To Be Continued: The Case for GP-Led Secondary Funds

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DeMarche

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Points of Discussion

Abstract

General Partner-led (GP-led) secondary investments are an important part of an evolving toolkit for investors seeking strong IRRs and J-Curve mitigation while also avoiding the "blind pool" risk associated with traditional investments in private equity. Although situations may vary, DeMarche believes that continuation funds with strong alignment of interest provisions can present a particularly attractive proposition as investors build out their private markets portfolio.

A Changing Landscape

Many of us recall a time before DVRs in which television shows used “to be continued” as a technique to encourage future viewership by linking two episodes together. In many cases, the cliffhanger would not be resolved for an entire week. Fortunately those days are largely behind us. We can binge watch an entire season of our favorite show over a rainy weekend! Conversely, private equity secondary investing has reached a point where “to be continued” is more and more common. The common thread is that it wasn’t always possible to know what lies ahead, although we often suspected that Batman and Robin would likely survive to fight crime in Gotham City another day. In the case of private equity funds that are to be continued, the sponsoring general partner (GP) also believes that they know how the fund’s story will have a positive ending as well.

The market for secondary private equity interests continues to evolve. While the secondary market emerged in the late 1990s as a venue for limited partners (LPs) to transact fund interests, the latest decade has brought hyper-growth of commitments to “secondary funds” that are specifically designed to target these opportunities. This trend continued into 2019 as six of the 20 largest private equity funds raised that year were secondary funds. Further, dry powder in the secondary market today is $180 billion, continuing a secular trend dating back to at least 2012, as evidenced by the graphic in Figure 1.

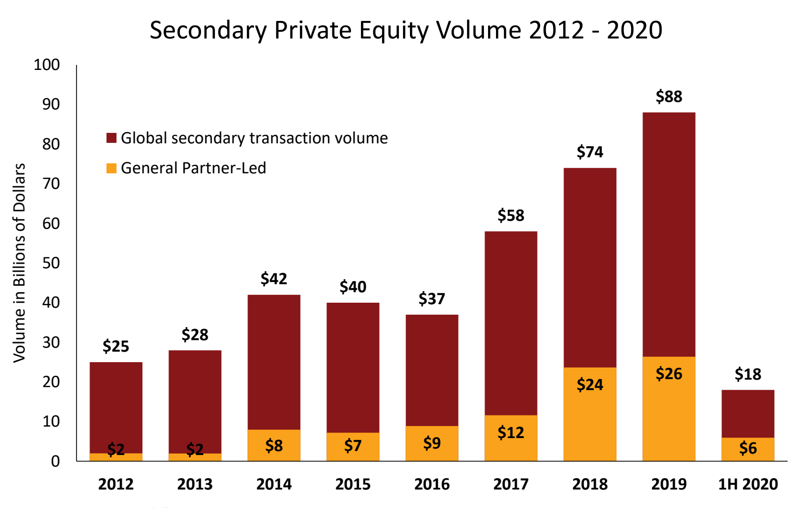


Figure 1

Investors Discover Secondaries

Initially, secondary markets were pretty homogeneous and more or less a direct derivative of the primary market for private equity. Historically, secondary investors sought diversified exposure to private companies by purchasing LP fund positions (or sometimes an entire portfolio of LP fund positions), usually at a discount to Net Asset Value (NAV). The ability to "look through" a portfolio was considered highly desirable, especially for those investors seeking less "blind pool" risk. However, as Michael Woolhouse of TPG Capital has noted, large secondary funds that might contain several hundred underlying companies represent more of a macro investment, thus lessening the importance of underwriting individual companies.[1]

Following the Great Financial Crisis (GFC), managers typically competed in the secondary market by positioning their offerings as benefitting from differentiated deal flow or proprietary due diligence and underwriting capabilities. Leverage was relatively rare, and GP-led and single asset transactions were not typically on the agenda. Fast forward to today and the market for secondary investment opportunities has developed into an increasingly complex ecosystem with different investment strategies focused on fundamentally different economic exposures. This paper will focus on GP-led secondary investing and, more specifically, so-called "continuation funds," which have at times been unfairly accused of being the sole purview of sponsoring GPs that, often for self-serving reasons, did not want to call it quits just yet.

As private equity allocations have continued to increase, as evidenced in Figure 2, plan sponsors often turned to private equity secondaries as an effective J-Curve mitigant as committed capital was typically put to work quickly. Attractive IRRs often followed as successful secondary funds generated significant cash returns, having purchased LP interests that were often in the harvesting phase. In addition, new entrants to the asset class could attain immediate exposure to investments across prior vintages, strategies, and industries.

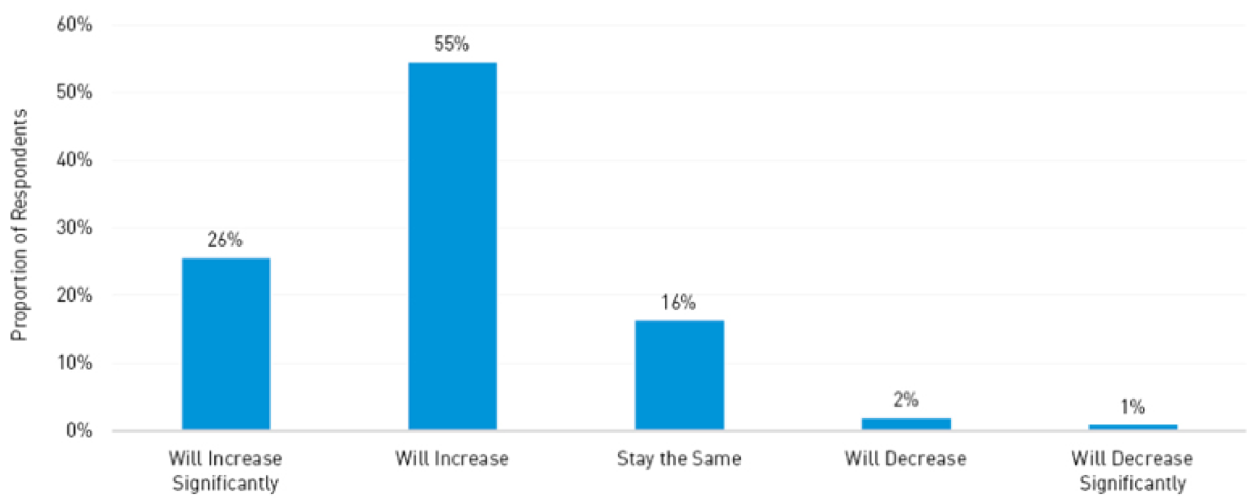


Figure 2

Source: Preqin Investor Survey, August 2020

[1] A. L. (2021, March 1). *GP-led Secondaries Enter New Waters*. Private Funds CFO. https://www.privatefundscfo.com/gp-led-secondaries-enter-new-waters/.

Holding Periods Are Increasing

In general, PE firms often sell their best performers early, thus locking in gains (and attractive IRRs) for investors, while at the same time providing liquidity (these early "wins" are also often celebrated in subsequent capital raises). However, it has become evident that a major structural limitation of the typical PE fund model is that after 10 years the trajectory of one or more portfolio companies could still be very promising, even after a strong return had often been locked in for the fund. According to a recent report issued by Morgan Stanley, prior to the Global Financial Crisis, approximately 40% of private equity portfolio companies were sold within three years of acquisition.

From 2009–2018, however, the average holding period has increased by 32%. As a consequence, the median time it takes for a private equity fund to liquidate fully is now longer than 13 years, while the average term for a PE vehicle remains at 10 years. GP-led secondaries are ideally positioned to address this duration mismatch.

Initially, secondary strategies were often associated with broken or "zombie" funds with misaligned (future) economics and were characterized as existing to maintain fee generation for the GP. At times, legitimate criticism was leveled against the sponsoring GP as it became apparent that the existing fund/strategy was not going to generate competitive results (and associated carried interest for the GP). As a result, subsequent funds would not be coming to market, or would likely be much smaller. Therefore, holding onto some tail-end assets and collecting management fees (while hoping for a miracle) became a path forward for some GPs while they plotted their next move. However, as LPs have become more sophisticated (often backed by strong advisory boards, not to mention the Institutional Limited Partners Association's (ILPA) guidance), a different picture has started to emerge. Specifically, a paradigm change has occurred in which secondary offerings are now part of a much more robust tool set for plan sponsors versus a last-ditch provider of liquidity.

GP-led to the Rescue!

Today, certain secondary investors focus on tail-end fund solutions, whereas others seek to invest in more recent vintages that are still deploying capital. To navigate today's complex secondary market, investors need to answer a single but key question: What risk-return profile and secondary investment strategies are appropriate for my portfolio? To answer this question, it is important to look at the different types of underlying secondary transactions and investment strategies. Generally, transactions range from (i) highly diversified portfolio deals that can be levered to (ii) very concentrated single asset deals. In highly diversified portfolio deals, idiosyncratic risk is relatively low and higher returns are often achieved by employing additional leverage. These types of transactions essentially provide levered beta exposure to PE as an asset class. On the other end of the spectrum are single asset transactions with higher idiosyncratic risk. This type of approach, at times, provides initially high IRRs that can burn off as discounts are realized. The potential to generate high return multiples is, however, often limited given the high level of diversification and mature nature of the underlying investments. Secondary strategies that provide this exposure are typically more focused on IRR and less focused on return multiples. Returns for these portfolios are often driven by capturing inefficiencies at the smaller end of the market or by exposure to a successful individual deal.

Before the advent of GP-led secondaries, GPs were often faced with primarily two, arguably sub-optimal, paths—either sell to another entity and forego future potential value appreciation or try and extend duration for all LPs and reduce the liquidity available to LPs who may lack patience. Compounding this decision are recent macro events like the global pandemic, which often served to throw off the best laid plans. Enter the single-asset continuation fund.

What is a Continuation Fund?

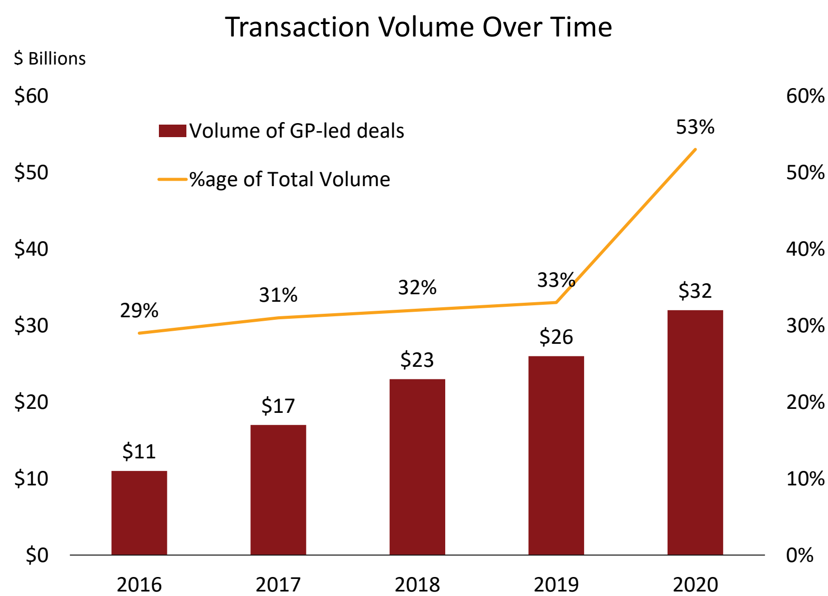
A single-asset continuation fund is actually a Special Purpose Vehicle (SPV) in which the secondary buyer provides liquidity to the sponsoring GP, looking for either additional capital or a longer runway for value realization. The establishment of the SPV allows GPs to continue to manage a particular holding for a longer period of time while also providing follow-on capital as needed. Second, the SPV offers existing LPs the option to cash out or to remain invested for a longer duration. Investors that roll their interest into the newly created (and concentrated) strategy should reasonably expect to benefit from the GP's deep knowledge of a specific asset and exposure to the assets with the greatest remaining return potential within the GP's portfolio. On the other hand, an LP may be wary of holding such a concentrated position and prefer a more diversified approach with their capital. Also key is understanding that existing investors who opt to roll into the continuation fund receive a corresponding economic interest in the new fund, so no new tax liability is incurred. Perhaps more importantly, any earned carried interest from the previous fund typically becomes an LP interest in the continuation fund, thus improving alignment of interest.

According to Evercore in 2020, 27% of LPs elected to roll their investment into the continuation fund. However, it's very possible that the pandemic may have skewed that number.

To increase the likelihood of a successful outcome, the general partner must set, and the limited partner(s) must understand, how potential conflicts will be identified and addressed. Specifically, ILPA recommends that limited partners should receive detailed disclosures on the terms of the new entity created by the restructuring, particularly around any differentiation in terms for new or rolling LPs. Limited Partner Advisory Committee (LPAC) members should be provided enough information to assess whether the GP-led process was appropriate to ensure that a fair price was obtained. A fairness opinion from an independent financial advisor may be helpful in this context. Additionally, the general partner should provide to the LPAC a description of the solicitation process and overview of bids received. Limited partners should review existing fund documents, including side letters, especially in cases where they may be aware of the opportunity to update the side letter in cases where they may be rolling into a new fund (and new agreement).

Conclusion

Like some of our favorite old TV shows, DeMarche believes that continuation funds are likely going to be a permanent part of the private equity investment landscape, as evidenced by GP-led secondary volume eclipsing 50% of the total opportunity set according to Evercore's 2020 Year End survey data (Figure 3).



Source: Evercore

Figure 3

As such, DeMarche expects GP-led secondary funds to be an important part of the solution set used by institutional investors in reaching their target allocation for private equity.

Put Research to Work
with the DeMarche Team

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