KEYNOTE INTERVIEW

Behind the uptake of continuation vehicles



The GP-led secondaries market continues to benefit from innovation and shows no signs of slowing down, say Mary Lavelle, Daniel Quinn and Fadi Samman at Akin Gump Strauss Hauer & Feld

Q What innovations are you seeing in GP-led secondaries right now?

Fadi Samman: Having watched this market develop, we are seeing traditional M&A technology and techniques increasingly creeping in. We are also seeing the introduction of leverage into continuation fund transactions in a way that is tied to the deal, so the portfolio company is being levered as part of the transaction and the proceeds are being used for a specific M&A objective of the portfolio company.

We have also seen the use of earn-outs as a way to help bring price discrepancies together between buyers and sellers. In addition, we are seeing managers going on the offensive, using these transactions as a tool to help their next fundraise and to enhance the offering to their investor base, as opposed to just as a response to LP liquidity demands.

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Mary Lavelle: The diversification of the market across different sectors, asset classes and geographies has been another theme. People often now refer to this simply as the private secondaries market, rather than the private equity secondaries market, and we have seen secondaries taking off in private credit and venture capital, while real estate secondaries achieved a record year. GP-led transactions are playing a big role in that, giving investors exposure to assets in a different way.

We are also seeing a lot of dedicated secondaries funds coming to market with quite specific niche strategies, focused on GP-led deals, tail-end portfolio stakes, or particular regions. That will continue and it will be interesting to see whether emerging markets will start to see more secondaries growth.

Daniel Quinn: The wider market has realised how much innovative thinking has been done by the secondaries market and that has spurred adoption. We are in the early to mid-adoption phase as that innovation spreads throughout the market. Secondaries technology is no longer seen as unusual, instead it is developing into one of the primary exit strategies for many managers.

Q What are some of the challenges facing market participants when it comes to continuation funds?

DQ: One of the challenges is that these transactions are increasingly regarded as a standard exit route, with all the issues that implies about management expectations, co-investors asking difficult questions about drag-and-tag rights and persuading LPs that a GP-led transaction is the right exit strategy.

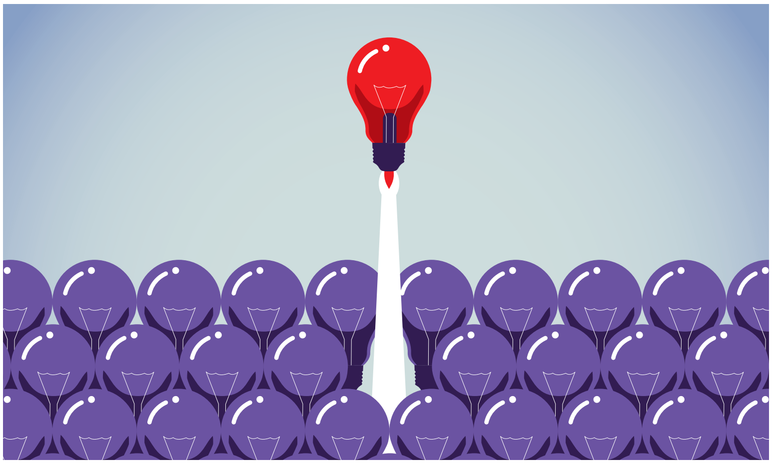
Managers need to be able to justify and sell the fact that they are selling to an associated fund rather than to the wider market, while also keeping an active eye on regulatory risk. There still has not been significant enforcement action around conflicts of interest on these deals, but it is important to keep employing best practices and not take an overly relaxed approach on those issues.

ML: There is the fundamental concern of whether investor demand will continue to match supply. The amount of dry powder in the secondaries market is estimated to be less than two years' worth of supply, in a market that is throwing out more and more dealflow. There is also an increasing burden on LPs, who need the bandwidth to deal with the frequent opportunities that are presented by their GPs. There are also some issues with LPs becoming over-allocated to certain GPs that are raising more and more frequently and challenges around secondaries fund portfolio construction.

Diversity and inclusion is another issue; diversity is behind in the secondaries market, particularly at senior levels, and that will become a challenge as dealflow continues to expand. Firms are going to need the best talent, so efforts to attract and retain top female talent should be prioritised.

FS: If demand continues, there is also a potential challenge around valuations. There are numerous deals where pricing is set and valuations are moving so fast that by the time investors are evaluating the deal the current valuation is materially higher. That is pushing for extreme speed of execution, and whether buyers and sellers can keep up with that is a key question.

On the regulatory side, the US



Q How can managers stand out to investors when launching secondaries funds?

DQ: Through excellence and specialisation. The market has become increasingly crowded as secondaries have become a growing part of portfolio construction, so managers with a good track record and expertise will continue to do well.

Otherwise, managers can stand out by targeting a particular sector or niche, like single-asset GP-led transactions, fund-backed deals, or infrastructure or real estate secondaries. The market is so diverse that there are a huge range of opportunities for managers to distinguish themselves.

ML: With specialisation comes different risk-return profiles, so having a clear strategy that offers a specific risk-return profile also helps a manager to differentiate its products to investors.

FS: We will also continue to see alignment with larger platforms, which expands the potential opportunity set for funds in terms of the deals they can do.

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>
> **FADI SAMMAN**

Securities and Exchange Commission's desire to monitor the real-time occurrence of these transactions could create scenarios that are very different to the inspection regime managers are used to.

Q How are changes in the market for representation and warranty insurance impacting deal dynamics?

FS: The overwhelming majority of GP-led deals we saw last year involved reps and warranty insurance. Insurance providers have adapted to these deals – they started off expecting buyers to do significant due diligence, but they now understand how the deals work and have changed the underwriting processes to primarily look to GPs to answer their questions, which helps execution.

There is still a question on the value proposition. We see buyers getting better indemnity terms but not necessarily better reps and warranties with respect to underlying assets, because the insurers would still expect more extensive due diligence on the portfolio company and that is generally not happening.

ML: There are some innovative new products emerging, such as the syndicated warranty packages that have attracted interest in the last year. In theory they can position the buyer well, but to get good reps and warranties there still needs to be a due diligence process that time may not allow for, so they do not solve all of the challenges.

Q Will GP-led clauses become commonplace in LPAs? How feasible are standardised terms and legal documentation for these deals?

ML: We are definitely seeing more GP-led clauses and I think they will eventually become commonplace. It makes sense, given the increasing number of transactions happening and given they are relatively new. If an LP is signing up to a fund today that has a 10-year duration or more, it has to be possible that continuation funds will be an exit solution in the future. It seems sensible to have something governing how that will happen, so the GP has some reassurance on how it will go about doing a GP-led transaction and a prescribed procedure around the levels of consent required. The LPs also get to negotiate how that should work, including aspects such as minimum timeframes of notice for LPs, pricing procedures and information requirements, to get a process they are happy with.

That said, LPs are currently wary of these clauses because they are new, and so they are subject to quite heavy negotiation. Over time, I think they will become more familiar with them and we will see some common parameters emerge.

DQ: There is a huge additional burden that the growth of this market has placed on investors, particularly on investors that sit on fund advisory committees. The materiality of the decisions they are making, the information they are having to digest and the time they are getting to do that probably represent one of the biggest changes for LPs in recent times.

We are seeing the market trying to address that in limited partnership agreements, but it is a case of finding the right balance between setting out a process while maintaining an adequate level of investor oversight at the time of a deal.

However, GP-led transactions are not yet ripe for standardisation. There are certain aspects of the secondaries market that are, but GP-led deals are no less or more ready for standardisation than any other M&A exit options.

FS: These deals involve a level of complexity that makes it difficult to envisage standardisation, but there are a few firms in the market that are regular players and their documentation tends to be recycled. There is also some standardisation of concepts and a tighter range of terms. There will still be outliers, but we are seeing some coalescence around terms for deals that might be characterised as similar.

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> **MARY LAVELLE**

Q How has LP appetite for GP-led secondaries evolved over the past year, and how do you expect it to develop going forward?

ML: Appetite is very high and growing at a faster pace than fund books in most asset classes, particularly in core asset classes like real estate. Appetite also continues to be selective, with LPs seeking out the good quality opportunities and also using these deals to get exposure to strategies they might not otherwise invest in. That will likely increase.

FS: Large institutional LPs will continue to have a growing interest in continuation vehicles because standing behind them are GPs saying that they like an asset and do not want to sell it. LPs may have a similar mindset and so if the deal involves a good manager and LPs have capital, they will continue to view these deals favourably and will at least want an option to participate in them. ■

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