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GP-Led Continuation Vehicles

New Opportunities, New Considerations

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PATHWAY RESEARCH

GP-LED CONTINUATION VEHICLES: NEW OPPORTUNITIES, NEW CONSIDERATIONS

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GP-led continuation vehicles ("CVs"), a type of GP-led secondary whereby GPs initiate a secondary transaction for one or more assets from their own fund or funds, are the latest evolution in the continually maturing secondary market. According to Jefferies,[1] GP-led secondary volume reached a record $68 billion in 2021 and represented 52% of all secondary activity during the year. It also represented the second-consecutive year that GP-led secondaries accounted for the majority of all secondary market activity. Market participants now broadly agree that GP-led secondaries have been a significant development for the secondary market and are here to stay. However, investors seeking access to GP-led secondary deals, particularly to CVs, should be aware that these transactions differ enough from traditional LP secondary deals to warrant their own due diligence processes. There are numerous issues to consider, but in this paper we will explore three primary areas that investors should focus on: valuation conflicts, GP alignment of interests, and concentration issues.

Valuation Conflicts

Existing LPs and potential secondary investors should consider the inherent conflicts related to the pricing of CV transactions. A GP ultimately has two groups to satisfy to successfully close a CV transaction, and these groups have opposing interests: existing LPs that are selling who want to fully maximize their return on the assets involved, and new and rolling LPs who want a fair, or even low, price that leaves room for go-forward appreciation. Existing LPs should also understand a GP's rationale for utilizing a CV as its method to generate liquidity rather than a traditional exit, such as a sale or public offering. As with traditional portfolio company exits, in CV transactions, managers are ideally attempting to exit the assets at optimal valuation. Meanwhile, similar to making a new investment, a GP re-investing in an asset via a continuation fund will want to avoid overpaying so that it may generate a strong return going forward for its investors. Because GPs are on both sides in a CV transaction and must ensure fair pricing for investors on opposite sides with competing objectives, investors require some evidence that the valuation does not overly benefit one side over the other. Certain investors are comforted by knowing the details behind the M&A or secondary sale process that sets the price, whereas others may want to see a third-party valuation or fairness opinion. Given this complexity, it is important for investors to have the resources to make their own conclusions on the reasonableness of the transaction price and to evaluate the process that was taken to arrive at that price.

GP Alignment of Interests

Alignment of interests is another key question for participants in CV deals. Such alignment can come in many forms, including rolled carried interest and potentially an incremental GP commitment for the new vehicle being raised. In such instances, investors should consider if the GP's commitment to the new vehicle provides suffi-

cient alignment with continuation fund investors. In most cases, GPs are committing more than the typical 1% to 2% for a standard private equity fund; however, there is no consensus on what the appropriate amount should be. Some investors are comfortable with any percentage above the normal 1% to 2% because it demonstrates (at least on a relative basis) more "skin in the game" toward the continuation fund assets than was previously the case. Others are not comfortable until they have been assured that GPs are rolling both 100% of the GP commitment attributed to the assets and 100% of the carry that will be realized. As such, it is critical for investors to understand and evaluate what level of alignment they require for each transaction.

Concentration Issues

CVs are generally more concentrated than the average traditional LP secondary. This is because managers are typically selecting a key asset for a single-asset continuation fund or a handful of larger assets for a multi-asset continuation fund. Due to the larger-than-usual exposures, investors should consider the level of diligence required to underwrite these transactions. Many secondary buyers have revealed that the diligence they perform on CV transactions, particularly for single-asset deals, is closer to that of a co-investment or direct investment underwriting than to a traditional LP-deal underwriting. Far more so than with traditional LP secondaries, participants in CVs are taking a deep dive into information for portfolio companies, taking into account the experience of the GP deal team and company management, historical and projected financial performance, capital structure and leverage, specifics on the value-creation plan and budget, and overall industry trends. Given these differences, investment approaches must be tailored to meet the more rigorous diligence required.

These three areas are just a few of the many considerations that come with evaluating CV transactions. Some other issues that an investor may need to explore include the following:

- Are the GP's deal team and portfolio company management staying in place for the next holding period? How aligned are management and any co-investors?
- How different is the new value-creation plan for the asset from the plan during the previous holding period? What is the rationale behind any changes?
- Is the amount of unfunded capital being requested by the GP appropriate given what is known about the go-forward plan for the asset?
- Are the terms of the new vehicle appropriate given what is known about the projected returns of the asset and relative to the terms of the vehicle the asset comes from?

The key takeaway is that although CV transactions are a novel and exciting component of the secondary market, they come with a number of new diligence items for investors to consider to ensure successful participation in these transactions.

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