

Fund sponsors are increasingly turning to the secondaries market for liquidity solutions and value enhancement

AUTHORS



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Worldwide, general partners (GPs) of private funds have been increasingly looking to GP-led secondary transactions to provide liquidity solutions and to secure pre-emptive extensions of fund terms to maximize the value of fund assets. We expect this trend to continue to accelerate in light of market disruptions resulting from the COVID-19 pandemic.

Expansion of the GP-led secondary transaction market

The secondaries market began as a tool for limited partners (LPs) to sell their interests in private funds. While traditional sales of LP interests still comprise the majority of the secondaries market, as the market has matured and grown exponentially over the last 20 years, GP-led secondary transactions now make up a significant portion of overall deal volume; GPs are increasingly turning to these arrangements to allow them to continue to manage portfolio companies that have yet to fully realize their investment objectives and to provide liquidity to their LPs. GP-led secondary transactions are no longer associated with GPs of problem funds trying to dispose of undesired assets but are instead viewed as strategies to create liquidity solutions for both GPs and LPs alike with more attractive valuations than traditional dispositions of fund assets.

Types of GP-led secondary transactions

There are several broad categories of GP-led secondary transactions, including:

- **Fund restructurings:** All or part of a fund's assets are transferred to a new vehicle managed by the same GP. LPs are given the opportunity to sell their interest in the existing assets or roll all or part of such interest into the new vehicle.
- **Tender offers:** The GP arranges for a buyer (who could be an existing LP or an affiliate of the GP or otherwise) to make a tender offer to purchase the existing LP interests in the fund.
- **Stapled secondaries:** In connection with a fund restructuring or a tender offer, there is a secondary element, being the sale of an LP's existing interest in a fund, combined with, or "stapled" to, a primary element, being such LP's commitment to subscribe for interests in a new fund raised by the same GP.
- **Direct secondaries:** All or part of a fund's interests in its underlying assets (i.e., the portfolio companies, as opposed to interests in the fund itself) are sold to a buyer directly and the buyer will either manage the investments itself or arrange for a new investment manager.

Benefits of GP-led secondary transactions for GPs

GP-led secondary transactions have several benefits to GPs, including:

- **Easing timeline constraints:** Allowing GPs to continue to manage and realize the future upside from assets that have not fully matured as of the end of a fund's pre-defined term.
- **Increasing liquidity options:** Allowing GPs to offer liquidity to their LPs at a given point in time, in some cases allowing such LPs to use that liquidity to invest in other funds offered by the GP.
- **Triggering compensation:** Resetting the fund economics, crystalizing carry and re-incentivizing GP personnel.
- **Enhancing asset value:** Offering an alternative to distributing assets to LPs in-kind or selling them at a suboptimal value due to depressed market conditions or other factors.
- **Improving optionality:** Being flexible transactions that can be tailored to meet the specific needs of a GP and the LPs.

Structuring considerations for GPs

There are various matters for GPs to consider when structuring a GP-led secondary transaction; and we have suggested a handful of such considerations below.

- **Conflicts:** Be conscious of conflicts of interest that can arise in GP-led secondary transactions and carefully manage those conflicts to ensure LPs trust the process and to avoid regulatory scrutiny.
- **Timing:** GP-led secondary transactions can be complex, so LPs should be given sufficient time to make an informed decision.
- **Transaction price:** Legitimize the transaction price for LPs and regulators by having a price either negotiated with an arm's-length third-party with full access to information or supported by a third-party independent valuation.
- **Disclosure:** To get LP buy-in, provide LPs with robust disclosure, including the rationale for the transaction, how conflicts are managed and details on transaction terms. Keep the limited partner advisory committee fully informed from the onset of the process.
- **Advisors:** Engage the right advisors. Experienced secondaries agents can smooth the entire GP-led process. Legal and tax advisors can ensure the transaction is structured efficiently and surface potential issues before they become a problem.

Market outlook, including impact of COVID-19

At the onset of the COVID-19 pandemic, the secondary market experienced a slowdown as many secondary deal processes were paused and LPs were hesitant to sell their interests in the secondary market given the economic uncertainty and the unknown effects on the value of their fund interests. We believe this slowdown will be short-lived, however. Through 2020, we have found that secondaries funds have continued their robust fundraising efforts, and considering secondaries funds typically have shorter investment periods, we expect continued activity in the GP-led secondaries market as these funds look to deploy their abundant dry powder. We also expect GPs to increasingly look to GP-led secondary transactions as an alternative to M&A exits in a market depressed due to the COVID-19 pandemic. Finally, we anticipate a continuation of the desire for more bespoke structuring solutions, which could involve greater complexity in the transaction's legal documents.

What you need to know

- GPs of private funds have been increasingly looking to GP-led secondary transactions to provide liquidity solutions and to secure pre-emptive extensions of fund terms to maximize the value of fund assets.
- There are several broad categories of GP-led secondary transactions, including fund restructurings, tender offers, stapled secondaries and direct secondaries.
- GP-led secondary transactions have several benefits to GPs, such as easing timeline constraints, increasing liquidity options, triggering compensation, enhancing asset value and improving optionality.
- There are various matters for GPs to consider when structuring a GP-led secondary transaction, for example conflicts, timing, transaction price, disclosure to limited partners and use of advisors.
- Despite an initial slowdown at the onset of the COVID-19 pandemic, secondaries funds are continuing their robust fundraising efforts and we expect continued activity as GPs look to deploy dry powder and for alternatives to M&A exits.

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