

IN FOCUS

The complexity premium in GP-led secondaries

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Investors who can navigate the inherent complexities in GP-led opportunities are best positioned to generate alpha for their private asset portfolios.

The secondary market has evolved over the last two decades. Founded on traditional LP sales, secondaries are now driven meaningfully by GP-led transactions. Sponsors are increasingly using GP-leds to manage their portfolios and offer new liquidity options for LPs.

Despite their broad adoption, GP-leds are inherently complex. They require investor expertise to source and evaluate opportunities, and to assess their macro- and micro-risk factors. The complexity premium in GP-leds is the incremental return generated when a secondary investor successfully manages these intricacies.

GP-leds are thriving within private equity, but only investors who can navigate their complexities are best positioned to extract alpha from such opportunities.

What are GP-led transactions?

GP-led transactions involve the sale of one or more assets from an old fund to a new vehicle, which the existing sponsor continues to manage. Sponsors pursue GP-leds to further maximize value for a portfolio by providing it with additional time and / or capital.

Sponsors who complete a GP-led can take a longer-term view on a company. They effectively extend the holding period for an asset beyond the traditional four to six year time frame, applying the skills and experiences acquired through managing it. The underlying company benefits by maintaining continuity with a GP that knows them well, avoiding potential disruption from new ownership upon a sale event.



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GP-leds substitute assets being sold from one GP to the next. They can also offer LPs a more attractive fee and economic structure with stronger alignment than they would have achieved through a typical primary commitment. This ultimately makes the private equity industry more efficient.

LPs have more options at their disposal, including a full or partial sale of their interests, that may not have been available otherwise, thereby reducing private equity's dependence on traditional exit strategies. The accelerated sell option allows those investors to use the GP-led secondary market for broader portfolio management purposes as well. From an analytical perspective, LPs can take a direct investment approach to evaluate a roll or sell decision, applying their skills in a tangible manner, on their exposure to a fund undergoing a GP-led.

GP-led transactions positively impact stakeholders across private equity, but they are dependent on a mutually beneficial solution driven by the investors.

Complexity premium sources in GP-leds

The graphic below breaks down the sources of complexity premium in GP-leds, from which value is generated throughout the investment process, when matched by the appropriate skills.

Each investment captures complexity premium in its own unique way. Even so, in the current environment, secondary investors can extract alpha in GP-leds from three main sources:

- **Specialised skillsets**
- **Access**
- **Speed and execution capabilities**

Specialised skillsets

Multiple elements of a GP-led transaction need to come together from origination to closing. After selecting the most attractive opportunity to pursue, the secondary investor conducts direct investment-style due diligence on the portfolio. Taking a simultaneous bottom-up, top-down approach on each company, the investor will assess the follow-on capital needs, GP quality, fund performance, LP base and GP alignment.

Sources of private asset complexity premium



Cultural and language barriers

 Key focus areas of complexity premium in GP-leds for discussion

 Other potential sources of complexity premium in GP-leds

Source: Schroders Capital, 2021.

Other sources of complexity exist within GP-led transactions outside these three areas, and can even overlap with one another. For example:

- Secondary investors implement 'deal structuring skills', offering customised solutions (e.g. deferrals, earn-outs, re-financings, preferred equity, etc.) to better match a fund's objectives. GP-led term sheets, a relevant structuring topic, will be covered in 'specialised skillsets'.
- Investors focus on 'organic roll-out strategies' to assess the standalone value creation potential of a business, and conversely 'consolidation/buy-and-build strategies', the incremental value that can be achieved through add-ons, a dynamic we see often in the current GP-led environment involving follow-on capital for M&A.
- Certain secondary investors take a 'contrarian' approach to GP-leds, also with 'turnaround/restructuring strategies', focusing on opportunities they believe are underappreciated by the market.
- 'Privileged information access' is possible through leveraging existing relationships, an area we will explore with 'access'.
- 'ESG' is becoming ever more relevant to private capital beyond secondary GP-leds.
- 'Pre-defined exits' are relevant in GP-leds where the final exit path for the main asset is well-defined up front by the sponsor (e.g. planned IPO or strategic sale), providing visibility on near-term distributions and enhancing J-curve mitigation.

As we can see, there are various examples of the complexity premium's sources within GP-led investments, and they will continue to evolve alongside private equity.

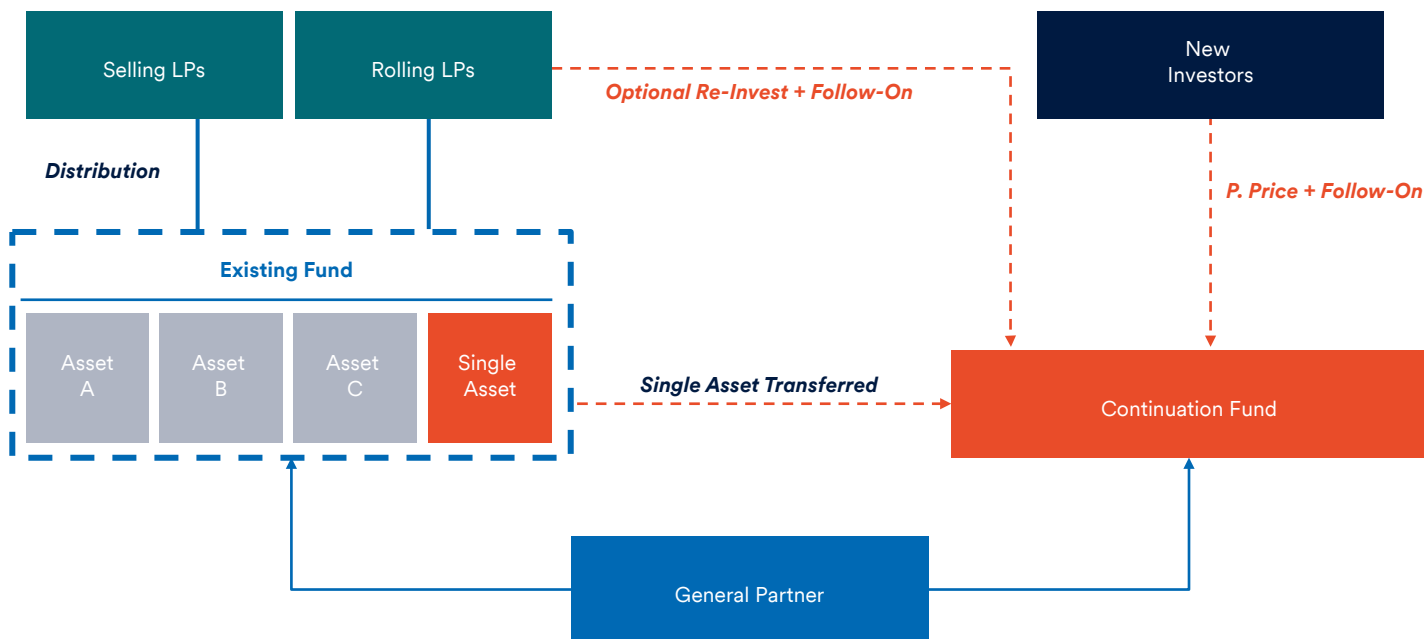
Price discovery is determined by formulating a view on the assets, their respective industries, comparable businesses, market trends and valuations. In addition, it is paramount to understand the sponsor's motivation and structure proper GP alignment through rolling crystallised carry (i.e. unrealised carry that becomes realised as a result of the GP-led) plus investing new money on the same terms as the secondary capital. All this is happening in parallel with ongoing LP discussions, who ultimately need to consent to the transaction.

While there is a general market understanding of key terms for GP-leds, each opportunity requires its own structuring and bespoke term sheet to match its merits and risks. Secondary investors must view all these elements as a package to properly assess the attractiveness of a given opportunity while mitigating risk.

One example of 'specialised skillsets' in practice involved one of our European GPs that contemplated a continuation vehicle for a single asset. The company generated strong performance and maintained a robust outlook based on industry tailwinds and new product launches. However, the fund required more time beyond the existing term to maximise value.

The sponsor proactively reached out to us when they were first contemplating a GP-led, during which we shaped the opportunity with them. We conducted deep due diligence throughout the process, including visiting the company facilities in-person, evaluating management and interviewing third-party references. We engaged external consultants for market research and used in-house knowledge of similar assets across our broader portfolio. Negotiating the entry price and structuring the terms of the new vehicle, while balancing the selling fund's objectives, were critical. The complexity of the deal required 'specialised skillsets' to navigate the various dynamics and negotiations with the sponsor, in addition to structuring the investment to maximise its value creation potential.

Illustrative GP-led transaction schematic



Source: Schroders Capital. Note: For illustrative purposes.

Access

Private equity is a restrictive asset class. It is limited to accredited investors by select attributes, including minimum capital thresholds, select legal or regulatory requirements, sophistication and professional experience. More importantly is the role of existing trust-based relationships between the GP and investor.

All else equal, sponsors prefer working on transactional opportunities with investors they know well that can add value to their platform. This holds true in GP-leds, in which sponsors seek out secondary investors they view as long-term partners. Ideally, they will have primary and co-investment capabilities, in addition to other characteristics such as strategy focus (e.g. lower middle market) or local teams and offices.

A recent example of the 'access' driver of complexity premium in GP-leds involved a lower middle-market, software-focused European sponsor with whom we have a longstanding relationship. The GP was selling multiple assets to a continuation fund. They approached us at the earliest stages given our pre-existing knowledge of the portfolio, fund and sponsor.

Access complexity premium illustration

Potential investors	Existing GP relationship	Primary/co-invest platform	Dedicated local presence	Lower middle-market focus	Access
Investor A	✓	✓	✓	✓	Best positioned
Investor B	✓	✓			Other potential investors for consideration
Investor C		✓	✓	✓	
Investor D			✓	✓	
Investor E	✓			✓	
Investor F	✓		✓		
Investor G		✓	✓		

The GP limited the outreach to existing investors only and preferred those with a local team in the same core region as the sponsor. The location was relevant to facilitate diligence, given the nuances of software companies operating in specific European markets, and to continue building the relationship through future primary and co-investment opportunities. We were well-positioned for 'access' throughout the process, possessing key qualities that were paramount to the sponsor from the onset.

Speed and execution capabilities

GP-led processes can move quickly, especially when they involve high quality assets and sponsors. Investors leverage their existing sponsor relationships to get into GP-leds early on to diligence and shape a transaction. Those without coverage are inherently disadvantaged and can even get dropped from a GP-led with strong demand if they are unable to complete their diligence in time.

A risk to all investors is being scaled back on top quality GP-leds where there is meaningful interest. Investors who can follow through with

swift yet thorough diligence and execution on such opportunities – usually only possible with a pre-existing relationship – and help the GP structure the transaction, are best positioned to generate preferential deal flow and maintain a competitive edge against the broader market.

Our ‘speed and execution capabilities’ were recently at play with a high quality asset and one of our core US lower middle market managers. The transaction involved the full sale of the asset, offering liquidity to all shareholders, a debt refinancing to clean up the balance sheet and follow-on capital for add-ons. The company completed an add-on during the process and had an active M&A pipeline to pursue following the close. In addition, the GP’s successor fund was investing in the company alongside the continuation fund.

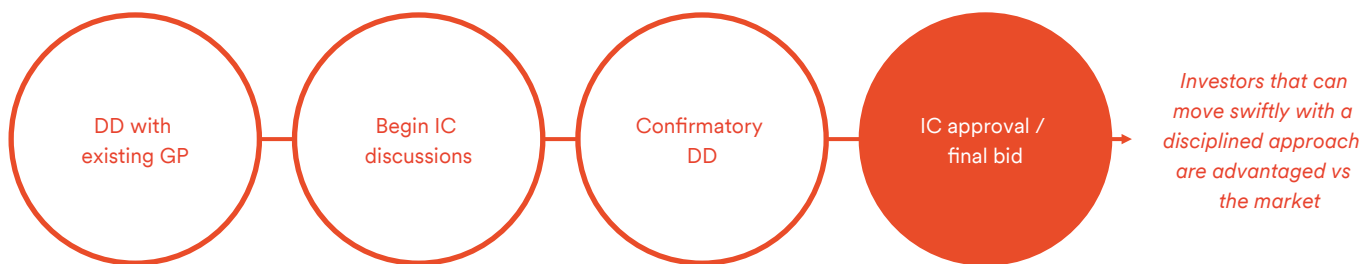
There were a number of moving parts to the GP-led occurring simultaneously, adding to the complexity and requiring any new investor to understand the key motivations of each stakeholder on top of evaluating the asset. We leveraged our pre-existing relationship and knowledge of the company through our primary and co-investment programs to begin diligence before the opportunity came to market. We were also proactive in facilitating deal structuring, including alignment, early on, given our proximity to the GP.

We remained ahead of the process through consistent dialogue with the sponsor and third-party advisors. Our approach drove momentum for the GP and transaction on a high quality asset, where we secured allocation and favorable governance within an expedited timeframe from origination through closing.

Illustration on speed and execution capabilities complexity in GP-leds



Timeline for an investor leveraging speed and execution capabilities in GP-leds



Timeline for the broader market in GP-leds



Source: Schroders Capital. Note: For illustrative purposes.

Secondary GP-led complexity premium in aggregate

GP-leds are an evolving secondary structure, which we believe will continue to offer incremental returns through complexity. The natural barriers to entry in GP-leds limit the investor universe not only to secondary firms – a subset within private equity – but even further to those with teams and resources dedicated to GP-led opportunities.

They are inherently complex, requiring secondary investors to possess ‘specialised skillsets’ to properly screen, evaluate, structure and lead, in an effort to ultimately build a GP-led portfolio.

We have seen that an investor who can leverage its existing sponsor network and add value from its platform (e.g. primary and co-investment capabilities, strategic angles or multi-regional teams) is well-positioned to ‘access’ high quality GP-led deal flow, limited from the broader market.

‘Speed and execution capabilities’ directly impacts an investor’s ability to extract value as well. An investor that can remain ahead of a process, facilitating deal momentum for the GP while maintaining a disciplined approach, is favoured by the sponsor. Securing a “seat at the deal table” allows influence in shaping the GP-led and securing allocation, and represents a valuable competitive advantage.

The complexities of GP-leds are often intertwined and do not exist in isolation. Secondary investors who can effectively navigate the intricacies of GP-leds as a whole will be best positioned to capture the complexity premium in their returns, generate alpha and maximise value creation for their portfolios.

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