PRIVATE MARKET INSIGHTS

THE DEVELOPMENT OF COMPLEX SECONDARIES: FROM LP-LED TO GP-LED

The private equity secondary market has grown rapidly as both limited partners (LPs) and general partners (GPs) look for flexibility and liquidity in managing their private market investments.

The increasing maturity and scale of both the private equity market and the investors in that market have created more complex situations in which a traditional secondary transaction may not achieve the goals and objectives of all stakeholders. This reality has helped drive the growth of complex secondary transactions, which demand significant experience and differentiated expertise to execute.

THE DEMANDS OF COMPLEX SECONDARIES

Complex secondary transactions are generally more resource-intensive, demand more time and patience to complete, and often carry greater execution risk. Some of the specialized skills necessary include the ability to:

> Originate investment opportunities outside of the traditional secondary market, where intermediaries play a more active role
> Navigate multi-party negotiations and solve for multiple, sometimes competing, transaction objectives
> Create and structure new legal entities with customized governance and economic provisions
> Address more nuanced legal, tax, accounting, and reporting obligations

TRADITIONAL SECONDARY TRANSACTIONS

The private equity secondary market emerged in the 1980s through a series of one-off transactions between a small number of LPs and a smaller number of buyers. These early transactions were spurred on one side by investors seeking liquidity and on the other by buyers taking advantage of those opportunities as a way to arbitrage dislocations in the market.

These initial, now referred to as “traditional”, secondary purchases involve one party buying an existing limited partnership interest in one or more private equity funds from another party where the key, and typically only, variable is price.

GP-LED TRANSACTIONS MID-2000s

The earliest GP-led transactions were initiated in the mid-2000s. From their origin as LP-to-LP transactions, secondaries started to evolve into potential solutions for GPs.

In many cases, early GP-led deals involved funds that had failed to meet investors' original expectations and were looking for creative ways to generate liquidity from portfolios at or near the end of their initial term. These GPs looked to the secondary market as a source of such liquidity.

This meant that instead of working directly with a single LP, a secondary buyer could now create the opportunity to transact with all the LPs in a fund. This demanded coordination with the GP of that fund to develop a holistic, customized liquidity solution. These deals offered value for both the GP and the LPs of the fund, while representing a new approach by which secondary buyers could create investment opportunities. Initially an ad hoc and opportunistic process, these deals gradually catalyzed the emergence of a coherent GP-led market for secondaries.

Along with growing scale has come a broadening of exposure. Initially concentrated among lesser-known GPs, often with more challenged portfolio companies, GP-led transactions are now employed by proven, top-tier GPs with high-quality assets as part of their portfolio management toolkits.

The GP-led market segment today can be broken down into two broad transaction types:

Fund Recapitalization/Asset Sale

The GP sells all or a subset of the underlying companies in one or more funds it manages to a newly created vehicle that is financed by a secondary buyer. The GP of the selling fund(s) continues as the manager of the assets in the new vehicle. The new fund carries customized economic terms and governance provisions, which are typically negotiated by the GP and the secondary buyer. The existing LPs in the fund usually have the option to either take liquidity or retain exposure to the assets by becoming an investor in the new vehicle alongside the secondary buyer.

LP Tender Offers

The GP helps coordinate a process whereby a secondary buyer extends an offer to purchase interests in a fund from its LPs, typically with no material changes to the terms of the fund. LPs that want liquidity can elect to sell their interest, while those that do not simply retain their existing interest.

HOW GPs BENEFIT FROM GP-LED TRANSACTIONS

1. Accelerates liquidity and potentially locks in gains for their LPs
2. Enables existing LPs to reduce their exposure to a legacy fund, freeing up capacity for investing in a GP's new fund offering
3. Brings a strategic, long-term investor into the GP's investor base

Fund recapitalizations and asset sales specifically can create other important benefits for GPs:

1. Extends the duration of a fund to give the GP more time to create value within the underlying portfolio
2. Often brings in fresh capital for follow-on investments in existing portfolio companies; in some cases, capital may also be reserved for making new investments
3. Enhances GP alignment by re-setting the economics of the fund and focusing the GP on maximizing the value of the portfolio relative to the price paid by the secondary buyer
4. Provides options for the GPs to deliver a more customized solution to LPs; for example, by creating a liquidity solution for only a subset of the companies in a given fund or, at the other end of the scale, one that encompasses multiple funds managed by the GP

As of 2019, GP–led transactions had grown to account for approximately 30% of aggregate secondary market transaction value.[1]

1 Greenhill, Global Secondary Market Trends & Outlook, January 2020

HOW LPs BENEFIT FROM GP-LED TRANSACTIONS

1. Provides the option to realize returns sooner than expected from an illiquid investment, potentially locking in gains and generating liquidity needed for other purposes
2. Allows LPs to efficiently rebalance their private market portfolios. Many LPs choose to engage in these transactions in order to sell non-core holdings and consolidate GP relationships; shift portfolio exposures; or meet changing investment needs

Guidelines from the Institutional Limited Partners Association help to protect LP interests in these transactions in several ways, encouraging GPs and secondary buyers to:

> Clearly communicate to LPs the rationale for a transaction
> Seek LP/Limited Partner Advisory Committee (LPAC) input in the selection of an advisor who can ensure a fair price is achieved
> Provide LPs with fulsome information and sufficient time to evaluate the transaction

Case Study: GP-Led Transaction

January 2018

Transaction: $167 million fund recapitalization transaction involving the acquisition of the vast majority of assets from two mature US buyout funds by a newly formed vehicle managed by the incumbent GP.

Opportunity: Chance to acquire good quality assets at a meaningful discount to net asset value (NAV). Funds were already in their respective extension periods, but the GP was looking for more time and capital in order to maximize portfolio value. LPs saw value in realizing liquidity from funds more than 10 years old.

Challenge: Crafting a solution that suited all parties involved, including the GP and two different sets of LPs. Also, solving significant legal and regulatory complexity from the approvals needed given the underlying industries. Over 1,000 pages of transaction documentation were ultimately required.

Solution: Identified a solution in partnership with the GP to exclude from the transaction a portion of the equity one of the funds held in a large public company. In addition, HarbourVest formed a bespoke Bridge Fund to allow the GP to make new investments. These innovations allowed assets from both target funds to be acquired at a price that was acceptable to sellers while representing a significant discount to our estimation of value (including expected value appreciation). The GP was also attracted to our broad platform capabilities as a potential long-term partner.

The deal summary, general partner, and/or companies above are intended for illustrative purposes only. While this is an actual investment or relationship in a portfolio, there is no guarantee it will be in a future portfolio.

For part two of this series, which will look in more detail at spinouts and buy-ins, please click here. For part three of this series, which will look in more detail at public market transactions and structured liquidity solutions, please click here.

For more information on secondary funds, and how HarbourVest may be able to help you achieve your investment goals, please get in touch with your HarbourVest contact or email clientservice@harbourvest.com