When Worlds Collide: The Convergence of Primaries and Secondaries Through GP-Led Transactions

After a multi-year run-up in transaction volumes, GP-led transactions started the year with an estimated 40% share of the total secondary market.[1] Will COVID-19 finally bring this record growth to a halt or will this burgeoning market that blurs the lines between primary and secondary investing continue to upend the private equity ecosystem?

by Todd Miller and Katie Stitch

Current state of play:

- Over the past several years, we saw top-tier private equity firms embrace secondary solutions as an effective management tool, spearheading transactions for some of their best assets
- LPs are now comfortable with how GPs are managing the inherent conflicts in these transactions
- Secondary firms have benefitted from this attitudinal shift, whereas other institutional investors, including private equity firms and co-investors, are increasingly missing out on opportunities to

[1] Lisa Fu, 'Longer Asset Holds Drive Rising GP-led Secondary Deal Volume', PERE, January 9, 2020.

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buy compelling assets due to transactions circumventing the traditional exit routes of sponsor-to-sponsor sales and the public markets

- Increasingly, secondary bankers have been mandated to market these GP-led opportunities under the existing GP's management and leadership at the expense of traditional industry and M&A bankers
- While COVID-19 will slow GP-led transactions along with the broader secondary market, this market is well-positioned to rebound quickly. Numerous transactions were put on hold due to the pandemic and new opportunities will emerge to better realign capital reserves and duration for businesses against post COVID re-underwriting
- Private equity firms and the traditional sponsor coverage and industry bankers who advise them should use this time to explore how best to leverage this enormous market opportunity going forward

Cutting through the Noise. What is a Continuation Fund?

A lot of nomenclature is tossed around in the secondary market that can be confusing to most: Fund recaps, GP recaps, tender offers, structured secondaries, strip sales… the list goes on. Put the nuances of these deals aside for now and focus on the overarching terminology that captures the architect and the end-goal: GP-led secondary transactions.

GP-led secondary transactions, often falling under the umbrella of an acquisition fund or a continuation fund, are when a single asset or portfolio of assets is purchased from a fund or set of funds managed by a GP and put into a new vehicle with reset economics, duration and terms for the existing GP to continue managing the asset(s) going forward. These transactions offer selling LPs liquidity while affording electing prior investors and new LPs the opportunity to back the next phase of a company's growth. Investors are underwriting these deals to returns in line with control private equity – but now the existing GP can capture the opportunity for itself and ongoing investors versus leaving that potential return to a competing private equity firm. These transactions are not one-off case studies but rather represented 76% of the closed transactions in the $28 billion GP-led secondary market in 2019.[2]

[2] Source: Lazard Private Capital Advisory Secondary Market Overview, February 2020.

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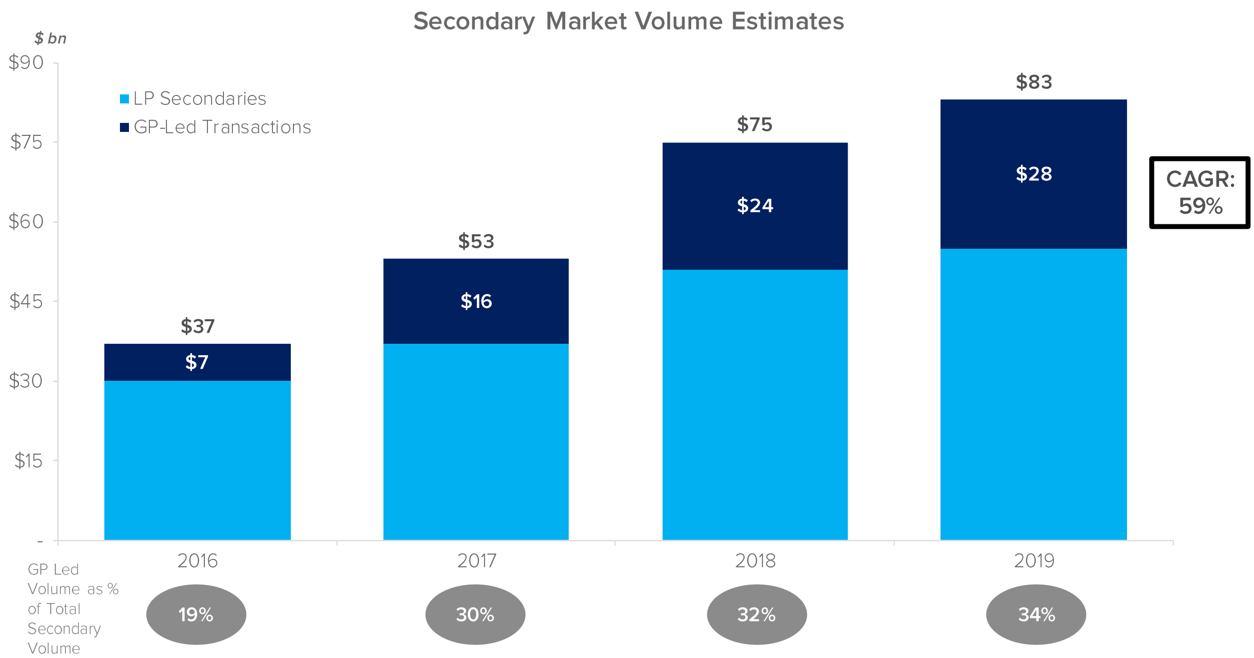
Market Perception of these Deals. Times Have Changed!

In the not-so-distant past, concerns over limited partner and market perception of these deals dissuaded top-tier GPs from pursuing a GP-led secondary transaction. The early incarnations of these deals were defensive, not offensive, and the league of firms pushed to explore these transactions wasn't a cohort GPs were keen to join. That dynamic has fundamentally changed. Within the last two years, Accel KKR, Ares, Blackstone, Carlyle-Riverstone, Insight, PAI, Permira, TPG and Warburg Pincus have all executed GP-led secondary transactions for a single asset or a portfolio of assets. We're in regular dialog with other PE firms yet to join these ranks but who are looking to better understand these compelling transactions and the realm of possibilities within their own portfolios. Not surprisingly, many bankers expect to see this market, which grew from $7 billion in 2016 to $28 billion last year[3], continue to accelerate.



Source: Lazard Private Capital Advisory Secondary Market Overview, February 2020.

[3] Source: Lazard Private Capital Advisory Secondary Market Overview, February 2020.

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The COVID-19 Impact

Prior to the onset of COVID-19, some industry participants were calling for the secondary market to grow to $100 billion in 2020, with GP-led transactions comprising 40-50% plus of total volumes.[4] 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. Both the LP secondary market and GP-led secondary markets are driven by the sponsor's current view on fair value of an asset and the outlook for future value accretion. At the time of Q1 valuations, many PE sponsors were still assessing and sensitizing the impact of COVID-19 on their portfolio companies with somewhat limited information and substantial ambiguity. As a result of this overall uncertainty, all but highly structured transactions seem unlikely to work for both buyers and sellers off of Q1 marks.

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. We believe most secondary buyers are waiting for Q2 and Q3 marks which will better reflect the impact of COVID-19 on company performance and value than Q1 valuations, many of which were completed by sponsors with prudence but early in the digestion of real-time information from their portfolio companies. In addition, secondary firms who strayed from a more diversified mandate into concentrated deals in sectors severely impacted by COVID-19 likely have a new appreciation for those risks. We expect some to retrench to more diversified LP portfolio purchases and to focus on credit and preferred-like structures collateralized by a broader assortment of positions.

[4] Rod James, 'Secondaries market in 2020: Big deals and bold predictions', Private Equity International, March 5, 2020.

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Valuation Bottom in 6-9 Months

Expected PE NAV bottoms, by quarter

Q1 2020	-
Q2 2020	56%
Q3 2020	30%
Q4 2020+	14%

Source: Greenhill – A Changing Secondary Market Landscape - 2020, April 2020.

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. Add to that pressure on the part of secondary investors to deploy some of the $103 billion of dedicated secondary dry powder[5] and one can foresee a quick bounce-back.

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[6] has been cited as a reason to hold off. According to Greenhill Cogent, several large GP-led deals amounting to $12 billion

[5] Source: Campbell-Lutyens 2020 Secondary Market Overview, March 2020.
[6] Lazard Financial Sponsor Secondary Market 2019 Year-End Review.

of net asset value failed in 2019[7]. 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 favorable 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 which the sponsor and underlying management team(s) would to 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; or
- Thematic reasons or market conditions why an exit inside of the sponsor's fund life would sub-optimize the value of the underlying asset(s)

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 (e.g. Quality of Earnings reports, consultant reports, industry studies, fairness opinions). A GP should also be ready to make themselves 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 Players

Without blind-pool risk yet with returns as compelling as new deals, this massive opportunity set will see continued investor appetite – and this market needs their capital to satisfy projected sponsoring-GP demand when the market returns. This market could be the long-dated fund or core fund opportunity on steroids, with the de-risking element that an existing GP already knows the asset as an owner versus

[7] Greenhill Cogent full-year 2019 volume report.

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having to hunt for an asset it hopes will have the same return opportunity to compound value in the future. With elements of secondary, coinvesting and primary underwriting, who is best positioned to win?

Secondary firms: Secondary firms have been active buyers of continuation funds and see these transactions as higher return opportunities than traditional secondary LP purchases. They are also well positioned because they are already in many of these funds as LPs and have been tracking the performance of the target assets. However, the underwriting for continuation funds is more extensive than traditional secondaries and more akin to primary/buyout investing, particularly for single asset continuation vehicles or highly concentrated portfolios with one or two key value drivers. It requires primary level underwriting including company and management visits, third party diligence and extensive financial and legal due diligence. Secondary firms will also need to push sponsoring GPs on running a process more like a change of control transaction than a LP secondary auction. These firms will need to ensure they have the right team with the right skillset to both catalyze and underwrite these transactions. These requirements will certainly open up more opportunity for dedicated secondary direct players in what promises to be a compelling and massive market.

Private equity firms: GPs and the bankers who market to them should be prepared for disappointment as assets they were hoping to have a shot at the next time they came to market don't change hands and rather stay within their current owner's managed fund universe. We've heard about traditional private equity firms contemplating setting up vehicles to pursue these types of deals, but that dynamic would have private equity firms co-controlling these assets with other GPs, who may even be competitors, over passive secondary firms keen to do the same deal. If they want to be a buyer and capital source for these transactions, traditional buyout firms will need to have a shift in mindset.

Bankers: GP-led transactions are becoming a windfall for secondary advisory firms. These advisors have the relationships with GPs, LPs and secondary buyers, and they are experienced in managing conflicts and running orderly processes. However, M&A bankers marketing the sale of an asset should be polling their secondary marketing relationships and leveraging their firm resources to determine if an asset they are hoping to take to market could have what it takes to be a value-driving component of a GP-led deal. If affirmed, this could mean a viable alternative transaction today or represent a new path for potential acquirors to consider in their set of underwriting cases. At the larger banks, it's important for the secondary groups, M&A bankers, sponsor coverage bankers and fundraising groups to be well integrated and properly incentivized to jointly tackle this market as a unified team. Otherwise, the franchise benefits of this large and growing segment of the market will fall exclusively to the small universe of established secondary advisory firms.

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Call to act

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 who 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 Group and have been actively involved as investors in the GP-led secondary market and the secondary direct sector (i.e., providing secondary liquidity to sponsors in private equity assets but outside of a sponsored vehicle). The continuation fund market is a natural extension of their efforts at W Capital and the broader W Capital secondary strategy. Todd Miller brings a varied perspective on the subject given his deep private equity background having worked at various private equity and secondary firms over the last 20 years, including TH Lee Putnam and Alpine Capital. Katie Stich has been at W Capital for more than 14 years and has been at the forefront of investing and shaping the secondary direct market. W Capital has invested $2.5 billion in over 50 direct secondary transactions, seeking to provide GPs and shareholders with a range of flexible capital liquidity solutions.

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