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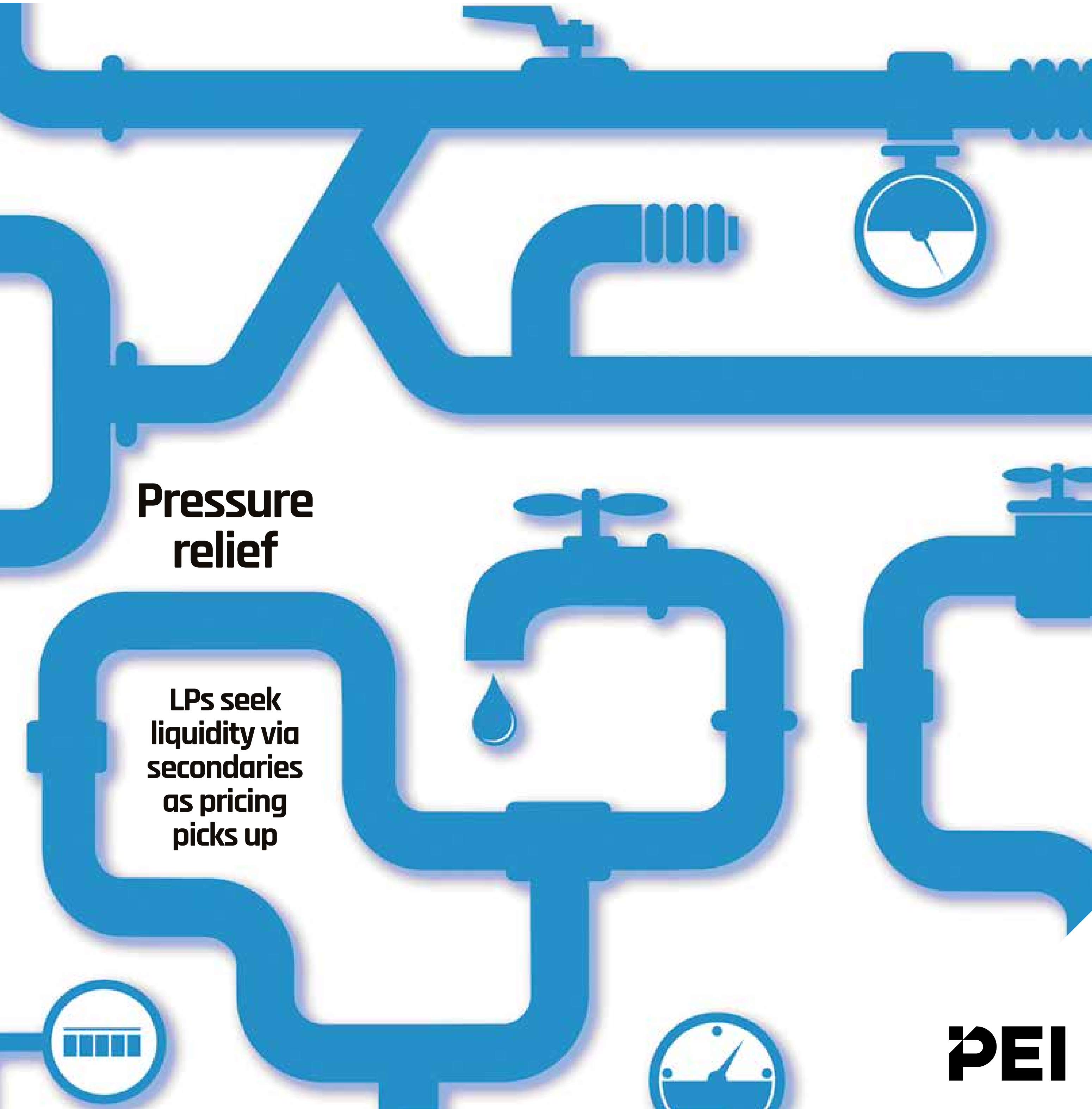

Pressure relief

LPs seek liquidity via secondaries as pricing picks up

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Editor's letter

Secondaries gears up for growth

Louise Fordham
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While last year's secondaries transaction volume didn't reach the dizzying heights of 2021, activity remained robust, with $100 billion-plus transacting globally for the third year in a row. This momentum is expected to continue through 2024. Some advisers are even predicting that it will be a record year for secondaries, propelled by ongoing liquidity needs, favorable market dynamics and the continued maturation of the industry, which has brought with it a greater range of structural innovations.

Indeed, a growing number of sponsors have been drawn to the GP-led market as they look to continuation funds to extend their hold on trophy assets or as an alternative route to exit amid weaker M&A and IPO markets. Meanwhile, more LP portfolio sales are being shopped on the secondaries market, attracted by strengthening pricing and a desire to generate liquidity and manage their portfolios.

Whether buyside demand can catch up with supply is another matter. Undercapitalization has been the perennial thorn in the side of the secondaries market, but that slowly seems to be changing. While 2024 wasn't a record year for transaction volume, it was for secondaries fundraising, with a number of eye wateringly large funds closing.

"Undercapitalization has been the perennial thorn in the side of the secondaries market"

In addition, new entrants are emerging on the buyside, including buyout firms launching dedicated secondaries strategies. Specialization also appears to be intensifying among new and long-standing players, for example, specialization by strategy, such as dedicated GP-led funds, or by segment – with the mid-market proving particularly appealing.

It will take time for the pool of secondaries buyside capital to become large enough to realize the full scale of the opportunity, but the long-term outlook for the market certainly appears to be characterized by growth.

Louise Fordham

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April 2024

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Insight

Secondaries trends **Maturing market attracts a more regular flow of LP and GP sellers as the buyside expands**

Amid a tough year for private markets, secondaries proved a bright spot in 2023, ***writes Louise Fordham.*** While private equity capital raising remained relatively stagnant year on year, global private equity secondaries fundraising neared the $100 billion mark, according to *Buyouts* data, roughly three times higher than in 2022. North America-headquartered firms accounted for $82.9 billion of the capital raised for such funds, up from $19.2 billion the prior year.

Meanwhile, global secondaries transaction volume exceeded $100 billion for the third consecutive year, according to adviser estimates, with activity picking up in the second half on both the LP- and GP-led sides of the market. Here, we look at what is driving LPs and sponsors to transact on the secondaries market, and how the surge in capital raised for secondaries strategies could help address chronic undercapitalization.

1 Strengthened pricing fuels LP-led dealflow

As exit activity has stalled, so too have distributions to LPs, hampering their ability to commit to newer funds. The secondaries market has long been a tool for LPs to generate liquidity, but unfavorable pricing saw more reticence among investors to shop portfolios in 2022 and H1 2023, with some pulling back after testing out pricing or receiving unsatisfactory bids.

However, the second half of last year saw a renewed flurry of activity as pricing strengthened. According to Jefferies, pricing rebounded by 400 basis points from 81 percent of NAV in 2022 to 85 percent of NAV in 2023, with pricing for buyout funds reaching 91 percent of NAV. Pricing for LP-led deals is expected to improve further this year; indeed, a recent survey of secondaries market participants conducted by Campbell Lutyens found that 38 percent of respondents believe these transactions will be more expensive through 2024.

"Secondaries pricing has increased, and buyer appetite has improved considerably, driven by a mix of successful, record secondary fundraises, public equity market appreciation and a much-improved macro sentiment," says Scott Beckelman, a managing director and global co-head of private capital advisory at Jefferies.

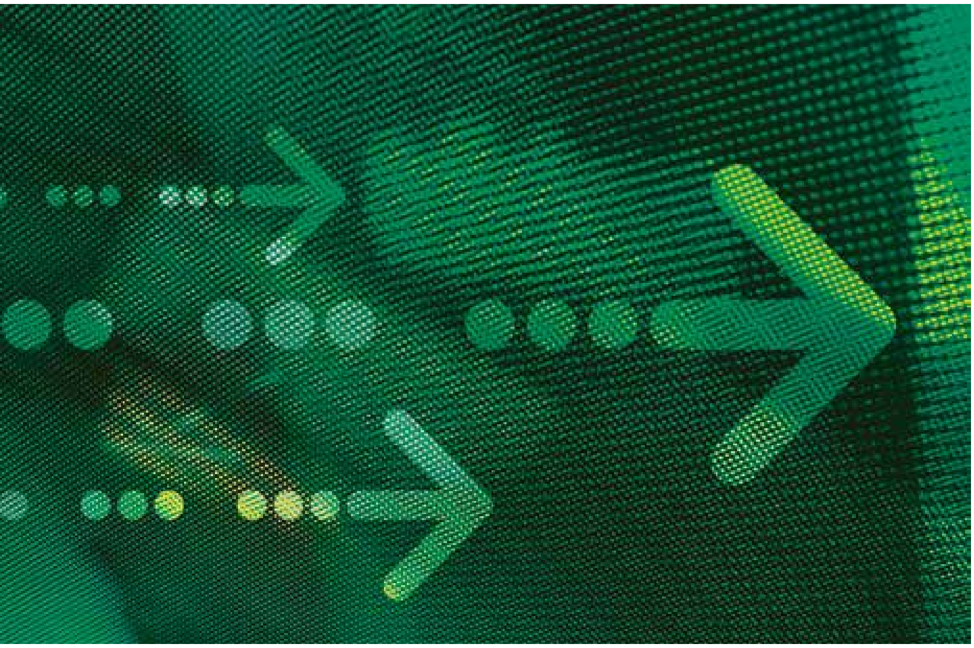
"While LPs continue to grapple with the same underlying need for liquidity, pricing has improved to the point where sellers are able to fully satisfy their objectives and large transactions are now clearing the market."

Such transactions include the likes of a $1.4 billion-plus sale of fund stakes by Los Angeles County Employees' Retirement Association, which is understood to have closed in the spring with a group of buyers.

While liquidity appears to be the primary reason for shopping portfolios in the current environment – liquidity was the rationale behind

$60bn

LP-led transaction volume in 2023
Source: Jefferies' Global Secondary Market Review, January 2024



> 100 percent rollover is a very important feature of alignment from our perspective, but it is really the starting point
>
> Charlotte Morris, Pantheon

44 percent of LP-led deals that closed in 2023, compared with just 10 percent in 2022, per Lazard data – LPs are also becoming more comfortable at using the secondaries market as a regular means of portfolio management.

Non-profit healthcare organization Kaiser Permanente, for example, recently came back to market with a multi-billion-dollar portfolio of private equity fund stakes, its third process in three years. The deal was anticipated to close in H1, with the expectation that around $1 billion to $2 billion would transact, sources told *Buyouts* in March. The institution previously closed a $5 billion-plus portfolio sale in June 2023, one of the largest-ever secondaries sales.

While a number of North American LPs now regularly use the secondaries market to actively manage their portfolios, there are signs that this approach could become more widespread among investors.

"We're seeing a much broader cross-section of LPs approaching the market for the first time," Ben Pearce, a partner and head of LP secondaries advisory in EMEA at Campbell Lutyens, told affiliate title *Secondaries Investor* in March, "and when they see what value the market can offer and how deep, mature and efficient it can be, many will be added to the list of repeat sellers using the market to more actively manage their portfolios."

2 Buyers take their pick of GP-leds

GP-led activity has been fairly robust over the past year – around $52 billion transacted in 2023, per Jefferies data, in line with 2022 – although the growing wave of deals coming to market continues to outstrip the supply of buyside capital.

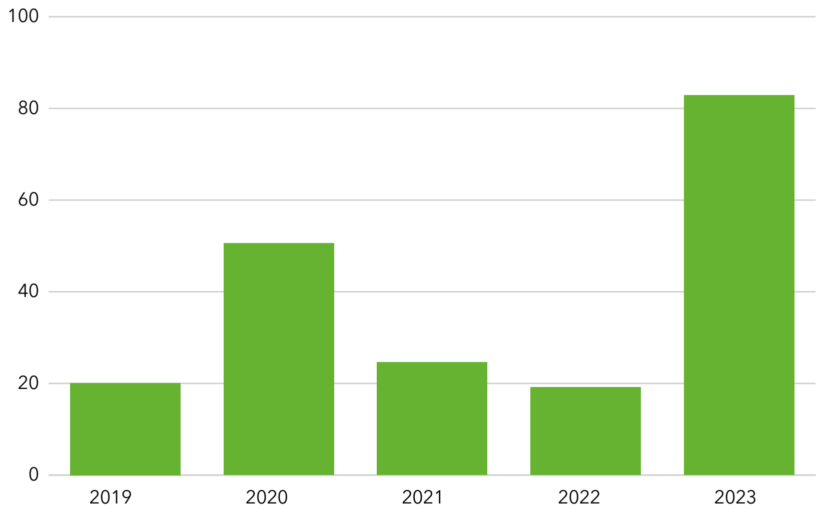
Continuation funds have proved to be an enticing prospect for sponsors, enabling them to deliver liquidity to those LPs that want it, to extend the value-creation runway for what are often prize assets, to raise addition capital to support portfolio company growth, or to wait until exit markets become more favorable.

However, the mismatch in supply and demand means that it is a buyers' market. "Given the meaningful opportunity set today, secondaries buyers have the ability to be highly selective in the deals they choose to pursue," says HarbourVest Partners managing director Rajesh Senapati.

"This includes the ability to potentially shape a portfolio that is high quality but that will also price well for LPs receiving the liquidity option. Taking a mixed-quality portfolio to market today as part of an end-of-life solution may not get the level of interest that GPs would like, or the type of pricing LPs may be looking for."

Not only do sponsors need to ensure they select the right asset, or assets, to successfully complete a GP-led transaction, they must also demonstrate a compelling rationale for the deal and clear alignment of interests. One way they can demonstrate the latter

Private equity secondaries fundraising by North America-headquartered firms ($bn)



Source: Buyouts

51%

GP-led deals as a proportion of secondaries transactions that involved deferred payments in 2023
Source: Campbell Lutyens' 2024 Secondary Market Overview

is through the GP commitment.

Last year, more than nine in 10 deals saw the sponsor roll at least 100 percent of their proceeds, according to data from PJT Park Hill. In addition to rolling over all their proceeds, sponsors also made incremental commitments on 43 percent of deals and a further 18 percent saw GPs make new fund commitments.

"That 100 percent rollover is a very important feature of alignment from our perspective, but it is really the starting point," says Charlotte Morris, a partner in Pantheon's global secondaries team. "We expect GPs to consider whether they have further capital to invest and it is a strong endorsement if the deal team are willing to invest more cash out of their own pockets."

Meanwhile, sponsors also appear to be increasingly open to structures such as deferred payments to help bridge gaps in pricing expectations and get deals across the finish line.

Some 63 percent of respondents to Campbell Lutyens' survey used deferred payments last year, with GP-led transactions accounting for 51 percent of transactions in which deferrals were used, up from 6 percent in 2022.

"GPs recognize they need to show the best price possible in order to ensure that any offer is well received by LPs," says Gerald Cooper, a partner and head of Campbell Lutyens' secondaries advisory practice in North America.

"We are seeing GPs using deferrals to move up pricing to par or as close to NAV as possible. LPs are welcoming the opportunity to sacrifice immediate liquidity in order to generate a few extra percentage points on the purchase price."

3 Green shoots appear amid undercapitalization

While structural innovations are helping to support secondaries transaction volumes, undercapitalization remains the key threat to the industry's continued growth, hindering buyers' ability to meet the increasing number of deals coming to market.

Yet there are green shoots here. Last year was a record-breaking one for secondaries fundraising – the highest-ever amount of capital was raised by secondaries funds globally at just shy of $100 billion, and Lexington Partners smashed the record for largest-ever secondaries fund, closing its latest flagship vehicle on $22.7 billion.

LPs' taste for secondaries has grown steadily in recent years. The proportion of investors planning to commit capital to private equity secondaries funds over the next 12 months now stands at 59 percent, according to affiliate title *Private Equity International*'s *LP Perspectives 2024 Study*, up from 44 percent in the 2020 study.

It's not just established secondaries buyers that are benefiting from LP appetite for secondaries exposure – new players are also entering the market. "Big funds will continue to get bigger, undoubtedly," says Immanuel Rubin, a partner and head of European secondaries at Campbell Lutyens. "But we are also seeing quite a few entrants, particularly in the single-asset GP-led space."

Many of these new entrants appear to be tapping into the growing trend for specialization in the secondaries market, focusing on the burgeoning but undercapitalized continuation fund space.

For example, European buyout firm Astorg has launched a single-asset continuation fund strategy, while Leonard Green & Partners is expected to launch its debut GP-led fund later this year. ■

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- Our team fully integrates practitioners with **top-of-the-market knowledge** of the assets that are the frequent subject matter of secondaries transactions.
- Mandates in which we have been involved are among the most **highly acclaimed** globally.

Secondaries Investor (2023)

Gibson Dunn Transaction Named Among Top Five Secondaries Deals of 2023

Chambers USA (2023)

Ranked in the areas of: Private Equity: Buyouts and Private Equity: Fund Formation

U.S. News – Best Lawyers (2023)

National Tier 1 ranking in Private Funds / Hedge Funds Law

The Legal 500 U.S. (2023)

Ranked among leading firms in Investment Fund Formation and Management: Private Equity Funds (including venture capital)

KEYNOTE INTERVIEW

Oiling the wheels of private equity

As contributions exceed distributions in the private equity asset class, the secondaries market is proving more important than ever, says Northleaf Capital Partners managing director Matthew Sparks

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Q How would you characterize secondaries dealflow?

Private equity has been plagued by a lack of liquidity in recent months, and that has driven significant secondaries dealflow across both the LP-led and GP-led markets. Many investors remain overallocated to private equity, relative to other asset classes, and are entering the secondaries market to trim their exposure. Meanwhile, market statistics show that contributions have exceeded distributions since 2018, after an extended period in which the reverse was true. Managers are holding companies for longer and returning less capital to their investors. This is providing real tailwinds for the secondaries market, which is delivering much needed liquidity to both LPs and GPs.

At the same time, we are seeing more LPs getting comfortable with using the secondaries market as a portfolio management tool. We continue to see repeat sellers that are programmatically using secondaries to manage their liquidity and private equity relationships on an annual basis. We are also seeing new sellers enter the market.

GP-led secondaries dealflow also remains robust, particularly in the mid-market, due to capital constraints on the buy side. We expect to continue to see volumes increase, given the value proposition that GP-led deals represent. The GP can continue to own a trophy asset it would rather not sell, while LPs can achieve liquidity in a challenging exit environment. Secondaries buyers, meanwhile, get the opportunity to deploy capital in attractive companies, supporting the next stage of value creation.

Q How are pricing dynamics evolving, and to what

extent are you seeing structure being used to bridge any residual gaps?

Pricing for buyout interests, which is where we primarily focus, has increased over the past 12 months. This is being driven by a robust public market as well as improved visibility on the future performance of underlying assets and on where the US Federal Reserve stands with regards to interest rates. These factors have enabled buyers to underwrite with more confidence.

This has contributed to an increase in dealflow as more sellers come to market to take advantage of higher optical pricing. Where there has been a gap in pricing expectations over the past 12 to 18 months, we have worked closely with sellers to achieve their objectives using structure.

In particular, the deferral of a portion of the purchase price has been quite common. This is a 'buy now, pay later' concept that allows the buyer to increase their optical price slightly to take advantage of later payment. We have also introduced price enhancing assets to deals – changing the composition of the portfolio that the seller was originally looking to sell to include more accretive assets that allow us to increase optical pricing. Finally, in some cases where sellers are looking for liquidity but where they have strong conviction in the assets, we have also proposed upside sharing elements to transactions.

Q How would you describe LP appetite for secondaries strategies, and what is behind the appeal?

The appetite for secondaries is substantial. Last year was a record year for secondaries fundraising, with over $100 billion amassed for an asset class that enables investors to rapidly build diversified exposure to private equity, while also providing J-curve mitigation and a compelling cash back profile. The appeal of secondaries has been enhanced by the attractive risk-adjusted returns that the asset class offers.

This strong performance has largely been driven by the inherent inefficiencies that continue to exist in the secondaries market. We believe that is particularly the case in the mid-market, where there are fewer LPs and therefore, fewer buyers with access to information. These mid-market funds also tend to have more levers for value creation with which to enhance returns.

Q How would you describe supply/demand dynamics, and how do you see that playing out going forward?

The secondaries market continues to benefit from attractive supply/demand dynamics. In 2023, there was roughly $110 billion of market volume, and we're projecting market growth in 2024. Dry powder across the market, meanwhile, sits at approximately $150 billion – in other words, roughly a ratio of 1:1. That is extremely favorable when compared to the broader buyout market, where the ratio is closer to 1:3. We would expect those dynamics to remain favorable for quite some time.

Private equity NAV is increasing due to capital inflows into the asset class. At the same time, hold periods are being stretched because exits are scarce. One of the key drivers behind the growth of the secondaries market is total NAV. The other is the turnover ratio. How much of that NAV changes hands each year? As more and more LPs use the secondaries market for portfolio management, we will see an increase in turnover. The two factors combined will create significant need for secondaries capital across both LP-led and GP-led deals.

Q How are secondaries firms differentiating themselves, and what should LPs be looking for in a manager?

There are five key elements to consider when looking for a secondaries manager. First is the existence of a platform. The secondaries market is inefficient.

> *"Appetite for secondaries is substantial"*

Dealflow and access to information is driven through relationships. Having a global platform with an active primary and private credit program provides critical outreach and coverage for a secondaries manager.

Next, I would point to market focus. The greatest inefficiencies can be found in the mid-market. There are also more opportunities for mid-market companies to create value beyond revenue growth, margin expansion and debt pay down; these levers include professionalization, for example the upgrading of a management team, the institutionalization of the sales force or the streamlining of operations, all of which can enhance the purchase price multiple at exit.

The third factor is team. Investors will benefit from a team that is experienced across multiple cycles, and which has a depth and breadth of skills and capabilities. There will always be an ebb and flow to supply/demand dynamics across LP-led and GP-led opportunities. The risk-adjusted returns on offer will shift. It is therefore important to invest with a firm able to deploy capital across both strategies, executing on those deals that represent the most attractive risk/return profile at any one point in time.

Track record is an obvious point of differentiation. Investors will want to see a manager that has proven itself over a long period of time, and that goes hand in hand with my final point – risk management. Investors should consider how managers have generated their returns – how risky the underlying assets have been and how much leverage has been used across the portfolio to generate that performance. ■

LP-led news wrap

A round-up of how North American LPs have been looking to tap the secondaries market over the last 12 months

Michigan pulls back on secondaries sale

Michigan's large state retirement system, which had been dialing back on private equity amid overexposure issues, put a portfolio of private equity fund stakes to bid, but pulled back after pricing came in too low, sources told *Buyouts*. Michigan took its portfolio, which was said to be valued at $1 billion-plus, to the market and received bidding, a system spokesperson confirmed. "We decided against the sale in the end," the spokesperson said, while declining to comment on why the system pulled back on the sale.

AUG 2023 SEP OCT NOV DEC

Partners Group steps up as buyer on CDPQ sale

Partners Group stepped up as a buyer for a large portion of a portfolio of fund stakes and co-investments being shopped by Canadian pension giant Caisse de dépôt et placement du Québec, sources told *Buyouts*. The CDPQ sale was re-launched after the system shopped a portfolio in 2022 but decided to pull back as prices fell in the market decline. According to sources, Partners Group decided to buy a portfolio of partial stakes in funds and co-investments from across CDPQ's private equity portfolio with net asset value of roughly $1.1 billion.

HarbourVest emerges as largest buyer of NYSTRS portfolio

HarbourVest Partners emerged as the buyer of a large portion of the massive $6 billion portfolio of private equity fund stakes shopped by New York State Teachers' Retirement System, sources told *Buyouts*. One of the biggest portfolios of 2023, NYSTRS' process was an example of a seller shopping a large offering and letting buyers pick and choose their favorites. HarbourVest picked up a portfolio in the range of $2 billion to $3 billion, and Lexington Partners also picked up a smaller part of the portfolio, sources said.

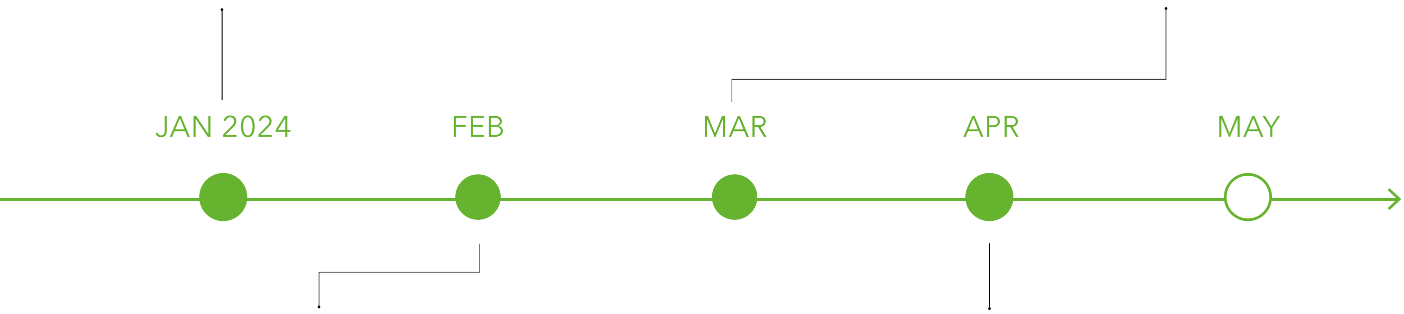
Washington pension system shops large PE portfolio

Washington State Investment Board shopped a multi-billion dollar portfolio of private equity fund stakes in a re-engagement with the market after pulling a similar sale in 2022, sources told *Buyouts*. The LP portfolio was said to be upwards of $2 billion.

Kaiser Permanente shops 'multi-billion dollar' portfolio

Non-profit healthcare organization Kaiser Permanente shopped a large portfolio of PE fund stakes, sources told *Buyouts*. The total value of the portfolio was in the multi-billion-dollar range, according to sources, although the expectation was that around $1 billion to $2 billion would transact.

Kaiser has been a programmatic seller of PE fund stakes for the past few years. It held what was understood to be the largest LP portfolio sale in 2023, transacting on more than $5 billion. The institution ramped up its PE exposure quickly, from about $6 billion in PE NAV in 2019 to $33 billion in 2021. Kaiser appeared to be using secondaries sales to rebalance its portfolio, which grew so quickly it became overexposed to the asset class, sources previously told *Buyouts*.



Pension OPTrust shops small portfolio

Sources told *Buyouts* that Canadian pension system OPTrust was selling a small portion of its private equity portfolio in a targeted sale, forming part of the larger flow of LP secondaries hitting the market this year. OPTrust is among a crop of newer LPs in private equity. The system, with net assets of about C$25 billion ($18 billion; €17 billion), was selling a package of fund stakes valued at around $300 million to $400 million, sources told *Buyouts*.

LACERA sells $1.4bn LP portfolio

Los Angeles County Employees' Retirement Association sold a large portfolio of LP stakes in mostly buyout funds amid a slowdown in distribution activity that has prompted many fund investors to seek alternative ways to generate liquidity.

According to sources, the process closed with a group of buyers, including Ardian. The size of the portfolio sale was more than $1.4 billion, sources said. Pricing was said to be strong on the portfolio, which was understood to have mostly consisted of stakes in buyout funds.

Doubling down on GP commitments

Going beyond standard commitment expectations in continuation fund transactions can help sponsors demonstrate alignment, writes Claire Coe Smith

Expectations around the GP commitment in GP-led secondaries are evolving as buyers and existing LPs continue to seek high levels of alignment. Nearly one in five continuation fund transactions saw sponsors making new fund commitments in addition to rolling over 100 percent of their proceeds in 2023, according to PJT Park Hill's *FY 2023 Secondary Market Insight* report.

A further 43 percent rolled 100 percent and made incremental commitments. The report notes a 5 percent-plus GP commitment is now viewed as market standard and was present in more than four in five deals last year.

"The historical standard GP fund commitment expectation used to be 2 percent for primary funds," says Christopher Areson, a partner in PJT Park Hill's private capital solutions group. "With these transactions, we are seeing that the GP fund commitment winds up being meaningfully higher, and that's because often these transactions are associated with trophy assets where there may be carry equitized as part of the transaction and rolled in as part of the GP commit. The major benefit to investors, of course, is that this demonstrates meaningful alignment."

Charlotte Morris, a partner in Pantheon's global secondaries team, says alignment is paramount for secondaries investors. "That 100 percent rollover is a very important feature of alignment from our perspective, but it is really the

starting point. We expect GPs to consider whether they have further capital to invest and it is a strong endorsement if the deal team are willing to invest more cash out of their own pockets."

Digging into pocket is key

Only 9 percent of transactions in 2023 did not see a full roll of GP proceeds, according to PJT data. "There are exceptions where maybe a fund isn't in carry, so they are going through the cash back to investors phase of a European waterfall before crystallizing carry themselves," says Morris. "In those situations it is particularly important that the GP is digging into their pocket and finding a way to boost the commitment that effectively comes from rolling their original GP commit in the asset, so topping that up with their own cash.

"If we don't have carry being crystallized, we often see the GP investing from their flagship fund, because sometimes they feel the opportunity is attractive enough that they want their current investors to benefit. That is a strong endorsement."

Areson says alignment has always been a first-tier due diligence item and there is no sign of the current high levels shifting. "In fact, we have seen a focus more recently not only on sponsor alignment but also on management team alignment," he says. "Depending on how the underlying management team's incentives plans are constructed, these transactions may result in a liquidity event for management.

"If that occurs, the expectation is certainly that alignment is important and underlying secondary investors are going to focus on the sponsor alignment and then on management team alignment. They will ask questions of the sponsor about how they are getting comfortable with the management team's alignment on a go-forward basis."

Indeed, the emphasis on alignment continues to grow. "There is probably more focus on alignment than ever before," says Gerald Cooper, a partner and head of Campbell Lutyens' North America secondaries advisory practice, "because there are more of these transactions in the market, more GPs trying to do deals and buyers are wary of going into situations where the GP is looking at them as a counterparty as opposed to a partner." ■

EXPERT COMMENTARY

Following a drought in distributions, private equity dealmaking is showing signs of awakening in 2024, writes Yann Robard, managing partner at Dawson Partners

Liquidity on the horizon?

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A dire year of distributions

2023 was the year when distributions dried up in private equity. Driven by markets that were largely shut over the past two years, transactions stalled. There was much confusion due to a lack of clarity in the markets broadly and little consensus in the direction of inflation and interest rates. For two years many GPs have created limited liquidity for their LPs, for themselves and for the market.

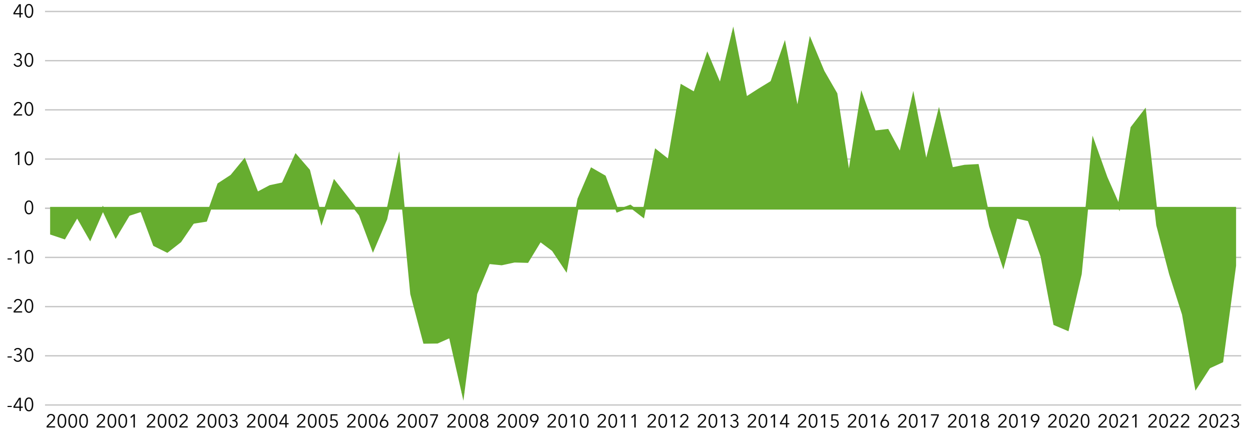
In fact, according to S&P Capital IQ, M&A volume was down 70 percent in 2023 compared with 2021, while IPO activity was down 90 percent during that same period. Essentially, GPs chose to hold assets through the market volatility, not sell in the eye of the storm, and that resulted in limited distributions to their LPs.

For most private equity investors, this refrain will not come as a surprise. Many have felt a drought in distributions. Many have seen their allocations to private equity impacted by this muted activity. So, we asked ourselves… how bad has it been? The answer was striking.

We looked at the net cashflows of private equity LPs to get better context. Said differently, did LPs receive more calls or more distributions in a given year? The answer can be seen in chart 1. From January 1, 2022, to September 30, 2023, buyout private equity portfolios generated significant negative net cashflows (ie, more capital calls than distributions). In fact, it was nearly identical to lows seen during the global financial crisis (GFC).

Let us say this again: private equity cashflow levels over the last two years have replicated what LPs and GPs experienced in 2008 and 2009 during the worst of the GFC, when Lehman Brothers collapsed and when the

Chart 1: Private equity net cashflows to LPs ($bn)



Source: MSCI Private Capital Solutions data as of September 30, 2023. (Data set excludes venture capital and reflects 4,031 funds with a capitalization of $4,935bn. Data since September 30, 2023 not yet available on MSCI Private Capital Solutions)

markets crashed. That is how bad it has been.

What's ahead for 2024?

Fast forward to today, we certainly feel like market sentiment is shifting. While there remains concern that inflation may persist, and that there may be higher rates for longer, there is more clarity in the market today on the path forward. The economy has surprised to the upside over the past year. Fears of a hard landing have largely tempered. Today, in short, there seems to be less confusion, more clarity and broader consensus in the markets.

And the public markets have responded. From September 30, 2023, to March 31, 2024, the S&P 500 and Russell 2000 were up 23 percent and 21 percent, respectively. However, that enthusiasm seen in the public markets does not yet appear to be reflected in private equity.

In fact, according to MSCI Private Capital Solutions, buyout private equity valuations were only up 3.4 percent in Q4 2023 while the S&P 500 and Russell 2000 were up 11 percent and 14 percent, respectively. We believe the private equity recovery is lagging that of the public markets and the tides may be turning.

Now let us be clear. The broader markets generally seem to agree that we are not out of the woods yet. There is increasing consensus that interest rates will be higher for longer and that inflation will be sticky. But for markets to open and transactions to get completed, we believe clarity on the direction of the economy is as important as the direction itself.

"Today there seems to be less confusion, more clarity and broader consensus in the markets"

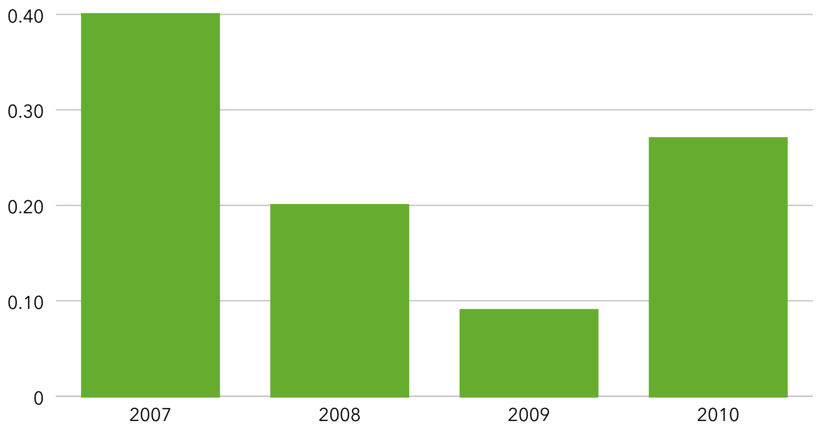
And now that we have more clarity on the direction of inflation and interest rates, bid/ask spreads are starting to narrow. Many, including Dawson, believe the market is awakening. Deals are returning. We believe things are shifting. We are seeing deal activity ramping up. As spring has sprung, private equity seems to have sprung into action.

Looking back at the GFC

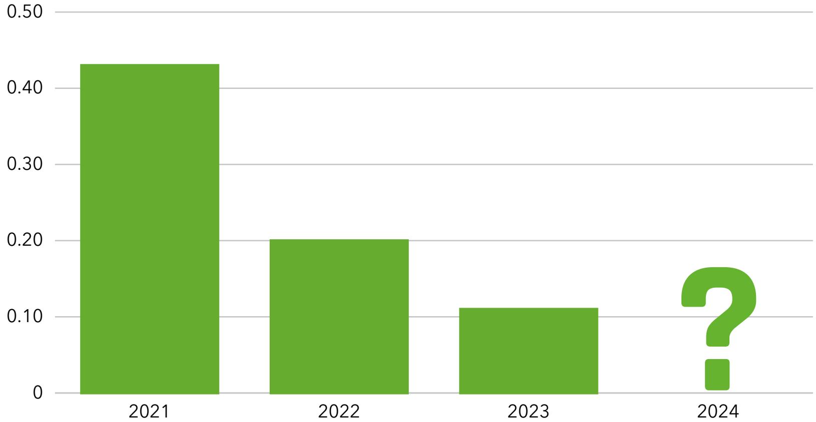
So, we thought it would be interesting to look at GFC distributions by buyout private equity portfolios to help provide perspective. We looked at three periods: pre-GFC, during the GFC and post-GFC.

Prior to the GFC, in 2007, on average, for every dollar of net asset value in a private equity portfolio, 40 percent of it was returned that year. It was a big year for liquidity. The peak before the crisis. In 2008, that number declined by half to 20 percent. And in 2009, that declined again by half to 9 percent. In fact, 2009 was the worst year of distributions over the past 20 years.

Chart 2: Distribution profile (GFC)
Average annual private equity net distributions over carrying value



Distribution profile (recent)
Average annual private equity net distributions over carrying value



Source: MSCI Private Capital Solutions data as of February 29, 2024. (Reflects data for 50th percentile North American buyout funds greater than $250m and represents annual average of fund vintages that are 3-10 years old. Selection criteria based on Dawson views. Different criteria would have yielded different results)

We then examined liquidity levels over the past three years and saw something shockingly similar – private equity distributions have largely replicated the distribution levels experienced during the GFC.

Like 2007, 2021 was a big year for liquidity. As markets peaked, so did distributions. For every dollar in net asset value at the beginning of the year, 43 percent of it was returned in distributions that year. Then 2022 replicated 2008, with 20 percent of net asset value coming back in distributions. And if we look at 2023 – with markets worried about high inflation and climbing interest rates – distribution levels nearly replicated that of 2009, at 11 percent.

> *"Over the past three years LPs and GPs have experienced distributions similar to the GFC"*

Said differently, over the past three years LPs and GPs have experienced distributions similar to the GFC.

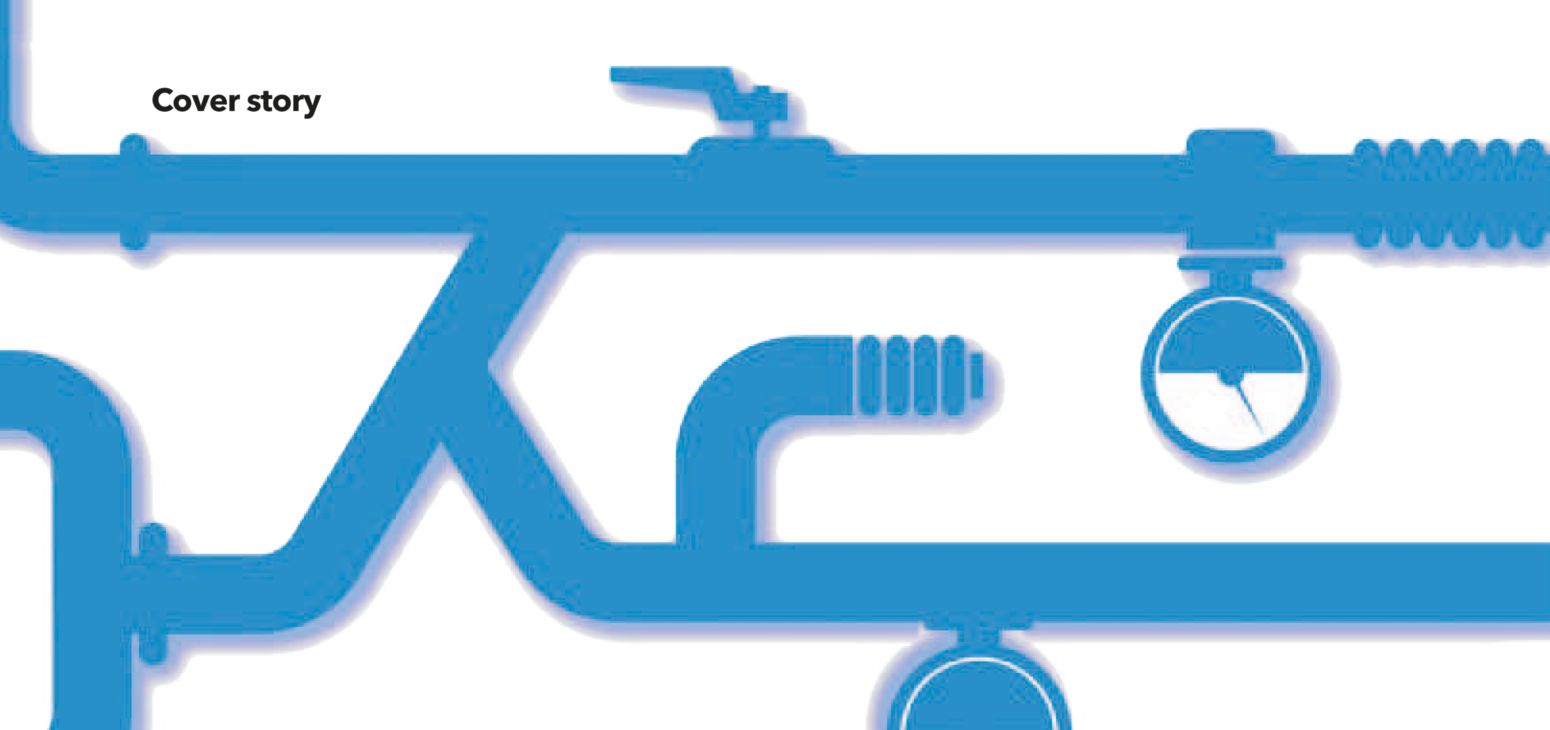
The natural question we had was: what happened in 2010 after the GFC came to an end? And the answer: distributions came back. In fact, in chart 2 you can see that investors received three times more distributions in 2010 than they received in 2009. The market rebounded quickly after a dire year of distributions.

Which leads us to our next question: could history repeat itself? Will 2024 be a big liquidity year? With more clarity in the direction of the economy, market and interest rates, has the bid/ask spread sufficiently narrowed for the pace of deals to accelerate?

We believe, absent a material geopolitical event, that the private equity dealmaking market is awakening. After two years of many GPs holding steady and waiting for the storm to pass, they are starting to act and bringing assets to market. And while the flood gates have not opened just yet, the momentum is building.

Remember, there is generally a three-to-six-month lag between when deals are announced and when they close. On that basis, distributions may not pick up until the second half of the year despite the feeling of momentum. Nevertheless, an increasing number of recent deal announcements could suggest a return to a more normalized level of distribution in the second half of the year.

To conclude, we at Dawson predict that the second half of 2024 will see a return of distributions to a more normalized historical level. Said differently, we expect 2024 full-year distributions to be somewhere between 2009 and 2010 activity. We believe there will be a bounce back from the trough, but not necessarily as quick a rebound as in 2010. We also believe, when we look back over time, that 2023 will have been the trough year for distributions as a result of this recent market volatility. Time will tell. You be the judge. ■



Pressure relief

LPs are turning to the secondaries market to address liquidity constraints amid improved pricing, as compelling supply/demand dynamics and structural innovations help fuel LP-led dealflow. Amy Carroll reports

The sale of substantial LP portfolios dominated the secondaries narrative in 2023 with a wave of large deals transacting, the biggest of which was understood to be Kaiser Permanente's $5 billion-plus portfolio sale.

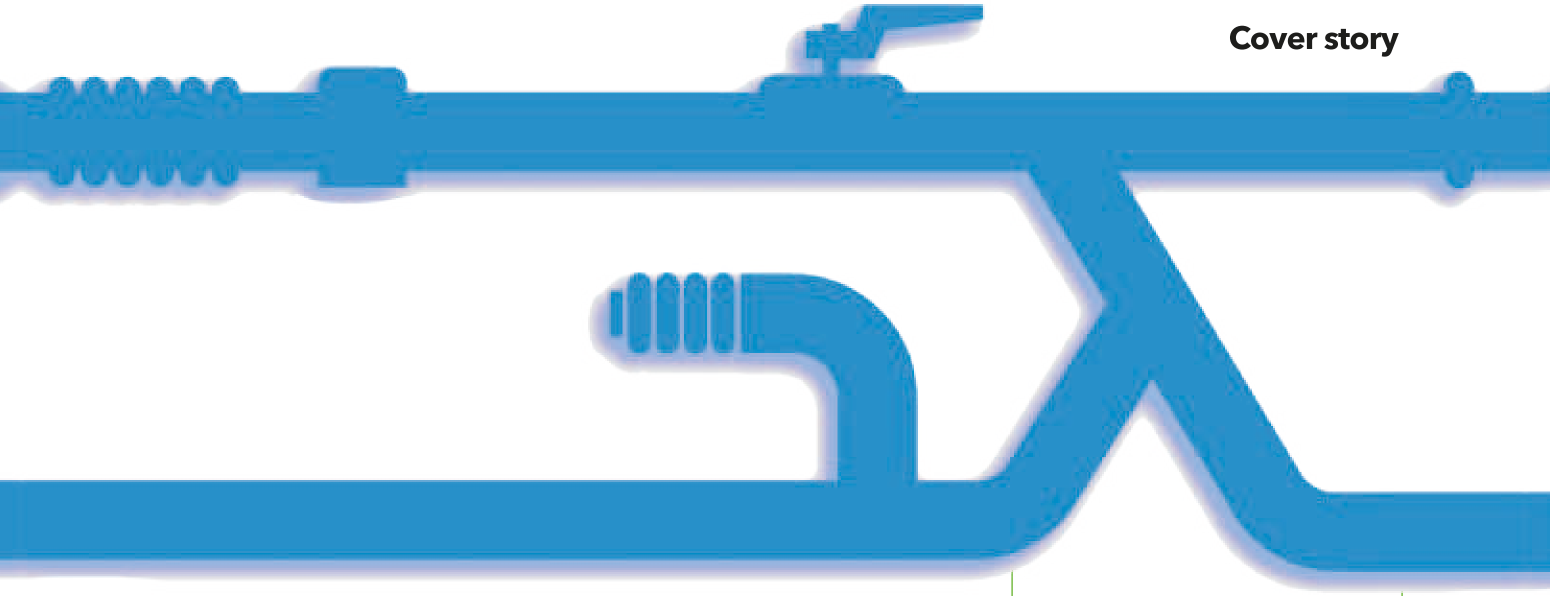
The deal marked the end of a period of stalemate for LP secondaries, caused by pervasive macroeconomic uncertainty and a stubborn bid-ask spread. New York State Teachers' Retirement System shopped a sizeable portfolio to buyers including HarbourVest Partners and Lexington Partners soon after. Other chunky deals included a $1.1 billion portfolio of fund stakes and co-investments offloaded by Caisse de dépôt et placement du Québec.

Indeed, LP portfolio sales hit around $60 billion last year, according to adviser estimates. Meanwhile, the selling spree looks set to continue in 2024. Already, Washington State Investment Board has brought a multi-billion-dollar portfolio to market, amid a spate of other hefty transactions.

"Private equity has seen tremendous growth in the low interest rate environment, and with exit activity falling off over the past two years we are now seeing a significant amount of NAV inventory that needs to be cleared," says Shane Feeney, a managing director and global head of secondaries at Northleaf Capital Partners. "Secondaries transactions are acting as the relief valve as bid/ask spreads continue to disrupt buyout exit activity."

"The LP secondaries market is incredibly active," adds Scott Beckelman, a managing director and global co-head of private capital advisory at Jefferies. "Q1 has been very busy, and we believe all the conditions are in place for potential record volume this year. LPs are continuing to feel the pressure in a historically slow distribution environment, and many large allocators that are already near or above target allocations to the asset class need liquidity to execute on a growing primary pipeline of opportunities."

Of course, liquidity constraints combined with the denominator effect are nothing new. This challenging double whammy has plagued private



markets for nearly two years. What has changed in recent months, however, is pricing. Both CDPQ and Washington State are understood to have pulled back on portfolio sales in 2022 due to an impasse on price, but a public markets revival coupled with greater visibility around macro conditions, has closed the gap that previously existed between buyers and sellers.

"Secondaries pricing has increased, and buyer appetite has improved considerably, driven by a mix of successful, record secondary fundraises, public equity market appreciation and a much-improved macro sentiment," Beckelman says. "While LPs continue to grapple with the same underlying need for liquidity, pricing has improved to the point where sellers are able to fully satisfy their objectives and large transactions are now clearing the market."

Specialization

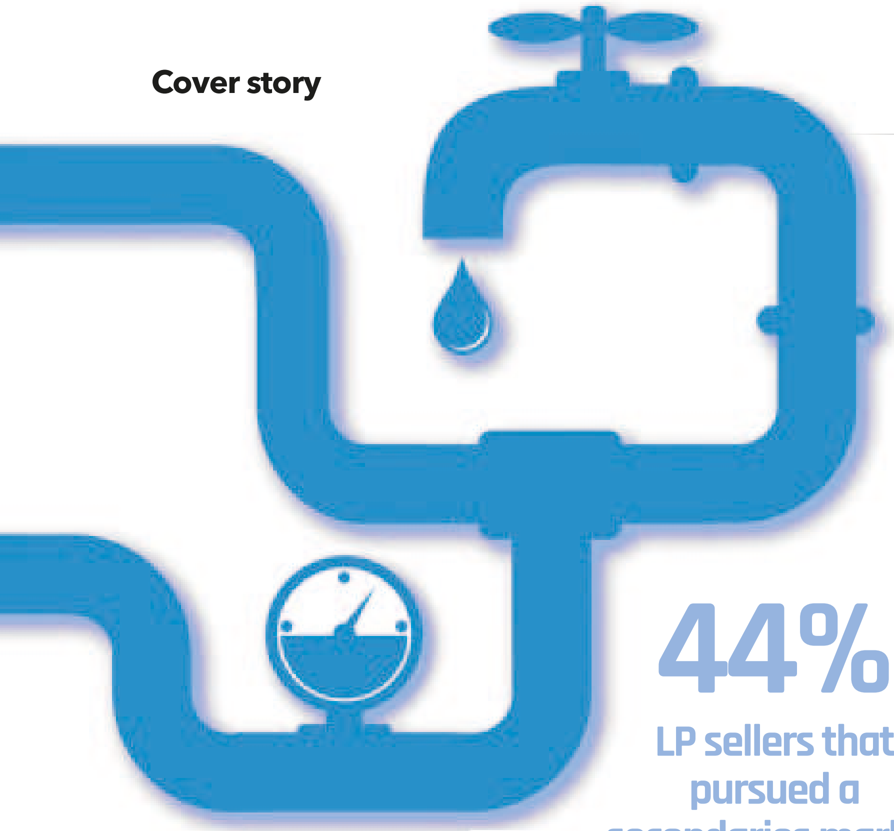
While pricing has certainly tightened, there are still attractive opportunities for buyers, and appetite remains strong. "There were periods over the past year where we were able to secure pricing for even the most high-quality portfolios in the mid-to-high teens, which just reflected the wider risk environment and need for liquidity," says Amyn Hassanally, a partner and global head of private equity secondaries at Pantheon. "That being said, pricing is still attractive relative to asset quality – we're seeing entry discounts of mid-to-high single digits and even 10 percent for very high-quality portfolios, which as much as anything else is a function of the supply of deals far exceeding the volume of buyside capital that is available to deploy each year."

Hassanally adds that supply/demand dynamics are particularly appealing in the mid-market. "The capital overhang – or the volume of capital that is available in aggregate divided by deal volume – is around 2.3x, but this is being increasingly driven by mega-funds targeting larger and more competitive deals," he explains. "For example, the five largest funds in the market are targeting in excess of $60 billion of capital. In the mid-market, there is a lower volume of capital chasing a large funnel of deals, and that is supporting attractive pricing dynamics at a time when liquidity is at a premium."

Ardian, by contrast, favors the competitive landscape that exists for the very largest secondaries deals. "We typically focus on transactions of at least $1 billion where we don't experience much competition," says Ardian executive vice-president Jan Philipp Schmitz. "We have even underwritten $5 billion deals single handedly. These are large and complex transactions where price is not necessarily the

> *"Pricing has improved to the point where sellers are able to fully satisfy their objectives and large transactions are now clearing the market"*
>
> **SCOTT BECKELMAN**
> **Jefferies**

> *"In uncertain times, it is key to evaluate the managers of the portfolios being sold and what they bring to the table"*
>
> **AMYN HASSANALLY**
> **Pantheon**



44%

LP sellers that pursued a secondaries market transaction for liquidity reasons in 2023, up from 10% in 2022

Source: Lazard's Secondary Market Report 2023

determining factor. The scale alone eliminates most of our peers."

This contrast in strategy is reflective of a broader trend of specialization that is increasingly characterizing the secondaries industry. "Secondaries is an evolving market and as more and more managers come to the fore, we're seeing specialization in terms of focus on particular segments of the market, geographies, stages, deal types, or access points to investments, in terms of operating primarily as lead or syndicate investors," says Hassanally.

Different buyers are looking for different things, adds Keith Brittain, a managing director on the secondaries investment team at Hamilton Lane. "Some focus purely on tail-end portfolios. Others differentiate themselves based on access to deals or the ability to price funds quickly, others by asset class, with dedicated secondaries funds for credit and infrastructure, for example," he says.

Regardless of their area of specialization, however, Brittain says that buyers in the LP-led secondaries space are typically looking to buy at a discount or to buy into the funds they believe will appreciate materially in value – or else a combination of the two.

"First and foremost, it is about the quality of the assets in the portfolios," says Hassanally. "In uncertain times, it is also key to evaluate the managers of the portfolios being sold and what they bring to the table to help build value in the assets they manage, or their experience in operational improvement and driving through to exit. In many cases, that means buying into portfolios managed by GPs on our primary buy lists, with which in most cases we have invested previously."

Indeed, having access to information on the underlying portfolio, due to exposure to the manager as a primary investor, can shed light on near-term liquidity events or other embedded value that can provide additional comfort on pricing, Hassanally explains. "That can help us to underwrite attractive base rate returns and so submit competitive offers."

Gerald Cooper, a partner and head of the secondaries advisory practice in North America at Campbell Lutyens, agrees that buyers are gravitating toward assets and GPs that they are particularly familiar with. "They may be able to be a bit more aggressive in their underwriting if they have strong conviction in the GP's projections, or their valuation policy or their ability to navigate cycles. That information asymmetry is important in a market that is still inefficient."

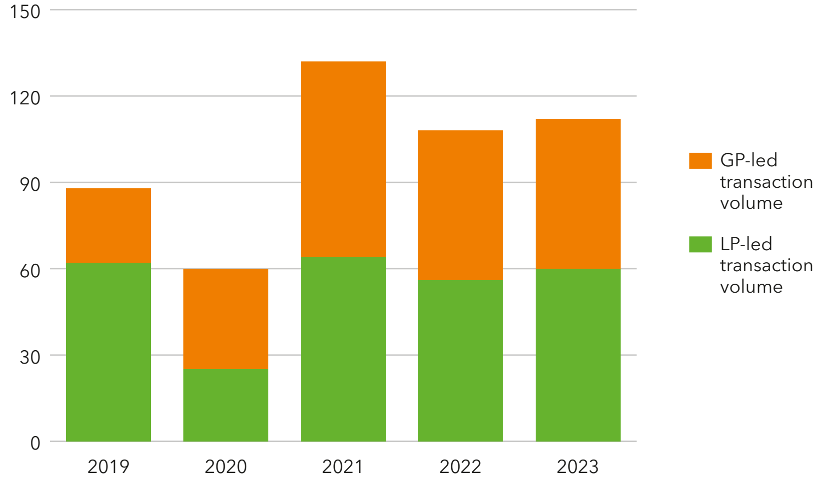
Structuring

In addition to improved pricing dynamics and a focus on high conviction managers, structure has also had a role to play in reigniting LP secondaries dealflow.

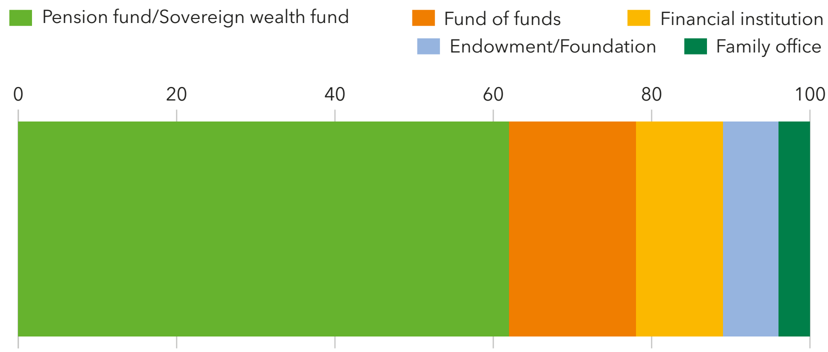
"In the current market, we're seeing flexibility on the part of sellers to accept and engage with mosaic solutions where, rather than transact with a single buyer, they are willing to transact with a group of buyers each of whom are speaking for different parts of their portfolios based on their respective appetite, specialism and pricing," says Hassanally. "We're also seeing greater seller acceptance of deal structuring, such as deferred payments and earn-outs, to get deals across the line in a congested market."

A leading adviser in the secondaries market who asked not to be named adds that they are seeing more partial liquidity discussions as LPs grow more comfortable with the shades of gray that exist between an outright sale and holding on to assets. "Historically, if an investor brought a portfolio to market and wasn't able to get the price that they wanted, the decision would have been between hold or sell," the adviser says. "Now we are seeing NAV-based solutions including dividend recaps with traditional bank lenders or

Annual secondaries transaction volume ($bn)

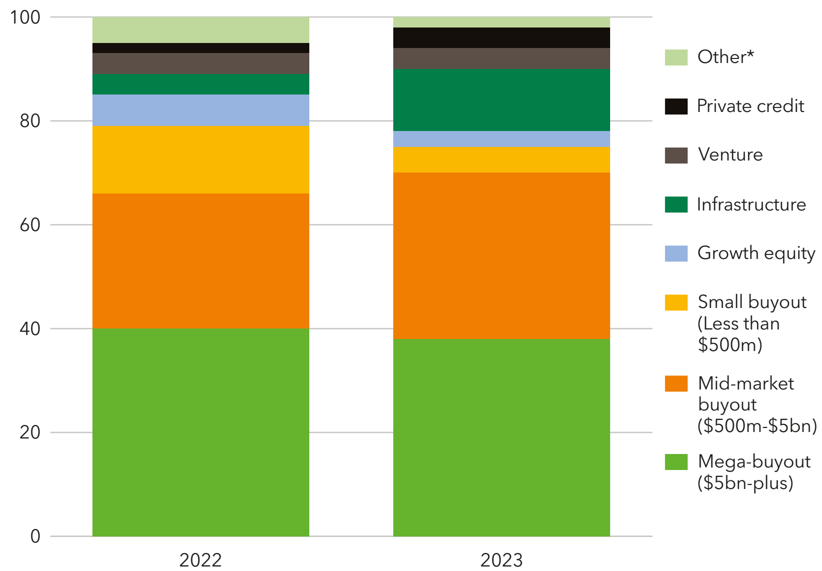


LP portfolio transaction volume in 2023 by seller type (%)



Source: Jefferies' Global Secondary Market Review, January 2024

Strategy of funds sold in LP-led transactions (%)



*Includes distressed/special situations, energy and real estate.
Split by transaction value (purchase price plus unfunded) per respondent

Source: Campbell Lutyens' 2024 Secondary Market Overview

preferred equity providers, as well as other earn-out solutions being incorporated into the set of options that LPs are reviewing."

Cooper, meanwhile, points to an interesting piece of structural innovation he says Campbell Lutyens has developed that would allow overallocated LPs to reduce their exposure to older vintage funds from a given GP while synthetically making new commitments to their current fund. "The structure is designed to avoid realizing a material discount on the secondary sale, while ensuring that the LP is able to actively manage their portfolio to maintain exposure to their core managers and latest vintage funds.

"This is a particularly interesting solution for LPs that have confidence in the buying opportunities that will present themselves to GPs over the next couple of years and those that don't want to risk having a vintage gap in their portfolios," he says. "The breadth of demand and level of sophistication with respect to market participants allows us to be highly creative in terms of crafting bespoke solutions for LPs."

Few of these deals have yet been transacted, according to Cooper, but when it comes to secondaries, innovation of this nature is to be expected. The advent of transformative technologies will only accelerate that progress.

"Innovation has always been a hallmark of the secondaries market, and over the last several years there has been exciting progress regarding deal structure and more broadly how industry participants are using technology and artificial intelligence," says Jefferies' Beckelman. "There is now a deep and growing market for preferred equity, private equity securitizations and similar liquidity solutions that offer liquidity and unfunded relief and a share of future upside.

"Beyond this, secondary market investors and advisers are beginning to utilize technology and AI to more efficiently price deals and streamline execution." ■

KEYNOTE INTERVIEW

Codifying best practice

The SEC private fund rules will provide a regulatory framework around GP-led secondaries, ultimately supporting their continued growth, say Tim Toska and Emily Ergang Pappas of Alter Domus

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Q To what extent do the SEC's private fund rules impact the secondaries industry and how have these changes been received?

Tim Toska: The US Securities and Exchange Commission's new private fund adviser rules are certainly far reaching and there are significant changes involved. But, as it relates to the secondaries industry, it is the mandatory requirement for a fairness opinion or valuation in every GP-led secondaries deal that is the most directly relevant. There are also new disclosure requirements around material business relationships and activities, which must be formally documented and posted to a portal.

In many instances, both are already happening, but the rules mean there is now a regulatory requirement to take these extra steps in what might well be a time sensitive transaction. That can always be a cause for concern. Managers want to be able to proceed with deals in as frictionless a way as possible. That said, compared to some other aspects of the rules, these provisions are unlikely to keep many awake at night.

Q Could a clearer regulatory framework around GP-led secondaries be welcomed, particularly when it comes to ensuring LPs are comfortable with these deals?

TT: Absolutely. This is a fast-growing market, and it has been exciting to see GP-led secondaries emerge as a valid avenue for generating liquidity, alongside traditional M&A and IPOs. But there are clearly some inherent conflicts of interest that need to be carefully managed because the last thing anyone wants is for questions to be asked in hindsight, should a deal not turn out as planned. These are not arms-length transactions and so they lend themselves to being second guessed. Increasing the regulatory framework helps eliminate any of that doubt and so from the perspective of the ongoing growth and maturity of the sector, I think it is largely to be welcomed.

Emily Ergang Pappas: It also goes a long way towards ensuring all investors are in the same situation. Yes, there were many funds that were already including fairness opinions in their deals and going the extra mile in terms of transparency, but now investors in every fund will be afforded that same level of protection from potential conflicts of interest. The codification of best practice means all investors are now in the same boat.

Q What modifications have we seen since the initial rules were proposed and where are we now in terms of when the rules will be enacted?

EEP: We are in a unique position as fund administrators in that these rules don't technically apply to us, but they will apply to most of our clients and will affect the services we provide. We are therefore keeping a close eye on how things develop. There are a number of lawsuits that are ongoing, and no-one is entirely sure what the timelines are likely to be, but we are certainly paying close attention.

I would agree with Tim though that this rule is not as controversial as some of the others. We have been heavily focused on the quarterly statement rule, for example, because there is a lack of clarity there and because it impacts our role as administrators particularly.

There have already been some modifications made between the proposed rules and final rules when it comes to secondaries, with greater flexibility to choose between either a fairness opinion or a valuation. Beyond that we are in a wait and watch holding pattern, considering what the eventual outcomes are going to mean for clients.

Q Given the GP-led market's growth, is it reasonable to expect it will be subject to greater regulatory scrutiny going forward, beyond these specific rules?

EEP: The short answer is yes, absolutely. Any time something grows in size and popularity to this extent, particularly when it involves readily identifiable conflicts of interest, it is inevitable that the SEC and other regulators around the world are going to want to put some parameters in place to ensure investors are adequately protected.

Q Against this regulatory backdrop, how are you seeing the GP-led secondaries market evolve?

TT: I would say that the GP-led secondaries market has now reached a stage in its maturation journey where it sits side by side with other strategies. Certainly, in terms of deal volumes, GP-leds have been at or about 50 percent of the overall secondaries market for the past few years. In fact, there has been insufficient capital available to meet demand from GPs, who now view this as a viable exit route and means to generate liquidity in an environment where liquidity has been in short supply.

Q Will that growth trajectory continue unabated as and when M&A markets return?

TT: I believe that it will. There will always be reasons for GPs to pursue this type of deal, regardless of what is happening in the broader macroeconomic environment. It is true that a revival in M&A will lessen the need for GPs to turn to continuation vehicles to generate distributions for investors. However, there will always be sectors, or segments of the market, that are facing structural or economic hardships and where secondaries capital is required.

Furthermore, there will always be situations where the timing just isn't right for a GP to exit, despite the fact it is running up against the limits of a fund's life. Due to the intense growth in volume and awareness over the past few years, GPs know these GP-led deals are something they will always have in their back pocket.

> *"There are clearly some inherent conflicts of interest that need to be carefully managed"*
>
> **TIM TOSKA**

Q The GP-led market is widely believed to be one of the most undercapitalized corners of private markets. How do you see the buyside evolving going forward?

TT: The secondaries market, and GP-led secondaries in particular, are undercapitalized relative to the supply of transactions in the market. But I don't necessarily view that as a negative. In fact, in many ways it can be viewed as a positive, because it ensures buyers are able to originate and diligence opportunities in a disciplined manner rather than feeling any pressure to put money to work.

Of course, we don't want to see that undercapitalization continue forever. But it is no bad thing for supply to outpace demand as the asset class matures. That will help ensure everyone concerned has positive experiences, including LPs that decide to roll and the new investors that come in. The more of these win-win situations that we see come to fruition, ultimately leading to successful realizations over time, the better it is for the asset class in the long term. ■

Tim Toska is group sector head of private equity and Emily Ergang Pappas is head of legal for North America at Alter Domus

Deferrals become commonplace in GP-leds

More transactions are using a delayed payment structure in a bid to bridge mismatches in pricing expectations. Claire Coe Smith reports

A greater number of GP-led deals are using a method of delaying payments to help bridge the gap between sponsors and buyers on valuations and risk appetite. According to Campbell Lutyens' *2024 Secondary Market Overview*, GP-leds accounted for 51 percent of secondaries transactions that used a method of deferral in 2023, up from 6 percent in 2022, as GPs found creative ways to deliver liquidity to LPs at attractive prices in a market where buyers held the advantage.

"Valuations haven't reset and return hurdles have not come down materially, so deferral of payment is a way to bridge the gap in pricing expectations," says Gerald Cooper, a partner and head of Campbell Lutyens' North America secondaries advisory practice. "GPs recognize they need to show the best price possible in order to ensure that any offer is well received by LPs.

"We are seeing GPs using deferrals to move up pricing to par or as close to NAV as possible. LPs are welcoming the opportunity to sacrifice immediate liquidity in order to generate a few extra percentage points on the purchase price."

Charlotte Morris, a partner in Pantheon's global secondaries team, also notes the impact of pricing shifts. "A lot of deals were priced in a market environment that was much more buoyant in 2021 into 2022, and then in 2023 that changed quite meaningfully," she says. "When it comes to secondaries,

buyers want to see some embedded value at entry, and on the LP side of the market discounts are used to account for uncertainty in the macro environment.

"In GP-leds, especially for single-asset deals, there are typically trophy assets so underlying LPs and GPs are not expecting to see a significant discount, which means a deferral or some other kind of structuring can help to bridge that gap between buyer and seller expectations."

> *"GPs recognize they need to show the best price possible"*
>
> **GERALD COOPER**
> **Campbell Lutyens**

Deferrals can come in a variety of forms, says Morris: "It may be a proportion of the purchase price delayed for a period, so we have seen deals where up to 50 percent is delayed for six to 12 months. Or there are some deals being negotiated at the moment where it is the entire purchase price being deferred for a short period, probably a maximum of two quarters."

She also points to examples where the price at closing is linked to the underlying companies achieving a certain level of EBITDA threshold, effectively showing evidence of growth before the deal completes.

For Gibson Dunn associate attorney Kate Timmerman, the use of mechanisms such as deferrals is the latest sign of the secondaries market's maturation. "As people get more comfortable with these deals, we are seeing due diligence getting more sophisticated and more financial engineering around payment terms," she says.

"This is particularly a feature of the current market where financing is more expensive and people need to be more creative with the solutions they are offering in order to get deals done. But I think the use of deferrals will continue to grow; they are common in M&A deals and the secondary market is heading in the same direction." ■

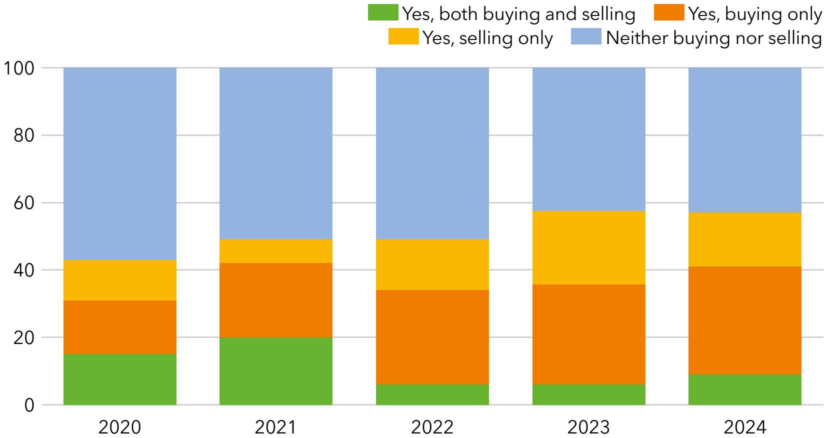
LP appetite for secondaries is on the up

The proportion of investors looking to back private equity secondaries funds has been rising steadily since 2020

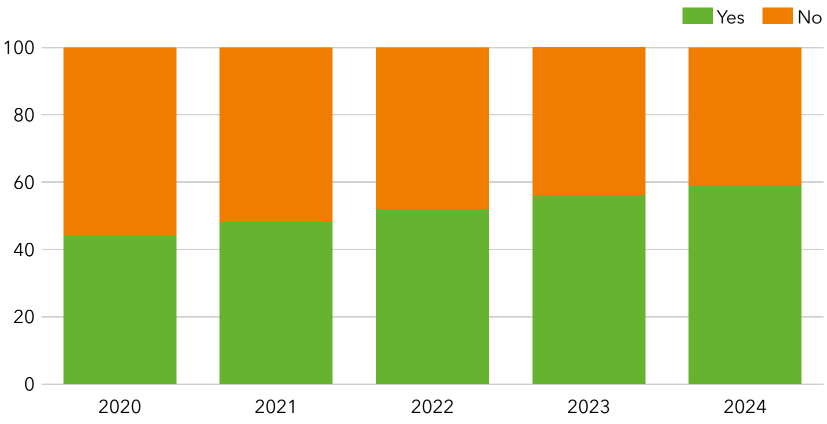
LPs have been gradually waking up to potential opportunities in the undercapitalized secondaries market. Over the last five years, there has been a 15 percentage point increase in LPs looking to commit capital to private equity secondaries funds, according to affiliate title *Private Equity International*'s *LP Perspectives 2024 Study*.

As appetite grows, the buyside has been responding in kind. In the last few years, there has been a stream of new entrants as well as the launch of specialized strategies. Indeed, 49 percent of respondents either have invested or plan to invest in dedicated GP-led funds – a segment that has picked up steam amid a slowdown in exit and M&A activity.

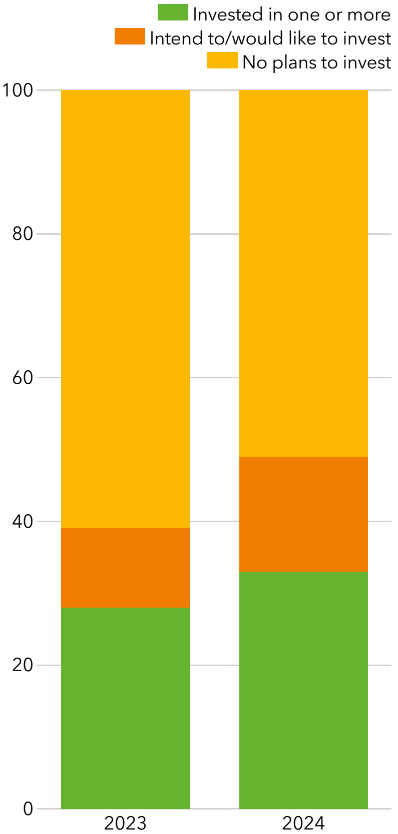
Do you plan to buy or sell private equity fund stakes on the secondaries market over the next 12 months? (%)



Do you plan to commit capital to private equity secondaries funds over the next 12 months? (%)



Do you invest in dedicated GP-led secondaries funds? (%)



Source: Private Equity International's LP Perspectives 2024 Study

KEYNOTE INTERVIEW

Motivated sellers create buyers' market



Liquidity challenges seem to be fueling secondaries dealflow, presenting compelling opportunities for buyers, say Tristram Perkins, Ben Perl and Victor Ko at Neuberger Berman

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Q What is driving secondaries volumes, particularly LP portfolio sales?

Tristram Perkins: The first thing to mention is that we have seen a complete reversal of the liquidity dynamics in private equity. Most of the last decade was characterized by record liquidity in private markets, but that started to tighten in 2021. Through 2022 and 2023 we saw fairly consistent net outflows on the part of private equity.

In our view, this reversal of cashflows is also being exacerbated by the fact that allocations to private equity have increased substantially over time. PE allocations on average now account for up to 15 percent of public institutional portfolios versus 2-3 percent a decade ago, and it is hard for distributions from prior vintages, that are now slowing, to offset larger contributions related to more recent vintages.

Those dynamics create a situation where LPs need liquidity, and that more motivated selling drives a more compelling opportunity for buyers. We know recent vintage private equity funds are lagging historical distributions and that will take time to work through, creating a longer and deeper J-curve.

Q How are those trends impacting what we are seeing in the GP-led market?

Ben Perl: We keep hearing and reading that the most important letters in private equity today are DPI (distributions to paid-in capital). This is because many investors find themselves overallocated to the private markets, and the distributions they projected would occur when they originally allocated are now materially lagging what was expected. One solution is, of course, for LPs to sell assets on the secondary market. Another, and we think increasingly common solution, is for GPs to help improve the DPI crisis by creating valuable liquidity options through continuation funds and other so-called GP-led secondaries.

It is our view that there are many sponsors with high conviction, well-performing assets, where the sponsor sees tremendous upside and is reticent to monetize in the current environment. A GP-led secondaries process provides a solution for everyone's needs in a customized manner. The sponsor can create liquidity for the fund, giving LPs the ability to monetize, and for those LPs that want to stay invested and share the conviction, there is the option to rollover.

TP: The GP-led market is probably one of the fastest-growing markets in private equity, but it is not solely driven by the need for liquidity in the current environment. GPs view the pursuit of a continuation vehicle as an attractive investment opportunity. When LPs are looking at continuation vehicles, they are looking at short-duration buyouts, and GPs see a lot of the same characteristics, with an attractive option to stay with assets for longer.

Victor Ko: The secondaries market is undercapitalized, and we believe the GP-led market is even more undercapitalized as the majority of secondaries dry powder is still earmarked for traditional LP-led deals. That means secondaries investors like us can be selective. In GP-led secondaries, there is always a focus on asset quality, but in today's climate, the deals getting done involve the highest quality assets in the market.

Q What are the key ingredients to getting LP portfolio sales over the line?

BP: There is very well-understood and very real pressure on many overallocated institutional investors to monetize through the secondaries market in the current environment. But, despite this, LP volumes were down from the peak we saw in 2021.

Why were volumes down? In our view, the primary issue was the bid/ask spread. Many investors wanted to reduce their exposure, but these same investors were in an acceptable cash position and not forced or compelled to get liquidity. As such, despite their motivation to get liquid, they were also motivated to not sell at deep discounts or take losses relative to where they had the assets marked on their books.

That having been said, there was a silver lining to this dynamic. The fact many sellers were focused on minimizing losses and choosing to sell less, meant that they were often willing to sell subsets of their assets, enabling buyers like us to cherry-pick what we wanted to own through so called mosaic sales as opposed to having to buy everything through portfolio sales. We have never been keen on buying highly diversified portfolios for a number of reasons, but we think selectivity is hugely important in the current market where we are probably not buyers of every asset.

Q What makes a good GP-led investment? Are different skills required compared with LP-led secondaries?

BP: For groups that have grown up with a more alpha orientation, the skill sets are quite similar, but for those that grew up buying large, diversified portfolios, that is arguably a different skill set which is not as relevant for individual company underwriting.

For us, there are four parts to the GP-led scorecard.

First, and most important, is the quality of the asset. We want to buy growing, profitable and well-positioned businesses in attractive industries, which can offer high visibility into future earnings potential.

Second is valuation and capital structure. If we can access some of the best assets at valuations that are arguably below public markets and where change-of-control private equity deals are happening, and make sure that the businesses are appropriately capitalized, that is compelling – especially in a market where not all assets are appropriately valued or leveraged.

Third, and unlike in direct investing where you only need to get the right asset, in a continuation fund you also need to understand the manager and their playbook or skills.

Fourth is alignment. One thing we like about the GP-led market is we are partnering with managers and enabling them to double down on their best investments. We want GPs to be reinvesting the totality of their investment, and we are really looking for them to increase their exposure to make these deals a net investment for them. This, combined with the tiering of carried interest, shows conviction and creates a compelling alignment.

VK: GP-leds are complex, lengthy and in-depth processes that require a different type of diligence to LP-led secondaries. Having deep sector expertise, capital markets knowledge and the ability to tap into researchers in a broader platform helps a lot.

Plus, your ability to partner with a GP is important. These transactions usually involve a diversified LP base being replaced with a concentrated group, so GPs care about who they partner with. We can support GPs on a primary basis, be a lender to their companies and invest as a co-investor, putting us in a strong position as a potential buyer.

TP: LPs generally think now is a good time to be looking at secondaries because of the lack of liquidity and widening discounts. So, figuring out where the best opportunities are is key.

At one end of the opportunity set, you have the levered beta buyers of large portfolios, relying on buoyant markets and a fair amount of leverage to drive returns. Then you have our approach, which is more focused on high-quality single funds and smaller portfolios, trying to leverage access to information and GPs we have in the platform without using leverage. We think the chronic undercapitalization in the GP-led market creates interesting opportunities for investors focused on the latter approach.

Q What impact will the SEC's private fund reforms have on the secondaries market?

BP: We don't expect a material impact on GP-led transactions, or at least not in a negative way. Overall, similar to the guidance provided by the Institutional Limited Partners Association around GP-led secondaries, we actually view them as a net positive. We have always believed that a clear set of rules or a well-understood framework for how to pursue a GP-led secondary would likely facilitate more growth and provide both LPs and GPs with comfort in how to successfully approach and complete a GP-led secondary in a fair and transparent manner with the right set of options.

Q What kind of activity have you been seeing in both GP and LP-led deals of late, and where do you see the market going from here?

TP: Over the past year, the mid-market has been the most active segment for GP-leds. One reason is that the amount of capital available to underwrite GP-led deals and the number of lead investors capable of underwriting deals has been limited, whereas the mid-market requires less capital.

> *"In today's climate, the GP-led deals getting done involve the highest quality assets in the market"*
>
> **VICTOR KO**

A lot of what had been driving activity in the large-cap single-asset continuation vehicle space was a deep syndication market. Often the PE owner of the asset would sell a minority stake and then essentially take their residual ownership, wrap a continuation vehicle around it and take that out to five to 10 secondaries groups to invest. You needed a significant number of investors to come in on these deals and that really tightened last year, so most of the activity was in the mid-market instead.

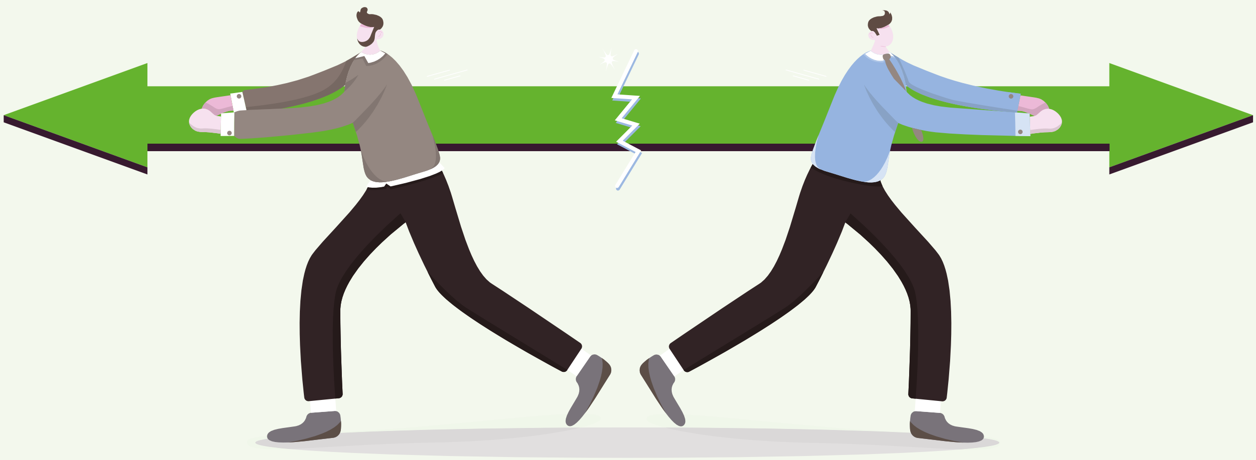
BP: The advisers we talk to generally expect this to be a record year for secondaries, driven by the pent-up need for liquidity. The private markets have over $10 trillion of unrealized value, and annual secondaries volumes make up just around 1 percent or a little more of that, so there is a lot of runway, both near term and long term.

What is really going to limit long-term growth in our view is capital formation for the asset class.

VK: While the lion's share of the secondaries market is expected to remain in North America and Western Europe, because that is where most of that unrealized value is, Asia has been very interesting. The private equity asset base is a meaningful size, but the secondaries market is small. Now, we see more GPs and LPs in the region exploring their options and trying to replicate the GP-led transactions they have seen in the US in Japan and Korea.

We recently completed the first-ever continuation fund transaction in Japan, with J-STAR, and we now see other GPs thinking about these transactions. We expect the technology to spread as an established alternative exit route, with adoption continuing to grow around the world. ■

Tristram Perkins and Ben Perl are managing directors at Neuberger Berman and global co-heads of NB Secondary Private Equity, and Victor Ko is a senior vice-president at the firm



Integrating GP stakes and secondaries

Blackstone's move to combine its GP stakes and secondaries businesses raises questions about how players in both markets should address potential conflicts of interest, writes Hannah Zhang

The natural links between GP stakes and secondaries have led to players in both markets exploring ways of combining the two strategies. Blackstone is the latest example.

In February, the firm said its secondaries division would absorb its GP stakes unit: the GP stakes business is now part of Blackstone Strategic Partners, its $69 billion secondaries business.

Other recent examples of convergence of the two strategies include GP stakes giant Blue Owl Capital launching its own secondaries business last August; Apogem Capital, which invests via secondaries funds, collecting $1.1 billion in January for RidgeLake Partners I, a GP stakes joint venture with OA Private Capital; and European GP stakes firm Armen, which has pedigree in both spheres after co-founder Dominique Gaillard brought over 20 years' experience from secondaries powerhouse Ardian.

The industry has also seen an increased number of GP stakes transactions involving secondaries firms in recent months. Last year, secondaries pioneer Coller Capital sold a minority stake in itself to Hunter Point Capital, while in February, Banner Ridge Partners sold a stake to Investcorp's Strategic Capital Group.

Inherent similarities

Something common to both GP stakes and secondaries strategies is the due diligence process at the manager level. In secondaries transactions, buyers need to conduct due diligence on the underlying portfolio companies or LP interests being sold, as well as the GPs managing those assets.

For secondaries buyers looking to venture into the GP stakes arena, being able to leverage their existing network of manager relationships is a critical edge.

"[Strategic Partners'] secondaries business can help [the GP stakes unit] source transactions. We know over 1,600 GPs and we can share our knowledge about the quality and future growth potential of these GPs," Verdun Perry, global head of Blackstone Strategic Partners, tells affiliate title *Private Equity International*. "GPs tend

> *"GPs tend to work with people they already know, trust and respect"*
>
> **VERDUN PERRY**
> **Blackstone Strategic Partners**

to work with people they already know, trust and respect."

Both GP stakes and secondaries boast shallow J-curves, while terms for GP stakes vehicles can also closely resemble those of secondaries funds, which often come with a 1 percent management fee and 10 percent carry. It stands to reason that the two units could find traction with the other's LP base when fundraising.

"Having the GP stakes business as part of [Strategic Partners] should help us be a better secondaries buyer," Perry says. "It does make us a better counterparty, because GP stakes adds another offering to our product line to provide solutions to both LPs and GPs… It's just a logical extension of that solutions-orientated business."

GP stakes could emerge as an important expansion strategy for secondaries players, according to Christopher Robinson, co-head of the secondaries transactions and liquidity solutions practice at law firm Proskauer.

"I think you will start to see these adjacent strategies overlap more as secondaries firms look to solve for liquidity constraints," Robinson says. The rapid rise of the secondaries market will continue as secondaries firms find the right opportunities to partner with high-quality sponsors and assets, he adds. GP minority stakes are a tool in their belt to further partnerships.

The secondaries market hit a new fundraising record amid continued market dislocation last year: almost $118 billion was raised across all asset classes in 2023, more than double the previous year's $53 billion, according to data from affiliate title *Secondaries Investor*.

Minimizing conflicts of interest

The integration of GP stakes and secondaries comes with potential misalignments of interests. For example, there is a strong wall between Blackstone Strategic Partners and the wider Blackstone organization to ensure GP information gathered by the former is not shared outside of the secondaries division.

Strategic Partners is able to execute on the large number of secondaries transactions it does – acquiring second-hand stakes in competitor GPs' funds and backing competitors' continuation vehicles – thanks in part to this separation.

The GP stakes unit will be walled off from the wider Blackstone business in the same way that Strategic Partners is siloed, according to Perry. In terms of the GP stakes unit's capacity to provide resources to firms it invests in, Perry says they "will have access to the huge breadth of resources typically reserved for Blackstone's portfolio companies." Much of the expertise shared with managers by the GP stakes unit – like how the broader firm creates value for portfolio companies – doesn't require access to confidential information, he adds.

Even if partnering with secondaries teams means GP stakes investors are unable to offer operational expertise to the GPs they invest in, it is unlikely to deter GPs from accepting capital, according to a lawyer specialized in GP stakes transactions.

"I wouldn't say they really have much input on operations," the lawyer says. "A lot of the GP stakes funds market themselves as providing enhanced distribution to the sponsors… Candidly, that's not a major part of doing the deal. The more compelling reason to do the deal is just the capital they provide to the GPs."

In the case of Blackstone's integration of its GP stakes and secondaries businesses, the main source of conflicts lies in whether Strategic Partners will invest in continuation vehicles or buy second-hand stakes in funds of managers with whom the GP stakes business owns an interest, according to the lawyer.

"We absolutely have the right to do that, but we are going to proactively disclose to LPs before commitment so everyone's aware," Perry says. ■

KEYNOTE INTERVIEW

Why the tide is turning toward GP-leds



After a strong year for LP-led secondaries sales, buyers are shifting their attention to GP-led transactions once again, say Ropes & Gray's Isabel Dische, Debra Lussier and Paul Van Houten

Q How would you describe the dealflow that you are seeing in the LP-led secondaries market, and what are the primary drivers?

Isabel Dische: LP-led dealflow is fairly strong. There are still some investors looking to rebalance their portfolios for denominator effect reasons, but we are also seeing a number of large investors using secondaries to adjust their portfolio allocations. Some of that portfolio management had been disrupted due to market dislocations through covid, but those programs are now being resumed, and that is leading to some meaningful activity.

In addition, there have been a number of unique situations that have driven additional dealflow. For example, when Liz Truss's brief stint as prime minister in the UK saw the pound fall in 2022, that led to a massive spike in sales by British institutions that were forced to turn to the secondaries market to meet their ongoing obligations.

Meanwhile, a consensus has now broadly been reached around valuations, easing the bid-ask spread that initially curtailed deal volumes, so the LP secondaries market remains active across most geographies and asset classes. One exception is China, where the broader geopolitical situation means the bid-ask spread persists and the market remains relatively frozen.

Q What are you seeing in terms of the use of structure in LP-led secondaries deals?

ID: Most LP portfolio sales are still straightforward cash transactions, although I would say we do see more deferrals now than we did a year ago. Furthermore, some of those deferrals are now being pushed out several years and involve a significant portion of the sale price. Earn-outs are much less common, although they do take place. What we are seeing more of, meanwhile, are preferred equity structures where an initial cash payment is combined with an agreed upon waterfall structure. The buyer and seller agree to split future distributions coming off the portfolio. They might also agree to split future capital call obligations.

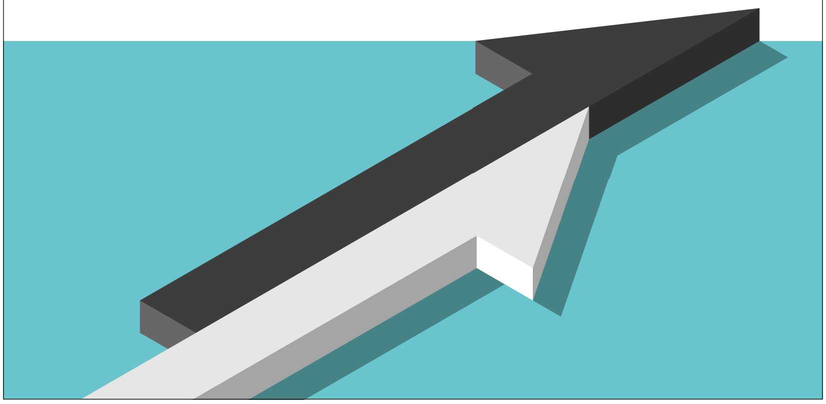
Q How do you expect LP-led activity to evolve over the rest of this year and beyond?

ID: I expect we will continue to see LP books trade, but it is important to recognize that many of the big secondaries buyers are looking to balance LP portfolio acquisitions with GP-led transactions, or more structured deals. Talking to these secondaries firms today, it appears that while they will, of course, continue to pursue LP-led secondaries opportunistically, their focus is likely to shift more towards GP-led secondaries in the near term. Ultimately, however, secondaries buyers will remain opportunistic.

Q How is buyside appetite evolving for the different asset classes within private markets?

ID: There is buyside capital targeting infrastructure, credit, real estate and venture capital. Secondaries activity certainly extends well beyond private equity. However, the underlying return profiles of those different asset classes vary significantly, which means there can be a mismatch between the opportunity set and the volume of buyside capital that is comfortable with the returns on offer. Players that can operate in these other asset classes therefore face more limited competition and have some very attractive opportunities to pursue.

DL: One area where we have seen less activity is credit. I would say there is still some inefficiency in credit secondaries deals. When loans are paying off every day, there is some inherent uncertainty around the assets that are going to trade, depending on how long negotiations take. There is more work to be done to make the process as efficient as possible, but as that happens, I think we will see more appetite for credit secondaries among those buyers that have the appropriate return profile.



Q Will the GP-led opportunity persist if and when the broader exit market opens up?

Debra Lussier: The GP-led secondaries market has certainly blossomed while traditional exit activity has been slow, but I don't think the two will necessarily be correlated going forward. Sponsors now have continuation vehicles in their toolkits and have become accustomed to evaluating them alongside other exit strategies. When the M&A and IPO markets fully reopen, I do not expect to see a drop-off in GP-led activity.

Data is now emerging that shows continuation vehicles are performing well against buyout benchmarks, and so for trophy assets that GPs want to continue to hold, these deals will continue to make a lot of sense. We are also starting to structure continuation vehicles with an ultimate IPO exit in mind. These continuation vehicles are being structured in such a way that the founder will be able to own a stake in the publicly traded company even after the fund sells, without impacting alignment of interest with the GP's underlying LPs.

Paul Van Houten: GP-led secondaries are no longer thought of as a last resort exit option if traditional routes aren't available. The sponsors that we are talking to have a balance of M&A exit plans and GP-led secondaries exit plans slated for the next 12 to 18 months. This is a strategic choice that they are making on a case-by-case basis. I think both forms of exit will grow in tandem and not in inverse proportion to one another.

Right now, GPs are just waiting for overall pricing and performance to improve before they bring assets to market. We have multiple clients with GP-leds on the runway, who are waiting for next quarter's performance figures, or else for market comps to pick up, before they launch.

Q How would you describe the secondaries fundraising environment?

ID: There are a number of secondaries mega-funds in the market right now, and several are trying to raise their hard-caps, which is indicative of strong investor appetite, particularly given a

"Many of the big secondaries buyers are looking to balance LP portfolio acquisitions with GP-led transactions, or more structured deals"

ISABEL DISCHE

"We are in a Goldilocks situation, where there are only buyers for deals of a certain size"

PAUL VAN HOUTEN

"We are starting to structure continuation vehicles with an ultimate IPO exit in mind"

DEBRA LUSSIER

challenging fundraising environment more broadly. It is important to recognize, however, that even with these large funds in the market, the secondaries industry remains undercapitalized. There is much less buyside capital available than there are potential deals. We therefore expect to see secondaries fundraising continue to grow. We also expect to see increased specialization as LPs look to refine their exposure.

PVH: I would absolutely agree that there is a supply/demand mismatch and that is impacting the GP-led side of the market, in particular. We are in a Goldilocks situation, where there are only buyers for deals of a certain size. There are not many buyers targeting the lower end of the deal spectrum, for example. Equally, there is a lack of capacity to address some of the larger deals that GPs would like to bring to market.

Q What impact is a higher interest rate environment having on the use of leverage in secondaries deals?

ID: We are still seeing leverage used in secondaries transactions, although it is obviously a decision that is underwritten on a deal-by-deal basis, depending on what makes sense. Generally, I would say that buyers that have historically not used much leverage have continued with that strategy, while those that have favored the use of leverage continue to do so as well.

Q As the secondaries market grows in scale and complexity, what capabilities do law firms need to bring to the table?

ID: With the rise of GP-led secondaries and other structured solutions, it is becoming more important than ever for lawyers involved in these deals to have both fund and M&A experience. They need to be hybrids. Working with attorneys that don't have that breadth of skill set can lead to blind spots.

PVH: I completely agree. In order to work on GP-led secondaries transactions, you need to understand M&A, you need to understand the underlying portfolio companies and you also need to have fund expertise in order to structure these continuation vehicles. For example, I started my career as a fund formation lawyer before moving to transactional work, and for the past decade or more, I have been focused on hybrid situations and general advisory work for private equity clients. It is critical to have that holistic skill set in order to bring these complex secondaries deals to fruition in a seamless fashion.

We want all our fund and transaction attorneys to be fluent in the full range of issues that sponsors face so that they can advise them on alternatives to GP-led secondaries if appropriate, for example, including M&A and IPOs. Similarly, from a structuring standpoint, we find it is important to really understand GPs' long-term strategies and what they are trying to achieve for their LPs.

DL: GP-led transactions can be transformative in that they allow the GP to clean up the capital structure. If there are former members of the management company that are no longer actively devoting time to particular portfolio companies but that are still entitled to carry, for example, a GP-led deal can be used as a way to cash them out, so that the right investment professionals are incentivized to focus on the asset going forward. A well-rounded lawyer who understands the way that private equity firms operate will be best positioned to advise on those types of goals and outcomes, rather than simply treating the deal as a discrete event with no wider ramifications. Good lawyers need to understand the big picture. ■

Isabel Dische is a partner and chair of the alternative asset opportunities group at Ropes & Gray, and Debra Lussier and Paul Van Houten are partners and co-leaders of the firm's sponsor solutions group

From proof of concept to lasting record

The secondaries industry is stepping up its reporting of the performance of continuation fund exits, writes Madeleine Farman

The secondaries market is stepping up its monitoring of continuation fund performance as the battle for LP dollars intensifies.

Recent research from PJT Partners tracks the performance of a number of continuation fund exits, following on from a project it began last year. It shows five single-asset continuation funds have realized gross multiples of invested capital of between 1.8x and 3x to investors within those vehicles. A $500 million multi-asset continuation fund with an around three-year hold delivered an over-3x return, while a €250 million single-asset continuation fund with a similar hold period delivered a 4.5x return.

This follows a recent Evercore study with the HEC School of Management in Paris – *Continuation Funds: Performance and Determinants* – which showed single-asset continuation funds provide more consistency in returns than buyout funds and similar performance. The report found single-asset continuation vehicles between the 2019-23 vintages achieved an average total value to paid-in ratio of 1.499x, closely aligned with the performance of 2019-vintage buyout funds, which generated an average TVPI of 1.513x. However, single-asset CVs have exhibited lower return dispersion than their buyout counterparts, indicating lower return variability.

Measuring returns

Although some continuation fund performance data has been available previously, examples were down to a few public exits and additional information PEI Group journalists have been able to source. What has changed is that the secondaries market's own efforts to publicly collate this information is making headway – presented in a way that is digestible and easy to find for LPs as well as new entrants looking to benchmark returns.

When asked what would help unlock more capital on the buyside, particularly for large single-asset continuation fund deals, Nigel Dawn, global head of Evercore's private capital advisory group, told delegates at PEI Group's NEXUS conference in March that new entrants will help, followed by crystallized performance – "having a benchmark which LPs don't have right now."

One helps the other – having crystallized returns will help this burgeoning new group of secondaries managers in the fundraising market, where GP-led strategies have proven to be more difficult to raise than market participants had anticipated.

PJT expects the GP-led market to reach $101 billion by 2028, with single-asset deals making up just over half of that figure, according to its report. More information about exits will be crucial for the continued growth of the continuation fund market, which is now seen as a viable exit option for the private markets community. ■

Secondaries sentiment in numbers

Recent survey findings highlight the experiences and expectations of buyers, sellers and investors in the secondaries market

59%

LPs that plan to commit capital to private equity secondaries funds over the next 12 months

Source: Private Equity International's LP Perspectives 2024 Study

24%

Proportion of private markets firms that say there is a 'moderate' level of interest in continuation funds among their investor base, with a further 6% observing a 'great' level of interest

Source: Private Equity International's Private Fund Leaders Survey

21%

LPs that expect liquidity requirements to constrain their participation in continuation funds over the next 12-18 months

Source: Coller Capital's Global Private Equity Barometer, Winter 2023-24

38%

Proportion of secondaries market participants that expect LP-led deals to be more expensive in 2024

Source: Campbell Lutyens' 2024 Secondary Market Overview

11%

Proportion of secondaries buyers that used leverage in 2023, down from 25% in 2022

Source: Campbell Lutyens' 2024 Secondary Market Overview

54%

Secondaries buyers that experienced failed deals in at least 20% of GP-led transactions they evaluated last year

Source: Lazard's Secondary Market Report 2023

63%

GPs that think GP-led transactions are a good way to get liquidity, compared with 61% of LPs

Source: Capstone Partners' Liquidity Solutions – A Mirror Survey for LPs and GPs

23%

LPs that think GP-led transactions are a poor way to get liquidity, compared with 3% of GPs

Source: Capstone Partners' Liquidity Solutions – A Mirror Survey for LPs and GPs

KEYNOTE INTERVIEW

Moving down market in secondaries

An abundance of deal opportunity and shortage of competition mean that mid-market GP-leds are the place to be, say New 2ND Capital partners Clay Cole and Evert Vink

Q How would you describe the evolution of the GP-led market in recent years?

Clay Cole: Since New 2ND Capital was launched eight years ago, the GP-led market has really taken off, growing at around a 20 percent annual growth rate. GP-led transactions now sit at just under half of overall secondaries market volume. While growth has moderated recently, we believe that does not reflect a lack of dealflow, rather it is reflective of a lack of dry powder among secondaries buyers.

Increased awareness and adoption have been driven by large bellwether deals, with some of the biggest private equity managers in the world transacting on multiple GP-led secondaries. That awareness and adoption has filtered down to the mid-market and lower mid-market, where we have seen significant demand in recent years.

The other recent evolution I would point to is a greater balance between single-asset and multi-asset deals. In 2020 and 2021, we saw a glut of single-asset transactions, but they have now fallen back to account for around half of continuation fund volume as investors look for more diversification.

SPONSOR
NEW 2ND CAPITAL

Q What are the key drivers of the deals you are seeing today?

Evert Vink: In our firm's early years, we were primarily seen as problem solvers for GPs that needed more time, more capital, or both, to maximize the value of a sub-set of their assets. That is still the case to a certain extent, but over the past couple of years a pronounced lack of liquidity has compounded demand for GP-led deals. The private equity world has seen very low levels of distributions over the past 24 months, and as a result, GPs have turned to secondaries solutions to demonstrate track record and liquidate assets as they prepare to raise new funds.

Q Given these favorable supply/demand dynamics, what are you looking for in a GP-led deal?

CC: We are looking for excellent businesses owned by strong GPs with a sector focus and demonstrable track record, as well as the right management teams for the right assets. We are also highly focused on alignment with the GP. I would add that GPs need to be realistic on pricing, particularly in the current environment. GP-leds are not a direct substitute for traditional M&A. Those deals where GPs are coming out with overly sharp, aspirational marks, are not clearing in the secondaries world.

What is also very important to us is the rationale for the deal. We want to be providing a win-win-win solution for the existing LPs, the GP and ourselves. We are not in the business of creating options without good reason.

Q Why have you chosen to focus on the mid-market and lower mid-market?

EV: The firm was set up by former investors from Carlyle's AlpInvest unit. The idea was to specialize in GP-leds and to do so in the relatively untapped mid- and lower mid-market.

If you look back 30 years, almost all PE firms were generalists. LPs will no longer accept that. They seek some degree of specialization. We believe the same specialization trend is going to play out in secondaries and we wanted to be at the forefront of that.

CC: Coming out of a large secondaries firm, we asked ourselves how we would attack this market if we were starting with a blank sheet of paper and we concluded that the most attractive risk-adjusted returns could be found in mid-market GP-leds in North America. There are two reasons for that: the scale of the opportunity set and a lack of competition.

There are thousands of sponsors and tens of thousands of portfolio companies in the US mid-market. We like the valuations, the leverage profiles and the value-creation opportunities in this space, and we like the fact there is a robust buyer universe at exit. You are not relying on a handful of mega buyout funds or the IPO market to generate liquidity. Meanwhile, most firms with experience in sourcing, diligencing and structuring GP-leds have gravitated towards the top of the market, competing for the largest deals. We therefore see a real opportunity to bring that big firm skill-set to bear lower down the size spectrum.

Q What are your views on the attractiveness of single- versus multi-asset deals?

CC: We like the diversification and cashflow modulation opportunity that multi-asset deals offer. We will also undertake high conviction single-asset deals, but the bar is higher, particularly when it comes to alignment and the rationale for the deal. What we don't like are single-asset transactions in which the GP is looking to de-risk its own portfolio after a few years of ownership. Often there is no reason why the next stage of value creation shouldn't be captured by the original LPs when there are seven or eight years of fund life left.

> *"There are thousands of sponsors and tens of thousands of portfolio companies in the US mid-market"*
>
> **CLAY COLE**

Q How do you think the GP-led market is performing?

CC: It's too early to say on an absolute basis, but we believe the initial data seems promising in terms of GP-leds comfortably outperforming LP-led transactions on an unlevered basis. Intense competition at the top end of the market could potentially erode returns for the biggest deals but we believe the opportunity set in the mid-market, coupled with a lack of dedicated buyers in that space, should lead to outperformance.

The early benchmarking of GP-leds against the broader buyout market also looks promising, particularly in terms of the risk-reward profile. The reduced volatility we are seeing in the GP-led space should mean this proves to be an attractive asset class when compared to direct buyout deals.

Q How do you see the GP-led market evolving, particularly in a more favorable M&A market?

EV: Today's liquidity crunch is not going to be fixed overnight, and the lack of liquidity is being exacerbated by GPs coming back to market more quickly with ever larger funds.

Going forward, I think GP-leds will be viewed as a critical tool in the GP's toolkit, and awareness and adoption will continue to spread down market. From a buyer's perspective, I expect we will see additional capitalization. Increased fund sizes will allow secondaries firms to chase this abundance of opportunity. We will also see more intermediaries in this space – every bulge bracket bank will have a dedicated group. Finally, we will see more new entrants on the buyside, but most of those new entrants will focus on the largest deals, continuing to intensify competition at the top end of the market. ■

Will the rise of mosaic deals affect returns?

As the LP-led market grows 'white hot,' mosaic transactions are sparking debate among some practitioners over the impact on returns. Hannah Zhang reports

LP portfolio mosaic deals, in which a sale is split among multiple buyers, have been picking up steam as the secondaries market matures.

The share of multi-buyer mosaic transactions reached 63 percent of all LP portfolio sales advised by Greenhill last year, according to the firm's *FY 2023 Global Secondary Market Review*. This was an all-time high and up from 50 percent in 2022. Mosaic deals have been especially popular among mixed-quality and more diversified portfolios, according to the report.

A rise in mosaic deals shouldn't be a surprise in today's LP-led market, which, according to a North America-based adviser, is "white hot" as $1 billion-plus portfolios surface more often than before. Buyers have gained the upper hand in some transactions and the freedom to "cherry pick" their favorite assets. Sellers may also leverage mosaic transactions to maximize returns by tailoring sales strategies for different assets within a diversified portfolio.

However, it's not all rosy for buyers despite the advantages. Those who cannot discern outperforming assets from the expanding array of LP portfolios available on the market could fall behind their peers in returns, according to one buyer. "You have to be very thoughtful about what you are buying and how that plays into your portfolio," the buyer says, adding that they expect a wider performance gap among secondaries funds as now there are a broader variety of assets in buyers' portfolios.

For buyers that also invest in single-asset continuation vehicles from their flagship generic funds, this may add to the growing performance gap, the buyer says. "For the first time in a long time, you're seeing secondary fund managers are differing quite widely: who did one [continuation vehicle] that's concentrated, and who did not?"

Others disagree that a wider array of choices for buyers will lead to dispersion in returns. One adviser says they expect the overall performance of secondaries funds to improve in a buyers' market if investors are underwriting assets they know the best.

Meanwhile, a London-based buyer points out that returns of secondaries funds are more dependent on the discount rather than the quality of the assets. "Secondaries is a pretty diversified bet either way," they say.

Aggressive bidding behavior

It could take some time to evaluate mosaic transactions' impact on divergence of returns. Yet even if the London-based buyer is right – that the returns on secondaries funds depend more on the discounts rather than the asset quality – dispersions in returns are likely. Pricing in mosaic deals appears to have been subject to wide dispersions themselves, with Greenhill observing "aggressive bidding behavior" from buyers chasing high-quality mosaic transactions last year. The result was spreads as large as 20 percentage points between highest and lowest offers.

It's unclear at what price these transactions ultimately traded at. Still, with views on an asset's worth diverging so greatly, ultimate returns from these transactions could be similarly divergent in the years to come. ■

Here comes the secondaries operating partner

Secondaries capital that comes with deep sector expertise may define the next iteration of the GP-led market, writes Adam Le

US private equity firm Clayton, Dubilier & Rice is widely credited for having pioneered the operating partner model – one in which portfolio company value creation is driven by strategic operational developments through the hiring of industry specialists.

Almost a half century since CD&R's founding, this approach is beginning to appear in the GP-led market. In January it emerged that Accel-KKR, one of the US's better-known tech-focused buyout and growth firms, was the lead investor in a continuation fund deal involving assets managed by Germany's LEA Partners. Accel-KKR used mainly balance sheet capital to back this deal as an LP in the continuation fund. A source familiar with the transaction said the firm may eventually aim to raise a dedicated fund to invest in such deals.

Leonard Green & Partners is also getting in on the action, bringing onboard David Fox from Strategic Partners earlier this year. It has also hired Garrett Hall from AlpInvest Partners, according to a source familiar with the firm. The pair will serve as partners and co-heads of a debut fund focusing on investing in continuation funds, and LGP sees an opportunity to be a value-add partner, affiliate title *Secondaries Investor* understands. The firm is not launching a wider secondaries business, the source added.

European buyout firm Astorg has also launched a unit focusing on continuation funds and will focus on backing deals within its own sweet spots of healthcare, business services, industrials and technology.

It's easy to see why traditional buyout firms are keen to get a slice of the continuation fund action. This is a market that accounted for 12 percent of global sponsor-backed exit volume last year, according to data from Jefferies, and one which many expect will grow.

Firms also appear to be aiming to fill a white space in the continuation fund market: that of the sector specialist secondaries buyer. A GP running a continuation fund process could partner with a generalist secondaries firm and passive LP capital, or it could receive secondaries capital from a buyer with deep knowledge in a particular sector.

"If I'm a GP, do I want plain vanilla passive capital from a secondaries fund, or do I want slightly more active capital that comes with sector expertise and access to specialized networks?" says a former big-name LP.

There are cases where more active specialist secondaries capital won't be appealing. A large-cap software-focused GP might not want secondaries capital from another large-cap software-focused GP in its continuation fund for obvious reasons. Yet, a lower mid-market European tech firm might find the idea of accepting secondaries capital from a mid-market West Coast-based tech and growth GP a particularly valuable opportunity.

Of course, PE firms will need to hire people with demonstrable track records executing on GP-led deals if their attempts at building secondaries units are to be successful. If they can do this, though, their firm's expertise in a particular sector or industry may well give them an edge over their plain vanilla secondaries counterparts. ■

KEYNOTE INTERVIEW

Secondaries 3.0: Beyond continuation funds

The next phase of secondaries will see GPs embracing a broader range of interim liquidity solutions, say David Wachter and Todd Miller at W Capital Partners

Q W Capital defines its strategy as providing 'GP solutions.' Is this just another term for GP-led secondaries?

David Wachter: The term 'GP solutions' captures a broader range of liquidity options, each designed to help GPs better manage their portfolio exposure and fund performance. In addition to GP-led secondaries – or continuation vehicles – these solutions include minority recapitalizations, direct share purchases and GP customized solutions.

The term 'GP-led' was coined by secondaries managers to differentiate those transactions from LP-led secondaries, but we don't believe it adequately conveys the full range of liquidity-driving structures and opportunities that are now available to GPs.

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GPs are now comfortable pursuing a number of different types of transactions that generate partial liquidity during the holding period of high-quality assets. If done constructively, and with the right companies, these deals result in a win for the GP, which gains more control over its exit strategy, allowing it to both grow and exit its best companies at the same time. Meanwhile, LPs win by getting steadier distributions and secondaries investors like us win by gaining access to great portfolio companies, mid-way through their growth story and path to eventual exit.

Q What trends are creating the need for these GP solutions?

Todd Miller: Demand is being driven by both short-term and long-term trends. In the short term, exits are down considerably. There is a pronounced lack of liquidity in the market through traditional M&A, IPOs and dividend recaps. That is forcing sponsors to contemplate secondaries solutions to achieve their annual liquidity targets.

Meanwhile, even beyond the immediacy of the current macro environment, exits haven't kept pace with the explosive growth the private equity market has experienced over the past few decades. At the same time, sponsors are increasingly embracing secondaries transactions as a way to retain their best assets. This trend is unlikely to reverse. In fact, most top sponsors have already completed some type of secondaries transaction, and these secondaries solutions have become a strategic tool, rather than a one-off option.

As David says, these creative liquidity solutions have created a win-win dynamic for all parties – sponsors, LPs, portfolio companies and secondaries investors such as us. These solutions are not one-size-fits-all. They can be customized to meet specific needs.

Finally, secondary transactions are becoming a core offering at investment banks, presented alongside M&A and IPOs. Secondaries groups used to be siloed, but now they are fully integrated with other teams within the banks, which means secondaries solutions are routinely being presented as a viable option. The pitch is now sell, go public or explore interim liquidity solutions, which means secondaries options are now very much in the mainstream. It is a combination of all these trends that is fueling the tremendous demand we are seeing for GP solutions today.

Q Beyond the continuation vehicle, what other options exist for GPs?

TM: The exploding continuation vehicle market has served as a wake-up call for sponsors. It has drawn their attention to the wider range of options available in the secondary market, which may provide a better fit for their specific needs. These solutions include minority recapitalizations, where a minority stake is purchased directly from the controlling sponsor. We can also address liquidity needs of minority stakeholders seeking an earlier exit compared to other investors with longer horizons, such as those holding rollover equity or co-investment positions.

Furthermore, we collaborate with sponsors to consolidate the shareholder bases of their portfolio companies through broad-based tender offerings. This approach improves alignment with the institutional investors and management aiming to grow the business before exiting. In essence, all these solutions offer various forms of interim liquidity or other strategic options to sponsors at different stages during their investment period.

Q When does a continuation fund make sense and when is a minority recap a better option?

TM: Continuation vehicles offer multiple benefits. Sponsors can maintain AUM while generating liquidity for LPs and continuing to work with high conviction portfolio companies. However, continuation vehicle deals are complex, requiring LPAC approval, third-party valuations, tender offers and often syndication. They can be lengthy to complete.

Minority recaps, by contrast, offer a more straightforward and streamlined alternative while still providing partial liquidity and locking in a partial gain for the sponsor. The GP enters into a partnership with a secondaries firm that's comfortable underwriting to a shorter duration, allowing the GP to retain its control position. Generally speaking, minority recaps are great for investments that are two to four years old, whereas continuation vehicles may be a better fit for older investments where the sponsor is running into fund duration issues.

Q W Capital recently announced a strategic relationship with AXA Investment Managers. How will that support plans for the GP solutions business going forward?

DW: AXA shares our vision about where the private equity industry is heading and the opportunity that being a solutions provider represents. AXA formed a private markets division called Prime two years ago, covering private fund investing, co-investing, direct lending and NAV lending. But they also see GP solutions as a key component of that overall strategy and share our views that the solutions that can be offered are far broader than just continuation vehicles. Both businesses have over 20 years of GP, banker and LP relationships to leverage and by cross-marketing and collaborating, we believe we can be a meaningful contributor to the private equity liquidity landscape.

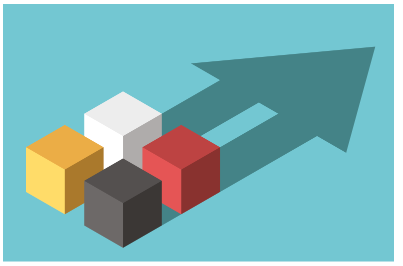
Q How do you see the GP solutions market developing in the future?

DW: There are currently around 28,000 private equity-backed companies representing some $3.2 trillion in unrealized global buyout AUM, according to Bain & Company data. However, only around 1,400 exits are taking place each year. The private equity industry has exploded in size, but the exit market has not kept pace, leaving 20 years of overhang today.

With GP distribution pacing continuing to decline, GPs must embrace GP solutions for the private equity industry to continue to thrive. Given the win-win nature of GP solutions, we believe that 20 percent of the more than $3 trillion out there will come from the GP solutions industry in the future.

TM: The secondary market began with LP-driven trades. That was version 1.0. The emergence of continuation vehicles represents version 2.0. We believe the next phase will involve the offering of a wider range of GP solutions. That is version 3.0, and it is clearly where the secondaries industry is heading. ■

David Wachter is founder and managing partner at W Capital Partners and Todd Miller is a partner at the firm



The importance of alignment

As lines blur between secondaries and co-investments, a strong rationale remains critical to LPs accepting continuation vehicles, say panelists at PEI Group's NEXUS summit. Carmela Mendoza reports

The proliferation of continuation vehicles has changed the discussion around fees between LPs and GPs, according to panelists at PEI Group's NEXUS 2024 summit in March.

Speaking at the event, Allen Waldrop, director of private equity at Alaska Permanent Fund Corporation, said he can get on board with management fees charged on continuation funds, as long as he understands the rationale for such transactions.

"The process to evaluate a single-asset continuation vehicle can be very similar to evaluating a co-investment, but the transaction starts in a different place," he said. "There are important distinctions, and an argument on CVs is that you have to understand the rationale for it. For some, that makes complete sense and it's a great structure, and there's some [where] that makes no sense at all and you would never do that."

According to Waldrop, what's especially interesting is that in continuation vehicles, the firm knows the business and management team well. "A lot of the risk you would see in a new transaction [isn't] there… Some risk is certainly off the table, and you also have the management and GPs rolling [over their exposure] a lot. You got a pretty solid alignment relative to a traditional investment."

Chris Eckerman, senior portfolio manager and co-investments head at State of Wisconsin Investment Board, said continuation funds can be the "right tool for the right job," yet they may have been overused in some situations to date. Some LPs might not have enough bandwidth – the right team or governance – to evaluate these opportunities within the appropriate timelines, he added.

Todd Abbrecht, co-chief executive of Thomas H Lee Partners, noted that his firm has one cardinal rule on single-asset special purpose vehicles.

"The solution pursued with the SPV must be the single best solution for the fund from which the asset comes," he said.

"That process drives a very specific type of behavior around the SPV. Often, in the single-asset SPVs we have executed, there's been a pricing agent in the form of another GP.

"And in order to move the remainder of the exposure from the fund out, the buying third-party GP requires that we continue to be involved. If a substantial portion of that went to co-invest, that makes it not possible for us to devote the resources we need to the asset to continue to be successful. There are very specific origin stories around SPVs that, as they're happening, make them the clear and right product as opposed to co-investment."

Meanwhile, Anne Philpott, managing director for junior capital and private equity solutions at Churchill Asset Management, noted that co-investments and secondaries are complementary within her firm's business.

"In most CVs, the dynamics are favorable – you have management that you're familiar with, who typically roll their interest in the continuation vehicle… and they've done all of the heavy lifting," she said. "They bolstered the management team and they're familiar with the nuances of the market so they're able to take the business to the next level. That piece of the business is not competitive to our co-investment program." ■

Behind the growing pool of secondaries capital

Money continues to flow into this most undercapitalized corner of private equity. Amy Carroll reports

In the midst of one of the most grueling fundraising markets ever, the secondaries industry raised a record $117.9 billion last year across asset classes, per data from affiliate title *Secondaries Investor*. Lexington Partners and Blackstone Strategic Partners both smashed the $20 billion barrier, leading more than 90 funds in total that reached final closes in 2023.

And the consensus is that secondaries' growth trajectory is set to continue. After all, this remains one of the most chronically undercapitalized corners of private markets, with little more than a year's worth of dry powder estimated to be available, despite these superlative fundraising efforts.

"This is still an undercapitalized industry relative to the size of the opportunity," says Immanuel Rubin, a partner and head of European secondaries at Campbell Lutyens. "We are only seeing the turnover of a small proportion of what's in the ground."

More than half (59 percent) of respondents to affiliate title *Private Equity International*'s *LP Perspectives 2024 Study* intend to commit capital to private equity secondaries funds over the next 12 months, a proportion that has been steadily growing year-on-year.

"LPs commit to secondaries funds because they see that this is a materially undercapitalized market," says Jan Philipp Schmitz, executive vice-president at Ardian. "Of the $200 billion or so of dealflow that we could have seen last year, only $120 billion-$130 billion transacted, because the capital just wasn't there. That makes this a buyer's market, and investors recognize that."

Indeed, according to Ryan Cooney, a managing director at Hamilton Lane, investor allocations to secondaries have generally increased from 5-10 percent a decade ago, to closer to 20 percent today. "In some cases, that increase has been taken out of primary allocations. In other cases, investors have been reducing public equity exposure," he says.

In part, this is due to the powerful

"The retailization journey is still in its infancy but the secondaries market is resonating well with this pool of capital"

EDWARD HOLDSWORTH
HarbourVest Partners

"Big funds will continue to get bigger, undoubtedly. But we are also seeing quite a few entrants, particularly in the single-asset GP-led space"

IMMANUEL RUBIN
Campbell Lutyens

Secondaries fundraising across asset classes

Source: Secondaries Investor

forces driving secondaries dealflow today. "This is a strategy that prospers in times of volatility, dislocation and distress," says Edward Holdsworth, a managing director at HarbourVest Partners. "In today's environment, we are able to buy high-quality assets at wider discounts, which is extremely attractive and resonates well with investors."

But far from merely a cyclical phenomenon, the secondaries market is in long-term growth mode. "The last three years have been the first with transaction volume of over $100 billion per annum. This is an asset class that is on an upward trajectory," says Gordon Appell, a managing director in the private capital solutions group at PJT Park Hill. "That is attracting new pools of capital looking to get into private markets in a way that offers vintage year diversification and J-curve mitigation. For retail investors, secondaries make a lot of sense as well."

In fact, one of the most transformative trends to impact secondaries fundraising is likely to be the democratization of private markets. "Private wealth investors like the idea of gaining access to private markets through a diversified, lower risk strategy like secondaries, as well as buying an appreciating asset at a discount," says Cooney.

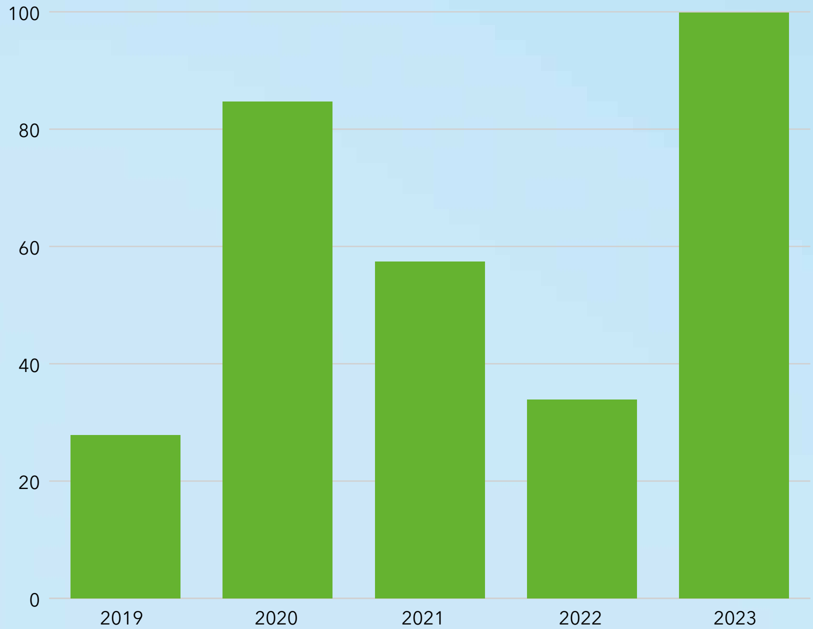
It is still early days, however. "The retailization journey is still in its infancy," says Holdsworth, "but the secondaries market is resonating well with this pool of capital, given its low loss ratios, J-curve mitigation and diversification."

Democratization could also further fuel secondaries dealflow. "We believe the democratization of private markets could increase the penetration rate of secondaries as a percentage of AUM from where it sits today in the low single digits," says Shane Feeney, a managing director and global head of secondaries at Northleaf Capital Partners. "Retail investors are likely to have a greater need for liquidity than institutional investors, and secondaries can play an important role in facilitating that."

Changing shape of the market

Growth in fundraising is also being driven by a proliferation of strategies as managers diversify into other asset classes, including infrastructure and

Private equity secondaries fundraising ($bn)



Source: Secondaries Investor

private debt. Secondaries has historically been dominated by a small number of large players, however, and the expectation is that the majority of capital inflows will continue to go to those established names. But not exclusively.

"Big funds will continue to get bigger, undoubtedly. But we are also seeing quite a few entrants, particularly in the single-asset GP-led space," says Rubin, pointing to buyout platforms that are looking to leverage their exposure in the continuation vehicle space.

Firms that have made this move include TPG and Astorg. "I expect more of this to come," Rubin says.

"The single-asset GP-led market is where we expect to see high growth," adds Holdsworth. "This is the most undercapitalized opportunity set within secondaries, given that generalist secondaries funds are restricted in how much exposure they can have to these deals."

Entrants on the LP secondaries side are expected to be limited, however. "Barriers to entry are high. This is a difficult market to break into," Rubin explains. "The big players have the coverage and setup to be able to transact in a fast and efficient manner. That isn't easy to replicate."

> *"This is an asset class that is on an upward trajectory"*
>
> **GORDON APPELL**
> **PJT Park Hill**

Ardian's Schmitz agrees: "You need to have big teams and big databases in order to buy large LP portfolios with 100 funds and perhaps 1,000 underlying portfolio companies. Importantly, in our opinion, you also need to be investors in these funds. This isn't like the public markets. You can't get information from one of the well-known data providers. That is why I really don't see there being many, if any, new entrants in this space."

Yet PJT's Appell points to more artificial intelligence-enabled, data-driven entrants looking at the LP-led space. Some asset managers are also attempting to circumnavigate barriers to entry by buying fully formed secondaries teams. CVC Capital Partners acquired Glendower Capital, for example, Franklin Templeton acquired Lexington and Ares Management acquired Landmark Partners. The trouble is that asset managers are running out of firms to buy.

"There just aren't that many independents remaining," says Rubin. "I think firms that have yet to secure a secondaries business will be scrambling around trying to figure out how to get hold of [one]. No doubt, we will see more M&A as groups try and buy up those last few standalone secondaries outfits."

Appell, meanwhile, says that, while a lot of groups have already been purchased, there are still opportunities if asset managers are willing to think broader, potentially acquiring combined secondaries, fund of funds and co-investment businesses. "There are certainly some firms out there with $30 billion-$40 billion in AUM but without the broad distribution capabilities needed to scale further. My sense is that this could be a logical route forward for large multi-strategy platforms wanting to get into the secondaries space and questioning whether to buy or build." ■

KEYNOTE INTERVIEW

Market maturity prompts secondaries shifts

As its popularity continues to grow, the secondaries market is seeing increased levels of innovation, competition and regulatory scrutiny, say Gibson Dunn's Shukie Grossman, Sean McFarlane and Kate Timmerman

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Q Given the recent slowdown in M&A activity, have you seen an uptick in GP-led deals?

Sean McFarlane: Private equity sponsors and investors are dealing with interest rates that look set to remain higher for longer. Together with heightened geopolitical risk and election risk, these conditions have caused uncertainty among buyers and sellers, which has resulted in limited M&A activity.

At the same time, there is record dry powder available, and assets are sitting in portfolios because sponsors don't want to sell them at unfavorable valuations. That has led to a maturing of the GP-led secondaries asset class, which offers an opportunity for LPs to realize some liquidity while GPs can continue to hold onto high performing assets for longer than the original fund term.

Q Which areas of the secondaries market are currently most active, and where do you expect to be busy through the rest of 2024?

Kate Timmerman: GP-leds continue to dominate the secondaries market as they have done for the past five or so years. While previously viewed negatively by LPs, they are now seen as a favorable way of giving additional life to assets that are already performing well for sponsors and investors.

We recently supported Leonard Green & Partners in closing a $2 billion-plus continuation fund to continue backing four portfolio companies, in partnership with AlpInvest Partners. This transaction is consistent with the demand we see for large-scale diversified portfolio transactions, and we expect that to continue through the rest of 2024 and beyond.

On the LP side, the current environment is causing a lot of reassessment of portfolios, particularly in real estate, and that is driving further traction in the secondaries market. Where previously there was a discount to NAV on these transactions, there is now more competition and innovation and we are seeing deferred purchase prices, seller financing and other creative solutions becoming more common.

Q How has the increase in GP-led secondaries transactions impacted fundraising?

Shukie Grossman: Capital raising has been quite challenging over the past 18 months. This is the case, in part, because it has been more difficult for sponsors to exit investments and so investors looking to see a track record with realizations from prior funds have been reluctant to allocate new capital. We see GP-leds as a means by which successful GPs can provide those realizations to LPs and grease the wheels of fundraising.

Further, because GP-leds have become so interesting, many sponsors that have traditionally focused on raising buyout funds are now raising separate funds dedicated to investing in these vehicles. That is testament to the popularity of GP-leds, and as we see more dedicated capital raised, we can look forward to deployment driving more activity in this area.

Q How do negotiations on single-asset GP-led deals differ from those on diversified portfolio transactions?

SM: There needs to be a compelling rationale on the part of the GP entering into a single-asset deal as to why it is pursuing this strategy. Everyone has become comfortable with diversified portfolio sales, where funds reaching end of life put a variety of assets into a continuation vehicle, which matches LPs' appetite for diversification. But single-asset deals are more difficult and the strategy of the GP is scrutinized more closely.

That being said, there has been a substantial increase in single-asset continuation vehicles, which have started to resemble traditional private equity M&A transactions. They have a more standard due diligence process not typically seen in the secondaries space, as people want to do a full underwriting exercise to understand the asset and why it is being sold.

Also, rep and warranty insurance (RWI) has come a long way in this space. Where historically RWI only covered standard fundamental representations and maybe a few knowledge-qualified reps for portfolio companies, today's buyers' market has driven demand for better protections. Insurance has provided a solution to streamline processes.

Q What do the SEC's private fund rules mean for the secondaries market?

SG: The Securities and Exchange Commission has adopted a new set of private funds rules covering a broad array of topics, one of which is adviser-led secondaries, or GP-led recapitalizations, as we call them.

The major innovation under the new rule is that, when implemented, sponsors will be required to provide investors with a fairness or valuation opinion from an independent third party in advance of the consummation of most GP-leds, along with a summary of any material business relationships the sponsor has had with the opinion provider in the previous two years.

In many instances, that is consistent with market practice because these deals typically require approval of the LP advisory committee of the selling fund along with some third-party countenance of pricing.

But, in some cases, it could have a chilling effect on transactions because it has not always been market practice on smaller deals, particularly where there is a competitive process providing the necessary price discovery. There is some feeling in the industry that it might have been best for the SEC to leave this to the discretion of GPs and their investors who would bear the cost of obtaining a fairness or valuation opinion.

As a point of note, the rules are currently subject to a lawsuit where Gibson Dunn is representing key industry groups. If successful, it is possible the rule will not actually take effect as a requirement and price validation will remain a point for commercial discussion. The other relevant regulatory change is the new requirement that a sponsor of a GP-led transaction must report it to the SEC in a non-public filing within 60 days of the end of the quarter in which it closed.

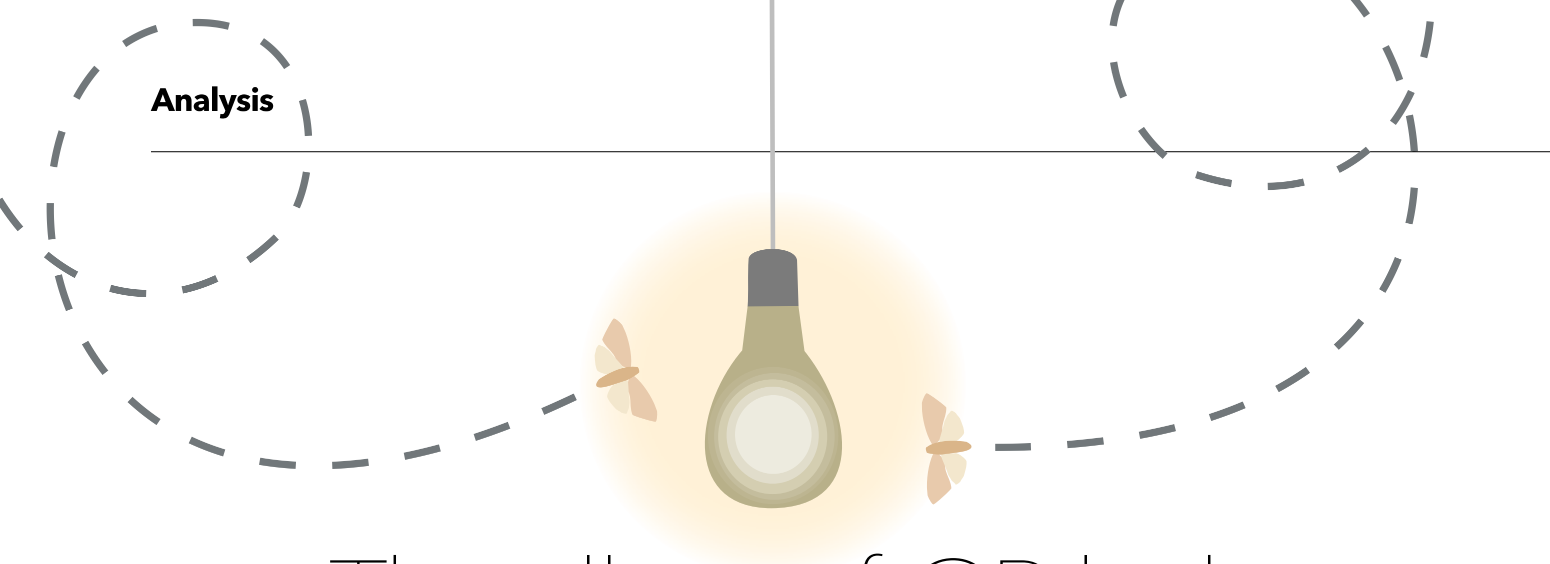
Again, this is nothing particularly dramatic, but it is an additional administrative burden that may be of no consequence for large sponsors but for others will generate greater expense.

Q What are your predictions for the future of secondaries?

KT: We expect the GP-led market to become busier after a volatile few years, with more players entering the market and doing more sophisticated deals, both in terms of deal constructs and the documentation required.

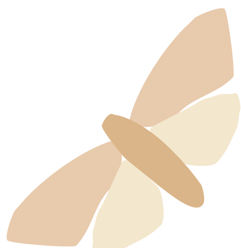
Longer term, secondaries are becoming a bigger part of our practice, and we expect people to lean on innovations such as artificial intelligence to enhance processes. We also anticipate the use of blockchain and the digitalization of assets as both sponsors and investors become more comfortable with those technologies. ■

Shukie Grossman is a partner and co-chair of the Investment Funds Group at Gibson Dunn, Sean McFarlane is a partner and Kate Timmerman is an associate attorney at the firm



The allure of GP-led secondaries

Muted M&A activity and liquidity demands are prompting more sponsors to consider moving assets into continuation funds, but competition is fierce. Amy Carroll reports



The pursuit among sponsors of GP-led secondaries deals has reached fever pitch, and it isn't hard to see why. The success of future fundraising endeavors rests squarely on a firm's ability to deliver liquidity to existing LPs. With M&A and IPO markets still dragging their heels, the opportunity for a private equity firm to sell an asset to themselves, obtain a cash injection to embark on a new chapter in the company's growth story, all while delivering cash back to investors, thereby keeping the fundraising wheels in motion, is understandably a welcome option.

"For over a decade, LPs have generally been cashflow positive on their private equity books," says HarbourVest Partners managing director Rajesh Senapati. "More cash was coming in than was going out the door to service capital calls, even with investors running modest over-commitment strategies. But that has all changed in the past year and a half. LPs and GPs alike are now clamoring for liquidity.

"Continuation vehicles are therefore a great solution that allow GPs to provide optionality for LPs in need of liquidity, while at the same time achieving other objectives, such as raising incremental capital to support growth, getting more time in order to wait for a better exit environment, or realigning incentives for go-forward value creation."

Palladium Equity Partners is one firm that has taken the plunge, announcing the close of a $450 million continuation vehicle earlier this year encompassing three businesses: entertainment destination Sky Zone, Hispanic cuisine specialist Del Real Foods and low-calorie flavorings provider

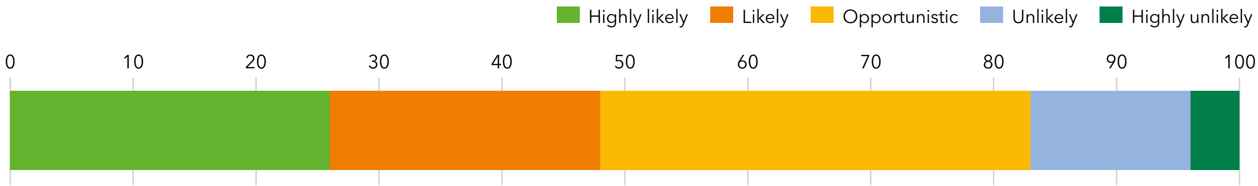
$51bn

GP-led transaction volume in 2023
Source: Evercore's FY 2023 Secondary Market Survey

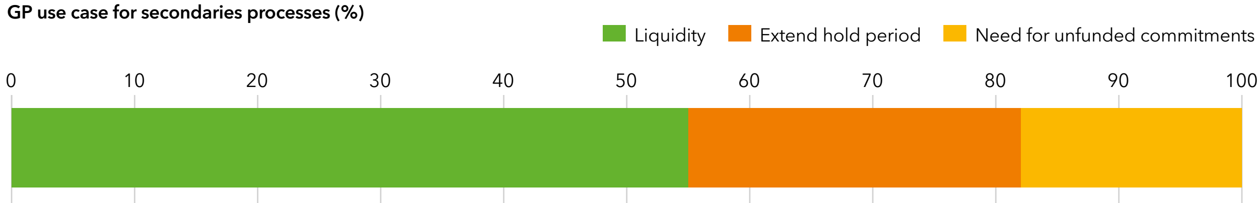
88%

Continuation fund transactions as a percentage of total GP-led secondaries volume in 2023
Source: Jefferies' Global Secondary Market Review, January 2024

GP likelihood of using the secondaries market in the next 24 months (%)



GP use case for secondaries processes (%)



Source: PJT's FY 2023 Secondary Market Insight report

Jordan's Skinny Mixes, all companies acquired by Palladium's fourth fund, which closed almost 10 years ago.

"The primary appeal for us was providing optionality to our limited partners to best meet their needs," says Justin Green, a partner and co-head of flagship funds at Palladium. "A continuation vehicle provided our LPs with an option to take liquidity if they wanted to do that while allowing us to own the assets longer and create what we expect to be additional value for limited partners that preferred to stay in the deals."

One Equity Partners, meanwhile, closed a substantial continuation fund last year, which centered around two European portfolio companies. Additional capital from the deal will be used to drive transformation acquisitions at aftermarket construction parts manufacturer and distributor USCO and laboratory glassware manufacturer DWK Life Sciences.

"One of the reasons these deals are so attractive in the current environment is [because] exits are down across the board and so LPs are starved of distributions," says David Lippin, a partner and head of investor relations at One Equity Partners. "A continuation vehicle allows the GP to monetize the value created over years of ownership,

> *"Given the meaningful opportunity set today, secondaries buyers have the ability to be highly selective in the deals they choose to pursue"*
>
> **RAJESH SENAPATI**
> **HarbourVest Partners**

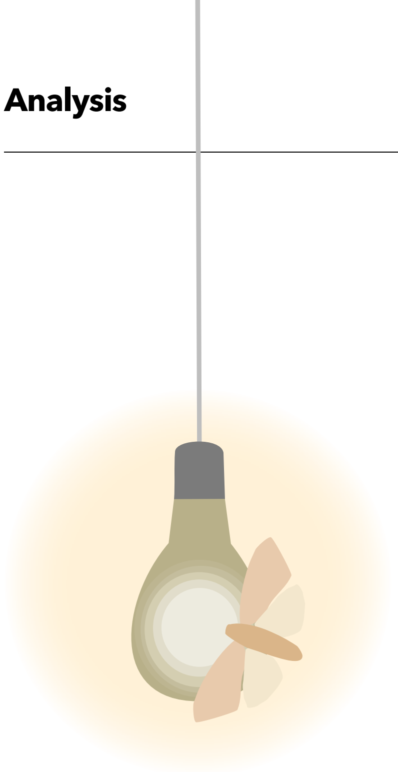
generating liquidity for those LPs that want it. At the same time, it gives the sponsor the opportunity to continue to grow and develop those businesses, allowing the growth trajectory of assets they really like to continue."

Exit woes

Indeed, in many cases today, GP-led secondaries are not just the most attractive exit option available, they may well be the only exit option on the table.

"In 2019 and 2020, when the M&A market was hot, sponsors were using continuation vehicles to retain ownership of assets where they had long-term conviction, while generating liquidity and de-risking existing LPs," says John Rife, a partner at law firm Debevoise & Plimpton. "Now that other forms of exit have dried up, however, the focus is less on de-risking existing funds, and more about realizing assets in a market where there are few other credible exit routes. In fact, a continuation vehicle may well be the most likely exit route to succeed today, whereas in 2020, it was just one option among many."

The problem, of course, is that this has exacerbated the supply/demand imbalance in the GP-led market. "Given the meaningful opportunity set today, secondaries buyers have the ability to be highly selective in the deals they



choose to pursue," says Senapati. "This includes the ability to potentially shape a portfolio that is high quality but that will also price well for LPs receiving the liquidity option. Taking a mixed-quality portfolio to market today as part of an end-of-life solution may not get the level of interest that GPs would like, or the type of pricing LPs may be looking for."

"There seems to be a lot of supply in the market right now relative to demand," adds Palladium's Green. "As a result, some capital providers are focusing on existing relationships, looking for deals that meet very specific criteria or looking for significant pricing discounts. While it is possible to get deals done, I do think the market is challenging."

Amyn Hassanally, a partner and global head of private equity secondaries at Pantheon, agrees. "It is clearly a buyer's market and so only the most compelling opportunities will complete. There needs to be realistic valuation expectations, high-quality assets and managers, strong alignment and sound transaction rationale if a deal is going to get across the finishing line."

Market awareness is also key, says David Perdue, a partner and global head of the secondaries advisory business within PJT Park Hill. "Given the current supply/demand dynamics, it is important to understand the demand for your transaction," he says, "as well as market awareness of what other deals are in competition with your deal, to inform an optimal marketing and execution strategy." ■

Asset selection

Given the pronounced supply/demand dynamic that exists in the GP-led secondaries market, the selection of the asset or assets to be placed into the continuation vehicle is paramount.

"There was a time when you could get away with selecting a couple of good companies and then maybe slipping in another that you couldn't otherwise get rid of," says Debevoise & Plimpton partner Gavin Anderson. "I think those days are largely over. It is a buyer's market, and to get buyers' attention you need assets with a compelling story."

Meanwhile, Debevoise's John Rife says deals with a strong transformative component are proving popular, citing Pollen Street Capital's 2023 continuation vehicle as a case in point. Pollen Street only acquired insurance group Markerstudy in 2021 but moved it into a continuation fund last year, alongside a parallel M&A process that saw Markerstudy acquire Atlanta Group in a bolt-on transaction.

"Those are the deals that are resonating best with the market," Rife says. "There needs to be some sort of time sensitivity as to why a deal needs to execute today, rather than in two years' time. What doesn't resonate well is to say that you have a good asset that you can't sell to anyone else right now, so you are going to sell it to yourself."

However, there is a tension at play between the need to remain laser-focused on the best and most appropriate assets, and secondaries buyers' growing aversion to the heavy concentration of single-asset deals. "The big single-asset deals that generated so much excitement in the wake of covid are perhaps falling out of favor a bit as secondaries buyers prioritize diversification," says Anderson.

But Pantheon's Amyn Hassanally says GPs still need to be highly selective and may be better off pursuing a single-asset deal, unless they have multiple assets that are of sufficient quality to attract buyers.

This is a balancing act that One Equity Partners' David Lippin knows only too well. "I would certainly embark on a continuation vehicle again, but I would do it differently," he says. "We started out with one company in mind, but our advisers recommended adding another because secondaries investors preferred multi-asset deals. The problem was we ended up with something that wasn't a single-asset deal, but didn't have enough assets involved to be considered a multi-asset transaction. It was a bit of a no-man's land. In hindsight it would have been better to focus on one company and take that to market."

GP-leds in the news

A number of continuation fund deals have made headlines so far this year. Here we round up five notable transactions

Accel-KKR turns secondaries buyer

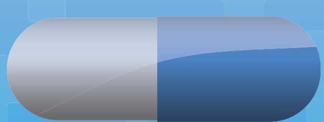
Accel-KKR, one of the better-known tech investors in the US, backed what is understood to be its first continuation fund deal on the buyside. The Menlo Park-headquartered firm, better known for its buyout and growth investments in tech and software, was the lead investor in a GP-led process involving German private equity and venture capital firm LEA Partners, sources familiar with the matter told affiliate title *Secondaries Investor* in January. The transaction, which was understood to be worth around €650 million and was expected to close in February, involved moving two companies out of Karlsruhe-headquartered LEA's Fund I, into a separate vehicle, the sources said.

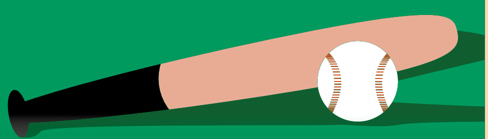
Vestar's $1bn-plus single-asset deal

In February, *Buyouts* reported that Vestar Capital was working on a single-asset process for portfolio company Circana (formerly IRI) as a way to deliver liquidity back to LPs in an older fund. The potential size of the process was in the range of $1.2 billion, according to a source. Circana provides data and predictive analytics for healthcare organizations, retailers, financial services and media companies. Vestar invested in Circana in 2018 through its seventh fund, which closed on $1.1 billion in 2020.

Goldman Sachs, AlpInvest lead Cinven's Barentz secondary

Lead buyers emerged in March for Cinven's single-asset continuation fund process, which will extend the London-headquartered buyout firm's hold of global life science ingredients distributor Barentz. Goldman Sachs Asset Management acted as lead buyer on the transaction while Carlyle's AlpInvest Partners took a junior lead position, sources said.



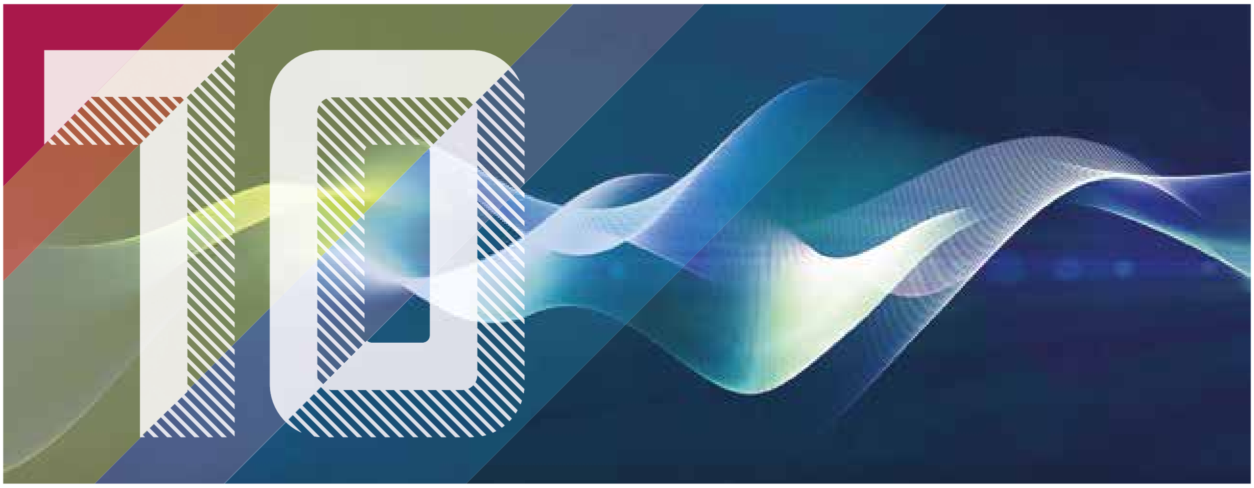


Anchor LP David Rubenstein seeks liquidity

Growth-focused shop Declaration Partners was exploring a GP-led secondary on several assets to generate liquidity for the firm's anchor limited partner, Carlyle Group co-founder David Rubenstein, sources told *Buyouts* in April. The deal, facilitated by adviser Fairview Capital Group, would allow Rubenstein to sell partial stakes in the assets, which will support his investment in the Baltimore Orioles Major League Baseball franchise, the sources said.

StepStone leads on insurance-focused CV

StepStone Group took the lead on a continuation fund transaction involving five assets in the insurance industry, *Secondaries Investor* reported in April. Hudson Structured Capital Management, a Connecticut-based alternative asset manager focused on insurance and transportation, moved its stake in five life insurance investments held by its multi-sector insurance-focused HSCM Bermuda Fund into a continuation vehicle, a statement noted.



Tune into the secondaries market

Listen to the new podcast series, A Decade of Secondaries Investing, to hear a range of industry stakeholders discuss the evolution of the market over the past 10 years

Affiliate title *Secondaries Investor* celebrated its 10th anniversary with the launch of a new podcast series, *A Decade of Secondaries Investing*. The series reflects on the key trends that have shaped the secondaries market over the past decade and takes a glimpse at what lies ahead.

When *Secondaries Investor* launched in 2014, the market was just finding its momentum. In 2014, total secondaries volume came in at around $47 billion. Fast forward 10 years and annual volume has more than doubled. There is every indication the next decade will be no less eventful, or transformative.

Scan to listen to the series

This special podcast miniseries revisits how far the secondaries market has come and previews where it is headed. The series kicks off with a step back in time to when the Volcker Rule and post-GFC legislative frameworks spurred secondaries sales.

Further episodes cover topics such as the development of continuation vehicles, regulatory changes, the evolution of the North American and European secondaries markets, the birth of programmatic secondaries, the growth of non-PE secondaries and the gender gap within the industry.

Guests include some of the biggest names in secondaries, such as global head of Blackstone Strategic Partners Verdun Perry, Evercore global head of private capital advisory Nigel Dawn, Coller Capital chief investment officer and managing partner Jeremy Coller and many others. ■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