KEYNOTE INTERVIEW

An undercapitalised opportunity

Sponsors are increasingly turning to GP-led deals to manage their portfolios and more capital is needed to meet growing demand, says Scott Humber at Landmark Partners, an Ares company

Q What have been the most significant developments in the secondaries market over the past five years?

Today's secondaries market consists of two primary categories – LP solutions and GP solutions. Between 1 percent and 2 percent of private equity net asset value has consistently turned over annually for the past 15 to 20 years. On the LP side, the market has become efficient, and leverage is often used to generate target returns. However, the real evolution has taken place on the GP side, where we see two different types of transactions.

First, there are deals at the asset level, where the GP is looking to create liquidity for specific companies or perhaps engage in a holistic fund recapitalisation. These are typically executed through a GP continuation vehicle. Then there are transactions at the GP management company or balance sheet level, where the GP may be looking for capital to fund expansion, for example.

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The GP-led part of the market has seen tremendous growth over the past six years, increasing from around $8 billion in 2015 to almost $30 billion in 2020. Early data for 2021 suggests GP-led transaction volume north of $60 billion. We see a real opportunity to generate a higher multiple on invested capital in the GP-led space, while continuing to build out a diversified portfolio of lower risk assets.

Q What have been the key drivers of growth for single-asset deals?

Private equity valuations have been increasing and the market is competitive. GP continuation vehicles make sense because they allow sponsors to keep hold of their higher quality assets in a market where it can be difficult to find quality at a reasonable value. For secondaries investors, the opportunity is to participate alongside these sponsors in backing high quality and known assets.

Q How does the diligence process differ for these types of transactions?

With traditional LP secondaries, information and interaction with the underlying GPs tends to be more limited. With concentrated GP-led transactions, transparency is extremely important. If a GP seeks to limit the depth or quality of the information available, we will pass as there are plenty of other opportunities to consider. It is a partnership with the GP and transparency is essential. Yet, it is not only a question of manager assessment and alignment. We also perform direct underwriting on the asset itself, taking factors such as the addressable market, growth opportunities, the competitive landscape, margin stability and pricing trends into account.

Q What types of resource and expertise does that require?

Having direct investment experience on the team can be helpful, but the real differentiator comes with access to a broad platform to help validate the diligence process. We can leverage the overall Ares platform, for example, where we have access to a global direct lending business and a scaled direct private equity team, alongside dedicated research coverage and industry expertise, all of which can be extremely valuable as we work through diligence on these transactions. As having the ability to fully assess manager quality is also important, we also have a quantitative research group of almost 25 professionals who spend a lot of time helping us evaluate GP track records at a granular level.

Q Why are single-asset deals attractive to GPs, secondaries investors and the underlying LPs?

The GP can hold on to high performing assets while also creating liquidity for their LPs. It provides the GP with the opportunity to execute on ongoing value-creation plans and could also provide the company with additional capital to assist in further expansion. It also enables the GP to deploy capital with less risk as it knows the asset and management team.

The secondaries investor, meanwhile, can partner with high-quality sponsors on their best-in-class assets, again with a lower risk profile relative to an asset that is unknown, and with strong alignment. Different secondaries managers have different portfolio construction objectives. We believe that procuring an attractive and diversified portfolio of these investments within our broader portfolio is a complement to the overall portfolio construction of a secondaries fund.

Finally, for LPs there is the option to take liquidity or to maintain exposure to these high-quality assets. LPs have different timelines, liquidity needs and portfolio construction objectives. These deals provide that optionality.

Q Are there any challenges to incorporating single-asset transactions into secondaries portfolios? How can those be overcome?

One potential area of concern is asset concentration. Many LPs like secondaries because of the diversification factor and if a secondaries fund becomes too concentrated in certain companies, it will begin to have characteristics that are more akin to a direct strategy.

However, if the secondaries firm can remain disciplined through concentration limits that govern the fund's exposure to any one company or sponsor, the buyer can create a portfolio of high-quality GP-led deals that provides the fund-level diversification limited partners expect. That exposure can be an attractive complement to the buildout of an overall secondaries fund.

Another potential challenge is the ability to properly diligence the opportunity set. We have seen some firms jumping into the space that do not necessarily have a defined process or the requisite experience. Having access to a broader platform that can bring value to the diligence process makes a real difference.

Q Is the market prepared for a surge in GP-led deals and is there enough capital to support the opportunity?

For the past 10 to 15 years, secondaries transaction volume has grown at greater than 15 percent per year. However, from 2015, when GP-led deals started to become a more meaningful part of the market, that annual growth in transaction volume has been greater than 40 percent. Currently there is around $170 billion of near-term secondaries demand, versus between $110 and $130 billion of market volume in 2021 alone. That implies less than two years of inventory. The bottom line is that more capital is needed to execute on this growing market opportunity.

Q Looking forward, what are your expectations for the GP-led market?

The GP-led space is a meaningful component of the secondaries market. It has represented more than 50 percent of overall secondaries volume for the past two years and yet only a fraction of GPs have executed GP-led deals to date. GPs are increasingly accepting of the secondaries market as a portfolio management tool, and that sentiment will serve as a long-term tailwind for growth. Afterall, there is approximately $110 billion of NAV in extension-phase buyout funds globally, more than $750 billion of NAV post-investment period, and $1.1 trillion of NAV still within the life cycle of the investment period, according to Preqin data. As that NAV continues to mature, GPs will increasingly consider alternatives for their assets, including GP-led transactions. ■

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