## Examining the Psyche behind GP-led Secondaries (Continuation Funds)

As part of the fellowship of analysts, allocators, and investors seeking consistent, uncorrelated, and outsized returns, these lines from the band Oasis' 1995 smash hit song "Wonderwall" play over and over in my mind – "All the roads we have to walk are winding, and all the lights that lead us there are blinding". Never have truer words been spoken about any worthwhile pursuit.

Private assets investing sometimes feels like going through the same revolving door, but continuously ending up in a different room. This is to be expected when decoding a gumbo made from a capitalist base, and a vast amount of ingredients that include, extremely talented people, financial engineering, varying degrees of alignment, diverse risk appetites, shades of escapism, agency problems, etc. An investment analyst's brain has to be on an infinite swivel to help evade the downfalls of entering unexpected rooms.

A peculiar room (yes, I know I am taking this analogy too far) that has been in the decoration phase for a few years now but is currently showing its full splendor is "GP-led Secondaries", sometimes also referred to as "Continuation Funds". This investment strategy, which started to gain real recognition during the GFC, involves a general partner ("GP"/fund manager) creating a new vehicle and moving a single investment holding or a select amount of holdings into it as a means of investment life extension. The limited partners ("LPs") of the original fund have the option to liquidate their share of these assets or roll over their value into a new vehicle. Terms such as fees, carried interest ("carry"), fund term length, etc. are usually reset, and the new vehicle is typically able to admit new (investors not part of the original fund) LPs. In these transactions, the GP typically also rolls over its GP interests (including any carry) into the new vehicle as a means of demonstrating alignment and neutralizing any perception of conflicts of interest.

Without rehashing the well-documented and well-publicized general advantages of secondary investing which include strong relative returns (particularly IRRs), limited blind-pool risk, good downside protection, quicker realizations, vintage year backfilling, a prudent private assets starter kit, etc., it is important to underscore the prominent growth of GP-led secondary investments which have taken decent share from their LP-led (transactions where an LP in a fund sells its fund interests to another party) compatriots – *in the first half of 2023, GP-led transactions made up ~42% of the of secondary transactions executed in the market*. The higher interest rates, higher inflation, denominator effect ramifications, reduced exits/realizations, higher investment selectivity by LPs and GPs, etc., that the private assets market is currently experiencing, are all contributing to the increased relevance of GP-led secondary deals. In an environment where realizations (asset sales/distributions) are as scarce as ever, innovative GPs have flocked to GP-led secondaries as a means of appeasing the liquidity needs of their LPs, while also maintaining potential upside.

GP-led transactions/funds typically involve the best assets or the assets with the most growth potential in a portfolio. These deals also tend to be concentrated (involving one or a select few crown jewels), are devoid of the discounts (or the degree of discounts) that LP-led vendors herald, and have the potential for relatively more upside. All these characteristics have aspects that can be debated ad-nauseum, but the one characteristic I want to unpack a little more deliberately is a fast-becoming mainstream sentiment decreeing GP-led secondaries or continuation funds as a bona fide exit method. Historically, most private assets investors (GPs and LPs) have viewed strategic sales, financial sales, and IPOs as the primary avenues for exits, but should GP-led secondaries be added to the list?

Secondaries have been used as liquidity levers for a long time, but LPs (at their discretion) were usually the catalysts or the instigators through LP-led transactions. GP-led transactions, on the other hand, are typically initiated by the GP and although there are a few alignment-minded checks and balances along the way to execution, there is still the potential for seemingly good intentions to lead to a mismatch or blurriness regarding the sought-after end goal.

GP-led transactions sometimes start with the polling of, or voting by LPs to ascertain whether they would be open to the potential of liquidity creation through some sort of continuation fund. However, in most cases, it is clear that the decision to pursue such an option is mainly driven by the GP. It is usually presented as a win-win scenario where LPs that need liquidity can choose to take chips off the table (typically at the most recent NAV), and the LPs that have a longer time horizon can rollover the value of their holdings into a new vehicle where the investment clock is reset. Fund terms and incentives are also reset, and ongoing value-creation goals for the ringfenced asset (or assets) are stated. Assets chosen are usually the most prized, so the likelihood of losses tends to be low. As mentioned earlier, the GP rolls over its LP and GP interests (as well as its potential carry from the liquidation event) into the new vehicle. Capital for the liquidation event is typically provided by a secondary fund that uses its acquired fraction of ownership (as well as additional equity or the right to add more equity) as its commitment to the new vehicle.

I want to emphasize here that secondary funds that provide the capital for GP-led investments should not be villainized. These entities are opportunistically solving a gaping need in the market – GPs want to hold on to the assets that have the most potential and some LPs want liquidity, so the secondary fund swoops in like a superhero that is here to help, but with a clear return threshold as its price. These secondary funds have their LPs with their unique expectations so aggregating a fund made up of a variety of crown jewels from different GPs is a very viable/understandable investment strategy.

Back to the actual transactions – I am not insinuating that anything nefarious is occurring with GP-led transactions. I am just trying to critically think about what this broad acceptance of continuation funds as an exit mechanism does to the psyche of GPs as they are raising funds with a generally accepted relatively concrete timeline of 10 years (plus some potential additional one-year extensions at the discretion of the GP or with LP consent). One could argue that having a strict timeline for GPs to create value implies and underscores discipline to the promise of fund managers to be in and out of deals within a stipulated time. Of course, since no investor has consistently proven clairvoyance, there should always be room for adjustments. However, broad acceptance of a mechanism that allows GPs to take multiple bites of the proverbial apple (in terms of more management fees as well as additional carry) can consciously or subconsciously create undesirable agency problems.

Additionally, many of the GP-led transactions I have come across are not necessarily happening at the tail end (say years 8 – 10) of a fund's life – they are happening a lot earlier than that and are being put forward under the pretext that these deals have a lot of additional potential upside but need more money and time to generate even greater success/returns. To be fair, there are some funds that explicitly state at their inception that they reserve the right to hold companies that end up exhibiting certain characteristics (bond-like, coupon-like, extreme recurring cash generators, etc.) for much longer than a traditional fund term – this is transparent and allows LPs to weigh pros and cons before they commit.

I believe that going forward, thorough LPs and analysts trying to assess how GPs will act in certain scenarios will have to deeply understand managers' mindsets regarding how they intend to treat their best deals. We will need to fully understand the motives behind these types of transactions. Could we see "continuation funds of continuation funds" in the future? When does this stretching of fortunes end? And how does one assess the risk (which exists in every transaction no matter how seemingly safe) of pushing one's fate in a particular asset over and over again? On the winding road with blinding lights that lead to alpha generation, we should all try not to be further burdened with self-inflicted voracity.

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