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All About Secondaries (Fourth of a Series)

THE LEAD | September 28, 2023

Last week in our special series on private equity secondaries, we discussed how GPs are leveraging newly developed liquidity in that market to manage funds and assist their LPs with their specialized investment needs. Given today's challenged capital markets it's also tougher to extract expected values from your best properties.

Sponsors are looking inwards and leaning into "know what you own," our head of secondaries, Nick Lawler, tells us. They can raise incremental capital, continue investing in and owning a "trophy" asset, while not breaching concentration limits in a traditional fund structure (usually set at 15-25% of a fund's total cost basis). Secondary trades enable the fund to not have an overly elongated hold.

A core element of CVs is optimal alignment of interests between the GP and their LPs. Active PE partners are required to roll 100% of their carried interest and GP commitment associated with the assets as their commitment going into the CV. The sponsor may be compelled to invest fresh equity from their personal balance sheets for any unfunded equity in the vehicle, or simply for even greater alignment. This can put more of the partners' personal capital at risk than in a traditional fund construct.

"It's important to note what continuation vehicles are not," said Lawler. "They are not value-maximizing liquidity events. That's why a rollover option is critical for existing investors." In third-party buyouts, control premiums are common, with valuations often above sponsor carrying values.

"However, that doesn't mean there isn't fair and reasonable price discovery. CV values are set by at least one of the following: a) a competitive investment bank process among secondary buyers, (b) a minority investment by another GP or large institutional investor, or (c) a full equity investment from the existing sponsor's new fund to the CV. Recent SEC guidance has also prescribed a fairness opinion be obtained in conjunction with a CV, further enhancing valuation transparency."

CVs have been referred to, unfairly in our view, as "co-investments with fees." No-fee co-investments are attractive LP opportunities, but a very different animal. New LBOs involve meaningful up-front due diligence by the sponsor. Whether risk of fraud, unexpected customer losses or C-suite changes, there's business stuff you don't know until you own it. With CVs, out-of-the-gates risks should be infrequent.

Good candidates for a CV include high-performing businesses owned for at least three years, operating in markets with significant tailwinds, and generated 3x-plus returns with more room to run. Loss rates for "knowns" should be lower than new deals. While the data is still relatively limited, the first generation of CV exits appear to be compelling. Our friends at Lazard recently published their analysis, reporting 67% single-asset continuation vehicle exits have returned at least 2x gross invested capital, and 44% greater than 2.5x.