KEYNOTE INTERVIEW

Secondaries evolution will require a multidisciplinary approach

A challenging market environment has led to more creativity in secondaries deal structuring, say Kenneth Blazejewski and Maurice Gindi, partners at Cleary Gottlieb

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Q How has the secondaries market evolved in recent years?

Kenneth Blazejewski: The secondaries market has developed and evolved tremendously from the early days of largely LP trades. Today, GP-led secondaries have become an established segment of the market, averaging roughly half of all secondaries deal volume in recent years.

Even within the GP-led secondaries sector, where we spend most of our time, there has been a lot of diversification in recent years, with single-asset deals driving a degree of specialisation. A number of new entrants from non-secondaries backgrounds have come into the market with a focus on that particular angle, further shaping the market.

Single-asset deals have made sectors of the secondaries market look more and more like traditional private equity M&A markets. Within those deals, you will now regularly see company capital structures and management incentive plans being revisited, with more portfolio-company-specific diligence, as well as reps and warranties, than you would see in a broader portfolio transaction. All that technology has been taken from the M&A market and brought into secondaries.

Maurice Gindi: The other development is the diversification of both participants and transaction types within secondaries, all of which is underpinned by a real shift in perception by both LPs and GPs who no longer consider the market just as a place for troubled assets or sponsors. Premier assets and sponsors are some of the best use cases for these deals, and that acceptance has led to more creativity on the deal-side and among the investor base.

We have seen a real expansion in the number of participants on the buyside, which has been historically dominated by secondaries funds. We also see more asset manager participants and a lot of traditional private equity sponsors entering secondaries for the first time.

There is growing interest from sovereign wealth funds and high-net-worth individuals as well.

With respect to deal dynamics, we are seeing structures being used to generate liquidity that can take many forms. In addition to single-asset and portfolio continuation fund deals, we see strip sale transactions, preferred equity structures and NAV loans all featuring in the secondaries market.

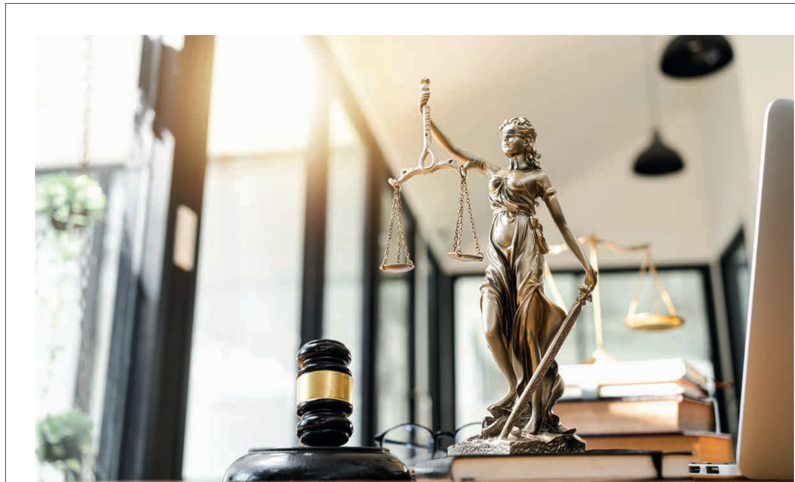
Q How is the current economic environment impacting secondaries dealflow?

KB: There are two dynamics working in opposite directions at present. On the one hand, the tightness of the market for traditional sponsor exits means GP-led secondaries have become an attractive way of creating liquidity and ensuring portfolio companies are in good hands for the next stage of their growth. On the other hand, there has been a bit of a mismatch on pricing in recent months, which has led to a dampening of transaction volume.

That is why it is important for sponsors to consider alternative liquidity transactions. Outright sales of assets to continuation funds can be very attractive deals for all parties, but in some circumstances, alternative transaction structures, such as asset-backed or preferred equity transactions, may provide additional flexibility. This allows you to potentially satisfy liquidity goals and generate additional cash for the underlying portfolio, while also allowing parties to avoid fraught discussions about pricing and dilution.

MG: Buyers can be a little more selective in considering which deals they want to participate in, and they have the flexibility to take a closer look at assets. This opens the door to different players, including those that might be approaching from a different perspective.

The traditional fundraising environment has also clearly come off its peak, which means sponsors are thinking about how secondaries transactions might play into broader financing arrangements for their funds. There is more interest in transactions like stapled secondaries and using secondaries to generate liquidity for older funds to facilitate fundraising for successor funds. Finally, challenging credit markets have given GP-led secondaries – and, in particular, the single-asset deal – a leg up. That is because sponsors can often retain an asset's existing financing when it is transferred to a continuation vehicle that is an affiliate of the selling



Q How has the evolution of the secondaries market impacted the legal side of things?

Kenneth Blazejewski: From our perspective, the key to managing this evolution is approaching our clients' needs not with traditional law firm departments in mind, but with alternative transactions that can assist with achieving their goals. We find ourselves collaborating across a variety of areas of legal expertise and speaking to private equity clients not necessarily about just secondaries, but about alternative liquidity transactions writ large.

Cleary brings a deep bench of private funds, private equity M&A, structured finance, real estate, regulatory, tax and executive compensation expertise to clients looking for liquidity solutions. Informally, we have been doing that for years; formally, we have recently organised Cleary's Private Funds Alternative and Liquidity Transactions group. The PF ALTs group is a multidisciplinary practice that works to help our clients navigate their most complex legal issues in the market.

Maurice Gindi: We have seen real growth in these transactions, and a lot of law firms are looking to build their practices in this area. We believe Cleary's PF ALTs practice stands out both on the buyside and the sellside for its ability to bring creativity to any transaction.

Many firms market themselves based on the volume of secondaries deals they are doing, but a lot of those are cookie-cutter transactions. We do execute efficiently on those types of transactions, including through the use of technology and alternative resources, but we also prioritise and thrive on advising on cutting-edge transactions and the development of solutions that solve the most challenging problems for our clients. We live for those kinds of deals.

fund, so there is not the same need to go back to the credit markets that you have in the context of a traditional buyout.

Q What does this environment mean for terms and structuring?

KB: Today's more challenging market means that, where GP-leds are getting done, there is a premium on alignment between investors and sponsors. There is a starting assumption of the GP rolling 100 percent of carry, with limited deal-specific exceptions, followed by discussions about whether incremental carry will be required in a continuation vehicle or whether a successor fund will invest in or alongside the continuation vehicle. Both parties are looking for creative ways to further strengthen that alignment.

Another thing we are seeing is that, because it can be a little bit more challenging to fill up the book for a continuation vehicle, it is less common for a single secondaries anchor investor to take down the entire commitment, as used to be the case. Sponsors are having to build out broader syndicates that may include high-net-worth individuals or sovereign wealth funds.

That also opens the door to structure these transactions in a way that permits partial sales, where there is some flexibility on the part of the selling fund to not necessarily sell the entire asset to the continuation vehicle, but to hold a preliminary closing where only a portion is sold.

> *"Outright sales of assets to continuation funds can be very attractive, but alternative transaction structures… may provide additional flexibility"*
>
> **KENNETH BLAZEJEWSKI**

Q How is the regulatory environment evolving for secondaries? What developments do you expect in the next 12 months?

MG: This is certainly an area of focus for the Securities and Exchange Commission in the US. We are seeing that both in public and behind the scenes.

In terms of the public focus, the SEC has recently made amendments to the Form PF: it now requires sponsors that engage in transactions where investors are given the choice to sell or roll their interests in a private fund to report the transaction to the SEC, so the commission knows these deals are happening.

Additionally, proposals issued last year could create real, substantive regulation on the use of GP-led transactions – in particular, a requirement to obtain a fairness opinion in these deals. From our perspective, this is more an indication that the SEC cares about these transactions than it is a hurdle, because most of these deals are already obtaining fairness opinions or utilising other conflict mitigants.

Meanwhile, behind the scenes, we are seeing the SEC focusing on these quite a bit more in examinations, which we believe indicates that the SEC is looking to get smarter on market practices in the secondaries space. GP-leds are conflicted transactions, and the SEC approaches conflicted deals with a certain degree of scepticism.

Sponsors engaging in GP-led deals should work with reputable financial advisers and legal counsel to run solid processes, have early and ongoing discussions with investors, and keep thorough records and documentation, including the sponsor's rationale for the transaction.

> *"We see strip sale transactions, preferred equity structures and NAV loans all featuring in the secondaries market"*
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> **MAURICE GINDI**

KB: The SEC hasn't done anything that fundamentally alters the way these deals get done, but clearly there is no substitute for working with seasoned counsel that is thoughtful about mitigating conflicts and driving quality disclosures. It is critical to pay attention to what is coming out of the SEC, but that shouldn't be the starting point: the starting point should be making sure that all parties understand the nature of the conflicts inherent in these deals and how to work through them.

It is worth recalling that one of the few enforcement actions from the SEC in this area was in 2018, in the context of a GP-led buyback involving a sponsor called VSS Fund Management. That settlement is worth reviewing because it underscores the importance of quality disclosure when asking investors to make what is essentially an investment decision when faced with a liquidity opportunity. ■