KEYNOTE INTERVIEW

# The return of the LP-led secondary

*Concentrated GP-led secondaries dominated in 2020, but buyers are seeking diversification once again, says Gerald Cooper, head of Campbell Lutyens' North America secondaries advisory*

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**Q How would you describe the volume and nature of secondaries dealflow over the past year and today?**
The secondaries market was very quiet in the first half of last year as a result of the pandemic. Then, in about June or July, public markets rebounded and that led to some interesting dealflow emerging. Buyers were very much focused on opportunities where they could get a handle on the resilience of the underlying assets, for downside protection, and where there was opportunity for significant upside.

That meant a heavy preponderance of GP-led transactions in the healthcare and technology sectors. It also meant increased appetite for concentrated portfolios, rather than diversification, for the simple reason that it is easier to assess risk when you are dealing with fewer assets.

LP transactions, on the other hand, remained scarce throughout 2020. I think that is mainly because the spread on LP books was fairly wide and the majority of LP secondaries market dealflow is about portfolio management rather than the need for liquidity. There is an element of forced selling at the smaller end, but elsewhere, sellers tend to be opportunistic.

As we head into 2021, however, there is a great deal of pent-up demand for LP portfolios, from buyers who invested more heavily in concentrated GP-led deals than they have historically and are now looking for a greater level of diversification. Equally, sellers that postponed sales in 2020 have seen prices rebound. It is once again possible for LPs to proactively manage their portfolios without taking a major hit on the discount.

**Q As you say, GP-led deals have really accelerated. What makes an attractive GP-led transaction?**
There needs to be sufficient upside

remaining in the assets being sold. There also needs to be strong alignment. Indeed, the sheer volume of GP-led transactions that have come to market has put renewed emphasis on this point, and buyers are really zeroing in on the level of capital the GP is rolling over and how much new capital is going in if carry has been crystalized. If the alignment isn't right, they won't even pick up a pen.

We are also seeing less appetite for turnaround stories and greater demand for companies that have demonstrated consistently strong performance. Secondaries investors are wary of companies that are highly levered. Businesses with strong secular tailwinds and large defensible market share will also attract significant interest. Finally, there needs to be a clear and well-defined exit path. If the exits are too far out it will impact IRR and if they are too near-term, they may not generate a sufficient money multiple. Generally speaking, the ideal exit window is between three to five years.

**Q Why do you think these GP-led deals are good for investors in secondaries funds, and why are they good for the market?**

GP-led transactions have proven to be an effective way for secondary buyers to create alpha in their funds as returns in traditional LP transactions have compressed significantly. There is also greater opportunity to differentiate based on relationship with the GP, familiarity with the assets or expertise in the industry. Most secondary buyers will not get involved in a GP-led transaction unless they feel like they have some sort of angle. This gives them comfort around their competitive edge and theoretically should improve their success rate. The higher returns and potentially better hit-ratio can be a seductive combination if married with proper portfolio construction that mitigates risk.

GP-led transactions are becoming an important tool for the market as LPs engage in more active portfolio management. It is interesting to look at the relative pricing of GP-led and LP-led secondaries in 2020. Most transactions on the GP-led side, priced at a 5 percent discount or better, while only a very small percentage of LP-led secondaries deals priced at anything better than a 10 percent discount.

That contrast was amplified in the year of a pandemic, but actually the trend is quite consistent, because whenever you have GPs playing an active role in a process, the outcomes are going to be better in terms of purchase price. More transparency and a greater opportunity for due diligence will ultimately be reflected in a lower risk premium compared with an LP-led transaction where access to information is limited. This dynamic ultimately makes the market more efficient and represents an alternative path to liquidity.

**Q How would you describe LP appetite for secondaries funds?**

Demand is extremely robust. More than $50 billion of capital was raised by secondaries funds last year – the second-best year for fundraising ever. I think that appetite was driven by relatively strong, consistent returns. It's likely that people also expected a broad dislocation in private markets, which hasn't really panned out, but which likely drove money into the asset class.

Investors are also generally looking to increase their allocations to alternatives and the secondaries market is an effective way of doing so, because you can put money to work quickly and because of the inherent J-curve mitigation. Finally, the high-profile GPs that embarked on GP-led sales over the past year have also drawn attention to the secondaries industry.

*"There is a great deal of pent-up demand for LP portfolios"*

**Q But do the characteristics that have drawn LPs – J-curve mitigation, diversification – hold true with such a high level of concentrated GP-led activity?**

That is an interesting point. I think we will end up seeing more specialization in the secondaries space. All secondaries buyers have a nuanced approach to deploying capital, but for the vast majority, some level of diversification is key. They think incredibly carefully about portfolio construction, which is why we are seeing such strong demand for LP portfolios in 2021, in order to offset concentrated GP-led exposure from 2020.

Those GP-led deals may produce increased levels of alpha, but they also carry greater risk, and the cashflow profiles are different. At the end of the day, of course, what is most important is that a secondaries firm delivers on what its LPs signed up for.

**Q How do you see the market evolving, outside of mainstream private equity?**

We have already seen significant growth in infrastructure and we think this trend will continue. Infrastructure funds have raised a lot of capital and we are beginning to see some rationalization of that exposure amongst the LP community. LPs are taking a more sophisticated approach to portfolio management and are willing to monetize their non-core allocations. Commitments to infrastructure funds can be substantial since these are capital intensive investments; we are seeing a real need for scalable creative solutions. Infrastructure secondaries volume was about $3.5 billion in 2020, but we think volumes could hit $12 billion in 2021.

The private credit market has been slower to embrace secondaries than we might have anticipated given how much primary capital has gone into that space, but I do think it is inevitable that we will start to see more secondaries programs focused on this investment strategy. We are already witnessing a material uptick in demand for private credit in some of the transactions that we are executing in 2021 versus years past. ■