KEYNOTE INTERVIEW

More than just continuation vehicles




Buyout and growth capital investors are embracing a broad range of GP-led solutions, say W Capital Partners managing partner and co-founder David Wachter and partners Blake Heston, Todd Miller and Katie Stitch

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Q The GP-led solutions market has exploded over the past couple of years. What are the advantages of these transactions for sponsors?

David Wachter: There's a broad range of GP-led solutions that create win-win opportunities for sellers, capital providers, and underlying portfolio companies, because they provide the ability to realign duration and set objectives for that business over an appropriate timeframe.

The key advantages for the GP are realized returns, expanded liquidity options and the ability, in certain situations, to hold great assets beyond the fixed life of the fund. But it's important to note that we're not only talking about GP-led continuation vehicles which are generating so much excitement right now. Direct stock sales and minority recaps are also prominent secondaries tools. Together, along with continuation vehicles, they represent what we call "GP solutions," and it's a market that we've been operating in for the past 20 years.

Q As you say, these GP-led solutions have been a part of the secondaries tool kit for a long-time. Why do you think the broader private equity industry is only waking up to this opportunity now?

DW: I think there are several reasons. First, you need to look at the macro picture. The private equity industry has grown dramatically over the years to $6 trillion or $7 trillion today. With that growth, the types of participants operating in the market has expanded greatly. We have traditional GPs, financial institutions, family offices, asset managers and hedge funds all playing directly or indirectly in private equity. Second, the hold period of underlying assets has continued to increase. It's a self-fulfilling prophecy that companies will stay private longer because there's more liquidity in private markets. GPs are also becoming more sophisticated regarding how to manage fund level liquidity.

The watershed moment that has led to the current explosion in GP solutions has been market leading GPs fully embracing the strategy, as well as the underlying LPs. The very best GPs have validated the generation of asset liquidity through secondaries transactions, whether that be direct share purchases, minority recaps or continuation funds. These are all now seen as legitimate ways for a GP to maximize returns for its LPs and maximize the potential for the underlying portfolio company.

Q Do you see differences in the way buyout and growth capital GPs are embracing these solutions?

Todd Miller: In general, buyout managers work with us on minority recaps, continuation vehicles and the sale of rollover equity positions. The motivation for minority recaps and continuation vehicles are similar. The sponsor wants to hold the asset longer, but also wants to generate liquidity and recognize a partial gain given the growth of the underlying business from their initial investment. Minority recaps take place at the company level and offer the controlling sponsor a partial gain and more time with the asset without ceding control or bringing in a traditional investor with a longer time horizon.

Continuation vehicles, on the other hand, take place at the fund level. The sponsor wants to move an asset out of one fund and place it in a new fund with a new term and set of economics. Both structures can be great tools for buyout managers with strong assets and compelling theses.

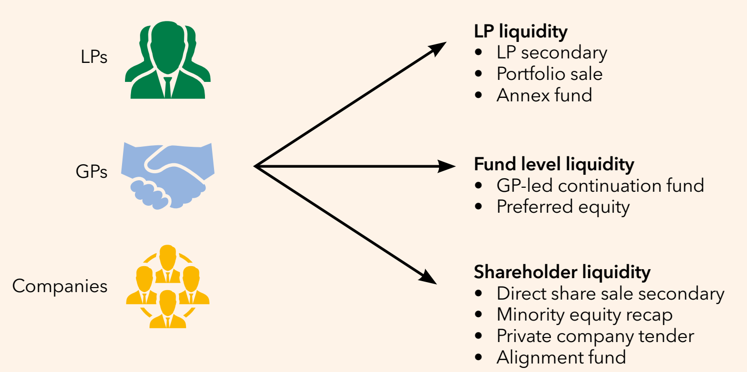
Rollover equity, meanwhile, is where a sponsor sells a business to another sponsor, but rolls into a minority position. By definition, there's a misalignment around timing from the outset of the transaction with the new sponsor. We're active buyers of these rollover equity positions, generally a year or two after the transaction when the former sponsor, now minority shareholder, needs liquidity.

Q Why would a GP be motivated to pursue asset liquidity strategies for generating fund returns?

Blake Heston: These strategies generate increased liquidity in an otherwise illiquid asset class, which, overall, is a positive for all participants – the GP, LP and underlying portfolio company. For the GP, these solutions create greater control and flexibility when it comes to optimizing value in the portfolio. Using these tools, the GP can focus on long-term value creation initiatives, while still meeting the liquidity horizons of their LPs, and any other company shareholders.

Firms pursuing these transactions are therefore looking to do several things. They're looking to increase LP distributions; partially monetize concentrated portfolio positions; manage fund life and team resources and then, at a company level, improve alignment amongst shareholders and management in order to drive common outcomes. The other benefit of a GP solution is that it enables the GP to reinvest in assets they know well. They're able to maintain relationships with their best performing portfolio companies, retain AUM in these assets, while at the same time, re-invest in areas where they see significant long-term growth potential. At W Capital, we use this chart to illustrate the range of liquidity solutions available to a GP at the LP, fund, and company level.

Range of GP solutions in the growing secondaries market



Q And what about growth equity firms?

TM: Growth equity firms tend to face a different set of challenges from control sponsors. These firms are typically minority investors in companies with multiple shareholders. It's inevitable that shareholders in these syndicated deals, coming in at different times and with different cost bases, fund constraints and liquidity expectations, are going to have different time horizons for the investment. We often work with these growth equity GPs through direct stock sales, tender offers, and something we call alignment vehicles.

In direct stock sales, we purchase minority positions in a company from a specific GP who wants to exit before a natural exit of the business. With tender offers, we offer partial liquidity to all shareholders, including management. Tenders are common when a company decides to push out their exit and wants to refocus everyone's attention on the next phase of growth versus having everyone myopically focus on a near-term liquidity event.

Finally, we're also working with growth equity investors through alignment vehicles. Here, we work with existing shareholders who want to expand their ownership in well-performing portfolio companies but who don't have the capital to pursue alone. We provide financing to an SPV, and partner with these GPs to pursue these compelling secondaries transactions.

Q What makes the GP-led solutions market an interesting investment strategy?

Katie Stitch: In these transactions, secondaries investors are partnering with top tier GPs and getting access to their best portfolio companies. These transactions involve well-performing portfolio companies that countless GPs would want to own but that are not for sale or seeking primary capital.

Furthermore, when buyers are evaluating an opportunity, they can evaluate how these companies have performed over the past several years under current PE ownership and management. Those insights are attractive to buyers in this market relative to other private equity strategies.

Alignment with existing GPs and management to a nearer term and visible path to exit is a third benefit. A big part of due diligence for buyers is ensuring that they are getting involved in an aligned win-win situation for new investors, ongoing GPs and the companies themselves.

Q This is a part of the private equity market that has really skyrocketed of late, of course. What changes are you seeing in competitive dynamics?

DW: On the buyside, we're seeing a significant level of specialization developing. For example, many of the big LP secondaries managers are now fully embracing GP continuation funds. But there are many different types of continuation fund opportunities for them to pursue, and you're seeing parameters being more clearly defined. For example, some groups prioritize diversification at the transaction level while others are happy to do single-asset transactions. Some groups have a strong preference for buyout-stage assets while others will look across venture and growth. Some groups require GP management of the assets while others prefer direct ownership.

As the market continues to expand and deepen, that specialization by type of seller, type of underlying asset and type of deal structure is increasing. You have players like W Capital coming at the market from a more bottoms-up and targeted approach with a growth orientation relative to the large-cap global secondaries players and a wide range of others in between.

"The hold period of underlying assets has continued to increase"

DAVID WACHTER

"A big part of due diligence for buyers is ensuring that they are getting involved in an aligned win-win situation"

KATIE STITCH

KS: Frankly, there is so much opportunity in the GP solutions space that some of this specialization is a result of investors needing to prioritize and maximize efficiency. We see this market as undercapitalized and under-resourced – a dynamic we think will continue given the pace of adoption by GPs and continued market growth. A high success rate in these transactions will likely persuade even more GPs to explore GP-led solutions for their portfolio companies. We see more experienced investors dedicated to this opportunity as driving greater opportunity for all participants.

DW: And it isn't only the secondaries players that are embracing this market. Direct GPs are interested in generating liquidity from these solutions for their best performing companies, on the one hand, but also in getting access to high growth companies on the buyside. Then you have hedge funds and crossover funds, keen to get access to pre-IPO opportunities. The range of market participants is certainly growing, but we see the sheer scale of opportunity is also enormous.

Q Where next for GP-led solutions? What does the future hold?

TM: We believe the explosive growth this market has witnessed over the past couple of years will continue as sponsors of all types embrace secondaries tools. In general, GPs are much more sophisticated around balance sheet management and, as a result, will continue tapping the secondaries market to better manage liquidity and returns, both at the fund and company level. We fully expect more GPs will seek out continuation vehicles, alignment vehicles – particularly on the growth equity side – and other targeted secondaries solutions. There's been tremendous innovation in the secondaries sector, and we certainly expect that trend to continue long-term. ■