

Secondaries Investor

By: Guest writer
PUBLISHED: 9 May, 2024

NEWS & ANALYSIS

Five recent trends impacting continuation fund SPAs

Lawyers from Skadden, Arps examine how sale and purchase agreements have evolved to better fit sponsor-initiated processes.

The continuation fund market has rapidly developed since its inception to become a strategic tool for sponsors to continue owning an asset and maximise its value while providing liquidity to its investors.

In the early days, the terms of continuation fund sale and purchase agreements were heavily influenced by the LP-led market. Over the past decade, however, the structure and terms of continuation fund transactions have become more complex through the growing use of M&A legal technology.

Here are five trends impacting continuation fund SPAs.

Purchase price and leakage

Continuation fund SPAs, following the LP-led secondaries market, use a “locked box” approach where the purchase price is fixed at a historic valuation date and is adjusted for any distributions received or contributions made by the selling fund between that date and closing.

The traditional definition of “distributions” is generally limited to cash distributions to the selling fund and does not capture other possible sources of leakage that may arise during a company transfer, such as waivers of obligations or claims against the selling fund, transaction expenses paid by the target company and transaction bonuses paid to management.

Therefore, a broader M&A-style definition of “leakage” is increasingly being adopted, subject to a narrow set of “permitted leakage” items agreed by the lead investor, to prevent value extraction from the target company until the closing date.

W&I insurance

Warranty and indemnity insurance has recently become an essential tool in the secondaries toolkit. In 2023, a majority of the continuation fund deals we saw used W&I insurance, which is still relatively new in LP-led secondary transactions. By eliminating the need for escrow and holdback arrangements, W&I insurance allows the selling fund to have a clean break by capping its liability under the SPA at \$1 and distributing the full purchase price proceeds to its investors at closing. We also see top-up policies being offered by insurers for losses up to 100 percent of the purchase price for fundamental warranty breaches and excluded obligations (thereby putting the buy-side in the same position it would normally be in for a non-W&I insurance deal), as well as synthetic cover for excluded obligations in certain limited situations.

Accelerated use of M&A legal technology due to the increase in single-asset deals

The recent rise in single-asset deals has accelerated the use of M&A legal technology in continuation fund SPAs,

blurring the lines between these deals and the buyout universe.

In many continuation fund transactions, the selling fund gives a limited suite of secondaries-style warranties covering fundamental issues, with the sponsor’s diligence generally limited to a title and transferability report. In single-asset deals, however, a set of additional M&A-style company level warranties is often also given, underpinned by a full vendor due diligence report commissioned by the sponsor and a more robust disclosure exercise involving the portfolio company’s management team.

In addition, single-asset deals can be more highly structured, for instance by having a simultaneous refinancing of the target company’s debt arrangements or resetting any existing management incentive plans.

Deferred payment mechanisms and earn-outs

In 2023, transaction structures for continuation fund deals became increasingly more complex to address pricing pressures, with over 50 percent of continuation fund SPAs containing deferred payment mechanisms, according to advisory estimates. The terms of such deferral mechanisms are deal-specific, but the deferral period typically ranges between 6-12 months.

We also saw an increase in the use of

Secondaries Investor

performance-related earn-outs to bridge the valuation gap between the sell-side and the buy-side, and to further incentivise and enhance alignment with the sponsor.

Additional governance rights

In addition to receiving seats on the continuation fund's advisory committee, we have recently seen some lead investors request certain additional governance rights, particularly if they are holding a dominant interest in the continuation fund. These rights may include a board or observer seat at the company level or enhanced information rights, allowing the investor to monitor its investment in real-time. This arrangement can also benefit the sponsor, particularly if the investor has expertise in the underlying asset class, which can be leveraged.

With a trend towards more specialisation and the arrival of new entrants focusing on GP-led secondaries, we expect continuation fund SPAs to continue to evolve as both sponsors and investors turn to M&A legal technology to meet their needs.

Delphine Jaugey is a counsel, Laurence Hanesworth is an associate and Greg Norman is a partner at law firm Skadden, Arps, Slate, Meagher & Flom. Jaugey is head of secondaries for Europe, while Hanesworth works in the M&A Group and focuses on secondaries transactions.