ADVERTISEMENT

Sponsored

AltamarCAM Partners on evaluating risk in GP-led deals

LPs face new risk management and execution issues as the GP-led secondaries market expands, say AltamarCAM Partners global CEO and managing partner José Luis Molina and partner Derek Snyder.

PEI Staff - 1 March 2022

This article is sponsored by AltamarCAM Partners.

Copyright PEI Media
Not for publication, email or dissemination

What is behind managers' increased uptake of GP-led transactions, and how do you expect the sell-side drivers of these deals to play out in 2022?

Derek Synder

Derek Snyder: Fundamentally these transactions make sense. GPs desire to continue to hold key assets. They also offer an opportunity to reset alignment and to source new capital. Buyers previously were reluctant to provide new unfunded capital, but now nearly every transaction includes new powder. It's often a component of the value proposition. We see no change to manager appetite – these transactions are here to stay.

On the sell side, the attitude of existing investors has evolved. Initially, LPs viewed these transactions as a route to liquidity or to maintain exposure to quality assets. Most deals had a clear status quo option. However, now terms are changing and not every deal offers a true status quo.

These deals also place a significant administrative burden on LPs that used to evaluate only a few liquidity options per year, but now could be reviewing five at a time.

If you throw in limited election periods and complex options and terms on top of that, you can see why this has become an onerous process for LPs. We're seeing more and more existing investors elect to roll, and we expect that to continue.

José Luis Molina: In a trend similar to that of co-investments a decade ago, every LP wants to participate in this market, but few are well equipped to execute. This is more than just an administrative burden because these are complex investment decisions, creating a tension in the mindset of LPs as to whether they can keep pace. The amount of dealflow and opportunity set is asymmetric from a supply-demand dynamic.

What impact has the increased popularity of single-asset deals had on exit timelines and value creation?

DS: Timelines have certainly shifted. There is now a solution available that allows GPs to consider holding an asset for not five, but in some cases seven to 10 years or more. GPs certainly appreciate this optionality.

In some cases we can see how it makes sense. We've watched a lower-market sponsor sell a company to a mid-market sponsor which then flips that same business to a large/mega-cap sponsor all within 10 years, each making an attractive return along the way. Those lower-market sponsors are now questioning the wisdom of selling prized assets to another party – why not just capture all of that value creation in one hold? Previously they were confined by fund terms or the need for liquidity or both. The single-asset solution solves these problems.

However, single-asset deals are not altering value-creation plans. These are good companies with good managers, so the transaction is about providing more runway and capital to execute a plan that's already working.

JLM: Limited partnership structures with five-year average hold periods were the market standard until recently, as that is the period managers typically need to return investor capital. These deals allow for greater optionality. Issues arise for

certain investors, like funds of funds, where fund agreements don't allow them to roll over, so people are thinking about additional flexibility to allow them to continue 'playing the game'.

José Luis Molina

In due diligence, what are secondaries managers looking for in prospective targets?

DS: We consider four elements. The first is the motivation behind the transaction. We don't want to see any incentive imbalance – these deals should be win-win-win. We avoid transactions that appear opportunistic or manufactured.

The second is alignment, where buyers have historically made good progress with GPs. It's rare to see a single-asset deal today without a substantial roll of exposure. We welcome that, but want to see components of alignment beyond just rolling an existing position. The third is quality, in the asset and the manager.

Finally, we must be comfortable with pricing. It's very important as an entry point to see either a discount to net asset value or to our perspective of intrinsic worth. We are less comfortable with pricing of single-asset deals being set by external M&A rounds. Generally, secondaries capital should not be the market topping price.

JLM: An additional point, to be decided early in the process, is whether there is a deal to be done at all. Are we going to put a lot of work in and find there's no deal, as all the existing LPs roll?

Copyright PEI Media
Not for publication, email or dissemination

How can deal-breaking concerns over GP-led transactions be mitigated, for both sponsors and buyers?

DS: Those four elements I mentioned are key, and if they are not present or there are pending concerns, then that cannot be mitigated. Terms are just the guard rails and not a solution to mitigate core risks. Governance rights cannot fully compensate for concerns with a GP.

We view terms negotiations as a helpful signalling exercise to evaluate a GP's viewpoint. If a GP expresses concerns about where to set a carry hurdle, that is very useful information.

For some sponsors, if a buyer needs control rights that can be a dealbreaker. If buyers are reluctant to provide enough follow-on capital to execute a growth plan, that may also cause a GP to rethink plans or to seek another lead buyer.

What are the key risk management considerations around these deals?

DS: The risk considerations are very different from 'plain vanilla' secondary deals at the portfolio level, both in terms of concentration risk and the degree of due diligence available. If you are looking at over 100 assets in a portfolio, timelines typically don't allow for in-depth due diligence.

Unlike with co-investments, there are fewer asymmetries of information in a single-asset secondaries deal, and thus a lower level of risk. There is also an element of risk management at the portfolio level, which determines whether we will be comfortable with the degree of concentration risk.

JLM: We are a conservative house. When you look at our track record, we are proud of our returns but more importantly proud of our loss ratio. We focus our time on what happens if something goes wrong. One of the best means of managing risk is to test your own hypotheses and figure out when you would begin to incur losses.

How is investor sentiment for these deals likely to evolve through 2022?

DS: The first few weeks of 2022 have been extremely active, and we would be surprised if 2022 didn't look a lot like 2021 in terms of total deal volume.

Looking five years out, there is no constraint on the number of opportunities on the GP side – the only constraint is buyer capital. Some of these deals are so large now that they require a massive syndication process.

As we see it, the best deals are going to get snapped up without the need for participation beyond existing LPs. Those with more apparent concerns will probably be syndicated. Those deficient in the diligence elements I mentioned previously will likely die on the vine.

JLM: Returns have been so strong in the secondaries market that no one is questioning the opportunity. We expect this market will grow much faster over the next 10 years than it has over the previous decade, and buy-side fundraising will be chasing to keep up.

ADVERTISEMENT

Copyright PEI Media
Not for publication, email or dissemination