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All About Secondaries (Third of a Series)

THE LEAD | September 20, 2023

Our head of secondaries, Nick Lawler, relates the following story:

“In April 2019, I was in the middle of a road-trip from Chicago to Louisville, when I got a call from one of our relationships at a major investment bank to discuss a new deal. The sponsor, one of the nation’s largest and most respected, was considering a continuation vehicle for what was one of their most sizable, best performing investments. This US-based security guard services business was owned by the sponsor’s seven-year old vintage fund.

“The firm had recently sold a minority stake to a pension fund, delivering liquidity to a family office that had been a long-time investor in the business. It became clear that 1) the business had great growth potential, 2) the sponsor sought majority ownership, 3) there was an opportunity to clean up and consolidate the equity cap table, and 4) investors in the 2012 vintage fund would appreciate receiving liquidity. The sponsor could use capital from its most recent buyout fund for a fund-to-fund trade, but these types of transactions were often frowned upon by LPs, particularly if they are not investors in both funds.

“A better option was to raise a single asset continuation vehicle, provide existing investors liquidity and the option, but not obligation, to continue for the next phase of growth. This was done, and incremental capital was raised to continue executing the business’ M&A strategy. A year later the sponsor used the dry powder to acquire a similar UK-based company that expanded the platform’s footprint into Europe and globally. The merger created the world’s largest security company; almost twice the size of its largest competitor.”

While perhaps not a perfect tipping point, transactions such as this allowed the CV market to hit its stride in late 2020 and 2021, with notable high-profile sponsors bringing deals to market, including Clearlake, Leonard Green, Madison Dearborn, and Accel-KKR.

Over the past two years, GP-led transactions have represented 40-50% of all secondary market volume. Since then, CV technology has proliferated downstream, from predominantly larger buyout firms to now mid-market sponsors effectively using the deal structure for the same reasons. In baseball terms, we’re probably in the second or third inning of what could be a 12-inning game.

GP-led CVs can be efficient mechanisms to give LPs choices: take liquidity or re-invest for the next stage of growth. Rollovers have been widely debated; specifically, the “status quo” option. Recent ILPA guidance suggests existing investors should be offered a rollover option with no worse than existing terms. In practice, this can be complicated depending on the nature of the rollover (i.e., a no-fee, no-carry paying equity co-investor, or a fund investor with exposure on a look-through basis).

Typical CV structures offer lower economic incentives to sponsors, such as lower management fees and tiered carried interest including certain return hurdles. The concept is secondary investors seek downside protection and upside participation. If a significant equity co-invest was required to acquire the original asset, it’s hard to argue investors should not be granted a true status quo option. Nonetheless, the benefits of investing in CVs cannot be ignored by either GPs or LPs. For GPs, it’s maintaining ownership of franchise assets while delivering liquidity to LPs; LPs can continue backing trophy assets in a concentrated manner and support the next phase of growth.

As our friends at Secondaries Investor point out, keeping LPs whole in a roll-over depends on a variety of factors. How close to maturity is the existing fund? Do the economics argue for a reset or continuation of terms? Will new LP appetite crowd out existing LP commitments?

They quote one attorney as saying, “the GP should not coerce the selling fund LPs into a transaction by offering the choice between an unattractive exit price and a roll option with materially less favorable terms.”