

# KEYNOTE INTERVIEW

## Concentrated deals gather pace



*The growing appetite for recapitalisations of small numbers of high-performing assets is adding further opportunities (and challenges) to the GP-led market, say Travers Smith partner Sam Kay and senior associate Ed Ford*

### **Q** What level of activity around concentrated deals did you observe last year?

**Sam Kay:** There has been a growing market for GP-led transactions in recent years and a step-change in the past 12 months or so to a greater focus on concentrated deals, namely single-asset deals or transactions where there is a group of often high-performing connected assets. That was evident pre-covid, but there was a pause last March as the market reassessed pricing.

Since then, we have seen a lot of enquiries from GPs wanting to understand how they can use these tools to help existing portfolios and extend

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financing for particular assets. Since H2 2020 there has been a real push for transactions that do not necessarily involve end-of-life portfolios. Instead, these focus on high-performing or resilient assets where the GP sees the benefit of holding for a longer period. The GP needs to find new investors to underwrite the transaction, but also needs to create the narrative to explain to existing investors why the transaction (and costs) makes sense.

**Ed Ford:** Given the volatility of the

past 12 months or so, it has been easier for secondary buyers to price and underwrite a concentrated portfolio consisting of a handful of assets than it has been to price and underwrite a highly diversified LP portfolio with a look through ownership to hundreds of portfolio companies, some of which are heavily exposed to covid-related risks and some of which are not. This has helped in concluding concentrated GP-led transactions. Additionally, one of the key features in these deals is that a secondary buyer has extensive access to the GP and the portfolio company management, which can clearly help a secondary buyer's conviction – that access does not generally exist in a more

diversified deal and has helped generate competitive pricing in the space.

### **Q When setting the economics for a continuation fund, how can GPs strike a balanced approach that will be attractive to all parties?**

**EF:** GPs are rightly keen to emphasise that the transaction is about maximising value creation, not their economics. Ultimately, the key points are consistency with that principle and alignment of interest across all parties. On a continuation fund, this generally includes aiming to set the management fees, hurdles and carried interest rates at a point where they are not price destructive; if the fees are so high that the price that the buyer is willing to pay for the portfolio is significantly reduced, then this is likely to be questioned by the LPAC.

Equally, the buyers (who are often effectively fund of funds) will want to make sure that carried interest is only 'paid' by them when their own target returns are met – this often leads to economic arrangements that are a bit more structured than in typical buyout funds and may include ratcheted distribution waterfalls and/or MOIC-based return targets.

Both the buyers and the existing LPs are likely to expect to see their management fee charged at a percentage of invested capital (typically, 1.25-1.75 percent per year). It is generally straightforward to work out what the secondary buyers' invested capital is, but there is a question for existing LPs as to whether that should be tied to the invested capital calculated at the time of the original acquisition or at the price at which the GP-led transaction is executed.

### **Q What are the key issues to consider when moving the assets into a continuation fund?**

**SK:** This is a complex area. The first consideration relates to how the assets are moved into the new fund vehicle. Private equity assets are typically

subject to a number of transfer restrictions, including 'tag rights' held by each asset's management team and other minority shareholders (co-investors, JV partners etc). The key question here is whether the GP-led transaction is intended to generate liquidity for those stakeholders – if not (which is more typical, at least in the case of management teams), then an important part of the transaction is establishing whether third-party consents are needed to execute the transaction and to ensure that management are aligned and engaged with the process. Depending on the portfolio and the structure, there will also be significant tax work needed on the ECI withholding tax rules and stamp duty and there may also be other consents needed (from regulatory/competition authorities, lenders etc).

The other fundamental consideration relates to how the existing LPs and the carried interest holders 'roll' into the continuation fund; there is a delicate balance to be struck between the desire to achieve that in a tax efficient manner and the desire to minimise deal complexity and execution risk.

### **Q How does the liability profile work?**

**EF:** On a typical M&A transaction, the selling fund makes only very high-level warranties, with the portfolio company management team generally providing the buyer with a set of 'business' warranties relating to the portfolio company being sold. The transaction dynamics incentivise the management team to provide those warranties, which form a key part of the buyer's due diligence, because the management team are also selling, so are taking liquidity from the transaction. In that case, the buyer is looking for alignment with management.

The dynamics in a typical GP-led deal differ significantly; it is possible that management are not receiving liquidity so there is little incentive for them to provide an extensive warranty package and the secondary buyer

generally looks first to alignment with the GP then to the GP's and the buyer's (collective) alignment with management. This impacts all sorts of elements within the transaction and may mean that it is not practical for management to provide any form of warranty package.

This area is very transaction specific, but it is not uncommon for the selling fund to make a broader set of warranties than it would in a typical M&A exit, which implicitly extends the liability position of both the selling fund and, via the 'LP giveback' provision, its LPs. That means the warranty package is increasingly backed by a specifically tailored GP-led W&I insurance policy – this helps the GP de-risk the sellers/LPs' liability and, importantly, means that the GP does not have to effectively sue itself for breach of warranty (as it may otherwise be required to bring a claim on behalf of the continuation fund against the selling fund for breach of warranty).

### **Q Is it common to have follow-on capital made available? If so, how is this structured?**

**SK:** Follow-on capital is commonplace because the GP will want to continue to support the assets and help them grow. It is relatively easy for the buyers to put in extra capital because that will be taken into account when considering whether to underwrite the deal.

However, there is an inherent tension between the idea that a GP should offer the existing LP base a 'status quo' option (ie, extend those LPs the right to maintain the same transaction exposure to the underlying assets before and after closing) and raising follow-on capital, which necessarily involves either an increase in rolling LPs' undrawn capital or some form of dilution. Of course, there are a number of ways to mitigate this, including structuring follow-on capital via some form of non-dilutive instrument (eg, a payment-in-kind loan note or preferred equity). ■