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Secondaries Sophistication Drives a Surge in Activity

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Secondaries deal volume reached unprecedented heights in 2021 as fund investors rebalanced their portfolios and fund managers tapped GP-led transactions, including single-asset deals, as an alternative exit route. Deal activity remains robust in 2022, even as the market keeps a close eye on regulatory and geopolitical developments.

The private equity (PE) secondaries market delivered a blowout year in 2021. Activity across all deal types soared, and a number of large asset managers expanded their secondaries capabilities. That momentum looks set to continue for the rest of 2022.

According to figures from investment bank Jefferies, secondaries deal value for 2021 totaled a record US$132 billion, 120% up from 2020's full-year total. This saw the market surpass the previous all-time high of US$88 billion worth of deals posted in 2019.[1]

GP-led deals have moved firmly into the mainstream

A surge in general partner (GP)-led deals—where PE fund managers transfer existing assets into continuation funds and provide limited partner (LP) investors with the option to cash out or roll over their stakes—has been a key driver of this rise in activity.

According to Jefferies, GP-led transactions grew by 94% in 2021, year-over-year, and accounted for 52% of secondaries deals by volume, outstripping LP portfolio sales (where investors initiate the sales of their positions in PE funds) for the second year running.[2]

"GP-led deals used to be regarded as a last resort for managers sitting on underperforming assets that they couldn't exit via M&A or IPO or for which they'd run out of capital to support a business plan, but that perception has changed completely," says **Isabel Dische**, a New York-based asset management partner at Ropes & Gray and co-lead of the firm's institutional investors team. "A GP-led deal is now seen as a credible option for top-quality sponsors and assets, offering sponsors a way to maintain exposure to an asset they like and investors the flexibility to either retain their exposure to a portfolio of assets or cash in their stakes if they choose."

Dische adds that blue-chip sponsors with high-quality portfolios are embracing GP-led deals in greater numbers, which has led to bigger ticket sizes, a higher volume of quality deals and more sophisticated transactions.

"In addition to the mainstream single-fund GP-led deals, we have noted a significant increase in single-asset deals and complex transactions involving assets held across multiple fund vintages," says Dische. "These deals haven't just taken place in PE; we're also seeing them in real estate and infrastructure. The secondaries space has really broadened out."

K1 Investment Management's plans to strike a US$3+ billion GP-led deal involving up to nine assets from older funds, including Smarsh, a provider of hosted services for archiving email, instant messages and social media posts, is illustrative of the market's growing sophistication.[3]

Single-asset deals offer a new exit route for GPs

The rise in single-asset GP-led deals has been particularly noteworthy. According to Jefferies, single-asset deals accounted for roughly half of GP-led deals during 2021.[4]

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> —*Isabel Dische, Asset Management*

The spike in single-asset deals in the past 12-plus months shows how GP-led transactions have opened a new exit route for portfolio companies. As **Chau Le**, a San Francisco-based PE partner at Ropes & Gray, points out, "When preparing a business for sale, PE sellers will look at a single-asset GP-led deal alongside IPO and M&A options." Notable recent single-asset transactions include Stonepeak's GP-led deal for data center platform Cologix, for which it raised a US$3 billion continuation fund.[5]

Le adds that it has become increasingly common for GPs to run dual-track processes when selling portfolio companies, testing various exit routes to find the best valuations.

In some cases, PE sponsors have opted to sell a minority stake in a portfolio company to ascertain valuation and then use this as the basis to set pricing for a subsequent GP-led transaction.

Warburg Pincus, for example, sold a minority stake in packaging services company Duravant to The Carlyle Group before commencing a GP-led deal for the asset said to be worth between US$1.5 billion and US$2 billion.[6] Clearlake, meanwhile, agreed to the sale of a minority stake in software services company Ivanti to TA Associates before proceeding with a GP-led secondary transaction that attracted strong interest from multiple secondaries houses.[7]

Single-asset deals for portfolio companies have been observed across all sectors, although a single asset GP-led secondary has proven particularly suitable in situations where PE fund managers are pursuing strategies that require longer hold periods.

"A single-asset deal is well suited to buy-and-build plays, where sponsors are building out platform companies through acquisition over longer investment horizons," says Le. "It is also a good fit for growth companies that are scaling up rapidly but still require time to deliver consistent profitability."

Boston-based Ropes & Gray asset management partner and co-lead of the firm's buyout funds team **Debra Lussier** says the popularity of single-asset deals can also be attributed to a desire among PE fund managers to hold prized assets for longer.

"When a sponsor believes the value of a portfolio company is going to continue increasing, why not find a way to hold it for the benefit of investors who want to continue to own it?" says Lussier. "A GP-led deal is appealing when the only reason for a full exit is that the time frame of a current fund won't allow for a longer hold."

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Indeed, the growth in GP-led deal volume has coincided with a broader pivot toward fund structures that will enable GPs to hold assets for longer than permitted in traditional 10-year buyout funds, adds **Marc Biamonte**, a New York-based asset management partner at Ropes & Gray and co-lead of the firm's institutional investors and buyout funds teams.

According to research from alternative assets software platform eFront, PE hold periods have extended from an average of 3.8 years to 5.4 years in the past decade, with longer hold periods correlating with higher returns.[8]

"There has been a long-held desire among PE firms to develop an evergreen fund that can keep investing forever," says Biamonte. "A GP-led structure provides a way to continue holding assets over longer periods of time. It's another way to have more time to develop well-performing assets."

Conventional secondaries deals keep rolling

Although the rapid growth of GP-led deals has grabbed the headlines, activity and appetite for traditional secondaries deals has been robust in the past 12-plus months. According to Jefferies, LP portfolio sale volumes in 2021 increased by 156% over the previous year, with more than 20 deals worth over US$1 billion secured in the past year.[9]

After a degree of market dislocation due to COVID-19, Triago figures show that funds traded in secondaries deals in the first three quarters of 2021 were pricing at an average of 95% of portfolio net asset values versus 89% in H2 2020.[10] Stabilizing pricing has drawn both sellers and buyers of fund stakes back to the market.

Boston-based Ropes & Gray asset management partner **Adam Dobson** says recovering fund prices have also seen institutions turn to secondaries transactions to rejigger portfolios that had gone overweight on PE as fund valuations recovered.

"As pricing concerns have eased, investors on the sell side have taken the opportunity to clear out asset backlogs and rebalance portfolios that were over-concentrated toward PE, freeing up capacity to make new commitments," says Dobson. "We have also seen institutions reassess their exposure to fund recapitalizations and single-asset deals and up their investments in conventional fund transactions to bring more balance to secondaries programs."

Traditional LP portfolio secondaries trades have also remained the dominant source of deal flow outside of the more mature U.S. and European PE markets, according to Hong Kong-based Ropes & Gray asset management partner **Vincent Ip**.

"We have seen an uptick in GP-led deals in Asia, but the volumes have been significantly lower than those observed in the United States and Europe," says Ip. "Managers in Asia have noted the spectacular success of GP-led deals in other regions, and the market here is not too far behind, but, for now, LP stake deals still account for most secondaries deal activity."

The rules of the game are changing

One potential headwind facing the thriving secondaries market is the possibility of regulatory intervention in the space, with the Securities and Exchange Commission (SEC) scrutinizing the PE market.

In February 2022, the SEC voted to put a series of new rules for private fund advisers out for public consultation. These included restrictions on certain types of fees and expenses, requirements regarding the standard of care for advisers, and the requirement to disclose preferential terms offered to select investors in funds to other investors.

"For secondaries deals specifically, the SEC's two main concerns are around valuation transparency and the fact that the GP sits on both sides of the transaction," says **Jason Brown**, a Boston-based asset management partner at Ropes & Gray and co-head of the firm's private funds regulatory practice.

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"On valuation, even though there is third-party money coming in, the SEC has proposed a rule requiring an 'independent fairness' opinion. Third-party money coming in is helpful, so it is not a pure cross-trade, but the SEC is sufficiently concerned to have proposed this rule," says Brown.

"GP-led deals also allow managers to reset carry and management fees and continue these fee streams," Brown adds. "The SEC is questioning whether this is in the best interest of LPs. One proposal is that the SEC should be notified within one day of a GP-led deal proceeding. These are just proposals at this stage, but the fact that the SEC has put them forward signals secondaries deals are on its watch list."

While additional regulation could increase friction points in fund recapitalizations, the space has already evolved, and most deals already include procedural steps to provide investors with the opportunity to evaluate any potential conflicts of interest in connection with their decision to sell or roll/reinvest in the deal.

Lussier says the fact that the GP-led space has transformed into a marketplace for portfolio companies of the highest quality has helped mitigate concerns about conflicts.

"Some early GP-led deals involved zombie funds that were well into their liquidation periods and were continuing to charge management fees," says Lussier. "Regulators were concerned about conflicted transactions in those contexts. The market has evolved, however, and GP-led transactions aren't a last-gasp effort but a creditable exit strategy at various stages of a fund's life, often including portfolio company 'gems.'"

The fact that LPs have the choice to roll or otherwise continue their investment or cash out already provides a choice to investors. Most fund documentation will also mandate that GP-led deals must be signed off by a fund's limited partner advisory committee to proceed.

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According to **Alex Chauvin**, London-based counsel at Ropes & Gray, GP-led processes are also now structured to avoid disputes and treat all stakeholders fairly.

"Sponsors are getting better at anticipating disclosure and transparency needs and balancing that against the risk of any deal information leaking," Chauvin says. "In fund recaps and single-asset deals in particular, there is a desire to share as much information as possible with the LPs in the asset's existing fund. With any sought-after asset, there is always debate around whether the timing is right to convey that a sale is in the cards, but, that notwithstanding, there will always be disclosures to the existing LPs."

Chauvin adds that after a sponsor has signed a letter of intent with a sell-side adviser to launch an auction process, there is a real focus from the sponsor to show that the auction has been set up to achieve the best price possible for existing LPs.

Given the focus across the industry on mitigating the conflicts of interest inherent in these deals, it is hoped that, in most cases, market participants will be able to adapt to any new regulation with minimal disruption. Many PE fund managers, for example, are already securing third-party fairness opinions on valuations, even though this is not yet mandatory.

The war in Ukraine creates additional uncertainty

Russia's invasion of Ukraine—and the resulting waves of new sanctions and trade restrictions—has prompted sponsors and LPs alike to scour their investment portfolios for Russian exposure.

Secondary investors are increasingly proactive in probing the sanctions- and export-focused due diligence that lead sponsors undertake for investment opportunities, according to **Ama Adams**, a Washington, D.C.-based international risk partner at Ropes & Gray.

"Because of Russia's corruption risk profile, diligence historically has focused on sales activity," says Adams. "But the introduction of new trade restrictions requires a broader assessment, including with respect to supply chain and banking relationships."

Adams adds that while the impact for investment targets that derive material revenue in Russia is clear, other implications of the new sanctions may be less obvious. "Even predominantly domestic companies may have business-critical supplier or vendor relationships that run through Russia," Adams says.

With respect to existing investments, sanctions liability at the investor level would be premised on either active involvement in underlying violations or under a control theory, notes **Brendan Hanifin**, a Chicago-based international risk partner at Ropes & Gray.

"There is recent precedent for holding U.S. private equity sponsors responsible for sanctions violations committed by controlled portfolio companies outside the United States," notes Hanifin. "However, there is no precedent for punishing a non-controlling minority investor for violations committed by portfolio companies without the investor's knowledge or involvement. For secondary investors, financial impact generally outweighs liability risk."

For most investors, the new restrictions announced to date have been manageable, although general aversion to Russian exposure appears locked in, at least for the near-to-medium term.

The secondaries market remains upbeat

Overall, the outlook for secondaries deal activity in the next 12 to 18 months remains positive. A survey of LPs by secondaries house Coller Capital found that 86% of investors expect the secondaries asset class to keep growing in the next 36 months.[11]

The number of large, high-quality players in the market is expanding as several blue-chip PE sponsors and institutions note the growth of the secondaries market.

PE firms have moved actively to build out their secondaries capabilities and diversify their PE strategies. PE platforms have either hired talent from incumbent players—as seen with TPG recruiting from CPPIB and Landmark Partners—or undertaken acquisitions of independent secondaries players. Ares Management, for example, acquired Landmark Partners, and Franklin Templeton bought out Lexington Partners. In Europe, Prudential acquired Montana Capital.[12] And, in one cross-border deal, U.S. asset management firm Oaktree acquired a majority stake in U.K.-based PE firm 17Capital.[13]

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The market is also continuing to evolve at pace, with strategies becoming more specialized and niche. Blackstone, for example, closed its sophomore secondaries fund focused exclusively on GP-led deals on US$5.6 billion at the end of 2021,[14] while Coller Capital closed its first-ever fund focused on secondaries in the private credit space on US$1.4 billion early in 2022.[15]

"LPs have seen some great performance from GP-led secondaries and single-asset deals, which have become similar to doing a direct co-investment," says Biamonte. "The demand is there among LPs, and managers are responding by developing specialized strategies that match up to the different risk profiles and return expectations of their investors."

In younger PE markets, products are also becoming more niche and following a similar progression as we have seen in U.S. and European secondaries markets, adds Ip: "There is continued interest in the Asian market for preferred equity deals (where debt-like structures are used to finance a secondaries deal or fund commitment), and we have seen several deals where sponsors have tapped preferred equity lines to fund or expand the GP commitment to a fund."

The investment in secondaries capabilities by sponsors and the emergence of increasingly sophisticated strategies and specialization will inject ever more liquidity and demand into the market.

After a bumper year in 2021, an even busier 12 months may lie ahead for secondaries dealmakers.

ENDNOTES

[1] https://www.secondariesinvestor.com/deal-volume-topped-130bn-last-year-say-jefferies-greenhill/; https://www.privateequityinternational.com/gp-led-secondaries-report-2022/

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[5] www.secondariesinvestor.com/stonepeak-raises-3bn-continuation-fund-to-recapitalise-cologix

[6] https://www.buyoutsinsider.com/warburg-runs-process-for-more-time-capital-with-duravant/

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[11] https://www.bain.com/insights/topics/global-private-equity-report/; *see page 22, par 3*

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