

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.

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

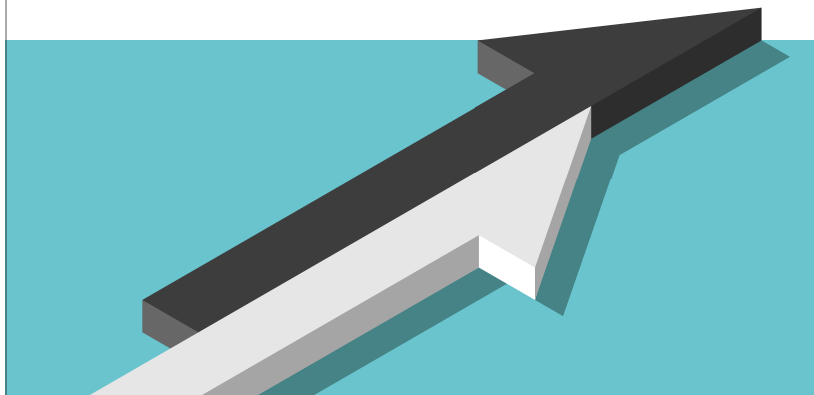
Debra Lussier: The GP-led secondaries market has certainly blossomed while traditional exit activity has been slow, but I don't think the two will necessarily be correlated going forward. Sponsors now have continuation vehicles in their toolkits and have become accustomed to evaluating them alongside 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

Q How is buy-side appetite evolving for the different asset classes within private markets?

ID: There is buy-side 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 buy-side 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.



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

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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 buy-side 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