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The love-hate relationship in private equity secondaries

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Over the past two decades, the private equity secondaries market has transformed into one of the highest growth and, in our opinion, most specialized areas of alternative investments. From 2002 to 2023, global secondary market volume scaled from \$2 billion to \$114 billion in transaction value.[1]

Despite this tremendous success, there remains a healthy debate within the private equity community on its future, exemplified by the love-hate relationship many have with the asset class.

In this paper, we explore the tensions, digging into the data to better quantify the relative merits and considerations of each side of the market.

Our conclusions: (i) the limited partner (LP)-led side of the market is far from mature and continues to deliver strong performance for investors, (ii) the general partner (GP)-led side of the market is here to stay regardless of the M&A environment, and (iii) investors in secondaries strategies would benefit from having exposure to both sides of the market.

HOW LP-LED AND GP-LED TRANSACTIONS DIFFER

At a high level, the secondaries market can be broken-down into two core segments: LP-led and GP-led transactions. LP-led transactions involve a limited partner (LP) electing to sell its interest (in whole or in part) in one or more private equity funds prior to the fund's maturity. GP-led transactions, the vast majority of which are structured as continuation vehicles (CVs), involve a private equity firm (GP) recapitalizing the equity of one or more portfolio companies while maintaining control of the asset(s).

In GP-led transactions, LPs in the private equity fund are offered a liquidity option for their economic interest in the portfolio companies, but are also provided the option to rollover or re-invest proceeds alongside the GP and new secondary investors to capitalize on continued growth.

Over the past decade, the LP-led segment of the market has grown consistently. The growth has not primarily been driven by distress, but rather by sophisticated institutional investors implementing portfolio management practices to optimize exposure and generate liquidity in a low distribution environment.

On the other hand, the GP-led market has exploded over the past five years and now represents almost 50% of secondary market volume. Today, more than half of the largest 100 private equity firms have executed a GP-led transaction.[2]

Together, the secondaries market has demonstrated impressive performance, and notably with far less volatility than other core alternative strategies.

WHY LOVE-HATE

The tensions, however, do not lie in LP-led vs. GP-led transactions.They are evident in both sides of the market.

Some view the LP-led market as mature, commoditized, and only beneficial early in the lifecycle of a private equity program to mitigate the J-Curve, add reverse vintage diversification and provide early cashflow. Others maintain exposure to the market as a core component of their portfolios, pointing to credit-like risk and yield profiles with upside potential consistent with equity strategies.

On the GP-led side, skeptics point to conflicts of interest in asset valuation, similar economic structures to equity co-investment programs but with fees or adverse selection. Conversely, proponents of the GP-led market point to superior alignment of interests, positive asset-level selection bias, shorter than typical hold periods and private equity return profiles with potentially lower risk.

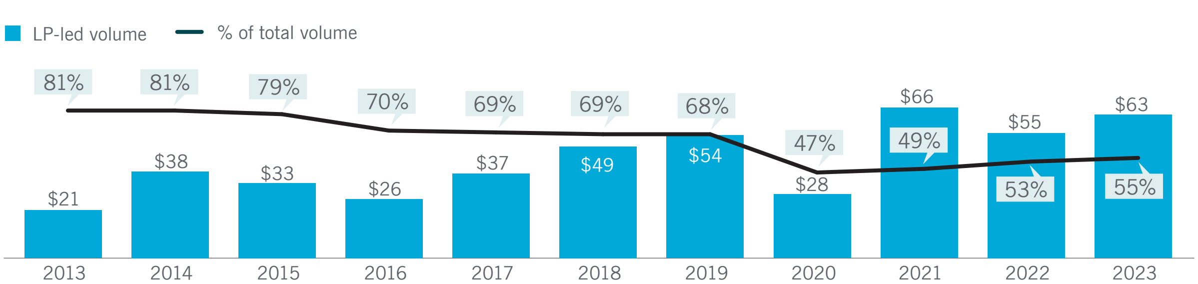
WHY LP-LED DEALS STILL MATTER

Private equity investments are, by design, illiquid in nature. However, investors in the asset class are still able to sell their LP interests and do so for a myriad of reasons, including:

- A desire to generate liquidity
- Reduce overallocation to the asset class or a particular GP
- The need to avoid future capital calls/reduce unfunded commitments
- Shifting regulatory requirements
- Rebalancing of portfolio exposure to crystallize illiquid gains, reduce concentrated exposures or divest non-core assets

The LP-led market tripled in size to $63bn from 2013 to 2023 (Figure 1). Large incumbent LP-led focused secondary buyers have raised record sums of capital. For example, Ardian, Lexington and Blackstone Strategic Partners reported fundraises

Figure 1: Historical LP-led volumes



Past performance does not guarantee future results.

Data source: Evercore Private Capital Advisory – FY 2023 Secondary Market Highlights published January 2024.

in excess of $20bn since 2022. Meanwhile, the rise of retail-focused, semi-liquid strategies that require quick deployment are, presumably, driving pricing up. Yet, if the market were mature, well capitalized, or commoditized, as some assert, one would expect to see three trends: (i) return compression due to competition, (ii) increasing churn rates reflective of an efficient market, and (iii) healthy levels of buyside dry powder. In fact, the data shows none of those trends exist.

Stable return generation: The secondaries asset class has historically generated strong and narrowly banded returns. Compared to traditional private equity fund investments, secondaries investments have limited blind pool risk (i.e., funds have deployed a majority of, if not all, investable capital), offer shorter duration given maturity of underlying assets, and provide immediate downside protection as a result of effective entry discounts.

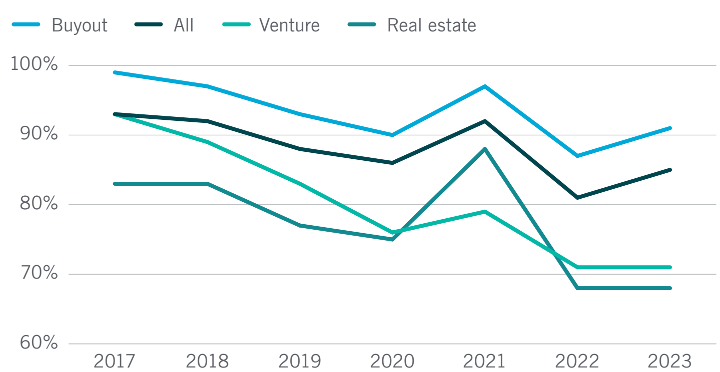
Given the recency of the GP-led phenomenon, available historical benchmarking data is predominantly focused on LP-led strategies. In no vintage years dating back to 2002 have bottom quartile returns in secondaries investments been negative for the asset class, and in more recent years, returns have actually increased (Figure 2).[3]

What's driving this? While the increased adoption of deferred payment structures, use of subscription facilities and NAV (net asset value) financing have contributed to enhanced performance, pricing remains a core element of the equation.

We have observed the ability of secondary buyers to react dynamically to macro and micro factors in the pricing they are willing to offer sellers. In expanding economic climates, you would expect headline pricing to improve as underlying assets are growing and compounding at higher rates. In contracting markets, secondary buyers require additional cushion to protect themselves from NAV declines, driving pricing down. The LP-led asset class also presents investors an element of countercyclicality. In periods of recession, or market dislocation, liquidity comes at a premium, thus the price for liquidity of illiquid investments goes up. Said differently, discounts widen.

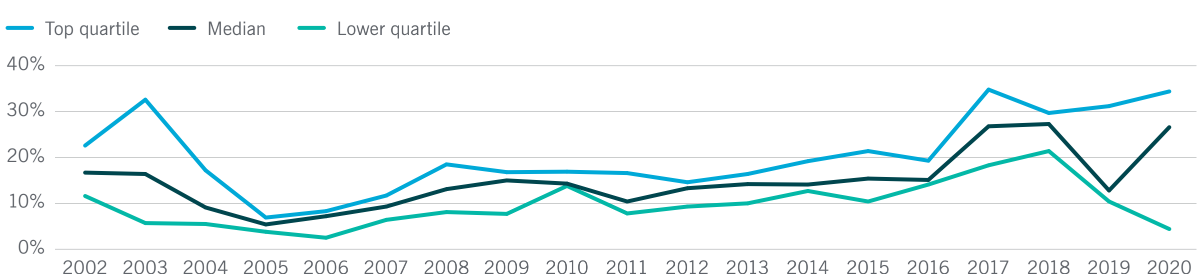
Further, in prolonged periods of dislocation, secondary buyers are not only paying lower prices, but also acquiring assets off depressed valuations and financial profiles. We saw this dynamic after the dot-com bubble, over the course of the global financial crisis, and more recently with COVID-19 in 2020. The market also responded rapidly with price fluctuation with the Russian invasion of Ukraine in 2022, the rapid decline in technology valuations, and the escalating conflict in Israel in 2023 (Figure 3).

Figure 3: LP portfolio pricing (% of NAV)



Past performance does not guarantee future results.
Data source: Jefferies – Global Secondary Market Review (January 2024)

Figure 2: Secondaries net IRR performance by vintage



Past performance does not guarantee future results.
Data source: Cambridge Associates secondaries since-inception net IRR data as of 30 Sep 2023.

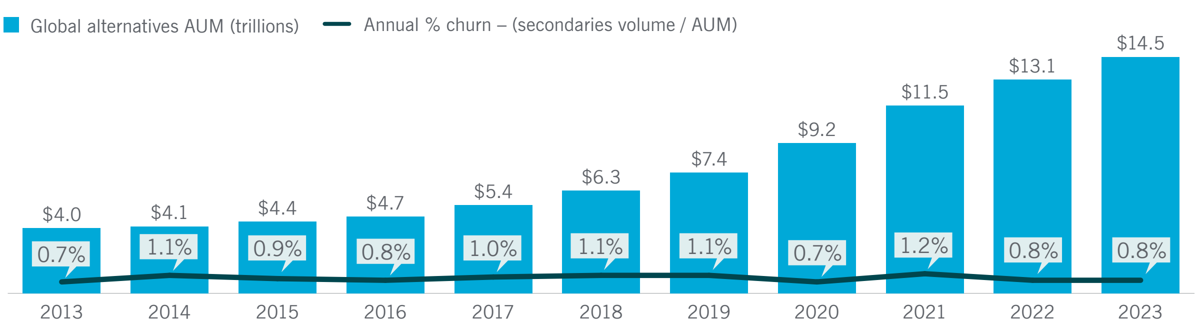
Churn rates: Bain's Global Private Equity Report 2024 points to $15 trillion in assets under management across private markets as of 30 June 2023. Buyout AUM was the largest component at $3.9 trillion, followed by venture capital at $2.8 trillion, real estate and private debt both at $1.7 trillion, infrastructure at $1.5 trillion and growth equity at $1.4 trillion. The entirety of the secondaries market across all those asset classes combined sits at $114 billion in annual volume, or a <1% churn rate (Figure 4).[1, 4]

To put this in perspective, in the modern real estate era, for any given 1,000 homes in the U.S., according to Redfin data, around 5% are typically for sale in what is arguably a far more illiquid asset. We believe this represents a conservative reference point for illiquid asset churn levels in an efficient market, particularly when considering the many factors influencing the inherent stickiness of residential real estate (e.g., job location, school districting and time of year, tax implications, burden of moving and finding a new home, etc.).

Using residential home turnover as a conservative proxy, we believe it is reasonable to anticipate some level of increased churn, particularly as asset classes with almost non-existent secondary markets take shape. Take private credit in 2023, for instance. Evercore's annual market survey reported only $4 billion of private credit secondary volume, virtually non-existent for a $1.7 trillion asset class.[1]

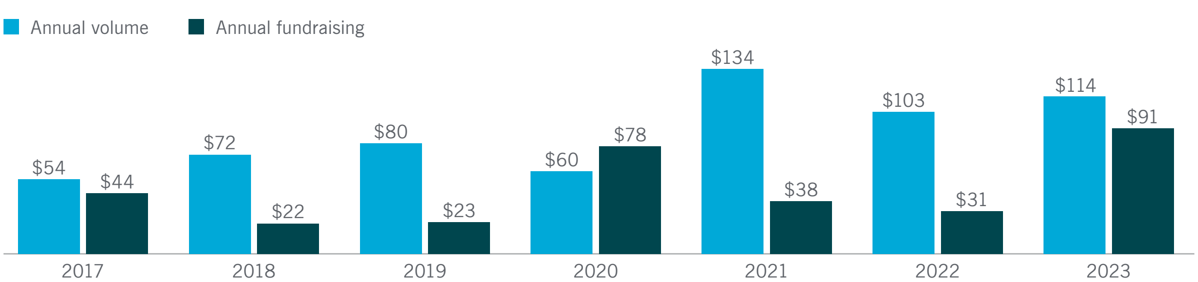
Market capitalization: Despite record-breaking fundraises in recent years, in our view the secondaries market remains severely undercapitalized. We estimate that the current capital overhang is only in the range of 1.4x – 1.8x dry powder to annual deployment volume. According to Lazard's Annual 2023 Secondary Market Report, from 2020 to 2023, $397 billion was invested in secondaries transactions, while only $238 billion of dry powder was raised (Figure 5).[5] So, the secondaries market's dry powder is actually shrinking. As a result, secondaries buyers are forced to be disciplined and selective in their underwriting and deal selection, and pricing power shifts to buyers vs. sellers.

Figure 4: Global alternatives AUM vs. annual churn rate



Past performance does not guarantee future results.
Data source: Bain Global Private Equity Report 2024; Evercore Private Capital Advisory - FY 2023 Secondary Market Highlights published January 2024.

Figure 5: Transaction volume vs. annual fundraising ($bn)

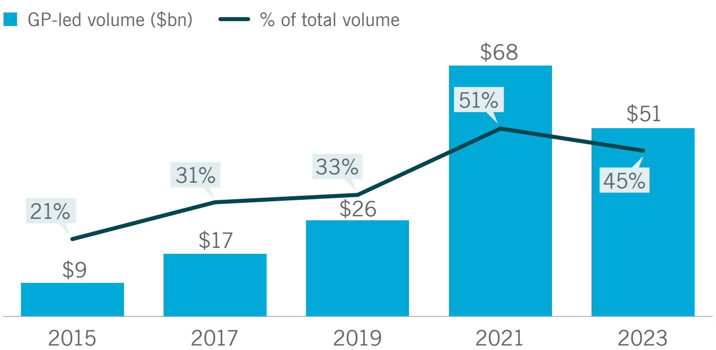


Past performance does not guarantee future results.
Data source: Lazard Annual 2023 Secondary Market Report published February 2024; Evercore Private Capital Advisory–FY 2023 Secondary Market Highlights published January 2024.

WHY THE GP-LED MARKET IS HERE TO STAY

GP-led market volume grew more than 10x over the last decade, to $51bn in 2023 (Figure 6). While this segment represents a multitude of GP-focused solutions (i.e., strip sales, tenders, preferred equity, etc.), we have focused exclusively on CVs, which represent around 80% of transaction volume.[1] CVs are special purpose vehicles that own equity interests in a portfolio company (or multiple portfolio companies), managed by the existing GP and capitalized by existing LPs and new secondaries market participants.

Figure 6: Growth within the GP-led secondaries market ($mn)



Past performance does not guarantee future results.
Data source: Evercore Private Capital Advisory – FY 2023 Secondary Market Highlights and published January 2024. Data as of 31 Dec 2023.

Critics of the GP-led market typically point to the following: conflicts of interest; fees being paid to sponsors in what could otherwise be no-fee, no-carry co-invest capital; and motivations of structuring CVs as a result of not being able to pursue a traditional sale or IPO.

Despite the significant growth in use of CVs by private equity firms, there are material concerns to consider before entering the market.

Conflicts of interest: GP sare inherently conflicted in CVs given they are both a buyer and a seller in the transaction. As such, industry constituents and regulators have put guardrails in place to minimize such conflicts, including the following:

- The industry group Institutional Limited Partners Association has issued guidance to the private equity community including (a) hiring an advisor to ensure an arms-length transaction, (b) LPAC (limited partner advisory committee) consent early in the process, (c) a status quo option available for existing LPs, (d) symmetrical information for secondary buyers and existing LPs, and (e) obtainment of a third-party fairness opinion
- Secondary trades have always been in the purview of the SEC but, more recently, there has been increased attention on continuation vehicles with a focus on (a) adequate and timely disclosure of transactions and (b) obtainment of a formal valuation or fairness opinion[6]
- Representation and warranty insurance has become commonplace to offer further protections to selling LPs
- Existing LPs are provided true optionality — the ability to receive liquidity or continue on for the next phase of growth

Ultimately though, our overarching view is the market is comprised of rational investors acting in good faith, and self-policing has historically addressed these items.

Co-investments with fees: CVs have been referred to, unfairly in our view, as “co-investments with fees.” However, co-investments are very different. Equity co-investment programs primarily only provide opportunities to new LBOs (leveraged buyouts) which involve meaningful up-front due-diligence and the establishment of a new value-creation-plan that may (or may not) prove to be successful. Additionally, new LBOs come with material unknowns including, but not limited to, risk of fraud, weaker-than-expected customer relationships and unanticipated C-suite changes.

On the other side, good candidates for a CV include high-performing businesses owned typically for at least three years, operate in markets with significant tailwinds, and generate returns in excess of the original underwriting case with more room to run.

In addition, there are far fewer unknowns in a CV because the management teams and value creation plan are already in place and performing. The CV doesn't have to undertake the traditional heavy lifting that is required of a GP in a LBO (which is often taking a company one step backwards to hopefully make two steps forward).

While economics are structured in CVs to compensate sponsors, these are generally done in a way that provides secondaries investors downside protection, upside capture and alignment of interests (in terms of the GP's personal capital at risk).

Early performance data, published by Morgan Stanley in January 2024, makes a strong case for the CV asset class, with the 2018 to 2020 vintages of single-asset CVs delivering median performance of 2.2x net MoC (multiple of capital) and upper quartile performance of a 3.3x net MoC.[2]

Unsellable assets: Critics commonly assert the purpose of CVs is because the GP was unable to sell or unable to get a desired valuation for an asset. As mentioned previously, good candidates for CVs are the highest performing assets that GPs want to own longer and want more capital to continue executing and accelerating. Existing LPs should never have to question whether they are getting a good deal, as the right candidate for a CV should be one where LPs are thrilled with both the prospect of rolling or selling in the transaction.

Over time, it is likely we see a return of post-GFC restructuring due to macroeconomics events, but that is not the state of the market today. Data from 2023 CVs, published by PJT Partners in January 2024, showed that gross MOCs returned to existing investors were greater than 2.0x in 100%, 84% and 68% of transactions across mega, large-cap and mid-market GPs, respectively.

Why many secondary buyers are leaning in

- **Asset familiarity/positive selection bias:** GPs have perfect visibility and information on a business before executing a sale process. This is unlike a buyer in a traditional LBO who has imperfect information and is subject to previously unidentified unknowns and an unproven value creation strategy. In CVs, GPs leverage this information asymmetry to self-select the highest performing asset(s) to extend the hold period alongside a proven management team and value creation plan.
- **Conservative valuations:** GPs typically hold net asset value at conservative marks relative to what a business would be worth on the open market in a competitive process. This is more generally referred to as a "control premium", or the amount a buyer is willing to pay in excess of fair market value to gain control of a company. Supporting this is recent Whitehorse Liquidity Partners' analysis across over 1,000 transactions. It showed that valuations at exit were, on average, 28% higher than where the GP was valuing the business two quarters prior.[7]
- **Enhanced alignment of interests:** In CVs, secondary buyers generally require a GP to roll c. 100% of its GP commitment and crystallized carry. This means the GPs ownership of the CV generally ranges from five to 25 percent, meaningfully higher than the 2%–5% GP commitment to a traditional fund. Performance-based carried interest is generally tiered based on net returns to secondary LPs, driving enhanced alignment of upside relative to a traditional 20% carry over 8% preferred return. Additionally, management fees in CVs typically range from 50 to 125 basis points, a material discount to the 2% management fee in traditional buyout funds.
- **Shortened hold periods:** Hold periods for CVs should be lower than traditional LBOs given a sponsor is not having to do the heavy lifting in a new investment.

In short, the GP-led market has transitioned from a last resort into the ultimate alignment of interests for all investors around a curated selection of high-performing asset(s). Emerging performance data shows this is an asset class that should not be ignored. While skeptics of GP-leds present both valid and rationale considerations for the asset class, we believe the merits carry the day.

HOW SECONDARY TRANSACTIONS HAVE EVOLVED

Like any novel concept, it is important to understand the origin and evolution of the structures. While GP-led transactions have become mainstream today, they are not a new concept, but appeared in the 2012–2014 era largely borne out of the GFC.

First inning

Following the GFC, a subset of private asset managers were left with a critical dilemma: portfolio company performance and valuations were down, fund returns were below their preferred return hurdle, and LPs were demanding liquidity despite limited appetite from potential acquirors.

In need of additional time and fresh capital, GPs brought in new secondaries LPs to "restructure" dated funds and provide liquidity options to existing LPs. CVs were arguably born out of necessity, not opportunity, and viewed as a lifeline for assets that could not otherwise be sold. Firms, such as JW Childs and Irving Place Capital among others, pursued such fund restructurings.

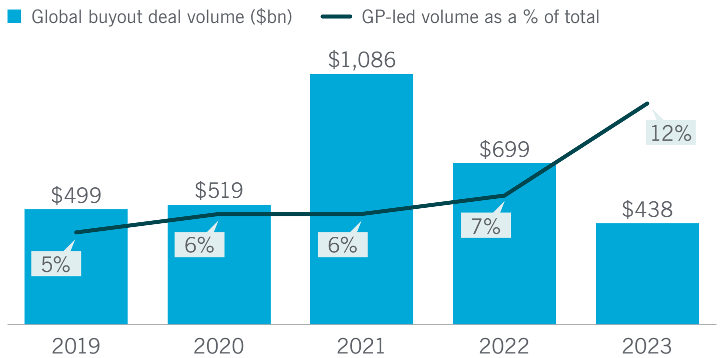
Second inning

Fast forward to around 2018 and GPs began to recognize these innovative structures represented an attractive solution to extend the investment period for their highest performing assets. A paradigm shift began as GPs turned to CVs for assets they wanted to own longer, not had to own longer. During that time, given the creativity and complexity these transactions require, the asset class was primarily reserved for the largest and most well-capitalized GPs in the market, with firms such as Warburg Pincus, Blackstone, CD&R and others tapping the CV market.

Third inning

Five years later and one item is abundantly clear: continuation vehicles have gone mainstream. Since 2018, the GP-led market has been the fastest-growing segment of the secondaries landscape and has grown as a percentage of global private-equity exit volume from 5% to 12% (Figure 7). We expect this trend to not only continue, but in fact accelerate, as realizations occur and showcase the power of holding the highest performing assets for longer.

Figure 7: GP-led volume as a % of global buyout volume



Past performance does not guarantee future results.

Data source: Evercore Private Capital Advisory – FY 2023 Secondary Market Highlights published January 2024; Bain 2024 Global Private Equity Report. Data as of 31 Dec 2023.

WHAT DO FUTURE INNINGS HOLD?

While a confluence of factors contributed to the rapid adoption of CVs, we believe the most critical driver was and continues to be the proliferation of middle market and lower middle market transactions. Increasing prevalence in the middle market, by definition, equates to smaller companies and, on average, smaller transaction sizes. We predict an increasing number of access-constrained deals with little syndication, meaning direct relationships with GPs will increase in importance. Further, GP and LP market acceptance of CVs as a viable and attractive alternative to more traditional exit avenues is adding fuel to the fire. In our view, LPs who refuse to adapt and embrace CVs will be self-selecting out of investment opportunities some of the highest performing assets.

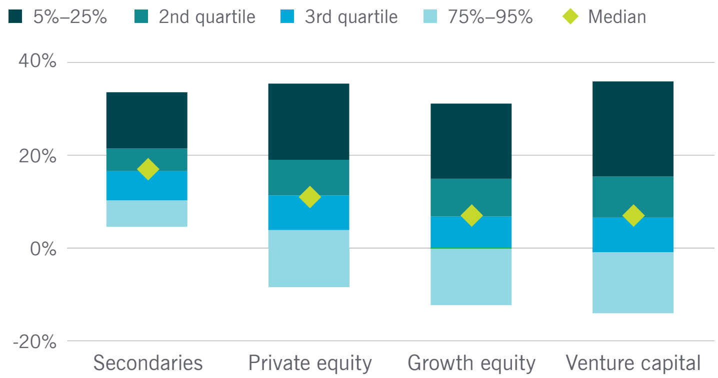
SUCCESS IN SECONDARIES

In many ways, love-hate relationships make a market; different market participants place different values on different assets and deals. Understanding how the market is evolving, accessing deals and assessing their suitability will be key to success for investors.

Our research into the trends and tensions of the secondaries market indicates that:

- the LP-led side of the market will continue to develop, with the potential for strong investment returns
- the GP-led side of the market is well established, irrespective of the ebbs and flows of M&A activity
- We believe significant opportunity exists to invest in both LP-led and GP-led strategies, using LP deals to drive enhanced distributions and GP-led deals to drive high MoCs.

Figure 8: Net IRR dispersion by asset class



Past performance does not guarantee future results.

Data source: Cambridge Net IRR Since Inception, Vintages 1993 – 2022 (Cambridge Net IRR Since Inception, Vintages 1993 – 2022 (as of 9/30/23)

Authors and contributors

Nick Lawler serves as a Managing Director and Head of Secondaries on the Private Equity and Junior Capital team at Churchill Asset Management, based in Chicago. His responsibilities include oversight of origination, underwriting and portfolio management activities for secondary investments. **Andrew Topping**, Principal, and **Connor Gay**, Vice President, of the Churchill Secondaries team contributed to the writing and research of this piece.

For more information, please visit nuveen.com.

Endnotes

Sources

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