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GP-Led Secondaries

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CONTRIBUTORS
Steve Hartt, CAIA
Balaj Singh, CFA, CAIA

General Partner-led ("GP-led") Secondaries offer the option for Limited Partners ("LPs") to achieve full or partial liquidity on their fund interests, while a General Partner ("GP") often gets the opportunity to secure additional time and capital to maximize the value of a fund's remaining asset(s). In recent years, as the secondaries market flourished, the profile of such transactions has changed. No longer solely the domain of troubled managers and poorly performing assets, GP-led secondaries transactions are increasingly common in the private equity industry.

It is not uncommon for one or more assets in a private market portfolio to linger on past the end of the expected life of a partnership. This presents a challenge for LPs who want to re-invest their capital, and minimize their oversight and reporting requirements. Historically, some LPs would address this problem by selling their stakes in the secondary market. However, some GPs decided they could meet the needs of these LPs while potentially improving the return prospects for their remaining LPs on these last few assets by engaging in what has become known as a GP-led secondary sale.

GP-led secondaries involve a GP leading a sale process to provide liquidity to LPs in one or more of their funds while retaining ownership of an asset or group of assets, usually in a new vehicle. GP-led transactions were once perceived as a way for underperforming managers to hold on to assets and therefore extend the life of their franchise. However, in recent years these deals have been utilized by GPs as a flexible means to hold on to key assets that are often top performers – giving them further time and capital to potentially generate additional value. As a result, while the stigma associated with such deals has diminished, their increasing prevalence raises questions for many LPs, specifically around a GP's plan and their alignment of interest when it comes to managing these assets.

What are GP-Led Secondaries?

GP-led transactions are distinct from traditional secondary deals. A traditional secondary transaction involves an LP selling their interest in one or more partnerships. In traditional secondaries, an LP decides to sell its interest in a fund (or, potentially, a portfolio of fund interests) and approaches potential buyers, ultimately leading to a transfer of the fund interest(s) with GP consent, with the buyer becoming an LP (and taking on the seller's future obligations to the fund) in respect of the transferred interests.

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In contrast, GP-led transactions are initiated by the GP, often to restructure the ownership of one or more assets within their funds while providing a liquidity option to existing LPs. While the bespoke nature of GP-led transactions has produced a variety of structures, the vast majority involve creating a new vehicle, called a "continuation fund," that purchases one or more companies from the GP's existing fund(s). The continuation fund is managed by the same GP and backed by new investors plus any existing LPs that wish to retain exposure to the asset(s).

The mechanics of these transactions

In the GP-led secondary process, the GP decides they would like to continue to maintain ownership of one or more assets in a fund that is nearing the end of its term. The GP causes their fund to enter into an agreement with a continuation fund (also controlled by the GP) to purchase a significant portion of one or more of the assets. As part of this transaction, the GP negotiates with an unaffiliated third party to provide capital to, among other things, offer liquidity to those LPs that wish to exit their investment.

In connection with the transaction, the GP typically offers the existing LPs of the fund the below options:

A	B	C	D
To sell their interest and receive the pro rata portion of the cash purchase price,	To "roll" their pro rata share of the Limited Partnership interests in the fund into the continuation fund established to purchase the asset(s),	To increase their participation above their pro rata share of the new interest, or	In some cases, to receive a combination of options **A** and **B**.

While the "sell option" is relatively straightforward, the "roll option" is in fact an exchange of existing fund LP interests for new LP interests in the continuation fund. The continuation fund, which is managed by the GP of the original fund, offers new terms for managing the acquired assets, new economics for the GP (e.g., carried interest and management fee resets) and, in some cases, additional capital for follow-on opportunities. In some cases, the GP will offer LPs the opportunity to roll and maintain the same relative interest in the continuation fund that they had in the original fund, with no change to their obligation to pay management fees or carry. This scenario is often referred to as the "status quo" option, with the only change being an extension of the fund's term with no change in economic terms. GPs do not typically offer a "no transaction option" which might result in the extension or continuation of the original fund.

Challenges and considerations

GP-led secondary transactions require significant attention from LPs, but the timing and process is often difficult to predict. This can be disruptive for an LP that is reviewing multiple deals at the same time.

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The structure of each GP-led secondary transaction is typically unique, making evaluating the impact of an election to buy, sell, or hold complex. Due diligence for GP-led secondaries can often be labor and resource intensive. These transactions require a distinct skill set to respond in a "real-time", transaction-oriented time frame to evaluate factors including transaction pricing and valuation, vehicle structure, and economic terms.

Given that the particular asset has likely been "de-risked" (e.g., more diversified revenue base, increased operational efficiency, higher profit margins, lower debt ratio, etc.) under the GP's ownership, the next leg of value development may offer less upside than the first phase. The investor should understand the value creation strategy as well as the scope of the GP's resources to assist the company in its next phase of growth.

GP-led secondary transactions can also present conflicts of interest, as the transaction can introduce different alignments of interest among the parties, including, for instance, payment of carried interest to the GP. The GP has a duty to act in the best interest of the LPs in the current fund while also trying to broker a deal with a buyer which the GP itself controls, thereby giving the GP a financial interest on both sides of the transaction. To address the conflict of interest related to valuations, GPs should consider engaging an independent valuation firm and also consider obtaining Limited Partner Advisory Committee ("LPAC") or investor approval of the transaction terms, especially the sale price.

While a secondaries transaction is an opportunity for a GP to reset fees and economics, it can also be an opportunity for the GP to receive meaningful carried interest. A GP's commitment to reinvest in the transaction may be an indication of their belief in the asset and may signify alignment with the LPs. GPs typically reinvest all or substantially all of the crystalized carry they receive as part of the sale of the asset. Historically, few Limited Partner Agreements ("LPAs") were drafted to contemplate GP-led secondaries and, therefore, there can be meaningful differences in the quantity and level of information available to an LP.

The GP perspective

A GP-led secondary transaction can provide several benefits to the GP. First, a GP can extend their holding period for a particular company. For instance, the growth trajectory of a company may be longer than a typical private equity fund term, or perhaps the company was acquired late in the investment period of the fund. Additionally, a GP-led secondary often provides additional capital to support further growth for the underlying company. Second, as an existing asset, the GP knows the portfolio company well and will generally have a well-developed plan for future value creation, versus a new investment that often includes additional risks related to the lack of familiarity with the company and its management team. Next, because the GP-led secondary company is sold by the original fund, the GP is able to monetize at least a portion of the profit associated with its investment and can receive carried interest as part of the transaction. With the creation of the continuation vehicle, the GP's economics (fees and carry) with respect to the company are often reset to new levels.

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The LP perspective

A GP-led secondary typically provides benefits to the LPs. Primarily, a GP-led secondary offers LPs the option to either lock in performance associated with the target assets and receive liquidity, or to retain their existing exposure through reinvestment into the continuation fund. Alternatively, a GP-led secondary often provides an opportunity to retain interest in a high-quality asset that is well known to the sponsor and participate in potential future growth and value creation. However, it is possible that the forward return profile for that asset may be somewhat lower given the investment has likely been de-risked (e.g., it has a more diversified revenue base, higher profit margins, lower debt ratio) under the GP's prior management and value creation. An LP would want to fully understand the future value creation plan for the investment and assess whether the future risk/reward profile remains attractive relative to other options for allocating their capital.

Given that both the fund selling the asset as well as the continuation fund are controlled by the same GP, there are inherent conflicts of interest, of which asset valuation is key. Specifically, while the selling fund would clearly like to receive the highest possible price for the asset, the continuation fund would like to pay the lowest. In order to help mitigate this conflict, GPs typically negotiate with an unaffiliated third party to invest in the continuation fund and thereby set the valuation. That said, the investing third party will typically seek to invest at a lower price. Additionally, in some transactions, GPs seek a valuation opinion from a recognized independent valuation service firm to provide additional support for the price. However, given that the GP typically retains control of the asset, any "control premium" is not typically reflected in the valuation.

Also, as described above, a GP-led secondary can often lead to a GP receiving carried interest even though they retain control of the asset. However, most GP-led secondaries provide that the GP reinvest a substantial portion, or even all, of their carry into the continuation fund as part of the transaction. Although the vast majority of continuation funds will include fees and carried interest for the GP, a continuation fund's fee structure is usually at a lower rate than new funds.

Another consideration is whether the next phase of ownership will be as profitable for the LP because GPs may have already implemented significant value creation during the initial stages of ownership. Hence, if the GP is extending its ownership of a particular asset, there often is a targeted plan that may incur execution risk for the LPs to see attractive returns from the longer ownership period.

Recent trends

The secondaries market has grown substantially in recent years. Over $132 billion in secondary transactions took place in 2021. The secondary transaction boom has been accompanied by strong growth in GP-led secondary transactions. As shown in Figure 1, over 50% of secondary transactions in 2020 and 2021 were GP-led deals. Further, GP-led secondary transactions grew from $9 billion in 2015 to $68 billion at its peak in 2021.

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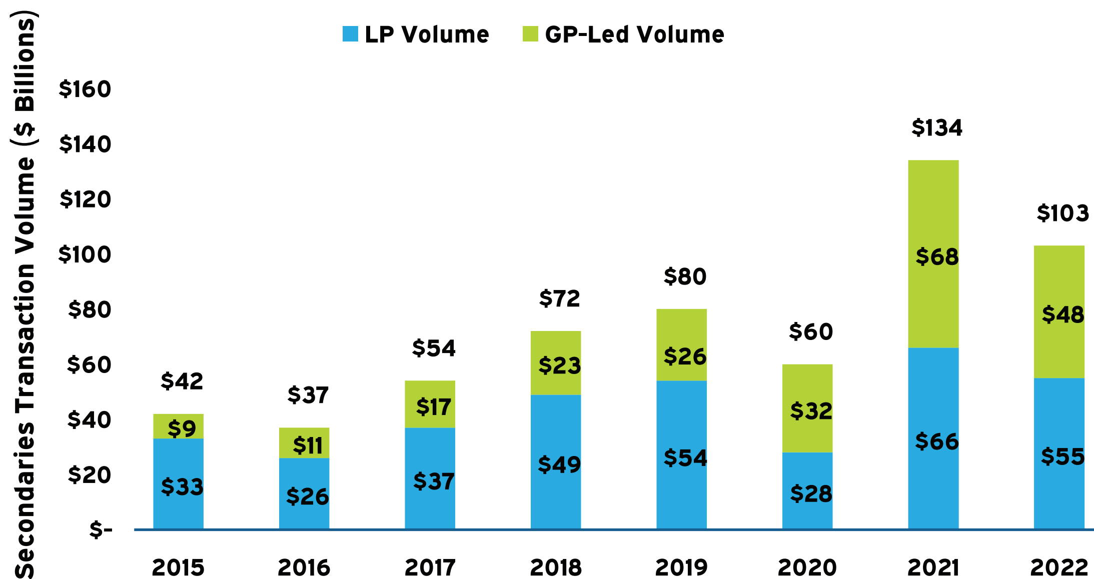

FIGURE 1
Secondary Market Annual Transaction Volume
Source: Evercore, 2022 Secondary Market Synopsis.

The number of GP-led transactions each year has also grown – from the teens in 2016 to over 100 in 2021.[1] The rise of GP-led deals has been accompanied by increasing transaction sizes, with more than 15 GP-led deals valued at $1 billion or more completed in 2021.[2] While single-asset transactions are the most common, many transactions included multiple assets in a continuation vehicle. Of all private market strategies, buyout investments represented over 75% of total transactions (by value), but growth equity, venture capital, and infrastructure also had numerous GP-led secondary transactions.[3]

[1] Source: Jefferies, 2022 Global Secondary Market Review.

[2] Source: Jefferies, 1H 2022 Global Secondary Market Review.

[3] Ibid.

Historically, generalist secondary managers have allocated a portion of their diversified secondary funds to invest in GP-led transactions. The increased volume of GP-led secondary transactions has led several secondary managers to form dedicated pools of capital focused on GP-led deals or other types of continuation vehicles. Additionally, some traditional private equity managers have dedicated resources and capital to the GP-led market. Evercore estimates close to $50 billion of capital was available for GP-led secondary transactions as of December 31, 2022.[4]

[4] Source: Evercore, 2022 Secondary Market Synopsis.

Conclusions

For experienced LPs with capital to deploy, there is currently an abundant supply of GP-led secondary transactions in which to potentially invest. We expect that there will continue to be a substantial number of GP-led secondary transactions to consider, particularly in today's more challenging market conditions and slower transaction volume. However, not all deals are created equal, and GP-led transactions tend to have different structures and considerations for investors to consider. Often the due diligence can include meaningful structural and legal complexity. Due diligence for GP-led deals is also often labor- and resource-intensive and requires a distinct skill set to, among other things, ensure that all parties' interests are properly aligned on areas such as pricing and valuation, timing, vehicle structure, and economic terms.

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