KEYNOTE INTERVIEW

Pulling in the same direction

As GP-led deals have evolved, so too have the terms designed to create alignment of interest between all parties, say Proskauer's Jordan Hurwitz and Natalie Scott

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Q How can alignment be achieved in GP-led deals?

Jordan Hurwitz: We now have a relatively well-trodden path with regard to what elements are needed to achieve alignment in GP-led deals to ensure such transactions are viable. Creating alignment often involves early discussions and obtaining consent from the existing fund's limited partner advisory committee, independent price verification, the GP rolling over its crystallised carry, lower management fee charges, tiered waterfalls where the level of carried interest is linked to performance-based hurdles and providing appropriate optionality to existing investors. Achieving alignment among all parties has always been a key focus and will continue to be going forward.

Natalie Scott: Investors on the buy side of these transactions are looking for sponsors to roll 100 percent of the carry they have earned into the new deal as a means of encouraging economic alignment. Investors also seek heightened governance rights in the continuation fund or, in some cases, at the portfolio company level, which functions as an extra guardrail where perfect alignment is lacking.

Q How are participants gaining the disclosure they require?

NS: GPs will often provide a suite of due diligence information for new investors early in the process to aid them in evaluating the transaction. Ideally, sponsors also make this same information available to existing LPs. A more comprehensive disclosure document is also prepared for existing LPs to allow them to evaluate whether they want to sell their interest or continue to hold onto the asset.

JH: Providing a clear and comprehensive overview of all aspects of the transaction to the existing investor base is

fundamental. A significant amount of time and effort will be spent by GPs on the preparation of the investor communication and election packs, and it is imperative to ensure the documentation is 100 percent accurate prior to circulation. If significant details are inadvertently omitted or certain aspects not made clear enough, such documentation may need to be reissued, which could negatively impact the deal timeline.

Q Clearly, setting a fair price for the asset or assets is vital. What developments are you seeing here?

JH: For any deal to take place, some form of third-party pricing verification is essential and has been a common feature in GP-led deals. One of the most common pricing verification methods involves the issue of fairness and valuation opinions. However, you may also see a minority position in the underlying asset sold to a third party ahead of the deal, with the applicable price then being used for the wider continuation fund transaction.

The US Securities and Exchange Commission recently proposed new rules, which if implemented would fall under the Investment Advisers Act of 1940 and would result in many GPs being required to obtain a fairness opinion from an independent third party in connection with any GP-led transaction. So, obtaining a fairness opinion may soon become a legal and regulatory obligation, notwithstanding the fact this is already common practice.

NS: Another way that GPs ensure fair pricing is by running competitive auction processes with a range of potential buyers. Arriving at the right valuation is, however, one of the most difficult aspects of getting these deals done. This is especially true at a time when there is a price expectations gap in the M&A market more generally and it has increasingly been a contributing factor for broken deals in recent months.

Q How does the GP's knowledge of the asset come into the alignment of interest equation?

JH: GP-led deals are often used to hold on to the GP's most attractive 'trophy assets', giving it more time to extract unrealised value and growth, which will hopefully lead to greater returns. Presuming there are existing positive relationships between the GP and management teams running the day-to-day operations of the underlying companies, the GP will have a significant head start due to its time already working with such companies. In comparison, 'new owners' in the context of a third-party sale would require more time to get up to speed with the businesses and make their mark.

NS: From a commercial perspective, these deals are very different to a primary investment in a blind-pool fund. There are targeted assets that have become part of the deal because of their performance history and so buyers have a higher vested interest in each specific asset's continued performance. But structurally, the terms are often quite similar to blind-pool funds and so buyers are inherently reliant on a GP's knowledge of the specific assets involved in the deal in light of typically fairly limited governance rights.

Q Natalie, you mentioned carry rollover. Has practice changed here?

NS: The vast majority of deals I see involve the GP rolling 90-100 percent of their carry, although there are some unique situations where buyers will accept less than this and it will depend very much on the quality of the asset and sponsor.

JH: We recently carried out a review of all GP-led transactions we worked on in the 18 months running to June 2022 and only one-third of deals required the sponsor to roll 100 percent of the crystallised carry into the new fund. In other deals, we saw parties agreeing a set dollar amount to be invested by the GP, which was not necessarily reflective of proceeds allocated to the sponsor.

As transaction volumes proliferated when dealflow was still rife, with high quality assets and blue-chip sponsors accessing the market, we saw GPs successfully arguing for a lower proportion of crystallised carry being rolled into the deal. That said, bargaining power appears to be shifting back to the buyers and there is an expectation that a far greater proportion of deals will return to 100 percent rollover of crystallised carry.

Q What is happening with management fees in GP-led deals?

JH: To create greater alignment, continuation funds typically charge lower management fees – in the range of 0.5 percent to 1.25 percent, which of course differs to the 2 percent seen in your typical primary funds. Certain continuation funds don't charge any management fee at all, but we have only seen that on European transactions. In the US, the most prevalent fee rate we have seen is 1 percent, whereas in Europe we saw more variation, with an even split between GPs charging 0.5 percent and 1.0 percent. Such percentage is typically applied to net invested capital – ie, the acquisition cost of unrealised assets net of write-offs.

NS: There are always some nuances with management fees to consider. If you have existing investors in a fund, that is relatively mature so there is no management fee; the GP needs to consider whether those rolling over should be charged management fees in the new vehicle. Early on, there was more of a presumption of offering existing investors the option to roll over while preserving their existing economics. The market is trending away from this practice though, so it's more common that LPs electing to roll will pay the same management fee as new investors.

Q This raises an interesting point about existing versus new investors. What's the state of play around status quo?

NS: We are seeing a move away from offering existing investors a true status quo option. It used to be considered the gold standard since it meant that GPs were not changing the position of existing investors who elected not to sell, other than perhaps by way of a term extension. This approach has the potential to cause misalignment between new and existing investors. If new and existing investors have differing fee and carry structures, they may not be economically aligned with one another in respect of the disposition of the subject asset(s) on a go-forward basis.

While we do still see some transactions where GPs offer to preserve the existing fund economics for investors that roll, it is becoming much less prevalent.

Overall, the more optionality you offer to existing investors, the more complex the situation becomes. That doesn't mean existing investors aren't asking for this and even expecting to see it, but they are beginning to accept that they may not get a true status quo option.

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JORDAN HURWITZ

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NATALIE SCOTT

Q How do you see fund terms shifting over the coming period to create greater alignment between all parties?

JH: We are continuing to experience a significant drop in dealflow, largely due to the ongoing valuation gap. It will be interesting to see whether there is a shift in fund terms as and when parties return to the negotiation table and deals start to get over the line.

There is now a relatively established set of criteria that all parties expect to be present on GP-led transactions to maximise alignment and reduce conflicts as far as possible. While the most reputable GPs may still seek to dictate terms for the most sought-after assets, the expectation is that the pendulum is swinging in favour of the buyers.

Buyers will be pushing harder than ever for greater alignment, which is likely to include requiring the GP to roll 100 percent of its crystallised carry generated by the transaction into the new fund so the GP is not taking any money off the table, as well as having the GP commit fresh capital. Enhanced information, governance and consent rights are also likely to be a common ask. ■

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