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GP-led fund restructuring as a portfolio exit mechanism

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1. Introduction

The rapid evolution of the private equity secondary market, concerning the sale and purchase of existing interests in private equity funds, has opened up innovative avenues for sponsors seeking to exit their portfolio investments. If none of the conventional exit routes, such as trade sale, IPO or sale to another financial sponsor, seems right, why not exit by selling the portfolio investment to another investment vehicle managed by yourself? Sponsor-led (GP-led) 'fund restructurings' or 'fund recapitalisations' (as these transactions are known) are innovative transactions that draw on elements from routine secondary transfers of fund interests and private equity M&A-style deals, with added layers of complexity. They are increasingly popular because they offer liquidity for investors and sponsors alike. According to one recent estimate, GP-led transactions accounted for over US$26 billion of secondary transaction market volume in 2020,[1] representing almost half of private equity secondary deal activity for the year.[2]

The sheer volume of the market for secondary transactions calls into question the premise that private equity fund interests (and indeed private fund interests in other asset classes) are inherently illiquid. This premise is rooted in the outright prohibition on any transfer of interest (perhaps with the exception of affiliate transfers) during the fund's term by an investor without the GP's consent. The GP's consent can be denied for any or no reason leaving investors with no choice but to remain committed to their investment for the duration of the fund's life. A private equity fund typically has a ten-year term, with the possibility of extensions to the original term of up to two or three years. A fund could be in liquidation mode indefinitely post-extension. Traditionally, an investor seeking liquidity had to find its own buyer and convince the GP to consent to the transfer of its interest in the fund. GPs were not always

1 Source: Greenhill (as quoted in) www.privateequityinternational.com/four-key-trends-in-gp-led-secondaries-deals/.

2 Source: Triago (as quoted in) https://debtexplorer.whitecase.com/leveraged-finance-commentary/private-equity-turns-to-fund-restructurings-in-covid-19-slowdown#.

welcoming of such transfers given the administrative hassle and unforeseen change in their investor base. Now, however, investors have more variety and greater GP support in obtaining liquidity, particularly towards the end of the fund's life when facilitating investor liquidity can also meet the GP's objective of finding an exit route for one or more portfolio investments.

2. What are GP-led liquidity solutions?

A GP-led liquidity solution is typically designed by the sponsor to provide liquidity on a large scale, usually for several or all investors in one or more of its existing funds. Notwithstanding the GP's critical role in the process, it is increasingly common for sophisticated institutional investors and specialist secondary buyers to initiate discussions on liquidity solutions and negotiate bespoke terms for participation in such transactions. In a typical GP-led fund restructuring, an existing fund that is nearing the end of its term sells one or more of its portfolio investments to a new vehicle managed by the same sponsor. This provides liquidity for certain or all limited partners in the existing vehicle and enables participation in the underlying investment(s) for certain existing investors and new investors in a new 'continuation' vehicle.

Although this chapter is focused on fund restructurings, GP-led liquidity solutions more generally can take various other forms, eg, a tender offer for a number of limited partnership interests in the fund, a preferred equity issuance, or the use of bespoke debt arrangements. Where contractual or regulatory restrictions do not restrict transfers of portfolio investments, a fund recapitalisation is an attractive exit option. Indeed, it is the most popular GP-led liquidity solution in the European market. Variations such as single-asset transactions, where a specific portfolio investment is identified and restructured into a new continuation vehicle, and strip sales, where a portion of the relevant portfolio investments held by an existing fund is restructured into a new continuation vehicle, are also becoming increasingly popular.

3. A 'one-size-fits-all' solution?

GP-led fund restructurings were initially aimed at addressing the spectre of 'zombie funds', ie, funds with a protracted lifespan beyond the original term that were holding on to portfolio investments with little possibility of achieving a viable exit in the near term or generating any upside to the investors or the sponsor. Recently, however, such transactions have been used by sponsors proactively to manage portfolio investments, incentivise investment personnel and refresh their investor base. Far from being discounted deals, such transactions increasingly involve trophy assets and are now priced at compelling valuations in light of increasing investor demand.

A carefully structured GP-led fund recapitalisation can provide an optimal outcome for all transaction parties for a combination of the following reasons.

- The GP is not compelled to exit investments at an inopportune time. It can buy time to effectively manage investments that have intrinsic value but face adverse economic or market conditions or are otherwise unsaleable temporarily, eg, as a result of pending litigation, regulatory hurdle or other overhang.
- The GP can meet the additional capital needs of portfolio companies where there are meaningful near-term opportunities for follow-on investment and the potential to unlock value and create further upside.
- The GP can reset the economics in its favour, particularly where it would not have been entitled to management fees or carried interest on the relevant investments from the existing fund. This is an effective tool to incentivise investment professionals, particularly if there has been a change of personnel from the time of the original investment.
- Existing investors that are seeking liquidity can exit all or part of their interests in the existing fund portfolio, thereby crystallising gains on assets that have performed strongly and terminating exposure to underperforming assets.
- Existing investors that are amenable to continuing exposure to the relevant portfolio investments can recalibrate their holdings (by exiting part of the interests, for example). This often comes with the added benefit of being able to renegotiate to their advantage the terms of their participation in a continuation vehicle.
- Incoming investors can deploy capital towards a known portfolio of investments at an attractive valuation. They are also afforded the opportunity to develop a relationship with a new or existing manager.

4. Planning and structuring the transaction

Although each GP-led fund restructuring has its nuances, such transactions generally share several common features. Typically, limited partners in the existing fund are given options to: (i) participate in the sale to the continuation fund and receive cash for selling their interests; (ii) retain their interests in the existing fund with existing economics and without the need to make any additional commitment (also known as the 'status quo' option); or (iii) roll their interests into the continuation fund with reset economics with the option to make a further follow-on commitment.

As illustrated in Figure 1 overleaf, the sponsor forms a new continuation fund in which existing 'rollover' investors and new investors participate. The purchase price paid by the new investors provides the cash distributions required for exiting investors. The underlying assets are transferred from the existing fund to the continuation fund, typically paving the way for the eventual dissolution of the existing fund.

This extract is taken from the "GP-led fund restructuring as a portfolio exit mechanism" chapter by Tom Alabaster and Lavanya Raghavan in Private Equity Exits, Third Edition. Full details can be found at www.globelawandbusiness.com/PEE3.