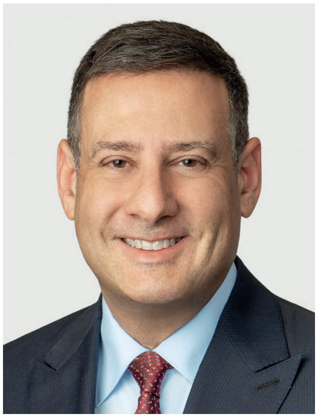
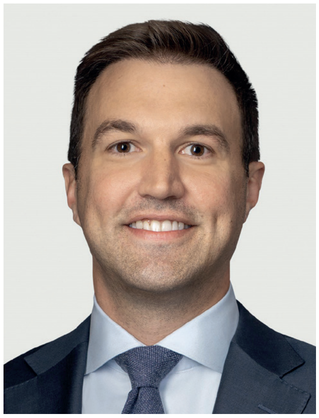
KEYNOTE INTERVIEW

Market maturity prompts secondaries shifts





As its popularity continues to grow, the secondaries market is seeing increased levels of innovation, competition and regulatory scrutiny, say Gibson Dunn's Shukie Grossman, Sean McFarlane and Kate Timmerman

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Q Given the recent slowdown in M&A activity, have you seen an uptick in GP-led deals?

Sean McFarlane: Private equity sponsors and investors are dealing with interest rates that look set to remain higher for longer. Together with heightened geopolitical risk and election risk, these conditions have caused uncertainty among buyers and sellers, which has resulted in limited M&A activity.

At the same time, there is record dry powder available, and assets are sitting in portfolios because sponsors don't want to sell them at unfavorable valuations. That has led to a maturing of the GP-led secondaries asset class, which offers an opportunity for LPs to realize some liquidity while GPs can continue to hold onto high performing assets for longer than the original fund term.

Q Which areas of the secondaries market are currently most active, and where do you expect to be busy through the rest of 2024?

Kate Timmerman: GP-leds continue to dominate the secondaries market as they have done for the past five or so years. While previously viewed negatively by LPs, they are now seen as a favorable way of giving additional life to assets that are already performing well for sponsors and investors.

We recently supported Leonard Green & Partners in closing a $2 billion-plus continuation fund to continue backing four portfolio companies, in partnership with AlpInvest Partners. This transaction is consistent with the demand we see for large-scale diversified portfolio transactions, and we expect that to continue through the rest of 2024 and beyond.

On the LP side, the current environment is causing a lot of reassessment of portfolios, particularly in real estate, and that is driving further traction in the secondaries market. Where previously there was a discount to NAV on these transactions, there is now more competition and innovation and we are seeing deferred purchase prices, seller financing and other creative solutions becoming more common.

Q How has the increase in GP-led secondaries transactions impacted fundraising?

Shukie Grossman: Capital raising has been quite challenging over the past 18 months. This is the case, in part, because it has been more difficult for sponsors to exit investments and so investors looking to see a track record with realizations from prior funds have been reluctant to allocate new capital. We see GP-leds as a means by which successful GPs can provide those realizations to LPs and grease the wheels of fundraising.

Further, because GP-leds have become so interesting, many sponsors that have traditionally focused on raising buyout funds are now raising separate funds dedicated to investing in these vehicles. That is testament to the popularity of GP-leds, and as we see more dedicated capital raised, we can look forward to deployment driving more activity in this area.

Q How do negotiations on single-asset GP-led deals differ from those on diversified portfolio transactions?

SM: There needs to be a compelling rationale on the part of the GP entering into a single-asset deal as to why it is pursuing this strategy. Everyone has become comfortable with diversified portfolio sales, where funds reaching end of life put a variety of assets into a continuation vehicle, which matches LPs' appetite for diversification. But single-asset deals are more difficult and the strategy of the GP is scrutinized more closely.

That being said, there has been a substantial increase in single-asset continuation vehicles, which have started to resemble traditional private equity M&A transactions. They have a more standard due diligence process not typically seen in the secondaries space, as people want to do a full underwriting exercise to understand the asset and why it is being sold.

Also, rep and warranty insurance (RWI) has come a long way in this space. Where historically RWI only covered standard fundamental representations and maybe a few knowledge-qualified reps for portfolio companies, today's buyers' market has driven demand for better protections. Insurance has provided a solution to streamline processes.

Q What do the SEC's private fund rules mean for the secondaries market?

SG: The Securities and Exchange Commission has adopted a new set of private funds rules covering a broad array of topics, one of which is adviser-led secondaries, or GP-led recapitalizations, as we call them.

The major innovation under the new rule is that, when implemented, sponsors will be required to provide investors with a fairness or valuation opinion from an independent third party in advance of the consummation of most GP-leds, along with a summary of any material business relationships the sponsor has had with the opinion provider in the previous two years.

In many instances, that is consistent with market practice because these deals typically require approval of the LP advisory committee of the selling fund along with some third-party countenance of pricing.

But, in some cases, it could have a chilling effect on transactions because it has not always been market practice on smaller deals, particularly where there is a competitive process providing the necessary price discovery. There is some feeling in the industry that it might have been best for the SEC to leave this to the discretion of GPs and their investors who would bear the cost of obtaining a fairness or valuation opinion.

As a point of note, the rules are currently subject to a lawsuit where Gibson Dunn is representing key industry groups. If successful, it is possible the rule will not actually take effect as a requirement and price validation will remain a point for commercial discussion. The other relevant regulatory change is the new requirement that a sponsor of a GP-led transaction must report it to the SEC in a non-public filing within 60 days of the end of the quarter in which it closed.

Again, this is nothing particularly dramatic, but it is an additional administrative burden that may be of no consequence for large sponsors but for others will generate greater expense.

Q What are your predictions for the future of secondaries?

KT: We expect the GP-led market to become busier after a volatile few years, with more players entering the market and doing more sophisticated deals, both in terms of deal constructs and the documentation required.

Longer term, secondaries are becoming a bigger part of our practice, and we expect people to lean on innovations such as artificial intelligence to enhance processes. We also anticipate the use of blockchain and the digitalization of assets as both sponsors and investors become more comfortable with those technologies. ■

Shukie Grossman is a partner and co-chair of the Investment Funds Group at Gibson Dunn, Sean McFarlane is a partner and Kate Timmerman is an associate attorney at the firm