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Secondaries: A Powerful Tool for Private Equity Liquidity and Value Creation

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The **private equity (PE) secondary market** facilitates transactions between existing investors, allowing for the sale and purchase of interests in pre-existing assets from the primary market before a traditional liquidity event has occurred, such as a sale of a portfolio company. This has the benefit of providing an early liquidity option for the seller and, for the buyer, an opportunity to buy in to other existing funds and assets, often at discounted prices.

The secondary market for PE has experienced significant growth in recent years, driven by the increasing maturity of the private markets and the need for liquidity solutions. One of the key drivers of this growth has been the rise of secondaries led by General Partners (GP), which have become an increasingly popular tool for GPs to manage their portfolios and provide liquidity options to their limited partner (LP) investors. GP-led secondary transactions often involve a GP transferring a portfolio of assets from an existing fund to a new vehicle, referred to as "continuation vehicles" or "continuation funds", typically with the participation of a new set of investors. These transactions allow GPs to extend the holding period of their most promising portfolio companies, providing additional time and capital to execute value creation strategies[5]. Simultaneously, they offer LPs an opportunity to crystallize returns or rebalance their portfolios[2].

The Rise of GP-Led Secondaries

The resilience of the GP-led secondary market is driven by a confluence of factors supporting both buyer demand and seller supply. For GPs, secondary markets allow them to retain control over high-quality assets that may require additional time and capital to maximize value. It also provides a mechanism for addressing issues such as fund term limits, concentration risks, or misaligned incentives between the GP and LP investors. On the demand side, LPs continue to experience a dearth of liquidity from their private market portfolios, as global PE exits reached a decade low in 2023[1]. This scarcity of liquidity has prompted LPs to seek alternative means of portfolio rebalancing and capital recycling.

Key Benefits for GPs and LPs

GP-led secondaries offer several advantages for both GPs and LPs:

For GPs:

1. Extend the holding period of high-performing assets, allowing more time for value creation strategies and an optimal exit [5]
2. Access additional capital for follow-on investments or bolt-on acquisitions[5]
3. Manage legacy portfolios and navigate periods of disruption[5]

For LPs:

1. Gain liquidity and rebalance portfolios without being forced sellers[2]
2. Crystallize returns on mature investments[4]
3. Potentially access top-tier managers or funds that may be difficult to access in the primary market[4]

For both GPs and LPs, the shared benefits also include reducing blind pool risk and moderating the J-curve effect, paving the way for a more stable growth trajectory compared to the traditional worse-before-better investment models.

The Future of GP-Led Secondaries

The continued growth of the GP-led secondary market is supported by several key factors:

1. **Demand for Liquidity**: As private markets mature, LPs are increasingly seeking liquidity solutions to rebalance their portfolios and manage cash flows[1][2].
2. **GP Familiarity**: GPs have become more familiar with GP-led secondary transactions, recognizing their potential for value creation and portfolio management[1].
3. **Availability of Capital**: The secondary market has attracted significant capital from investors seeking exposure to the asset class, creating a deep pool of capital for GP-led transactions[5].
4. **Regulatory Changes**: The SEC's new rules requiring fairness opinions for certain adviser-led secondary transactions have increased transparency and confidence in the market[6] .
5. **Seller Benefits**: Sellers benefit from the ability to manage their portfolios actively and secure liquidity for new projects. The secondary market is known for its transaction speed and the availability of discounts reflecting market conditions[2].
6. **Robust Underwriting**: Strong due diligence processes bolster underwriting standards. Given the more selective amount of investments in GP-led transactions compared to LP-secondaries, GP-led secondaries may provide more focus and transparency in the due diligence of targeted portfolios to ensure investment success[5].

The Role of Fairness Opinion Providers

As GP-led secondaries have become more prevalent, there has been an increasing focus on ensuring that these transactions are conducted in a fair and transparent manner, particularly given the potential conflicts of interest that may arise between GPs and LP investors.

To address these concerns, on August 14, 2023, the U.S. Securities and Exchange Commission adopted a new set of rules requiring registered investment advisers to obtain and distribute a fairness opinion or valuation opinion from an independent opinion provider to investors in connection with any adviser-led secondary transaction[7] . This ruling will be enforced in staggering periods depending on adviser assets under management (AUM) sizes from either 12 or 18 months from September 14, 2023, which is the date the new set of rules was published in the Federal Register[8].

The fairness opinion is intended to provide an objective evaluation of whether the consideration being offered in the transaction is fair from a financial point of view. At this time, it is currently unclear as to the SEC interpretations between a fairness opinion and valuation opinion. However, it is believed that the fairness opinion represents a stronger and more comprehensive form of opinion, taking into account both sides of the transaction - the value of the assets or securities being exchanged for specified amount and form of consideration.

Fairness opinion providers play a critical role in transactions by conducting a thorough due diligence process and providing an independent assessment of the transaction. This typically involves:

- **Valuation Analysis**: Determining a range of values for the assets being transferred, taking into account factors such as market conditions, comparable transactions, and the underlying performance and prospects of the portfolio companies.
- **Transaction Structure Review**: Evaluating the proposed transaction structure, including the terms and conditions, to ensure that it is fair and reasonable for all parties involved.
- **Conflict of Interest Assessment**: Identifying and assessing any potential conflicts of interest that may exist between the GP and investors, and ensuring that appropriate measures are in place to mitigate these conflicts.
- **Opinion Issuance**: Providing a written opinion stating whether the consideration being offered in the transaction is fair from a financial point of view, based on the analysis conducted.

By engaging an experienced and reputable fairness opinion provider, GPs can demonstrate that they have fulfilled their fiduciary duties and acted in good faith in structuring the transaction. This can help to build trust and confidence among investors, increasing the likelihood of their participation in the new vehicle.

Moreover, fairness opinions can help to mitigate the risk of litigation or regulatory scrutiny by providing an objective and independent assessment of the transaction's fairness. As the private markets industry continues to evolve and mature, the role of fairness opinion providers is likely to become increasingly important in facilitating GP-led secondaries and ensuring that these transactions are conducted in a transparent and equitable manner for all parties, such as safeguarding the interests of LPs.

Marshall & Stevens has been in the valuation business for more than 90 years and has substantial expertise in rendering fairness and solvency opinions on a wide variety of public and private transactions. Employing a high degree of thoroughness and diligence, our professionals bring a wealth of experience from backgrounds in valuation, law, investment banking and accounting.

Conclusion

As the private markets continue to grow and mature, the demand for liquidity solutions and portfolio management tools is likely to increase. GP-led secondaries are well-positioned to meet this demand, offering a powerful tool for GPs to maximize value creation and for LPs to manage their portfolios effectively[5] .

With the involvement of fairness opinion and valuation opinion providers and the ongoing evolution of regulatory frameworks, the GP-led secondary market is poised to become an increasingly important and transparent segment of the broader PE landscape.

Citations:

[1] https://www.jefferies.com/wp-content/uploads/sites/4/2024/01/Jefferies-Global-Secondary-Market-Review-January-2024_1cb2e6.pdf

[2] https://www.apollo.com/content/dam/apolloaem/documents/insights/apollo-global-s3-equity-and-hybrid-solutions-wp-2024.pdf

[3] https://www.blackrock.com/institutions/en-us/literature/market-commentary/blackrock-secondary-market-outlook-1h-2024.pdf

[4] https://pitchbook.com/news/articles/time-for-secondaries-to-take-center-stage

[5] https://www.nb.com/en/global/insights/whitepaper-the-rise-of-gp-led-secondaries

[6] https://russellinvestments.com/nz/blog/private-equity-secondaries-market-benefits

[7] https://www.sec.gov/files/rules/final/2023/ia-6383.pdf

[8] https://www.debevoise.com/insights/publications/2023/09/compliance-dates-for-new-private-fund-adviser

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