ROUNDTABLE

From left:
Daryl Li, Jeff Keay, Anthony Shontz, Scott Humber, David Schwartz and Andy Nick

Keeping LPs centre-stage

Prioritising the needs of LPs is more important than ever in an increasingly complex secondaries market, write **Isobel Markham** and **Marine Cole**

SPONSORED BY: Ardian, Debevoise & Plimpton, Greenhill Cogent, HarbourVest, Landmark Partners and Partners Group

GP-led transactions stole the spotlight in a record-breaking year that saw $58 billion of secondaries transaction volume. That segment of the market – which has experienced nearly 50 percent annualised growth since 2011 – accounted for around $14 billion in 2017, according to research by Greenhill Cogent. The advisory firm predicts GP-leds could exceed $20 billion this year.

It should come as no surprise, then, that the segment was the first topic of conversation around the table at *Private Equity International*'s annual secondaries roundtable in Debevoise & Plimpton's New York office in late March.

David Schwartz, who heads up the law firm's fund formation practice, says there has been a rise in interest in these transactions as the market continues to see many more funds that still have significant assets left at the end of their life.

"Depending on the LP base and stage in a GP's fundraising lifecycle, GPs are often very proactive and use a restructuring as a segue into their next fundraise," he says.

In the early days of the GP-led secondaries market, the transactions were typically used by franchises looking to wind down, says Andy Nick, managing director at Greenhill Cogent.

"Now we're seeing those same types of transactions from very alive-and-well GPs that are just using the market as a tool to reduce their administrative burden or wind down a fund that may have been around for 12 or more years. Maybe the investors did very well on it and the GP is on Fund VI, VII, VIII and they're thinking about what to do with Fund III," Nick says. "We're seeing GPs that arguably have greater AUM and probably greater forward prospects than some of the earlier GPs who used the market."

GP-led deals used to take two basic forms: a tender offer, where LPs can opt to liquidate their stakes and the fund structure doesn't change; or a restructuring, where assets are moved out of the fund into a new vehicle. Today, there are more options on the table, says Anthony Shontz, managing director and co-head of private equity integrated investments for the Americas region at Partners Group.

"More recently we've seen some hybrids such as the strip sales, where you bifurcate the portfolio," he says.

Last year Warburg Pincus sold a roughly $1.2 billion strip of its Asia portfolio, made up of stakes in 29 companies, into a new vehicle with new terms. Lexington was the majority buyer, joined by Goldman Sachs Asset Management and a few other parties.

Other ways to split the portfolio include by public and private assets, or – particularly in the case of infrastructure – by »

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Daryl Li

mature or de-risked assets and those that are still development-oriented, Shontz explains.

Some deals have combined GP-led transactions and preferred equity.

"We have worked with GPs to create solutions for all parties involved," says Scott Humber, a managing director at Landmark.

"In this 'thought partner' approach, we have structured transactions that involved a preferred interest in multiple funds. In our experience, we have completed transactions to solve GPs' desires to take on strategic capital without taking on permanent capital. We have developed defined exit mechanisms, which is important to GPs."

The majority of GP-led activity has been concentrated in Europe. Data from Greenhill Cogent show transactions in the region accounted for 48 percent of that market last year, compared with 40 percent in North America. In a sub-asset class where evolution usually comes from North America – after all, the region accounted for 66 percent of all deals last year – this is surprising.

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> **David Schwartz**

Jeff Keay, a managing director with HarbourVest, suggests several reasons why this has been the case. "I think it's the appetite of general partners to explore a transaction that's not necessarily right up the fairway of what GPs typically do from a fund management standpoint," he says.

"Part of it may be the profile of the limited partner base of some of the funds where these transactions have taken place; there's more willingness to manage through the inevitable conflicts that arise."

Momentum within the region has also played a major role. "European managers have seen their peers pursue those opportunities and that's lowered the barriers to pursue additional deals. That's obviously spreading now on a more global basis," Keay says, adding the balance among geographies is likely to level off this year.

Shontz points out an important structural reason why European GPs are leading this movement: carry. Vehicles with a European-style waterfall don't take carry until all cost has been returned, whereas those with the American model are taking carry on a deal-by-deal basis. "That creates a real incentive for a GP with a European-style waterfall to accelerate or crystalise the carry through a GP-led transaction."

WIN-WIN

These transactions can be an attractive tool for GPs and LPs alike. For GPs, providing additional runway for certain assets that have upside potential, as well as realigning and motivating investment teams are two reasons to consider a GP-led transaction, says Humber.

"In a situation where a majority of the carry has been allocated to the more senior partners, some of whom may have taken a step back during the life of the fund, a transaction can serve as an opportunity to establish better alignment and incentives on a go-forward basis for the junior partners who have led the portfolio."

For LPs, providing a liquidity alternative can be an attractive feature, he adds.

However, all the experts agree the most important thing for ensuring a successful

GP-led transaction is looking after the existing LPs.

"Sometimes there is a monetisation event where carry is distributed to the team, so we are very active and very vocal to protect our investors who are in the fund," says Daryl Li, a director at Ardian, which also makes primary commitments through its fund of funds programme.

"We will negotiate status quo options, making sure existing investors get to remain in the same terms and conditions they signed up for, or if there's a big carry event, we want to make sure the key people in the team are incentivised going forward, either through appropriate vesting mechanisms or ensuring they roll an appropriate amount of carry into the new fund."

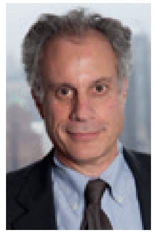
Li stresses the need for active communication between the LPs, the GPs and the new investors throughout the process. "GPs have an objective or several objectives they want to achieve through this transaction, and LPs are usually understanding as long as you have an open line of communication with them. It's important to establish that and work out a solution for everybody."

> ***The reputation you create there has a bigger cost beyond that individual deal***
>
> **Jeff Keay**

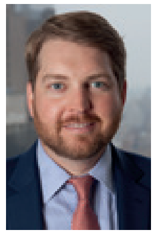
It is typically preferred to offer a status quo option, but it is not always a possibility, says Shontz, for example if the portfolio needs a capital infusion. "Investors may

MEET THE ROUNDTABLE

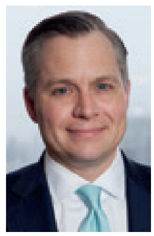
DARYL LI
director
ARDIAN
Li works in Ardian's fund of funds and co-investment teams and is based in New York. The firm has has about $67 billion in assets under management, including $38 billion in its fund of funds strategy, which targets primary investments and secondaries.



DAVID SCHWARTZ
partner
DEBEVOISE & PLIMPTON
New York-based Schwartz heads the firm's fund formation practice, representing sponsors of, and institutional investors in, private equity funds. He also regularly represents GPs and LPs in traditional and complex secondaries recapitalisations and restructurings.



ANDY NICK
managing director
GREENHILL COGENT
Nick advises limited partners and general partners on secondaries market transactions and is based in San Francisco. Greenhill Cogent has approximately 35 professionals dedicated to secondaries in five global offices.



JEFF KEAY
managing director
HARBOURVEST
Based in Boston, Keay focuses on global secondaries investments at HarbourVest, which has deployed more than $60 billion in assets in private equity since inception, including nearly $20 billion in secondaries since 1986.

SCOTT HUMBER
managing director
LANDMARK PARTNERS
Landmark Partners focuses solely on secondaries in private equity, real estate and real assets with about $22 billion of invested and committed capital. Humber is based in the Boston office.

ANTHONY SHONTZ
managing director
PARTNERS GROUP
Based in Denver, Shontz is co-head of Partners Group's integrated investment team in the Americas, which focuses on primary investments, secondaries and co-investments. The firm has $74 billion in AUM and invests over $2 billion a year in secondaries.

» be faced with the tough situation: do we put in additional capital or do we keep the status quo and have the companies fail, or do we allow some kind of restructuring?"

However, there are creative ways to approach the problem to find outcomes with which existing LPs are comfortable, says Schwartz.

"Often existing LPs who remain in the restructured fund do not want to commit additional capital," he says.

"One alternative is to recycle distributions rather than require LPs to make additional capital contributions. The GP can use cash that would have ordinarily been distributed to all of the partners, including the status quo rollover partners, and recycle or reinvest such cash in portfolio investments. There's a lot of creative ways you can structure to have almost a status quo, and I think having a status quo or an almost status quo is very important to getting the deal done."

Shontz points out that most GP-led situations are focused on mature funds, predicting that in the future liquidity offerings may become standard.

"There are discussions taking place with GPs around building automatic liquidity options once a fund reaches a certain age into limited partnership agreements, and it could become a standard feature that at some point in time there is an offer for all LPs to get out if they want to."

Schwartz says such liquidity provisions are part of the conversation, though he has yet to see them in widespread use.

LONG MEMORIES

While there are several elements HarbourVest focuses on when evaluating a potential GP-led deal, such as asset quality and manager quality, a major factor is the manager's approach to the transaction – and their ability to put themselves in their limited partners' shoes.

"If you approach it from the standpoint of 'I want to increase my fees, I want to create the opportunity for more carry' and that's what drives your decision-making, you're probably not going to end up with a deal that gets support and it could potentially put you at risk with your LP base."

Secondaries buyers must bear in mind that some of the existing investors in these funds could be investors in their own funds.

Schwartz mentions a recent deal in which LPs had just 20 days to review a very lengthy disclosure document and decide whether they wanted to roll over into a new vehicle or cash out.

"There was a lot of bad reaction from the LP community," he says.

"The sponsor and the secondaries players should spend real time communicating with the LP base and bringing them along: meeting with the advisory committee, holding structuring calls with the limited partners and regular process updates, so that when the official offer is made, it's just part of the process, it's not 'this is the first time you're actually explaining

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>
> **Andy Nick**

the deal and you have two weeks to decide'."

Although the deal was ultimately done, the experts agree LPs "don't forget about being mistreated". The real success of a GP-led transaction is not on whether the deal gets done but on whether the GP has a successful follow-on fundraising.

"The real cost is not in the uptake – you can drive it ahead and still get a transaction done – but in the next fundraise you will have and the sentiment in the market around how you partner with LPs," Keay says.

"The reputation you create there has a bigger cost beyond that individual deal."

MEGA-FUNDS DRIVING MEGA-DEALS

For Li and Ardian, finding situations where the firm has a competitive advantage is paramount. As such, the firm is still focusing primarily on large LP portfolios where its business model gives it an information advantage, and it can to react very quickly to speak for the entire portfolio.

Recent mega-fundraisings in the primary market are likely to drive more activity in this market segment, Li says.

"Previously in a mega-fund, the biggest equity cheque would be $500 million; nowadays we're seeing investors that can speak for $750 million or even $1 billion primary commitments."

Ardian's ability to take down large portfolios on its own also helps it to feed its LPs' desire for co-investment.

"There's a lot of demand for secondaries co-investment paper and we are mindful of that, and that's a big part of our investment strategy," Li says.

"In addition, for the large portfolios there tends to be sizeable GP commitments involved, and GPs are becoming more and more involved controlling the secondaries process."

Often the secondaries buyer is taking out a fund's anchor investor. In such situations, Ardian's strong relationship with GPs through its primary platform, out of which it deploys $1 billion a year through separately managed accounts, is a competitive advantage.

"That helps us develop very strong relationships with GPs, so then when we replace anchor investors, they know they can potentially develop a long relationship with Ardian and that we speak for primary capital."

PILING UP

Nick sees pricing as correlated to the public markets, with pricing as a percentage of net asset value rising as the public markets are rising, taking into account the lag in NAV reporting dates. One factor overarching both the macro environment and the public markets is the effect of leverage and the amount of dry powder in the market.

"There's less of a capital overhang in the secondaries market than the buyout market, but it's still more dry powder than we've seen historically on average in the market," Nick says.

"That has been benefiting our clients who have been looking to sell, and even »

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>
> **Scott Humber**

» with the equity markets being a little bit choppy, secondaries pricing has stayed at a high level."

His firm is seeing more limited partners taking large portfolios to market with the design of only selling a portion of it.

"We have a lot of clients that have a core portfolio that's the high-conviction 'we're going to market because we want to sell this portfolio of assets'. But then alongside that they have an opportunistic portfolio where they understand there's certain things in high demand on the buyside, so if they can mix some of the lower-pricing assets that they want to get rid of more with some of the things that the buyside's clamouring for, it raises the average price," he says. A successful deal for such a seller may be offloading 50-60 percent of what they took to market.

In recent years there have been whispers of greater interest from LPs – traditionally sellers on the secondaries market – in becoming buyers. As on the primary side, co-investment opportunities are a good place to start.

Humber estimates there's around $100 billion of capacity to buy in the secondaries marketplace, and of that, $15 billion is estimated to come from non-traditional secondaries buyers, including LPs looking to buy directly.

ENERGY BOOST

Less than 50 percent of the funds sold last year were buyout vehicles, according to Greenhill, showing the role energy, infrastructure and real estate play in the market. Keay identifies energy as one of the larger growth areas in the last year thanks to a large universe of LPs with exposure which are looking to de-risk and an improvement in pricing on the back of greater stability in oil pricing.

"Those assets are still trading at discounts, but I think LPs are looking to de-risk their portfolios given the risk profile," he says. "It was painful for some LPs when the price of oil bottomed out."

Ardian has also had an active year in energy and infrastructure secondaries, including picking up a €300 million portfolio of infrastructure LP interests from Italian banking group UniCredit.

Meanwhile, in its dedicated real estate business, Landmark is seeing signs that sellers are more willing to transact.

"Real estate secondaries transaction volume reached about $6 billion last year, and has grown approximately 25 percent per year since 2008," says Humber. "We consider dealflow opportunity over the next two to three years and forecast $15 billion-$25 billion of aggregate transaction volume."

Nick points out there was an increase in non-traditional buyers during the last downturn. It is tough for LPs to convince boards and committees to buy into buyout funds they like and want increased exposure to if the stakes are priced at par or above. However, if pricing dips, there could be a rise in interest from these buyers. ■

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