Private Equity Fund of Funds & Secondaries – Certification Quiz Questions

Module SEC-04 – GP-Led Secondary Deal Analysis (Multi-Asset) (4-Hour Case Study)

21. You are now analyzing a GP-led secondary deal for 5 portfolio companies currently owned by a single middle-market PE fund. You have concerns about the valuations the GP has marked two of these companies at, so if you end up doing the deal, you want to reduce the downside risk.

    Since this is a multi-asset deal, which of the following represents a **REASONABLE** method of mitigating the risk that is **NOT** available in a GP-led secondary deal for a single asset?

    a. Negotiate for a longer purchase price deferral or continuation vehicle (CV) close date to increase the roll-forward discount.

    b. Conduct bottoms-up analysis to determine portfolio-level pricing and line-by-line pricing to allocate the purchase price in line with the seller's preferences.

    c. In the Carried Interest Waterfall for the CV, request Hurdle Rates well above the standard 8%, such as 15% or 20%.

    d. Instead of using a single Carried Interest Waterfall for the CV, set up a different Waterfall for each asset, with higher Hurdle Rates for the two companies that might be overvalued.

22. For this same multi-asset GP-led deal, you have built a multi-tier Carried Interest waterfall in which the Hurdle in each tier is based on the **GREATER** of an MOIC or IRR.

    For example, the Tier 1 Preferred Return is linked to the greater of a 15% IRR and a 1.5x MOIC, and in Tier 2, it is linked to the greater of a 20% IRR and a 2.0x MOIC.

    As shown in the image below, with the current assumptions for the exit values and dates, Tier 1 applies the IRR-based Hurdle, while Tier 2 applies the MOIC-based Hurdle.

Which of the following is a **CORRECT** statement or observation about this schedule?

	C	D	E	F	G	H	I
101	**Step 2: Tier 1 Preferred Return:**		**Year 0**	**Year 1**	**Year 2**	**Year 3**	**Year 4**
102	**IRR-Based Hurdle:**						
103	Beginning Balance:	*$ M*	$ -	$ -	$ 130.9	$ 282.7	$ 458.7
104	(+) Accrual:	*$ M*	-	130.9	151.8	175.9	138.1
105	(-) Current Paydown:	*$ M*	-	-	-	-	(596.8)
106	**Ending Balance:**	*$ M*	**-**	**130.9**	**282.7**	**458.7**	**-**
107							
108	Cash Flow to Limited Partners (LPs):	*$ M*	(872.7)	(8.7)	(8.7)	428.0	1,058.9
109	*Hurdle Rate Check:*	*%*	*15.0%*				
110							
111	**MOIC-Based Hurdle:**						
112	Beginning Balance:	*$ M*	$ -	$ 1,309.0	$ 1,322.1	$ 1,335.2	$ 911.5
113	(+) Accrual:	*$ M*	1,309.0	13.1	13.1	13.1	9.9
114	(-) Return of Capital:	*$ M*	-	-	-	(436.7)	(468.7)
115	(-) Current Paydown:	*$ M*	-	-	-	-	(452.7)
116	**Ending Balance**	*$ M*	**1,309.0**	**1,322.1**	**1,335.2**	**911.5**	**-**
117							
118	*MOIC Check:*	*x*	*1.5 x*				
119							
120	*LP Cash Flows in Step 2:*	*$ M*	-	-	-	-	*596.8*
121							
122	**CF Available After Tier 1 Preferred Return:**	*$ M*	**$ -**	**$ -**	**$ -**	**$ -**	**$ 549.3**

	C	D	E	F	G	H	I
141	**Step 4: Tier 2 Preferred Return:**		**Year 0**	**Year 1**	**Year 2**	**Year 3**	**Year 4**
142	**IRR-Based Hurdle:**						
143	Beginning Balance:	*$ M*	$ -	$ -	$ 174.5	$ 385.7	$ 640.9
144	(+) Accrual:	*$ M*	-	174.5	211.2	255.2	220.6
145	(-) Tier 1 Preferred Return:	*$ M*	-	-	-	-	(596.8)
146	(-) Current Paydown:	*$ M*	-	-	-	-	(264.7)
147	**Ending Balance:**	*$ M*	**-**	**174.5**	**385.7**	**640.9**	**-**
148							
149	Cash Flow to Limited Partners (LPs):	$ M	(872.7)	(8.7)	(8.7)	428.0	1,323.6
150	*Hurdle Rate Check:*	*%*	*20.0%*				
151							
152	**MOIC-Based Hurdle:**						
153	Beginning Balance:	*$ M*	$ -	$ 1,745.3	$ 1,762.8	$ 1,780.2	$ 1,361.0
154	(+) Accrual:	*$ M*	1,745.3	17.5	17.5	17.5	13.2
155	(-) Return of Capital:	*$ M*	-	-	-	(436.7)	(468.7)
156	(-) Tier 1 Preferred Return:	*$ M*	-	-	-	-	(596.8)
157	(-) Current Paydown:	*$ M*	-	-	-	-	(308.6)
158	**Ending Balance:**	*$ M*	**1,745.3**	**1,762.8**	**1,780.2**	**1,361.0**	**-**
159							
160	*MOIC Check:*	*x*	*2.0 x*				
161							
162	*LP Cash Flows in Step 4:*	*$ M*	-	-	-	-	*308.6*
163							
164	**CF Available After Tier 2 Preferred Return:**	*$ M*	**$ -**	**$ -**	**$ -**	**$ -**	**$ 135.3**

a. If the GPs are not *fully* caught up in Tier 1, the Preferred Return in Tier 2 may not be correct.

b. This type of “mixed” Hurdle in each tier creates calculation errors only if the CV achieves its Hurdle in Tier 1 but fails to do so in Tier 2.

c. If the portfolio company exits are delayed to Year 5 or 6, both Hurdles are likely to use the IRRs rather than the MOICs.

d. With a much higher Bid Discount in the beginning, such as 30% rather than 10%, the MOIC Hurdle would be more likely to activate for both Preferred Tiers.