CHALLENGING EXIT AND DEBT CONDITIONS PROMPT FINANCIAL SPONSORS TO ADOPT WORKAROUNDS

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Key Points

- Financial sponsors are navigating their way through a macroeconomic and geopolitical storm comprising high interest rates, valuation gaps and increased competition for high-quality assets.
- Funds are sitting on record levels of capital ready to be deployed, but sale processes for "hot" assets remain highly competitive.
- A challenging exit market has forced financial sponsors to think creatively about routes to liquidity as pressure mounts to return capital to investors.
- The rise in secondaries transactions, refinancings and recapitalizations has proven to be an effective, albeit in certain cases temporary, liquidity solution until exit market conditions improve.

The challenges facing financial sponsors in the past couple of years have been widely discussed. Their funds have amassed over $1 trillion in dry powder that they are competing to deploy in a weak exit market.

Traditional debt financing has been more expensive due to higher interest rates (though signs on rates are improving) and less liquidity in debt markets, and a gap in valuation expectations between buyers and sellers continues to exist in many sectors. This has meant fewer high-quality assets coming to market as financial sponsors wait for more favorable exit conditions. The impact has been felt particularly at the top end of the market, where larger debt facilities are needed to make deals viable.

At the same time, there is increasing pressure on

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financial sponsors to return capital to their limited partners as funds come to the end of their investment cycles. Financial sponsors are turning to creative interim liquidity solutions that allow funds to own high-quality assets beyond the traditional holding period in order to fully realize their potential value.

The Race To Deploy Capital

Less attractive terms from traditional lenders have led financial sponsors to rethink how deals are funded. Given a lack of liquidity in the syndicated loan market, private credit was a staple of transactions and a lifeline to the M&A market in 2023. An increasing number of financial sponsors now have their own credit funds to capitalize on the increased use of private credit on deals.

We have also seen some financial sponsors underwriting transactions with equity in anticipation of syndicating their interests in the period before closing or undertaking a leveraged recapitalization/refinancing post-closing.

Financial sponsors have also been clubbing together in co-investment or consortium transactions, allowing them to diversify risk for large-cap transactions or enabling smaller players to take positions that they would otherwise be priced out of.

While the differential in price expectations between buying and selling sponsors has reduced the number of deal opportunities, competition for high-quality businesses remains fierce, and some financial sponsors (particularly those with a more generalized investment focus and more flexibility through their investment process) are still willing to pay top dollar for the best assets.

The Rise of the Liquidity Quick Fix

With increasing demand for liquidity from limited partners on the one hand, and a difficult exit environment on the other, sponsors have had to employ creative solutions to generate liquidity without having to sell trophy assets in a softened market.

Some popular routes to early liquidity being used include:

Secondaries transactions. We have seen a boom in the secondaries market over the last few years, with many sponsors launching, or considering launching, specific secondaries teams/strategies. In particular, continuation vehicles—where the asset is transferred to a new fund with the same manager—are becoming increasingly popular. Limited partners in the existing fund are given the option to cash out and/or reinvest in the new continuation fund. This allows general partners to extend the investment hold period, while existing limited partners are given an opportunity to restructure the size and duration of their stakes.

In secondaries deals, limited partners have the benefit of having seen the asset's performance over the past few years, and new investors are given the option to join an investment opportunity that they otherwise would not have had access to. While this does provide a route to liquidity for existing limited partners, they are often electing to roll into continuation vehicles if the underlying asset is attractive.[1]

Private IPOs. These are formalized "internal market" structures that enable investors in private companies to sell to or buy from other stakeholders and give new investors a chance to buy into the asset, in each case at specified intervals, while the company remains private. This can be a strategic first step toward ultimately pursuing a traditional public IPO and a good option for assets that are too big to sell privately.

Fund-level financing. This type of financing—where a fund takes on debt secured by its portfolio holdings—has also been a useful tool for interim liquidity, both for injecting capital into portfolio companies and for returning capital to limited partners. We have seen a surge in debt financing based on the net asset value of portfolio companies as well as the provision of debt-like preferred equity instruments that are paid out ahead of the fund waterfall, particularly as a means to meet limited partner liquidity demands.

Dividend recaps. A portfolio company will take on new or incremental debt to return capital to investors. This option can be used where portfolio companies have

strong balance sheets and/or demonstrable growth potential and is a great route to provide liquidity where a short-term exit is not achievable.

These options all come with potential pitfalls that should be considered well in advance of implementation, as some are coming under increased scrutiny from limited partners and regulators.

Matters that need to be carefully thought through include:

- Potential conflicts of interest.
- Fund-specific requirements such as asset concentration restrictions and regulatory requirements (*e.g.*, the U.S. Securities and Exchange Commission's requirement for a fairness opinion/valuation in secondaries transactions).

All Roads Lead to Exit

Over the past couple of years, general partners have demonstrated that they are able to adapt to new market conditions and use creative liquidity solutions. That said, some of these solutions are intended to be temporary, and conventional exits ultimately provide for fuller realization of investment value.

Both deal volume and size have increased in 2024, and with the rebound of syndicated lending, we have seen improved liquidity in the leveraged finance market. A further convergence of price expectations between buyers and sellers could translate into a better exit market later this year.

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ENDNOTES:

[1]For more on this topic, *see* our May 22, 2024, client alert "Continuation Funds: What You Need To Know" (https://www.skadden.com/insights/publications/2024/05/continuation-funds-what-you-need-to-know).

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