GCM GROSVENOR

In-Depth

CAPITALIZING ON THE **GROWING GP-LED SECONDARY MARKET**

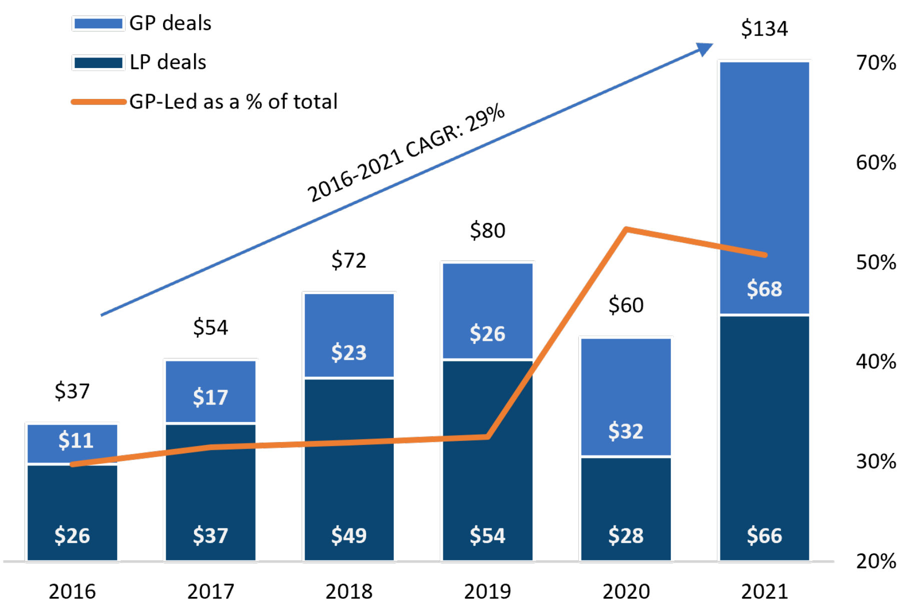
March 2022

There has recently been a sharp rise in the number of GP-led private equity secondary market transactions as investors and sponsors alike recognize the benefits of the approach. We explore the reasons for the increase and highlight some of the advantages presented to secondary investors who pursue GP-led deals. In doing so, we present the key elements for investors to consider to best capitalize on GP-led secondaries.

THE RISE OF GP-LED SECONDARIES

The secondary market for private equity fund interests has regularly evolved, but never more so than over the past five years. Not only has transaction volume more than tripled during this time to $134 billion, there has also been a significant shift in the transaction mix. Once just a small piece of the deal volume and comprised mostly of underperforming funds, GP-led transactions now account for approximately 50% of the overall secondary market volume and include some of the best-performing companies and sponsors.

Transaction volume by year ($ bn)



Volume growth (%)	46%	33%	11%	-25%	123%[1]
LP-Led growth (%)	42%	32%	10%	-48%	136%[1]
GP-Led growth (%)	55%	35%	13%	23%	113%[1]

Data source: Evercore 2021 Survey Results.
1 Represents 2021 volume growth.

As shown above, from 2016 to 2021, the secondary market grew at an approximately 30% CAGR. This growth can be largely explained by the expansion of the GP-led market, which grew at a 50% CAGR over the same period and represents about 60% of the overall growth in the market. What was once considered an alternative for only underperforming funds and companies, the market has morphed into a natural option for many of the most sophisticated and accomplished sponsors. As GP-led transactions became more common, the historical stigma associated with fund restructurings fell away.

The trend of utilizing GP-led deals as a viable liquidity alternative was amplified by the COVID-19 pandemic. Early in the pandemic, sponsors recognized that conditions and valuations weren't optimal for full exits given the uncertainty in the economy. Sponsors were receptive to options that would allow them to provide partial liquidity to investors, while also enabling them to wait for the optimal exit environment. Continuation vehicles seemed to offer the perfect solutions since they allowed investors the option of taking liquidity if they needed it, or retaining their investment if liquidity was not a priority.

During the pandemic, continuation vehicles were successful as sponsors recognized that, in addition to solving liquidity issues for their LPs, continuation vehicles offered sponsors the ability to retain assets under management (AUM). Many realized it is easier to continue to grow a company they know and like than it is to source a new investment at a compelling price in an increasingly competitive environment. As a result, in situations involving a prized asset where the sponsor was confident they could grow the value by another 2x+, they increasingly favored GP-led continuation vehicle solutions over selling the asset to a competitor through a traditional M&A process or taking the company public via an IPO.

During the earlier phases of the pandemic while GP-led deals were thriving, the traditional LP market was faltering. This decline often caused bankers to shift their marketing activities to GP-led transactions. The success getting deals closed in 2020 caused many bankers to devote even more resources to this activity, creating a positive feedback loop between sponsors and bankers. Before long, GP-led deals became something every sponsor was considering. GP-led transactions are now just one of several exit alternatives a sponsor will consider for an investment, along with an IPO, sale to a strategic partner, or sale to another PE sponsor.

TYPES OF GP-LED TRANSACTIONS

GP-led transactions generally fall into three categories: (i) continuation funds; (ii) asset strip sales; and (iii) tender offers. Despite specific nuances, all GP-led deals revolve around the same basic structure in which existing investors are offered liquidity for their interest in a fund and incoming investors obtain a mostly passive interest in a limited partnership. Below we provide an overview of the different types of GP-led deals.

Continuation funds: One or more assets in a legacy fund are transferred to a new fund, typically managed by the same sponsor. The limited partners in the legacy fund are typically given the option to sell their interest or roll their interest into the continuation fund. The new vehicle usually has new fund terms that would include a rest-of-the-fund term and a new incentive structure for the sponsor. Transactions involving a continuation fund tend to be larger in size than a traditional secondary transaction but are often less diversified. In fact, it is not unusual for a continuation fund to hold a single investment.

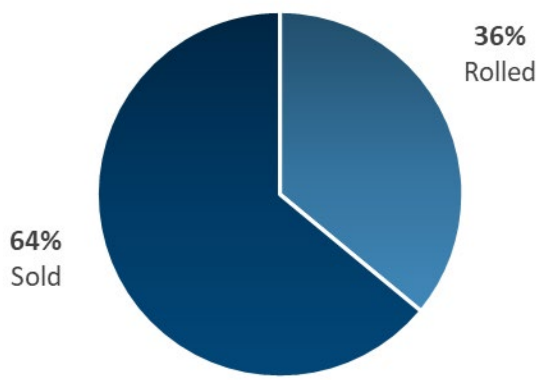
Asset strip sales: These deals involve the sale of a percentage of the fund's portfolio to a new vehicle typically managed by the same sponsor. The new vehicle can be capitalized with additional follow-on commitments. Sponsors can use this type of transaction when they need additional dry powder for the portfolio, as proceeds from the sale can be retained by the fund and reinvested in the portfolio alongside the new fund or distributed to investors. This structure can also be used to accelerate distributions to investors. Unlike continuation fund deals, the decision to sell is typically made by the sponsor, not by individual investors. The legacy sponsor is often responsible for managing and overseeing the acquisition fund.

Tender offers: Here, the sponsor organizes a competitive process to identify a secondary buyer to provide liquidity to all or a portion of the fund's limited partners. Once a potential buyer is selected, limited partners are given an option to cash-out or to remain in the fund. While the sponsor's incentive structure (i.e., management fee and carried interest) are not typically reset in a tender transaction, the fund life may be extended to provide the sponsor more time to monetize the remaining assets. The sponsor often requires the secondary buyer to provide a "stapled" primary commitment to the sponsor's next fund.

In continuation fund situations, existing limited partners have historically elected to sell more often than roll their interest into the new vehicle. The sell decision is typically influenced by the performance of the investment to date – the better the performance the more likely an investor is to sell – and a desire to maintain a regular flow of distributions in-line with their internal cash flow models. LPs rely on these distributions for capital to invest in their pipeline of new primary fund commitments and their models are typically not prepared to extend the duration and/or support these continuation funds.

Interestingly, most investors don't seem to put as much weight on the return projections for the continuation fund, perhaps because they don't feel well-equipped or have the staff to evaluate the likelihood of achieving those projections. Given these factors, we anticipate this trend of existing limited partners electing to sell their interest more often than roll it into the new vehicle to continue in the near term.

Percent of 2021 GP-led transaction volume



Source: Evercore 2021 Survey Results

ADVANTAGES OF GP-LED TRANSACTIONS FOR SECONDARY INVESTORS

GP-led transactions can offer several compelling advantages to secondary investors: (i) access to the best quality assets and sponsors; (ii) unusually strong alignment with the sponsor; (iii) inefficient pricing; (iv) enhanced ability to influence sector exposure; and (v) deep access to due diligence.

Best quality assets and sponsors: As the GP-led market has matured, many sponsors have realized that continuation funds are an efficient way to hold on to trophy assets, retain AUM, and drive continued value creation. Instead of selling a prized investment to a competitor, sponsors are utilizing continuation funds to hold on to these assets longer while executing on the same strategy for the investment that has worked in the past.

Increasingly, many of the best quality sponsors are considering continuation vehicles as one of many exit alternatives for their portfolio companies. According to sell-side advisors, approximately 60% of the top 50 GPs have successfully completed transactions in the secondary market,[1] and we expect this percentage to increase over the next few years. Alongside an increase in sponsor quality, GP-led transactions tend to also involve many of the best quality assets. We believe this is because the secondary market forces the sponsor to make a material commitment to the continuation vehicle that is much larger than they would typically make to a blind pool fund (see "alignment of interest" below). With so much of their net worth at stake, sponsors only typically consider a continuation fund solution for their best quality companies. As a result, continuation funds usually include companies that are market leaders with compelling financial characteristics, multiple growth levers, and exceptional performance under the sponsor's ownership.

Strong alignment of interest with GP (dollars invested or rolled over, plus carry reset on transaction cost basis): For continuation deals, it is common for secondary buyers to require a sponsor to roll-over all or most of their accrued carried interest from the selling fund into the continuation fund. A new incentive structure is then put in place using the cost basis of the secondary transaction as the starting point. In addition to rolled-over carried interest, sponsors may also make large personal commitments into the continuation fund using other sources of funds. Such commitments are often well in excess of the 1%-2% commitment a sponsor would typically make to a newly raised blind pool fund, and it's not unusual to see commitments greater than $100 million. Sponsors may also invest capital out of their latest fund into the deal to further demonstrate their conviction in the asset(s).

Inefficient pricing: Pricing for continuation fund deals is often anchored around the most recently reported NAV since secondary buyers typically do not wish to pay more than NAV. It is not unusual for the reported NAV to be conservative, as sponsors typically value their assets based on the average of trading and precedent comparables, even if the financial profile of the relevant asset(s) would suggest a better-than-average multiple. Further, GP-led deals can take several months, or even several quarters,

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[1] Source: Lazard

to close, but the pricing doesn't often change during this period. As a result, buyers can benefit from pricing off a stale record date and any increase in value or momentum the business may have generated between the reference date and the closing. Finally, since continuation deals are typically large and more concentrated (i.e., too large for a single buyer), they often involve a syndicate of buyers. This creates a dynamic in which investors can participate in the transaction even if they aren't the highest bidder, resulting in muted pricing. Because the sponsor isn't exiting the investment, their new incentive structure is based on the price of the deal, and because they want the new investors to have a good experience in the continuation fund, they may not be incented to maximize value.

Better ability to influence sector exposure: GP-led deals often involve a single company or, even when there is more than one company, the value is concentrated in a single company. As a result, buyers are better able to tactically influence sector exposure in their own funds relative to traditional LP deals that are often diversified across industries and asset quality.

Deeper due diligence access: In GP-led deals there is typically a more transparent and fulsome flow of information about the underlying assets to buyers, compared with traditional LP deals. The process often includes a comprehensive online data room that will include projections, industry reports, quality of earnings reports, among other documents, to ensure buyers and potential sellers have access to the same information. As part of the due diligence process, buyers are provided access to the sponsor as well as the management team of the portfolio company. This contrasts with traditional LP deals where it is unusual for a buyer to get access to any of the aforementioned documents or the management team of the underlying company(s).

CONSIDERATIONS OF GP-LED TRANSACTIONS FOR SECONDARY INVESTORS

While there are many benefits to a GP-Led deal, there are also several factors that secondary investors should consider before investing. These factors include: (i) portfolio concentration; (ii) investment duration; (iii) post acquisition valuation (also known as accounting value), and (iv) conflicts of interest.

Portfolio concentration: Investors should understand that GP-led deals tend to be more concentrated than traditional LP deals and often involve a single company. In fact, single asset continuation funds represent about 50% of total GP-led volume. While individual deals may be concentrated, secondary funds typically manage their exposure to individual companies and sectors by scaling the size of their commitment to a given deal such that their funds remain highly diversified. Because most GP-led deals involve purchasing syndicates, it is relatively easy for buyers to adjust the size of their investment to achieve optimal exposure.

Longer duration: Unlike traditional LP deals, the more concentrated nature of GP-led transactions means there may be more limited interim distributions. In addition, because the sponsor typically resets the investment horizon on the investment, most GP-led deals have a duration of over three years. While the duration of a GP-led deal is longer than a traditional LP secondary, it is typically shorter than that of a co-investment or direct investment. In a co-investment, it typically takes a sponsor a year or more to get familiar with the industry, company, or management team of the new investment and to implement the changes necessary to execute their investment thesis. For continuation funds, the sponsor is already familiar with the asset so there is no disruption to the value-creation momentum.

Smaller accounting discount: GP-led deals are often carried at the secondary buyer's cost for the first few quarters after close. There are some exceptions to this norm, but it is generally easier to book an accounting discount in an LP deal than in a GP-led transaction. However, while buyers may not be able to see an immediate write-up in their investment, they typically acquire these assets at a discount to the value that could be obtained by the sponsor through an organized M&A process. As noted previously, GP-led deals are typically priced around the sponsor's recent carrying value for the investments, and these valuations are often conservative.

Potential conflict of interest: Sponsors may attempt to raise a continuation fund around an under-performing investment to retain AUM, continue to collect fees, or as part of a traditional M&A process. However, these situations are fairly easy for secondary buyers to identify, and the market typically shuns assets and sponsors that aren't high quality or where the GP is not showing strong conviction in the investment by making a substantial commitment alongside the secondary buyers.

GCM GROSVENOR APPROACH TO GP-LED DEALS

We believe it is important to focus on four key elements when evaluating GP-led deals: (i) a strategic edge resulting from platform synergies; (ii) sponsor/company quality; (iii) return profile; and (iv) sponsor alignment and conviction.

At GCM Grosvenor, we favor transactions in which our platform provides a sourcing and intelligence advantage, usually because of an existing relationship with the sponsor, an entry valuation that is a discount to what the underlying asset(s) could command in a traditional M&A sale, and a return profile with right tail skew. Many of the deals to which we are attracted involve oversubscribed syndicates that allow us to leverage our active participation in the primary market or our relationship with the sponsor to secure a favorable allocation to the deal. We look for situations where GCM Grosvenor will be favorably positioned as a lead, co-lead, or syndicate member because of our existing relationship with the sponsor, or because of the sponsor's desire to develop a relationship with GCM Grosvenor in order to diversify and/or grow its future LP base.

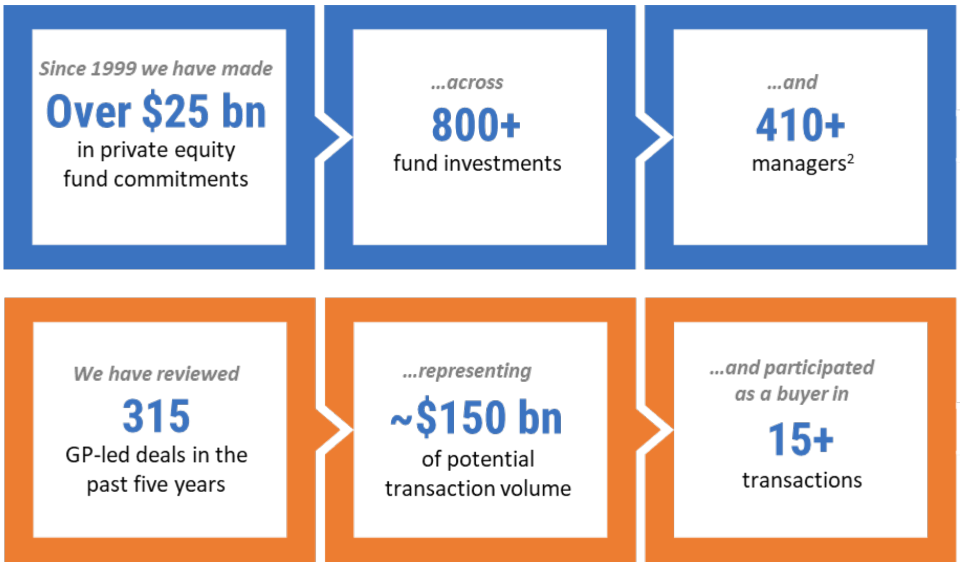
We focus on quality assets and target deals where the underlying business is a market leader with compelling financial characteristics (margins, FCF profile, industry tailwinds, etc.), multiple growth levers to drive value potential at exit, strong performance under the sponsor's ownership to date, and high capital efficiency.

As noted earlier, we believe GP-led deals often have stronger alignment of interest between the sponsor and the secondary investor than traditional LP deals, in which the sponsor and the investor often have a different time horizon and cost basis. Thus, we focus on situations where the manager is not "cashing-out," and will have a material exposure to the continuation vehicle through the investment of new capital or through the roll-over of its position in the legacy fund. We also seek to ensure the go-forward performance incentive is allocated to the appropriate members of the deal team. We give preference to deals in which the sponsor is investing out of their latest fund and pay close attention to whether the management team of the portfolio company is generating liquidity as part of the transaction. We believe deals with strong alignment of interests can provide the best returns for those investing alongside them in these vehicles.

GCM GROSVENOR IS UNIQUELY POSITIONED TO CAPITALIZE ON GP-LED OPPORTUNITIES

We believe we are uniquely positioned to capitalize on the GP-led segment due to our primary investing activities that provide us with early looks at deals, gives us historical perspective on companies and the sponsors, and offers favorable allocations to oversubscribed situations. GCM Grosvenor has unique exposure to, and coverage of, the lower middle market, middle market, and small buyout fund sectors.

GCM Grosvenor experience: by the numbers



Additionally, GCM Grosvenor was an investor with the underlying sponsor in nearly 56% of the deals we sourced in the past five years, giving us an early and differentiated inside view of the opportunities, and a perspective as both a buyer and a potential seller. The limited partners in a fund usually hear about a continuation fund situation well before external investors, and we try to use this early notification to reserve an allocation for our secondary programs. This early registration of interest makes it easier for us to get an allocation to over-subscribed situations that often include particularly attractive pricing and dynamics.

Even in situations where we do not have an existing investment with the sponsor, we are often considered a syndicate member of choice because of our ability, but not obligation, to participate as a primary investor in the sponsor's future funds.

LOOKING AHEAD

The GP-led market has seen tremendous growth in the past five years. Sponsors are increasingly using continuation funds as a mechanism to hold on to their trophy assets while also providing a liquidity option to investors. Given the attractive value proposition, several sponsors have utilized continuation funds as the primary exit path for their portfolio companies. We anticipate this trend will continue and we see buy-side capital as being the main constraint in the market today. As secondary players continue to raise record-level capital, we see a path to the GP-led volume growing another two- or three-fold over the next five years.

[2] Data as of September 30, 2021.

ABOUT GCM GROSVENOR

GCM Grosvenor (Nasdaq: GCMG) is a global alternative asset management solutions provider with approximately $72 billion in assets under management across private equity, infrastructure, real estate, credit, and absolute return investment strategies. The firm has specialized in alternatives for more than 50 years and is dedicated to delivering value for clients by leveraging its cross-asset class and flexible investment platform. GCM Grosvenor's experienced team of approximately 520 professionals serves a global client base of institutional and high net worth investors.

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

Headquarters
Chicago
+1 312 506 6500

New York
+1 646 362 3700

Toronto
+1 647 417 7361

London
+44 (0) 20 3727 4450

Frankfurt
+49 69 5899 6526

Tokyo
+81 3 5573 8110

Hong Kong
+852 3420 1777

Seoul
+82 2 2158 8500

All data as of December 31, 2021 unless otherwise noted.

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