KEYNOTE INTERVIEW

Building GP-leds into the portfolio

Consistent market activity and deep domain expertise can help overcome the challenges associated with integrating continuation vehicles into a broader secondaries portfolio, says Partners Group's Anthony Shontz

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Q How would you describe the GP-led secondaries investment space at the moment?

Extension secondary investment activity is robust – of the approximately $130 billion in secondaries investment volume in 2021, 51 percent involved liquidity solution transactions. That is a significant increase on prior years and the pipeline remains strong heading into 2022.

We are also seeing a resurgence in traditional secondaries volume – diversified LP portfolios – as pricing has recovered and as the denominator effect comes into play with declines in public equities and continuing strong performance in private markets. It is an exciting time for the entire secondaries industry.

Q What makes GP-led investments attractive for GPs and for secondaries buyers?

From the perspective of the GP, continuation vehicles often represent a very low risk proposition. They are looking at a known company in a known industry with a known management team. In a high-priced environment with strong competition for new investments, there are information asymmetries and, therefore, the best and lowest risk investment opportunities can often be found within a GP's own portfolio. GPs recognise that and they are increasingly using these types of vehicles to structure, and essentially decrease risk, in their investment strategies.

Meanwhile, extension secondaries are attractive to buyers because they provide an opportunity to access premium assets that would not otherwise be available on the market. These

Q What are some of the challenges involved in integrating GP-led secondaries into a broader secondaries portfolio?

One challenge is the concentration inherent in a continuation vehicle, which often involves a single asset or three or four assets at most. While that does present a risk, a buyer can easily mitigate this through consistent investment activity, and building up a more diversified portfolio. Another challenge from the perspective of the buyer is valuation risk, which I have already touched on. Unlike traditional secondaries, there is no discount with continuation fund transactions.

The assets in a continuation vehicle go into our portfolio at 1x, unlike diversified LP portfolios where we close at 1.1x or 1.2x due to buying at a discount. The absence of that immediate mark-up needs to be taken into consideration. You could call that a risk but essentially it just means you must have high conviction in what you are buying. We partner with GPs that we trust and invest in premium assets in industries which we know well, so we can get comfortable with the lack of discount.

The third challenge associated with extension secondaries in terms of portfolio construction involves the timing of cashflows. These transactions often come about because there is another chapter to the growth story; for example, a pipeline of acquisitions or a series of product launches. There is more to do to create value and one of the GP's primary objectives is to reset the clock and to extend the timeline for value creation.

This pushes back the exit horizon, which means the cash profile is different to a diversified portfolio of LP interests where there can be distributions accruing to the buyer even before the transaction closes. This is a consideration when it comes to portfolio construction. If you are consistently in the market investing in continuation vehicles, you can build up a portfolio that will generate a diversified stream of cashflows. However, that will not happen overnight as it does with an LP secondaries strategy.

assets are often GPs' best companies that have already delivered strong performance and may be written up by 3x or 4x. There may be a perceived risk with buying in at a higher valuation, but we have observed time and time again in private equity that the winners keep on winning.

Q The performance of the underlying assets is clearly key, but what else do you look for in an attractive GP-led opportunity?

We look for strong performance and resilient companies first and foremost, but we also look for good partners. We want to ensure we are working with a GP that has the ability to drive the value-creation strategy. This means a sponsor with domain expertise, which will work to structure a transaction that addresses potential conflicts of interest and that aligns the needs of the buyer, selling LP, rollover LP and GP. There are a lot of different counterparties involved in extension secondaries, so we want to work with sponsors which take that into account.

Q How would you describe the competitive dynamics of the GP-led secondaries space today?

It is certainly a competitive market. GPs have a fiduciary duty to maximise the price of an asset and to deliver a fair outcome to their LPs, which means there is typically a healthy competitive dynamic. This is true of the lead or anchor positions that set the terms and secure a larger allocation in the transaction.

It can then also be hyper-competitive to secure positions as a syndicate partner. There tends to be a long list of institutions that are willing to participate in transactions once the price and terms have been set by the lead or group of leads. That is why it is critical to decide where and how you want to compete, and to differentiate yourself as a lead investor.

Q How have LP attitudes to GP-led secondaries evolved over time and how have sellers and buyers changed their approach to mitigate LP concerns?

LPs have warmed up to these types of transaction as the terms and conditions have become more standardised and as GPs, buyers and advisers have all started to acknowledge concerns around timelines. It is also now market standard to have a rollover option. This rollover option may sometimes involve an extension of the investment horizon or a need to commit new capital to support the growth and valuation plan.

Crucially, LPs do have options and the industry as a whole has moved to adopt longer timelines in which those options can be considered. There is a tender period to allow investors the time they need to perform their due diligence and make their rollover decision.

The other thing that has changed is the amount of information made available to LPs. In the past, this has been one of the potential conflicts of interest and it is an area Partners Group has always been very focused on. When we participate in these transactions as a buyer, we insist on equal information to the seller. We are not looking to trick the selling LPs into a bad trade and equally the GPs that we work with are not looking to hide information and sell assets at a low price.

Selling LPs have access to data rooms and to the GP and can participate in due diligence calls. They have access to all of that information, which addresses the potential conflicts of interest many LPs expressed concerns about when these transactions were new to the market.

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Q The GP-led market is attracting interest from traditional secondaries firms and direct buyout investors. What attributes are required to execute these transactions and how do those differ from the attributes required for diversified LP secondaries?

Let's start with what they both have in common. Traditional secondaries and continuation vehicles both require access to GPs. Strength of relationships is important for both strategies and can help differentiate you as a buyer.

A key difference, however, is the speed and depth of underwriting. These are concentrated portfolios, and you are often paying full price.

Most of these investments take place at premiums to NAV and require deep industry expertise to be able to understand and price the assets and to assess the value-creation plan. That involves analysing the M&A pipeline, as well as analysing products, competitive dynamics and management teams. It is a complex due diligence process that is a lot more akin to direct, control buyout investing than it is to traditional secondaries underwriting.

Q What do you believe the future holds for this part of the market?

I think the extension secondary market will continue to grow. As mentioned, investment volume for the entire secondaries market reached around $130 billion in 2021. I think the continuation vehicle market alone could exceed $130 billion by 2025. I also believe we will continue to see a blurring of the lines between the secondaries market and the primary buyout market.

We have already seen a number of sponsors entering the space, either through the acquisition of secondaries investors or by competing directly against secondaries buyers. As GPs look at all available options for liquidity, they are increasingly turning to continuation vehicles and that sometimes requires another sponsor to come in and set the price by purchasing a minority position. The GP then uses that price to raise a continuation vehicle and maintain control. We believe this is a trend that is going to accelerate because, right now, there is not enough capital in the secondaries market to support demand from GPs.

Secondaries funds are getting bigger and bigger. Secondaries firms are writing ever larger cheques and becoming more comfortable with concentrated positions. However, there is still not enough capital to support GP demand from within the secondaries industry. ■

Anthony Shontz is co-head of private equity integrated investments at Partners Group