Are All CVs Created Equal?

Fall 2023

Are All CVs Created Equal?

Fall 2023

Overview

In the ever-evolving landscape of private equity, Continuation Vehicles (CVs) have emerged as a critical tool for General Partners (GPs) and Limited Partners (LPs). GPs use CVs to create liquidity for their investors and provide LPs an option to extend their investment in assets expected to generate attractive risk-adjusted returns. LPs have increasingly used CVs to lock in strong realized IRRs, improve DPI and rebalance their portfolios (either as sellers or as buyers, to adjust exposure to sectors, geographies, strategies, or core managers).

Amidst the growing popularity of CVs, there are skeptics. A recent commentary by Matt Levine in Bloomberg Opinion referenced an article from the Financial Times that raised concerns about the nature of CVs.[1,2] This article stated that "*the buyout business looks like a pyramid scheme because of the circular deals in which companies are sold between private owners at high valuations*" and suggested that PE firms disproportionately benefit vis-a-vis investors due to inherent conflicts of interest and the opaqueness of valuations.

As with any financial innovation (GP-led transactions have only become prevalent over the last five to seven years), structures have and will continue to evolve. Market efficiency, perhaps aided by industry guidance (ILPA) and rules established by regulators, will lead to either broad market adoption and standardization (i.e. GP Stakes) or the curtailment of such structures if they cannot create win-win outcomes (i.e. unregulated crypto currency exchanges).

In the case of GP-led secondary transactions, all roads point to staying power. Upwelling believes such transactions will maintain their popularity across all private asset classes, including private credit, real assets, and infrastructure, for the following reasons:

- GP-led transactions typically provide benefits to existing LPs by offering early liquidity at fair exit values
- New investors (generally secondary funds supported by institutional LPs) benefit from their ability to target their investment exposure with a higher probability of achieving attractive investment returns
- Industry best practices designed to protect existing LPs, particularly those involving suitable and timely disclosures related to the transaction structures and sale processes, have already taken root in advance of new regulations being applied to the secondary market[3,4]
- The development of internal capabilities and third-party resources is enabling LPs to evaluate CV opportunities as direct buyers and sellers, and/or as investors in dedicated secondary funds focused on GP-led transactions

[1] Matt Levine – Money Stuff - "Buyout Funds Buy From Themselves" July 2023
[2] Financial Times - "The Big Read - Selling to yourself: the private equity groups that buy companies they own" June 2022
[3] ILPA - "Continuation Funds - Considerations for Limited Partners and General Partners", May 2023
[4] SEC - "SEC Enhances the Regulation of Private Fund Advisers", August 2023

One possible implication of the GP-led secondary market growth is a moderation in the size of future blind pool funds. Effectively, LPs may become more inclined to limit fund commitments in favor of holding back capital to invest in CVs, doubling down alongside their GPs in the best performing portfolio companies.

Debunking the banter (a closer look at the criticism of GP-led secondaries)

The Financial Times article raised many of the following concerns:

CVs lack the sanctity of third-party pricing

Not True

As is commonly understood, market processes establish fair pricing, which is the case with the formation of CVs. New CV investors understand that the sale price must be attractive for the GP to establish an exit value and facilitate seller's approval.

- According to PJT Partners H1 2023 Secondary Market report, 70% of large cap funds had an exit value of 2.0x MOIC or greater with "Mega buyout" transactions creating at least a 3x outcome 80% of the time[5]
- On average, pricing for single-asset CVs reached 96% of FMV 87% of FMV[6] for multi-asset CVs

Existing LPs get the short end of the stick

Not True

Because LPs are critical for future primary fundraising, many GPs not only disclose potential CVs to their LPs in a timely manner (according to ILPA, this should be a minimum 20-to-30-day period), but also offer LPs a wide range of incentives to participate, including discounted carried interest and management fees.

- CVs help preserve fund diversification and avoid breaching the 10-15% concentrations limits typically mandated by a fund's limited partnership agreement
- CVs mitigate conflicts associated with traditional cross fund investing including the misalignment of investment time horizons of the various funds' LPs
- CVs often offer discounted economics relative to traditional "2 & 20" funds
- CVs help alleviate the pressure of premature exits, enabling GPs to extend ownership of investments with prospects for additional upside, while giving LPs the option for liquidity in the near term
- Furthermore, Upwelling notes that many LPs have requested their GPs to consider CVs to address their over-allocations to private markets

[5] PJT Partners - "H1 2023 Secondary Market Insight" July 2023
[6] PJT Partners - "H1 2023 Secondary Market Insight" July 2023

GPs charge "super carry" and high management fees for CVs

Not True

Although there is a perception that PE firms charge higher management fees on CVs, most CVs have a discount of 50% on management fees compared to traditional funds and have a shorter fund life (5 years vs. 10 years), which reduces the economic cost. Further, there is a view that CVs have premium carried interest structures (i.e., in excess of 20%). In reality, most CVs have a tiered carried interest structure ranging from 10% to 20%, which is a lower economic basis than traditional funds.

- Typically, economics of traditional PE funds are more expensive than CVs, which feature scaling carried interest based on performance thresholds
- Today's supply/demand environment has improved economics for investors in CVs
- While performance data is somewhat limited, CVs outperformed similar vintage years and rank in the top quartile using both IRR and TVPI measurements using Pitchbook benchmarks (Table 1)[7]:

Table 1: Pitchbook CV Performance and Benchmarks

CV Median IRR	CV Average IRR	Buyout 1st Quartile	CV Median TVPI	CV Average TVPI	Buyout 1st Quartile
34.1%	55.1%	22.1%	1.6x	1.5x	1.3x

These outcomes are consistent with previous performance analysis from Upwelling's October 2022 research report.[8]

Poor economic alignment

Not True

Most CV investors require a strong GP alignment of interest. According to PJT, the average GP commitment for CVs in their database has grown to over 8% of committed capital compared to the typical 1% - 2% for a traditional fund.[9] Upwelling believes GPs generally reinvest most of their after-tax economics earned from the asset(s) sale into their respective CVs. These Vehicles further enhance alignment by:

- Extending the investment horizon, which ensures GPs are focused on maximizing value for new investors over a longer period. This fosters alignment and patient capital deployment during down-markets
- Creating a liquidity mechanism for LPs currently overallocated to private markets, which is particularly valuable in a less favorable exit environment

[7] Source: Pitchbook - Out of 93 named continuation funds, nine have performance information available. The median IRR and TVPI are 34.1% and 1.5x, respectively. It is important to note these CVs have young vintages and many self-report, which may influence the high performance metrics.

[8] Upwelling Capital Group - "Are LPs Missing the Boat? Examining GP-Led secondaries in the private equity market" October 2022

[9] PJT Partners - "H1 2023 Secondary Market Insight" July 2023

- Allowing GPs and LPs an opportunity to renegotiate their fees and structures, reflecting current market conditions
- Granting investors additional governance rights, particularly if the CVs extend beyond their terms

Shelter real valuations

Not True

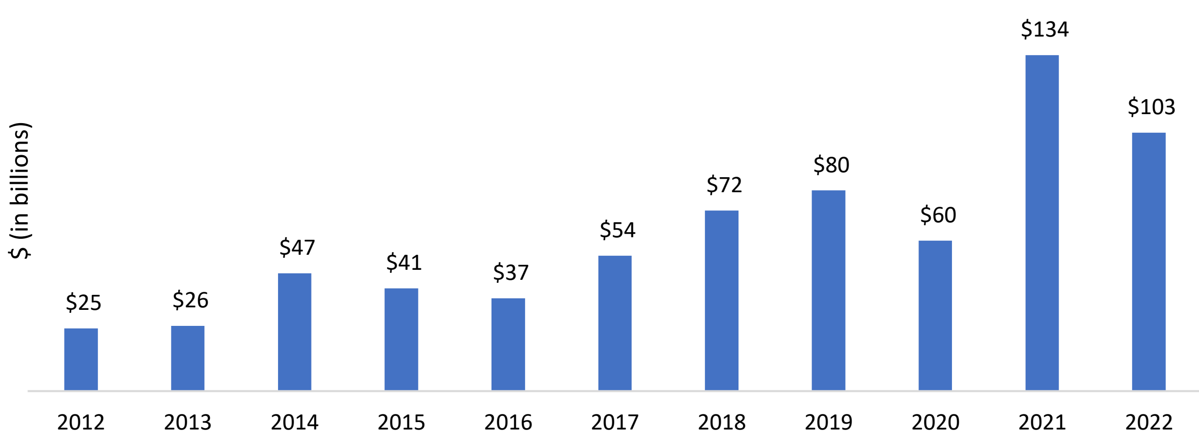
Over the last 25 years, private market valuation standards have matured as a result of input from investors, regulators, auditors, and valuation firms. Current valuation protocols are more consistent as the industry has transitioned away from a cost-based valuation system to a fair market valuation system. In summary, today's private market valuations better reflect fundamental market values (long gone are the days of "the lower of cost or the market"). For CVs, an ever-increasingly efficient secondary market establishes a threshold for achieving appropriate valuations based on the underlying assets' pre-transaction marks.

Evolution of the Secondary Market

It is important to recognize that the growth of the secondary funds market has been driven by institutional limited partners. Their appetite for secondary funds is a product of the attractive DPI and IRRs generated by secondary strategies over the last 25 years. Increasingly, secondary funds have allocated more capital to GP-led secondaries – supported by LPs who continue to increase their allocation to secondary managers. For this reason, GP-led secondaries have become a fundamental component of the private markets.

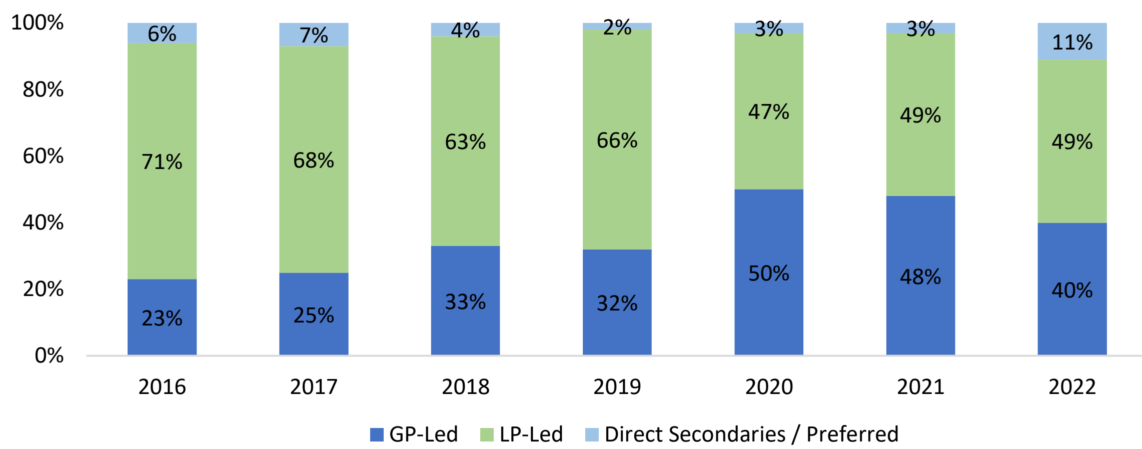
Please see Upwelling research report from October 2022 for a broader perspective of growth of the secondary market.[8]

Secondary market transaction value over time[10]



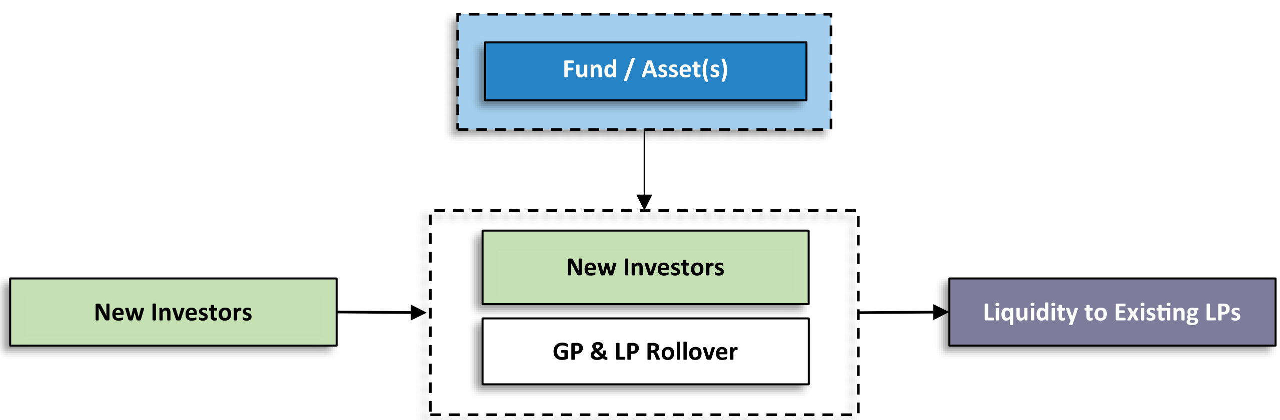
[10] Evercore - "2022 Secondary Market Synopsis"

Secondary market transaction type by value[11,12]



Where Do CV's Make Sense?

As the industry innovates around GP-led secondaries, a question beckons: "Are all CVs made alike?" Beneath the surface of this seemingly straightforward question lies numerous intricacies, where the nuances of CV design, structure and execution shape the outcomes for both GPs and LPs.



While these concerns are legitimate, not all CVs are equal. Continuation vehicles require a compelling investment thesis that clearly identifies the growth potential and value creation opportunities of the target assets. Successful CVs require a strong and experienced GP capable of executing an effective strategy, with a proven track record. Moreover, the GP must ensure the terms and structure of the vehicle align the interests of all parties involved: A sizable GP rollover, sound governance and appropriate economics paid by new investors.

---

[11] 2016-2021 - Coller Capital - "State of Private Capital Secondary Market, March 23, 2022"
[12] 2022 - Campbell Lutyens 2023 Secondary Market Overview

There are numerous situations where a CV is advantageous to both GPs and LPs: i) elimination of cross fund investing and premature exits, ii) gaps in fundraising and capital needs, iii) recycling of capital, iv) transition from a minority to majority owner, and v) creation of a liquidity event in tail-end funds.

Key elements of a successful CV:

Increasingly, there is a well-defined set of market standards guiding the formation of continuation vehicles, which include potential regulatory changes and benefit from input from ILPA.

Based on Upwelling's experience, we believe the following is a model framework for successful GP-led secondaries:

<u>High quality assets:</u>

- CV assets should have clear growth prospects (vs. simply a liquidity event for the LP and GP)
    - Acquisition opportunities
    - Shareholder consolidation
    - Organic CAPEX
- CV purchase price should generate attractive returns for exiting LPs

<u>Comprehensive transaction process:</u>

- Fair pricing manifested through use of third-party transaction advisers
- Transparency to existing LPs
    - At least 30 calendar days evaluation period
    - Visibility into future upside of assets
    - Sound rationale for creation of CV
        - Assets require additional time to realize full value
        - In situations where GP is minority shareholder, opportunity to provide liquidity to investors
        - GP desires to become majority shareholder
    - GP should ensure that existing LPs have access to the same level of information provided in the secondary process to prospective buyers
    - LPs should be able to have access to advisers hired to run the process on behalf of the partnership(s)
- There should be fairness in economics charged to the LPs who roll either their fund interests or co-investment interests into CV

<u>Strong alignment of interest:</u>

- The GP should have meaningful "skin in the game" by rolling a significant portion of their after-tax economics into the CV
- LPs should be offered the opportunity to participate in the CV with terms that are no worse than those in the selling entity

- Transaction expenses should be appropriately allocated between buyers and sellers
- Management fees should be based on invested capital
- Carried interest should be earned after LPs have received full return of their capital
- CV investors should be granted appropriate governance, including consent to extensions

Conclusion: GP-led secondaries can provide a win-win for all parties

There is no doubt that GP-led secondaries are becoming pervasive in the private markets. Upwelling believes this is generally a good thing. Market efficiencies, structural advancements, guidelines and regulations are all reinforcing this important industry development. GP-led transactions offer benefits to buyers and sellers under a framework that allows for improved due diligence and broad-based participation (i.e. LPs are becoming a higher percentage of CV syndicates).

Private market investors are long-term in nature, which is essential to matching their long-term liabilities with their asset pools. CVs allow investors to increase their exposure to high quality private investments. LPs are offered an option to maintain exposure to companies that best fit their portfolio construction objectives or sell for a reasonable price. This is especially valuable in the current market where exit options for GPs via M&A or the public markets are less attractive or simply not viable.

When an LP decides to roll into a CV and maintain ownership of assets for an extended period of time, this helps mitigate their burden of recommitting/reinvesting capital into unknown new companies that may or may not be successful. Without question, what appeals to one LP may not be optimal for another. GP-led transactions help address this situation as CVs provide more options for investors to have more control over their portfolio construction, a key critique of blind pool fund investment strategies.

At the same time, GP-led secondaries play a pivotal role for both large and small GPs who are seeking ways to increase the value of their investments. Historically, GPs were forced to sell assets outright in order to return capital to their LPs despite, in many cases, having confidence that certain companies or assets are well positioned to continue generating attractive returns. Given today's challenging primary fundraising environment, CVs and other GP-led secondary solutions pave the way for managers to access capital, maintain organizational stability and create excess value while anchoring themselves to their best investments.

LPs can follow suit, as they support their core managers (and emerging managers) in their highest conviction investments while utilizing the secondary market, including the sale of LP interests, to rebalance their portfolios that best align with their risk-return objectives.

Despite all these positive developments there are still risks worth considering:

- CV performance is quite nascent in its evolution and, over time, GP-led secondaries could underperform fund benchmarks
- LPs now need to modify their evaluation of GP track records to include CV performance

- Given the growth of the CV market, this may limit co-investment opportunities for LPs, which have become an important way to lower fund investment costs
- LPs could downsize their primary fund commitments to prioritize CVs if such performance exceeds fund benchmarks

Upwelling believes that these and other potential unintended consequences could meaningfully impact the shaping of the market.

Clearly, not all CVs are created equal.

So go ahead and embrace the next CV that comes your way (or at least evaluate its potential), as long as it offers the appropriate structural and economic guardrails that help to ensure alignment with the GP while providing a rational exit alternative to existing fund LPs.

About Upwelling Capital Group

Founded in 2011, Upwelling Capital Group LLC ("Upwelling") is a registered investment adviser that provides customized strategies and solutions to enhance the overall returns for premier alternative investments. Upwelling specializes in providing secondary liquidity solutions across asset classes and capital structures. Principals have cumulatively overseen over $50 billion in global private equity commitments and have successfully managed over $5 billion in legacy, tail-end commitments, transfers, and workouts for leading institutional investors. Securities offered through Bridge Capital Associates, Inc. Member FINRA / SIPC

For additional information, contact:

Eric Green

egreen@upwellingcapital.com

(212) 503-2101

Joncarlo Mark

jmark@upwellingcapital.com

(530)-758-7888

Jesse S. Rodriguez

jrodriguez@upwellingcapital.com

(530) 758-9888