SWISS FINANCE PARTNERS GROUP

Swiss Finance Partners Group

Your Preferred Financial Service Provider

Our Guide to Private Equity Secondaries Investments

2019

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Swiss Finance Partners

We are a regulated international stock holding company being active on a worldwide basis in the field of finance ranging from general investment advice; asset-management services to corporate finance, private equity to investment banking services dedicated to providing innovative and professional financial services to all kind of customers throughout the world.

Our services are aimed as well as to the private investor as to an institutional clientele who is seeking a truly independent and tailor-made approach to their needs.

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- Financial Services
- Corporate Finance
- Family Office Services
- Secondary Private Equity
- Asset Management Services
- Company Formation Services

Through its highly qualified team coming from all corners of the financial world and bringing along with them years and years of experience; as well as its global presence in the main financial centers of the world; Swiss Finance Partners Group is indeed in an exceptional position to deliver high quality services satisfying even the highest expectations.

Indeed, even so being of small size compared to other international financial institutions; Swiss Finance Partners Group can rely on a global network of financial partners in the international financial community allowing therefore to deliver to its clients a highly professional and tailor-made service in all of its fields of activity.

Secondary Private Equity

Introduction

Welcome to this " Guide to the Private Equity Secondaries Market ", the latest in a series of guides & brochures designed to act as an introduction to our activities and fields of expertise.

The " Private Equity Secondary" market (also often called "Private Equity Secondaries" or "Secondaries") refers to the buying and selling of pre-existing investor commitments to private equity and other alternative investment funds. Indeed, for the vast majority of these private equity investments, there is no listed public market; however, there is a robust and maturing secondary market available for both parties.

The market is indeed basically divided into two sections:

- Secondary Private Equity Investments (LP Fund Interests, or otherwise stated investments in private equity funds)
- Secondary Direct Investments (Secondary Direct Portfolios, or otherwise stated investments in all kind of assets such as commercial & industrial enterprises, real estate properties or indeed as well infrastructure related projects)

Private equity secondaries have indeed become an important component of a Limited Partner's investment strategy, partly down to the maturity of the European private equity market, but as well given added impetus in the wake of the financial crisis.

Private equity is traditionally seen as an illiquid asset class, and compared to publicly listed shares it most certainly is. Yet the rise and establishment of the secondaries market has injected a significant degree of fluidity which many investors have sought given the pressures on their portfolios since 2008, whether brought about by shifting allocation priorities or regulatory changes, particularly pertinent given the finalization of the Volcker Rule in December 2013.

Globally, secondaries funds raised US$21 billion in 2012, almost double the amount of the previous year, helped in no small part by AXA Private Equity, now Ardian following the spin-out, which raised US$7.1 billion, the largest private equity secondaries fund ever, and this year's Lexington Partners launch of its fund with a target of US$10 billion.

All of this activity on the fundraising side has led to an expectation of a particularly active market this year. One recent report estimates indeed that secondary market deals could top US$30 billion in 2014, the highest combined total so far, driven in part by dry powder and the rise of traditional institutional investors entering the market place as buyers.

In response to growing demand the secondary market now offers a far wider range of solutions than it did a decade ago. As a result it has become a more complicated place, requiring expert knowledge to successfully navigate. This guide presents a top-level overview of the various options open to investors, and some of the key drivers behind market trends, to assist in decision-making and strategy development.

Indeed, in the last decade there has been substantial growth in the private equity secondaries market. Along with the increase in the number and size, the transactions have become more sophisticated and there have been substantial developments in the process and execution of secondary deals. There has also been an increase in the number of dedicated secondaries funds and funds with a mandate to undertake secondary transactions.

This guide seeks to give a brief tour of the major deal and fund structures currently driving the secondaries market, highlighting where these structures find their greatest use, and giving some indication of the issues involved with each.

The first chapter looks at the fund interest secondary, this being the sale and purchase of a single fund interest or a portfolio of fund interests. This remains the most common form of private equity secondary transaction.

Investors who may once have thought themselves locked-in to a long term commitment now appreciate there may be opportunities for liquidity and more active portfolio management through the fund interest secondary market.

The second chapter deals with listed secondaries, which is where fund interests are listed on an exchange. Listed secondaries are complex deals. Unlike traditional fund interest secondaries, listed secondaries can often involve some form of public offer. In such cases they need to be structured to comply with an often complex regime of takeover rules, anti-trust and other regulatory requirements.

In the fourth chapter synthetic secondaries are explored. These are where an investor pays the holder of the fund interest for the right to economics which are equivalent or related to those of a fund interest without actually acquiring the interest itself. These are often suggested as alternatives to fund interest secondaries, but for tax and other reasons are complicated and often difficult to implement.

It is worth noting that ‘secondary directs’ were sometimes called synthetic secondaries, but it seems that secondary directs are now less frequently described as such.

The third chapter examines this type of transaction, which is where a fund purchases a portfolio of business interests, or in some cases a single business interest, including ‘GP for Hire’ deals.

These types of deals have become more prevalent and sophisticated. They are often complex but can give participants a different return profile to other secondary and traditional M&A deals.

The final chapter in this guide examines secondary funds. With the growth of the private equity secondary market, there is an increased number of funds with a mandate to do secondary deals across a range of asset classes. Whilst the primary fund of funds market has suffered in recent years, the commitments to secondary funds have continued to increase.

These funds have also provided exit solutions for investors in funds nearing the end of their lives that face difficult exit situations. Such tail-end deals, whether fund interest secondaries, secondary directs or other bespoke structured arrangements, have been successfully used to give liquidity to investors in so- called ‘zombie’ funds and potentially provide new capital, and a new lease of life, for those managers.

In the same chapter stapled secondaries are also discussed. This is where managers tie a fund interest secondary with a subscription to a new fund being raised in order to assist the fund raising.

The rise and increasing complexity of the secondary market presents a range of new opportunities for investors, both purchasers and vendors alike. This guide aims to give the reader an overview of current trends and serve as an introduction to the sector.

Fund interest secondaries

The fund interest secondary – the sale and purchase of a single fund interest or a portfolio of fund interests – is the most common form of private equity secondary transaction.

The need for relief from long-term commitments and to rebalance portfolios as a result of the financial crisis, as well as new capital adequacy rules for banks and insurance companies, have driven the substantial increase in fund interest secondaries over the last several years.

Some of these factors, including the US Volcker Rule, may continue to drive activity. It is also now clear to investors who hold fund interests, who may have thought they were locked into an illiquid asset class, that it is possible to realize or partially realize fund interests effectively and efficiently, including from a pricing and process perspective.

Whilst it may still be too early to determine how efficient the fund interest secondary market is, there has been increased standardization of the process and terms yet it seems there is some way to go before such transactions can be considered 'off the shelf' deals.

Buyers and sellers continue to deliberate over terms, including the allocation of post-purchase liabilities between them (through the so called 'excluded obligations' concept) and the extent to which the seller should represent and warrant that its holding and sale of the fund interest will not cause any issues for the buyer.

Where sellers have successfully curtailed their liability risk, or passed on liability risk to buyers, including where terms have been set as part of an auction process, it is not clear to what extent buyers have discounted their pricing to reflect the assumption of risk.

Impact of local M&A practices

As M&A law and practice differs by country, the extent to which local M&A practice is imported in any particular deal can lead to different commercial terms to those which a buyer or seller may generally be accustomed. This can cause frustration for buyers and sellers particularly as a fund interest secondary may not have a strong geographic nexus with any particular country – buyer, seller and interests may all be in different countries.

Recent developments

Deferred consideration, where part of the purchase price is paid over a one to three year period, has become a feature of some fund interest secondaries.

In these cases the buyer is able to offer a higher purchase price in exchange for the deferral. Such deferral may be as much as two-thirds of the purchase price. For sellers there are various ways that they get comfortable with or seek to mitigate the credit risk associated with deferred consideration.

Fund interest secondaries are being used to provide tail-end solutions to funds approaching the end of their life. Whether the buyer is a turnaround fund, private equity secondary fund or other purchaser, these deals are able to bring liquidity to investors.

Some fund managers are using fund interest secondaries to procure investment in their new funds by linking their consent to a part of a pre-agreed deal package between managers and buyers, rather than managers seeking to force a new fund subscription on buyers when approached for consent to a fund interest secondary.

Listed private equity

Funds listed on public securities exchanges afford a broad range of investors, including retail investors, access to private equity. Fund of funds vehicles give investors exposure to a diversified portfolio of private equity investments, while direct investment companies make various investments with the same manager.

Both types of listed funds have significant interests across the private equity sector meaning that acquisitions of listed funds can present important opportunities in the secondaries market for sophisticated buyers willing to navigate the complexities of a public acquisition.

Structural complexity

These investments are not for the faint hearted. Prospective purchasers must navigate a complex overlay of fund regulation, securities law requirements and tax considerations. But the rewards can be attractive.

The structural complexity of a listed vehicle acquisition is driven largely by the multiple layers of regulation applicable to the fund and its investments. To market its equity to retail investors, the fund will normally be subject to more stringent domestic regulations than those that apply to funds restricted to institutional/ high net worth individual investors. Also, as a listed entity, the fund is likely to be subject to takeover laws as well as prospectus requirements should a transaction involve a new issuance of securities.

Transactional Forms

An important threshold decision for a buyer is the choice of transactional forms. This usually means a choice between an asset purchase or a tender or exchange offer. In a tender or exchange offer, a buyer makes an offer directly to the shareholders or Limited Partners of the publicly traded vehicle.
Depending on the jurisdiction of the target fund, this type of structure may implicate takeover rules that closely regulate the offer process.

For example, throughout Europe there are regulatory limits on the buyer's ability to make an offer for less than 100% of the equity in the fund, requirements for equal treatment of holders, and detailed procedural requirements governing the offer process and timing. If the goal is to take the fund private, the buyer must also consider the minimum acceptance threshold required to delist.

An asset transaction can be structured for the acquisition of all or some portion of the fund's investment portfolio directly from the fund, or for the acquisition of one or more fund entities that hold the portfolio. Depending on the applicable regulatory regime, this type of structure can avoid some of the regulatory requirements that would be applicable to a tender offer process.

Of course, the consent and procedural requirements that apply in any particular situation will also depend on the fund's governing documents, which are likely to give holders a right to vote on significant transactions.

Consideration type

Further structural complications flow from the type of consideration being offered by the buyer. In some cases the buyer may give the holders of a listed fund the option to accept equity consideration so they can continue their exposure to the underlying private equity investments. This consideration could consist of new equity securities of an existing fund entity, or equity securities issued by an entirely new investment vehicle.

In the European Union an offer of new equity to holders will sometimes require a prospectus and regulatory approval. From a securities law perspective any offer of equity consideration also requires careful analysis of registration exemptions under United States Federal and state securities laws, as well as the rules of other jurisdictions.

The acquisition of a listed private equity fund is a complex transaction that poses significant challenges to the buyer, the listed fund and their respective advisers, but – if structured, priced and timed correctly – can provide the seller with needed secondary liquidity"

Tax Considerations

There are also a myriad of tax issues facing the participants in any transaction involving a listed private equity fund. It is important to avoid or minimize future adverse tax consequences for the ultimate investors. The buyer will need to consider the impact of local taxes, withholding taxes on dividends and interest, as well as any other restrictions on the ability to repatriate earnings.

Any offer of equity consideration to the holders of the listed fund will also require careful tax analysis to determine, among other things, whether the existing holders can obtain tax-free rollover treatment and whether the acquisition should be bifurcated as a part-sale and part-contribution/merger transaction for tax purposes.

Similarities to public/private acquisitions

In some ways negotiating the acquisition of a listed fund or its portfolio raises the same issues that arise in the context of most public company acquisitions, including little or no opportunity for post-closing recourse. Therefore, buyer's due diligence is critical.

In other ways the multiple constituencies and counterparties make these transactions more akin to negotiating a complex private acquisition. Unlike a standard secondary trade, a significant investment or takeover of a listed fund usually involves negotiations with several parties, including other shareholders in the listed fund, the fund's board of directors or General Partner, and the fund's investment manager.

Often these parties will have divergent objectives. Once the definitive agreements are signed, requirements for underlying General Partner notices or consents, regulatory approvals and offering disclosure can lead to a substantial period of time between signing and closing. It is important for the parties to reach a comprehensive understanding in the acquisition agreement regarding process, timetable and the level of effort required to overcome the hurdles to execution.

Conclusion

The acquisition of a listed private equity fund is a complex transaction that poses significant challenges to the buyer, the listed fund and their respective advisers, but – if structured, priced and timed correctly – can provide the seller with needed secondary liquidity and the buyer with opportunity for an attractive return. As listed private equity emerges from the financial crisis and continues to mature, it is likely that complex secondary transactions will drive additional consolidation in the sector.

Secondary directs andGPs for hire

Of the several different uses of the term ‘secondary’ in private equity transactions, ‘secondary directs’ are one of the more common. These involve the simultaneous (or near simultaneous) acquisition of direct stakes in a number of portfolio companies by an investor.

The new owner will often be a partnership formed for the purpose of the acquisition, and may involve the team previously managing the assets or a third party ‘GP for hire’, with fnancial backing being provided by one or more secondary investors.

Why secondary directs?

There are a number of potential sellers in the secondary direct market, including fnancial institutions, such as banks, existing private equity managers and diverse conglomerates. The factors motivating sellers usually include one or more of the following:

- a desire to exit legacy investments or non- core businesses, releasing sellers to focus on deploying new capital and developing new opportunities;
- changes in the regulatory landscape, particularly for fnancial institutions;
- achieving liquidity;
- rebalancing a portfolio or effecting a change in investment strategy;
- achieving investment clarity in respect of future fund raising;
- a desire to wind-up a fund

Secondary directs give sellers the opportunity to exit multiple companies in one deal, often in a situation where the usual exit options are not feasible on a portfolio company by portfolio company basis.

Dynamics of secondary directs

The parties to secondary direct transactions will typically include the seller, other shareholders (excluding management) in the portfolio companies being sold, management of each of the portfolio companies, banks, secondary investors and, if relevant, the GP for hire. Each participant will have its own objectives and priorities for the transaction.

Sellers will be motivated to maximise proceeds, reduce conditionality, keep timing as tight as possible and ensure that all, or a minimum number of, assets are sold in the transaction. This will need to be balanced against the issues arising from potential exercise by other shareholders in the portfolio companies of pre- emption rights on transfers of shares and the desire of buyers to cherry-pick the best assets.

Buyers will be keen to minimise price, consistent with agreeing a deal or winning an auction, and ensure that shares in certain key portfolio companies are acquired (which is likely to require that value is appropriately allocated within the portfolio), that key managers are retained and incentivised and that unexpected liabilities are not transferred.

Key agreements and issues will include:

- focused due diligence exercise – to identify key assets and value drivers in the portfolio and potential execution and other risks, e.g.pension liabilities;
- managing pre-emption rights and other exit rights at portfolio company level;
- dealing with key management;
- tax structuring;
- conditionality, including any required regulatory consents and approvals this will, obviously, contain the key terms of the acquisition including price (and any
- formula for calculating price), conditionality (including any minimum transfer thresholds
- for the transaction) and timing. It will also contain representations and warranties from the seller, although market practice is for these to be very limited in relation to the portfolio companies;
- Limited Partnership Agreement – this will govern on-going relations between theinvestors and also, if relevant, the GP for hire.

Secondary transactions, including secondary directs, are complex as they involve a number of connected acquisitions together with agreements between a large number of interested parties. To execute successfully requires both experience of the likely issues and the ability to focus on those that matter.

Synthetic secondaries

Under a synthetic secondary, a Limited Partner in a fund seeks to confer the benefit and burden of being a Limited Partner on another person whilst remaining the Limited Partner in the fund. Thus, it is intended to achieve the same broad effect as a transfer of the Limited Partner interest, but without there being any actual transfer. The term ‘synthetic secondary’ has been applied to secondary directs, but that use of the expression seems to be becoming less common.

There is no standard form structure for a synthetic secondary. Each transaction needs to be tailored to the particular circumstances in which it is to be used. It will generally involve a contractual and/or a trust arrangement between the ‘transferor’ and the ‘transferee’.

Why use asynthetic secondary?

There are various reasons why a synthetic secondary might be used, including where there is a desire to keep the ‘transfer’ confdential, where there are tax, accounting or regulatory reasons for avoiding an outright transfer, or where there is a concern that the General Partner will not otherwise consent to the transfer of the Limited Partner interest.

Do synthetic secondaries give rise to concerns?

Synthetic secondaries involve a number of potential issues. The starting point is to check whether the Limited Partnership Agreement of the fund requires the General Partner’s consent to the synthetic secondary.

Even though a synthetic secondary does not amount to a full transfer of the Limited Partner interest, the transfer restrictions in a fund Limited Partnership Agreement may be drafted broadly enough to include transactions such as synthetic secondaries. A transfer in breach of those transfer restrictions may have serious consequences.

For example, a ‘transfer’ or attempted ‘transfer’ in breach of the transfer restrictions may put the ‘transferor’ Limited Partner in default giving rise to potential forfeiture, as well as other consequences.

Each of the ‘transferor’ and the ‘transferee’ under a synthetic secondary will be exposed to the credit risk of the other (for example, in relation to capital calls and distributions). Attempting to secure these risks (other than by a guarantee by a suitable person) can create difficulties, particularly if security is sought to be given over the Limited Partnership interest and the arrangement is intended to be confidential.

Ideally the synthetic secondary should also seek to capture the ‘non-financial’ rights of the ‘transferor’ Limited Partner, such as the receipt of information from the fund, nominating a person to be a member of the Advisory Committee, and any consent or voting rights of the ‘transferor’ Limited Partner.

In such cases the ‘transferee’ will need some control over how the ‘transferor’ behaves as a partner. This may present concerns to the ‘transferor’, particularly if a contentious issue arises where the ‘transferor’ feels uncomfortable following the directions of the ‘transferee’.

The confidentiality obligations imposed on the partners under the Limited Partnership Agreement will also need to be checked if information concerning the fund is to be passed to the ‘transferee’.

A more general question is whether the ‘transferor’ Limited Partner could be acting in breach of its good faith/fiduciary obligations to its other partners by entering into the synthetic does not reveal the existence of the synthetic secondary to its partners). This will depend on the applicable law and on the drafting of the Limited Partnership Agreement. Some comfort could be obtained by suitable indemnities provided by the ‘transferee’.

The ‘transferor’ and ‘transferee’ will need to consider the tax, accounting and regulatory implications of the synthetic secondary.

For example, is the effect of the synthetic secondary that distributions from the fund are treated for tax/accounting purposes as receipts of the ‘transferee’ and not of the ‘transferor’?

Conclusion

Although synthetic secondaries have excited interest over the years, they are infrequently encountered in practice. Whilst the concept of a synthetic secondary may appeal in certain circumstances, it is often difficult for the parties to become comfortable on the issues they present.

Secondaries funds and stapled secondaries transactions

Unlike a traditional fund of funds, formed for the purpose of making primary commitments to underlying funds at the beginning of their life, a secondaries fund may engage in a broader range of transactions. These may include fund interest secondaries or secondary directs, as described earlier in this guide.

It may also include participating in co-investment opportunities, often on a primary basis with sponsors of underlying funds that it has acquired an interest in on the secondary market.

Secondaries funds increasingly also provide exit solutions for investors in investment funds nearing the end of their lives that hold assets with attractive longer term prospects but that have limited short-term exit opportunities.

In these ‘tail-end’ cases, a secondaries fund may provide liquidity to investors that are seeking to exit the end-of-life fund through a fund interest secondary or secondary direct deal, or bespoke solution, including acquiring an interest in the existing investment fund’s holding vehicle or in a new vehicle that invests in the underlying assets and is managed by the same fund investment team that originally managed the investment.

Secondaries funds focused on fund interest strategy of investing in substantially unfunded positions (early stage) or in substantially funded positions (late stage). Late stage secondaries funds seek to mitigate blind-pool risk by performing diligence on a target fund’s underlying assets, while an early stage secondaries fund is more reliant on traditional fund of funds-style diligence on a target fund’s sponsor and its investment team. In addition to dedicated secondaries funds, many traditional fund of funds also have the ability to invest some portion of their commitments in secondary transactions.

Secondaries fund terms often reflect a middle ground between the economic arrangements typical in a traditional fund of funds and those more standard in funds engaging exclusively in direct investments.

It is common for management fees and carried interest rates applicable to an investment in a secondaries fund to be lower than in a direct private equity fund, but higher than in a standard fund of funds. It is also common for a secondaries fund’s carried interest to apply across the board to all the different types of secondary investments that it makes, in contrast to a conventional fund of funds that is more likely to charge a higher carried interest in respect of co-investments and other direct investments, but a much lower carried interest (if any) on primary investments in underlying funds.

Following the expiration of the investment period, management fees in secondaries funds gradually (e.g., 10% each year) than they do in direct funds where the management fee is a percentage of the cost basis of unrealized assets. Secondaries funds also benefit from broad rights to re-invest capital returned to investors to support the full investment of the aggregate commitments to the secondaries fund.

“Secondaries fund terms often reflect a middle ground between the economic arrangements typical in a traditional fund of funds and those more standard in funds engaging exclusively in direct investments”

Stapled secondaries

In addition to discrete secondary transactions, secondaries funds may be presented with ‘stapled secondary’ transactions where the secondary transaction is linked to the secondaries fund (or its affiliate) agreeing to make a primary commitment to a new product that is being raised by the sponsor of the target fund.

Such stapled transactions can be used by sponsors of underlying funds as a ‘sweetener’ to investors considering an investment in a new fund being raised by that sponsor. Secondaries funds themselves can also use stapled secondary transactions as a means of attracting investment capital.

Issues can arise with respect to the timing of completion of each element of the stapled transaction, with the secondary sale often moving more quickly than the primary fundraising, thereby requiring that completion of the secondary and primary elements remain cross-conditional with each other to ensure the stapling is effective.

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