ROUNDTABLE

SPONSORS

DEBEVOISE & PLIMPTON • JEFFERIES • LANDMARK PARTNERS • NEUBERGER BERMAN
PJT PARTNERS • SCHRODER ADVEQ

Untold potential

The sheer scale of GP-led secondaries opportunities is enormous. But with turnover still marginal, the LP secondaries market is also poised for exponential growth, write Amy Carroll and Adam Le

It is no secret that the concentrated GP-led secondaries market has exploded over the past 12 months, as sponsors have weighed up the comparative risks of executing new buyout deals in the midst of a global pandemic, against holding on to high-conviction assets with proven management teams for longer.

LPs are also increasingly supportive of these single, or concentrated multi-asset, deals. "Two-thirds of private equity M&A exits are sponsor-to-sponsor," David Perdue, partner in the strategic advisory group at PJT Partners, says at our secondaries roundtable.

"If you are a large LP, that means the chances are you will be owning the same underlying risk. But take deal frictions into account, plus the fact you have an unproven relationship between the new sponsor and management team, and LPs inevitably start to wonder if it wouldn't be better for these high-quality assets to stay where they are."

Meanwhile, for secondaries buyers, of course, these transactions have come to represent the opportunity to access exceptional managers and their star portfolio companies. But with the full pricing and inherent concentration risk that come with the assumption that you are buying into the best, diligence is key.

"If you are going to put a big chunk of your fund into a particular asset, you need to be sure you have done all the work you possibly can – not limited by lawyers, or access to the GP, or deadlines," says Christiaan van der Kam, head of secondaries at Schroder Adveq. "One of the most attractive aspects of GP-led deals is the ability to be in discussions with the sponsor throughout the life of the process and ideally even before the process has begun."

Indeed, Scott Humber, a partner in Landmark Partners' private equity group, adds that his firm has been known to have conversations for over a year before an actionable opportunity emerges.

"That transaction may then go to a broker. It often makes sense for a GP to clear the market and have that third-party vetting," he says. "But we are still able to have meaningful influence in crafting the structure. We would much rather be in that position than having limited time, limited access to information, and limited input."

The other essential ingredient for a concentrated GP-led transaction is alignment. "Complex deals really do need to be a win-win-win for all the counterparties at the table," says Scott Beckelman, managing director and co-head of private capital advisory at Jefferies, adding that this can manifest itself in a number of ways, including an increase in GP commitment, the roll or re-investment of any realised carry and a shift in economics, such as a reduction in management fee or tiered carry structure, as well.

"Alignment with the GP is very important. There are some GPs that are taking a lot of money off the table and no longer have enough skin in the game," says Humber. "We will press

hard on that aspect of a deal and walk away if the alignment is not there."

Secondaries or syndication?

As appetite for single-asset GP-led deals escalates, however, that ability to do due diligence and achieve enhanced alignment is becoming harder to achieve. John Rife, partner at Debevoise & Plimpton, points to a recent deal he worked on involving a syndicate of around 30 investors, none of which was a recognisable lead.

"The GP decided to use the same documentation it had negotiated and agreed for a prior GP-led secondaries deal," he recalls. "I am not really sure that is the best way to be doing these transactions. I don't think it creates the right alignment tailored to the deal."

"Those sorts of deals look to us like more of a syndication," agrees Tristram Perkins, head of secondaries at Neuberger Berman. "The GP picks the asset, sets the price and terms for the continuation vehicle. And the investors line up. That dynamic is a whole lot less interesting to us than the more complex multi-asset deals, where we may not necessarily be shaping the portfolio, but we have input and we work with the GP directly to negotiate the price and the GP economics. From a complexity standpoint, those syndicated, single-asset deals feel more like capital markets trades when compared to negotiating, structuring and closing a multi-asset continuation fund, which can feel like closing multiple-buyout deals in parallel."

There is also a trend towards sponsors using a continuation fund in parallel, or on the heels, of a partial M&A stake sale, where pricing is derived from that third-party process.

"The sponsor uses that as a tool to lock in a great return for an older fund, giving LPs the opportunity to re-invest but also to generate liquidity on attractive terms," says Beckelman. "In those cases, the secondaries market is

"Complex deals really do need to be a win-win-win for all the counterparties at the table"

SCOTT BECKELMAN
Jefferies

"The challenge is limited bandwidth. It can be difficult to corral everyone's time and attention because of the exceptional volume of supply"

DAVID PERDUE
PJT Partners

Tristram Perkins

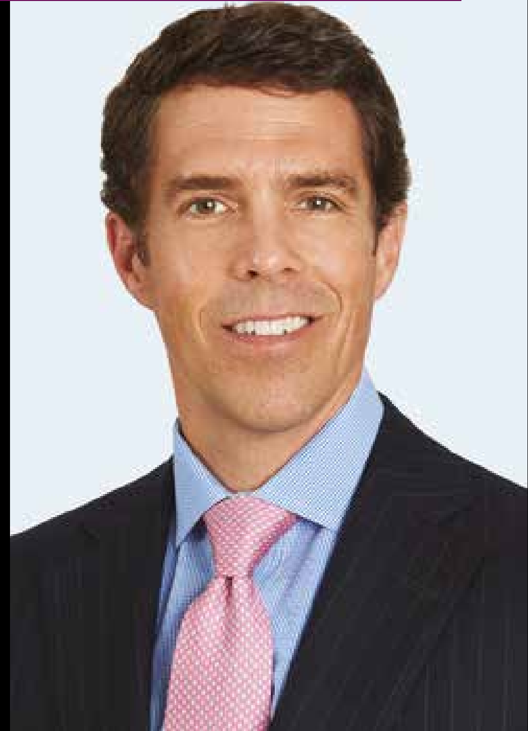
Managing director and global head of secondary private equity, Neuberger Berman

Tristram Perkins oversees the origination and valuation of secondaries investments. He joined Neuberger Berman from Deutsche Bank, where he spent eight years in the private equity division. Prior to that, he worked for four years in investment banking with Alex Brown & Sons.

Scott Beckelman

Managing director and co-head of private capital advisory, Jefferies

Scott Beckelman joined Jefferies at the start of 2021, after a secondaries market career that spans Landmark Partners, Cogent and, most recently, Greenhill & Co. At Jefferies, he and his team will advise private equity sponsors and their investors seeking liquidity from the secondaries market.



John Rife

Partner, Debevoise & Plimpton

John Rife is a partner in the corporate department at Debevoise & Plimpton and a member of the firm's funds group. He is also a leader in the alternative assets transactions and liquidity solutions group and regularly advises sponsors and investors on secondaries transactions, including GP-led fund restructurings, LP interest portfolio transactions and fundless sponsor transactions.

Scott Humber

Partner, Landmark Partners

Scott Humber is engaged in all facets of Landmark's secondaries private equity investment activities, including origination, negotiation, structuring and capital raising. Prior to joining the firm, Humber worked at Boston Capital Private Equity Partners and Triumph Capital Group. He began his career at Salomon Smith Barney.

Christiaan van der Kam

Head of secondaries, Schroder Adveq

Christiaan van der Kam joined Schroder Adveq from Unigestion last year. At Unigestion, he was co-head of secondaries and instrumental in building the firm's secondaries platform. He has also worked at New Amsterdam Capital and ATP Private Equity Partners.

David Perdue

Partner in the strategic advisory group, PJT Partners

Prior to joining PJT Partners, David Perdue worked at Goldman Sachs, managing private equity, family office and related portfolio company client relationships. He previously worked in Goldman Sachs' leveraged finance group but began his career in the telecommunications industry, most recently at AT&T.

not being used as a pricing mechanism, but as a syndication mechanism. You are co-investing alongside that sponsor at a pre-determined price, rather than crafting a customised solution."

Indeed, the growing convergence between single-asset secondaries and co-investment is a challenge in itself. "One challenge that we see, when we look at these single-asset deals being priced through a minority buyout transaction, as opposed to the secondary market, is the incremental layer of GP economics paid by the secondary investors," says Perkins. "We have struggled on a number of these deals to make the math work for our investors."

Van der Kam adds: "Some of these GP-led deals are more akin to co-investment in terms of the underwriting risk, which couldn't be more different to the underwriting risk involved in acquiring a large portfolio of fund positions. Of course, by focusing on the best assets and the best GPs, you are taking a lot of that risk off the table. But price is often being sacrificed. Some of these transactions have priced at highly questionable levels."

> *"It feels like buyers used to adopt a three-strikes before you kill the deal rule. Now it seems to be one strike, before you divert resources to something else"*
>
> **JOHN RIFE**
> **Debevoise & Plimpton**

Back to basics

Indeed, the definition of a secondaries investment has morphed to such an extent, that it is important to go back to basics – and remember the dynamics that underlying investors are typically seeking from secondaries exposure, namely diversification and J-curve mitigation.

"Single-asset transactions tend to have the opposite return profile as compared to a classic LP portfolio transaction, the latter of which has high diversification, shorter path to liquidity and pricing at some level of discount to NAV," says Beckelman. "Although, buyers can get comfortable with the more concentrated nature of GP led deals through deeper diligence and ability to ensure proper alignment and governance going forward."

Furthermore, Perkins notes that the liquidity profile for Neuberger Berman's GP-led deals has, in fact, been similar to its traditional LP secondaries. But Humber says that duration is something to be mindful of when stepping into GP-led deals and evaluating the possibility of early liquidity, such as a potential dividend recap, should be considered when assessing transaction opportunities.

The way to enhance diversification, meanwhile, is to complement concentrated GP-led transactions with large diverse fund portfolios. Because, while the GP-led market is flourishing, the LP secondaries market is also coming back with a vengeance.

Not only is the pipeline of deals that stalled amid the volatility of the pandemic starting to return to the market, but a significant proportion of the vast number of LPs that have never pursued a secondaries sale before are beginning to contemplate the opportunity.

"LPs are spending more time than ever underwriting and re-evaluating their existing portfolios," says Beckelman. "This dynamic, coupled with an active new primary investment environment, is prompting many LPs to pursue secondary sales of funds well before they reach the 'tail-end stage', resulting in more recent vintage assets for sale and adding to an overall increase in turnover."

Indeed, if anything, it appears that the biggest limiter on secondaries

"One of the most attractive aspects of GP-led deals is the ability to be in discussions with the sponsor throughout the life of the process and ideally even before the process has begun"

CHRISTIAAN VAN DER KAM
Schroder Adveq

activity, currently, is human capital constraint. The situation has been exacerbated by the dominance of GP-led deals, which typically require more diligence.

"That is particularly true of concentrated portfolios," says Perdue. "The challenge is limited bandwidth. It can be difficult to corral everyone's time and attention because of the exceptional volume of supply."

Bandwidth constraint has also led to buyers being more willing to walk away from transactions. "I have worked on more deals that have fallen over in the past 12 months that the entirety of the rest of my career," says Rife. "It feels like buyers used to adopt a three-strikes before you kill the deal rule. Now it seems to be one strike, before you divert resources to something else.

"Those deals are either falling over because buyers have dug into the economics and the numbers aren't there,

Debt and secondaries

Leverage is increasingly being used to accelerate cashflow, especially on index deals

"Investors in secondaries funds are increasingly focused on the use of intermediate leverage – not fund level borrowing, which tends to be governed by the LPA, and not asset level leverage, but the financial engineering that goes on between the two," says John Rife of Debevoise & Plimpton.

"We have seen a fair amount of NAV facilities being used to accelerate cashflow back to investors and that is something LPs are now more clued up on and more interested in regulating."

Tristram Perkins of Neuberger Berman, meanwhile, says there is bifurcation in the use of leverage between the index secondary funds – buyers of large, diversified portfolios of private equity funds – and those secondary managers executing more complex GP-led deals.

"We have sold funds into the secondaries market ourselves on behalf of our investors. These are secondary funds sold in years 10, 11 and 12, with upwards of 500 underlying companies, typically sold to a single buyer," he says.

"And to us, it looked as though upwards of 40 percent of the return generated from those diversified index deals is being driven by buyers' use of leverage."

Jefferies' Scott Beckelman adds: "We are witnessing an increasing number of sponsors recapitalising debt for portfolio companies that are part of secondary transactions. Continuation fund transactions mark an inflection point for the sponsor and management team and it's a logical time to re-evaluate capitalisation and ensure it is optimised for the company's next leg of growth."

or because over the course of the transaction it becomes clear the sponsor is being less than above board, either with the buyers or their existing LPs. It is long way from being fraudulent, but it does raise questions over whether this is a GP you want to jump into bed with."

Explosive growth

There seems little doubt, however, that the secondaries asset class is on the cusp of an explosion. Despite the fact the market started out 2021 with a capital overhang of 2.9x – equating to around $177 billion of dry powder against deal volume for the previous 12 months – the roundtable participants describe the market as undercapitalised, in terms of both human resources and funds.

Humber is also convinced that, with the right human resource in play, the scale of the secondaries market opportunity is vast.

"A supply/demand balance of approximately two years of normalised transaction volume is an attractive dynamic for buyers, especially when compared to the approximate five-year overhang in the primary buyout market," he says.

"Furthermore, despite the growth we have seen in secondaries, it remains a very small proportion of the overall primary market – around 5 percent. That means there is significant white space in the market and shows just how much potential remains."

Van der Kam highlights the untapped opportunity at the lower end of the market. "Two-thirds of secondaries capital sits with a handful of groups that have raised $10 billion-plus funds. Those groups tend to focus on large, diversified portfolios or large cap single-asset deals. There is a real opportunity for GP-leds further down the market, particularly if we can get the advisory community involved," he says.

Perdue points to opportunities in adjacent asset classes. "The market is heavily focused on the private equity industry today," he says. "But more and more money is going into real estate, infrastructure, venture capital and private credit – only a very small part of those markets has really started to transact."

Rife, meanwhile, believes that opportunities emerging directly from the current crisis have yet to run their course. "It is not clear to me that the

> *"Alignment with the GP is very important. There are some GPs that are taking a lot of money off the table and no longer have enough skin in the game. We will press hard on that aspect of a deal and walk away if the alignment is not there"*
>
> **SCOTT HUMBER**
> **Landmark Partners**

> *"Turnover today is so low, and it is our view that even a half a percentage point [turn] increase would have a massive impact on dealflow"*
>
> **TRISTRAM PERKINS**
> **Neuberger Berman**

full economic consequences of the pandemic have really trickled through the economy yet and so I think the secondaries market will have an important role to play when they do," he says.

The potential to open up private equity to retail investors could also represent a step change in secondaries activity. "We expect to see a whole new universe of participants ultimately looking for liquidity," says Perkins. "Turnover today is so low, and it is our view that even a half a percentage point [turn] increase would have a massive impact on dealflow. We are confident in our belief that the market will continue to grow by leaps and bounds."

Finally, the growing trend towards GPs selling minority stakes in themselves to permanent capital providers spells yet another opportunity. Just over half of the 100 largest managers are understood to have completed some type of deal such as this, and some of these managers have subsequently used the secondaries market to generate liquidity for their minority stake holders.

"We have seen permanent capital providers move into that space, but they too will need liquidity and there are opportunities for the secondaries market there," says Humber. "And bear in mind that most GP stake transactions have been concentrated in the largest, most-established managers. As more capital is raised to pursue these types of transactions, it is likely that there will be a natural shift towards smaller GPs."

It is clear then, that the secondaries industry is benefiting from some gale-force tailwinds, not least the meteoric rise of the concentrated GP-led secondary. In 2015, only around $7 billion of GP-led deals were completed. There is roughly $7 trillion of invested capital in private markets asset classes today. "The potential is enormous," adds Humber. "The numbers, quite frankly, speak for themselves." ■