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INVESTMENT MANAGEMENT

Re-writing the Playbook on Alignment

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Amid today's environment and ongoing growth in GP-led deals, rolling carry and putting additional capital at risk are no longer enough to guarantee alignment, says Morgan Stanley Investment Management's Nash Waterman

AUTHOR

NASH WATERMAN
Head of Private Equity Secondaries at Morgan Stanley Investment Management

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How is the economic environment impacting sponsor interest in pursuing GP-led secondaries transactions?

There has never been more interest in general partner-led opportunities[1]—so much so that the market today is vastly undercapitalized. The growth in demand has not been met with a commensurate increase in fundraising, and this can be seen in the numbers. The ratio of dry powder to yearly transaction volumes in the secondaries industry continues to be depressed relative to 2020 highs[1] which tells you that there is not enough capital out there to pursue all the available deal flow, which in turn means buyers can be extremely selective. I think there is a sense among GPs that, as other exit routes have become more challenging, GP-leds represent the easy option, but I don't believe that is the case. Supply/demand dynamics mean that only those GP-led secondaries deals involving the best assets are getting done.

Is the economic environment also impacting the ability for GPs and secondaries buyers to come together on price?

Prior to rising interest rates and this more challenging economic environment, deals in the GP-led market typically only took place at par value or above. Now, most deals involve some sort of discount, so I would say that in this segment of the market, more so than in other parts of the asset class, there has been a sufficient adjustment in price expectations to allow buyers and sellers to come to an agreement.

How are secondaries investors responding in terms of underwriting GP-leds? Has the emphasis of your due diligence changed?

The last four years have been extremely volatile to both the upside and the downside, so when it comes to underwriting, it has become more important

[1] Source: Jefferies Group, Global Secondary Market Review, January 2024

than ever to look at historical financial performance for assets in the context of what was going on at that time.[2] For example, Covid-19 was accompanied by a massive increase in liquidity, which in many cases led to unsustainable growth. Many businesses faced a significant retraction in late 2022 and into 2023, which highlighted the importance of scrutinizing historical performance and examining the extent to which it can be replicated going forward.

What do you require from the GP in terms of economic alignment, and what other levers are you able to pull as a secondaries buyer to ensure alignment?

The playbook around alignment has completely changed. Simply rolling carry and putting additional money into transactions are no longer enough to guarantee alignment. Exits have been so limited over the past couple of years, and the pressure put on GPs to generate distributions in order to secure future fundraisings has altered the focus for many GPs when it comes to GP-led secondaries. In many cases, GPs may be willing to put a lot of their own money at risk simply to create the distribution to paid-in capital (DPI) necessary to raise their next fund, which is integral to the ongoing commercial success of their business. Buyers therefore need to dig deep into the real motivation for the GP pursuing the deal and consider it in the context of the fund that the asset currently sits in, as well as the GP's broader organization. Has the sponsor failed to exit any assets from the fund for a significant period? Is the firm's fundraising contingent on this GP-led deal taking place?

These aren't issues that can be resolved through structure—by creating different carry incentives, for example. You need to delve into the underlying motivation to understand what the GP is really trying to accomplish. It is also worth considering that secondaries buyers often put pressure on GPs to bring multi-asset deals to market, because so many secondaries funds have diversification requirements.[3] As a result, these multi-asset deals are often manufactured by GPs by combining one prime asset they really want to sell with other assets in order to create those diversified dynamics. The problem is that these additional companies are rarely as good as the key asset, and buyers end up taking the good with the bad. I think this is something buyers need to be wary of, and I continue to believe the best opportunities involve single assets.

What types of opportunities are you currently favoring in terms of sector and geography?

The US and Western Europe are the best places to invest in GP-led secondaries, having the most dealflow and excellent stability from a geopolitical perspective. I would contrast that to China, in particular, where there has been significant volatility over the past few years and where we see continued and material geopolitical risk. That said, the Japanese, Korean and Australian GP-led markets are growing quickly and offer relative stability. It is important to ensure the underlying asset does not have an extensive global supply chain. That creates too much risk around terrorism and trade wars. I see the best opportunities in buy-and-build plays in the commercial services space. These companies are labor intensive, which means there is potential to positively disrupt with technology. Furthermore, it is difficult to scale these businesses organically. You need to grow through acquisitions, and that plays to private equity's strength in consolidating and integrating companies.

What trends are likely to shape the opportunity set over the coming years?

Technology will continue to create change in both the services and manufacturing spaces. Within manufacturing, in particular, a combination of enhanced robotics lowering labor costs and the desire to bring manufacturing closer to the end customer will present private equity firms with great opportunities to build better and more profitable businesses.

What expertise or skill sets do you believe are required to be successful in this environment?

The GP-led secondaries market requires a skill set that is closer to direct private equity than to the skills required to buy portfolios of LP stakes. For that reason, I believe we will continue to see the need for greater specialization among secondaries buyers. The investment opportunities are very different in nature, and I don't believe it is natural to combine the two, even though that remains prevalent today.

Do you expect to see many new entrants to the GP-led space?

There have been remarkably few new entrants. I believe that is because it is very difficult to raise money in the secondaries market if you don't have a long track record.[4] LPs aren't that interested in backing new groups, which means there is a fantastic opportunity for existing secondaries players to take advantage of this undercapitalized space.

[2] Past performance is not indicative of future results.

[3] Diversification does not eliminate the risk of loss.

[4] Past performance is not indicative of future results.

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