KEYNOTE INTERVIEW

Innovative secondaries solutions for mid-market managers

With so many options on how to provide liquidity to investors, Northleaf managing director Matthieu Ducharme details the structures available to mid-market GPs and the related pitfalls to avoid

Northleaf Capital Partners is a global private markets investment firm, headquartered in Toronto, with a presence in the US, UK and Australia. As part of its $16 billion platform, Northleaf manages $10 billion of private equity commitments, including more than $3.5 billion dedicated to its secondaries strategy. That strategy is particularly focused on mid-market GPs and deals, involving companies with approximately $10 million-$150 million of EBITDA.

Matthieu Ducharme, managing director and secondaries specialist in Northleaf's London office, talks about innovation in the secondaries mid-market, including tender offers and the rapidly growing continuation fund and preferred equity markets.

SPONSOR
NORTHLEAF CAPITAL PARTNERS

Q When can a tender offer be the most attractive option for a fund manager?

The typical situation is when the manager needs an additional two or three years after the end of the fund life to maximize the underlying assets' value. However, the GP realizes that this may not be what investors were originally expecting, so it wants to give LPs the option to receive some liquidity. This is the most straightforward option for GPs although it does not bring any additional capital to potentially fund the growth of the underlying assets; and the economics of the fund (fees and carry) are not re-aligned. We have been involved in several tender offers, helping mid-market GPs deliver liquidity to their LPs. These remain complex and time-consuming transactions, particularly as it is important to make a strong effort to avoid conflicts of interest and give LPs a fair price.

Q And when might a manager opt for a continuation fund?

This is another solution for when the fund manager needs some additional time and perhaps additional capital as well. The fund manager may also feel that instead of selling a good asset to a competitor, they would rather keep it for another three, four or five years, because they know the asset's potential upside. This may be for

all the assets in the fund or just for one or two of the underlying assets. If they prefer to continue benefiting from the upside, investors usually have the option to roll into the new fund.

These are sophisticated solutions with a number of parameters to consider and the potential for perceived conflicts of interest, so choosing the right partner to offer a tailored structure and a fair process is crucial.

Q Tell us more about how to manage the complexities of tender offers and continuation funds.

We are fortunate that we have internal legal and tax expertise to assist with these complicated transactions. In addition, because we have completed many of these transactions and have also been on the other side as a primary fund investor, we have a template for best practices, and we are always refining our approach.

It is important to make the process easy, clear and transparent for investors. For example, we did a tender offer for a small cap fund in France involving more than 20 limited partners selling. A number of them were high-net-worth individuals, rather than sophisticated institutions. That made clarity all the more important.

Similarly, we recently led a recapitalization of an IT services company by working closely with the GP to create a continuation vehicle in order to provide liquidity to existing investors as well as additional capital to finance a large, identified add-on acquisition. The structure of the transaction was fully tailored to the needs of the GP and offered existing LPs the option to join in the new transaction.

Q What is causing the recent surge in continuation funds?

This is partly about the market becoming more educated about them. GPs now realize that there is a third option, aside from selling an asset to their competitors or keeping an asset in the existing fund.

However, structural issues have also made this more popular. The pandemic forced GPs to accept that they need more time to realize the business plan for some of the underlying companies in their portfolios. We could say that the pandemic has accelerated the trend towards using continuation funds.

Another factor is that these deals used to be mainly done by large cap buyout funds. GP-leds are becoming more mainstream, and small and mid-market GPs are more aware of these structures. We have been particularly active in GP-led deals with our mid-market GPs.

> *"Choosing the right partner to offer a tailored structure and a fair process is crucial"*

Q How popular is preferred equity these days? Why is it a growing segment?

Preferred equity transactions are still relatively recent, and we were among the first to offer this solution in the mid-market. However, the segment is growing extremely fast, primarily due to the flexibility.

The pandemic has been a catalyst for this trend for both defensive and offensive reasons. GPs have needed additional equity to invest in their portfolios because they have good opportunities to buy companies at attractive prices. Others have required new capital to protect their existing portfolio companies.

GPs can, of course, seek bank funding instead. Preferred equity is more expensive than bank funding, but many GPs feel that banks do not provide instruments that are flexible enough for them.

Q What are some options for using preferred equity?

Preferred equity can be used at the fund-level or for individual businesses. However, it is more economical for the GP to use their entire fund. It depends on companies' sectors and sizes, but generally speaking, the more assets and therefore the more diversity you have, the better the price and the higher the possible loan-to-value (LTV). For preferred equity for an entire fund, we could probably go up to 40 percent LTV, whereas for a single company, we would look at the existing capital structure and the equity cushion available and would not want this to be below 30 percent.

The benefits of preferred equity are in the flexibility and the way it can be tailored to match the GP's needs. For example, we recently provided a unique financing solution for a GP on a portfolio of four assets in order to refinance an existing credit facility. At the same time, the transaction enabled them to invest in existing and new portfolio companies by allowing them to recycle up to 50 percent of repayments on the investment during the first 24 months.

At the company level, we worked with another GP that, prior to covid-19, was planning to launch a sale process for a physician practice management company. Instead, they decided to hold the asset and we provided capital enabling the GP to continue executing its M&A strategy as their fund was fully invested. These examples demonstrate the flexibility of preferred equity as a new tool for GPs.

Q What pitfalls should managers avoid when using these innovative solutions?

For tender offers and continuation funds, we need to make sure there are no perceived conflicts of interest between the multiple parties involved. Everything must be done fairly and transparently, with every party getting the same information. If anyone is upset by the process, it can damage the GP's reputation.

For preferred equity, it is important that a deal is relevant for both the GP and its investors. We do not want to make a fund distressed because we have added a layer of preferred equity on top. It is best to avoid pushing the LTV too high so GPs have some flexibility. We also want to be aligned through exposure to the upside. Sharing the equity is a good way for secondary investors to ensure their interests are aligned with the GP and investors. ■