BEST PRACTICES: MANAGING LIQUIDITY THROUGH GENERAL PARTNER-LED SECONDARIES (PART II)

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ARTICLE SUMMARY

- The venture capital ecosystem continues to evolve, and offering Limited Partners ("LP's") proactive liquidity solutions is becoming a cornerstone of prudent fund management
- Sophisticated General Partners ("GP's"), both established and emerging, will need to strategically implement secondaries in their portfolios
- There is no "one-size-fits-all" approach for a GP-led transaction, but multiple levers can be employed to create bespoke approaches tailored to a fund's circumstances
- These best practices aim to serve as a companion framework for internal assessment by GPs, enabling more effective and efficient secondary transactions

Drought Brings Liquidity Into Focus

The IPO and M&A liquidity drought commencing in 2022 has increased the focus in GP-led secondaries over the past two years. While these transactions have been growing popularity for over a decade, they are now recognized as a critical long-term liquidity solution. In our previous article, we explored the foundational aspects of GP-led secondaries and an architectural overview of a subset like continuation funds and strip sales. We encourage you to read that initial primer focused on the "what" and "why"—while this follow-up delves into the "how", offering actionable insights and best practices for implementation.

Substantial capital has poured into the venture ecosystem over the past decade, lengthening the path to exit and increasing competition for liquidity:[1]

- **$1.7 trillion** into venture-backed companies from 2013 to 2023
- **$903 billion** made in venture capital fund commitments
- **$300 - 600 million+** in revenue required for IPO eligibility, with $100 million considered subscale
- Nearly **150 publicly traded SaaS companies** and 750+ tech companies—must be special!

Despite improved sentiment and potential regulatory changes under the new U.S. administration, even well-established businesses with unique offerings face exit challenges. M&A activity has been subdued in recent years, potentially recoverable through lower interest rates and shifts in antitrust policies. Nonetheless, even megacap businesses can consolidate only so much innovation. Public market investors are also grappling with a backlog of IPOs, which limits their capacity to absorb new entrants.

Lastly, large private tech companies such as Stripe, SpaceX, ByteDance, Canva, and OpenAI have found private markets favorable, often delaying or foregoing public listings. These firms regularly engage in private

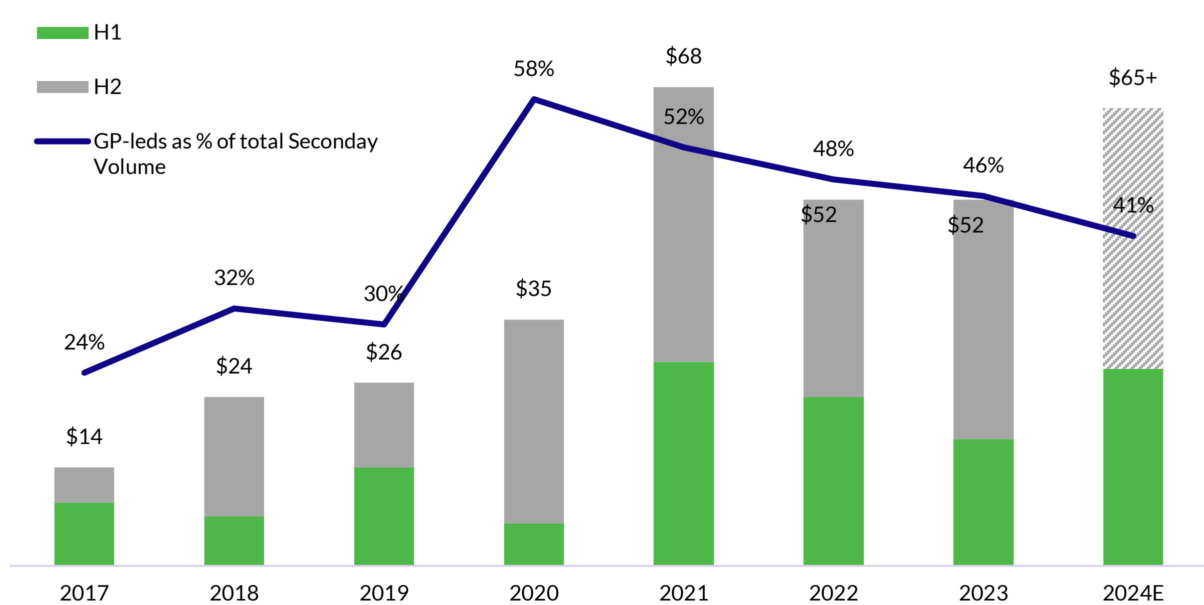
[1] Source for investment and fundraising aggregate data: Q2 2024 Pitchbook – NVCA Venture Monitor

tender offerings to manage stock options and support long-term shareholders. It is likely that a significant portion of the venture market will remain private, relying increasingly on sponsor-to-sponsor secondary transactions, similar to trends in traditional private equity. Illiquidity is begging the question today, but secondaries represent a long-term answer.

The State of the GP-Led Market

GP-led secondary transactions, which first gained traction in traditional buyout funds, have become increasingly prevalent across the private equity landscape. In 2024, GP-led transactions are expected to account for 41% of the projected $140 billion in secondary transaction volume, a sharp rise from 24% in 2017.[2] While most of these transactions occur within larger buyout funds, smaller tech buyout and venture fund managers are now utilizing them as well.

Figure 1. GP-Led Annual Transaction Volume ($B)

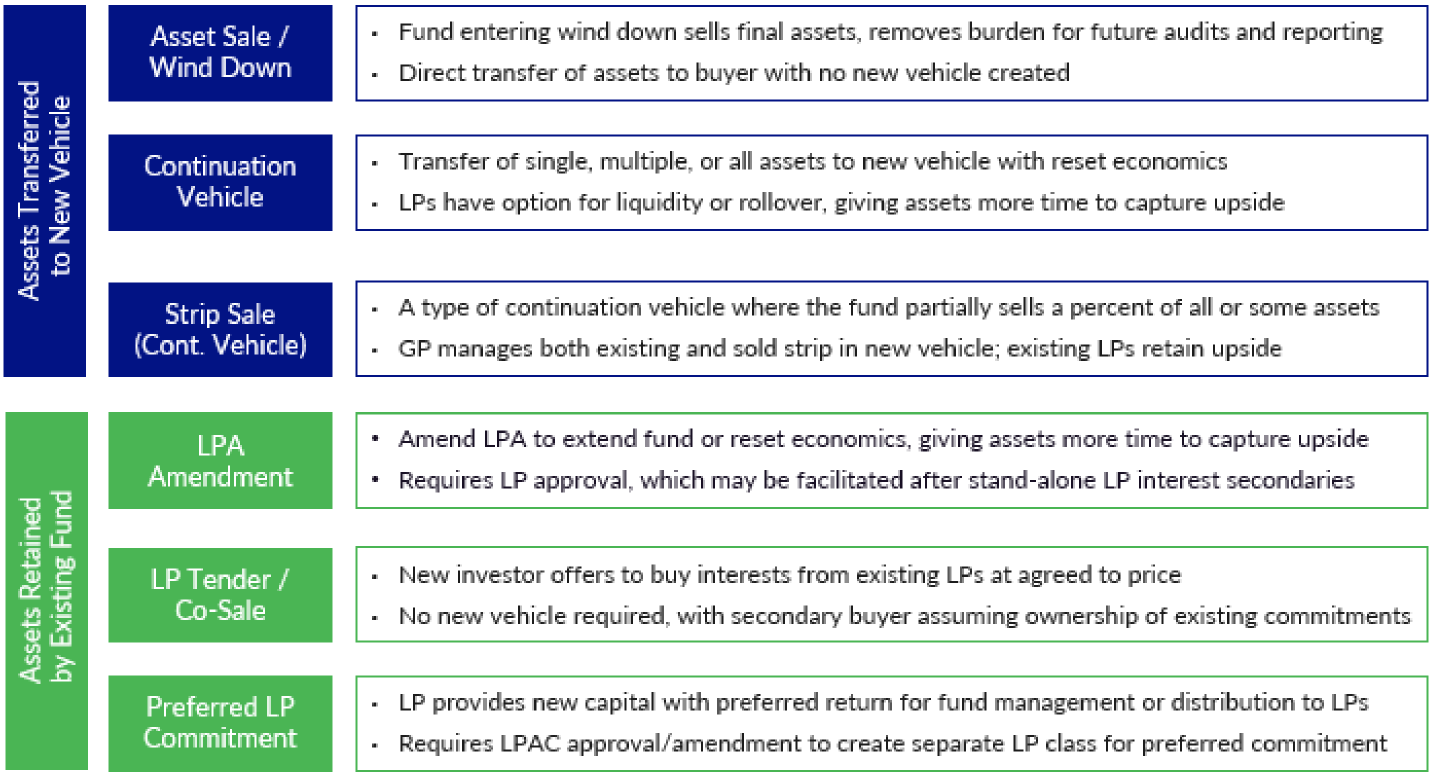


Source: Jefferies H1 2024 Global Secondary Market Review

With GP-led transactions, GPs can explore various structures, each with numerous permutations. Industry Ventures, a pioneer in the venture secondary market, has been involved in over a dozen transaction types. Below is an overview of the most common GP-led deal profiles, serving as a [foundation for internal assessment](). Ultimately, the most effective approach will depend on the specific circumstances and goals of the GP.

[2]Jefferies H1 2024 Global Secondary Market Review, *July 2024,* https://www.jefferies.com/wp-content/uploads/sites/4/2024/07/Jefferies-Global-Secondary-Market-Review-July-2024.pdf

Figure 2. GP-Led Transaction Types



Source: Industry Ventures proprietary insights, as of November 2024

In 2024 there have been several high-profile GP-led transactions in the venture capital and growth equity space, which have utilized a variety of the transaction types highlighted in ***Figure 2***. While most GP-led liquidity investments go unreported, some recent high-profile transactions have garnered attention. According to several news sources, these include deals led by Insight Partners, New Enterprise Associates, Lightspeed Venture Partners, General Catalyst, and Shasta Ventures.[3,4,5,6,7] While these GPs

[3] “Insight Partners Announces Closing of Continuation Fund III with HarbourVest Partners as Lead Investor”, *PRNewswire*, October 2024, https://www.prnewswire.com/news-releases/insight-partners-announces-closing-of-continuation-fund-iii-with-harbourvest-partners-as-lead-investor-302275714.html

[4] “Goldman-Led Group Backs Databricks, Plaid Through NEA Vehicle.” *Bloomberg, 15 July 2024, https://www.bloomberg.com/news/articles/2024-07-15/goldman-led-group-backs-databricks-plaid-through-nea-vehicle*.

[5] “Continuation Fund Developments.” *Financial Times*, 25 January 2024, https://www.ft.com/content/18430e05-33c0-4f48-8c87-fae74ff29bbf.

[6] “General Catalyst Is Working on a Continuation Fund Worth Up to $1B, Sources Say.” *TechCrunch*, 7 October 2024, https://techcrunch.com/2024/10/07/general-catalyst-is-working-on-a-continuation-fund-worth-up-to-1b-sources-say/.

[7] “Shasta Ventures Fails to Secure LPs’ Approval for Continuation Fund Deal with StepStone.” *SecondaryLink*, *24 April*

primarily executed continuation or consolidation funds (combining assets from multiple older funds into a single, newly-formed entity) the specifics of their liquidity solutions varied widely.

Initial Considerations for GP-Led Transactions

GPs often have concerns about pricing, structuring, and execution, compounded by potential conflicts of interest. These transactions can be controversial among LPs, emphasizing the need for transparency, fairness, and clear communication. By involving LPACs, providing adequate disclosures, and engaging all stakeholders, GPs can enhance investor relations, improve DPI for older funds, and attract new LP partnerships.

GP-led transactions typically take three to nine months and require clear objectives from both GPs and LPs. The timeline and goals can vary depending on factors such as a fund's history, LP composition, or turnover among GP members. Additional considerations may arise based on whether the manager is emerging or established, as well as whether the GP is actively fundraising. Deal sizes can also vary significantly, underscoring the importance of selecting the right partner. In 2024, multiple GP-led secondaries have exceeded $1 billion among venture capital managers alone, excluding even larger transactions in growth equity and buyouts.[8] At the other end of the spectrum, smaller tail-end funds have closed deals ranging from $10 million to $50 million.

One critical factor early in a GP-led transaction is determining whether the proposed structure might trigger the need to register as a Registered Investment Advisor (RIA). Many venture firms operate under the [Venture Capital Adviser Exemption], which allows them to avoid the costs and compliance obligations associated with SEC registration. If a GP is not already an RIA, they should assess whether registration is worthwhile or explore alternative ways to achieve their transaction goals. While this article does not delve into legal specifics, a transaction involving the transfer of assets to a vehicle managed by the GP could be classified as a secondary transaction. If more than 20% of the new fund's committed capital is allocated to non-qualifying investments, the GP would likely need to register as an RIA. In such cases, the GP might consider alternatives to traditional continuation funds, such as an LP tender.

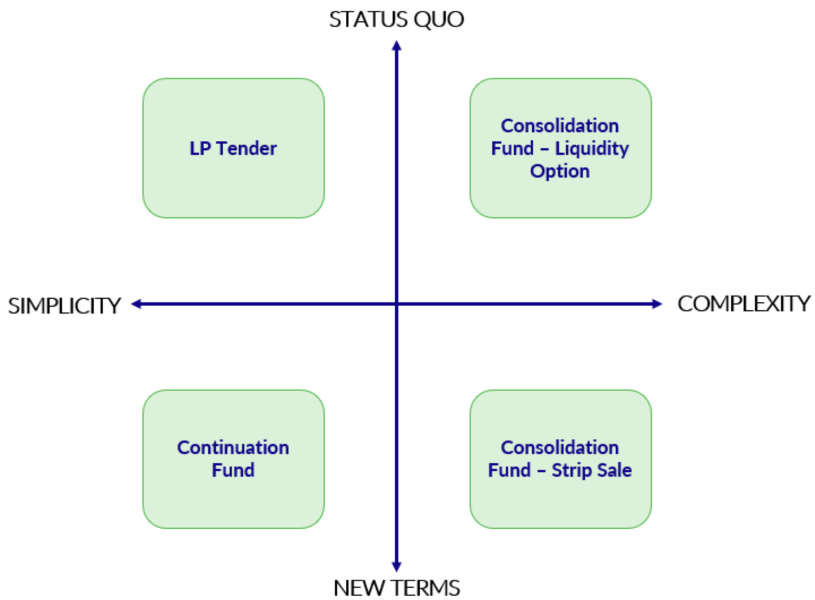
A Framework for Implementation

To guide GP-led execution, it can be helpful to map transaction goals along two axes: complexity (X-axis) and impact on GP/LP economics (Y-axis). This framework helps identify solutions ranging from simple LP tenders to more complex consolidation funds. Below are examples illustrating these approaches.

2024 https://secondarylink.com/seclink/news/66292383e866e57c95eb42f3/shasta-ventures-fails-to-secure-lps-approval-for-continuation-fund-deal-with-stepstone.

[8] "Single-Asset Continuation Funds Surge in 2023." Transacted.io, https://transacted.io/single-asset-continuation-funds-surge-in-202/. Accessed 21 Nov. 2024.

Figure 3. GP-Led Implementation with Example Transactions



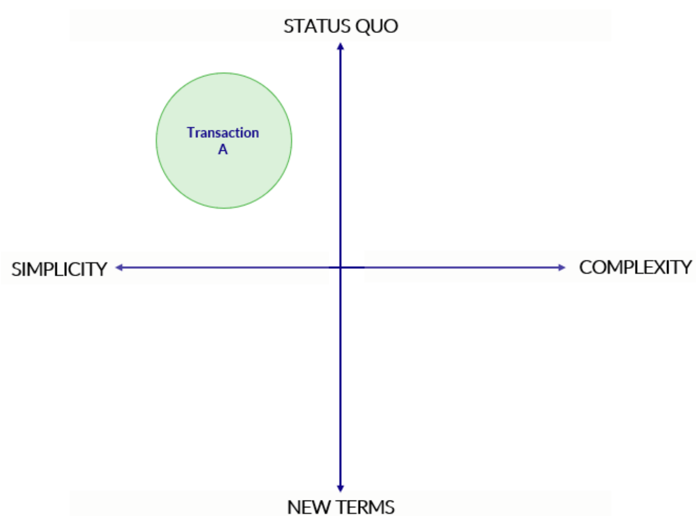
To put some meat on the bones of this framework, we will walk through four illustrative examples that reflect each quadrant. These examples are rooted in real market transactions which occurred over the last two years, though details may be adjusted for educational purposes of this article. Of course, a comprehensive review must include consultation with accounting, tax, valuation, and legal counsel before embarking upon a transaction of this nature.

Simple Execution, Status Quo Maintained

Example Transaction A (LP Tender)

A secondary buyer offered to purchase LP interests at a price agreed upon by the buyer and the GP.

- Assets do not change title/fund
- Can allow LP election of cash or waiver
- LPs do not receive new cap account reporting
- Status Quo: no changes to fee or carry
- No change to track record
- No GP carried interest crystallization
- Can create new LP series if new terms needed
- New LP composition could improve voting

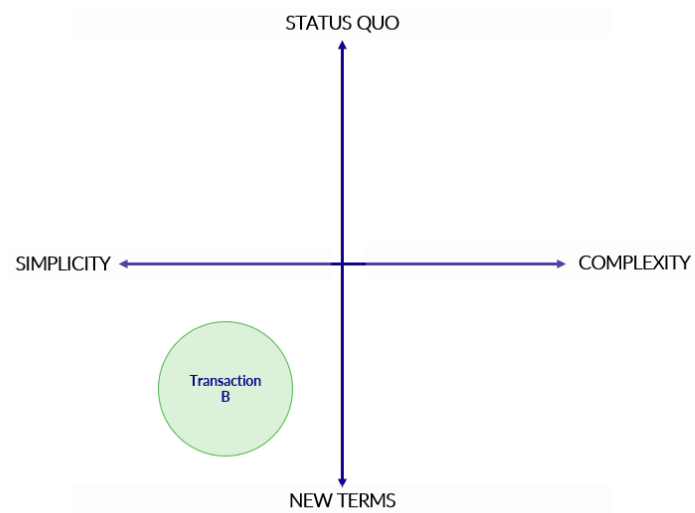


Simple Execution, New Terms Established

Example Transaction B (Continuation Fund)

Tail-end fund with remaining assets that needed time to achieve full upside potential, but had LPs seeking near-term liquidity. RIA status required.

- Move assets from old fund into new vehicle
- Run a quicker process with short list of bids
- No LP rollover option: proceeds distributed
- Set fee/carry for all LPs buying in new fund
- Enables wind down of the existing fund/LPs
- Forge relationships with LPs in new vehicle
- Locks in the track record of the existing fund
- GP carried interest crystallized in old fund

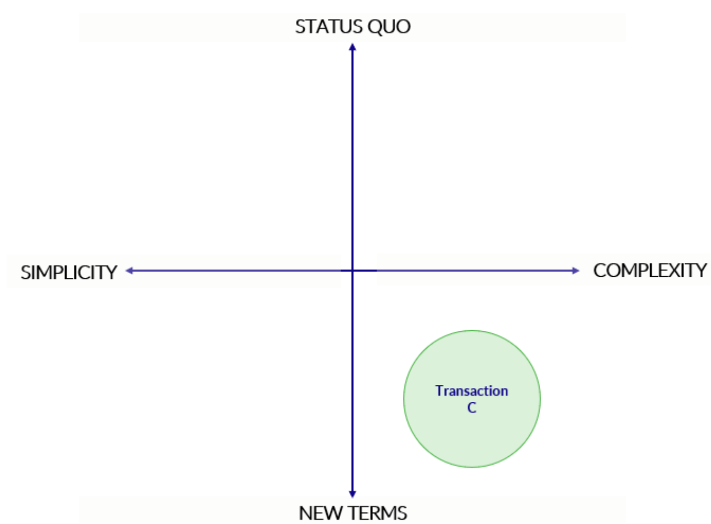


Complex Execution, New Terms Established

Example Transaction C (Consolidation Fund – Strip Sale)

A GP wanted to generate liquidity across multiple older vintages, each of which had remaining assets with continued upside potential. RIA status required.

- Default LP option is to receive cash proceeds
- LPs cannot rollover: must invest in new vehicle
- GP rolls old, crystallized carry as GP commit
- Management fee for new LPs in new fund
- Re-investing LPs do not pay fees in new fund
- New GP carry set in new fund for all LPs
- New investment vehicle created for strip of assets
- Requires robust back-office and accounting team

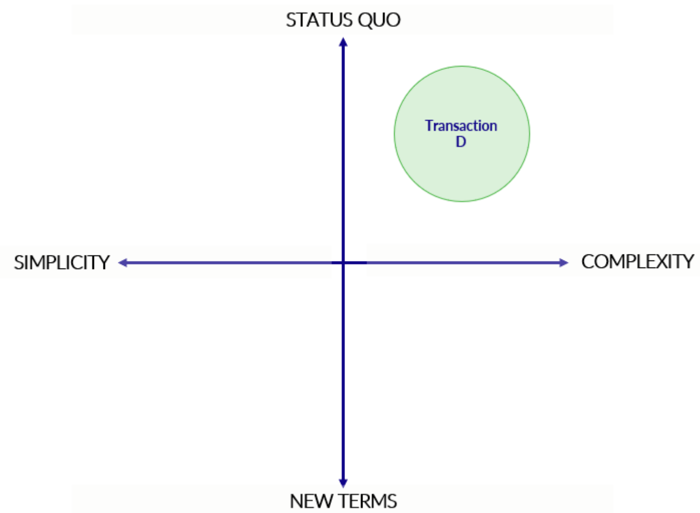


Complex Execution, Status Quo Maintained

Example Transaction D (Consolidation Fund Liquidity Option)

A different approach to a similar situation to the above, with a more accommodating liquidity option for existing LPs. RIA status required.

- LP-friendly liquidity option
- No double-dipping on additional economics
- No management fee helps buyer improve pricing
- New LPs may insist on new GP carry for alignment
- GP may rebate portion of carry to original fund(s)
- No rollover needed if LPs opt out of cash proceeds
- Holding interests drop into a new sub-entity
- Requires robust back-office & accounting team



Self-Assessment for Implementation

A thorough self-assessment is crucial to ensure a potential transaction aligns with the GP's objectives, addresses LP needs, and considers the specific circumstances of the fund(s). With the illustrative examples outlined earlier highlighting key considerations, GPs can now evaluate their goals and determine the essential attributes to include in their GP-led transaction. The following assessment framework, informed by ***Figure 2*** and the four examples, guides GPs through the process by examining key factors such as pricing, rollover elections, portfolio selection, and economics.

PRICING CONSIDERATIONS:

- Buyers focus not just on today's fair market value (FMV) but also on where they can underwrite a return.
- **Is the deal substantial enough to involve a banker?** As the market matures, more investment banks are specializing in secondary transactions. Some banks may require a purchase price of $100M+ to engage, though others may be more flexible.
- **Are there 3–5+ buyers interested in participating?** Directly engaging with buyers or soliciting multiple bids through an intermediary can help ensure LPs receive a fair market price.
- **Would hiring a third-party valuation agent add value?** In some scenarios, an independent valuation can supplement and validate the pricing process.

ROLLOVER ELECTIONS:

- **Will LPs be required to take liquidity, or can they roll into the new vehicle?** Providing a rollover option adds flexibility and may align better with LP preferences.
- **If a roll option is offered, how will fees be structured?** Will existing LPs maintain status quo provisions to avoid new fees, or will all LPs in the new vehicle pay the same economics?
- **Can LPs opt to do nothing, or is a partial sale sufficient?** Allowing LPs to retain upside in the existing fund often requires a significant back-office and legal effort.

PORTFOLIO SELECTION:

- **Is the portfolio still compounding value, or is the timing unfavorable for an exit?** The decision to pursue a transaction should align with the growth trajectory of the portfolio.
- **Does the portfolio include near-term exits that could attract buyers?** A blend of mature assets nearing liquidity and earlier-stage assets with upside potential often creates a compelling proposition.
- **Does the portfolio balance high-quality assets with other components?** Successful multi-asset GP-led transactions typically include a mix of asset qualities. A significant portion of FMV should be in "A" quality assets to attract buyers, while "B," "C," and "D" quality assets provide diversification.

GP AND LP ECONOMICS:

- **Will the new vehicle incur ongoing fees?** Secondary buyers often account for future fees by reducing purchase prices. Continuation funds should focus on aligning portfolio companies and fund timelines for exit, rather than serving as a revenue source for GPs.
- **Will the new vehicle include carry?** Carry aligns GPs with new investors but can reduce purchase price, creating potential tension. Existing LPs may resist paying double carry, having already borne prior costs. Tiered carry structures can help mitigate such concerns.
- **Will new primary capital be raised alongside the secondary transaction?** Raising new primary capital can support portfolio reserves and strengthen LP relationships, adding strategic flexibility.

CONCLUSION

The evolving venture capital landscape underscores the growing importance of GP-led secondary transactions as a prudent liquidity management strategy. Given there is no universal approach, each manager must explore the various levers available to create tailored solutions. By adhering to best practices, GPs can balance the diverse demands of stakeholders, positioning their portfolios for long-term success.
