WHY ARE SECONDARIES COMING FIRST?

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Legal Briefings – By **William Hickey**

During the last few years, the secondaries market has steadily turned the alternatives space into a relatively liquid asset class, creating an industry in itself that demands special attention.

IN BRIEF
With approximately A$100 billion in commitments dedicated to secondary transactions[1] (being the trading of existing fund investments) and 28% year-on-year growth in deal volume between 2017 and 2018,[2] even traditionally passive investors are now actively considering secondary opportunities.

This article is the first in a series that explores developing trends in the private funds industry and explores the growing attraction towards secondary transactions, the role of fund managers in transfers and why institutional investors are considering the use of secondaries to actively manage their portfolios.

Future articles will consider, among other things, GP-led fund restructures, the extensive use (or even overuse) of debt through fund structures and the importance of co-investment strategies.

WHAT ARE SECONDARIES?

Compared to "primary" investments, where investors commit to a fund on establishment without necessarily knowing what investments it will make, a "secondary" transaction is the sale of an existing investor's investment in a fund (and indirect investment in known underlying assets), along with their undrawn commitments, to a buyer.

In its simplest form, secondary transactions involve the sale of a single fund interest, requiring the fund manager's consent to the transfer. However the term "secondary" now covers a range of complex transactions which all seek to address the same goal of creating liquidity:

Portfolio sales
The sale of a number of fund interests (between 2 – 400+) as a packaged portfolio to one or more buyers. Each additional interest increases the complexity of the transaction, as separate consent from each fund manager for each fund it manages is required.

Direct sales
The sale of direct interests in portfolio companies or co-investment structures. Compared to the relatively passive nature of fund investors, direct investors will likely have greater involvement in the day to day management of the asset (through board seats, minority rights or otherwise), resulting in bespoke arrangements for each transfer.

GP/fund manager-led fund restructures
The restructuring of funds (or their underlying assets) for various reasons including to allow existing investors to exit, while allowing fund managers to hold onto the underlying assets for a longer period of time to maximise potential return through a new fund with new investors. GP-led restructures are an increasingly common alternative to realising portfolio companies and accounted for almost 40% of total secondary deal volume in 2018.[3]

Ultimately, the sale as between the seller and buyer is governed by a sale and purchase agreement (similar to any asset sale) and the fund manager will consent to the transfer under a separate transfer agreement for each transferring fund, usually through a standard-form agreement that cannot be significantly negotiated.

WHY BUY OR SELL?

Although the most active buyers in the industry continue to be dedicated secondary fund-of-funds, we have noticed a trend of sovereign wealth funds, superfunds, pension funds and other traditionally passive investors starting to involve themselves in secondary bidding processes, both as buyers, or by pairing up as joint-buyers with experienced secondary buyers. In fact, institutional investors are often best placed to act as buyers as, to the extent they already hold target interests in their holdings, they will be able more accurately price those interests and will benefit from a pre-existing relationship with the fund manager.

Secondary buyers target secondary investments for a range of reasons, including:
- **Investment certainty** – At the time of acquisition, a buyer will have visibility of the fund's underlying assets and is better placed to price the interest based on the past and anticipated performance of each portfolio company.
- **Shorter hold periods** – A fund interest will usually be sold after the fund's commitment period has expired, meaning that the incoming buyer need only own the interest for a few years before it is liquidated.
- **Limited unfunded & faster realisation** – Since most of the fund's commitments will have been called and the fund will usually be looking to exit its portfolio companies by the time a buyer acquires its interest, buyers can expect limited calls and faster returns on the investment, effectively shortening their investment "J-Curve".
- **Historically attractive pricing** – To incentivise buyers, sellers have historically needed to sell fund interests at heavy discounts to the interest's net asset value due to the inherent illiquidity of the asset class. That said, recent trends show discounts are decreasing, largely attributable to the highly competitive buyers' market and increased transparency and liquidity of the industry.

On the other hand, secondary sellers seek to exit investments to accelerate their investment timeline, and due to various other reasons:

- **Over-exposure** – Sellers may be required to exit investments due to overexposure to certain sectors or asset classes, whether resulting from changes to internal investment policies or imposed as a result of legal, regulatory or tax-related requirements.
- **Limited future upside** – Sellers may consider that fund interests will have limited/no future upside. Rather than waiting for eventual liquidation of the fund, a secondary sale creates an earlier realisation event for the seller, subject to a pricing discount to reflect the time-value of money and the illiquid nature of the investment.
- **Liquidation of seller vehicles** – Sellers themselves may have target investment horizons which force them to exit all investments at a particular point in time, or where the seller itself is a fund-of-funds, it will need to exit its own investments in order to liquidate.
- **Transaction speed & simplicity** – The private nature of secondary transactions allows for speedy and simple transactions. Where standard fund interests are being sold, motivated parties can sell a single interest in a matter of days and portfolios of 30+ interests can be transferred within weeks.

GETTING THE FUND MANAGER ON SIDE

In order to transfer legal title to a fund interest, the transferring parties will need to obtain the fund manager's consent.

Historically, fund managers have not been incentivised to grant transfer consents as fund terms give them strong veto rights without incentive to accommodate transfers, but with secondary transfers becoming increasingly common in certain jurisdictions, they are now more likely to facilitate transfers, presumably in recognition of the important symbiotic investor/fund manager relationship.

Secondaries allow fund managers to foster new relationships with incoming buyers and while creating liquidity for exiting investors, allowing them to re-invest in other funds, including successor funds managed by the same fund manager.

Although case law states fund managers are meant to act in the best interests of the fund as a whole in approving or rejecting transfers, a minority fund managers still impose difficult and seemingly self-serving hurdles on the transferring parties:

- **Buyer white-lists** – Fund managers may restrict potential buyers to a list of pre-approved parties with pre-existing relationships with the fund manager, even if the fund terms do not contain pre-emption rights.
- **Staples** – Fund managers may require buyers to commit additional capital to another fund being raised by the fund manager (known as stapled transactions), a practice that has been questioned by regulators.
- **Pre-approvals** – Fund managers may require buyers to cast future votes in a way that benefits the fund manager, for example, agreeing to fund extensions or pre-consenting to GP-led fund restructures.

In our experience, new funds that are currently being raised are more likely to include pre-emption rights, water-tight transfer restrictions and anti-avoidance measures to ensure fund managers can scrutinise incoming investors and ensure they retain control of their investor base.

That said, we do not see the industry slowing down, so if fund managers and investors do not adapt and start to appreciate this important industry, they risk being left behind.

ENDNOTES

1. Campbell Lutyens - 2019 Secondary Market Overview.
2. Greenhill's secondary market analysis another record for transaction volume.
3. GPs overtake pensions and SWFs as biggest sellers – Greenhill report.

KEY CONTACTS

If you have any questions, or would like to know how this might affect your business, phone, or email these key contacts.

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