APRIL | 2023

Private Equity Liquidity Strategies

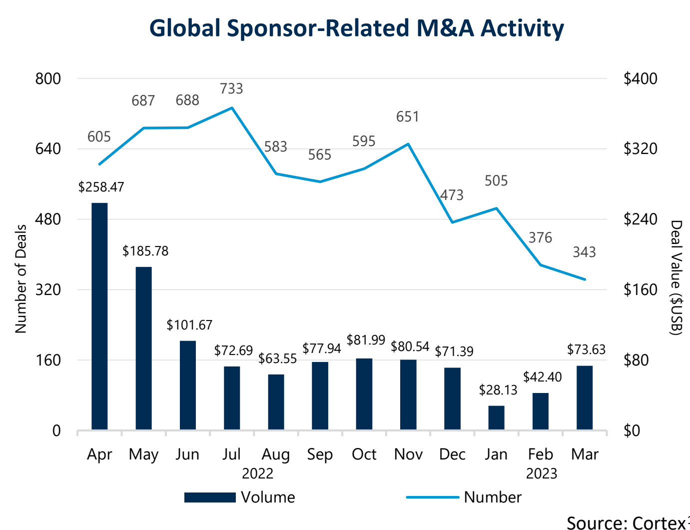
Quick Takes

The first quarter of 2023 generally extended the slower global and U.S. private equity activity seen at the end of 2022. While the number of deals continued to fall between January and March, total deal values increased but were still consistent with the lower levels seen toward the end of 2022. In view of the current market conditions, general and limited partners may desire to explore fund-level liquidity structures as an alternative to traditional exits. In this issue, we discuss some of these potential liquidity strategies.

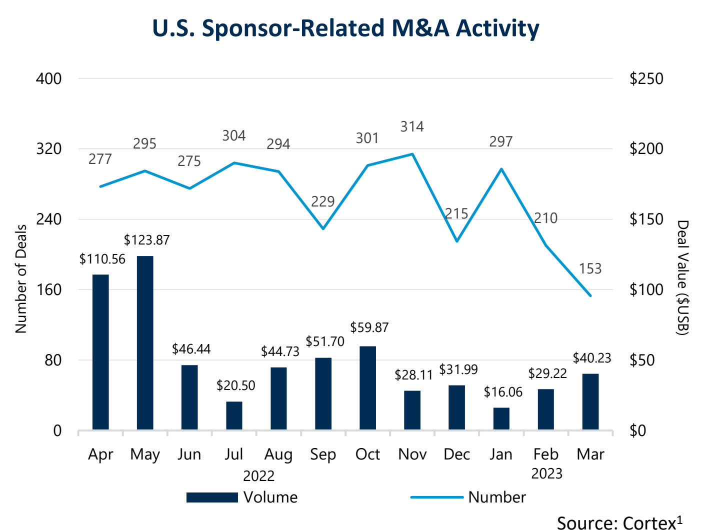
In the face of shifting market conditions, general partners ("GPs") and limited partners ("LPs") have incentives to investigate new options for achieving liquidity and furthering their investment objectives. GPs may seek new fund structures or other alternative liquidity strategies to, among other things: (i) add time for more meaningful value creation; (ii) delay monetization of investments for a more attractive environment; (iii) raise additional follow-on capital to support certain investments or achieve greater diversification; (iv) realign economic incentives, such as carried interest and management fees, to incentivize their current management teams; (v) attract new investors to their platform; or (vi) provide attractive end-of-life options for existing investors. For LPs, these alternative liquidity strategies present opportunities to (a) monetize their investments (particularly in older vintage funds); (b) extend their exposure to well-performing assets through new structures; (c) streamline private equity portfolios; or (d) address emergent sensitivities regarding particular assets. LPs may also wish to rebalance their portfolios across all asset classes following recent declines in public equity valuations in order to remain in compliance with their stated investment strategies, a phenomenon known as the "denominator effect." Below, we give an overview of several fund-level strategies for achieving these goals and related considerations. While certain of the above objectives may also be achieved using portfolio company recapitalizations, whether debt or equity, we will save that discussion for another day.

Continuation Funds

In a continuation fund transaction, one or more assets of a GP's existing fund are purchased by a newly established fund managed by the same GP or an affiliate thereof (a "continuation fund").



Source: Cortex[1]



Source: Cortex[1]

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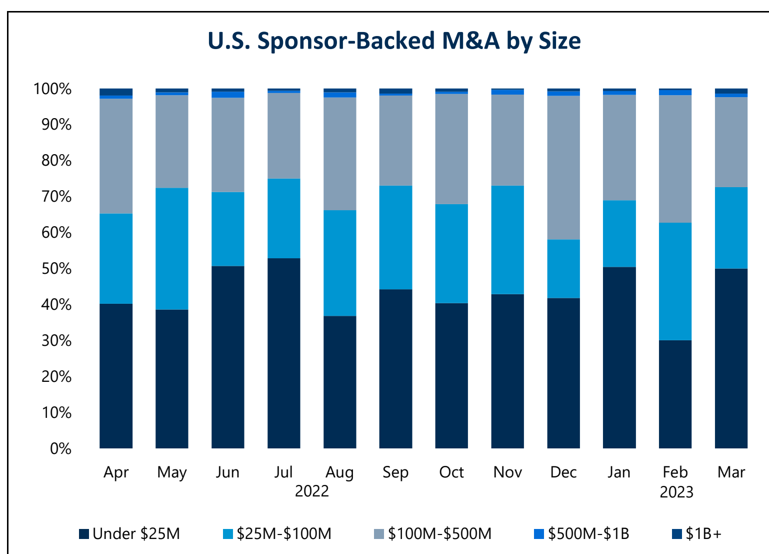
Continuation funds are suitable for a number of situations, including (i) where an existing fund has remaining assets but has reached the end of its life, (ii) where the GP needs more time and/or capital to prepare assets for sale or await more favorable exit conditions or (iii) where a single asset or group of assets in an existing fund have performed well but have not yet reached their full potential. What has previously been an investment structure used towards the later life of the investment fund to dispose of its entire portfolio and wrap up the fund is increasingly becoming used earlier in the harvest period. Single asset transactions are becoming much more common as well.



Source: PitchBook Data, Inc.[2]

In a continuation fund transaction, the GP typically offers LPs of the legacy fund the option to cash out (i.e., sell) their indirect interests in the asset(s) being sold or to reinvest, or “roll,” these interests into the continuation fund with new terms, including a new life span and new economics, as well as additional capital to be used for follow-on investments in respect of the asset(s) and expenses of the continuation fund. The capital needed to cash out the selling LPs of the legacy fund is raised by the GP from secondary buyers that are admitted to the continuation fund and have agreed to the continuation fund’s acquisition of the asset(s) at a particular price. In many instances, this price is determined pursuant to a competitive auction process administered by the GP or, more typically, a third-party placement agent. The existing GP is often required to “roll” into the continuation fund a large portion of any carried interest that the GP crystallized in the legacy fund’s sale of the asset(s) to the continuation fund, as well as the GP’s capital interest attributable to the asset(s).[3] The sale of assets by the legacy fund to the continuation fund generally requires the consent of the LPs or LP advisory committee of the legacy fund (the “LPAC”).

When considering a continuation fund, the various interests[4] of the GP, the original LPs and the secondary buyers need to be balanced in establishing the terms of continuation fund and the ability of original LPs to roll their interests. Discussions with certain LPs or the LPAC early in the process will help identify potential hurdles to obtaining consent before too many resources have been invested in the continuation fund process. GPs should also be aware of new rules proposed by the SEC in 2022 that would require managers to report GP-led secondaries transactions within one business day of closing and to obtain an independent fairness opinion in connection with all such transactions (although it is currently common practice to obtain a fairness opinion in these deals already).

Tender Offers

Tender offers present an attractive liquidity strategy, including in situations where, due to regulatory restrictions applicable to fund assets or other transactional complexities, such assets cannot easily be rolled over to a new continuation fund. Tender offers can also spare GPs many of the regulatory hurdles, investor negotiations and expenses associated with establishing a continuation fund while at the same time expanding the pool of investors, as seen in a continuation fund transaction. Another benefit to this type of transaction is that new investors often commit to subscribe for a “stapled” interest in another fund being raised by the GP.

In a tender offer, the GP offers LPs of an existing fund the option to tender their interests in the fund or elect to remain in the fund on the exact same terms. The capital needed to acquire the interests in the fund from the tendering LPs is raised from secondary buyers who submit bids to acquire those interests at a particular price and, like with continuation funds, GPs typically engage a placement agent to assist in the process. This process may be conducted without fund-level consent (depending on the structure of the offer and the terms of the fund’s limited partnership agreement), as the LPs that do not wish to sell their interests have a status quo option. The fund’s economics are typically not reset, but the GP may seek consent from LPs for an extension of the fund’s life if the tender offer goes through following achievement of a minimum tender threshold.

A tender offer will generally require the GP or its advisor to run a competitive process resulting in a price sufficient for LPs to want to tender their interests, which is often based on a percentage of the net asset value of the fund interests as reflected in the prior financials. If too few LPs accept the offer, the deal size may be too small to attract secondary buyer interest. There are generally no LP negotiations, so LPs can only elect whether or not to accept the offer that is presented to them (subject to the

secondary buyers' willingness to amend the offer terms). GPs should keep in mind that a tender offer does not produce carry distributions or an opportunity to modify fund terms (without LP consent), and that it can be difficult to find buyers willing to assume fund interests from existing investors with a variety of tax profiles.

Equity Strip Sales

In addition to providing a partial liquidity option to LPs, equity strip sales are useful for creating recyclable capital in an existing fund that is fully deployed early in its life. In an equity strip sale, the GP conducts a partial sale (e.g., 25%) of the fund's portfolio company investments (or a subset thereof) at a price negotiated with a prospective buyer (typically a percentage of net asset value). Buyers that participate in these types of transactions are often other private equity funds that are not initially looking to acquire a controlling interest in the underlying assets, although the buyer may negotiate certain governance or observer rights. This sale creates partial liquidity in a well-performing portfolio without sacrificing full control of the underlying assets, but the existing fund does give up a percentage of the assets' upside.

GPs contemplating equity strip sales should consider whether such a sale requires approval from the fund's LPs or LPAC, whether there are transfer restrictions on any fund assets, whether there are conflicts of interest that need to be addressed and potential implications for the governance, financing and executive compensation arrangements of the applicable portfolio companies. GPs should also carefully evaluate the likelihood of obtaining an appropriate price for the fund's investment in the applicable portfolio companies, especially in light of minority discounts.

Net Asset Value Loans

A net asset value loan (a "NAV loan") can provide liquidity for funds when economic conditions make asset sales difficult. They also may allow a fund to invest in struggling portfolio companies that may face higher financing costs on their own. Language can be included in a fund's governing documents permitting the sponsor to add NAV debt to the fund without LP approval under certain circumstances.

Unlike a portfolio company leveraged recapitalization, in which the debt financing is incurred by a single fund asset, a NAV loan involves the issuance of debt backed by a pool of fund portfolio investments. NAV loans serve as a natural transition from subscription lines of credit offered by banks and backed by LP commitments for funds that have drawn down significantly on LP commitments but whose sponsors still want to maintain a certain amount of fund-level financing. The diversified nature of a typical fund portfolio and low debt-value ratio of the loan—a typical NAV loan does not exceed 30% of the value of the assets in the collateral pool—helps to reduce the risk for lenders. Many lenders will also request a guaranty, equity commitment letter or some other form of credit support from the fund itself if the borrower is a subsidiary. The collateral for NAV loans varies. In some cases, lenders will expect liens on all eligible investments. In others, lenders may simply accept a pledge of the account in which the proceeds of investments are deposited.

Considerations

Ultimately, the appropriate liquidity strategy for a particular fund at a particular time will depend on multiple factors related to economic conditions, market volatility, interest rates, fund and asset performance and prevailing asset prices. GPs should review what their governing fund and portfolio company-level documents allow and what LP consents may be required. When presenting a proposed liquidity strategy to investors, a compelling narrative is helpful to gather support from the LPs, including explaining to LPs the alternatives that were considered and why a particular strategy was chosen.

With respect to the equity-based liquidation strategies discussed above, the following considerations will also be important:

- Size: Secondary buyers are typically capped in the amount of exposure they can take on in any one company. GPs should compose buyer lists with particular attention to book-build dynamics between different types of investors.
- Transferability of Assets: Portfolio assets may have limitations on direct or indirect transfers of ownership (which may apply to cross-fund sales as well). Among other things, GPs should consider conducting an upfront analysis of portfolio company governance agreements, management incentives and regulatory considerations to identify potential factors that can impact the transaction.
- Due Diligence: Secondary investors' level of diligence varies significantly by group and certain investors may require detailed asset information. GPs should consider setting up a full data room for lead investors to reduce time delays on the back end of the transaction process and providing access to the prospective sellers, if applicable.

- Potential Buyers: New entrants on the buy side may have limited experience with secondary transactions, so investors should be vetted for pre-qualification and experience with similar transactions as appropriate to ensure optimal execution. In addition, GPs should review tax and other considerations of the buyers that could potentially create pitfalls for the funds and existing LPs.

- Transaction Terms: LPs will focus on the economic terms, reinvestment options and allocations associated with any secondary transaction. GPs should consider the appropriate syndication requirements, internal rates of return and multiples on invested capital. In developing proposed term sheets for investors to begin negotiations for a new continuation fund, GPs should consider structuring fund economics to align as appropriate their interests with those of existing LPs being given the option to roll or sell, as well as with buyers at the continuation fund level, and with respect to the liquidity options being offered at the portfolio company level. Fairness opinions to help validate transaction pricing are typical.

With respect to NAV loans, among other things, GPs should consider the following:

- Collateral: Transfer restrictions, change of control provisions or other items in underlying investment agreements may prevent certain assets from being used as collateral. GPs should review the underlying agreements for any assets being considered as collateral to ensure any possible obstacles to a transaction contained therein are addressed.

- Loan Agreements: Covenants in loan agreements may restrict the ability of GPs to freely dispose of assets without notice to or consent by the lender or create other restrictions on the GP's control over the assets. Loan agreement provisions might also subject a fund to higher interest rates or early loan repayment before making distributions to investors if a decline in the portfolio value causes a breach of an established loan-to-value ratio. Other provisions may provide for certain troubled investments to be removed from the borrowing base if they fail to meet eligibility requirements. GPs should carefully consider any such covenants and their potential effects on the fund, as well as any relevant fund-level borrowing restrictions or limitations in the fund governing documents or LPs' side letters.

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[1] Sponsor categorization determined by Cortex; as of April 10, 2023. Deal volume by dollar value is calculated from the subset of deals that include a disclosed deal value. Paul, Weiss has not reviewed data for accuracy.

[2] Data provided by Pitchbook Data, Inc. as of April 17, 2023. Pitchbook's current data methodology includes all announced and completed deals for sponsor-backed M&A. Sponsor categorization determined by PitchBook. Paul, Weiss has not reviewed data for accuracy.

[3] Since an affiliate of the GP comprised of the same, or substantially the same, members of the GP will be managing the continuation fund, those members of the GP will also be entitled to share in the future realized profits of the continuation fund as well as management fees.

[4] Among other things, tax and regulatory considerations are key factors.

This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

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