Institutional investment

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What can secondaries do for LPs and GPs?

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Secondaries can help with LPs and GPs that are going to need ways to confront and resolve the particular challenges imposed on them by the coronavirus-induced economic crisis:

- As has been widely reported, many portfolio companies are severely impacted and in desperate need of cash. Private equity-backed companies do have access to the parent fund's dry powder. But where investment periods have expired and reserves at fund and asset level are exhausted, GPs are on the lookout for additional sources of capital.
- The slowdown in M&A activity delays both new investments and exits. That's a pressing concern for funds still in their investment period or nearing the end of their term. Some market players believe that it may take 12-18 months for M&A to pick up.
- Many LPs face significant liquidity demands, with funds accelerating capital calls (in order to support portfolio companies and repay subscription lines, the use of which is much more prevalent than during the GFC), paired with a reduction in distributions (as GPs conserve cash for emergencies).
- Institutional investors are assessing the impact of the crisis on their portfolios to see if reallocations are necessary, although the full impact of this is not expected to be established until the second half of the year.

> Necessity is often the genesis of opportunity.

The secondary market is well placed to help LPs and GPs in need of liquidity or additional capital. New fundraising is holding up well. Dry powder at secondaries funds is estimated at $150 billion (including leverage), four times bigger than in the global financial crisis (**GFC**). The pool of buyers is larger: ten secondaries funds currently hold more than $2 billion of dry powder each. Secondaries teams that got through the GFC learned from that experience. Here's a quick round-up of secondary market offerings:

Preferred equity at investor level

Preferred equity solutions offer LPs an alternative to being forced to sell at deep discounts, while allowing deployment of dry powder. There are several types. For instance, an LP may receive an immediate pay-out from the preferred equity buyer while retaining its interest in the fund. The LP remains entitled to future distributions from the fund's portfolio, but only after the preferred equity buyer has been paid out. For those LPs who do not wish to sell their interests but need help meeting their unfunded commitment, it won't receive an immediate pay-out, but the preferred equity buyer instead meets drawdown requests on the LP's behalf.

Preferred equity at fund level

For mature funds with expired investment periods, no unfunded commitments and limited exit opportunities, a preferred equity solution can also be implemented at fund level. Preferred investors inject fresh capital, which can be used to finance follow-on investments, refinance asset level debt, or provide partial distributions to existing investors. In return, the preferred investors receive priority on future distributions.

Preferred equity transactions generally incur fewer conflicts than other forms of GP-led secondary, so we expect to see this solution to become popular in the near term, given the level of dry powder and number of funds raised in the last 5-7 years. Unlike NAV-based loans, preferred equity solutions do not include repayment terms, acceleration rights or security, which makes them more flexible, but more expensive, than debt.

LP stake sales

Big discounts are likely to persist at least until the Q2 (and possibly Q3) valuations become available later this year. The ensuing wide bid/ask spread means that 'vanilla' sales are likely to interest only the more distressed sellers for now. The same thing occurred for a protracted period in the GFC: deals were closing at more than 100% of NAV in Q3/Q4 2007, but when the crisis hit, prices dropped more than 60% over the following 18 months; deal volume fell 50% in 2009. The market didn't recover until

2010, as demand accelerated and discounts shrank.

In this crisis, we expect to see more innovative pricing mechanisms, which factor in the potential upside in NAV once the COVID-19 impact has subsided. Responsive pricing of this sort should encourage participants not to defer transactions.

If an LP needs liquidity now, it may be preferable to focus on selling commitments which are proportionately less drawn-down. This allows the LP to reduce undrawn liabilities, while confining the discount impact to a smaller amount of drawn-down capital. On the other side of the equation, secondaries buyers raise their market exposure while benefiting from the new pricing environment. Secondaries advisers expect to see the return of the 'wish list', as institutional investors chase down top-quality GPs with younger-vintage, undrawn funds, as happened in the GFC.

Meanwhile, the reduction in near term distributions (which provide attractive IRRs and recycling opportunities) means that older-vintage funds can expect to attract larger discounts. It is likely that it will take some time for tail end sales to return to normal.

GP-led secondaries

Once pricing settles, we are likely to see a return of GP-led LP tender offers, where the GP organises a secondary sales process, giving existing investors an option to retain interests in the fund or sell to a new secondaries investor. The GP may also combine this with multi-year fund extensions (as opposed to the usual practice of yearly extensions, one year at a time) and a stapled secondary (i.e., buyers also subscribe capital to the GP's new fund).

Continuation funds are another form of GP-led secondary. Assets are transferred from an existing fund to a new (continuation) fund, which is managed by the same GP. LPs in the existing fund are typically given the option to cash-out, roll into the new continuation fund, or a combination of the two. The rolling investors and incoming secondaries investors commit additional capital to the continuation fund (the stapled element). When exits are hard to find and portfolios impaired, a continuation fund gives the GP time and follow-on capital to optimise the value of the portfolio, while simultaneously offering liquidity to those LPs who need it.

Continuation funds can be used for a single asset or multiple assets. They typically include new economics for the GP (carry and management fee resets). This helps incentivise the management team to continue to grow the portfolio.

GP-led solutions are inherently conflictual, with the same GP active on both the buy and sell sides of the transaction, so fairness and transparency on pricing are key; they are unlikely to take off in a big way until pricing has settled somewhat. ILPA helpfully issued guidance last year on how to manage conflicts in GP-led secondaries.

Strip sale

This is similar to a continuation fund, but it involves a "strip" of an asset (or assets) being sold, rather than the whole asset. This allows the existing fund to remain in control of the assets and the LPs to benefit from any future valuation upside while providing them with partial liquidity and/or a cash injection for the fund through recycling. *Secondaries Investor* recently reported on StepStone Group's acquisition of a strip of assets from an Israeli venture fund for $80 million, one of the few transactions closed in the pandemic.

Beware the PTP

It's worth noting that, even before the COVID crisis, a lot of PE partnerships had hit their annual limit for LP transfers under America's publicly traded partnership (**PTP**) regulations. Exceeding the limit would make the fund a PTP, which is taxable as a corporation. With transfer volumes hit by the crisis, this has dropped down the list of concerns for the time being. But when sales recover, there will probably be a backlog of transfers, potentially leading to lengthy delays as GPs are compelled to queue the transactions to avoid triggering PTP.

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If you would like to find out more about our secondaries practice, you can do so here.

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