Truffle hunting: looking for value in GP-led private equity secondaries

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Hayfin's Private Equity Solutions Team discusses why finding high-quality secondary investment opportunities in the middle market requires a specialist approach and lots of "digging" – much like hunting for truffles.

Market evolution

The secondary market has evolved significantly over the last 20 years but has always served a key function in the private equity industry – providing liquidity. As the private equity asset class grew, it increased the need for sophisticated institutional investors to more actively manage their portfolios, resulting in a booming secondary segment with deal volumes reaching $80bn+ in 2019[1], an impressive 21% CAGR over the previous decade. Traditionally, private equity secondaries were mainly associated with a Limited Partner ("LP") selling one or more fund commitments to another LP in order to adjust its long-term PE exposure or to liquidate positions that had been sitting in its portfolio for a long time (usually 10+ years). Although General Partners ("GPs") have always played an important role in these transactions, providing information about the underlying assets, approving transfers or even suggesting some potential buyers within their own active LP roster, they had never been an active participant in these transactions. But no more.

The combination of fierce competition for high-quality assets in the market and the inherent limitations of the traditional fund structure, where GPs need to liquidate a portfolio within a limited amount of time regardless of potential value creation opportunities, has resulted in a new breed of secondaries: GP-led transactions. The main premise remains the same as for LP-led secondaries, providing liquidity to existing investors, but this time allowing the same GP to retain more control and extend the ownership period. In such situations, the sponsor not only facilitates but actively drives the process. There are many flavours of GP-led secondaries, ranging from plain vanilla fund tenders where the sponsor would support new investors to replace existing ones in a managed process that retains the existing fund structure, to more complex transactions, known as single-asset secondaries, where one company within the portfolio is transferred out of an existing fund to a new vehicle managed by the same GP.

These relatively new structures started to gain momentum shortly after the beginning of the global financial crisis in 2008/2009, but it has taken the market over a decade to embrace GP-led secondary transactions and to move away from the stigma of linking secondaries to underperforming funds in need of restructuring. Today, there is a new, more fitting name, "continuation funds", and the GP-led transaction volume, which now accounts for 30%-40% of overall PE secondary volume[1], is dominated by blue-chip sponsors that are employing these structures to add another valuable tool to manage the balance between exit timing and value optimisation. In 2020 alone, the likes of PAI, TPG, Providence, Blackstone and others executed these continuation funds and, with the added dislocation of COVID-19, it seems that this part of the market is just getting started.

Win Win Win

From GPs' perspective, the commercial rationale is clear – allowing additional time for value creation, securing more follow-on capital for assets and potentially realigning the future value creation to the current investment team and management. Additionally, existing LPs can maintain exposure to attractive investments in their portfolio, while also having the option to sell and get liquidity if required. Everyone wins.

While these types of vehicles generally benefit all parties, the conflict of interest for the GP, who acts both as a buyer and a seller in the transaction, remains a focal point. There are many ways to manage this conflict, however. The key levers to achieve a successful transaction are clear commercial rationale, open and regular

[1] *Greenhill Global Secondary Market Review, Jan 2021*

communication with LPs and transparent price discovery and valuation processes. Some institutional LPs have questioned the validity of GP-led deals as an optimal route to exit due to the inherent conflict and the perceived lack of "market" pricing. The reality, however, is that many of these transactions are based on pricing that the GP has received in the market through a formal sale process or informal market testing. Furthermore, in most cases, existing investors are able to re-invest if they desire and, most importantly, secondary buyers, who are taking significant portions of concentred exposure, have re-tooled their investment teams and processes to effectively price and execute on complex transactions. For us, as an active participant in this market, there are four key characteristics that make the GP-led segment, particularly single-asset secondaries, at least as appealing as co-investing directly into businesses:

- **Trophy Assets:** single-asset (or concentrated) secondaries are often focused on businesses that have performed very strongly and have established a leading position in their market, often being the key consolidator in a region or sector. GPs are generally keen to retain those assets as they are difficult to find and originate in an increasingly competitive market, but also because they have developed deep knowledge of the business and the management team, significantly improving the odds of a successful investment;
- **Partner Fit:** as current owners, incumbent GPs have created strong links with management and industry participants and have a deep understanding of the business, materially decreasing the unknowns associated with a new acquisition;
- **Alignment:** in many transactions of this nature, or at least the ones we actively pursue, the GP is re-investing, at a minimum, the capital released from the realisation of the asset in the selling vehicle, including carried interest. This results in a GP commitment well above the market standard of 1%-2% of total commitments. Furthermore, alignment can be targeted, with negotiation of personal commitments from the individuals directly responsible for the investment for amounts that are material for their personal net worth. In addition, management rarely takes significant proceeds off the table and usually re-invests well ahead of the levels seen in primary M&A transactions;
- **Carve a Deal:** not every good business makes a good deal, so the flexibility to engage with GPs and create a transaction that works for all parties is key in the context of a GP-led secondary. Buyers have the ability to not only price the deal, but also implement structural enhancements (e.g. earn-outs, vendor loans, etc).

These are just some of the aspects that allow secondary buyers to differentiate their selection, origination and execution capabilities and invest through a strategy that can target specific niches of the market (i.e. regions, sectors, company sizing), rather than deliver exposure to a highly diversified pool of PE assets. We see secondary structures as a key tool for increased creativity in a maturing PE market. We have been involved in several GP-led transactions solving various vendor needs such as partial liquidity, growth/M&A financing and time extensions.

Small is beautiful

Over the past 18 months sponsors have marketed a number of marquee, multi-billion EV assets looking for longer hold periods and, in some cases, more firepower for M&A. Although this trend has pushed GP-led secondaries into the mainstream and captured media attention, we prefer the less-talked-about mid-cap segment of the market. Our core belief is that GP-led secondary transactions, especially concentrated ones, should be motivated by a strong commercial rationale for the GP to "keep" the asset and are most attractive in offensive situations where a proven platform is looking to continue an accretive buy-and-build strategy. That mantra fits the mid-market space naturally as many sponsors take on the journey of acquiring sub-€10-20m EBITDA platforms and grow these to regional or product champions with strong management and business infrastructure, just to sell them when the value creation opportunity is most tangible.

This is where the sweet spot lies – finding a business with proven management (willing to reinvest heavily), professionalised processes and reporting (allowing efficient diligence) and capabilities to systematically acquire and integrate add-ons (to extract the full synergy potential). In that type of situation, a secondary investor is in a position to provide stability and continuity for a growing business with the same GP and management team in the lead and invest in not just a great business, but one that can compound capital by re-investing cashflows at attractive rates. Apart from the deeper pool of assets and optimal timing we also see a relatively more attractive valuation and origination opportunity in the mid-market as pricing and intermediation remains less efficient compared to the large-cap segment.

Much like truffle hunting, finding high-quality investment opportunities in the middle market involves a lot of "digging" and a highly specialised and experienced team. Most of all, a successful GP-led strategy requires a partnership approach and willingness to create solutions for the GPs on the back of well-founded and long-term relationships.

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