September 10, 2024

The Evolving Dual Track: Preserving Exit Optionality for PE Sponsors

Introduction

The average hold period for PE sponsors is the longest it has been since 2007.[1] Liquidity, and the path to realizing it, has rarely been a greater focus for private equity investors.

Traditionally, PE exits have typically taken one of two forms, often referred to as the "dual track": (i) an IPO or (ii) a sale to a third party (whether a strategic buyer or another PE sponsor).

If neither exit route is commercially viable, sponsors may consider a refinancing to fund a dividend and recapitalize the asset (known as a "dividend recap"), which can ease pressure on the sponsor from limited partners ("LPs") eager for liquidity and give the sponsor some valuable additional time in which to realize an exit. The historically low number of IPOs and the limited levels of M&A activity in recent years, together with high levels of dry powder in private credit, led to $30.2 billion worth of loans to finance dividend recaps in H1 2024 – the joint-highest level in the last decade.[2]

Against this backdrop—with subdued public markets, higher interest rates and generally limited exit opportunities—PE sponsors have become increasingly creative about generating liquidity, redefining the traditional "dual track" exit.

Alternative liquidity solutions: CVs and cross-fund deals

GP-led sales to continuation vehicles ("CVs") and cross-fund deals (i.e., where one of a sponsor's existing funds sells one or more of its assets to a successor fund or alternative fund strategy managed by the same sponsor) have increased both in popularity and sophistication.

Early sales to CVs and cross-fund deals were often based on technology developed in the context of LP-led secondary transactions and, therefore, lacked a number of features commonly found in M&A processes. For instance, warranties would not be given about the underlying portfolio company.

However, as the market has matured and they have become more common and more concentrated on single assets, CV and cross-fund transactions have taken on features more akin to classic private M&A deals.

For example:

- it is common for a fuller suite of business warranties to be given by management in relation to the target (usually on a knowledge-qualified basis);

1 Source: "Private Equity Won't Stop Gorging on Debt to Pay Investors", Bloomberg News (published 17 June 2024).

2 ibid.

© 2024 Paul, Weiss, Rifkind, Wharton & Garrison LLP. In some jurisdictions, this publication may be considered attorney advertising. Past representations are no guarantee of future outcomes.

- these business warranties are increasingly backed by W&I insurance, minimizing exposure for management. In addition, the selling sponsor will require the W&I insurance coverage to extend to the fundamental warranties to give them a clean break on completion, and quickly return proceeds to their LPs; and

- to support this increase in the scope of business warranties, a vendor due diligence exercise is commonly undertaken, regardless of whether the buyer is a third party, a CV or an affiliated fund. Potential secondary investors in the CV, like any third-party purchaser, will carry out due diligence on the target and providing such investors with vendor due diligence reports will streamline this process.

A cornerstone investor in the CV may act as "Lead Investor" and lead the transaction document negotiations from the buy-side perspective—and, in doing so, they will view the acquisition terms through much the same lens as the buyer on a third-party sale. As an independent third party, the Lead Investor will also usually give the "no claims declaration" under the W&I insurance policy, underlining their leading buy-side role. Having a cornerstone investor take on the role of Lead Investor can help to provide comfort to other investors in the CV that an independent third party with whom they are economically aligned is negotiating on the CV's behalf; it may also help to reduce the extent to which the sponsor needs to engage in lengthy multilateral negotiations.

Commonly, alongside a CV transaction, the selling fund may sell a minority interest in the portfolio company to a third party (a "Minority Co-Investor") who will hold their interest at the level of the portfolio company directly alongside the CV. Such Minority Co-Investor plays a prominent role in buy-side negotiations. This helps to provide independent validation that the commercial deal is arm's length in terms of price and wider legal protection in the transaction documents, thereby giving comfort to investors in the CV (or, in the case of a cross-fund deal, the buying fund).

In addition, CV and cross-fund deals will usually need LPAC approval, which may require an independent fairness opinion to be provided. As such, even where no Minority Co-Investor is involved in the deal, there may still be a mechanism to provide independent validation that the transaction is on arm's-length terms.

Accordingly, there are a number of similarities between the process and negotiation dynamics on a sale to a third party and on a sale to a CV or a cross-fund deal.

Preserving exit optionality

It is important to ensure that advisers on any potential exit deliver a product that preserves optionality until the manner of exit is confirmed so that, if need be, the sponsor can pivot from one potential exit route to another without wasting cost and effort unnecessarily.

For example, materials produced as part of the legal workstream (including vendor due diligence reports, the sale and purchase agreement, management warranty deed, W&I NBI reports and stapled W&I insurance policies) can be used as part of either a third-party auction process or a CV or cross-fund transaction. The draft transaction documents will need to be amended to reflect a mid-process switch from, say, a bilateral third-party sale to a cross-fund sale, but if the sponsor and its legal advisers are cognizant from the outset that they may need to change approach, then the legal advisers should be able to adapt quickly and efficiently.

Similar considerations may apply on an IPO (and, noting the recent changes to the U.K. listing regime, we might expect U.K. IPOs to pick up in the medium term). While the legal documents for an IPO will be very different to the documents for a third-party sale, it is possible to leverage any vendor due diligence exercise carried out in connection with a potential sale process to inform the IPO offering documents and roadshow materials.

Notwithstanding the fact that on a CV or cross-fund transaction both the selling fund and the buying fund are controlled by the same sponsor, the transaction may still require antitrust, FDI or other regulatory approval. Analysis should, therefore, be carried

out whether the exit takes the form of a sale to a third party, a sale to a CV or a cross-fund transaction. It is worth bearing that in mind at the outset of any exit process so that any relevant antitrust, FDI and regulatory analysis can be leveraged if the expected exit route changes.

Liquidity for all?

Whether the transaction creates liquidity for all stakeholders must also be considered. While a sale to a third party will likely be a liquidity event for management, a sale to a CV or a cross-fund deal may not automatically trigger liquidity for management. In those circumstances, the sponsor may nonetheless consider giving management the opportunity to realize some liquidity (or otherwise incentivizing management through transaction bonuses or a similar mechanism) in order to keep the management team incentivized post-completion, as they will likely remain key to delivering growth.

Similarly, a CV or cross-fund transaction will not necessarily be a liquidity event for third-party lenders. Since the buying fund will typically be managed by the same investment adviser as the selling fund, the transfer of the portfolio company to the CV or buying fund (as applicable) may not give rise to a change of control under the incumbent finance arrangements, thereby making the debt portable and avoiding the need to refinance. In contrast, a sale to a third party will usually, absent a portability provision, constitute a change of control, triggering mandatory prepayment.

Conclusions

Given the evolving array (and potential combinations) of exit routes and the increasing complexity and sophistication of newer liquidity solutions, it is critical for sponsors and their advisers to consider in any exit process the steps involved in each potential route and the ways in which they differ and overlap. This is crucial in ensuring that the sponsor can maximize its optionality while minimizing wasted time and cost if it becomes necessary to change approach mid-process in a dynamic market environment.

* * *

This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

William Aitken-Davies
+44-20-7367-1611
waitken-Davies@paulweiss.com

Rohan Dey
+44-20-7601-8611
rdey@paulweiss.com

Annie Herdman
+44-20-7601-8602
aherdman@paulweiss.com

Roger Johnson
+44-20-7367-1603
rjohnson@paulweiss.com

Nicole Kar
+44-20-7601-8657
nkar@paulweiss.com

James King
+44-20-7601-8640
jking@paulweiss.com

Dan Schuster-Woldan
+44-20-7601-8693
dschusterwoldan@paulweiss.com

Christopher Sullivan
+44-20-7601-8650
csullivan@paulweiss.com

Associate Jon Webb contributed to this Client Alert.