KEYNOTE INTERVIEW

Pulling in the same direction

As GP-led deals have evolved, so too have the terms designed to create alignment of interest between all parties, say Proskauer's Jordan Hurwitz and Natalie Scott

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Q How can alignment be achieved in GP-led deals?

Jordan Hurwitz: We now have a relatively well-trodden path with regard to what elements are needed to achieve alignment in GP-led deals to ensure such transactions are viable. Creating alignment often involves early discussions and obtaining consent from the existing fund's limited partner advisory committee, independent price verification, the GP rolling over its crystallised carry, lower management fee charges, tiered waterfalls where the level of carried interest is linked to performance-based hurdles and providing appropriate optionality to existing investors. Achieving alignment among all parties has always been a key focus and will continue to be going forward.

Natalie Scott: Investors on the buy side of these transactions are looking for sponsors to roll 100 percent of the carry they have earned into the new deal as a means of encouraging economic alignment. Investors also seek heightened governance rights in the continuation fund or, in some cases, at the portfolio company level, which functions as an extra guardrail where perfect alignment is lacking.

Q How are participants gaining the disclosure they require?

NS: GPs will often provide a suite of due diligence information for new investors early in the process to aid them in evaluating the transaction. Ideally, sponsors also make this same information available to existing LPs. A more comprehensive disclosure document is also prepared for existing LPs to allow them to evaluate whether they want to sell their interest or continue to hold onto the asset.

JH: Providing a clear and comprehensive overview of all aspects of the transaction to the existing investor base is fundamental. A significant amount of time and effort will be spent by GPs on the preparation of the investor communication and election packs, and it is imperative to ensure the documentation is 100 percent accurate prior to circulation. If significant details are inadvertently omitted or certain aspects not made clear enough, such documentation may need to be reissued, which could negatively impact the deal timeline.

Q Clearly, setting a fair price for the asset or assets is vital. What developments are you seeing here?

JH: For any deal to take place, some form of third-party pricing verification is essential and has been a common feature in GP-led deals. One of the most common pricing verification methods involves the issue of fairness and valuation opinions. However, you may also see a minority position in the underlying asset sold to a third party ahead of the deal, with the applicable price then being used for the wider continuation fund transaction.

The US Securities and Exchange Commission recently proposed new rules, which if implemented would fall under the Investment Advisers Act of 1940 and would result in many GPs being required to obtain a fairness opinion from an independent third party in connection with any GP-led transaction. So, obtaining a fairness opinion may soon become a legal and regulatory obligation, notwithstanding the fact this is already common practice.

NS: Another way that GPs ensure fair pricing is by running competitive auction processes with a range of potential buyers. Arriving at the right valuation is, however, one of the most difficult aspects of getting these deals done. This is especially true at a time when there is a price expectations gap in the M&A market more generally and it has increasingly been a contributing factor for broken deals in recent months.

Q Natalie, you mentioned carry rollover. Has practice changed here?

NS: The vast majority of deals I see involve the GP rolling 90-100 percent of their carry, although there are some unique situations where buyers will accept less than this and it will depend very much on the quality of the asset and sponsor.

JH: We recently carried out a review of all GP-led transactions we worked on in the 18 months running to June 2022 and only one-third of deals required the sponsor to roll 100 percent of the crystallised carry into the new fund. In other deals, we saw parties agreeing a set dollar amount to be invested by the GP, which was not necessarily reflective of proceeds allocated to the sponsor.

As transaction volumes proliferated when dealflow was still rife, with high quality assets and blue-chip sponsors accessing the market, we saw GPs successfully arguing for a lower proportion of crystallised carry being rolled into the deal. That said, bargaining power appears to be shifting back to the buyers and there is an expectation that a far greater proportion of deals will return to 100 percent rollover of crystallised carry.

Q How does the GP's knowledge of the asset come into the alignment of interest equation?

JH: GP-led deals are often used to hold on to the GP's most attractive 'trophy assets', giving it more time to extract unrealised value and growth, which will hopefully lead to greater returns. Presuming there are existing positive relationships between the GP and management teams running the day-to-day operations of the underlying companies, the GP will have a significant head start due to its time already working with such companies. In comparison, 'new owners' in the context of a third-party sale would require more time to get up to speed with the businesses and make their mark.

NS: From a commercial perspective, these deals are very different to a primary investment in a blind-pool fund. There are targeted assets that have become part of the deal because of their performance history and so buyers have a higher vested interest in each specific asset's continued performance. But structurally, the terms are often quite similar to blind-pool funds and so buyers are inherently reliant on a GP's knowledge of the specific assets involved in the deal in light of typically fairly limited governance rights.

Q What is happening with management fees in GP-led deals?

JH: To create greater alignment, continuation funds typically charge lower management fees – in the range of 0.5 percent to 1.25 percent, which of course differs to the 2 percent seen in your typical primary funds. Certain continuation funds don't charge any management fee at all, but we have only seen that on European transactions. In the US, the most prevalent fee rate we have seen is 1 percent, whereas in Europe we saw more variation, with an even split between GPs charging 0.5 percent and 1.0 percent. Such percentage is typically applied to net invested capital – ie, the acquisition cost of unrealised assets net of write-offs.

NS: There are always some nuances with management fees to consider. If you have existing investors in a fund, that is relatively mature so there is no management fee; the GP needs to consider whether those rolling over should be charged management fees in the new vehicle. Early on, there was more of a presumption of offering existing investors the option to roll over while preserving their existing economics. The market is trending away from this practice though, so it's more common that LPs electing to roll will pay the same management fee as new investors.

Q This raises an interesting point about existing versus new investors. What's the state of play around status quo?

NS: We are seeing a move away from offering existing investors a true status quo option. It used to be considered the gold standard since it meant that GPs were not changing the position of existing investors who elected not to sell, other than perhaps by way of a term extension. This approach has the potential to cause misalignment between new and existing investors. If new and existing investors have differing fee and carry structures, they may not be economically aligned with one another in respect of the disposition of the subject asset(s) on a go-forward basis.

While we do still see some transactions where GPs offer to preserve the existing fund economics for investors that roll, it is becoming much less prevalent.

Overall, the more optionality you offer to existing investors, the more complex the situation becomes. That doesn't mean existing investors aren't asking for this and even expecting to see it, but they are beginning to accept that they may not get a true status quo option.

> *"There is an expectation that a far greater proportion of deals will return to 100 percent rollover of crystallised carry"*
>
> **JORDAN HURWITZ**

> *"We are seeing a move away from offering existing investors a true status quo option"*
>
> **NATALIE SCOTT**

Q How do you see fund terms shifting over the coming period to create greater alignment between all parties?

JH: We are continuing to experience a significant drop in dealflow, largely due to the ongoing valuation gap. It will be interesting to see whether there is a shift in fund terms as and when parties return to the negotiation table and deals start to get over the line.

There is now a relatively established set of criteria that all parties expect to be present on GP-led transactions to maximise alignment and reduce conflicts as far as possible. While the most reputable GPs may still seek to dictate terms for the most sought-after assets, the expectation is that the pendulum is swinging in favour of the buyers.

Buyers will be pushing harder than ever for greater alignment, which is likely to include requiring the GP to roll 100 percent of its crystallised carry generated by the transaction into the new fund so the GP is not taking any money off the table, as well as having the GP commit fresh capital. Enhanced information, governance and consent rights are also likely to be a common ask. ■

Jordan Hurwitz is a partner in the private funds group at Proskauer based in London. Natalie Scott is a senior counsel at the firm based in New York

dialogues
PUBLIC VOICES IN
PRIVATE EQUITY

Secondary Nature

Dialogues, Article 5
on **Winter 2022**

GP-led deals may have attracted a lot of attention recently, but activity in the LP-led segment of the secondaries market remains robust. How are public markets corrections and the denominator effect playing out in these transactions and what types of private market portfolios are changing hands? We asked a panel ofexperts.

Private markets secondary deals have been booming over recent years, with 2021 volumes reaching a record $132 billion, according to Jefferies. This is well above the previous high of $88 billion in 2019, and while some of this growth has come from increasing numbers of GP-led deals (they accounted for 58% of themarket in 2020), LP portfolio sales have continued apace as investors have continued to use secondary sales. In H1 2022, LP-led deals accounted for $33 billion of the $57 billion value of the secondary market, including the largest ever LP portfolio sale, worth $6 billion.

Perhaps unsurprisingly, much of the H1 2022 activity took place in the first three months, with deals slowing considerably following steep corrections to the public markets and the invasion of Ukraine. Yet times of dislocation often spell significant opportunity for secondaries players. So what is happening in the market nowthat LPs have had time to reflect on the changed environment they confront?

Dealing with the denominator effect

Many LPs are clearly facing private markets over-allocation challenges as their public markets portfolios have reduced in value materially (known as the denominator effect) – and this is causing some to sell portfolios. ““European LP secondaries activity has historically been slower than in the US,” says Ben Pearce, Partner at Campbell Lutyens. “But we’re now seeing significant activity in Europe, driven principally by pension funds andinsurance companies. Many LPs are heavily over allocated to alternatives in a way that we haven’t seenbefore, even during the GFC – and whilst some have had a degree of latitude with over allocations to date, with public market valuations dropping significantly, private market valuations remaining relatively stable and currencies in Europe weakening significantly, we're seeing increased scrutiny of over-allocations with some LPs exploring how they might bring them down through sales. Others, having enjoyed strong private market returns in recent years are looking to de-risk, particularly more mature pension funds, by locking in private markets returns through sales."

Yet unlike in previous difficult periods, the market is not characterised by fire-sales of portfolios. As Erwin Roex, Managing Partner of Bex Capital, explains: "The denominator effect drove a lot of sales in the past, suchas during the GFC. Yet many LPs today are less prepared to sell at the discounts they face, so they are holdingeven though they still need to somehow deal with the denominator effect."

Finding ways through

Where LPs are trading fund positions, buyers and sellers are increasingly turning to deal structuring to help bridge the bid-ask gap that stems from higher discounts to NAVs and from valuations generally trending lower
following public markets corrections. In 2021, approximately 10% of LP-led deals featured deferred payments;in H1 2022, an estimated 40% used these, according to Jefferies.

Payments are also being deferred for longer, says Mike Suppappola, Proskauer Partner. "We're seeing some deals get done with $0 down at closing and the full price paid up to two years later – you didn't see this three or four years ago. They suit the buyers because they can effectively pay for the deal using recycled proceeds, while for sellers, this can reduce the headline discount compared with what they would achieve if the full pricewas paid upfront - this can really matter for some LPs."

Preferred equity deals have also been on the rise since the pandemic, and particularly since the economic outlook started to cloud in the early part of 2022. These transactions see secondaries buyers offer liquidity to LPs or GPs in exchange for capital in priority to other LPs, plus a preferred return. They can offer LPs liquiditywithout having to sell their fund position and they are increasingly becoming part of the secondary market's toolkit for meeting LP and GP needs. "Preferred equity has historically been a niche strategy," says Suppappola. "But that's changing as more secondary buyers structure products that can accommodate different return profiles."

The other type of deal becoming more prevalent is the LP tender offer. These differ from traditional LP portfoliostake sales in that they are usually initiated by the GP and they frequently include a staple – a commitment by the buyers to the GP's new fund. This is an attractive proposition as raising capital becomes more challenging:private equity fundraising fell by 50.2% to $119 billion in Q2 2022 versus the same period a year earlier, according to Preqin figures.

“Tender offers are on the rise,” says Wilfred Small, Senior Managing Director at Ardian. “Increased allocation pressure is leading to LPs seeking liquidity and some GPs may use a tender offer to facilitate that.” However, they are not always straightforward. “When they are successful, you get proper alignment via a sell and roll option, yet still meaningful selling volume and everyone is happy,” adds Small. “But they can go wrong if selling volume is overestimated or where secondary market pricing is below the GP and sellers’ expectations. Given the number of counterparties involved in the transaction with differing sets of priorities, alignment is key.”

Broadening pool

The variety of deal types and structure, combined with the increased maturity of different areas and accesspoints of private markets, mean that the LP-led secondaries deal universe is broadening out.

Private equity secondaries in the US and Europe may have led the charge, but we are now seeing deals doneacross a wider spectrum of geographic areas. “From a deal sourcing perspective Asia will be an increasing contributor to deal sourcing. The region has attracted a lot of private capital funding and some of this will

change hands” says Guillaume Caulier, Principal, Lexington Partners. “Asia is now starting to be a bigcontributor to deal flow and sourcing,” says Guillaume Caulier, Principal, Lexington Partners.

“If you look at the 2017-2021 vintages little has been sold to the secondary market. These vintages add up to

$3.7 trillion of inventory, therefore assuming an average turnover of 11.5% which is the historical rate thatroughly implies $400bn and that enough for 3.5-4 years of secondary dealflow at current levels”

“Asia can be a compelling market, but you need to be extremely selective and with the right pocket of capital,”agrees Small. “Perhaps more interestingly, private equity portfolios have reached a level of maturity therewhere active management via secondary transactions is now a compelling proposition – not necessarily involving Asian assets. We’ve seen more activity here and we expect a lot more to come.”

The type of underlying asset available for trade is also diversifying. “We’re seeing a lot of activity in private credit,” says Pearce. “It has been slow to build, but there is now a large base of European direct lending strategies starting to churn. The question is whether there is enough buyside capital for what is out there –fortunately, there are several new entrants coming online”

“Private credit has become a trillion dollar-plus industry,” agrees Bruno Bertrand-Delfau, Partner at Proskauer.“It’s a mature market. We have recently seen secondary managers joining large asset management platform including in particular the private debt component. This may boost private debt secondaries.”

Infrastructure is another growth area, as Small notes: “In both private equity and infrastructure, the limiting factor to secondary deal volume is dry powder raised. But in infrastructure you have a more recently developing secondary market with very few dedicated funds. It’s early innings and so there are some reallycompelling transactions to be done.”

Looking ahead

As this broadening and deepening pool of opportunities suggests, the weight of capital going into the primary market drives activity in secondaries, albeit with a lag. The rise in private equity allocations and increased numbers of investors committed to private markets funds over recent years suggests the period to come will offer a healthy and expanding deal pipeline for secondaries players.“ In the years since the financial global crisis and possibly for longer than that we are currently at the lowest level of dry powder for the secondary market. We approximately have one year of dry powder in the entire secondary industry at the current level andthat compares to 1.7 years on average over the past several years and at least three-five years of dry powder for the primary market” says Caulier.

“It is probably a good time to be cautious especially in the early part of the cycle. We are looking for resilient portfolios where we have both diversification and especially discount. We are using our information advantageto make the best analysis and do the right deals, but what’s critical is how we leverage the experience and judgement of our team that has invested together over many cycles”.

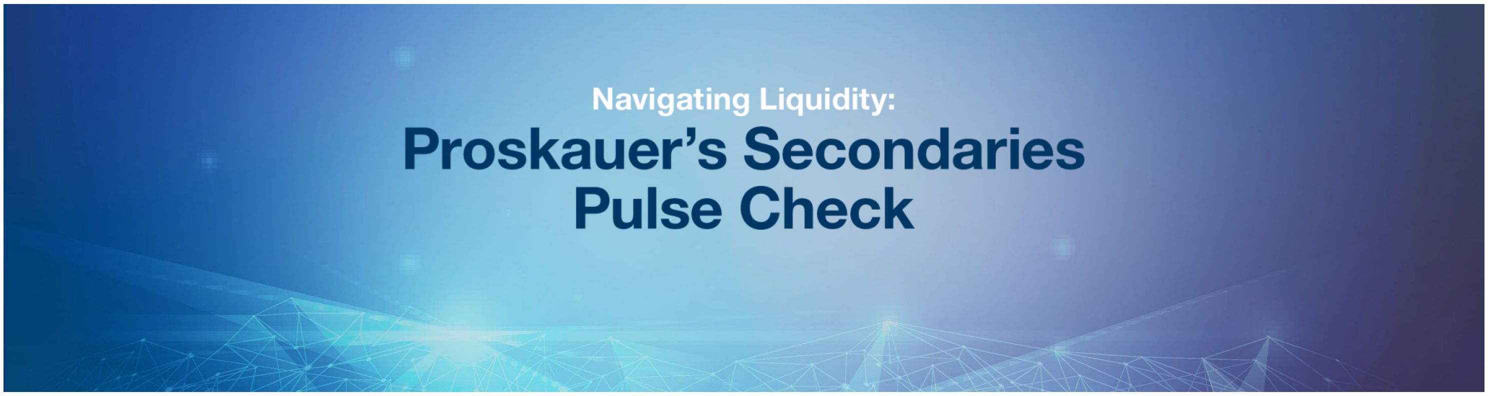
Bertrand-Delfau agrees. “The volume of capital that has been raised in the primary market is substantial, and coupled with an increase in turnover, there’s potential for a lot of upside,” he says. “Which means that the existing secondary funds will need to get ever bigger and there is also room for new entrants. I think we’ll seemore specialisation in secondaries players, which will need very well defined positioning in the market.”

For Roex, this latter point is vital. His firm specialises in secondary deals involving fund-of-fund interests andhe points to newer, but related, opportunities on the horizon. “Fund-of-funds secondaries will keep on tickingover as they have been for a while,” he says. “This part of the secondary market is younger, although increasingly maturing, and we are even starting to see

GP-led secondaries on funds-of-funds funds.”

Overall, the market looks set to be active over the next few years and beyond, with more evolutions coming down the line. As Small says: “Not only will there be more volume, but there’ll be more specialization, more innovation and more capacity for differentiation in years to come. It’s an exciting place to be within the privatemarkets industry.”

Dialogues is a private equity publication bringing together leading market voices and influencers to discuss the key issues affecting private equity.



Q&A with Partners Bruno Bertrand-Delfau and Chris Robinson

September 28, 2022

Ahead of our conference on October 12, partners Bruno Bertrand-Delfau and Chris Robinson give their insight into the latest trends and topical issues facing the secondaries industry, as they relate to both LP transactions and GP-led processes. Register now to reserve your place.

What have been the biggest factors impacting on LP portfolio transactions in 2022?

Bruno Bertrand-Delfau: "Financial market turmoil is making it hard to price fund interests. Uncertainties in the valuation of portfolios coupled with the impact of inflation and interests rate hike on companies' results, less short term exits for portfolio companies, more expensive debt will also be factors. Discounts to NAVs have sharply increased and many sellers are reluctant to launch processes or approve bids in such conditions. As soon as the market will stabilize I believe that we should see a flurry of LP portfolios being shopped. Denominator effect, scarcity of exits / distributions and need to reup in many top tier GPs in fundraising are going to fuel the market."

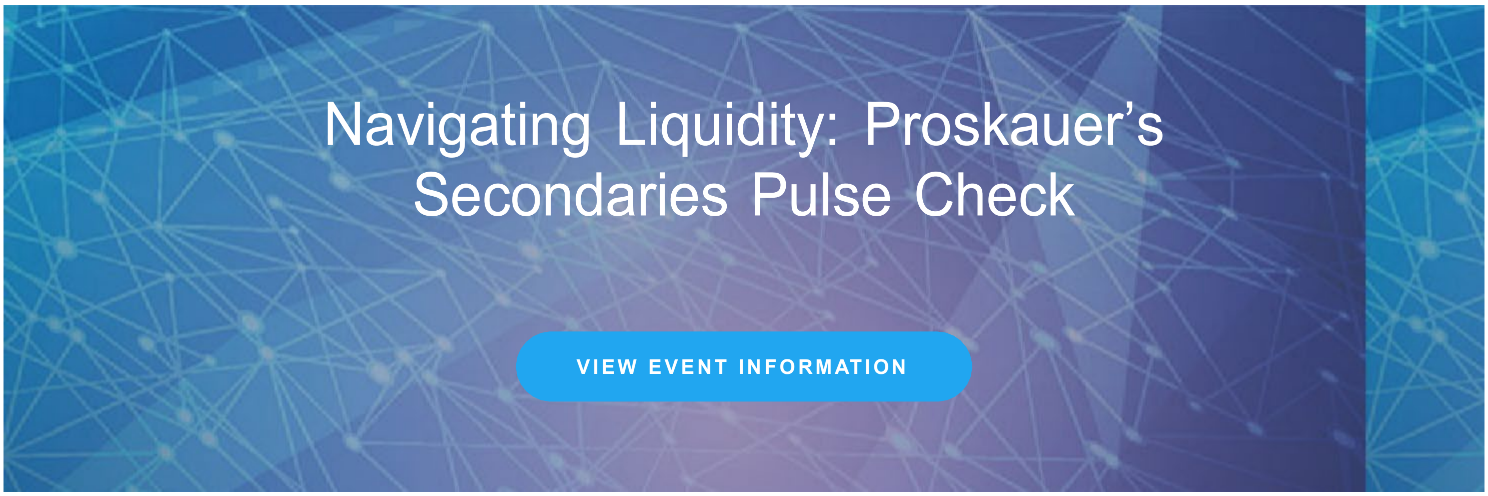
Chris Robinson: "After a strong first quarter, largely attributable to 2021 tailwinds where the secondaries market experienced record setting growth, activity in the secondaries market has slowed, consistent with an overall decline in public markets and investor confidence. Historically, pricing in the private markets lag a quarter or two behind public markets so many buyers have temporarily paused to allow valuations to stabilize and distribution activity to pick up as traditional M&A activity normalize. We expect bid–ask spreads to narrow in the fourth quarter of 2022 as the economic outlook becomes clearer."

How has growth in GP Led transactions over the last 5 years impacted the LP portfolio market?

Bruno Bertrand-Delfau: "The main impact has been allocation of resources and dry powder on the buy-side as secondary funds have been inundated with continuation funds projects. Many secondary funds deal teams have been unable to dedicate the same time and energy to pursue LP portfolio opportunities. Some players leaning traditionally more towards the LP portfolio business have therefore been able to seize good LP portfolios in 2021. With risk generally increasing in the current political and economic environment and LPs requesting more diversified portfolio, there should now be a good momentum for LP portfolios."

Chris Robinson: "The market volume for GP-led transactions has more than quadrupled over the last five years, accounting for close to 50% of the market in 2021. With that being said, dedicated available capital

remains high at an estimated at $227 billion (as of 6/30) so secondary buyers have ample capacity and demand, particularly for diversified LP portfolios."



What have been the biggest factors impacting sell side supply and why?

Bruno Bertrand-Delfau: "Financial markets collapsing and continuing high volatility in markets have limited sale volumes in the first part of the year. Hopefully, a denominator effect and search for liquidity to finance new commitments will push volumes up in the run up to year end."

Chris Robinson: "Many sellers are overweight in their private exposure and have sought to bring transactions to market to rebalance their asset allocations. In addition, faster turnarounds from sponsors looking to fundraise and a push to consolidate core GP relationships, have accelerated sell side LP portfolio supply."

What have been the biggest factors impacting buy side demand and why?

Bruno Bertrand-Delfau: "Scarcity of human resources and limit of dry powder have certainly restrained activity. More recently, turmoil in the markets , high inflation in nearly all developed economies and resulting interest rates hikes have made valuation and pricing of portfolios uneasy. LPs have been asking for more diversification and less risk and many secondary houses have been reluctant to put forward bids matching sellers' expectations. Leverage is also not as abundant or as inexpensive as it once was and many big names have started fundraising. Therefore, the global dry powder level should go up sharply in the coming months."

Chris Robinson: "In the first half of 2022, a challenging underwriting environment caused buyers to be highly selective in deploying capital. Buyers have sought and received extended due diligence periods, hoping to better analyze portfolio company performance in a challenging valuation environment. While it's expected that buyers will remain disciplined in the near term, several factors should lead to a strong year end supply of new opportunities, including (i) a desire to prudently deploy capital recently raised, (ii) a number of high quality transactions being brought to market, and (iii) new sources of capital, many of which are non-traditional investors looking to join the market."

What's next for the secondaries market? What are the areas of growth, evolution of techniques, etc?

Bruno Bertrand-Delfau: "Certain sub-segments like infrastructure secondaries are going to grow sharply. Portfolios are also going to continue their growth with potentially 10bn deal value being reached in the coming years. Deals are going to be executed at increased pace to avoid market reversals in an unstable economic environment. Optimal US tax and regulatory capabilities will still be key for a smooth deal execution. More deal structuring may be necessary to make deals possible in the current environment, with a variety of available tools, from deferred price to earn out."

Chris Robinson: "Given how healthy buy-side fundraising has been, we expect the secondaries market to continue its growth trajectory. As a sub-category, real estate and infrastructure transactions, with inflation and recession resistant characteristics will continue to be in high demand with several buyers raising dedicated pools of capital to these strategies."

KEYNOTE INTERVIEW

An asset class propelled by innovation



Private equity's resilience and innovation have allowed it to continuously meet the needs of GPs and LPs, say Proskauer's Monica Arora, Howard Beber and Nigel van Zyl

The private equity industry has grown in size and sophistication over the past two decades, to the extent that it is almost unrecognisable from where it stood when *Private Equity International* was first published in 2001. Monica Arora, Howard Beber and Nigel van Zyl, co-heads of the private funds group at law firm Proskauer, tell *PEI* that the ability to innovate has been key to the industry's success and, despite the current downturn, they believe the asset class can look forward to a bright future.

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Q What are the main changes you have seen in PE since 2001?

Howard Beber: Everything about this industry has become exponentially bigger in the last 21 years including the sheer number of private equity firms, assets under management, fund sizes, and the universe of LPs and service providers active in the industry. Managers have not only grown in size, but platforms have expanded and evolved. Years ago, most managers focused on one strategy or vertical in a single geographic region. While those managers still exist, today many managers now manage multiple fund products focusing on diverse strategies and geographies.

Private equity used to be a small, niche and opaque market. It was under the radar and a relatively small part of investment portfolios.

The asset class is much more visible now than it was 21 years ago. As one would expect, as the asset class has grown and become more visible, it has attracted more attention from regulators and political administrations than in earlier years.

I don't think anybody could possibly have predicted, 21 years ago, what this industry would look like today.

Q How have private equity firms adapted as the market has grown?

Monica Arora: We have seen managers of private investment firms lean into the opportunities and challenges that have accompanied the evolution of the market. Many managers have grown by augmenting legacy businesses with new platforms, either organically or through consolidation. They have recognised the need to broaden, as well as deepen, their areas of focus and expertise as part of the natural progression of a maturing industry.

To achieve this growth, managers have continued to prioritise talent, and have become more sophisticated in utilising tools to attract and retain talent. For example, there has been a renewed focus on internal economic arrangements and the manner in which talent may participate.

This has coincided with a period in which founders and senior leaders of private investment firms are retiring, making succession a large focal point for managers and investors alike. Twenty-one years ago, it was common to have the investment manager of a private fund governed by a barebones document; those days are long over as managers understand the value of their franchise and the importance of their internal arrangements, both with respect to talent as well as potential third-party investment.

Another area where managers have particularly adapted is increased investment in their internal infrastructure. In addition to compliance, which has been essential, the investor relations function has become more important than ever. Whereas it used to be that a firm would raise capital every couple of years, fundraising has now become perpetual. And the technicalities and the manner in which fundraising is conducted have become more complicated, which has highlighted the importance of the compliance and the investor relations functions working together.

Q What trends have you seen around deal terms over the last two decades?

HB: The fundamental two-and-20 economic deal, generally speaking, hasn't changed all that much, but that is about the only thing that hasn't changed. Before the creation of the Institutional Limited Partners Association, LPs lacked the means to organise and act in a concerted manner. LPs, for the most part, had very little leverage from a negotiating standpoint. Once ILPA was established and received a lot of institutional backing, that changed.

What has changed most is the transparency of the industry. That comes from more robust and standardised reporting and much more intense due diligence. Limited partners now require much more transparency throughout the life of a fund than they had years ago. In addition to ILPA, the regulatory landscape for private equity managers has changed dramatically in the US and Europe, which of course has led to more robust disclosure and transparency.

> *"Many managers have grown by augmenting legacy businesses with new platforms, either organically or through consolidation"*
>
> **MONICA ARORA**

Q Given that the industry is more sophisticated, is it harder now for emerging managers to come into the space?

Nigel van Zyl: There are always going to be peaks and troughs in terms of when emerging managers enter the market. Right now, given the crunch on capital in the fundraising market, it is more challenging.

But in order for the industry to grow, we'll continue to see spinouts, and we'll continue to see emerging managers setting up new and different strategies. One of the things the industry is very good at is evolving and finding solutions to capital needs in the global economy. For as long as the industry maintains that adaptability, we'll continue to see emerging managers enter the market.

MA: Early in the pandemic, the thought was that activity related to emerging managers would come to a halt. However, contrary to belief, we've seen that investors like the idea of emerging managers. It is no doubt difficult to get traction, but superstar investors setting up their own firms with successful deal experience and strong relationships have done well.

In many cases, emerging managers initially launch on a deal-by-deal basis. This permits them to deepen relationships while building a proprietary track record that can help create momentum in the community.

Q One of the big changes is the growth of the secondaries market. Do you expect to see continued growth there?

HB: The secondaries market for LP interests used to be a very closed market. There were few buyers and if you were a seller, you were probably in, or perceived to be in, a distressed situation. This meant that portfolio sales were kept very quiet. That sentiment began to shift about 15 years ago as the industry grew and LPs started using the secondaries market as more of a portfolio construction mechanism, as opposed to a way to offload assets in a distressed situation.

In addition, as the PE market grew, many new firms entered on the buy side and the market for agents and other service providers expanded exponentially. This of course created a more efficient market. Of course, the GP-led secondaries market was virtually non-existent until relatively recently and has now become a very large part of the overall secondaries market.

Right now, the market happens to be down, but in normal conditions, it is a fluid and liquid market for LP interests and GP-led deals. We expect that it will come back as markets stabilise.

> *"The industry is successful because it involves smart people who innovate to meet capital needs"*
>
> **NIGEL VAN ZYL**

NvZ: The industry is successful because it involves smart people who innovate to meet capital needs. Secondaries is a great example of this. Whether it's the buying and selling of LP interests, which has now become market practice, or the more recent development of continuation funds set up to provide GPs and investors the opportunity to continue to own assets beyond the traditional hold period while providing liquidity to those LPs who want it, I think GPs and LPs recognise that private equity is not necessarily the illiquid asset class it was once perceived to be.

One of the other innovations we have seen is the longer life, 15-to-20-year, fund. These have evolved from a recognition that for some assets the value proposition is longer than a traditional 10-year fund. These are all examples of an industry that does not stand still, it innovates, it evolves and it solves.

Q What has driven the rise of ESG in private equity?

NvZ: The industry cannot exist in isolation or ignore macro events, whether they are financial, social or environmental. ESG impacts everyone, from consumers to employees and investors, and therefore impacts the sustainability of the industry. Environmental and social issues are at the forefront for almost every investor and every manager and are also now a focus for regulators.

The rise of impact funds has been a particularly interesting development over the last few years. That is another example of innovation – seven or eight years ago, there were just a handful of impact funds but now impact investing is becoming a large subsector of the asset class.

Firms are asking their portfolio companies to be accountable to all stakeholders, whether that is their owners, their customers, or others impacted by their activities. It is also about the industry being relevant to the broader economy and society.

ESG issues are going to become increasingly urgent – and I am sure private equity will, as it has done on many other occasions, be one of the solution providers.

Q Will the political controversies around ESG force PE firms to change their strategies?

MA: There are many components of private equity that have been politicised, particularly in the US. Whereas some investors have mandates that require the incorporation of ESG-criteria by managers, others (specifically certain US state plans) have more recently enacted investment mandates requiring investment decisions be made solely on pecuniary factors (ie, disallowing the consideration of ESG principles under the theory that ESG comes at the expense of returns).

Despite this divide, it is standard for large asset allocators – globally, and particularly in Europe – to require that GPs have robust ESG policies and procedures. I do not know of any of our private fund clients that do not have a policy related to ESG. Firms are going to have to perform a continuous balancing act. ■

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Undercapitalization slows secondaries activity

While LPs and GPs cry out for liquidity, secondary funds are unable to recapitalize quickly, creating pent-up demand that bodes well for the future.
By Claire Coe Smith

After years of explosive growth, the global secondaries market hit a slowdown in the second half of 2022 that reflected challenges in the broader macroeconomic climate. Participants at the second annual *Buyouts* secondaries roundtable talked extensively of the challenges of undercapitalization but were unanimous in their belief that activity will soon rebound and today's slowdown bodes well for a strong uptick to address pent up demand.

"In January and February 2022, we still had a functioning secondary market," says Yann Robard, managing partner at Whitehorse Liquidity Partners. "In the first half of the year, $53 billion was traded and most of that happened in the first quarter. Remember that strong performance of private equity in 2021 left many LPs entering 2022 overallocated to private equity. Then public markets faltered in Q2 2022, compounding LPs' over-allocation to private equity, then distributions started declining and now capital call facilities are starting to get cleared, further compounding overallocation. If you wanted liquidity for your private equity portfolio, you had to start queueing in April of this year."

$85bn

The amount traded in the second half of 2021, accoring to reports cited by Yann Robard

Because fundraising is difficult right now, secondaries funds have been unable to recapitalize quickly, creating undercapitalization and a backlog of demand.

"Reports suggest that the dry powder in the market stands at $93 billion before any new fundraising," says Robard. "Last year, $85 billion traded in the second half of the year. Assuming a similar deployment this year, this would suggest that most, if not all, dry powder will have been extinguished by the end of 2022. Said differently, we're entering 2023 with a lot of pent-up liquidity and little to no capital to absorb that supply."

An additional challenge is that there is a pretty meaningful bid/ask spread in the market, as the difference between what buyers are willing to pay for assets increasingly diverges from the

Gordon Appell
Managing director, PJT Park Hill

Prior to joining PJT Park Hill in 2021, Gordon Appell was a director in the Client & Partner Group at Kohlberg Kravis Roberts, where he was a product specialist responsible for the firm's North American private equity and energy real assets platforms. Previously, Appell was a director in Credit Suisse's Private Fund Group.

Ben Perl
Managing director, Neuberger Berman

Ben Perl is global co-head of NB Secondary Private Equity. He is a member of the secondary, real estate secondary and strategic capital investment committees. Perl joined the firm in 2001 and Neuberger Berman Private Equity in 2007. Prior to that, he worked as an associate at Lehman Brothers Venture Partners (now Tenaya Capital).

Yann Robard
Founder, Whitehorse Liquidity Partners

Yann Robard founded Whitehorse in 2015 and has over 20 years of private equity experience. Based in Toronto, Whitehorse has raised over $12 billion in commitments, deployed over $16 billion in over 185 transactions and consists of a team of over 125 individuals. Prior to Whitehorse, Robard spent a cumulative 13 years at CPPIB.

Chris Robinson
Partner, Proskauer

Christopher Robinson primarily focuses his practice on representing buyers and sellers, as well as market intermediaries, in connection with complex secondary transactions, including traditional sales and purchases of fund interests, secondary direct transactions, captive fund spin-out arrangements, fund recapitalizations and restructurings, and "stapled" secondary transactions.

Sola Adeleye
Director, Citi Private Funds Group

Sola Adeleye co-heads Citi's Private Funds group and advises private market sponsors and institutional investors on secondary market liquidity solutions, primary fundraising and LP portfolio financing. He has over 15 years of private market experience across secondary advisory, secondary investing and investor relations from KKR, Landmark Partners and UBS.

> *"In this market, buyers are laser-focused on existing GP relationships"*
>
> **SOLA ADELEYE**
> **Citi private funds group**

lowest price that sellers are willing to accept.

"Private equity NAVs tend to be a little stickier and take a little more time to adjust to market sentiment," says Robard. "People who don't need to sell are not going to sell in this market and will hold out given higher optical discounts. This should self-correct over time. As markets settle and discounts to more recently marked books narrow, the need for liquidity will drive renewed activity in the market assuming the secondary market can recapitalize to absorb this demand."

Market slowdown

For sellers in the secondaries market, the route to exit a diversified portfolio sale to a buyer using significant leverage is challenged in this environment, both by the rising cost of leverage and a recognition by buyers of the uncertain conditions.

Ben Perl, managing director at Neuberger Berman and global co-head of NB Secondary Private Equity, says: "Each business has its own potential idiosyncratic issues right now, whether those relate to inflation, supply chains,

> *"People who don't need to sell are not going to sell in this market"*
>
> **YANN ROBARD**
> **Whitehorse Liquidity Partners**

energy inputs, labor costs or regulatory change. It is not an easy environment in which to operate, and it is not an environment where people want to blindly buy diversification. Buyers are going to want to be more targeted, to understand what they own, to price risk accordingly and to steer away from using a lot of leverage to amplify returns."

He adds: "There is a need for liquidity that is structural and will not go away, but there is not a ton of dry powder and buyers really want to be careful around what they own and the prices they pay. We are going to see GPs understanding that pressure for their LPs and understanding that their LPs may not have great liquidity options, so they will be trying to help manufacture liquidity for their LPs as well. We did not see that through the last downturn, when there was really no such thing as a GP-led secondary solution to help drive liquidity."

"You have to hit a bullseye across a select set of buyers"

GORDON APPELL
PJT Park Hill

Gordon Appell, managing director in PJT Park Hill's secondary advisory group, says: "The bid/ask spread that everyone is highlighting is a real issue. The Nasdaq is down around 30 per cent year-to-date, the S&P 500 is down around 20 per cent, but private equity NAV movements have been more muted so far. While this is not a surprise to see less volatility with private assets, a lot of buyers we talk to believe a downdraft is coming so they want to protect themselves from that, which is where some of the discounts come into play."

He says GPs are looking to do some really big deals in the single-asset space, because the IPO and traditional M&A markets are not there to the extent they have been in the past 12 months. "But getting a billion-dollar single-asset GP-led deal done now as opposed to 18 months ago is a very different proposition," says Appell. "You have to hit a bullseye across a select set of buyers, because the syndication market is not what it was, and then you have the pricing issue. It is going to take a lot of work to get deals done at scale. Advisers are a little more cautious and are guiding GPs towards things that are multi-asset, with tenders also coming back."

Tender offers are back in favor, allowing GPs to hold auctions to find secondaries firms willing to buy up a certain amount of fund interests from their existing LPs. Such deals had fallen out of fashion with buyers who did not like the amount of work required upfront with little certainty on the outcome.

Appell says: "Now we have a backdrop that has the right ingredients for those transactions. You have liquidity needs on the LP side and a primary fundraising market that is challenging, allowing for a rotation of LPs who can take liquidity from the transaction and use that to commit to a new fund, or to something else that is going to be core to their program going forward. The buyers that are stepping in are hopefully getting an interesting value orientation, and the sponsor is getting a little more momentum on their fundraise through some primary capital to support that.

"These tenders have elements that are relevant to all the different counterparties right now, but to be successful they need to be for the right sponsor with an attractive strategy, team and track record."

Bridging the gap

While some deals are still getting done in the secondaries space, Sola Adeleye, who heads Citi's secondary advisory team, says it has been challenging to bridge the valuation gap: "We are seeing good assets with great GPs not able to clear the market because of the bid/ask spread. It is tough as a GP to put something in front of the LP Advisory Council if there is a large headline discount. We continue to see supply on both the LP-led and GP-led side but the hit rate in terms of deals getting to the finish line has been lower than prior quarters. As audited year end NAVs get reset in Q1 2023, we expect to see an increase in transaction volume."

He points, however, to green shoots in the current market around credit and real assets. "We've seen recent pricing for some portfolios that were actually

> *"Each business has its own potential idiosyncratic issues right now"*
>
> **BEN PERL**
> **Neuberger Berman**

higher than it was in Q1 and Q2 of this year, because LPs and secondary funds are craving yield and they can get that from seasoned credit and infrastructure funds," he says. "Certain portfolios are getting bid up by both traditional secondary funds and non-traditional buyers as well.

"Given the undercapitalization on the dedicated secondary fund side, the net needs to be cast wide in order to reach a broader set of buyers, especially when it is a large transaction. Advisers' ability to access a wider pool of capital outside of dedicated secondary funds is extremely important to reduce execution risk. We are advising our sell-side clients that it is a buyers' market, and we expect that to continue over the short term. As a seller, you can influence that dynamic by being thoughtful about the size and type of asset or portfolio you bring to market."

Chris Robinson, partner in the private funds group at Proskauer, says that syndication of large deals can be challenging right now. "If large investors have marketed to their LPs that they are primarily seeking to take lead investor positions, this may cause them to pass on syndicate opportunities, thereby limiting the universe of potential buyers that can step in to help on some of these larger transactions," he says. "That is adding to the complexity in getting some of these deals to the finish line. The syndication process can become extremely difficult, depending on your closing timeline, as you start to try and line up investors that need to get up to speed pretty quickly."

There have been a few instances of pulled deals and limited examples of buyers coming back for revised pricing discussions where deals have been in the market for a while and reference dates needing to be updated.

But advisers are finding ways to bridge valuation gaps. Robinson says: "We have done a number of transactions where valuation is a concern but where GPs are confident in where a portfolio company's performance may ultimately end up, and we have been able to use alternative transaction structures, including preferred equity or performance based earnouts, to help bridge the gap. Where there continues to be a bid-ask spread, I expect to see more of these structures implemented."

Getting deals done

Adeleye says there are several factors influencing which transactions can get done, for both LP-led and GP-led deals. "Entry valuation is important in this volatile market environment," he says. "It is tough to make money when you overpay, so your entry price is probably your biggest value creation lever. While GPs are hesitant on marking down their books, buyers are maintaining price discipline as a result of the supply-demand imbalance that works in their favor."

If price can be agreed, alignment then becomes exceptionally important on GP-leds, as buyers look for the right mindset and expect GPs to double-down on the GP commit. Perl says:

> *"As bid/ask spreads reduce we will see a real rebound across the board"*
>
> **CHRIS ROBINSON**
> **Proskauer**

"Alignment isn't something you can easily summarize in one word – we sort of know it when we see it. Buyers are looking for GPs who want to re-risk, not de-risk. If the transaction is about de-risking for them, that doesn't necessarily mean buyers don't look at it, but it is typically a big negative and is likely difficult to overcome. The gold standard is the sponsor rolling over, not taking liquidity – save for maybe some exiting partners – and they are actually committing new capital."

Adeleye adds that existing relationships are also proving critical to getting transactions closed for GP-led deals: "In this market, buyers are laser-focused on existing GP relationships. The deals getting done tend to be led by one or two investors that are existing LPs of that GP and know the types of behaviors that GP exhibits in good times and bad. In most transactions, it is really about existing LPs leading and anchoring transactions."

Perl says: "Capital is precious and every deal has to stand out in this environment. If it's an average deal, there will be another deal like it in three to six months' time. Buyers today are looking for the best assets, the best risk-adjusted returns, good sponsors, good alignment and good valuations – it all needs to hang together."

What happens next

Looking forward, Robard argues that today's undercapitalization will set the secondaries market up for growth in the coming years.

"You have an undercapitalized market that is going to stay undercapitalized for a period of time," he says.

"But, as history shows, all of this resolves itself over time and over the cycle. When you look at 2009, there were lulls in the market during a period when bid/ask spreads widened, but then you had a decade of boom in secondaries, growing from $10 billion in 2009 to $134 billion in 2021. I see a similar thing happening now: in a 2022 world we could hit $100-125 billion this year, which is a bit less than last year. But I would watch this space closely as it's going to set us up for tremendous growth in 2023, 2024 and 2025 as we deal with that pent-up liquidity."

Perl says the pendulum has swung in favor of buyers right now, but it may take time for volumes to materialize. "The markets will set in, the reality of higher interest rates will set in, and we are already starting to see a realization from GPs as to the power of these GP-led solutions," he says.

"That is one of the only attractive options they have when they need to create liquidity for their LPs. No one wants to sell in a bad market, but a lot of people need liquidity, so those will tick back up and unlike other exit options, these give investors the flexibility to choose what is best for their specific needs."

Robinson predicts the last three quarters of next year will be particularly busy. "I think the first quarter will mirror what we are seeing right now with a softer market," he says. "With the number of sponsors in the market raising capital and pent-up demand on the sell side, we will likely see a race to get deals done.

"Portfolio transactions will probably come back first at a higher volume than GP-led transactions because there is an immediate need there that has to be addressed with motivated sellers and there are a number of buyers that may be a little overweighted with the flurry of GP-led transactions done over the last 12 months so those buyers will likely look to balance their investment mix with high quality LP portfolio transactions. Additionally, as bid/ask spreads reduce we will see a real rebound across the board."

It is true that 2022 has been a challenging year, but once the recapitalization starts taking shape, expect more secondaries growth to come. ■

A Proskauer Series

Beyond the Deal

Your source for quick commentary on key issues impacting dealmaking

Question of the Week:

How are current levels of dry powder impacting GPs and LPs in the secondary market?

October 6, 2022

"Dedicated available capital is estimated at $227 billion (as of June 30, 2022). We expect secondary investors to closely monitor valuations and public market conditions. But as investors continue to fundraise and deploy on pace with current expectations, the market appears open and well-capitalized heading into the fourth quarter."

Christopher Robinson, Private Funds, New York

"The U.S., Europe and UK are quite aligned. The dry powder available to secondary funds sharply increased in 2021, globally in conjunction with a sharp increase in secondary deals volume, for LP portfolios and for GP-leds, culminating at around $130 billion for that year. Most of the secondary players closed or are in the process of closing record funds. However, since the start of this year, the secondary market has been facing strong macro-economic headwinds.

In spite of the dry powder continuing to accumulate, the macro-economic conditions have resulted in a sharp slowdown in secondary activity in the first half of the year which will continue. Buyers have become much more cautious about risky assets, risk concentration and over pricing. Sellers have postponed or pulled off transactions because price expectations were not met. Hopefully when markets stabilize, volatility comes back to a reasonable level and all current giant fundraisings come to close, all conditions will be then met for a sharp activity pick up."

Bruno Bertrand-Delfau, Private Funds, London

"A record level of secondary dry powder was expended last year and the first half of this year, which resulted in many buyers being on or ahead of pace, with less pressure to deploy capital. Add in uncertain macroeconomic conditions and the resulting valuation discrepancy between seller and buyer pricing expectations, and there is an environment where buyers are being highly-selective about the assets they purchase. They are looking for "perfect" deals, and as a result, many sellers with portfolios that don't meet that description have been delaying sales processes in hopes they can get better pricing later.

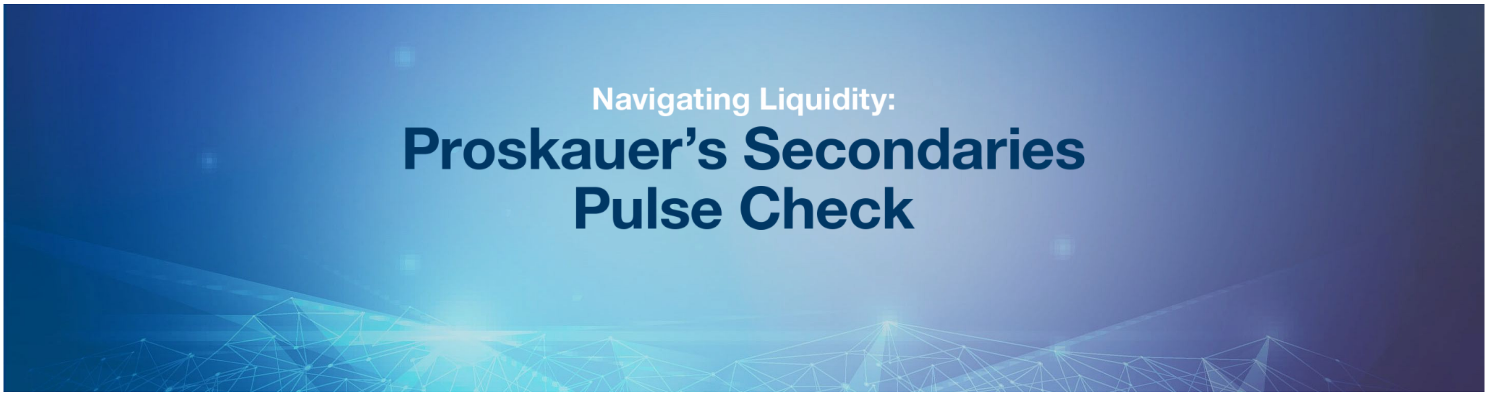
However, the current environment has also slowed down distributions, increased limited partner liquidity needs and seen several of the largest secondary buyers fundraising with anticipated totals of $15-$20 billion. Given all of that and a growing pipeline of deal flow, it's evident that secondaries deals are just taking a small breather as buyers and agents prepare for an incoming tsunami of activity in Q4 and/or Q1 of next year."

Mike Suppappola, Private Funds, Boston

"We experienced a particularly buoyant market last year. The levels of supply were such that buyers needed to carefully consider where to allocate resources, and some expressed concern that the market would reach saturation as supply outweighed demand.

There has, however, been strong secondary fundraising, with a number of the largest secondary buyers currently fundraising. While macro-economic and geo-political challenges has led to a slight slowdown in transaction activity, as buyers wait for the gap between sponsor and mark-to-market valuations to narrow, buyers should be well-placed to take advantage of increased transaction volumes as the market rebounds."

Warren Allan, Private Funds, London



Q&A with Partners Bruno Bertrand-Delfau and Chris Robinson

September 28, 2022

Ahead of our conference on October 12, partners Bruno Bertrand-Delfau and Chris Robinson give their insight into the latest trends and topical issues facing the secondaries industry, as they relate to both LP transactions and GP-led processes. Register now to reserve your place.

What have been the biggest factors impacting on LP portfolio transactions in 2022?

Bruno Bertrand-Delfau: "Financial market turmoil is making it hard to price fund interests. Uncertainties in the valuation of portfolios coupled with the impact of inflation and interests rate hike on companies' results, less short term exits for portfolio companies, more expensive debt will also be factors. Discounts to NAVs have sharply increased and many sellers are reluctant to launch processes or approve bids in such conditions. As soon as the market will stabilize I believe that we should see a flurry of LP portfolios being shopped. Denominator effect, scarcity of exits / distributions and need to reup in many top tier GPs in fundraising are going to fuel the market."

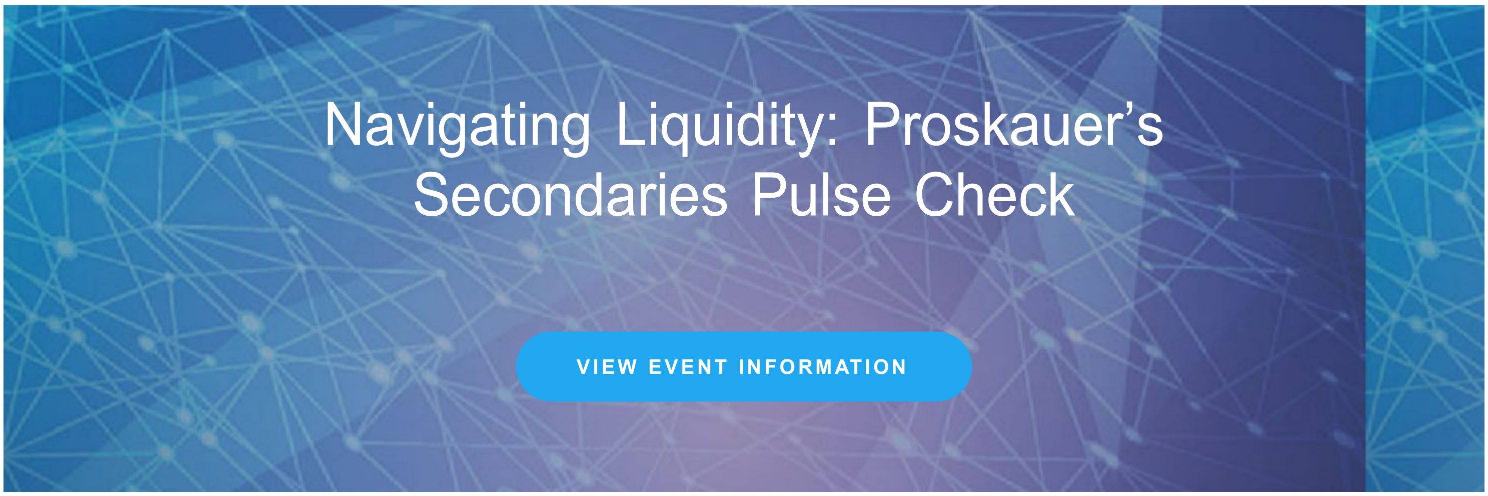
Chris Robinson: "After a strong first quarter, largely attributable to 2021 tailwinds where the secondaries market experienced record setting growth, activity in the secondaries market has slowed, consistent with an overall decline in public markets and investor confidence. Historically, pricing in the private markets lag a quarter or two behind public markets so many buyers have temporarily paused to allow valuations to stabilize and distribution activity to pick up as traditional M&A activity normalize. We expect bid–ask spreads to narrow in the fourth quarter of 2022 as the economic outlook becomes clearer."

How has growth in GP Led transactions over the last 5 years impacted the LP portfolio market?

Bruno Bertrand-Delfau: "The main impact has been allocation of resources and dry powder on the buy-side as secondary funds have been inundated with continuation funds projects. Many secondary funds deal teams have been unable to dedicate the same time and energy to pursue LP portfolio opportunities. Some players leaning traditionally more towards the LP portfolio business have therefore been able to seize good LP portfolios in 2021. With risk generally increasing in the current political and economic environment and LPs requesting more diversified portfolio, there should now be a good momentum for LP portfolios."

Chris Robinson: “The market volume for GP-led transactions has more than quadrupled over the last five years, accounting for close to 50% of the market in 2021. With that being said, dedicated available capital

remains high at an estimated at $227 billion (as of 6/30) so secondary buyers have ample capacity and demand, particularly for diversified LP portfolios.”



What have been the biggest factors impacting sell side supply and why?

Bruno Bertrand-Delfau: “Financial markets collapsing and continuing high volatility in markets have limited sale volumes in the first part of the year. Hopefully, a denominator effect and search for liquidity to finance new commitments will push volumes up in the run up to year end.”

Chris Robinson: “Many sellers are overweight in their private exposure and have sought to bring transactions to market to rebalance their asset allocations. In addition, faster turnarounds from sponsors looking to fundraise and a push to consolidate core GP relationships, have accelerated sell side LP portfolio supply.”

What have been the biggest factors impacting buy side demand and why?

Bruno Bertrand-Delfau: “Scarcity of human resources and limit of dry powder have certainly restrained activity. More recently, turmoil in the markets , high inflation in nearly all developed economies and resulting interest rates hikes have made valuation and pricing of portfolios uneasy. LPs have been asking for more diversification and less risk and many secondary houses have been reluctant to put forward bids matching sellers’ expectations. Leverage is also not as abundant or as inexpensive as it once was and many big names have started fundraising. Therefore, the global dry powder level should go up sharply in the coming months.”

Chris Robinson: "In the first half of 2022, a challenging underwriting environment caused buyers to be highly selective in deploying capital. Buyers have sought and received extended due diligence periods, hoping to better analyze portfolio company performance in a challenging valuation environment. While it’s expected that buyers will remain disciplined in the near term, several factors should lead to a strong year end supply of new opportunities, including (i) a desire to prudently deploy capital recently raised, (ii) a number of high quality transactions being brought to market, and (iii) new sources of capital, many of which are non-traditional investors looking to join the market."

What's next for the secondaries market? What are the areas of growth, evolution of techniques, etc?

Bruno Bertrand-Delfau: "Certain sub-segments like infrastructure secondaries are going to grow sharply. Portfolios are also going to continue their growth with potentially 10bn deal value being reached in the coming years. Deals are going to be executed at increased pace to avoid market reversals in an unstable economic environment. Optimal US tax and regulatory capabilities will still be key for a smooth deal execution. More deal structuring may be necessary to make deals possible in the current environment, with a variety of available tools, from deferred price to earn out."

Chris Robinson: "Given how healthy buy-side fundraising has been, we expect the secondaries market to continue its growth trajectory. As a sub-category, real estate and infrastructure transactions, with inflation and recession resistant characteristics will continue to be in high demand with several buyers raising dedicated pools of capital to these strategies."

KEYNOTE INTERVIEW

Mastering GP-led processes

A robust process is vital to any GP-led transaction, say Proskauer's Howard Beber and Warren Allan

While secondary buyers and LPs are becoming increasingly familiar with continuation funds, many sponsors are embarking on GP-led transactions for the first time and are not familiar with the process. Here, Howard Beber, co-head of private funds, and Warren Allan, partner in the private funds group at law firm Proskauer, set out what managers need to know about GP-led processes.

SPONSOR
PROSKAUER

Q What are the biggest challenges around GP-led processes that sponsors may not be aware of?

Howard Beber: First, these are time consuming and complex transactions. Next, there needs to be a compelling reason why a manager has opted for this type of transaction, beyond economics for the manager. Typical reasons include a misalignment of the portfolio relative to the timeframe of the fund, an asset needing follow-on capital, or just creating a good liquidity opportunity for existing LPs in an older fund.

These transactions almost always require some level of approval from existing LPs or the LP advisory committee of the selling fund, as well as some level of due diligence on the underlying portfolio companies, including to assess change of control and other issues that may be triggered upon the sale of a portfolio company.

Meanwhile, from the buy-side perspective, any secondaries buyer is going to expect the GP to participate in the continuation vehicle by virtue of a rollover of some or all of its interest in the underlying portfolio. Beyond that, there are internal GP issues that could arise: who is going to roll over, who is going to get carry in the continuation vehicle, and how that differs from the initial fund.

Warren Allan: At the outset, sponsors should be aware that GP-led processes are not bilateral deals, and will involve engagement with a number of different groups that have disparate interests. Successful deals are those that best marry up those interests, and achieve a win-win-win outcome.

In terms of the groups, there are the existing investors in the selling fund; the advisory committee of the selling fund; one or more lead buyers that are generally selected following a competitive process; a number of syndicate investors; and, as Howard has mentioned, there can be a number of internal discussions at the sponsor itself as to the shape of the deal and economics going forward.

Looking at the underlying asset level, there will need to be engagement with the management team of each of the portfolio companies. Discussions with other security holders of, and lenders to, underlying companies may be necessary, and there may also be a need to engage with regulatory authorities, for example if the target company is regulated.

There are a lot of participants, and the sponsor will be at the centre of discussions with each group.

HB: Another issue that adds complexity is the tax structuring of the portfolio. If the portfolio is layered with blockers and/or intermediary vehicles, or if the buyer is requiring tax structuring, that can be another challenge.

Q You mentioned due diligence issues. What other challenges tend to arise in relation to deal preparation at the fund and asset level?

HB: For most of these transactions, buyers are going to want to do some level of due diligence at the portfolio company level. This is where it becomes important to have good relationships with management teams at portfolio companies. The sponsor needs to work closely with the management team to make sure they are aware of the transaction and are prepared for buyer due diligence. This can be time consuming for management teams and particularly challenging if the sponsor doesn't control the portfolio company.

> *"The sponsor needs to work closely with the management team to make sure they are aware of the transaction and are prepared for buyer due diligence"*
>
> **HOWARD BEBER**

WA: It is important to get the portfolio composition right, and it helps if the portfolio composition is settled at the start of the transaction. From a transaction management perspective, it is better to get in front of diligence to flag any potential issues early on in the process. If a portfolio flexes during a process, it can lead to some process inefficiency, as the diligence workstream, on both the sell side and the buy side, will need to catch up in respect of the newly included assets.

Q What should sponsors focus on when it comes to choosing advisers?

HB: Choosing advisers with experience leading GP-led transactions is critical but experience is just table stakes. Sponsors should seek out advisers that have worked on similar types of GP-led transactions before – for example, if your transaction is on the smaller side, you want advisers that have worked on similar sized deals. After experience, the key is finding a good cultural fit and an adviser that you can regard as an extension of your internal team.

WA: It is important for a sponsor to engage both a financial adviser and a legal adviser with experience of acting for sponsors on GP-led activities. Good advisers will have been through the process a number of times already, and will be able to issue-spot and feed into the transaction structure and process to give the best chance of success. Having advisers on board that are experts in the market will benefit all parties to the transaction.

HB: LPs are now used to these transactions and there is nowhere near the level of scepticism that there used to be – LPs have seen the value from a liquidity perspective and can often be convinced these transactions can be beneficial for all parties.

Q What are some of the key considerations for sponsors in regard to new fund terms and retained liabilities?

HB: Managers should think about terms the same way that they do about main fund terms. Terms can set the tone of the transaction – some managers in a strong position with attractive asset(s) may choose to be aggressive, while others in an equally strong position may seek middle of the road terms. It is important for managers to align with where they are in the market, but also where they want to be perceived to be.

Unique to continuation vehicles is the 'allocation waterfall' which is necessary if there is more than one buyer. Because selling volume is unknown when deals are negotiating, buyers typically agree on a 'waterfall' dictating buyer participation relative to the eventual selling volume. In addition, for continuation vehicles the 'distribution waterfall' is typically different than a typical main fund in that it is standard to include one or more performance-based hurdles with multiple levels of carried interest depending on performance.

WA: Recourse for the liabilities of the selling fund will be a key point of discussion and focus during the negotiation of deal terms between the sponsor and the lead buyer.

If the selling fund has a limited term remaining, or will have limited assets remaining after completion of a transaction, a buyer will often seek a holdback from the purchase price or escrow arrangement. In addition, a buyer will want to carefully review the ability of the GP of the selling fund to recall distributions previously made to investors in the selling fund.

The use of warranty and indemnity insurance products has become more prevalent in GP-led deals, both for single-asset deals and portfolio transactions. These policies limit the risk of contingent liabilities for the selling fund and, given recovery is against the policy, can result in the selling fund being willing to give a broader set of warranties.

Q What about concerns around transparency of process and conflicts of interest? How can sponsors address these?

WA: Transparency is key in these transactions. Given the potential conflicts involved, these transactions often require consent of the LP advisory committee and, potentially, the broader investor base.

Sponsors are encouraged to have early engagement with the LP advisory committee, in particular, to consult on plans for a proposed GP-led transaction.

At these meetings, sponsors and advisers will seek to discuss conflicts of interest, the proposed transaction structure, and the alternative exit options considered. There is value in pre-empting questions on these topics.

The feedback from these discussions can often shape a deal and flag any issues with a proposed transaction structure early on. It is better to deal with those at the start of the process, rather than finding out, later in the process, that the deal terms or structure needs to change in order to obtain the necessary consents to do the deal.

Communicating with the broader investor base is also important, and a lot of time is put into the preparation of investor communications and election packs.

These will commonly contain: a description of the transaction process, how the lead buyer was chosen, what alternative transactions were considered, a summary of the key terms of the transaction, a description of the actual or potential conflicts and how they have been mitigated, and information about the options available to the investors, to elect to receive a cash distribution or roll into the acquirer or a mix of the two.

> *"Sponsors are encouraged to have early engagement with the LP advisory committee, in particular, to consult on plans for a proposed GP-led transaction"*
>
> **WARREN ALLAN**

Q Finally, what are the key factors that should be taken into consideration around portfolio composition?

HB: Around half of last year's GP-led deals were single-asset transactions. Single-asset deals are treated more like M&A transactions, with buyers engaging in fulsome due diligence on the asset.

On the sell side, if a sponsor is only selling one asset out of a fund that has other assets left, the transaction will likely be less attractive to LPs because it is not providing full liquidity, which could result in fewer LPs electing to sell.

Another important consideration for potential buyers is the relative unfunded commitment in the continuation vehicle. The more unfunded capital required in a transaction the less attractive the transaction will be to potential buyers. ■