KEYNOTE INTERVIEW

Making use of the evolving secondaries toolbox



Today's secondaries technology can provide flexible solutions for GPs and LPs during times of market turmoil, say Mary Lavelle, Daniel Quinn and Fadi Samman at Akin Gump Strauss Hauer & Feld

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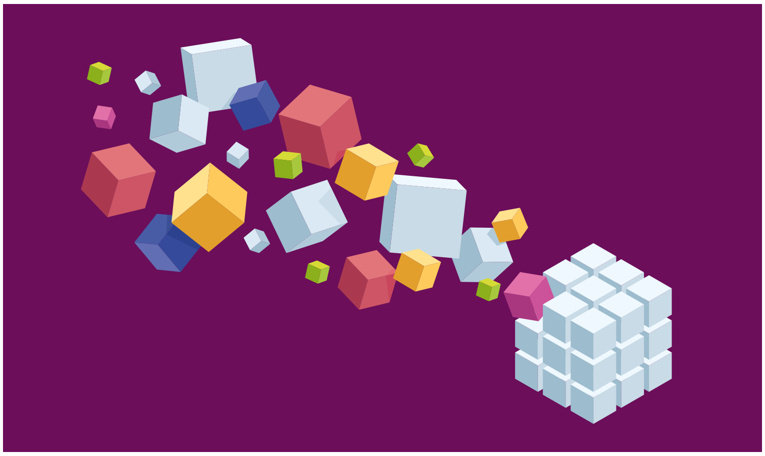
Q What types of transactions are currently most active in the secondaries space, and what are the drivers of deal activity?

Fadi Samman: What we have seen, particularly in the second half of last year, is a market reversal. Whereas previously GP-led transactions were dominant and the most active part of the secondaries market, towards the back end of last year traditional secondaries – meaning LP to LP sales – began to take prominence again and dominate activity.

The drivers for that are twofold. First, market dynamics around liquidity questions mean LPs are once again interested in selling and, in the face of challenging pricing dynamics, were sometimes willing to sell at lower prices. Second, GP-leds are harder to execute right now given those pricing dynamics. Traditionally, those deals have involved GPs bringing their best assets to market at little or zero discount, and the idea of executing a GP-led transaction at a meaningful discount is a much harder sell. As a result, we saw a lot fewer of those deals in the latter part of last year.

Mary Lavelle: On the LP portfolio sale side, we have seen a particular trend towards mosaic sales, where multiple buyers are taking on subsets of portfolios. That is the way a lot of LP-backed deals ended up playing out last year, whether structured in that way at the outset or not. That is partly down to buyer selectivity and some buyers being more focused on core relationships with GPs or on certain types of assets, and we expect that to be a trend that continues.



Q What new transaction structures are you seeing?
DQ: One of the reasons it is a really good time to be a secondaries lawyer is the secondaries market now compared to a decade ago is so much more mature and has so much more in its toolbox to deal with the economic environment. So much of what we have seen over the last 10 years will serve a purpose in a more volatile market, such as preferred equity, NAV financing, staples, tender offers and so on. All of these provide an incredibly flexible set of solutions to meet the needs of investors.

FS: One thing we are seeing firms experiment with today is the use of evergreen continuation fund structures, taking assets that have some level of liquidity features to them, or income protection features, and pulling them into a continuation vehicle with an evergreen feature so that it provides liquidity. That may not attract traditional secondaries buyers, but underpinning it is a secondaries approach of pooling assets together and syndicating exposures, even though the output is quite different. We see firms taking the building blocks of continuation funds from the secondaries world and looking to create different products with them, which is really interesting.

Q What market developments have you observed going into 2023 in light of economic headwinds?
Daniel Quinn: We are heading into a time of capital constraints from an investor perspective, which is going to drive a lot of secondaries market activity. One thing that GPs are thinking about is how they can access secondaries activity as a fundraising tool, which can be done in a variety of ways.

For example, we are seeing an increase in tender offers, sometimes tied with a staple to a fund currently in the market, to try and encourage commitments to that primary fund as well as freeing up dry powder for the GP to commit to that new fund. We also see firms thinking about what we call sweetened primaries, where a fund has already made significant investments, so a secondaries player can come in and provide primary capital but they at least partially know what they are going to invest in upfront. GPs are seeing the secondaries market as much more of a tool that they can use for primary capital in that way.

FS: The return of tender offers is interesting. Those fell out of favour with the rise of GP-led transactions, with one of the major reasons being issues with the take-up and success of those auctions. Now we see some of those issues rearing their heads again, so while there has been some interest in doing those deals, some of the challenges surrounding the transactions continue to play out. The question is whether tenders will continue to be used as a strategy given the difficulties with getting enough transaction volume coming out of the process.

ML: An ongoing theme is new entrants to the market, which is something that has been prevalent over the last few years. Particularly in the last year, a lot of the sellers in the market were first-time sellers, maybe more than half, and that's especially the case among pension funds. This is a relatively new market for them and we saw a few quite large portfolio sales by pension funds last year. That is a theme that will continue as organisations increasingly understand the benefits of the secondaries market as a portfolio management tool.

Another trend is deferrals of the purchase price, which we have been seeing as a means to get deals over the line in helping to bridge the pricing gap. Deferring the payment of a portion of the purchase price by the buyer by 12 to 18 months has helped buyers get more comfortable with doing deals in this market, including on the stapled side where we see secondaries buyers negotiating a delayed funding of the primary, which achieves a similar deferral effect. It will be interesting to see how other structures will be employed into GP-led transactions to bridge pricing gaps there, with the use of earn-outs, for example.

Finally, the expansion of the secondaries industry into other asset classes and sectors continues. Private credit secondaries have increased a lot, but we also see growing interest in real estate and infrastructure. Those deals as a proportion of overall deal volume did not reduce as much as buyout activity last year, possibly down to pricing being more stable there.

Q Are you seeing buyers adjust their approach to secondaries deals in light of the macro environment?

DQ: Given the market dynamics, buyers are being selective about deals, which they can probably afford to be, and zeroing in on terms a bit more than they were able to do over the last 12 to 18 months when it was more of a seller's market. That dynamic drives home the importance of alignment, which will continue to be the single most important factor in any secondaries transaction.

On the GP-led side, when the market is in turmoil and GPs need to free up capital, buyers are going to be absolutely focused on making sure the alignment is there so that deals will succeed.

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>
> **MARY LAVELLE**

ML: On terms, I have seen buyers scrutinising potential conflicts of interest a lot more, looking not just at how pricing is justified but also the real detail of the transaction documents. Buyers that aren't lead buyers are looking at the details of the reps and warranties under the sale and purchase agreement, for example, possibly because of the market nervousness around valuations and economics.

Q What is driving seller activity, and how do you think supply-demand dynamics will evolve through this year?

FS: If you look at the GP-led market, that is going to be a challenge this year. It will be difficult to figure out how to bring a process and a deal to market in this environment: the time to execution will be longer, the process is more challenging, investors are scrutinising deals more carefully and there is also a new regulatory overlay that we expect to come into effect and potentially slow things down a bit more.

The new regulatory requirement for GPs to obtain fairness opinions for GP-led deals is unlikely to have a huge effect, because fairness opinions were already part of the GP-led landscape. However, the US Securities and Exchange Commission requirement for almost contemporaneous reporting of deals closed does suggest the regulator will be scrutinising these transactions, which will add an extra layer of caution on the part of dealmakers. While these regulations will not chill the market, it will add a layer of caution to the execution process.

In the first half of 2023 I think we will see fewer deals getting executed because there will be more selectivity, LPs will self-select out of GP-led deals because they don't like the pricing, and we will perhaps see deals not making it to market because LPs are rejecting them at the LP advisory committee stage or through informal discussions even earlier in the process.

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DQ: Balanced against that is the fact that there is going to be a greater LP desire for liquidity, so LPs are going to be pulled in two different directions, still being highly motivated to get capital in to make fresh commitments, but also cautious on transacting in the secondaries space.

ML: The expectation is that activity will start to pick up slowly and then burst into life in the second half, with some predicting similar deal volume for the full year as we saw in 2021. It will certainly be a steadier start, but the maturation of the secondaries market means the highs and lows of activity levels are less pronounced than they used to be, so we expect 2023 to wind up being another busy year. ■

Mary Lavelle, Daniel Quinn and Fadi Samman are partners in the investment management practice at Akin Gump Strauss Hauer & Feld