating potentially attractive long-term returns for GP-led investors:

- LPs in the primary fund can either cash out their current stakes or roll them into the new continuation fund to extract additional value from select portfolio companies, allowing the individual LP to manage its specific duration and cash flow objectives.
- GPs get extra time and capital to create more value in some of their most successful portfolio companies. Rather than sell their best holdings to other PE sponsors, GPs can partner with secondary investors while still maintaining ownership and control of high-conviction assets.

[3] PJT Park Hill Secondary Market Insight Investor Roadmap 2023 Q1.
[4] Jefferies Global Secondary Market Review 2022 Q4.

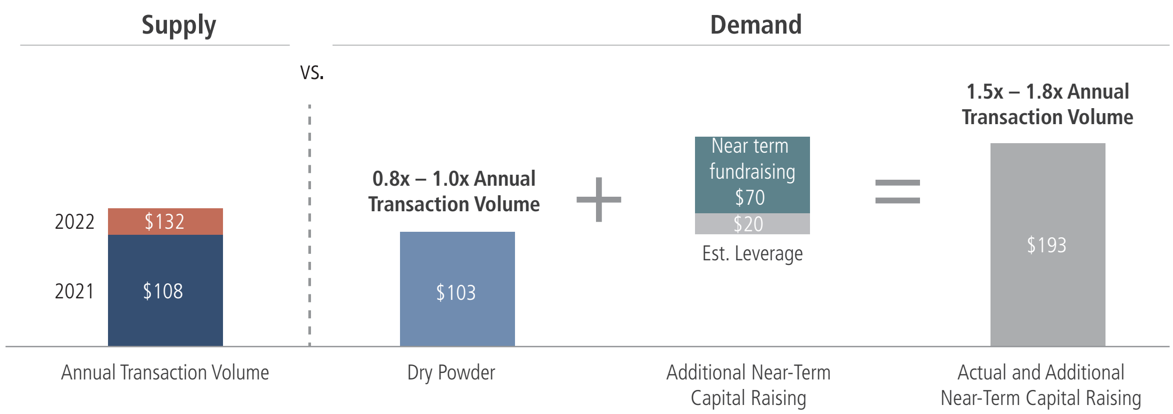
Attractive Supply-Demand Imbalance for Investors in GP-led Transactions

Over the past couple of years, capital formation in the secondary markets generally hasn't kept pace with the increasing supply of secondary investment opportunities,[5] thereby creating an attractive imbalance between supply and demand that we believe will persist for a period of time.

Dry powder in the overall secondary market is currently less than one times annual transaction volume, a long-time low (see figure 2); by some estimates, the ratio for GP-led secondaries is even lower. That's why we believe the recent decline in closed transactions in the GP-led market is largely due to a lack of available capital, as well as a bid-ask spread at times, but not primarily related to a declining supply of opportunities or flagging demand from GPs. Our conclusion is also in line with recent observations made by PJT Park Hill: "Volumes were impacted by a Q4 market slowdown, as well as a lack of capital for GP-led transactions."[6]

FIGURE 2: A DEARTH OF DRY POWDER IS HOLDING BACK THE NUMBER OF GP-LED DEALS

Transaction volume relative to estimated secondary dry powder ($ in billions)



Source: Jefferies – Global Secondary Market Review – January 2023. Leverage estimated as approximately 25% of equity dry powder plus near-term fundraising.

High Barriers to Entry in the GP-led Market

While current investment dynamics are attracting new entrants to the GP-led market, we believe success in this market requires a unique combination of skills and characteristics, including:

- *Underwriting resources and structuring capabilities:* Given the significant due diligence required in analyzing the underlying assets, we believe successful investors in GP-led transactions require substantial direct-underwriting resources and structuring capabilities akin to direct buyout investors. This skill set differs from that required to analyze diversified portfolios of LP positions. As noted in our previous paper, new entrants to the GP-led market often need to hire staff from outside the secondary market, and they can take years to train.
- *Ability to partner with GPs:* We believe successful investors in GP-led transactions should be able to partner productively with GPs to ensure access to high performing portfolio assets and to structure governance and alignment with GPs. We believe GPs prefer partnering with experienced GP-led investors to improve certainty of closure. Furthermore, in our view, secondary teams which are part of larger, integrated private-market platforms with dedicated fund-of-funds, co-investment and private debt offerings are well positioned to help provide long-term capital solutions for GPs.
- *Access to capital:* We believe successful investors in GP-led transactions require access to sufficient capital to position themselves as lead investors to set pricing and align governance with GPs.

[5] PJT Park Hill Q1 2023 Market Insight.
[6] PJT Park Hill Secondary Market Insight Investor Roadmap 2023 Q1.

Risk Mitigation by Targeting Quality Assets

While we remain optimistic about PE's long-term prospects and performance as an asset class, we also suspect there may be greater dispersion of ultimate returns within legacy portfolios given the changes we have observed in the macroeconomy and capital markets.[7]

Consequently, at this point in the economic and financial cycle, and in the face of persistent volatility and healthy secondary-transaction supply, we think investors may be better served taking a more thoughtfully targeted approach in the secondaries market rather than relying on diversification to mitigate risk.

In our view, such an approach has the potential to reduce risk by avoiding much of the underlying return dispersion that often comes with buying large, diversified portfolios. To quote the legendary Charlie Munger, co-founder of Berkshire Hathaway: "If you can find six wonderful businesses, that is all the diversification you need…Very few people have gotten rich on their seventh best idea."

While targeting smaller LP portfolios or even individual funds can provide exposure to high-quality assets, we believe GP-led transactions have the potential to isolate not only high performing PE portfolios, but also to go a level deeper and target what we believe to be the highest quality investments *within* those portfolios.

We also believe GP-led vehicles have additional structural benefits that can help investors maximize returns. For example, underlying GPs typically must make a substantial commitment to the new continuation fund (see the bullet on "Strong alignment with the underlying GPs" below). Secondary funds may also extend the investment holding period of a particular asset in a GP-led continuation fund (to provide more time to maximize value) or inject expansionary capital with which the fund can make add-on acquisitions or fund other growth initiatives in the portfolio companies.

Buyout Returns With Potentially Lower Risk

In our view, continuation funds have the potential to generate returns that compare favorably to those of traditional buyout firms, but with a superior risk profile. Reasons include:

- *Strong alignment with the underlying GPs:* In a GP-led transaction, secondary buyers typically aim to align interests with the GP by requiring a substantial GP commitment alongside them. And while each GP-led transaction is bespoke, investors often expect the GP to invest substantially all of the carry proceeds generated by the transaction back into the continuation fund, and also make a meaningful *new additional* commitment.
- *Lower execution risk:* GP-led opportunities tend to involve companies led by proven management teams. Underlying GPs typically have strong track records of managing the portfolio companies transferred into the continuation fund and successfully driving their growth strategies over many years; we believe this intimate understanding of target companies, and the solid relationships cultivated with their respective management teams, can help reduce the execution risk of GP-led transactions versus new buyouts. Furthermore, in GP-led transactions, underlying GPs are typically deciding to continue to own and invest in high-conviction assets which, in our view, also tends to lower long-term risk.
- *Shorter duration:* Because GPs are intimately familiar with managing the target companies, value creation continues from the day of the transaction—without the need of a 100-day plan or replacement of C-suite management teams.
- *Lower entry valuations:* In a typical GP-led transaction, the underlying GP maintains control of the assets. This means investors in the continuation fund don't have to pay a change-of-control premium, thereby potentially lowering the purchase price versus traditional buyouts, and also potentially creating a "value buffer" when the assets—and their control—are ultimately re-sold.
- *Safer capital structures:* Companies in GP-led transactions typically have spent time proving their business models and deleveraging their balance sheets versus traditional new buyouts.

Conclusion

Looking ahead, we think further economic and geopolitical uncertainty will bolster demand for liquidity by primary fund LPs and GPs, and ultimately continue to stoke GP-led transaction supply. In this undercapitalized and understaffed market, we continue to believe that experienced investors in the GP-led secondary market have the potential to capitalize on these structural dislocations and generate attractive long-term returns.

[7] Based on NBAA market observations and analysis as of June 2023 and no future date. May be subject to change.

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