Secondaries and Continuation Fund Market Update[1]

By Laura Whitley and Maria Parker

The "Secondaries and Continuation Fund Market Update" panel covered topics relating to the evolution, current state and outlook of the secondaries market and continuation funds from the perspectives of investment advisers, the LP community, fund counsel and credit providers. The panel discussed four general topics:

1. **Overview of the Secondaries Market**

   a. **Quick Facts about the Current State of the Market**

      i. Reports estimate that total AUM in the secondaries market is over $500 billion.

      ii. 2023 was the biggest year on record for fundraising at a little under $20 billion.

      iii. 2023 was the second highest year on record for deal volume, which was a little over $110 billion (with 2021 being the highest year on record). Out of these deals, a little over 55% were LP-led deals and roughly 45% were GP-led deals.

   b. **Brief Evolution of the Secondaries Market**

      The secondaries market for private equity has been developing for over 30 years. Development was initially slow, but tight liquidity in 2008 resulted in a groundswell of activity. The activity around 2008 was largely driven by investors needing access to liquidity and needing to manage large unfunded commitments. Over the past decade, the LP side of the market has transitioned to a portfolio management tool. Around that same time, GPs started to look at the secondaries market as a way to develop liquidity for their older funds. Coming out of the pandemic, the GP-led secondaries deals became driven by top sponsors that had great successes with portfolios wanting to provide DPI liquidity for investors while also holding onto their top performing portfolio companies.

   c. **Differences between GP-led and LP-led Transactions**

      i. One of the only ways investors are able to get liquidity is if they sell their LP interest to a secondary buyer. An LP-led transaction is between the current investor, the fund and

[1] The panelists were Scott Beckelman, Co-Head of the Private Capital Advisory practice at Jefferies, Will Carpenter, with the Teacher's Retirement System of Texas, Lauren King, Co-Head of the Fund Transactions practice and Finance Partner at Simpson Thacher & Bartlett LLP in New York, Ray Meyer, Co-Head of the Fund Finance, Advisory and Origination at Natixis CIB, and Ram Rao, Managing Director at Macquarie. The panel was moderated by Jinyoung Joo, Finance Partner at Proskauer in New York.

the secondary buyer (who assumes all rights and obligations of the seller) and doesn't typically involve the GP (aside from the GP agreeing to consent to the transfer).

ii. On the GP-led side, the GP is facilitating the transaction. There are a number of types of GP-led transactions, but the panel focused on continuation funds. In continuation funds, the sponsor obtains liquidity for their LPs by taking an interest in an asset (or the entire asset) and selling it to a new vehicle that the same sponsor has formed, which is called a "continuation fund". The continuation fund buys the interest in the relevant portfolio company or companies (depending on whether the transaction involves a single asset or multiple assets) and the capital used to acquire such asset(s) comes from investors who are committing to the continuation fund. These transactions usually involve one or more lead investors. The lead investors set the pricing and negotiate the terms of the transaction. The "syndicate" of investors in such transactions are the other investors that are investing capital into the continuation fund but are not negotiating any specific terms of the transaction.

2. Recap of 2023

a. **In 2023 was there a notable increase or decrease in the use of leverage in the secondaries market (particularly given the high interest rate environment we're currently in)?**

i. Some credit providers forecasted that given the high interest rates, the need for leverage was going to decrease. However, there was consistent deal flow. Some of that is due to structural considerations (e.g., transactions that already had financing in place for deals where funds and/or investors had deferred obligations led to a natural need for refinancing regardless of the interest rates).

ii. More relevant with respect to larger secondary buyers and larger transactions, there were no discernable changes in demand for financing or leverage. There was an increase in the number of deferrals or seller financings being provided on deals in the secondaries market. With respect to pricing, pricing was a bit higher last year than previous years. Another trend that was seen in 2023, was more participation in the market from non-bank lenders (such as insurance companies).

3. Continuation Fund and GP-led transactions

a. How does a financing for a continuation vehicle differ from a traditional fund finance product?

i. There are two major differences between a continuation vehicle and a traditional subscription facility, and the first is concentration. In a continuation fund, there is greater investor concentration and/or asset concentration. The other big difference is blind-pool risk. In a continuation fund, there is no blind-pool risk, the investors know exactly what they're investing in. In terms of pricing between the two vehicles, the pricing in continuation funds tends to be somewhere between a traditional subline deal and a NAV facility.

b. When a GP is structuring a continuation fund transaction, what types of conversations is the GP having with lenders and the lead-investor in the deal?

i. In a typical commingled fund, the limitations on borrowing or credit facilities are addressed in the limited partnership agreement and the investors are not involved in negotiating the terms of the credit facility. In the context of a continuation fund, lead-investors are focused on whether there will be leverage and heavily involved in the negotiation process. Lead investors expect to have consent rights in certain situations and want insight into the terms of any leverage.

c. Has anyone seen any unique or creative structures used by GPs to fund these types of transactions?

i. The deferred purchase price mechanic is becoming very common, although not really creative (the upfront percentage of the purchase price paid at closing and time periods for remaining payments vary). In other words, the lead investor, the syndicate investors and the continuation fund are not funding 100% of the purchase price on day one to close the transaction.

ii. Some continuation funds have borrowed money from the selling fund by having the selling fund drew down on its credit facility, which still had borrowing base capacity, to lend the money to the continuation fund and those funds were used to purchase the asset(s). The interest expense was considered a transaction expense, as without this mechanic, there would not have been a transaction because the lead investors were not willing to fund the purchase upfront.

4. Outlook for 2024

a. Can you give us an outlook for 2024 in the secondaries market space?

i. All of the fundamental basics for increasing volumes of transactions are present: strong need for liquidity, low amount of distributions and a lot of dry powder ($225 billion of dedicated capital that has been raised). Currently, there is a slow exit environment, distribution levels are low and investors want liquidity – these are all "good" things for the secondaries market. All panelists predicted that deal volume was going to be higher in 2024 compared to 2023, noting that some advisors in the space have predicted a 20-25% growth in deal volume.