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GP-Centered Secondaries:

Complementing Private Capital's Toolkit

Key Takeaways

1. In our second paper of our research series on the state of secondaries in the current investment cycle, we focus specifically on GP-centered transactions.

2. In contrast to LP-interest secondaries, GP-centered transactions are negotiated directly with a financial sponsor allowing buyers to purchase targeted exposure to specific assets in larger scale through a "one-to-many" approach.

3. Early forms of GP-centered transactions emerged nearly 20 years ago but gained significant traction only since the mid-2010s with the advent of continuation funds. Today, GP-centered transactions can account for approximately half of the turnover in the secondary market in any given year.

4. There is a variety of GP-centered solutions. The most common form are continuation funds, which enable managers to retain their well-performing assets and help maximize long-term value from these assets by optimizing the timing of exits; and allow existing investors seeking early liquidity to realize early gains on their investments.

5. In addition to equity-based solutions, GPs may use credit-oriented NAV-based instruments that may be considered as more efficient in certain situations. Fund financings may be preferred when funds seek to recapitalize portfolio companies, require capital for growth investments and opportunistic acquisitions, or wish to increase the liquidity position of their holdings without selling or diluting exposure in the underlying assets especially if buyers cannot agree on the GP's valuation.

6. Penetration of the private equity sponsor community is still relatively low, with only approximately 30% of GPs having pursued any form of GP-centered transaction to date. The fund financing space is even earlier in its development, with adoption following the path of continuation funds.

7. GP-centered secondaries represent a major innovation in a private capital market where fund structures have remained remarkably rigid. Providing efficient solutions to a potential mismatch between a fund's remaining life and the time it takes to maximize the value of an asset, GP-centered solutions broaden the toolbox of financial sponsors.

8. Continuation funds offer existing LPs the option to sell or to roll over their capital into the new vehicle. In the past, the vast majority have opted for the former, generating investment opportunities for new investors. Returns in GP-centered

9. secondaries seem to be uncorrelated with the percentage of rollovers across deals.

10. Investments in continuation funds involve a more targeted approach to asset allocation relative to LP-interest secondaries, requiring laser-focus on asset quality. As a result, GP-centered secondaries (especially single-asset transactions) have evolved to target trophy assets, often with embedded value and strong long-term realization options.

11. Continuation funds also typically limit unfunded commitments to follow-on capital, significantly reducing a buyer's "blind pool" risk relative to LP-interest secondaries.

12. GP-centered secondaries are inevitably subject to potential conflicts of interest. Aligning GPs' and LPs' interests in GP-centered transactions is best achieved by ensuring that sponsors have substantial "skin in the game." In such transactions, realized carry is usually fully rolled into the continuation vehicle with GPs often investing additional capital of their own in continuation funds to enhance alignment.

13. While GP-centered opportunities may have differentiated risk-return characteristics, given their complexity, investors must possess substantial underwriting resources and structuring capabilities, which are comparable to those needed by direct buyout investors.

14. Despite increased capital formation for GP-centered transactions, primarily through fundraising for integrated secondaries funds with GP-centered allocations, the market has remained significantly under-capitalized as available capital has hardly kept pace with investment opportunities. This imbalance helps explain why a significant number of potential deals in 2021 – 2022 have failed to close.

15. Meanwhile, an increased amount of capital has been raised by funds specializing in NAV lending, with fund financings accounting for the largest share of these investments to date.

16. We see little evidence that would suggest that current supply-demand dynamics will change in the foreseeable future.

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