Fund Finance

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The secondaries market: The rise of GP-led and preferred equity solutions

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In past editions of this book, we have looked at how the secondaries market has evolved and how the use of debt products by fund managers has played an important part in that growth and development. We first wrote this chapter three years ago and since that time, the secondaries market has experienced rapid growth and further evolution, showing itself to be leading with innovative solutions to private markets managers' liquidity and funding requirements.

Debt providers in the secondaries space have had to adapt and in the past 12 months, we have seen more creative structures and solutions in this market than ever before. In this edition, we take a closer look at the two biggest trends in the secondaries market, and how debt finance has played, and will continue to play, a crucial role in their evolution.

Introduction

Across all subsets of the secondaries market, it is clear that volume and size are increasing rapidly. Volume is expected to reach $90bn this year and, subject to the impact of a major market correction, it is likely that the magic $100bn figure the secondaries market has been waiting for will be hit in the next two years.

The secondaries space is awash with opportunities and the main challenge we are hearing in the market is the lack of human capital to keep up with the variety of options and deals. It's clear that debt finance is a key part of secondary GPs' strategies; some GPs which don't use leverage acknowledge they are losing deals to secondary players that do.

Like the secondaries market itself, the debt finance market supporting it is getting more creative: advancing against increasingly concentrated portfolios, LTVs are rising in some cases, and pricing is generally coming down for the "vanilla" diversified LP interest deals, which is driving financiers to look to be more innovative. So much so, that secondary houses now are hiring both bankers and lawyers with credit experience to enable them to bring this expertise in house. Although it remains a relatively small subset of the private markets, secondaries really do seem to involve some of the most creative and innovative solutions to GP/LP liquidity requirements.

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By far the two most exciting developments since we first wrote this chapter have been the emergence of GP-led transactions, and the success of the preferred equity strategy. This article focuses on how these facets of the secondaries market (and beyond, in the case of preferred equity) have evolved, and how debt and alternative providers have responded over the past few years by creating bespoke and innovative liquidity solutions for these situations/products.

Preferred equity – the best of both worlds?

What is preferred equity?

Preferred equity is a tool employed by dedicated funds and traditional secondary investors to provide liquidity and funding solutions to managers with portfolios of assets, looking for a solution which allows them to retain the majority of the upside and avoid giving up control of the portfolio in a down-side scenario, either where the manager is looking to accelerate liquidity or invest more capital. Whilst preferred equity has some down-side protection, it provides significantly more flexibility to managers than traditional debt which typically comes at a lower LTV, with a repayment profile, a set maturity date, collateral over all or part of the portfolio, and covenants.

Preferred equity lacks these features, making it more akin to equity, but ranks senior to the equity in terms of cash-flow until the preferred return is achieved. After this, all of the upside accrues to the equity holders. Preferred equity bridges the gap between traditional debt and equity, and it is easy to see why vehicles dedicated to this strategy have been so successful in the last 15 years or so.

Before the emergence of preferred equity in around 2006, managers with liquidity or capital requirements had the choice of either selling assets, thereby removing any potential upside, or adding leverage to their portfolios; the closest investors came to a preferred equity product was via single asset or holdco financings.

Dedicated vehicles have now taken this model and transformed the way it is used in private equity. Investors can gain exposure to private equity through this hybrid tool, which carries the upside potential of private equity returns over a shorter investment period, with volatility reduced as a result of the downside protections… Sound like the beginnings of the secondaries market? This is still a relatively small segment of the secondaries market (albeit it is acknowledged that not all 'pref deals' are necessarily counted in the global secondary figures and if they were, the number would be significantly higher), but one which is growing rapidly, accounting for an estimated 5% of global secondary deal activity last year. The number of secondary funds exploring it as an alternative investment is increasing day by day.

Where and when is preferred equity relevant?

Although the secondaries market has evolved as an efficient and effective trading ground for the sale of private equity portfolios, a traditional sale isn't necessarily the right solution for all managers. Where a manager still sees value and upside in the underlying portfolio, it may be that holding onto those assets, to allow them to mature and generate further returns rather than embarking on a traditional sale, is in the best interests of the investors. To that extent, preferred equity is a powerful source of capital to release liquidity in the portfolio or provide additional investment capacity without leveraging the portfolio directly. We are also seeing an increasing number of acquisitions supported by a preferred equity solution.

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How is debt finance used to support these transactions?

On the whole, private markets managers are very familiar with how to use subscription lines and who to approach as a provider. Finding a debt provider to lend on a non-recourse basis purely against a fund portfolio, particularly in the primary private equity space, is much more difficult and requires a financial institution to have end-to-end capabilities to diligence and analyse the credit of the underlying portfolio of investments, the underlying leverage and the impact on the potential financing.

Finding a debt provider who is able to lever a preferred equity interest is almost impossible. We were privileged to work on a ground-breaking transaction in 2019 with Investec, Palamon Capital Partners and Pomona Capital: a back-levered preferred equity financing which allowed for the creation of significant liquidity for investors, whilst avoiding creating additional leverage in the portfolio. The use of leverage as part of the structure was a key component in significantly driving down the blended cost of the preferred equity instrument, thus making the returns attractive from both Palamon and Pomona's perspective.

GP-leds

What is a GP-led?

With echoes of the secondaries market itself, 'GP-leds' have emerged, from being a last resort for struggling GPs to deal with troublesome assets, to a standalone subset of the secondaries market providing genuine optionality and liquidity to GPs and LPs looking to unlock liquidity in mature assets. It is clear this product is now being used across all types of situations, and few GPs don't now look at it as some form of a solution to their liquidity requirements. The jury is still out on how these deals will perform, but they accounted for over 40% of the market in the first half of 2019, so the growth trajectory is phenomenal – fifteen-fold in the last five years – and fund financiers are following suit to provide debt finance for these types of transactions.

However, the market expects mixed outcomes to these transactions. Key concerns centre around ensuring transparency, managing conflicts properly, giving LPs enough time to consider deals, and a feeling that LPs are becoming overwhelmed with requests to consider these transactions, with small teams not equipped to make the sorts of assessments necessary for a GP-led. LPs are leaning heavily on advisors to educate and guide them through the process.

Types of GP-led transactions

The main attraction of GP-led secondary transactions is that investors are offered an exit option whilst the value of mature investments is maximised. The four most popular types of GP-led transactions are: fund restructurings (also referred to as fund recapitalisations); direct secondaries; stapled secondaries; and tender offers. The common theme amongst all of them is that a secondary buyer purchases the existing investments and a new vehicle is established to hold those assets. The participation of the existing manager in the ongoing management of the assets, and the participation of the existing limited partners, are the key differences between the various types of transactions.

The primary characteristic of fund restructurings is that all existing investors are offered an opportunity to either sell their existing position in the fund, or an option to roll their positions into the new-formed vehicle. The GP typically remains in place to manage the underlying assets, with the added benefit of a longer investment period and added capital to assist them in maximising value. This option provides incentives to both the limited partners and the GP, while allowing them to pursue their independent investment strategies.

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This can give rise to potential conflict-of-interest issues for the GP who is on both sides of the table, and continues to owe a fiduciary duty to the existing limited partners.

Direct secondaries involve the sale of all of the assets in a portfolio to a buyer along with the responsibility to manage the portfolio, thereby excluding the GP from future management of those assets. This is of interest to GPs who are looking to focus their attention on other matters or investments. Stapled secondaries are a hybrid of a fund restructuring and offer investors the opportunity to participate in the GP's new fund, thereby combining a secondaries and primary offering (which potentially creates even more of a conflict).

Tender offers are the least complex of the GP-led secondary transaction types. These involve a buyer (who could be an existing investor or an affiliate of the GP) tendering for all or a portion of the existing limited partner interests.

Pros and cons

The principle behind GP-leds, and the reason for their phenomenal growth over the past few years, centres upon:

- the creation of liquidity for limited partners and the choice of continuing (or not) with their exposure, allowing limited partners to actively manage their portfolio; and
- providing additional time and sometimes capital (depending on the structure of the deal) for the relevant assets to mature and grow which, in turn, can lead to better returns on those assets, resulting in potential additional value for either the existing GP or a new manager, depending on the type of GP-led transaction.

However, new developments in the private markets usually come with challenges, and GP-leds are no exception. The rapid growth and prevalence of these transactions has resulted in LPs, the regulators and ILPA paying a lot of attention to how they are done, and various concerns have been raised around how these transactions play out, including:

- unsettled limited partners receiving multiple requests at any one time, who feel they do not have sufficient time and/or resources to properly evaluate the transaction; and
- in respect of the GP, a material conflict-of-interest risk. As there is no standardised approach to these types of transactions, ILPA has recently publicised recommendations with a view to increasing transparency, efficiency and fairness around these processes and their structures.

How is debt finance used to support these transactions?

As with the preferred equity financing model described above, financing a GP-led solution requires a debt provider to be more creative in providing a meaningful solution, which invariably involves accepting a much more concentrated risk position than fund finance lenders have historically taken. These lenders often look at a much smaller group of investors – perhaps even one – and will need to perform more diligence and potentially create more robust recourse against that investor. Given the invariably concentrated LP position, lenders will also look to the underlying assets for their credit risk, and these underlying positions are also likely to be concentrated.

The obvious use of financing is, of course, to bridge short-term exits within the portfolio. The use of financing at SPV level is often an attractive option in GP-led processes, especially if: (i) not all the investors in the continuation vehicle have the same access to subscription lines and the GP wants to ensure equal economics for all investors; (ii) the use of equity would be dilutive from a multiple perspective given the portfolio construct (the portfolio may include debt instruments); and/or (iii) the secondary fund is unable to participate in a transaction owing to size and concentration limits.

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In the recent Investec Secondary Survey (November 2019), more than half of the participants who responded, who participated in GP-led transactions, indicated that they saw debt finance in these transactions in some way shape or form. Approximately a third of them used ring-fenced finance at SPV level; a third used a hybrid solution; and a third used a traditional subscription line. Using a combination of all of these solutions is becoming more common. Whilst a specific funding solution is not necessarily applicable to every transaction, finding one that is scalable and can easily be implemented remains a key consideration for secondary firms, and often a decisive factor in determining who to partner with.

Summary

As the secondary market is continuing to evolve and innovate, so too are the financing solutions following it. Using the tools available in the secondary market, secondary funds and primary funds are increasingly relying on finance providers to partner with them to provide fire-power in competitive acquisition processes, and to unlock liquidity and value in their assets. The menu of solutions has increased significantly and we suspect this time next year, we will be discussing even more innovative and bespoke structures and processes.

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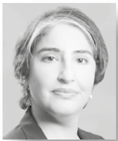
Samantha advises both financial institutions and private markets managers on the full range of fund finance products across all asset classes. She has advised on some of the largest subscription and leverage deals in the market, including a €7bn secondary financing for a leading primary PE manager, a €105m back-levered preferred equity financing, a €150m GP financing to a leading primary PA manager, as well as numerous secondary and GP-led financings. In the last 12 months she has advised on over 55 new fund financings, exceeding $23bn in value. Sam has been advising financial institutions and private markets managers for over 17 years, and her practice covers the full range of fund lending products, delivered via a number of different structures including framework and umbrella facilities.



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Amrita is a senior attorney in the Finance Group in Cadwalader's London office. Amrita has worked in the funds finance space for several years and has represented banks and private markets managers in many of the largest fund finance transactions in Europe. She has experience in not only subscription financings but also GP/co-investment financings, asset backed financings, hybrid and secondary acquisition financings.
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As part of the Investec Fund Finance team and Head of Secondaries, Ian structures a range of flexible funding solutions to funds and fund managers across private equity, infrastructure and other fund strategies throughout the entire fund lifecycle and across the entire risk spectrum (subscription facilities to NAV backed facilities). Over the last 12 months he has arranged a number of GP-led financing packages (portfolios from $50m to $1bn) for leading secondary managers, hybrid solutions, GP co-invest finance packages and bespoke portfolio liquidity solutions. Ian started his career as a corporate lawyer but has spent the last nine years with Investec, in roles within investment banking, leverage finance and the last five years in the fund finance team.

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