KEYNOTE INTERVIEW

# Finding CVs' place in portfolios

*Offering unique access to trophy assets, continuation vehicles could form a core part of any investor's secondaries strategy, says Nick Lawler, head of secondaries at Churchill Asset Management*

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**Q LPs have become more accepting of GP-led secondaries in recent years. Can the same be said of the continuation vehicle subset?**
Continuation vehicles (CVs) dominate the GP-led secondaries space today; GP restructurings, strip sales and tender offers all still occur, but to a much lesser degree.

There's something of a love-hate relationship in private equity secondaries towards CVs. Some investors are all-in on CVs, believing that opting out means missing some of the best companies in the private equity ecosystem, while others think the assets should sit in the main fund. As a result, that adoption curve is happening now, but there's still a healthy debate across the community.

**Q Do CVs fit strategically within investors' secondaries strategies and what they generally want them to achieve?**
In our view, yes. If you look at why investors access secondaries – particularly in the LP-led market – it's often to ramp up exposure to private equity quickly. LP-led secondaries can offer J-curve mitigation, prior vintage exposure, diversification, quicker cashflows and the potential for more consistent performance.

Many of those characteristics hold true for CVs too, which may offer discounted entry points, J-curve mitigation and faster deployment than investing in a traditional primary, as well as shorter hold periods when compared with co-investments, for instance.

Fundamentally, we underwrite the future growth of companies that a sponsor already owns – whether that is one company or a dozen – and determine the price we're willing to pay to generate attractive risk-adjusted returns.

## Q What differentiates CVs from other fund structures?

The alignment of interests is supercharged. It is market standard for the sponsor to roll everything – including carry and the GP commitment associated with that asset – into the new vehicle.

Often, the GP's personal money accounts for 5-25 percent of the total equity of the CV, compared with two to four percent in a traditional buyout fund.

There is also typically a tiered incentive structure that offers sponsors the opportunity to earn a full 20 percent carry, but with downside protection for secondaries investors. Carry steps up as the hurdle rates increase, and it's also common to have an MOIC hurdle to ensure the asset delivers cash-on-cash returns.

Depending on the transaction, management fees can be materially lower than a typical fund. A fee of 50 basis points up to about one percent is pretty much market standard today.

## Q What is the typical return profile and expected hold period for CVs?

The market today is underwriting single-asset CVs at 2x-plus MOIC and 20 percent-plus net IRR. Returns from multi-asset CVs could be slightly lower, reflecting diversification across three, four or five companies. The data on this is still relatively young, but published statistics out of the CV market have been in line with that underwriting.

Hold periods have typically been three to five years, and CVs are often structured with five-year terms. There is some ability for GPs to extend CVs, but generally our intent is to see a liquidity event within five years.

## Q How do strategies focused on CVs vary, and do you need any specialism to operate in this space?

People often bucket GP-leds and CVs together. But fundamentally, we see a wide variation in deals and investors' capacity to underwrite them. First, there's the market segment. There are players in the lower mid-market, the core mid-market and the large cap space. It's about whether secondaries buyers have the capital base and the expertise to be lead investors in CVs in those segments, determining the structure and price, or whether they're going to come along for the ride as syndicate investors.

Then there are three types of CV. First, there are fund wrap-ups, which focus on all the remaining companies, generally executed when the fund has come to the end of its stated life, but the sponsor desires additional time and capital to optimize the underlying businesses prior to a full sale, while simultaneously offering existing investors full liquidity. In terms of company quality, some underlying companies could be strong outperformers, while others could be underperformers.

The second type of CV we refer to as "midlife complexity". This could be a transformative merger opportunity that requires significantly more capital than is available in the fund and subsequently more time to integrate, optimise and grow. Or it could be a challenging situation, such as covid spillover impact or operational misstep that needs to be managed. The nuance is that the fundamental value creation plan will be different to what it was at the outset.

The third category is recapitalising the equity of those true trophy assets, companies that have generated returns well above a sponsor's base case. In that instance, the growth plan going forward should remain consistent. The sponsor simply doesn't want to sell the business and prefers to further invest and compound returns. But the crystallised return should be strong enough that it warrants offering existing investors liquidity, or the option to roll-over. This is the category my team and I are really focused on.

*"CVs may offer discounted entry points, J-curve mitigation and faster deployment"*

## Q Given that CVs have often concentrated on larger assets, should investors have any concerns about the long-term saleability of these companies?

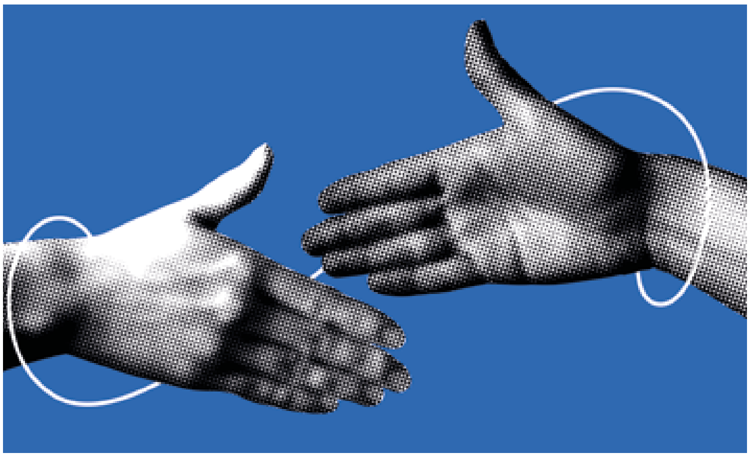
The market has morphed since the advent of CVs. The largest marquee assets may need to rely on the IPO market for exits. However, in the mid-market space (or \$10 million-\$100 million of EBITDA businesses), companies continue to have various exit options available, namely sales to strategics, sales to other sponsors, or IPOs if they become large enough. The thesis is very much the same: sponsors don't want to sell to a bigger private equity firm, but rather want to retain a great asset for longer.

## Q Some investors liken CVs to equity co-investments. Is that a fair analogy?

The two are similar in terms of the expertise required to underwrite the value creation plan for a single company, but that's where the similarity ends.

A co-investment is often the first acquisition of a business by a private equity firm, so it's very common for the GP to invest heavily in the business at the onset – often taking one step back to take two steps forward. The sponsor creates a value creation plan, and that may work perfectly, or it may not, and they have to go back to the drawing board. Many factors will also be unclear until the sponsor has owned the company for some time. Are the customer relationships as strong as they thought? How are management's capabilities? Equity co-investors are generally compensated for those risks with fee-free investments, which we view to be appropriate.

With a CV, on the other hand, the sponsor has generally owned a business for three to five years, has done a lot of heavy lifting, and the success of the strategy has been well observed. The unknowns are fundamentally fewer, and the path forward should be clear. It's also common – unlike with co-investments – to have meaningful unfunded capital for M&A or to support the business in a downside scenario.



The mid-market is the core of our model. We have a roster of more than 100 mid-market private equity firms that we work with, so we really don't need to go outside our sponsor base and play in the large cap arena, where there might be more exit risk.

## Q What are the attractions of investing in CVs via a secondaries fund, as opposed to going direct via a GP?

In the early days of CVs, investors could stock-pick their way into deals, whether or not they had an existing relationship with a private equity firm. Transactions were generally large enough, and there was enough syndicate room for any investor that had the internal capability to underwrite a single-asset transaction. There's still some ability for an investor to access those larger deals today, but in the mid-market, transactions are smaller and there are fewer, if any, syndications.

As such, to access this cohort of deals, you need one of two things – and ideally both. One is the capability to lead and structure the transaction, and the other is being an existing investor in that fund. If you don't have either of those things, the mid-market CV segment is quite difficult to access.

## Q Should the exit environment improve, what will be the future for CVs?

Many argue that CV growth is a product of high interest rates, a challenging M&A landscape and limited liquidity. However, 2021 was a record year for both private equity M&A activity and CVs. While 2024 CV volume eclipsed that of the prior 2021 record as the CV market has expanded, we believe the use case of preserving ownership of special businesses to further compound, raising incremental capital to support that growth, and providing existing investors true optionality to sell or hold – that is here to stay.

Adoption and acceptance take time, but I think we're just scratching the surface with CVs. More than 50 percent of the 100 largest private equity firms have completed at least one CV. But that figure is far lower in the mid-market segment, where there are far more sponsors and portfolio companies. That proliferation downstream is happening now.

Our view is that CVs should never become the default way of delivering liquidity to investors. It is still a GP's job to manage, grow and sell businesses, and they can only manage a finite number of businesses effectively, while also going out to find new acquisitions. However, for trophy assets – maybe just one or two companies per fund cycle – this is an amazing tool to compound on growth.

Finally, I would add that the secondaries market is the source of a lot of the dynamism in private equity today. Nothing has really changed about 10-year fund lives, two and 20 economic structures, or five-year target holds for decades. Sponsors that have tried have had limited success. So long as those structures remain the market standard, the innovation in secondaries will be helpful and very welcome. ■