KEYNOTE INTERVIEW

Portfolio construction in the age of GP-led deals

There is an art to managing the contrasting cashflow profiles of traditional LP and GP-led secondaries, says Charles Smith, chief investment officer and managing partner at secondaries firm Glendower Capital

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Q What role are investors looking for secondaries to play in their portfolios?

Investors look to secondary funds to provide a number of key benefits, including: rapid deployment of capital; rapid return of capital; high IRRs; and J-curve mitigation to their portfolios. This is particularly the case for investors that are looking to build up their portfolio at an earlier stage – as secondaries funds enable them to get money into the ground quickly, and for their programme to show positive early results, both in terms of cashflows and reported performance. Additionally, investors look to secondaries to provide higher levels of diversification than the primary private equity market can offer.

Q How do the return profiles of GP-led secondaries differ to traditional LP secondaries and what challenges can that present?

Traditional LP secondaries drive exactly the type of return profile that I have just described. From a cashflow perspective, buying mature fund interests deploys capital quickly, and as the assets mature, capital is returned quickly as well. You also get attractive reported returns, as the unwinding of the discount drives strong early performance, both in terms of IRR and multiple of invested capital. However, traditional fund secondaries tend to be somewhat constrained in terms of the overall multiple they can generate.

GP-led secondaries typically exhibit higher multiples of invested capital, longer durations and lower IRRs. They also do not provide the early distributions most investors associated with LP secondaries and cashflows are less predictable. The underlying portfolios of these transactions tend to be more concentrated, which means more volatility in returns. In addition, transactions are less likely to be done at a material discount, so you forgo that early pop in returns and J-curve mitigation. Indeed, the profile of some GP-led deals can look a lot more like a traditional primary buyout investment than a secondaries transaction.

Q How can secondaries managers incorporating both strategies within a single fund manage those contrasting characteristics?

As a secondaries manager, we believe you need to balance the portfolio construction of a secondary fund, to try to achieve the benefits of both types of deal – the attractive early returns of the LP secondary coupled with the higher eventual multiple of GP-led deals.

The first way to do this is to identify GP-led deals with some of the characteristics that are associated with fund secondaries. This includes focusing on transactions with a shorter duration, moderate diversification, the prospect of early write-ups in value and the potential for the early return of capital – potentially through a partial sale or dividend recap. There has been a trend towards single asset and more concentrated GP-led deals recently in the market, which has been exacerbated by the covid-19 crisis as managers attempt to focus on assets that are to some extent covid-resilient. However, greater concentration contributes to longer durations and increased volatility of returns, so you need to bear that in mind as you build up a portfolio because there will inevitably be an impact on the cashflow profile ultimately generated for your investors.

The second way is to manage the mix and timing of the execution of fund secondaries and GP-leds as you build a fund's portfolio over the investment period. At Glendower, we have found an approximate 50-50 mix of the two deal types enables us to deliver the desired performance characteristics to our investors. Additionally, it is often helpful to make sure you do some fund secondaries early in the life of a fund, to generate early returns, before building the long-term performance of the fund through GP-leds.

Q What are the advantages of bringing GP-leds into a traditional secondaries fund?

First, as I mentioned, GP-led deals can help drive higher long-term performance multiples by increasing the duration. Furthermore, some degree of greater concentration is not always a bad thing. For example, you can put capital behind single assets in high conviction situations. In these transactions, you can also do far deeper due diligence on those assets and the managers behind them. You can make bespoke arrangements between yourselves as the investor and the underlying managers of the assets, in a way that is not possible in the traditional secondaries market. There are certainly benefits from a portfolio construction perspective and its impact on long-term performance.

"GP-led deals can help drive higher long-term performance multiples by increasing the duration"

In addition, because secondaries funds have a core target of achieving diversification, they tend to have relatively low concentration limits. As a result, GP-led secondaries will often give you the opportunity to offer co-investment to your LPs, which can enhance a close working relationship with your most important investors and offer those investors an important benefit.

Q What is your outlook on the future of the GP-led secondaries market?

The GP-led market is here to stay. It has evolved into a well-established part of a GP's toolkit for managing the liquidity profile of their funds. It offers managers the ability to generate win-win-win situations. They can offer liquidity to existing LPs but still continue to manage the assets they most believe in and offer attractive returns to the secondaries investors coming in as well. These deals have become attractive options for all parties concerned. Indeed, I would say that GP-led secondaries are now considered a viable alternative to trade sales, IPOs or sales to another private equity shop. They have become a fourth exit route, sitting right alongside the others.

I do not expect any of that to change any time soon. We will continue to see the development of GP-led deals, both for single assets – what you might call the early realisation of the stars in a fund – but also the continuation fund deals that provide a second lease of life for the tail-ends of portfolios. Both types of transaction are entirely valid and will continue to be attractive for GPs, for whom they offer the combination of being able to continue to own an asset they know and love, while also being able to generate liquidity at reasonable valuations for their LPs.

I do not see the GP-led market diminishing. On the contrary, it is on a continued upward trajectory. If you look at last year's numbers, the general consensus is that the overall secondaries market hit $60 billion-$70 billion and that GP-led deals represented around half of that – and that is despite, and not because of, a global pandemic. That is approximately $30 billion of GP-led secondaries, against around $4 trillion of assets in the ground in private equity funds. That is still less than 1 percent of the addressable market and so I am convinced that GP-led secondaries are only poised to grow looking ahead. ■