CLIFFORD CHANCE

"DECODING" THE SECONDARY MARKET

PART V: GP-LED TRANSACTIONS

MAY 2022

INTRODUCTION

2021 saw the highest volume of GP-led secondary transactions in history, estimated to have reached over US$63 billion in deal value. This growth is expected to continue as market perception further evolves from viewing GP-led transactions as solutions for underperforming assets to more flexible liquidity solutions, including for the retention of high-quality assets.

As Part V of Clifford Chance's series on "Decoding" the Secondary Market, we explore some of the key trends and considerations for GP-led transactions.

TRENDS

1

Continuation funds as "fourth exit" track – continuation fund structures are becoming normalised as an exit alternative to the traditional asset-level exit routes (being sales, IPOs and refinancings). Notable deals by blue-chip sponsors and new market entrants are adding further profile and credibility. Increasing awareness of GP-leds has also translated to asset-level shareholder and co-investment arrangements catering for GP-led structures in the context of transfer (including tag / drag) and exit provisions.

2

Minority equity sales as valuation benchmark – minority M&A sell-downs are increasingly being used to benchmark price for GP-led transactions. This involves a minority sale of the asset(s) through a traditional M&A process, the valuation of which is then used to set the benchmark price for a continuation fund to subsequently purchase a stake in such asset(s). This can be attractive where sponsors or exiting LPs feel a conservative third-party valuation would not accurately reflect an asset's value as compared to one determined through a competitive M&A auction process. We have seen this price benchmarking used particularly effectively within the infrastructure asset class, given the typical size and shareholder base of those assets. We have also seen minority equity M&A sales evolve into full exits where an M&A buyer or consortium asserts its advantage in being able to move more quickly and unencumbered by the conflicts and LP election process of a GP-led continuation fund alternative.

3

"Trophy" single-asset transaction – there has been a clear rise in single-asset GP-led structures to allow sponsors to retain prized assets beyond the initial hold period. However, whilst single-asset deployment has continued in 2022, we expect some dedicated secondary funds to start approaching their concentration limits. This could see secondary buyers pivot their focus to multi-asset GP-led structures to meet fund diversification requirements.

TRENDS

4

Equity bridge financing – GP-led transactions have increasingly involved the use of equity bridge financing within continuation vehicles to fund a part of the purchase price. These facilities may be secured against uncalled capital commitments to the continuation fund and/or against the portfolio interests. Their use can have the effect of increasing returns to rolling investors.

5

W&I on GP-led transactions – with the growth of the GP-led secondary market, W&I brokers and insurers are increasingly expanding their offerings to cover GP-led transactions. W&I is most successfully deployed on GP-leds which have an M&A process overlap (e.g. via a minority sell-down as mentioned overleaf or an aborted auction process) where diligence and disclosure materials can be utilised for the W&I process. Pricing tends to be around 1.5-3% of the insurance limit (and can be on the lower end in European markets).

6

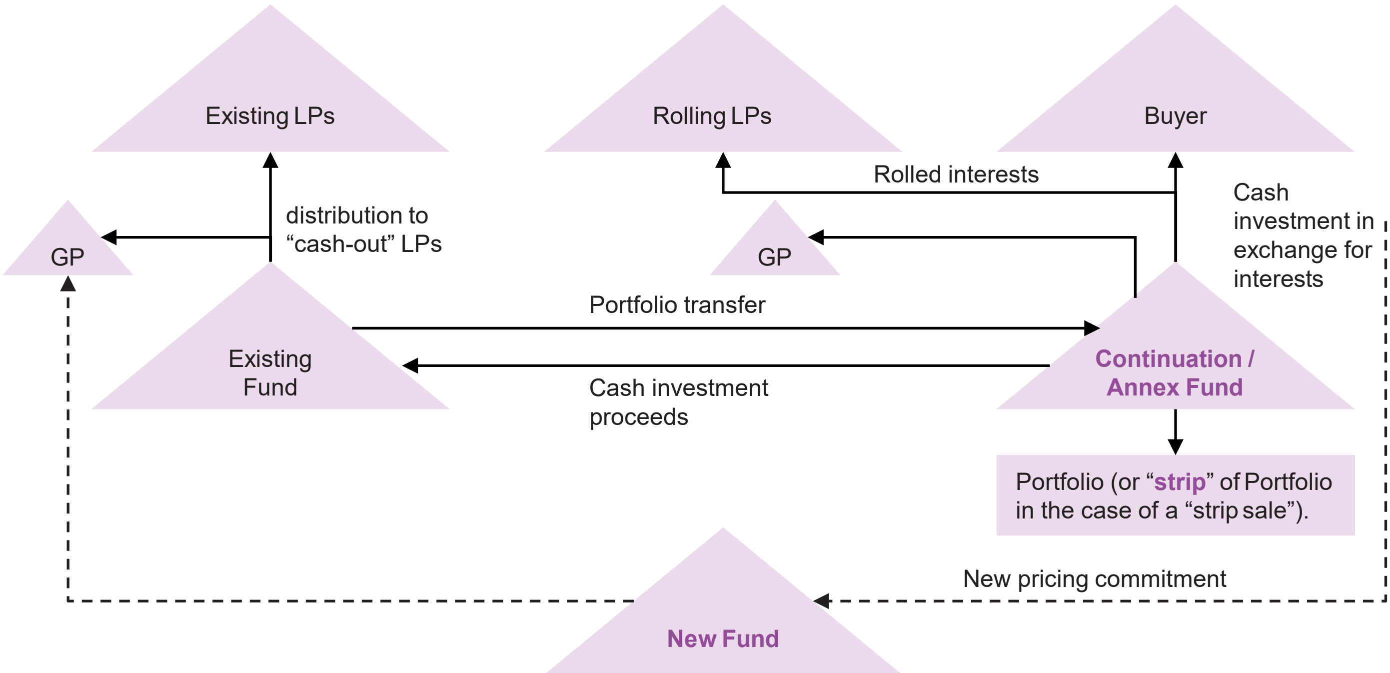
Growing diversity in asset class / region – whilst private equity remains the dominant asset class for GP-led transactions, as the market evolves, we expect to see continuing strong growth in the private credit, infrastructure, real estate and venture asset classes, with parties leveraging the know-how developed in PE but tailoring transactions to address asset class nuances. Although a relatively small part of the market by number, there have been large processes recently (and a few expected to come to market) in these latter asset classes, particularly where the underlying assets align with or support ecosystems benefiting from macro headwinds – e-commerce/logistics, healthcare and certain tech-thematic asset pools, for example. In APAC, where net distributions for LPs have historically been slower and Chinese Renminbi-denominated funds are typically shorter in length, the growth in acceptance of GP-led technology in recent years is expected to continue with more RMB-to-USD recaps, balance sheet de-risking and other event-driven situations.

7

Focus on transparency – with the increase in volume and size of GP-led deals, LPs continue to seek earlier engagement and further transparency from GPs on process and pricing. The US SEC also issued a proposal in February 2022 for sponsors to obtain fairness opinions on private fund deals, including on GP-led sales to continuation vehicles. This follows earlier proposals in January 2022 for US-regulated GPs to make notification filings within one business day of closing for most GP-led transactions. It remains to be seen in what shape, if at all, these proposals are adopted.

STRUCTURES

GP-led transactions can be highly bespoke and should be structured to achieve parties' specific objectives.



Minority equity sale: To benchmark price for the related GP-led transaction, minority stake in an asset is sold to a third-party in a traditional M&A process.

Continuation vehicle: Assets are sold to a new SPV managed by the same GP. LPs have the opportunity to roll-over their existing interest into the SPV (and new investors have the opportunity to invest).

Fund-to-fund transfer: An asset is transferred to a new flagship fund (no rollover option for existing LPs).

Annex fund / equity strip sale: Equity "strip" is sold across a portfolio or an asset to an annex fund managed by the same GP (existing LPs may be given the opportunity to rollover).

Tender offer: GP facilitates Buyer's acquisition from multiple LPs of interest in existing fund. No rollover option for existing LPs.

Preferred equity: New investor provides liquidity to fund in exchange for a preferred return up to an agreed threshold. No rollover option for existing LPs.

Benefits for GPs:

- Opportunity to return capital to LPs
- Ability to inject additional capital to support portfolio / asset
- Ability to navigate transfer restrictions / pre-emption rights in underlying shareholders' arrangements
- Where the transaction contemplates a continuation fund or fund-to-fund transfer:
  - ability to retain "trophy assets"
  - position a portfolio for recovery or extend holding periods for second phase value creation
  - Opportunity to reset carry

Benefits for LPs / new investors:

- Immediate and concentrated exposure to assets (including access to key "trophy" assets) for rolling and new investors
- Attractive risk-reward profile – existing LPs may be able to take advantage of strong alignment with GP and new investors benefit from GP's existing knowledge of the asset
- For LPs cashing out under a continuation fund structure, opportunity to fully or partially exit and de-risk from particular sectors / areas
- For rolling LPs, opportunity to benefit from the upside of a second phase of value creation and return exposure to performing asset(s)

KEY CONSIDERATIONS

Conflicts of interest

How will conflicts be managed (e.g. conflicts resulting from the GP being on "both sides" of the transaction where a continuation vehicle is used or the GP needing to ensure that one group of investors is not prioritised over another)? Do different teams need to be set up within the GP?

Risk concentration with single-asset

More in-depth due diligence is being conducted on GP-led deals particularly with single-assets where there is greater risk exposure to the asset. Consider how diligence materials will be prepared and provided – including need to involve management.

Pricing

GPs will need to be able to demonstrate fair pricing, whether through fairness opinions, external valuation and/or a parallel third-party transaction. Consider anti-embarrassment mechanism.

Asset-level arrangements

Analysis will need to be carried out over asset-level shareholders' agreement and MIP arrangements (including change of control / pre-emption or transfer restrictions and exit pay-outs). Other substantial asset level arrangements including financing arrangements and key commercial contracts should also be considered.

Regulatory consents/ notifications

Depending on the deal structure, GP-leds may trigger antitrust or other regulatory approval processes. For example, transfer of financially regulated assets may involve change of control approval / notice where control thresholds are triggered even by a change of passive indirect minority interest. Growing complexity of FDI regimes will require careful analysis across jurisdictions. Assets with listed instruments could also trigger public market notification and approval processes.

Tax

Different tax issues can arise depending on the structure adopted and the type of underlying asset(s). Rolling LPs (and the fund management team) in a continuation fund structure will be keen to ensure efficient tax roll-over treatment where possible. By contrast, a Buyer will want to ensure that it is not indirectly acquiring assets with significant built-in taxable gains. Transfer taxes may potentially be triggered and need to be shared between Rolling LPs and the Buyer.

The impact of the transaction on existing investment level tax structuring will also need to be considered to ensure investment proceeds can continue to be repatriated tax efficiently and that the transaction will not trigger, for example, new hybrid disallowance concerns.

Primary staple

Will the transaction involve a primary staple to the new fund by rollover LPs and new investors? Consider impact on conflicts analysis.

Cornerstone investor

In the context of continuation funds, is there an established cornerstone investor as lead buyer? Are they willing to underwrite the equity and step down to accommodate rolling LPs and new syndicate investors?

Transaction costs

Who will bear the transaction costs? This can include external valuation costs, financial adviser success fees, cost of continuation fund set up, as well as asset level costs and adviser fees for each relevant stakeholder and/or vehicle.

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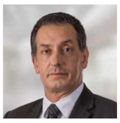

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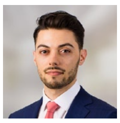

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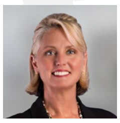

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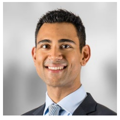

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