Perspectives in Partnership is Abbott's series that provides our audience insights into the information and knowledge we have accumulated during our four decades of investing in the private equity and venture capital markets and our unique position as both a general partner (GP) and limited partner (LP).

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SECONDARY SIGHTINGS: PART II

In the second installment of our multi-part series on private equity secondaries, we examine the inner workings of the private equity secondary market to better understand the behavior of LPs and GPs and the options available in the never-ending search for liquidity.

If you missed Part I, you can access it here: Secondary Sightings: Part I.

How do LPs view the secondary market?

Overall, a robust private equity secondary market permits LPs the ability to take an opportunistic approach to managing their own liquidity, with sales of limited partner interests often undertaken to sell off non-core relationships or tail-end funds. At the same time, GP-led transactions provide an additional liquidity stream for LPs via single- or multi-asset transactions.

From our perspective, in 2023, price discovery and exploratory conversations dominated the LP-led market. LPs seeking bids wanted to understand the prices they could achieve in the secondary market but often were unwilling and not ready to sell at the prices offered, even, at times, in the later stages of a transaction after initial pricing had been agreed upon. LPs were interested in selling, just "not at any price."

While LPs may have *desired* liquidity, most were not in *dire need* of liquidity, which is an important distinction. Rewind to the Global Financial Crisis, and LPs faced liquidity

constraints in their public portfolios and overallocation in their private portfolios due to the prolonged denominator effect. Today, an increasing number of options are available to generate liquidity from private market portfolios.

In a year that otherwise saw record-low traditional exit activity, GP-led transactions provided an additional liquidity stream for LPs, as GP-led transaction volume in 2023 remained flat year-over-year at roughly $52 billion.

It's worth noting that GP-led transactions have accounted for a slightly shrinking percentage of overall secondary market volume since it peaked at 58% in 2020. GP-led deals accounted for 46% of total transaction volume in 2023[1], signaling that the market is now relatively balanced in volume across the two transaction types.

With exit activity across buyouts and venture capital hitting 10-year lows, how did GPs and LPs react?

The *TLDR ("too long didn't read")* answer to the question is '*creatively.*'

With global buyout-backed exit value in 2023 falling by 66% compared to 2021's peak level[2], many GPs are searching for new ways to send money back to investors. Per Bain & Company, global dealmaking and exit volumes "derailed" in 2023 and left the capital flywheel "sputtering."

GPs are looking for solutions to generate liquidity for their LPs via GP-led transactions (single asset, multi-asset, or strip sales across multiple funds), LP-tender offers, NAV loans, and other creative ways designed to boost DPI numbers, often ahead of upcoming fundraises. LPs are embracing the secondary market as a liquidity and portfolio management tool. However, there appear to be fewer "fire sales," as pricing typically has to meet an acceptable level for a transaction to materialize.

GPs and LPs looking to get the flywheel unstuck appear to have turned to the secondary market for at least some liquidity until exit activity recovers more broadly.

How has the GP-led market changed the relationship between LPs, GPs, and secondary buyers?

GP-led transactions have provided GPs with an alternative exit route in addition to sales to strategics, IPOs, and sponsor-to-sponsor exits (aka secondary buyouts). It's possible that the growth in GP-led transactions may permanently eat into sponsor-to-sponsor transaction volume; why sell a strong portfolio company to a competitor when there is a way to hold onto the asset for longer and recap the business with equity provided by the secondary market?

From 2015–2020, secondary buyouts accounted for 30–35% of total private equity exit activity in any given year. In 2022 and 2023, sponsor-to-sponsor transactions declined to around 24% and 25%, respectively (see Figure 1).

[1] Jefferies Global Secondary Market Review, January 2024
[2] Bain & Company Global Private Equity Report 2024

While data is limited to the recent past, it seems that a trend is emerging – more GP-led transactions ultimately could mean fewer traditional exits (via IPOs, buyouts, and sponsor-to-sponsor transactions). The full extent of the liquidity provided to LPs via GP-led transactions is likely not yet included in standard industry exit tallies. However, that could change as the market continues to grow and evolve.

What's been viewed as a favorable development for LPs and GPs alike is that the proliferation of GP-led solutions has helped generate liquidity that allows LPs to re-deploy capital into new funds and strategies.

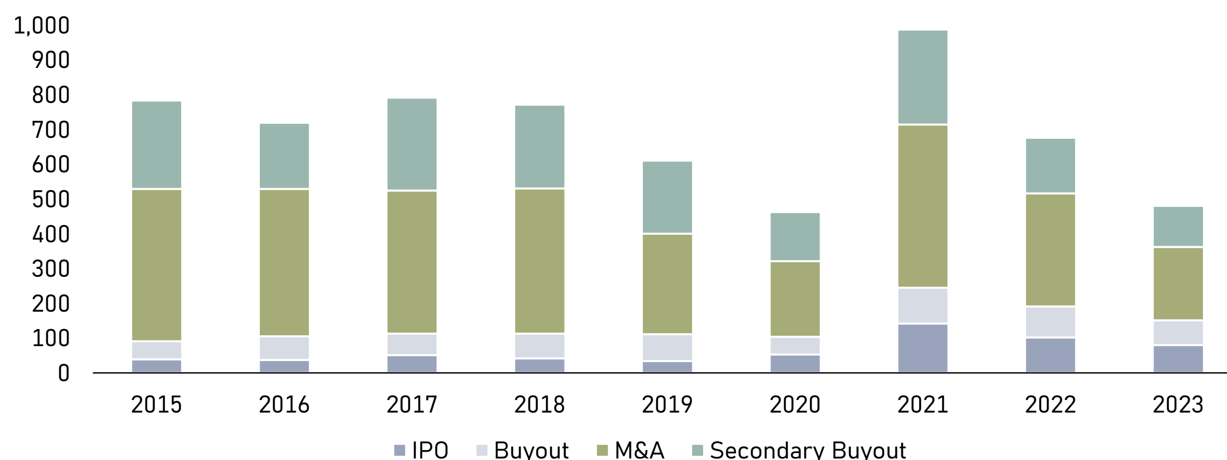
GP-led solutions have allowed GPs to offer limited partners liquidity while (a) retaining upside potential in a specific company and, maybe even more importantly, (b) not having to sell prized assets to a competitor sponsor.

While the liquidity opportunity has primarily been viewed positively, LPs continue to view GP-led deals with a healthy dose of skepticism.

That skepticism arises mainly from a potential misalignment of interest between the "sellers" in a GP-led transaction (the fund LPs) and the buyers (the GP and secondary investors) who are structuring the transaction and may have an information advantage.

If we look back at the origination of GP-led deal structures, they mainly involved the sale of assets in older funds that a GP had owned for years but needed more time and capital to fulfill the next chapter of growth. Generally viewed as a solution to wind down an older fund, a GP would transfer an asset to a special purpose continuation vehicle (CV) and provide LPs the option to roll or accept liquidity. Recently, GP-led transactions have included deals structured to provide an exit for assets owned by the GP for only 1-2 years, out of funds with sufficient time (and, in some cases, money) left to remain invested in the asset. When assets are carved out of a fund in a GP-led transaction instead of a sale through a traditional exit, a natural tension can arise between the fund LPs and the GP.

Figure 1: Exit Count by Type
2015–2023



Data Source: Pitchbook Data

Transactions are often pre-negotiated between GPs and secondary buyers well before most LPs (outside of LPAC members) are even made aware a process is being contemplated or undertaken. After all, a GP wants certainty that there is a buyer on the other side of the table to step in the shoes of selling LPs.

As such, a GP-led process presents a conflict of interest for the GP. The GP has the fiduciary duty to maximize the sale price of an asset for existing LPs, but at the same time, stands to benefit from an attractive secondary entry price, given the potential to earn carried interest on future value creation in the CV. Competitive processes, fairness opinions, and alignment via carry roll and incremental commitments may help mitigate the inherent conflicts of interest during the transaction.

If a GP were to systematically transfer the most attractive assets out of its primary fund structure too early, which could have a detrimental effect on its primary fund performance, LPs would likely notice and lose trust in backing the GP in the next fundraise.

On the other hand, a GP that launches several CVs that subsequently underperform will have difficulty accessing the secondary market in the future and will also lose trust with LPs that re-invested in a transaction.

In the long run, however, it remains to be seen who will benefit most from GP-led solutions. In a few years, LPs will be armed with the data to review their decisions and decide whether they were appropriately compensated for the additional hold period or if early liquidity would have been preferred.

> *"Ultimately, re-investing LPs rely on the GP to make the right decisions and drive value in the future. In this context, alignment between LPs and the GP is important in every GP-led transaction. As with everything else in the private equity industry, picking a partner you can trust matters most."*

What are LPs' common frustrations about GP-led transactions, and what options do they have?

Fundamentally, GP-led transactions place additional burdens on LPs who are presented with sell versus re-invest options. Specific LPs, particularly those that are under-resourced, have become frustrated as they feel like the GP has transferred the exit decision to them.

The dilemma created is rooted in opportunity cost; LPs must take time away from what they view as their core role of sourcing, conducting diligence, and monitoring funds. Instead, they've had to devote increasingly more time and attention to adopting policies and procedures and voting on GP-led transactions.

Additionally, if an LP doesn't have the necessary in-house resources, they often look to their advisors or consultants for advice. While some

consultants are experienced and highly knowledgeable in the secondary market, that is not always the case, and increasing complexity requires increased specialization from third-party advisors.

Exacerbating the problem of feeling ill-equipped to make re-investment decisions in a condensed time frame is the fact LPs may feel uncertainty and hesitancy around the valuation process undertaken in a secondary transaction. One GP's "par value" is not the same as another's. Not every GP applies the same valuation policies and practices. Some are more aggressive in valuing portfolio companies, while others can be more conservative.

The decision to elect liquidity or re-invest in a GP-led transaction is complex and involves a case-by-case analysis. LPs must balance the internal need and desire for liquidity with the opportunity's go-forward attractiveness, typically requiring another 3-5+ years of holding an asset.

Ultimately, re-investing LPs rely on the GP to make the right decisions and drive value in the future. In this context, alignment between LPs and the GP is important in every GP-led transaction. As with everything else in the private equity industry, picking a partner you can trust matters most.

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