KEYNOTE INTERVIEW

The future belongs to specialists

As GP-led secondaries continue to grow in popularity, TPG's Michael Woolhouse and Matt Jones argue that these are a distinct discipline from their LP counterparts, requiring specialization to flourish

In a way, specialization is always part of the investment process. That said, the need for specialization intensifies as an asset class matures, new and distinct market segments emerge and competition rises for capital and deals. From a bird's eye view, the sustained growth of secondaries would certainly argue it's time for managers to narrow their focus.

A closer look reveals the unique nature of secondaries and how their maturity has bifurcated into two separate disciplines: one, the classic LP secondaries that often involve dozens or more stakes in multiple funds, and two, GP-led secondaries that often focus on a single asset or more selective portfolio. In the case of the latter, specialization is a necessity, according to Michael Woolhouse and Matt Jones, co-managing partners of TPG GP Solutions, the firm's North American and European-focused secondaries business.

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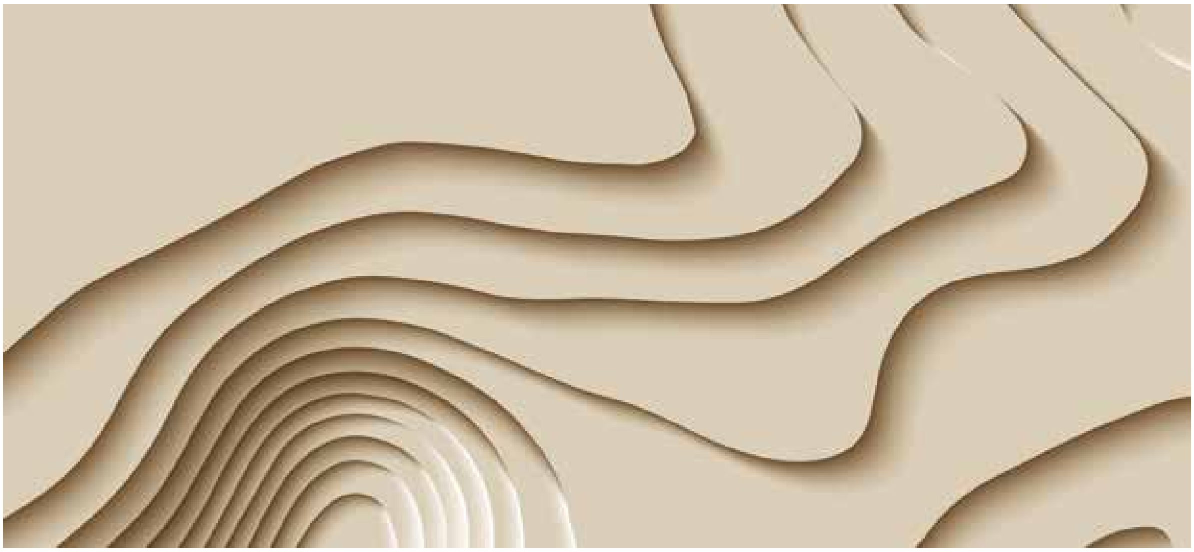
Q Let's start with how we reached this point, with regards to GP-led secondaries.

What drove the incredible growth in that segment of the market of late?

Michael Woolhouse: Ten years ago, the GP-led secondaries segment of the market barely existed. Now, it represents nearly half of all secondaries activity. What drove all that growth? Innovation. And in turn, that innovation drove adoption among sponsors by adding value. They added value by providing a new tool for sponsors to manage their portfolios and deliver liquidity to their investors.

While the origins of the GP-led market were in restructuring troubled



Q The attraction may be there, but what are the core challenges in launching and thriving as a fund dedicated to GP-led secondaries? What does the market look like in the next few years?

MJ: We believe the GP-led market will become much more direct in nature. We are already seeing this with advisers needing M&A sector teams to win mandates on GP-led deals. If GPs require their advisers to have sector expertise when advising on these deals, it's a small step before LPs start to demand the same of their GP-led secondaries managers. Ultimately, if someone is putting $200 million into a single company, who do you want to make that decision? Do you want a generalist secondaries player with no history of direct investing, or a firm that has deep sector expertise, a history of buying individual assets and the proven ability to underwrite?

The opportunity for GP-led specialists is to combine the experience that resides in the secondaries market with the experience in the private equity market. What does this mean? It means thematic sourcing in sectors where experience has been built up over decades. Knowing what really matters to focus on during diligence to make well-informed underwriting decisions and using that expertise to value businesses. This kind of experience is not easily acquired but will be critical for long-term success in this market.

MW: The market craves additional GP-led specialists to lead transactions and help the market continue to grow. A successful GP-led deal requires three key elements – first, a sponsor needs to agree on the price, terms and structure with the lead secondaries buyer; second, the sponsor then needs to secure support from their LPs; and third, additional capital is often required beyond what a single lead buyer can provide. In larger transactions, the sponsor and their adviser need to raise additional capital from other secondaries buyers and LPs.

A successful transaction requires all parties to view the lead buyer as both capable and credible. We believe secondaries groups that marry the skill set of buying single companies with expertise in the secondaries market will be viewed as the best of breed. That is the argument for a specialist fund dedicated to GP-led secondaries transactions.

funds for sponsors who were struggling to raise new funds, the opportunity set has significantly shifted. Today, the GP-led market is dominated by single company deals, featuring a sponsor's "trophy assets" where the existing investors are given an option to realize an attractive return and the sponsor can continue to own the asset

$500bn

TPG expects the GP-led market to reach as much as $500bn in annual deal volume over the next 10 years

for a second round of value creation. If the deals of the past were done out of necessity, today they're transactions of choice.

That's what I mean by innovation: a fundamental change in the nature of the underlying investment and the solution that it's providing to sponsors. That is what has driven the growth. We believe we're only in the early innings of the growth in this market.

Matt Jones: Single asset transactions have only existed in their current form for the last five years or so. In fact, if you were to go back five years and ask a few of the leading secondaries players about single asset transactions, several would have argued they shouldn't be done, and that they shouldn't even be considered secondaries at all.

Today, those very same groups are doing these deals because everyone can see they are attractive due to the quality of the assets, the strong alignment between buyers and the PE sponsor, and the potential for strong returns. However, those groups haven't made corresponding changes to their investment teams or capabilities. If you look at the evolution of the marketplace, the LP secondaries market and the GP-led market are now fundamentally different. A typical LP deal may involve putting $200 million into an LP transaction that has, let's say, 20 fund positions and 300 underlying companies. That is a very different investment skill compared to investing $200 million into one company.

Almost all the secondaries firms in the marketplace developed their expertise and track records investing in LP secondaries transactions, not buying single assets. Both segments share some of the same characteristics. They both benefit from market volatility. In both, you are buying into mature, established assets. Beyond that, they're different disciplines.

I think investors are starting to realize that there is a benefit to having specialization. The LP secondaries market provides broad coverage of the private equity market, a private market index or beta. The GP-led market offers an alpha strategy of much more concentrated portfolios of individual companies.

Q So what's the competitive landscape for these GP-led transactions today?

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MICHAEL WOOLHOUSE

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MATT JONES

MW: While the underlying investment opportunities have changed as GP-led transactions have taken increasing share, the overall buyer landscape of the secondaries market has not. The largest secondaries groups in the space 10 years ago are still the largest groups today. That is despite the fact that the skill set required to buy an LP portfolio is not the same skill set required for underwriting a single asset in a GP-led transaction.

And if you drill down a little farther, the GP-led segment is short of capital and capacity. There may be only six months of dry powder and only a handful of groups comfortable underwriting $200 million into a single company. As one secondaries adviser recently told us, there are simply not enough lead buyers to address the potential supply of dealflow available.

These dynamics are attracting more specialist capital into the space, where groups are built from the ground up specifically to do this style of secondaries. Over time, these specialists will help the market realize its full potential.

Q How large do you think the GP-led market could become in the next five, 10 years?

MJ: We believe the growth of the GP-led market is only just getting started and, in fact, is poised to accelerate due to continued expansion of the overall private equity market and an expected increase in the penetration of GP-led deals. We see it reaching as much as $500 billion in annual deal volume over the next 10 years, which is approximately eight times the size of the current market.

MW: The rise of GP-led specialists will be critical in enabling and realizing this potential. We believe GP-led specialists will be sought-after lead buyers by sponsors for single asset continuation vehicles due to the credibility they have with LPs and other capital providers to successfully execute these deals.