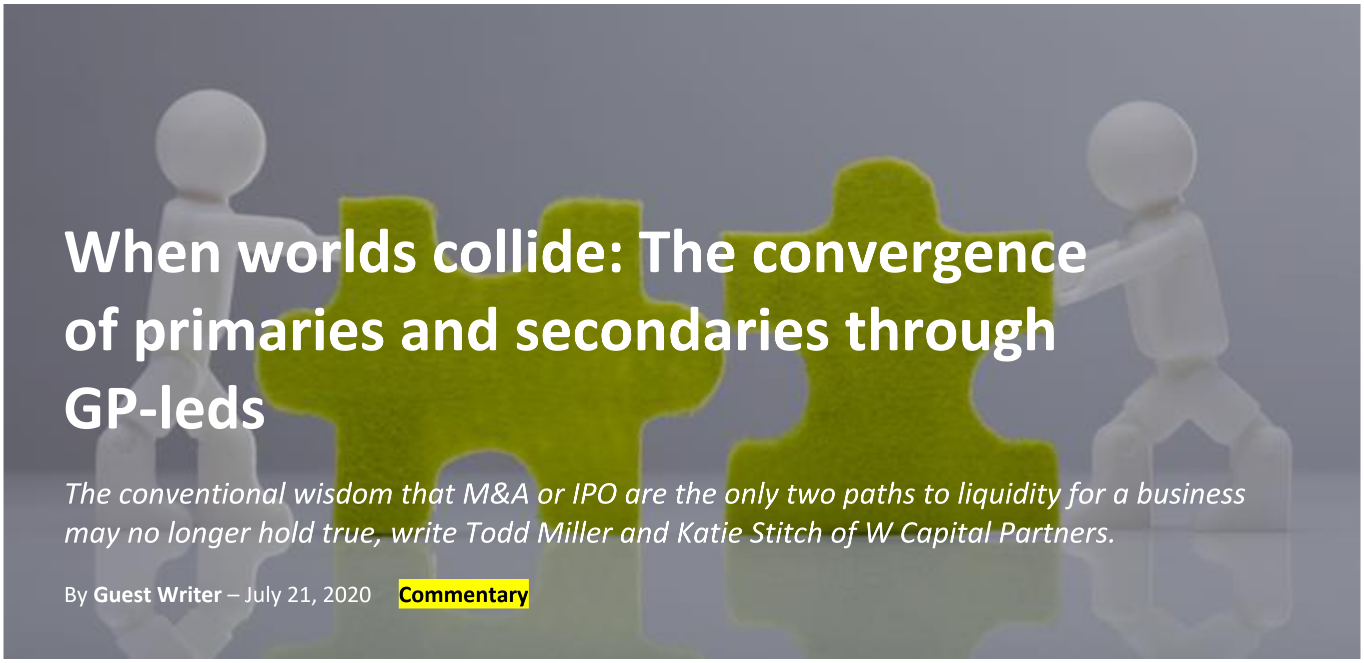
As published on Secondaries Investor



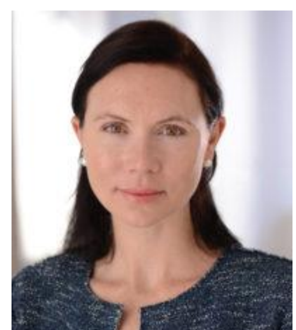
When worlds collide: The convergence of primaries and secondaries through GP-leds

The conventional wisdom that M&A or IPO are the only two paths to liquidity for a business may no longer hold true, write Todd Miller and Katie Stitch of W Capital Partners.

By **Guest Writer** – July 21, 2020 **Commentary**

Prior to the onset of covid-19, some industry participants were calling for the secondaries market to grow to $100 billion in 2020, with GP-led transactions comprising 40-50 percent-plus of total volumes. Covid-19 will likely augment the drivers and timing of that growth, much as it is altering the outlook for the traditional LP secondary market.

We believe secondary buyers like ourselves will wait for greater visibility on the overall market and company performance, as well as for valuations to reset, before leaning into more GP-led deals.



Stitch: buyers will wait for greater visibility before leaning into GP-leds

When the forward outlook is more certain, a number of factors could coalesce to drive a swift rebound. First, there is a pent-up supply of deals that were put on hold due to covid-19 as well as a pipeline of opportunities where the launch of processes was delayed due to market conditions. Many expect a wave of new opportunities as GPs grapple with pushing past the end of fund lives and equity capital needs beyond their reserves, be they for offensive or defensive purposes. The lower NAV valuations, which will be used as the benchmark to reset GP carry in these transactions, will only serve as an additional catalyst for sponsors to pursue these deals for their high-conviction assets.

On the LP front, GPs will have a new timetable for when traditional exits from their portfolio could realistically offer liquidity to LPs, which they may be looking for solutions to complement. We believe the potential step backwards in valuations and market-driven elongation of holding periods for private equity sponsors will create a wave of future GP-led opportunities that liquidity-starved LPs will be even more inclined to support.

Getting these deals right

With the involved disclosures and potential for limited partner resistance, the fact that only about two-thirds of the transactions brought to market in 2019 successfully closed during the year, according to Lazard, has been cited as a reason to hold off. According to Greenhill Cogent, several large GP-led deals amounting to $12 billion of net asset value failed in 2019. However, as primary GPs know, not every change of control sale is destined for success. The reasons cited for failed deals include misalignment between the GP and secondary buyers, price, asset quality and, perhaps worst of all, unclear rationale for the deal.

Much as the risk of an M&A process failing isn't enough to scare sellers off from ever trying, the focus should be on ensuring your transaction is in the group that reaches a favourable outcome. And what are the key ingredients for a successful GP-Led process? First and foremost, there needs to be a clear rationale for the transaction. Examples of a sponsoring GP's motivation that the market deems credible include:

- Compelling, accretive growth vectors that the sponsor and underlying management team(s) would like to pursue, which would extend the duration of the investment past the sponsor's fund term.
- Opportunity for additional equity capital provided by the continuation vehicle to fund add-on M&A or consolidate the shareholder base of the underlying portfolio company.
- Thematic reasons or market conditions why an exit inside of the sponsor's fund life would sub-optimise the value of the underlying asset(s).

Miller: the lines between primary and secondaries investing are blurring

A GP should be prepared with thoughtful process materials, a robust supporting data room and third-party support for a business and the recommended valuation (eg, quality of earnings reports, consultant reports, industry studies, fairness opinions). A GP should also be ready to make themself and their management partners available. The underpinning theme of these deals is the GP's continued conviction, which should be reflected in a meaningful GP commitment, often over-weighted to the principals closest to the asset. Finally, forget everything you ever knew about cross-fund investments: Here, a commitment out of a new, primary capital vehicle is seen as a positive and an added signal of conviction.

LPs, in fact, often find themselves on both sides of a GP-led transaction, evaluating why the calculus makes sense to seek liquidity and why new investors might be interested in supporting the existing sponsor to grow the asset from here. However, is this any different from a change-of-control sale of an individual asset in which an LP is invested with both the buyer and the seller? We would argue no.

The lines between primary investing and secondary investing are blurring, which opens up multiple paths to partnership with sponsors. The conventional wisdom that there are two paths to liquidity for a business – M&A or IPO – may no longer hold true. We would posit that, for the companies with the strongest prospects coming out of covid-19, there will increasingly be a third path.

GPs that don't yet appreciate the broad offering of secondary firms should use this time to refresh on what the market today could offer them. While covid-19 will certainly delay progress for a short while, top-performing GPs with strong assets certainly don't want to be flat footed when the market rebounds and there's a backlog of other GPs with their deals in front of them.

Todd Miller and Katie Stitch are managing directors of [W Capital Partners] and have been actively involved as investors in the GP-led secondary market and the secondary direct sector.

****

Click to view the long form