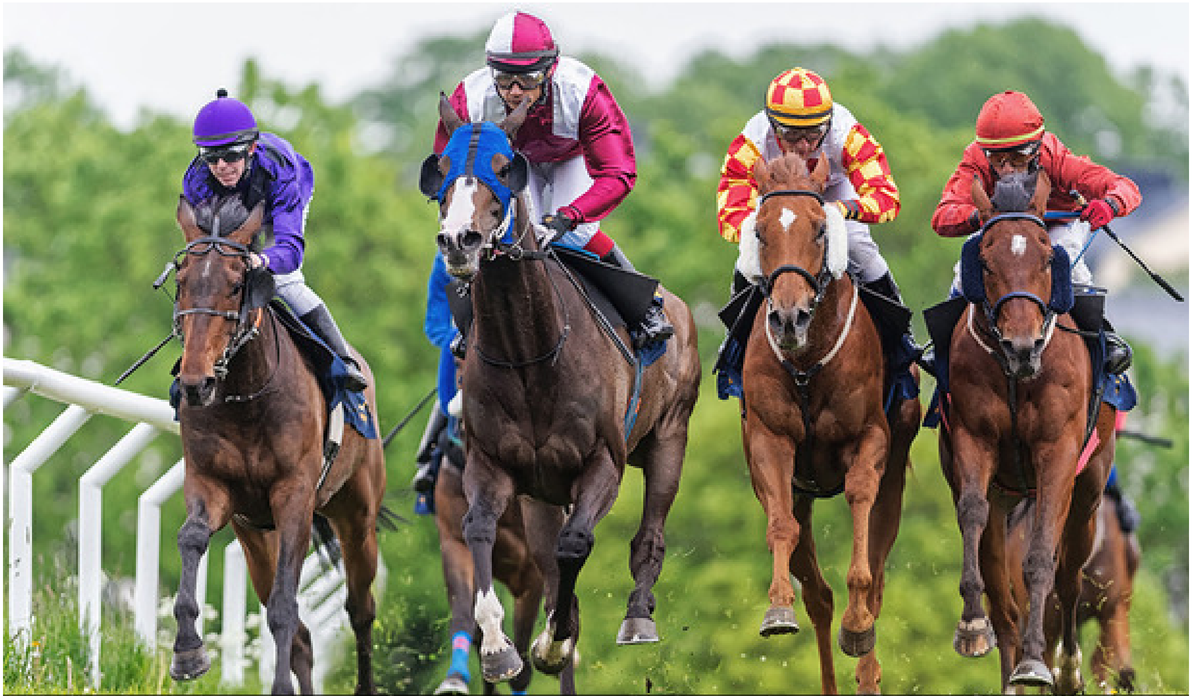
Secondaries sea change: Backing your winners



What was once the preserve of the underperformer is now shifting towards the prized asset

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The secondaries market was traditionally used to find solutions for troubled portfolios, but it is now being used by GPs to continue supporting high-performing assets. Denise Ko Genovese reports

An increasing number of GPs feel confident that the stigma attached to a GP-led secondaries deal has been well and truly shaken off, to the point that they are using the secondaries market to actively support their stellar performers, without the fear of the asset being tarnished in the process.

"In many ways, the LP mindset has evolved faster than that of a GP, with many of them happily endorsing – and in some cases even actively promoting – the use of secondary-market solutions," says Nicolas Lanel of Flow Advisors.

Many GPs will now go beyond the traditional dual track options of IPO and M&A sale, and will routinely ask themselves whether a single asset secondary sale constitutes a viable alternative exit route.

The approach is not necessarily without downsides, of course.

The higher value that one would expect from an IPO/ M&A sale process, due to the higher competitive tension or strategic synergies, is likely to raise questions from existing LPs when it relates to the proposed value of this asset, says Daniel Roddick of Ely Place Partners. But when this route is not possible or does not offer the best value, as long as the LP investor rights are respected and they are given sufficient time and information in a transparent process to take a decision, then LPs have the benefit of a liquidity option in an illiquid holding.

The sea change is all about the type of asset under consideration. What was once the preserve of the underperformer is now shifting towards the prized asset that a GP wants to retain as there are more opportunities for growth on the horizon.

Long haul
Part of this is driven by the significant amounts of capital raised by secondaries funds that needs to be put to work, but there are other reasons, explains Sam Kay, a partner at law firm Travers Smith. Some GPs and investors are prepared to hold assets for longer and there is far more private capital being used to support fast-growing businesses up to and beyond valuations of $1bn. On the flip-side, other investors may be increasingly focused on IRR rather than liability-matching, so are prepared to seek liquidity. These factors all contribute to well-performing assets being part of the package for GP-led restructurings.

"This is a real change, but as an investor you feel confident that the GP wants to continue to support a company, so we are very comfortable with it," says Mireille Klitting, managing partner of Rothschild Merchant Banking's Five Arrows Secondaries Opportunity Fund. "Since the early days, we have been focusing on these direct transactions – in our most recent fund, 90% of the transactions completed have been GP-led."

PAI's secondaries process for **portfolio company Froneri**, whereby the GP transferred the ice cream manufacturer from Fund V into a new vehicle, is an example of a private equity house actively wishing to keep control of a well-performing asset. The group had already identified an opportunity to acquire Nestle's US ice-cream business for $4bn, but with the vehicle in its 12th year, and with limited uncalled capital available, tapping the secondaries market for new cash made sense.

Others cite **Permira's Genesys** as an example of a GP wanting to keep hold of a performing asset. Secondary capital provided by Coller Capital and Neuberger Berman has already been committed to a feeder vehicle to provide liquidity to existing LPs that do not wish to remain in Fund IV for the five-year extension. The US/France headquartered software provider is the largest of the remaining assets – which include eDreams and Asia Broadband Satellite – and also viewed as the most attractive, a source familiar with the situation told *Unquote*. A tender offer is currently out to existing LPs for the remaining assets.

The secondaries market can help GPs that want to ride the upside, and do not want to sell just because the 10-year time frame is up. In some cases a stellar performer is bundled together with less prized assets, to draw in investors, leaving the nuance to pricing and valuation.

"The art is in which assets you put together for sale," says Rothschild's Klitting, "but this has always been the case, and ultimately it comes down to a combination of pricing and an assessment of the risk."

"These deals will almost invariably offer a double layer of protection to LPs in that they can usually vote the transaction down," says Flow Advisors' Lanel, "and if they don't like the price, they can roll into the acquisition vehicle, such that there shouldn't be any forced sellers."

Signalling risk

As well as ensuring against conflicts of interest, there is also the risk that a private equity house could be making a statement about its confidence, or lack of confidence, in the assets it does not retain for longer than the life of the original fund, especially if restructurings become increasingly used to back winners.

"What does it say to the market about something [a GP] is exiting and not following?" says Livingbridge's Susie Stanford, adding that this is possibly a nuance that the market has not fully grasped yet.

With increasingly innovative ways to use secondaries and GPs using the market to back companies at all different stages of performance, there could be the possibility that funds will begin to change the way they exit portfolios, says Travers' Kay. Rather than asset-by-asset realisations – whether trade sales, secondary buyouts or IPOs – the funds may instead do a mix of individual realisations and fund restructures. If the fund restructure involves multiple assets, that will reduce the overall number of M&A transactions in order to dispose of the whole of the fund's portfolio.