GCM Grosvenor

In Brief

September 2020

PRIVATE EQUITY

Past performance is not necessarily indicative of future results. No assurance can be given that any investment will achieve its objectives or avoid losses. Unless apparent from context, all statements herein represent GCM Grosvenor's opinion. ***Select risks include:*** *risks related to the lack of a liquid, transparent market for secondary investments, performance risk, and risks related to sourcing investments.*

The Rise of the GP-Led Secondary Investment

In the three years prior to 2020, the private equity secondary market more than doubled in size, and, despite the lull in activity for the first half of this year, we expect its growth to continue. Amid this growth, many funds participating in the market have expanded their focus beyond traditional limited partner (LP) interest deals and have been pursuing innovative deal structures in seeking to deploy much larger funds. As a result, non-traditional or "complex" deal structures, dominated by GP-led transactions, have increased in volume and now make up nearly a third of the secondary market.

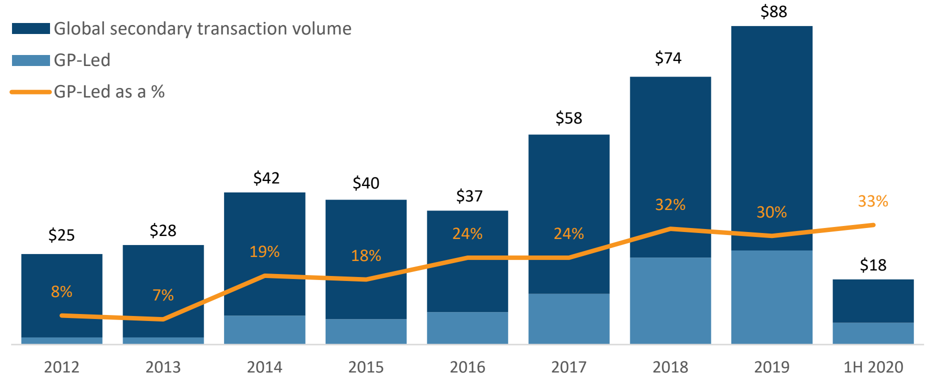
In the following, we explore the growth and evolution of the secondary market, compare complex non-traditional transactions with traditional secondaries, and discuss the importance of a robust platform of manager relationships to access GP-led deals.

GROWTH OF THE SECONDARIES MARKET

The secondary market grew from $37 billion in 2016 to $88 billion in 2019. We expect it to continue to climb, based simply on the amount of assets held in alternative investment funds and the growing adoption of the strategy by pensions and asset managers. The COVID-19 pandemic impacted volumes for both LP and GP transactions in the first half of 2020, but we anticipate record volumes once again in 2021 and 2022 as pent-up demand and less distribution activity from underlying portfolios can drive both LPs and GPs into the secondary market for liquidity.

The core of the secondaries market remains the traditional LP deal: the sale of a fund LP interest by a single seller, often as a part of a portfolio of interests. However, growth in the market is buffeted by other transaction types, typically labeled "complex" secondaries. GP-led transactions have emerged as the most common type and represent the second highest source of volume among secondaries overall, with $26 billion in 2019. As the historical stigma and heavily discounted pricing once associated with these processes have lifted, GPs have expanded their use of the secondary market, furthering its growth rate.

Secondary Volume 2012–2020



Source: Greenhill

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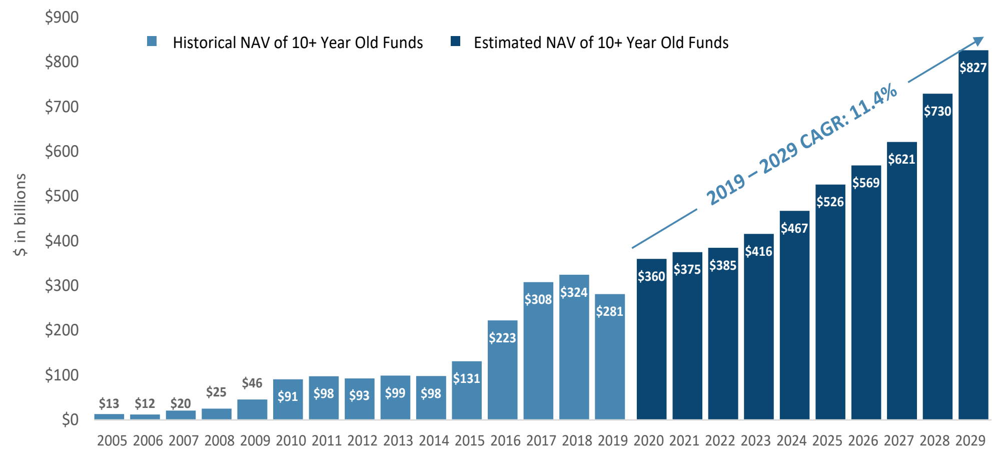
The amount of remaining net asset value (NAV) in funds that are 10+ years old is a strong expected driver of secondaries transaction volume. These older funds are more prone to be part of an LP sale or a GP-led transaction. By tracking the amount of unrealized value in one dataset (shown below) we can see that the volume of unrealized value in 10+ year-old funds has increased dramatically over the past 10 years, just as the secondary market has. Over this same period, the annual fundraising for private equity funds has increased three-fold, which implies that secondary market volume is poised to double yet again in the coming years as those funds reach maturity. We believe this wave of unrealized value in older funds will lead to a further increase in secondary transaction activity, particularly in GP-led liquidity offerings, as both GPs and investors become more familiar with that part of the market.

Expected Increase in NAV for Funds Greater Than 10 Years Old



Data source: BURGISS.

Data as of December 31, 2019. Data downloaded May 2, 2020. "Tail-End Funds" are defined as funds that are older than 10 years. The Historical NAV and Projected NAV in tail-end funds analysis is for 2000-2019 vintage funds.

GP-LED DEALS: A CLOSER LOOK

Although GP-led secondary deals vary somewhat in structure from traditional LP interests, we see more similarities than differences. In both GP-led and traditional LP transactions, the buyer acquires an interest in a limited partnership fund with the same set of considerations:

- Access to qualified information
- Alignment of interest with the manager
- Acquiring assets at a discount to intrinsic value
- Limited ability for the LP to influence the outcome once the investment has closed

GP-led deals do indeed provide buyers the opportunity to reset and influence key fund/deal terms such as management fees, carried interest, follow-on capital, governance, manager investment/rollover, reps and warranties, and more. But these elements have always been a focus for secondary buyers as well.

GP-led deals may differ from traditional secondary transactions in that all buyers typically gain access to data rooms that contain in-depth portfolio information beyond a fund's regular reporting. This is particularly attractive for many secondary-only platforms that often do not have relationships with managers to access detailed portfolio company information in traditional secondary transactions. However, in a GP-led deal, having greater access to data does not necessarily make the underwriting more or less complex. It just means there is more information available. And since secondary investors are typically not sector experts, they may likely need to rely at some level on the GP to help parse the information and evaluate investments.

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> **"Although GP-led secondary deals vary somewhat in structure from traditional LP interests, we see more similarities than differences."**

There are many types of GP-led deals including tender offers, continuation funds, asset sales, strip sales, and fund restructurings. Yet they all revolve around the same basic structure in which existing investors have an option for liquidity and incoming investors obtain a mostly passive interest in a limited partnership.

Additionally, as GP-led deals have become more common, they are more easily evaluated. There are now enough precedent transactions that buyers, lawyers, and advisors may assess which elements are typical, and which are outliers. Additionally, the Institutional Limited Partners Association (ILPA) issued guidance for GP-led deals in 2019, providing a framework for best practices in these transactions. As an investor assesses a GP-led transaction, given the relatively tight variability in key terms, we believe they should focus on determining the appropriate price for a portfolio of investments, while relying on the fund manager to direct the underlying fund and its investments.

THE IMPORTANCE OF MANAGER RELATIONSHIPS

As the secondary market continues to evolve and include a wider range of strategies, we believe investors with strong manager relationships will achieve an underwriting edge and more successfully invest in GP-led transactions. Managers – of primaries, secondaries, and co-investments – continue to value buyers and syndicate members who are long-term partners and are often willing to provide them with a level of insight and access to opportunities that secondary-only firms typically do not receive.

Similar to GPs increasingly restricting processes or access to information during a traditional LP deal, we see GP-led processes commonly steered towards favored relationships, particularly when forming a purchasing syndicate as GPs often seek to reward legacy investors or investors who can be long term partners.

Additionally, those with existing manager relationships may have a better vantage point and can act more quickly on fast-moving GP-led transactions, as it is likely they already have views on the relevant companies and managers. And, as mentioned, since secondary investors are typically not sector experts, they may need to rely on the GP to help evaluate investments and make these quick investment decisions, so trust, alignment, and a shared history with the manager are critical in our view.

Given these dynamics, secondary-only firms are increasingly fighting to stay relevant, often offering to take on large amounts of unfunded, even through stapled primary commitments, which can provide additional risks.

At GCM Grosvenor, our team of more than 45 dedicated private equity investment professionals maintain over 400 manager relationships, which we believe gives us rare visibility into the GP-led market. This broad information and relationship advantage enhances our sourcing and market intelligence, provides valuable and differentiated co-investment deal flow, and provides us with unique information and access to secondary opportunities. Our distinctive secondary-sourcing network is useful across all markets, but in our view, it is even more powerful in the atypical, liquidity-demanding market we currently find ourselves.

CONSIDERATIONS

Similar to LP deals, GP-led deals include perceived risks about portfolio concentration and duration. In seeking to mitigate such risks, it is often incumbent on the investor to manage exposure appropriately for the size of the program. Given the frequency of buyer syndicates in GP-led situations, it is usually easier for a buyer to control its exposure to individual companies and sectors by the size of its commitment to the transaction than in traditional LP deals. Traditional deals typically involve a range of investment quality, and it can be more difficult for buyers to purchase only the investments they like or scale their investment up or down. However, for more attractive GP-led transactions, the ability to participate meaningfully in a syndicate can largely fall upon the investor being able to lean on an existing primary relationship with the underlying manager, as these deals are often oversubscribed.

Duration risk can also arise from the stapled primary or follow-on commitments that increasingly accompany GP-led deals, particularly in tender situations. However, unfunded commitments, like other investment risks, can be mitigated by adjusting the purchase price. This part of the secondary market is getting tested. Roughly one-third of GP-led

“Access to a broad opportunity set is the foundation that allows any investor to be selective in deal selection, and the secondary market is no different.”

deal volume brought to market in 2019 resulted in a failed transaction, commonly due to misalignment of GP incentives, staple and follow-on requirements, mixed or poor asset quality, or lack of a clear transaction rationale. We expect this failure rate will decrease as norms continue to become more established.

With these added considerations, we believe the importance of deal selection is even more elevated when evaluating GP-led situations. This brings further into focus the ability for a platform to not only have the resources needed to properly evaluate these opportunities, but also the option for participation in as many GP-led situations as possible.

CONCLUSION

The secondary market has expanded and evolved but has very much adhered to the same mandate: provide liquidity for limited partners. GP-led deals have a slightly different form and rhythm, but the core principles of a secondary transaction remain the same. As with LP deals, GP-led situations require buyers to focus on having an informed point of view on the assets, ensuring alignment of interests with the manager, and acquiring assets at a discount to intrinsic value. We believe buyers with the highest probability of success have deep relationships with proven managers and the resources to be active across investment types and strategies.

ABOUT GCM GROSVENOR

GCM Grosvenor is a global alternative investment firm with $57 billion in assets under management in private equity, infrastructure, real estate, multi-asset class opportunistic investments, and absolute return strategies. The firm has specialized in alternatives since 1971 and is dedicated to unlocking value for clients by leveraging its cross-asset class and flexible investment platform.

GCM Grosvenor’s experienced team of approximately 500 professionals from diverse backgrounds serves a global client base of institutional and high net worth investors. The firm is headquartered in Chicago, with offices in New York, Los Angeles, London, Tokyo, Hong Kong, and Seoul.

CONTACT

Headquarters
Chicago
900 North Michigan Avenue
Suite 1100
Chicago, Illinois 60611
+1 312 506 6500

New York
+1 646 362 3700

Los Angeles
+1 310 651 8270

London
+44 (0) 20 3727 4450

Tokyo
+81 3 5573 8110

Hong Kong
+852 3420 1777

Seoul
+82 2 2158 8500

For more information:
inquiries@gcmlp.com
gcmgrosvenor.com

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