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Taking the Second Exit

WRITTEN BY

Patrick J. Bianchi | Stephanie Pindyck Costantino | P. Thao Le

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Secondaries may be a popular exit route for sponsors and investors alike, but sponsors should be aware of key legal considerations, say Troutman Pepper partners Patrick Bianchi, Stephanie Pindyck Costantino, and P. Thao Le.

Q: Continuation vehicles are an attractive exit route now, given the challenging macroeconomic backdrop. What valuation and fiduciary issues should sponsors consider with such transactions?

P Thao Le: When it comes to continuation vehicles, it is crucial for a sponsor to understand that, from a fiduciary standpoint, they sit on both sides of the transaction. It is an exit event that may crystallize carry and, therefore, a third-party valuation – and, in certain instances, a fairness opinion – will help the GP demonstrate that it is properly considering and executing on its duties.

From a regulatory perspective, there is concern surrounding continuation funds, including by the US Securities and Exchange Commission. GPs must be able to demonstrate that they are going to continue to monitor and grow the investment for a future exit, especially if the GP continues to receive compensation with respect to the 'continued' investment.

Stephanie Pindyck Costantino: Continuation fund transactions create a conflict issue for sponsors and the question is how best to handle the conflict or, in some cases, the appearance of a conflict. One way they can navigate this challenge is by consulting with their existing fund LP committee or advisory board before bringing in a financial adviser to determine price.

One of the overarching themes that needs to be prioritized is transparency; maintaining an open communication channel with existing investors about the process and how a price has been determined is critical. It is also important to ensure that existing investors have ample time to fully understand the process and respond to any documentation being presented to them.

Patrick Bianchi: This is part of the trade-off for continuation fund deals. There are increased costs associated with addressing valuation and fiduciary concerns, but there are a lot of upsides associated with knowing the asset well, which saves on due diligence time and costs, and familiarity with the value creation strategy.

That being said, sponsors will have to fulfil enhanced disclosure obligations and communicate with investors in ways they wouldn't consider on a regular deal.

Q: What opportunities and challenges exist in the secondaries market?

PB: For LPs that have already invested into funds, the biggest opportunity offered by the secondaries market is liquidity, with that ability to exit investments and receive proceeds in an earlier timeframe than would otherwise be achievable.

The other benefit for existing LPs is the ability to re-balance portfolios in a challenging macro environment so that they can exit industries or geographies in which they might find themselves too heavily weighted.

For buyers, the biggest opportunities are around attractive pricing, with the chance to enter into existing funds at a discount compared to what they would have had to pay for the same assets in the past. We are also seeing an increasing number of buyers in the secondaries space targeting certain sectors.

People are becoming much more familiar with the valuation process when it comes to these kinds of assets, which has historically been the biggest barrier to entry for new players. It can be difficult to get comfortable with the idea that you are appropriately valuing an interest in a competitive secondaries environment, but it is getting easier.

Q: What can managers do to prepare assets for sale and maximize their capacity for flexibility?

PTL: One question I always ask clients when they come to me looking to exit a portfolio company is, 'What is keeping you up at night in this business?' No company is perfect and if there is a known liability, the next question to ask yourself is how you can address that issue. For example, if there is some kind of litigation liability, do you have a reserve on your financial statements? If so, is the liability already factored into the sale price?

SPC: Liquidity is an issue for many managers right now, so the priority should be to look at the portfolio as a whole and rearrange things in a way that allows you to maximize the capacity for liquidity. That may involve undertaking a roll-up of existing portfolio companies in such a way that looks and feels different to create something that would make more sense for an acquisition by a strategic.

PTL: Managers are having to get creative with their approaches. If there is an option to combine two portfolio companies within a fund, for example, then the GP would need to look at the transaction with both its fund fiduciary duty and portfolio company fiduciary duty hats on, because the GP will often have representatives on the boards of those companies. In related party transactions, there may be conflicts between what works at the fund level and what works at the company level, and those nuances must be carefully navigated and given due consideration.

Q: What trends are you seeing in relation to partial exits?

PB: On the secondaries side, we are seeing people undertake partial exits for liquidity purposes and to rebalance portfolios. There are often valuation issues associated with those deals, just as there are with continuation fund transactions.

The good news is that as we see more players entering the secondaries market and targeting particular sectors, those buyers have a deeper understanding of valuations within portfolios.

Q: What issues do GPs face today in relation to conflicts of interest in exit processes?

SPC: There are a couple of hallmark conflict issues that most sponsors face, one being the 'multiple hats' issue, where sponsors are sitting at both the fund level and on boards at the portfolio company level. They are weighing up different factors at different times, treating their duties at each level seriously and distinctly.

In that context, depending on the type of transaction involved, there are valuation, timing and compensation issues to consider. You might have a sponsor that is very much involved with carry sitting on the board of a portfolio company, so understanding that potential conflict of interest is key when it comes to identifying when it might be a good time to sell for the fund's sake.

PB: Those same issues come up in GP-led secondary transactions. If one fund is in the carry, the manager will be getting carry and selling to another affiliate of the GP with presumably different fees and expenses arrangements, which presents potential conflicts.

PTL: There is a common theme here, which is valuation, transparency and fiduciary duties echo across all of the different aspects of these transactions, and they are often the subject of regulatory scrutiny. GPs are having to think about fiduciary duties from a regulatory perspective (for example, under the Investment Advisers Act) and under applicable corporate/entity laws.

Right now, a number of PE funds are well past their investment periods, so there is pressure for GPs to get out and avoid the perception that they are holding onto investments to continue receiving management fees. While that might make sense from a business perspective, from a regulatory perspective there is a bright light being shone on fiduciary duties to LPs and everything is being evaluated retrospectively.

Balancing the competing interests of new investors, old investors and GPs themselves must remain front-of-mind on these deals.

Q: What considerations should be given to ringfencing post-sale liabilities in the current market? When does it make sense to obtain reps and warranties insurance?

PTL: Generally speaking, with a true exit to a third-party buyer, a GP is looking to ringfence its post-sale liabilities so they can make a distribution to LPs and crystallize carry while mitigating the potential for distribution clawbacks. That is not a particular feature of the current market, but it can still be a challenge to execute.

If there is a very attractive asset in a competitive process, a GP can often lead a buyer to make its offer more attractive by obtaining representations and warranties insurance (RWI) or agreeing to a true 'walk-away' deal. In some instances, a buyer might 'self-insure' a deal by factoring the RWI retention or the risk of a 'walk-away' deal into the purchase price, or a working capital adjustment.

RWI and walk-away deals are more common among PE deal parties. Strategic buyers may prefer a traditional

indemnity package over a RWI deal as they weigh the benefits of reps and warranty insurance against the costs of obtaining the RWI policy and the likelihood of making successful claims on the policy. The cost of underwriting and the risk of claim denial may be too high for a strategic buyer.

The question remains as to whether the buyer wants to end up fighting with the insurer or with the seller. The current market trend is for buyers to do a cost-benefit analysis and some strategics are deciding against RWI deals, while PE sponsors may view RWI deals as more of the norm.

From the seller's perspective, if it can fund an escrow that is, say, 10 percent of the purchase price and have that escrow be the sole recourse against the seller for indemnity claims, that would be a great result. While the GP may think it might never get that escrow back, it knows that the fund's liability could be capped at that escrow and get comfortable about distributing the sale proceeds shortly after closing. If the escrow does get released, that is additional cash for investors. Many sellers, particularly private equity funds, would be happy with such results.

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