THE LEAD
https://theleadleft.com/all-about-secondaries-second-of-a-series/

All About Secondaries (Second of a Series)

THE LEAD | September 13, 2023

Over the past two decades, the private equity secondaries market has quietly expanded into one of the highest growth, yet still niche, areas of alternative investments. From 2002 to 2022, global secondary market volume scaled from $2 billion to over $100 billion in transaction value – a 50x growth rate. GP-led transactions now account for nearly half of the annual market volume.

"While large on an absolute basis," reports our head of secondaries, Nick Lawler, "the private equity secondary market is *de minimis* compared to the $10 trillion in outstanding alternative investment assets under management. At the same time, secondary market dry powder of $139 billion remains at the lowest relative levels seen over the past two decades. That level is less than 1.5x annual deal volume, versus historical averages of 2-2.5x."

The secondary market has not only scaled but widened. For most of the 2000 to 2010 decade, the market was mostly focused on purchases and sales of LP interests in private equity funds, often where investors needed liquidity. Since then, it has become both a technology and tool for GPs and LPs to manage portfolio and liquidity issues, including navigating concentrated exposures, extending the duration of top-performing assets, and wind-down tail-end positions.

Most notably has been the adoption and proliferation over the past decade of GP-led continuation vehicles (CVs). According to Mr. Lawler, a CV is a refinancing of the equity stack of one or more businesses in a private equity sponsor's portfolio, without a change of control. The concept largely was a product of the GFC, with some private equity funds emerging with fund performance challenges and misalignment of interests. Frustrated LPs wanted liquidity; GPs sat below their preferred return hurdles with a low likelihood of reaping any share of future profits.

Secondary market advisors and buyers saw the opportunity to "restructure" these funds, providing optional liquidity to underlying LPs (as well as a rollover option). Other outcomes included re-aligning LP and GP interests through a new economic deal, extending the duration of existing holds, and providing follow-on capital for accretive M&A and platform investments.

"In most cases," says Lawler, "these transactions comprised a majority, if not all, of the remaining assets in the target fund, with asset-level performance at the time of the transaction largely mixed – some high-performing and some challenged assets."

Restructurings, while effective, carried a somewhat negative connotation. Trades were viewed as a lifeline for otherwise zombie firms unable to raise new funds. Concurrently, the secondary market continued on its path of evolution and expansion, with the growth of leverage to acquire LP portfolios, adoption of preferred equity as an alternative to selling a portfolio, and other creative solutions such as fund-level tenders and portfolio strip sales.

However, strong performing GPs began to recognize the technology offered in a CV structure could be applied to a single portfolio company to both deliver optional liquidity to investors (refinancing of the equity stack), and maintain control of a franchise asset. That shift occurred quickly, and distinctly. As one managing partner of a top middle market PE firm put it, “In the past CVs were used because you couldn’t sell the business. Now we use them because we don’t want to sell the business.”