Articles + Publications | September 2026

Keeping Up The Pace

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This article originally appeared in the September 2026 Private Equity International Secondaries report and is reposted with permission.

Consistently high secondaries transaction volumes are being driven by enduring macro difficulties and opportunistic investment practices, say P. Thao Le and Stephanie Pindyck-Costantino, partners at Troutman Pepper Locke.

What's fuelling the high volume of secondaries transactions the market has been seeing?

P. Thao Le: Investors – whether institutional LPs, family offices or high-net-worth individuals – are increasingly rebalancing their overall portfolios by divesting private fund stakes, leading to a sustained high volume of LP-led secondaries. LPs no longer feel hand cuffed to a private fund investment, which means it's now the norm for them to use the secondaries market to balance portfolios and generate liquidity, and for other LPs to pick up those fund interests at a discount.

We continue to see an increase in GP-led transactions. Rising numbers of GPs are exploring secondaries transactions with continuation vehicles as a viable alternative to exiting assets through constrained M&A and IPO markets. Most of the GP-led transactions we see involve single-asset CVs; whether they proceed depends on the valuation and whether there are compelling reasons for a CV deal.

Stephanie Pindyck-Costantino: Funds with terms set to expire in the past five years have been extending their terms in response to a number of factors, including a lack of liquidity, longer investment periods or increased investments outside the investment periods, and reduced exit opportunities. Initially, LPs were willing to accommodate multiple extensions and, in some instances, continue to pay a full or decreased management fee. However, many LPs now are demanding complete exits to meet their own liquidity needs, and so are looking to the secondaries market.

On the buy side, we are seeing opportunistic LPs with capital to invest increasingly interested in acquiring specific high-quality assets through a CV from funds that, due to any number of factors (for instance, the post-covid slowdown or more recent macroeconomic uncertainty), made their best investments later in the fund's lifecycle. For opportunistic LPs with capital to invest, harvesting a specific asset that has more room to grow through a CV is an attractive option – one that allows selling LPs to access the liquidity they need.

Are there any particular sectors where you are seeing more of these types of deals?

SPC: Energy is one. Whether it's traditional or alternative energy investments, we are seeing managers reassess their portfolios and reposition their assets to meet the changing needs of the consumer. This reassessment is a natural prompt for secondaries activity, whether that's an LP looking to exit or a GP exploring a CV to give a specific asset more time and more targeted capital.

Real estate is also a complex space where both GPs and LPs are reassessing their portfolios. Some segments of the market are strong, while elsewhere there's a recalibration of assets – perhaps where property occupancy rates are lower than anticipated and operating income is not what investors expect it to be. That divergence within the asset class is itself creating a secondaries opportunity: in softer segments, GPs and LPs alike are turning to secondaries transactions to manage through a longer-than-expected hold period.

TL: In the US, we're seeing increased activity in the oil and gas sector thanks to deregulation in that space and the creativity of managers to repurpose investments. Where energy managers also hold land and mineral rights, they are reviewing how these assets are used, where their current value lies and whether a CV transaction would breathe new life into the assets.

We've talked about what's fuelling secondaries deals. What might be hindering them?

TL: At the macro level, rising interest rates, increased borrowing costs and inflation are discouraging investors from approaching the debt markets, which is straining traditional M&A exits. Those factors also put pressure on valuations for traditional M&A exits and secondaries exits. It's a compounding effect: when debt is expensive and exit multiples are compressed, the valuations gap also widens. That disconnect is one of the most consistent friction points we see in the market right now.

While secondaries deals are often priced at a historical reference date to give price certainty, the misalignment on valuation could hinder outcomes. Lead investors on a secondaries deal – typically institutional, well-capitalised secondaries buyers – are still motivated to acquire assets in secondaries deals, but time is on their side, so there is no rush to close.

They can take additional time for diligence to assess whether there truly is a quality asset and to negotiate price. But GPs (and their LPs) only have so much patience before they must move on – this back and forth and misalignment on valuation could put a brake on the pace of GP-led transactions.

That said, the appetite for GP-led transactions will continue to be strong as GPs figure out how to give their LPs liquidity in a fluctuating market. The questions, then, turn back to deal terms, valuation discounts and transaction efficiency. GPs that can navigate these issues will be able to leverage the secondaries market to their advantage.

How are regulatory changes impacting secondaries activity?

TL: The US Securities and Exchange Commission continues to scrutinise private equity funds, with a particular focus on conflicts of interest. There are often conflicts of interests when the GP sits on both sides of a transaction, so regulators are paying more attention to how GPs manage them.

GPs need to be inclusive when considering potential conflicts of interest and how they can be navigated and cleansed. GPs need to ensure they have adequate disclosures and policies regarding conflicts, and must ensure their practices match those disclosures and policies. The SEC will closely review existing fund documentation to determine whether a secondaries transaction is permitted or properly approved by LPs – and the LPAC, if necessary – and examine the substance and timing of disclosures to investors. In practice, this means GPs must consider conflicts management well before a transaction is initiated, not as an afterthought.

The LPAC's role in particular has come into sharper focus. Regulators want to see that it is functioning as a genuinely independent check on the process, not simply a rubber stamp. GPs that treat that process seriously, document it carefully and communicate transparently with their LP base are in a much stronger position if the SEC comes knocking.

SPC: We are also seeing renewed SEC focus on valuations. In secondaries transactions – particularly CVs – there is often a lot of discussion around the use of a fairness opinion: how was the value determined? What valuation methodologies were used? What sale processes were undertaken? What are the conflicts involved? The regulator is very interested in proper procedure, and optics matter.

We discuss this with clients a lot. How a transaction looks and feels is important; communicating clearly and using third parties, for instance, for a fairness opinion, is very helpful. A well run process with credible third-party involvement sends a signal to LPs and regulators alike that the GP is taking its fiduciary obligations seriously. In a market where trust and reputation matter enormously, that signal has real value beyond any individual transaction.

Have there been any significant policy-level impacts on the secondaries market?

SPC: With the types of investments where tax is a key value driver, either because of a treaty or a type of credit, we often discuss with clients what they might anticipate down the line if they plan to roll an asset into a CV. When the asset might have been acquired some years before, explaining the context and the potential tax implications of any changes to tax regimes is important, particularly if the asset or investor is overseas.

In cross-border transactions, this due diligence is especially critical: a change in tax treaty status, the introduction of new withholding tax requirements or the introduction of a new holding period can materially affect the economics of a CV for both rolling and incoming investors.

The GP and its investors need to consider the most tax-efficient structure, whether the tax treatment of the asset remains the same, and whether that creates an opportunity for incoming investors. Additionally, they must consider what's material and what new investors should be aware of with the investment structure. It comes back to the point about disclosure and GPs being transparent about what they are doing.

Given the complexity of GP-led transactions and the differing buyer and seller motivations, how do parties arrive at an agreement?

P. Thao Le: In large part, there's a common goal of selling an asset at a 'good valuation'. This measurement can vary between parties – for example, between the lead investor and the GP and LPs. The parties will work towards a valuation that makes sense for all stakeholders and come to an agreement on limiting post-closing liabilities for selling LPs. Lead investors will push for a higher discount on valuation, and the GP and LPs have to acknowledge that the discount is the price of liquidity. It will be up to the GP to justify to its LPs why the discount and valuation is appropriate.

Recognising they have limited recourse if there's post-close indemnity, buyers may be more aggressive on valuation and demand that selling LPs pay for rep and warranty insurance coverage. Limited post-closing liability for selling LPs may help justify the discounted purchase price and push the cost of rep and warranty insurance onto the selling LPs. We see a lot of push and pull in negotiations around these points, which are at their core no different from a traditional M&A transaction. At the end of the day, the secondaries deals get done because there is a buyer willing to provide LPs with certainty of liquidity and limited post-closing liabilities.

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