Buyouts

Insight

To CV, or not to CV? That is the question!

CVs are an attractive solution for many situations, but other secondary GP liquidity structures might be a better answer, writes W Capital Partners' Todd Miller.

Guest Writer – Jan 24, 2024

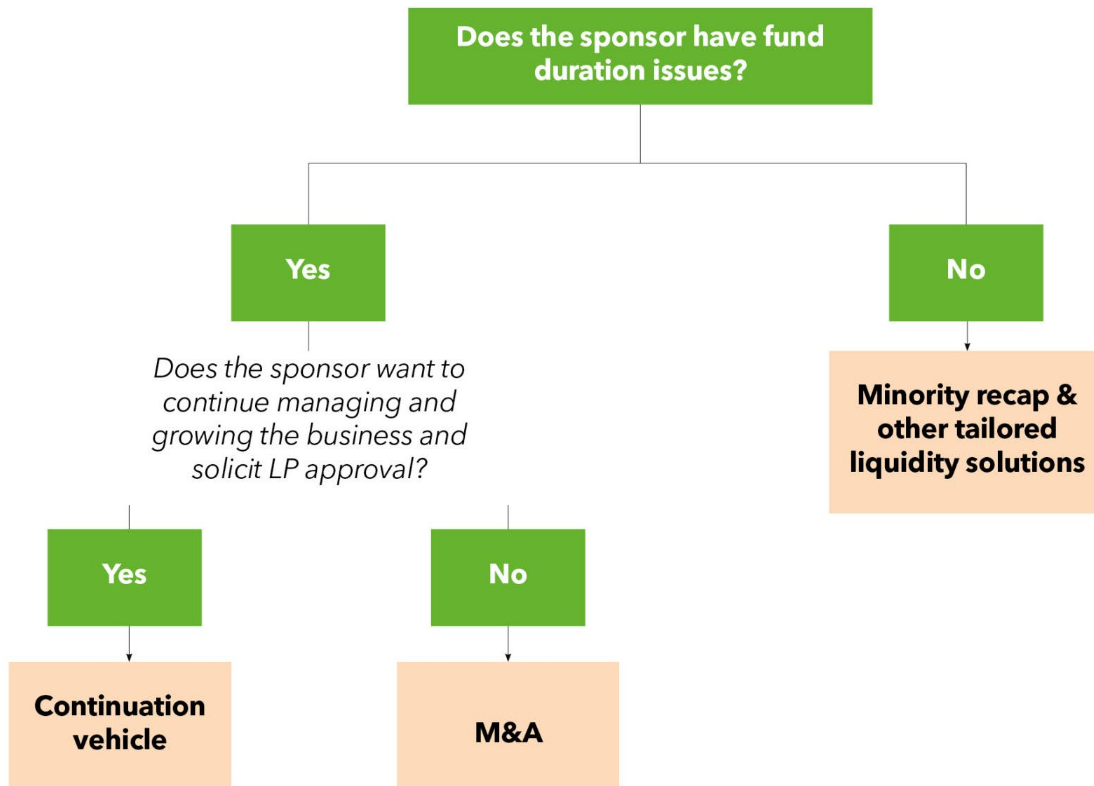
With the current liquidity challenges facing GPs as a result of the significant decline in the M&A and IPO markets, many sponsors are considering a continuation vehicle (CV) for their well-performing portfolio companies. CVs are an attractive solution for many situations, but other secondary GP liquidity structures might be materially better in certain circumstances.

Todd Miller, W Capital Partners

For instance, a private equity firm with an investment that is only four years old in a 10-year fund has more than enough time to grow that asset before considering a CV, but the GP may still want to de-risk or generate interim liquidity to satisfy portfolio performance and distribution objectives. At the same time, most LPs are both overwhelmed with CV requests, but also are seeking distributions when LP cashflow is down. In this example, the sponsor should really consider a minority recap with a secondary firm. Minority recaps are less disruptive than CVs and generate liquidity for funds, LPs, portfolio company management and co-investors.

Conversely, there are also situations, such as when an investment is in a fund nearing the end of firm's fund life, or when a growing portfolio company requires more acquisition capital than reserved in the fund that might yield a different answer. The exciting part is that this is where the secondaries market is heading: offering sponsors a wider range of products and solutions for these exact, yet different, situations.

As secondaries solutions are becoming more and more strategic, the decision tree for control sponsors looks something like this:



CVs vs minority recaps

There's no question that the CV market has positive benefits for sponsors, their portfolio companies and their LPs. The sponsor maintains AUM, generates liquidity for LPs and continues working with a portfolio company where the sponsor has conviction in the growth trajectory and future value creation. However, it requires a more complicated process than minority recaps, including LPAC approval, third-party valuation, tender process and, typically, a syndication since more capital is required to complete the transaction.

Minority recaps with buyout sponsors purchasing minority stakes from other sponsors took place well before there was ever a continuation fund market. But pursuing a minority recap with a secondary firm as a minority partner has distinct benefits. It allows the sponsor to maintain control over the investment and work with an investor who is comfortable underwriting to a shorter duration than control sponsors and, in turn, has return targets in line with that shorter holding

period. Additionally, secondary firms understand their role as a flexible solution provider standing behind and supporting a sponsor, not seeking to change the complexion of the investment. Minority recaps are more straightforward than CVs, don't involve the LPs and require less of a third-party process. As important, unlike CVs, is that the existing fund benefits from future appreciation in the unrealized portion of the underlying asset.

Minority recap vs CV summary

Minority recap	GP-led continuation vehicle
Bilateral negotiation	LPAC consent
Existing fund benefits from future upside	New vehicle benefits from future upside
Minority protections and governance	Third-party valuation
Partial liquidity (minority stake)	Full liquidity (100% of the sponsor's position)
Sponsor maintains control	Sponsor maintains control

Source: W Capital Partners

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CVs and minority recaps are just two examples of liquidity solutions for sponsors, but there are many other tailored solutions that secondary firms can provide, such as add-on capital for seasoned assets where the sponsor is under-reserved; partial liquidity for management teams to better align them around the sponsor's longer holding period; or liquidity for control sponsors who now own a minority stake in a company that is controlled by another sponsor.

The positive attributes of these liquidity solutions have spurred a $100 billion-plus GP-led market, essentially from nascency five years ago. This growth has been further accelerated by a growing number of specialized secondaries advisers and, as important, the integration of these groups with other parts of the investment bank, who are now collectively pitching secondaries as part of a menu of options for sponsors to consider; and a seismic growth in secondaries firms who are the typical buyers and architects of these transactions.

The inception of the secondaries market consisted largely of traditional LP trades. That was version 1.0 of the secondaries market. The emergence of CVs is

considered 2.0. I'd argue the next phase of offering sponsors a wider range of GP-led solutions is version 3.0 and is where the market is headed. Sponsors are quickly appreciating that the GP-led market is broader than just CVs. The secondaries market 3.0 will be massively larger than prior periods and will enable sponsors to capitalize on the right solution for the right situation. The real question for a sponsor is not "To CV or not to CV?", but rather: "which liquidity solution is the right one?"

Todd Miller is a Partner of W Capital Group and has been an active investor in the GP-led secondaries, minority recap and secondaries direct sector. W Capital has invested more than $3 billion since inception by offering GPs and shareholders a range of flexible liquidity solutions.

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