KEYNOTE INTERVIEW

Navigating innovation in fund terms

In the rapidly evolving GP-led market, new approaches to deal terms and structures are proving a hot topic, according to Akin partners Fadi Samman, Daniel Quinn and Simon Ellis

SPONSOR
AKIN

Q GP-led deals are now a familiar part of the secondaries market, but establishing valuation can still be an iterative and prolonged process. How are deal structures and terms evolving to address that?

Fadi Samman: Over the past year, we have seen more sophisticated pricing mechanisms coming into the market. Tools that would normally be associated with M&A deals have been applied to GP-led and continuation vehicle (CV) deals. Deferred purchase price mechanisms and other similar performance-based triggers, for example, are now more often included in deal terms.

There have even been conversations around structuring earnouts, although those can be more difficult to conceptualise and execute in the context of a CV. These terms help bring deals together, and for LPs these mechanisms help to realise better pricing in a way that might not have been possible in earlier, simpler iterations of CV transactions.

Simon Ellis: Deferrals have definitely helped to bring buyers and sellers together. GPs are reluctant to move very far from pricing at par in continuation fund deals, because more often than not these transactions will involve prize assets, and GPs will want to secure a deal that's good for their investors. On the buy side, however, par may not feel like the right price – particularly in multi-asset deals where pricing tends to track the discounts you will see in LP-led deals.

Deferrals create the ability to bridge that gap in pricing, which has allowed some deals to happen that might not otherwise have gone ahead.

Subscription line financing has been another tool that can bridge the gaps and help buyers to get comfortable with pricing levels. The subscription line solution, however, can be a double-edged sword, because while it does lead to a better IRR for the buyer, it also represents a better IRR for the purposes of the CV waterfall.

Daniel Quinn: Running a vigorous auction process goes a long way towards reassuring fund advisory committees and securing their blessing for a CV deal. It is also crucial to make sure that there is adequate disclosure, and that investors have the time and information they need to decide whether or not to sell or roll into the CV.

Q Are some of these steps now included in fund documentation?

DQ: The mechanics for approving GP-led transactions are starting to creep into documents, but in general the process is still primarily shaped by convention.

That said, limited partner agreements (LPAs) are getting more sophisticated to ensure that there is the necessary flexibility to actually implement these deals when they do get approved. Documentation will now include language to make sure that the GP has all the powers required to implement the deal, including approving distributions in kind or differential treatment for selling and rolling investors.

Ultimately, however, the progress of a deal still essentially comes down to advisory committee approval, rather than any kind of pre-blessing in the LPA.

FS: The counterpunch to those flexibility provisions has been LPs then either commenting on those provisions or seeking side letters to further clarify or limit that flexibility. We have seen LPs include this in side letter requests focused on GP-led situations as part of the fundraising process.

LPs are eager to ensure that these processes are run in a way that is fair and that meets their objectives. There is an acceptance that most GPs are likely to do a CV deal during the life of a fund, so it is becoming baked into the course of ordinary fund term negotiations.

Q Multi-asset CV deal volumes are increasing. What deal structuring complexities do these deals raise?

SE: Multi-asset deals will inevitably be more complex than a single-asset vehicle, particularly when there are multiple selling funds. One of the concerns is that because you're dealing with a different investor base in each of those funds, the percentage share of the assets being sold may be different for each fund. That will ultimately depend on the investors and what their appetite is to sell or roll. It's unlikely to be the case that all assets are equally important, although increasingly it's the prized assets that are being sold.

One of the things we have explored is implementing some elements of deal conditionality to ensure that the secondary investors aren't overconcentrated in a particular asset when the transaction completes.

Q How do sellers think about representations and warranties for buyers in a CV scenario?

FS: One of the hallmark objectives for sponsors on continuation fund deals is to create a clean exit for selling LPs with as little residual liability as possible. That is important for making the opportunity attractive for selling LPs.

That, of course, always leads to a degree of tension in negotiations on the scope of representations and warranties. In the US market, this has led to rep and warranty insurance becoming a frequently used tool in CV transactions. The lion's share of deals that we work on will use rep and warranty insurance, as GPs are ultimately using insurance to structure an attractive deal for sellers with no liability tail.

Rep and warranty insurance doesn't totally eliminate the selling funds' liability, but it does substantially reduce indemnity overhang and simplifies the negotiation because it eliminates a lot of the risk for the selling funds. That said, there is limited history of claims on these policies, so there is still some debate in the industry on whether to use regular indemnities instead of insurance policies.

DQ: The increasing sophistication and complexity of the GP-led transaction market is mirrored in the insurance products that are available too. Insurers are becoming very good at crafting policies to address particular issues within the secondaries market.

For example, we have worked on multi-asset secondary deals where we had an insurer pitching a product that would effectively cover the risk that some of the assets didn't come over while the others did, in case the buyer regarded the assets that didn't come over as the more accretive ones. That is a very interesting policy to be able to write and highlights the increasing sophistication of insurers.

Q What are the expectations for investors with respect to CV structures and terms?

SE: The secondaries buyer will generally be comfortable negotiating a document that follows the sponsor's latest flagship fund. Flagship fund terms are intensely negotiated, so there is limited value in relitigating everything.

There will always be a focus on preventing any GP-friendly changes that aren't a function of the fund being a CV rather than a blind-pool fund. But one of the biggest priorities in CV negotiations will be limited partner

advisory committee (LPAC) membership.

In a blind-pool fund, GPs will typically have discretion as to who joins the LPAC, but secondaries investors in CVs will want tighter controls over LPAC representation. Secondaries investors may not be aligned with rolling investors on exit timings and objectives, so they won't want a situation where the LPAC consists of the GP's closest investors, who may also have an eye on securing a good allocation to the GP's next flagship fund.

These conflicts between the investors can be exacerbated further if you form structures where secondary investors and rolling LPs are investing on different terms (for example, a status quo option or a "roll in place"), as this will introduce complexities that will come to light over the course of the fund.

DQ: The size of the GP commitment is another focus area. There is variation from deal to deal, depending on the circumstances of the manager, but investors will obviously push for as large a GP commitment as possible to ensure maximum alignment, which is really the key to these transactions.

The minimum starting position for an investor will be that the GP rolls the entirety of its proceeds from the sale, both in terms of the GP commitment piece in the selling fund and any crystallised carry. Investors don't always get that, but that would certainly be the starting position.

> *"Deferrals have definitely helped to bring buyers and sellers together"*
>
> **SIMON ELLIS**

> *"Running a vigorous auction process goes a long way towards reassuring fund advisory committees"*
>
> **DANIEL QUINN**

Q Are there any sticking points on terms and negotiations that recur across the market?

DQ: As mentioned earlier, there is always a healthy debate around the scope of the warranties. The selling GP will sometimes try and pitch the CV deal as more akin to a normal fund investment, as opposed to the blended transaction that CVs really are. So, there's often a bit of back and forth on what the appropriate warranty package should be.

There is a relatively well understood set of continuation fund warranties that you're pretty sure you're going to get, but there will be debate around how deep into the portfolio company business itself you go in the warranties. It is always one of the most highly contested topics.

SE: Cost allocation is always a hot topic too. The sponsor will work across all sides of the deal, which raises questions around the costs the sponsor will incur and how those should be allocated.

There are some costs where it's fairly obvious who should bear the cost, but there are also grey areas. Some sponsors will try to shortcut that by just splitting the costs 50/50, but that doesn't really take into account that the lead investor costs are also going to be carried by the CV. It is always a subject of extensive debate and negotiation.

FS: Sticking points also vary according to asset class. The perspectives of buyers in infrastructure, energy and real asset CV deals tend to be a little bit different to the traditional buyout CV.

In private equity, the buyers typically seek very limited asset-level rights, but in other categories you do notice a desire to have a little bit more control and influence on the asset post-closing. That creates a healthy tension in negotiations. ■