AN OVERVIEW OF GP-LED FUND RESTRUCTURINGS

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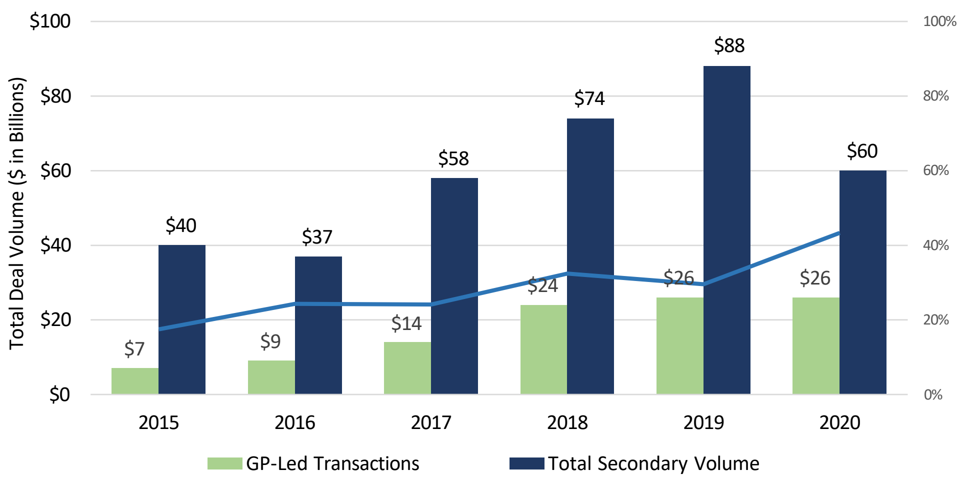
Introduction

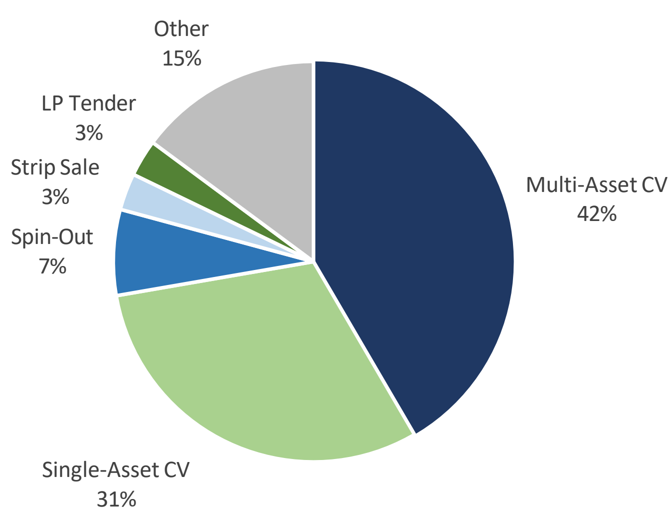
Over the last several years, General Partner-led (GP-led) transactions have become increasingly prevalent across different asset classes, sectors, and vintage years. These types of transactions, including GP-led restructurings, are used as a tool for efficient fund management, benefiting both GPs and LPs. As such, the volume of GP-led transactions has grown alongside volume in the broader secondary market. In 2020, GP-led deals accounted for $26 billion of deal volume, which was greater than 40% of total secondary activity.

GP-Led Transaction Volume vs. Total Secondary Market[1]



There are several motivations for a GP-led fund restructuring. Most commonly, GPs seek to extend the fund's life in order to manage the assets beyond the originally prescribed term and maximize the value of remaining fund assets. Restructurings may also provide access to additional capital, provide liquidity to existing LPs, realign the overall LP base, and reset GP economics. In 2020, fund restructurings into continuation vehicles (CVs) accounted for 73% of all GP-led secondary volume.

GP-Led Volume by Deal Type[2]



[1] Source: Greenhill Global Secondary Market Review, January 2021.
[2] Source: Greenhill Global Secondary Market Review, January 2021.

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In This White Paper:

Potential benefits of GP-led fund restructurings:

- Extend fund life
- Maximize the value of remaining assets
- Provide access to additional / unfunded capital
- Provide liquidity to existing LPs
- Realign overall LP base

Key components of the restructuring process include defining the deal structure, managing communications to existing LPs, ensuring proper legal documentation, and finding the right secondary partner.

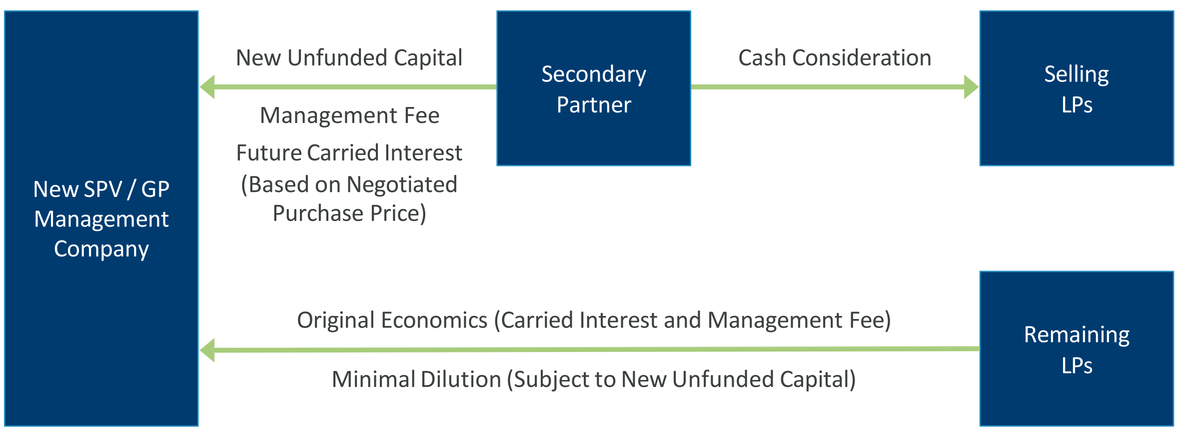
Deal Structure

A GP-led restructuring typically occurs when the remaining assets of a fund are rehoused into a new vehicle. The target fund will typically work with a secondary partner to purchase the fund's assets for a negotiated price. Existing LPs are given the option to either: 1) sell their interest at the agreed-upon price, 2) roll their interest into a special purpose vehicle (SPV) established to purchase the assets of the target fund, or 3) some combination thereof. The SPV will typically include new, unfunded capital from the secondary partner to support the portfolio assets. LPs that elect to roll into the new fund will be diluted by this unfunded capital component.

The SPV is typically managed by the existing GP of the target fund, although subject to a new partnership agreement. This agreement will provide for a number of "resets," in terms of economics (carry and management fee), fund life, and follow-on capital commitment. As part of the reset economics, secondary partners and LPs will typically expect the GP to invest alongside in the transaction. This GP capital commitment is usually satisfied through a 100% roll of any after-tax carried interest proceeds that are realized as part of the transaction.

Each fund restructuring is unique, and as such, these specific terms tend to vary for each deal. Unlike a typical blind-pool fund, these terms are negotiated and customized to reflect the composition of the LP base, secondary partner, and requirements of the remaining assets (time and capital).

Illustration: Fund Restructuring



By restructuring into a new vehicle, the GP effectively extends the life of the fund. This relieves pressure on the GP to exit investments before key value-creation milestones have occurred, and in many cases, provides additional capital for both offensive and defensive investment opportunities.

Key Considerations

The restructuring process can be complex, with multiple steps, decision points, and disclosures required. According to Greenhill, a third of GP-led secondary deals in 2020 were either put on hold or have failed. Properly managing key components of the process can assure a greater likelihood of success.

Asset Valuation. Pricing for a fund restructuring is highly-specific, and may be presented as a premium or discount to net asset value. A sophisticated secondary partner will account for many factors in determining the right asset valuation, including LP and GP dynamics, attractiveness of portfolio assets, portfolio concentration (across number of assets, sector, stage, etc.), projected appreciation in asset value, future capital needs of portfolio companies, and timeframes for exits / liquidity.

It is important to note that GP-led secondaries deals are vulnerable to conflicts of interest, none more so than regarding asset valuation. For a contemplated restructuring, there are four stakeholder groups with different objectives: 1) existing investors seeking liquidity/exit, 2) existing investors seeking to roll, 3) the secondary partner, and 4) the GPs. The GP has a fiduciary duty to the investors in its existing fund, which entails maximizing the value of the remaining assets. Conversely, the GP is incentivized to sell the assets to the new vehicle at a lower price, as the carried interest economics will generally be tied to this revised "mark."

Identifying the right asset valuation to balance the competing objectives of all four stakeholder groups is key. The negotiated price must be high enough to entice certain LPs to sell their interests, but low enough that GPs and the secondary partner are properly aligned. As such, GPs will typically obtain a fairness opinion to provide comfort to all parties and reduce the risk of breaching fiduciary duty.

Deal Process and LP Engagement. In April 2019, the Institutional Limited Partners Association (ILPA) issued guidance for both GPs and LPs, with four main procedural recommendations: 1) When GPs initiate a restructuring process, the overarching objective should be to provide efficiency and transparency for all LPs, 2) GPs should engage LPs as early as possible to provide rationale for the restructuring and any alternatives considered, 3) The GP should provide detailed disclosures, along with sufficient time (at least 30 calendar days) for LPs to fully consider the terms of the proposed transaction, and 4) GPs and LPs must have clear expectations around identifying and mitigating conflicts.

Key Stages of a GP-Led Fund Restructuring

- **Engage LP Advisory Committee (LPAC) to present transaction rationale.** The GP will need to obtain consents from the fund's advisory committee for a fund restructuring. In order to ensure a smooth transaction process, the GP should engage the LPAC as early as possible and provide ample information to explain the rationale for the transaction (including outlook for the fund's remaining assets, projected time to realization, the amount of new capital required, and contemplated terms). For end-of-life scenarios, the lead time should be no less than six months before the expiration of the fund's term.

- **Selection of advisor and secondary partner.** The GP should run a formal process and solicit bids from multiple potential secondary partners. This will enable the GP to objectively identify a partner who can provide the most favorable valuation and deal structure, while minimizing potential conflicts. To assist in this process, the GP and LPAC may elect to engage with an advisor who is familiar with the secondary universe and process considerations.

- **LPAC disclosure and review.** The LPAC should be provided with sufficient information to make an informed decision about the proposed restructuring, and to ensure that the structure is efficient and fair. The GP should also provide specific materials to demonstrate transparency in the deal process and pricing (including number, range, and content of bids received).

- **LP notifications and due diligence.** Upon signing a letter of intent with a potential partner, a confidential disclosure document should be circulated to all LPs, outlining the proposed terms, amendments to governing documents, and framework for allocating transaction-related expenses. GPs should also share the same diligence information as was provided to potential secondary partners (including data room access for diligence materials) to help inform LP decision-making.

- **LP election.** Existing LPs will make an election to sell their interests or roll into the new vehicle. The ILPA recommends that LPs be given at least 30 calendar days to evaluate the proposal and make their decision. If an LP does not make an election within the timeframe provided, such investors should be treated as if they have elected to roll, as opposed to selling their interest.

Tax Considerations. GPs should seek to maintain the same tax structure in the new SPV as the original fund, and operate the new vehicle in the same manner (i.e., short-term vs. long-term gain considerations, use of tax blockers, etc.). GPs should also maintain relevant tax protections for investors, such as avoiding unrelated business taxable income (for applicable tax-exempt investors). Lastly, LPs who roll into the new fund will typically receive a distribution in kind in order to avoid an immediate tax liability. The GP should coordinate with existing investors prior to finalizing the deal structure and rollover process; LPs may wish to consult with their own tax advisors to ensure alignment with the GPs approach.

Manager Economics. In most instances, the GP will seek "reset" economic rights for the new vehicle, including carried interest and management fee. Intended to incentivize individual managers to continue managing the portfolio assets, these economics are typically calculated based on the negotiated purchase price for the vehicle. However, in certain instances, including when the assets are sold at a steep discount to net asset value (i.e., an underperforming fund), rolling LPs may object to the lower cost basis for calculating carried interest. The GP may need to negotiate a customized waterfall, with certain tiers based on performance milestones (including gross multiple and/or IRR hurdles). Additionally, the GP may seek to offer a "status quo" option for rollover LPs (the same terms in the new vehicle as the previous fund), granting the option between two separate waterfalls in the new vehicle. Each fund restructuring is unique, and the revised manager economics should appropriately reflect the LP base and portfolio assets.

Finding the Right Secondary Partner

Finding the right secondary partner is not only critical to a deal's success, but also an opportunity to reshape the fund's ongoing LP base. This has long-term ramifications for portfolio management and overall value creation.

A number of factors may complicate a potential restructuring process and necessitate a specialized secondary partner. The most common consideration is sector focus – for example, a portfolio of healthcare assets will require a partner with sector-specific expertise and alignment, as opposed to a generalist approach. Other complicating factors may include portfolio concentration (i.e., a small number of assets comprise the majority of portfolio value) or assets that are early-stage or distressed in nature. When evaluating potential secondary partners, fund managers should seek a dedicated partner who not only has the deal experience and financial wherewithal to complete a restructuring, but also the expertise to maximize both near-term and long-term value.

Pricing. Valuing private assets within the target portfolio can be a complex process. For example, in order to properly value healthcare assets, a secondary partner must understand the regulatory, commercial, and legal dynamics specific to each company and sector. In addition, the optimal deal structure must account for these valuation factors relative to potential exit timing and follow-on capital needs.

Capital. The secondary partner should be sufficiently capitalized to both redeem the selling LPs, as well as provide additional capital to the fund, if needed. The GPs and LPAC should undergo a careful analysis regarding portfolio assets that may require additional capital to maximize value (or conversely, defensive capital to protect against downside).

Process management. As previously outlined, the process of negotiating the deal structure, communicating with LPs, and completing the restructuring can be complex. GPs should seek an experienced partner who can successfully navigate this nuanced process while balancing the different objectives of key stakeholder groups. In addition, a partner with a proven track record can provide comfort to the LPAC and LPs around deal execution and resulting outcomes.

Manager relationship. In most instances, the secondary partner will represent a significant LP stake in the new fund. As such, GPs should also seek a long-term manager relationship with the optimal strategic alignment. Secondary partners who are active in the relevant sectors may have greater insights and be able to move more quickly, given existing exposure to the GPs, portfolio companies, and co-investors.

Overview of Revelation Partners

Revelation Partners is a dedicated secondary investor, providing flexible capital solutions to the healthcare ecosystem. We specialize in shareholder liquidity, GP solutions, and growth capital with a customized and long-term approach.

With a 13-year track record, deep sector expertise, an extensive industry network, and over $1.5 billion of committed capital, Revelation Partners is atrusted partner to healthcare companies, investors, founders, and funds.

Sector expertise. Companies should evaluate a secondary buyer as a long-term partner, and as such, should prioritize a shareholder with specific sector expertise. Collectively, the team at Revelation Partners has over 60 years of experience investing in healthcare, and as such, is well-versed in the unique regulatory, commercial, and legal dynamics of the healthcare sector. Initially, this specific expertise can contribute to a smoother due diligence process and optimized pricing for the portfolio. Going forward, a knowledgeable investor is better positioned to support the GPs, both operationally and financially.

Transaction experience. Secondary transactions, particularly fund restructurings, are more complex than primary investments. Revelation Partners has partnered with over ten GPs to provide customized fund solutions, and as such, is well versed in the deal structuring and LP communication process. Additionally, as each restructuring opportunity is highly situation-specific, it is important to have a partner who can create a solution which maximizes portfolio value while satisfying the objectives of both GPs and LPs.

Dedicated Capital. A well-capitalized partner, with a dedicated capital pool, can ensure an expeditious closing, as well as provide additional capital for the portfolio. The partner's own fund timing should also be aligned with the objectives of the recapitalization and value creation milestones of the underlying portfolio assets.

About the Author

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