GP-Led Transactions: What LPs Need to Know

August 26, 2021 | Dennis Scharf, Managing Director

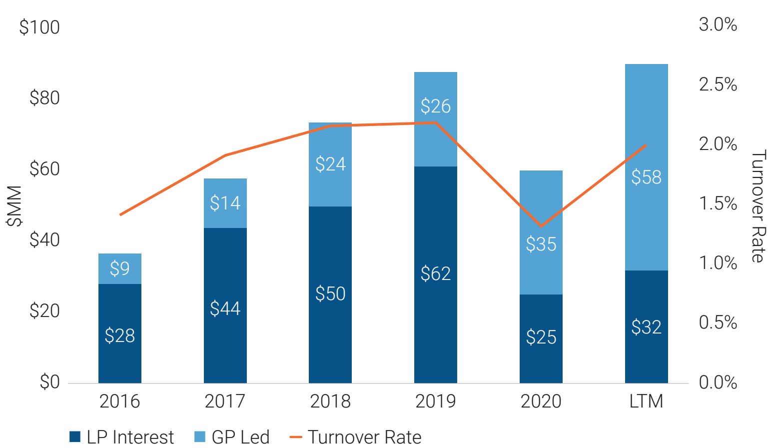
It's no secret to those in the private markets that the secondary market looks nothing like it did a year ago — or at any point in its history, for that matter.

Limited partners investing into the space now need to evaluate the secondary market's evolution and what it means with regard to portfolio allocation and manager selection. The good news is that the market is already at pre-COVID levels from a volume standpoint, with an increasingly buyer-friendly supply/demand dynamic supported by meaningful barriers to entry. At the same time, the market growth is being driven by a dramatic increase in GP-led transactions, which today represent nearly two-thirds of the overall market. As a result, limited partners must take a forward-looking view on how the market's shift towards these transactions may impact both the competitive positioning of buyers and the overall risk profile of secondary funds. What follows is our take, based on our market position and proprietary information, on how we believe LPs should be thinking about today's secondary market.

Current State of the Market: Volume Growth

Let's start with the good news: It's not April 2020 anymore. The table to the right shows annual secondary deal volume for the past five years, split between LP interest deals and GP-led deals (more on this term later). The chart also shows annual secondary market turnover, defined as secondary volume divided by overall private equity net asset value.

Annual Secondary Deal Volume



Source: Jefferies Global Secondary Market Review — 1H 2021 (July 2021)

The secondary market's strong growth is clearly being driven by a shift in transaction mix towards GP-led transactions — a shift that has accelerated materially over the past 12 months. GP-led transactions have grown at a 52% compounded annual growth rate since 2016 and, after factoring in the first half of 2021, have contributed 93% of the nominal volume growth over that time frame. In our view, the market's transformation into one dominated by GP-led transactions suggests a further acceleration of growth in the near- to medium-term. That is because the emergence of these transactions has effectively transferred secondary portfolio management responsibility from limited partners to general partners and, in turn, has helped eliminate the friction costs that have historically served as obstacles to increasing the annual secondary market turnover rate.

For certain limited partners — generally, those who may be less experienced, staff-constrained or beholden to less flexible approval processes — there is meaningful inertia preventing them from actively and routinely pursuing liquidity through traditional LP interest sales. GP-led transactions have eliminated these obstacles, presenting fully baked and negotiated liquidity offers to limited partners and giving them the option to seamlessly sell or retain their exposure to a fund by simply making an election. In addition to streamlining the secondary process, GP-led processes are also typically presented to 100% of a fund's limited partner base. The scalability of these transactions, combined with the fact that GPs are now facilitating portfolio management decisions for limited partners, could lead to a dramatic increase in secondary market turnover rate from the current level of 2%. As the secondary market is increasingly viewed by general partners as a viable and attractive alternative to traditional company exit paths, there is no reason why GP-led transactions can't become a much greater percentage of overall fund market liquidity (which, on average, has represented approximately 24% of NAV annually over the past decade).

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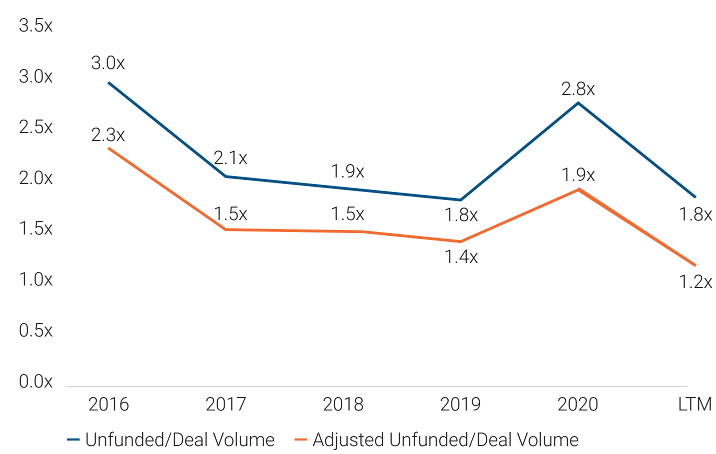
Current State of the Market: Supply/Demand Dynamics

But wait — there's more good news. While deal flow and volumes have rebounded significantly over the past year, dry powder has not been able to keep pace, which is creating a very attractive supply/demand dynamic for well-positioned buyers. The table to the right illustrates this dynamic, showing the ratio of secondary unfunded capital to secondary deal volume (i.e., overhang ratio) on an annual basis over the past five years.

As shown on the right, the overall ratio currently sits at a historical low of 1.8x. When you adjust the numerator to exclude older secondary funds that are out of their

Secondary Market Annual Capital Overhang



Source: Hamilton Lane Database (July 2021) investment period and thus not pursuing new deals, the current overhang ratio drops even further to 1.2x. This is an extremely favorable backdrop for secondary buyers, bolstered even further by the fact that the dry powder is concentrated amongst a limited group of secondary buyers. However, despite this dry powder concentration, the increasing size and concentration of GP-led transactions is increasingly preventing even the largest secondary funds from fully underwriting transactions. For instance, over the past year, the average continuation fund deal size stood at $1.1B and single-asset deals comprised close to 50% of all continuation vehicle transactions. And as a result, 26 of the 38 GP-led deals that Hamilton Lane reviewed as an existing LP over the past year had multiple secondary buyers as lead or syndicate investors. So, you have more complex deals requiring multiple lead investors being brought to a market defined by a small set of resource-constrained secondary firms.

This dynamic is affording certain secondary buyers the ability to be selective and gain access to an increasing number of deals on a non-competitive basis. But which secondary buyers are best positioned to capitalize on the current market backdrop and preserve differentiation? And how does the market shift towards GP-led transactions impact the go-forward competitive landscape and secondary transaction profile? Let's find out.

Defining the "GP-Led" Opportunity Set

The natural assumption would be that the dramatic shift in transaction type over the past 12 months materially alters the competitive positioning of current market participants and requires new entrants with differing skill sets. But if you ask us, that is far from the case. Rather than leading to a massive landscape shake-up, the shift in transaction type is simply accentuating the existing competitive advantages of the secondary firms that were already best positioned to capitalize on the growing secondary market. The best positioned buyers continue to be those that possess the trifecta of primary scale, secondary scale and flexibility as it relates to secondary strategy. But why? A more detailed breakdown of the GP-led category helps put this into perspective.

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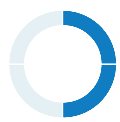
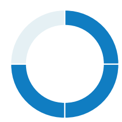
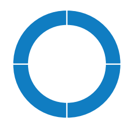
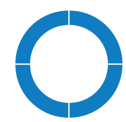
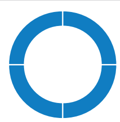
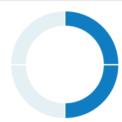
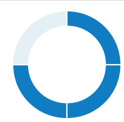
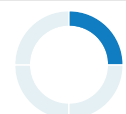
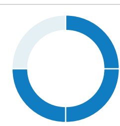
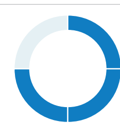
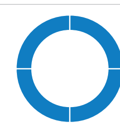
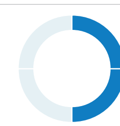
The term 'GP-led' has become synonymous with continuation vehicle transactions, where a general partner transfers assets out of one of its existing commingled funds into a newly-created vehicle that it manages on behalf of new investors. However, the GP-led category also captures other non-LP interest transaction types such as structured transactions (i.e. captive spin-outs and secondary directs), which typically target assets and/or general partners outside of the existing commingled fund market. And there is a fair amount of variability as it relates to competitive dynamics, counterparty motivations and transaction profile among these GP-led subcategories.

To help better explain the evolving transaction landscape, the following chart illustrates how market share (expressed as a percentage of Hamilton Lane secondary deal flow) has shifted amongst sub-categories in recent years and summarizes a few common features of each transaction type.

	GP-Led Transactions 67% of Market			LP Interest 33% of Market
	Structured Transactions[1] (7% of Market)	Existing Fund Market – 93% of Market		
		Tender Offer/Staple	Continuation Vehicle	LP Interests
% of Deal Flow: 2018 | LTM	16% | 7%	7% | 6%	19% | 54%	57% | 33%
Manager	New GP or Existing Team	Existing GP	Existing GP	Existing GP
Asset Holder	Third Party/ Balance Sheet	Existing PE Fund	Existing PE Fund	Existing PE Fund
Primary Scale Importance				
Complexity				
Size				

Source: Hamilton Lane Database (July 2021)

Continuation vehicles have clearly taken material market share in recent years. However, we view continuation vehicles as simply an extension of the existing commingled fund secondary market that not long ago consisted almost solely of LP interest transactions. Continuation vehicle transactions target the same assets, the same funds and the same general partners as LP interest transactions; they simply provide secondary buyers with the ability to access these assets in a more customized and scalable fashion via the underlying GPs. Thus, the competitive advantages of having primary scale that are invaluable in the LP interest market (i.e., strong GP relationships, pre-existing familiarity into funds and assets) are directly transferrable to continuation vehicle transactions. In fact, they are often magnified. On LP interest deals, GPs can only influence to whom an LP sells. With continuation vehicles, the general partners have actual control over how these transactions are managed and allocated and subject to receiving a fair price, will typically steer deals to buyers that represent potential long-term strategic (i.e., primary) capital. With 93% of the market now related to transactions (whether LP interest or GP-led) targeting existing funds as shown in the exhibit above, we are operating in a market where GP relationships (and in turn, primary scale) are more important than ever.

While primary relationships are vital in accessing continuation vehicles, given the complexity of continuation vehicle transactions relative to traditional LP interest deals, buyers also need the structuring expertise and secondary scale historically required to complete structured transactions in order to properly extract the benefits of these relationships. As such, the secondary buyers with scale and primary capabilities, who have always pursued a flexible strategy across LP interest and structured transactions, are now best positioned to capitalize on the growth of the continuation vehicle market. On the contrary, those buyers who lack either primary scale or secondary scale are unlikely to be viewed as preferred counterparties in this growing part of the market, and may find themselves exposed to adverse selection bias. And the challenge of organically obtaining this scale continues to be a major obstacle preventing a rush of new entrants from changing the attractive competitive dynamics currently present in the secondary market.

Continuation Vehicle Flight to Quality

While the ongoing market shift towards continuation vehicles may not be as transformative as some predict, there are certainly differences in the profile of these transactions relative to other secondary transaction types that are worth noting. The following table compares typical transaction profiles across subcategories of secondary transactions:

	GP-Led Transactions 67% of Market			LP Interest 33% of Market
		Existing Fund Market – 93% of Market		
	Structured Transactions[1] (7% of Market)	Tender Offer/Staple 6%	Continuation Vehicle 54%	LP Interests 33%
Diversification				
Near-Term Liquidity				
Optical Discount				
Visibility/Funded %				
Quality				
Alignment				

Source: Hamilton Lane Database (July 2021)

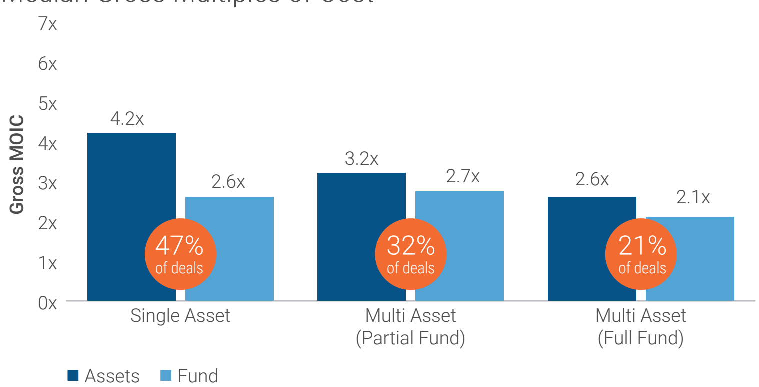
On average, continuation vehicles are more concentrated than other transaction types and are less likely to generate near-term distributions. However, although these transactions bring this increased concentration and duration, we believe that the most attractive continuation vehicle transactions in the market today also bring a level of manager quality, asset quality and alignment that far offsets these considerations. And for secondary buyers with flexible strategies, these transactions can be complimentary to LP interest and structured transactions in the context of a diversified secondary fund portfolio.

Now, all that limited partners have to do is look across their own portfolios to see that the GP-led secondary market is increasingly being utilized by the highest-quality sponsors, a multi-year trend that has recently accelerated. This acceleration has been driven by the acceptance of these transactions by the broader LP universe and by sponsors increasingly viewing these secondary transactions as an efficient way of achieving the formerly conflicting objectives of holding onto trophy assets longer and managing liquidity targets across their existing funds. Alongside an uptick in sponsor quality, the market has also witnessed a material improvement in underlying asset quality. This shift has really occurred over the past 12 months and has been driven by an increase in the number of single-asset and partial fund continuation vehicles at the expense of full fund continuation vehicles. These targeted GP-led deals are a function of a continually evolving and creative secondary market's reaction to COVID-19, and has enabled sponsors to anchor transactions specifically around those trophy assets without having to include dilutive exposures that could lead to discounted pricing.

So, let's turn to the Hamilton Lane proprietary database to more clearly illustrate the quality that currently defines the GP-led market. The table below shows the median realized gross multiples of cost (MOIC) of the assets being purchased in different constructs of continuation vehicle transactions compared to the median gross MOIC of the underlying selling fund at the time of the secondary transaction.

LTM Continuation Vehicle Transactions

Median Gross Multiples of Cost

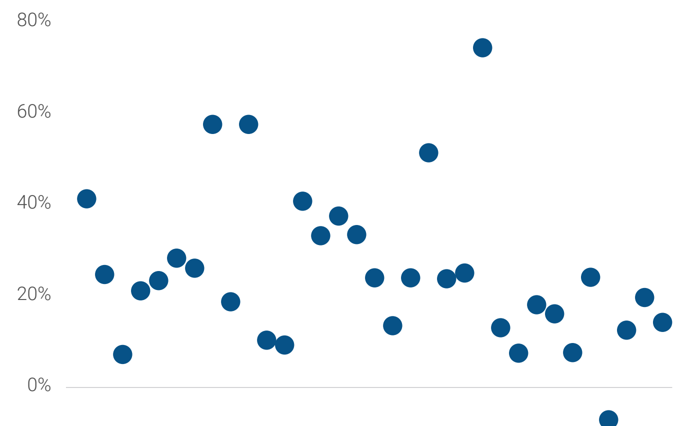


Source: Hamilton Lane Database (July 2021)

As shown above, the realized MOICs on assets sold to continuation vehicles are attractive both on an absolute basis and relative to the performance of their underlying funds. And the realized acquired asset MOIC and its outperformance relative to the MOIC of the underlying fund both increase as you move towards partial fund and ultimately, single-asset deals. It is clear that the opportunity set in the continuation vehicle market is weighted towards the best historically-performing assets within strong performing funds. To put another way, the market has embraced a ‘support the winners’ thesis. Now, cynics will say that these high realized MOICs could also be a sign of excessive valuations and may suggest that sponsors are bringing assets to the secondary market to achieve pricing not otherwise available via traditional exit means (which in 2021, would be saying something). And that likely is the case in certain transactions, as there continues to be varying sale motivations across the GP-led landscape. But to try and assess the typical sponsor motivation across the market, there is no better topic to turn to than alignment.

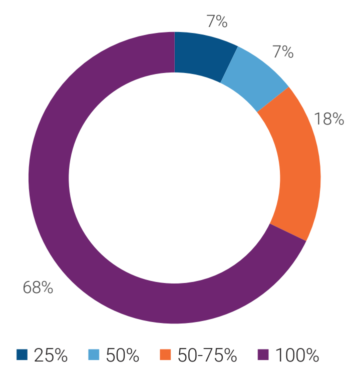
With the continuation vehicle market now concentrated in higher-quality managers, it should be no surprise that nearly all target funds sit well above their preferred hurdle. What this means is that continuation vehicle transactions help lock-in carried interest and, in most cases, result in carry being paid to the GP at transaction closing. While there is still variability across deals, increasingly GPs are agreeing to re-invest 100% of carry proceeds into continuation vehicle transactions alongside secondary buyers, resulting in strong alignment and suggesting that GPs believe in the go-forward return potential of these investments. In some instances, GPs have further aligned themselves with buyers by coming out of pocket to invest additional capital into the transaction,

Fund Net IRR at Time of Continuation Vehicle Closing



Source: Hamilton Lane Database (July 2021)

Continuation Vehicle by % Carry Rolled



Source: Hamilton Lane Database (July 2021)

literally buying into the ‘support the winners’ thesis themselves.

The general trend towards higher quality assets with aligned sponsors benefits the entire secondary market but is disproportionately beneficial to secondary buyers with large primary platforms and size flexibility. Participants with these characteristics are best positioned to employ a selective approach in pursuing the most attractive continuation vehicle transactions where a GP is motivated not solely by price, but also by a desire to find a strategic partner with whom to re-invest.

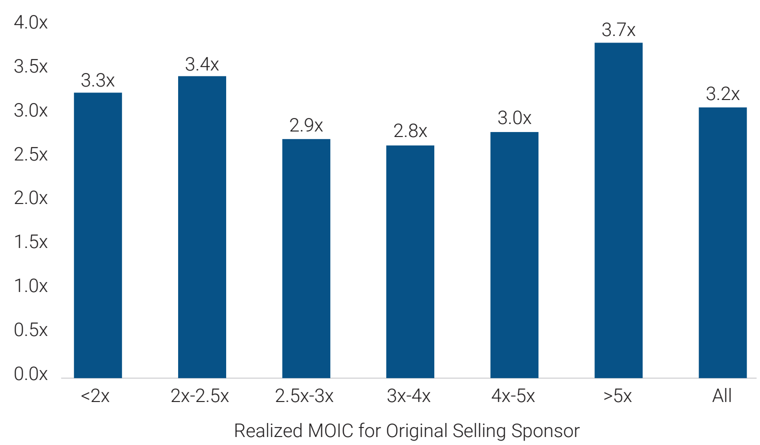
Single-Asset Continuation Vehicle - Deeper Dive

The GP rationale for single-asset continuation vehicle transactions is clear. Sponsors are now able to retain exposure to strong performing assets for an extended period of time as opposed to selling these assets to competing sponsors. These transactions also enable sponsors to continue receiving economics on these assets and often provide additional unfunded capital to the GP to enhance value creation (and economics) on a go-forward basis. For buyers, the supposed rationale is that these transactions offer the opportunity to cherry-pick the historically best-performing assets out of a high quality GP's portfolio in partnership with that manager. But are yesterday's winners likely to become tomorrow's winners, or is it more challenging to replicate a highly successful prior outcome that may have benefited from an investment thesis or valuation arbitrage that no longer exists? Fortunately, the Hamilton Lane proprietary database comes to our rescue again, offering actual data instead of opinion or conjecture.

We went back and analyzed 126 sponsor-to-sponsor buyout transactions where we had realized return data for both the selling (original) sponsor and the acquiring (second) sponsor. [Note: We excluded companies bought by the acquiring sponsor prior to January 2009 given the limited data we had for the pre-GFC period.] In our attempt to either support or refute the buyer rationale for single-asset continuation vehicles, we first analyzed how returns generated by the second sponsor varied based upon the returns generated by the original sponsor:

But are yesterday's winners likely to become tomorrow's winners, or is it more challenging to replicate a highly successful prior outcome that may have benefited from an investment thesis or valuation arbitrage that no longer exists?

Acquiring Sponsor — Average MOIC at Exit

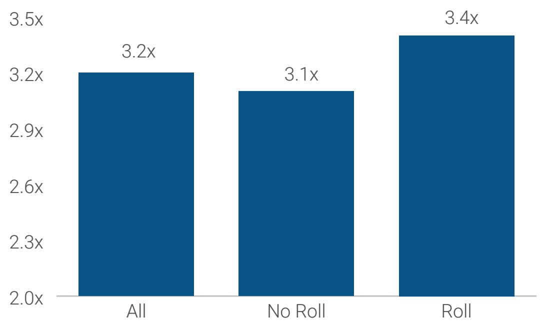


Source: Hamilton Lane Database (July 2021)

The first takeaway is the overall strong performance of sponsor-to-sponsor deals generally, with an average realized MOIC of 3.2x for the acquiring sponsor (Shameless plug: It is worth pointing out that this data comes from sponsors on which we conduct final due diligence, so there may be a quality bias skewing returns to the upside). However, it is also clear that the best performing deals for the second sponsor are those companies that generated the most outsized returns for the original selling sponsor. The correlation loses strength as you move away from these highest-returning deals, but there is certainly nothing from the data to suggest that an original sponsor's realized success can't be replicated.

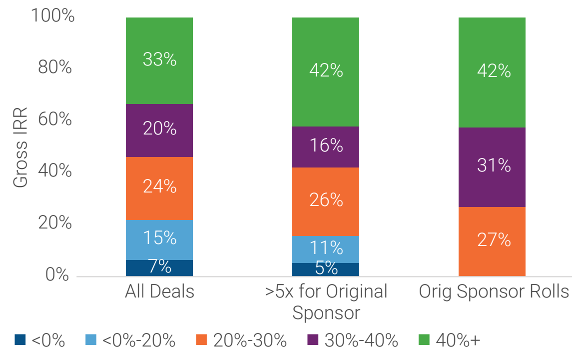
But perhaps even more relevant to validating the single-asset continuation vehicle thesis is an analysis of the returns generated on sponsor-to-sponsor deals where the original sponsor rolled a portion of their proceeds into the second deal. This analysis is summarized in the following two charts:

Acquiring Sponsor – Average MOIC at Exit



Source: Hamilton Lane Database (July 2021)

Distribution of Acquiring Sponsor IRR (by Deal Count)



Source: Hamilton Lane Database (July 2021)

Although the data is more limited (26 transactions), the average returns on these transactions exceeded those generated on sponsor-to-sponsor deals where the original sponsor fully exited the company. And these rolled deals generated this better performance with considerably less risk. Notably, all 26 deals generated gross IRRs in excess of 20% for the acquiring second sponsor, proving that the original sponsors knew it might not be the best time to pursue a full exit.

So in aggregate, the data certainly does more to support rather than refute the current buyer rationale of supporting historical winners in partnership and alignment with existing sponsors. As for whether an original sponsor can replicate past successes without the introduction of a new sponsor with a different skill set, that is a question for another day. (cynicism is exhausting and never-ending).