Buyouts

Insight

Beyond CVs: The rise of direct secondaries

While continuation vehicles may not always be the optimal solution for sponsors and LPs, other attractive liquidity solutions are gaining in popularity, writes Todd Miller, partner at W Capital Partners.

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The private equity industry is undergoing a shift in how it creates liquidity and conducts portfolio management. The focus has moved beyond solely utilizing continuation vehicles to considering a broader range of GP solutions and structures that are more situationally appropriate, easier to execute and more LP friendly.

Continuation vehicles are a valuable technology and a modern solution for sponsors. CVs extend the duration of high-performing assets and generate liquidity while also maintaining assets under management and growing management fees. These are some of the many benefits that have driven the CV market to a more than $60 billion market over the past five years. While an attractive and growing market, LPs and secondary buyers are growing increasingly skeptical of sponsors utilizing CVs when no imminent liquidity need or duration issue is evident.

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For instance, why would a sponsor transfer a healthy three- to five-year-old asset into a CV when ample time remains within their existing fund to accrete value and ultimately exit the investment? Many LP teams also lack the necessary resources and are encumbered by their own internal approval processes to swiftly evaluate CV opportunities and decide whether to cash out or reinvest.

LPs are now recognizing that they've funded the J-curve and taken the blind pool risk, only to lose out on the de-risked and higher-return cycle of a mature portfolio company. Sponsors are beginning to appreciate that this burden should not fall on LPs when the sponsor still has time to maximize an exit within their fund's lifecycle.

This dynamic has driven sponsors to assess each situation and explore additional innovative liquidity solutions beyond traditional CVs – and excitingly there are many. The constrained exit market and the substantial overhang of global PE portfolio companies necessitates more proactive liquidity and portfolio management to maintain returns, deliver cashflow to LPs and stay competitive for future LP capital commitments. The rise of in-house capital markets teams at PE firms underscores GPs' growing commitment to exploring more creative liquidity solutions.

GPs increasing focus on optimizing liquidity strategies has fueled equally rapid growth in direct secondaries, which we estimate to be nearly equal to CVs in market size today.

A broader toolkit for optimizing liquidity

Direct secondaries, coupled with CVs, encompass what W Capital refers to as “GP solutions.” We foresee GPs utilizing this even broader range of GP solutions structures and alternatives to deliver the best possible outcome for their flagship funds, while also creating growth in assets under management and franchise value for their firms.

As an alternative to a CV, a sponsor with a three- to five-year-old investment is increasingly considering a minority recap (selling a minority stake) as a more suitable option. A minority recap with a secondary firm (rather than with a competitive buyout firm) allows the sponsor to generate liquidity, validate the asset’s valuation and retain control. This approach is appealing to LPs as it provides liquidity while maintaining upside within the asset, given it remains within the sponsor’s existing fund.

LPs are also spared the complexities of electing to cash out or reinvest. It’s a great all-around outcome for the GP, LPs and secondary investor. Whereas in a CV, the LPs are in conflict with the GP, are likely cashing out too early in a strong portfolio company and the GP took away the remaining de-risked upside from the flagship fund.

Direct secondaries also include multiple other structures such as: providing liquidity for one or more minority investors when the lead-controlling investors want to hold the asset longer; providing mid-life growth capital to deleverage and/or strengthen a portfolio company’s balance sheet for acquisitions; or providing liquidity to management through a tender offer. All of these structures mitigate today’s stress and disproportionate focus on short-term exits at the expense of long-term value appreciation.

Tailoring solutions to deal dynamics

GP solutions allow GPs to more precisely target the right solution for the right situation based on the current duration and return profile of the deal.

Duration: Most sponsor portfolios exhibit a traditional bell curve in terms of investment duration, with a small proportion of new investments, a small proportion of older investments and a significant concentration of investments aged three to seven years, as shown below:

- Recent investments are typically too early for a secondary transaction.
- Older investments are ideal candidates for a traditional exit or a CV.
- The majority of the portfolio, those three to seven years old, are well-suited for a direct secondary.

Return: Approximately 20-30 percent of the portfolio companies in a typical fund are outperformers, achieving a >2.5x unrealized multiple during various vintages and fund lives. These assets, that have demonstrated strong performance and have been marked up by the sponsor over time, are prime candidates for a secondary transaction and delivering partial liquidity to LPs. Duration is the overriding factor in determining the most suitable solution, with older assets aligning with CVs and younger investments being more appropriate for direct secondaries.

After many years of secondaries being considered a sign of weakness for a GP or asset, it is exciting to see the rapid embrace by the PE industry that secondaries are a new and vibrant tool for the private equity industry. As in almost all asset classes, more liquidity strengthens the market. GP-led secondaries have emerged as a permanent third option for sponsors when evaluating liquidity options.

With careful consideration, creativity and a mindful approach there are now secondary transaction structures suitable for almost every situation. However, sponsors must consider the asset's holding period within the flagship fund's lifecycle, its performance and unrealized returns, perspectives of the LPs, as well as their own portfolio management objectives.

Gone is the era in which PE firms aimed to invest over five years, hold and grow for five years and then exit within 10 years. Fortunately, the scale of capital and technological innovations in the secondary market will permanently improve the PE investment industry with much needed liquidity options.

Over the past 20 years, secondaries have moved beyond merely facilitating LP trades ("secondaries 1.0") or solely backing continuation funds ("secondaries 2.0"). Today, the market encompasses a large and growing direct secondaries market, offering a diverse range of solutions tailored to bespoke circumstances ("secondaries 3.0").

Leading sponsors are increasingly leveraging modern solutions to enhance portfolio liquidity and achieve their strategic goals. For sponsors new to the space, exploring the potential of the evolving secondary market serves as a prudent strategy to maintain a competitive edge.

Todd Miller is a partner of W Capital Group, a division of AXA IM Prime based in New York, and has been an active investor in the GP-led secondary, minority recap and secondary direct sector.

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