Are LPs Missing the Boat?

Examining GP-Led secondaries in the private equity market

Headline

The advent of GP-led secondaries is one of the most important changes in the private equity industry over the last 20 years. Specifically, the use of Continuation Funds / Continuation Vehicles ("CVs") is booming, with an estimated $60-70 billion of single asset or multi-asset transactions completed in 2021 alone. This accounts for almost half of the overall secondary market, which, until recently, was primarily driven by LP portfolio sales of fund interests.

GP-led deals are not a temporary phenomenon as all signs point to this activity becoming a key component of the industry for the foreseeable future. In fact, both GPs and LPs should embrace GP-led transactions as an important tool for capital raising, portfolio management, risk mitigation and overall improved investment performance.

Once upon a time in the land of secondaries

Some history first. In conjunction with the overall growth of private equity as an institutional asset class, secondaries became a mainstay private equity strategy in the late 1990's. Until the Global Financial Crisis, secondaries were primarily used by LPs to rebalance their portfolios or for corporate entities and other more short-term investors such as banks to shed non-core assets.

The first phase of the GP-led market dates to around 2010 with transactions (often called "fund recaps") focused mostly on aged assets remaining in tail-end funds. The "targeted" portfolio companies were usually a mix of moderate to poor performing businesses that, for obvious reasons, had yet to be sold after a 10-year hold period. Demand from LPs to wrap up these older funds typically initiated these transactions; however, these processes were often poorly managed. Most importantly, there was a general sense amongst LPs that they were being "crammed" into asset sales that had asymmetric returns to the GPs (i.e., LPs were asked to "take it or leave it" with little information or a coherent process).

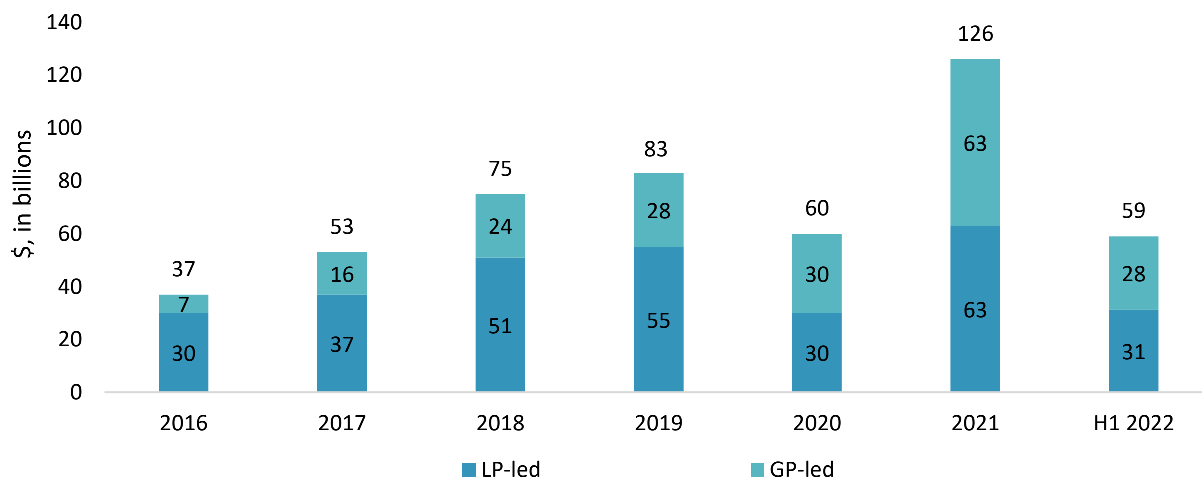
It is important to recognize that LPs tend to engage less in tail-end funds, especially those they deem managed by "retiring relationships". In these early days, inertia often reigned supreme, with many LPs unwilling or unable to spend the required time to understand the proposed structures. The by-product was often a polarized LP base, some of whom deemed the proposed sale options as reasonable outcomes while others vehemently opposed any deal offered from managers they did not trust. Rightly or wrongly, GPs were often frustrated that their LPs were often unresponsive, all the while the remnants of their once proud franchises hinged on the decisions of mostly disengaged investors.

Secondaries V 2.0

This all changed over the last five to seven years as newly coined "GP-led secondaries" increasingly offered investors an opportunity to double down on their most promising companies, including those more recently acquired.

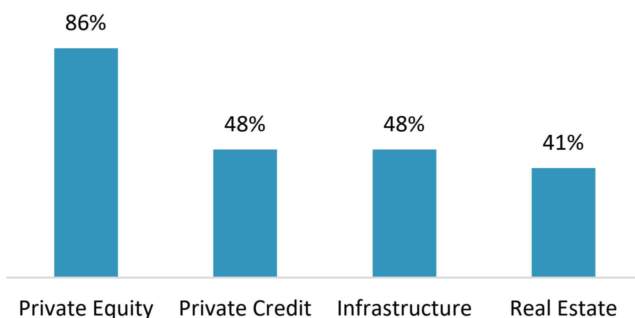
Well-oiled processes have become the norm, led by seasoned secondary bankers who have expanded their capabilities beyond LP portfolio secondary transactions. The explosive growth of this new form of secondaries has caught the eye of regulators, but even if the SEC endeavors to impose new rules to regulate them, GP-led transactions will continue to progress across the market. According to the Coller Capital's 2022 Global Private Equity Barometer, 86% of LPs expect the PE secondaries market to continue to expand over the next three years, which includes the GP-led category.[1,2] In 2021, CVs accounted for 84% of GP-led transactions, which totaled $68 billion[3,4]. Through the first half of 2022, it is estimated that almost 50% of the overall secondary market is comprised of GP-led deals. Additionally, based on data from Hamilton Lane, 93% of GPs that completed a GP-led secondary desire to do so again[5].

Secondary Transaction Volume

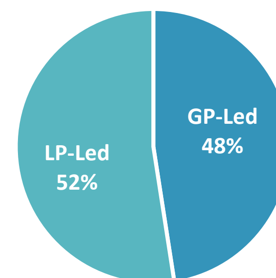


Source: Lazard Sponsor-Led Secondary Market Report H1 2022

Percent of LPs expecting Secondary Market Expansion



Percent of Transaction Volume in H1 2022



Source: Coller Capital Global Private Equity Barometer Winter 2021-22 & Lazard Sponsor-Led Secondary Market Report H1 2022

[1] Coller Capital - Global Private Equity Barometer, Winter 21-22
[2] PEI Future of Private Equity Magazine May 2022
[3] Jefferies"
[4] Madeline Shi "Continuation funds drive GP-led secondaries wave"
[5] Hamilton Lane 2022 Private Markets

There are several reasons why CVs are now more common and why they make sense for both GPs and LPs. At the core, these transactions serve to create further value from the best performing companies outside of the traditional co-mingled fund structure. CVs provide capital to:

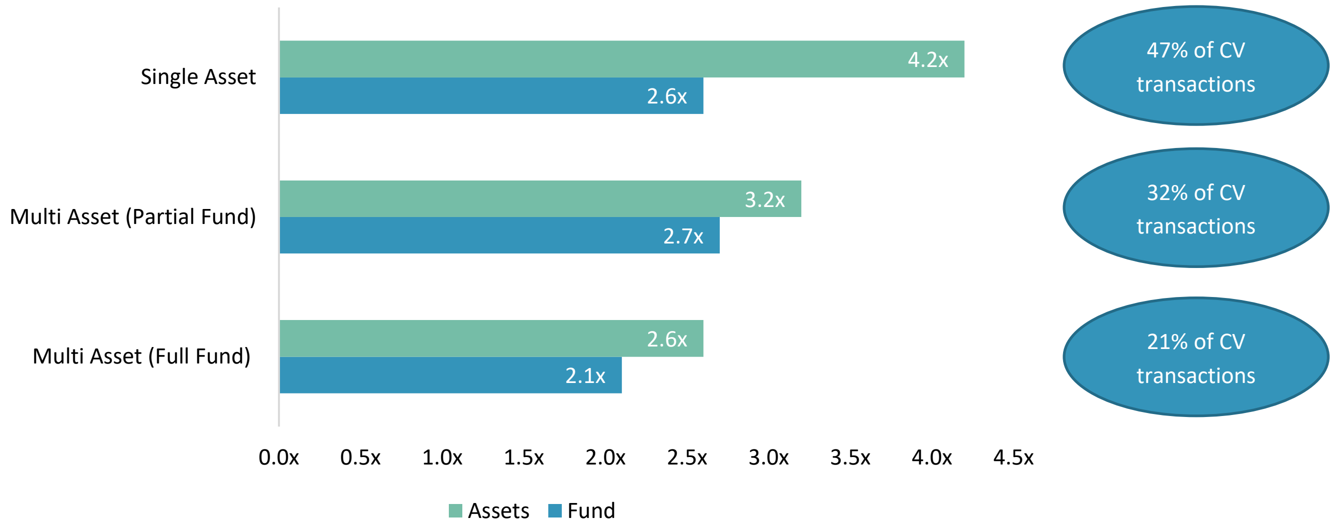
- Enable a GP to grow their best businesses through acquisitions without sharing the deal with a co-control owner
- Preserve fund diversification to avoid breaching the 10-15% concentration limit mandated by a fund's limited partnership agreement
- Allow a manager to increase their ownership stake in portfolio companies where they hold a minority position through a recap process
- Simply give investors an opportunity to own good assets longer than would be viable in a traditional 10-year term comingled fund
- Create a liquidity mechanism for GPs to offer their limited partners, which is particularly valuable in a less favorable exit environment as we are currently experiencing

There is no doubt that GP-led secondaries have their challenges. At their core, they are related party transactions that provide a GP an opportunity to generate better economic returns for themselves that may not be available to all the LPs (which we will get into later). The obligation of any GP is to uphold their fiduciary obligations to their investors such that returns are not compromised, no different than any other exit route pursued by a manager for their portfolio companies.

So what does this mean for LPs?

Although GP-led deals have a somewhat limited history, early returns provide evidence that both single asset and multi-asset GP-led transactions outperform their underlying funds. According to research published by Hamilton Lane in 2021, single asset and multi-asset vehicles have significantly outperformed their associated funds. Specifically, as measured by median realized gross multiples of investment cost (MOIC), single asset CVs have generated 4.2x vs. 2.6x MOIC, while multi asset CVs (both partial and full fund) have outperformed their corresponding funds by 0.5x MOIC. In addition, Preqin provides an independent source of performance information that illustrates a clear trend that CVs are outperforming comparable funds from the same vintage year (Figures on page 4).

Median Gross Multiple of Cost

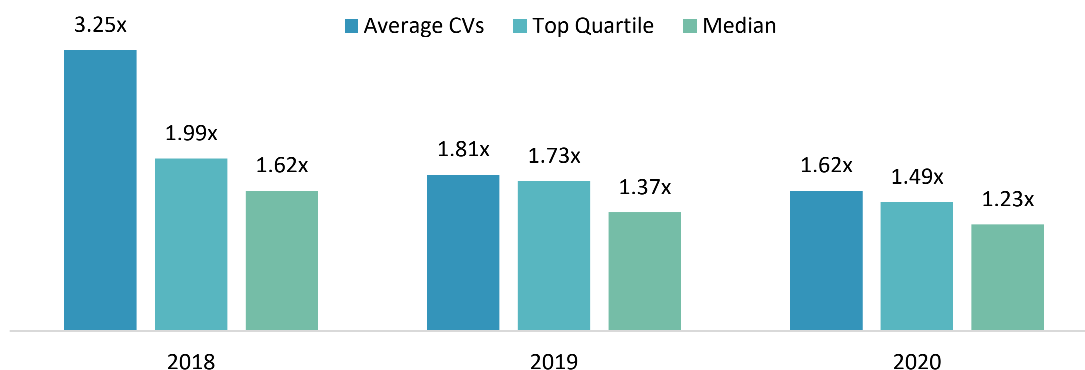


Source: Hamilton Lane Report (Aug 2021) – GP-Led Transactions: What LPs Need to Know

Despite this outperformance, most LPs have yet to embrace GP-led deals as attractive investment opportunities. In fact, when presented the option to roll into a CV or sell their pro rata interest in one or more companies, LPs are choosing liquidity. Based on a Lazard H1 2022 estimate, 90% of LPs are electing for liquidity in GP-led continuation vehicles.[6]

Another attractive feature of GP-led transactions is the optionality made available to LPs to manage liquidity and portfolio diversification (geographic or industry exposures). Historically, LPs have only been able to sell entire fund positions, while a GP-led transaction provides a better portfolio rebalancing outcome, either as a buyer or seller.

CV vs All Private Equity Benchmark (June 2022)



Source: Preqin – Benchmark Criteria – All Equity; CV Criteria – All Private Equity, Continuation Funds; Vintage Years 2018-2020. Comparison based on TVPI with reported numbers as of June 2022 and 2021 (if not reported in 2022). The number of CVs analyzed with Vintage Years of 2018, 2019, 2020 totaled 2, 4, and 7 respectively.

[6] Lazard Private Capital Advisory – Sponsor-Led Secondary Market Report H1'22

What are LPs thinking?

Based on our conversations with LPs, we believe there are several reasons why LPs have been slow to participate in GP-led transactions:

- There is a perception that GPs are conflicted and not aligned with LPs in GP-led transactions, particularly as it related to them crystalizing carried interests through CVs
- GP-led transactions deviate from the traditional path to liquidity (i.e., IPOs and trade sales, either strategic or to financial buyers)
- LPs do not have a process for executing CV transactions, mostly amongst those institutions with more structured investment policies and processes that require a consultant engagement and board of trustees' approval
- Value offered through GP-led secondaries is quite attract to sellers as pricing is usually close to the carrying value of the assets with reasonably good transactions multiples, which allows LPs to achieve high realized IRRs

What is Reality?

A GP's role and alignment in a GP-led transaction has evolved greatly. Although there are instances in which carried interest is generated for a GP through a GP-led sale, most CV investors insist that the GP roll a significant amount, if not all their "realized" economics (both invested capital and carry), into the new vehicle. In addition, GPs often roll into a security that is subordinated to the new capital, thus furthering alignment with the interests of the new LPs.

The concern that CVs are unnatural to the flow of PE is a mentality reminiscent of prevailing sentiments from 15 years ago when LPs were concerned about exits through GP-to-GP sales of their portfolio companies. Interestingly, CVs offer a process that allows GPs to have more flexibility to exit their portfolios companies, rather than selling to peers. Effectively, GP-led transactions put the LPs in control of whether they want to continue to own the transferred assets versus owning these companies through another existing GP relationship (the new buyers).

Further, selling into CV transactions will lead to additional organizational strain to reinvest the proceeds and meet targeted allocation levels. If the path taken is to make new fund commitments, IRR benefits realized from accepting the CV liquidity option may be offset by the downward J-curve of new funds.

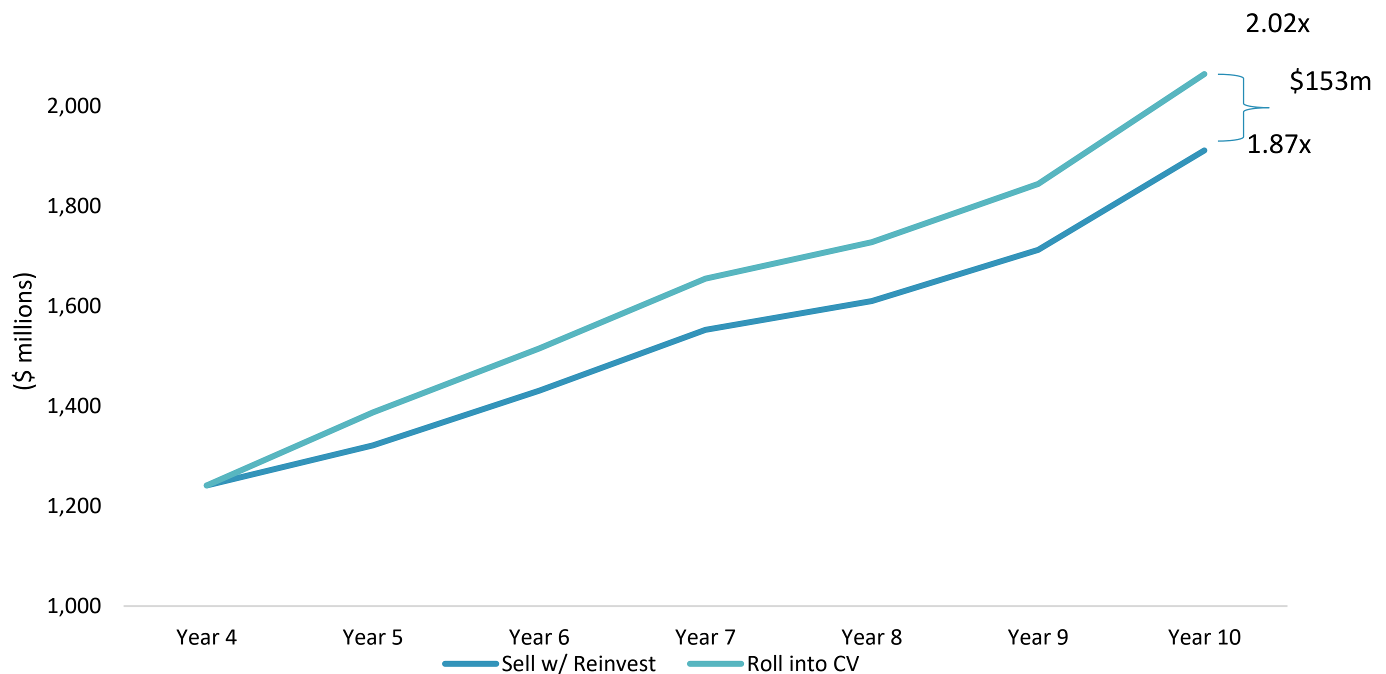
Also, one cannot discount the importance of traditional LPs serving as long term capital providers to GPs. For this reason, LPs have an advantage as an attractive capital source for CVs. This gives them a competitive advantage, assuming they can execute in a commercial fashion.

Perhaps most importantly, **LPs need to prioritize GP-led transactions because of the long-term cash-on-cash returns impact on their portfolios**. Fundamentally, if LPs accept the liquidity offered by CV transactions, they tradeoff Total Value to Paid In ("TVPI") over the long run for moderately higher realized IRRs. This TVPI tradeoff is exacerbated when put in the context of the compounding effect within a multi-year private equity program.

Upwelling research shows that systemically avoiding CV transactions has a tangible opportunity cost of 8% in a single vintage year. The diagram below is a hypothetical analysis of this opportunity cost.

Our assumptions include:

- $1 billion per year investment pace
- Median performance of entire portfolio based on TVPI of 2012 Vintage Year buyout funds
- 5.6%: rate of capital deployed annually in GP-led transactions relative to total buyout volume[7] [8]
- Weighted average performance for the CV as evidenced by Hamilton Lane's data aforementioned
- For LPs that sold into GP-led secondaries, proceeds were reinvested immediately with median returns
- 15% carried interest paid to the GP at end of Year 10
- LPs are not participating in GP-led transactions outside of those offered by the current manager



Source: Pitchbook – Benchmark Criteria – Buyout, USA, Vintage 2012, Fund Size > $100 million

[7] Bain & Company – Global Private Equity Report 2022 - $1.21 trillion total buyout transaction volume
[8] Lazard Private Capital Advisory – Sponsor-Led Secondary Market Report H1'22 -- $63 billion GP-led transaction volume

Our research suggests that rolling into the CV enhances TVPI and converts median portfolio performance (1.87x) into an upper middle or top quartile performer (2.02x). When considering the impact to an ongoing private equity program, this cumulative opportunity cost over a ten-year period could be in excess of 15% of total cash-on-cash returns.

In summary, we believe participating in CV transactions provides LPs an opportunity to implement a new strategy that offers attractive risk-adjusted returns through enhanced transaction economics with an ability to support their best existing GPs.

How can LPs get in the game?

There is no question that CV transactions offered to LPs by their existing managers create an "opt out" versus an "opt-in" situation when offered co-investments. This adds pressure on LPs to be better positioned to respond to CV opportunities. Many LPs are not able to react effectively to CVs today, which may be costing them significant upside in their private equity portfolios.

We believe there are several steps LPs and GPs should consider. First, LPs should be proactive in seeking out early notice from their GPs on possible CV candidates; this will afford sufficient time to have a thorough underwriting process of these opportunities. This means LPs need to be more active in monitoring their GPs and underlying portfolios. Next, we believe GPs should reciprocate to their LPs with regular dialogue to mitigate surprises. As GPs extend the time horizon of their best investments, we believe that securing participation from existing LPs as roll over capital providers would create healthy long-term alignment.

This approach will likely require changes to LPs' investment policies, processes, and staffing:

- Investment policies and processes that allow LPs to be nimble, including the delegation of investment authority to commit to CVs (in addition to funds and co-investments). This will require new internal and/or external resources to handle the additional workload, although the payoff appears to be worth the new expenditures required.
- Establish and communicate preferred investment structures for CVs, allowing LPs to more efficiently evaluate GP-led opportunities: This include minimum percentage of capital that should be rolled over by the GP, preferred economic framework which could include reduced management fees, tiered carried interest and co-investment rights in one or more of the CV portfolio companies.
- By increasing allocation to CV transactions, LPs may be required to reduce commitments to traditional primary funds and co-investments

The determination of preferred terms and structures will help LPs streamline their execution process in CV transactions, while creating efficiencies for GPs in their capital raising. Ultimately, this could ensure a solid LP rollover group for any transaction. If certain LPs are unable to make these changes, we believe that they should establish a CV investment program managed by an outside advisor or partner.

The Punchline

LPs should expect a continuous wave of GP-led opportunities across their portfolios. Although to date most CV transactions have been in buyout strategies, Upwelling is observing the expansion of CVs into private credit, real assets, and venture capital, where the market dislocation is having a significant impact on liquidity for high growth strategies

LPs should realize the short-term IRR focused approach to CVs currently taken by many investors will lead to long term degradation of capital appreciation as TVPI will decline meaningfully. GPs should prioritize LPs to give them as much an opportunity as the broader secondary market to participate in GP-led transactions. Ultimately, institutional investors are the most attractive long-term sources of capital, but LPs need to operate in a commercial fashion to respond appropriately.

In conclusion, Upwelling believes that increased participation in CV transactions is critical to any institutional investor's core strategy. This is particularly true over the long term.

About Upwelling Capital Group

Founded in 2011, Upwelling Capital Group LLC ("Upwelling") is a registered investment adviser that provides customized strategies and solutions to enhance the overall returns for premier alternative investments. Upwelling specializes in providing secondary liquidity solutions across asset classes and capital structures. Principals have cumulatively overseen over $50 billion in global private equity commitments and have successfully managed over $5 billion in legacy, tail-end commitments, transfers, and workouts for leading institutional investors. Securities offered through Bridge Capital Associates, Inc. Member FINRA / SIPC