KEYNOTE INTERVIEW

A parting of the ways

New pricing patterns and rising competitiveness are helping to distinguish GP-leds from the LP-led side of the market, says Morgan Stanley Investment Management's Nash Waterman

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Q From a competitive standpoint, how has the GP-led secondaries market developed?

We have seen a significant number of new entrants in recent years, both those reallocating capital towards these transactions and to a lesser extent entirely new institutions. This has led to an increase in competition, but only around the big, brand-name GPs that are bringing deals to market.

The reason that these big brands have such a gravitational pull is that a lot of the secondaries groups now pursuing GP-leds started out doing traditional LP-led transactions. Those LP trades were inevitably dominated by the largest funds. Secondaries firms have therefore come to know those managers well and can price those interests efficiently.

That same mentality has now moved to the GP-led side of the market too, where there is also a strong preference for the big-name GPs that secondaries houses are so familiar with. Those deals have therefore become more competitive. That doesn't mean that pricing has gone up materially, but it does mean that those GPs can set their own terms and set the timeframe in which they want to complete, which may be as short as three or four weeks.

That contrasts sharply with the mid-market and lower mid-market, where there is a much longer list of names, and the firms are generally not as well known. We have seen a reticence to work with these GPs among many secondaries groups. They may be very strong managers with great assets, but it is still harder for them to get transactions done. More and more of these managers are turning to the GP-led secondaries market, but the competitive intensity in that space remains unchanged.

Q What evolution have you seen in the types of GP-led deals coming to market?

GP-leds can take many different forms, beyond the conventional continuation vehicle. For example, there are situations where a GP-led opportunity may be structured around a single co-investor that is looking to sell. In that situation, the LPs in the fund don't necessarily need to get involved in the process.

We also see instances where public companies that still exist in private equity portfolios are being taken private again. This trend has become particularly prominent, as many mid-market companies that held IPOs in 2021 and early 2022 have fallen out of favour. Often, these companies were sold out of major passive index funds and simply didn't get the attention they needed in terms of equity research. We have therefore started to see a big divergence between their financial performance and stock price due to a lack of trading.

Furthermore, the cost of being a public company can be onerous if you are fairly small. These businesses are therefore better equipped to operate as private companies where there is clear alignment between owner and management team. GP-led secondaries deals can be used as a way to capture the value creation opportunity that these companies can represent.

Another example involves GPs that are looking to complete a large strategic acquisition but that don't have the capital remaining in the fund to do so, or else have hit portfolio concentration limits. GP-led secondaries investors can provide that capital and take ownership of the business in that way. These transactions are attractive because the acquisitions concerned are often transformational, thereby providing a unique and compelling entry point.

Finally, GP-led secondaries deals are occasionally used to de-lever overlevered portfolio companies. Sometimes you see promising companies with inappropriate balance sheets. Providing capital to these businesses so that they have an appropriate capital structure may pave the way for value creation going forward.

Q How attractive would you say pricing is today?

Over the past two years, the combination of a growing awareness of GP-led deals and an environment where it has been very hard to achieve liquidity has brought a set of extremely high-quality assets to the market. However, because there hasn't been enough buyside demand to meet the level of supply, that hasn't led to an increase in pricing. I don't see that changing. The desire of GPs to complete these deals still outstrips the capital available. As long as that remains the case, we will likely continue to find great value.

Q What is considered best practice when it comes to running these GP-led processes?

What is most important is ensuring that there is transparency for investors in terms of how the company is being valued and why that valuation is being struck. That puts those investors in the best possible position when it comes to deciding whether to sell or roll. There shouldn't be any surprises.

It is also incumbent on all market participants to ensure these deals are being done for the right reasons. You don't want to see situations where a GP-led deal takes place and then the company is sold for double that price a few months later. As a new buyer, we need to be aligned with rolling LPs around a long-term value creation opportunity, not quick value extraction.

Q How is the market defining pricing for GP-led deals?

Secondaries pricing is typically communicated in terms of a percentage of NAV, but that can have very little connection with reality, particularly in a GP-led context. You see data that shows GP-leds are generally being completed at 90-100 percent of NAV, and the inference is often that the market has become competitive, and pricing is high.

But the reality is that it depends on how these deals are structured. A deal may be priced at 100 percent of NAV, but if the deal is being structured around new capital to fund an acquisition, the company might be worth a lot more once that deal has taken place. Equally, if a business is growing very quickly, the pricing of a deal struck at 95 percent of NAV may look very different by the time that deal even closes.

The fact that secondaries market pricing revolves around a percentage of NAV is problematic, particularly for GP-leds. The emphasis should be on the valuation that is being paid, as it is in direct buyouts, not on how that relates to the last accounting value. It will be interesting to see if the GP-led market eventually starts presenting pricing that way.

Q What are the key ingredients that make up a good GP-led deal?

It starts with the asset. GP-led secondaries investors need to see assets that have performed well and that have the ability to continue to perform in the same way. That means they want to see management teams and GPs that do not need to do anything extraordinarily different in order for the business to grow in value.

One of the key advantages of these transactions is that you have the ability to see what the management team and sponsor have done with the business. That history should give you confidence about what lies ahead.

Alignment is also critical. You want to see that a GP is putting fresh capital into the deal. You also need to consider when these transactions are being done in the lifecycle of the GP. There have been situations where sponsors have used the GP-led market opportunistically to get liquidity for assets that they have not been able to find elsewhere. We have also seen situations where sponsors have used the market to try and save a company that is struggling.

What we want to see is that a GP-led deal will be meaningful to the sponsor going forward. We want to know that they will continue to hold significant ownership in one of their funds and hopefully their most recent fund, so that it is important to their franchise and not just to the continuation vehicle. That means we want the deal to be somewhere in the top 10, in terms of AUM. Ultimately, you want to be convinced that a sponsor is doing this because they believe they have a great company with a great future.

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Q To what extent do you expect to see the LP-led and GP-led secondaries markets diverging and becoming distinct asset classes?

It is really just an accident of history that secondaries firms are doing both LP-led and GP-led secondaries deals. They are drastically different investment practices. With LP-led secondaries, you are pricing large numbers of funds and companies at once, and you generally have to price the transactions very quickly. In most cases, the portfolios are so diversified that you don't have the time, or even the necessity, to dig deeply into each business. GP-led deals, and single asset GP-led deals in particular, are much more concentrated bets and the due diligence required is more akin to that done in the direct buyout world than it is to LP-led secondaries.

I believe, therefore, that clients will start demanding to invest in funds that either focus exclusively on LP- or GP-led deals, in part because the exposures are fundamentally different in terms of risk-return profile, and also because the skills required are so different. Having one team do both just isn't logical. It is akin to a mutual fund saying it wants to pursue both public equities and public bonds. They are totally different strategies and don't fit naturally within the same vehicle. ■

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Nash Waterman is head of the private equity secondaries team at Morgan Stanley Investment Management