Hogan Lovells

Sovereign Investor Insights
10 October 2019

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Growth of and trends in the private equity secondaries market

Over the past few years the historically illiquid private equity market has found a new path to liquidity through the meteoric rise of the private equity "secondaries" market, which is generally defined by the buying and selling of pre-existing investor commitments in private equity and other alternative investment funds. This development has fundamentally changed the private funds landscape. The secondaries market, which was once a niche and relatively simplistic market characterized by distressed sellers looking to exit certain long-term difficult-to-exit positions, has become a functional and active marketplace with increasingly sophisticated participants looking to take a more active role in the management of their investment portfolios. Through the first half of 2019, the worldwide private equity secondary market transaction volume reached an estimated US$55.4 billion, up 32% from the same period in 2018, according to an analysis conducted by NYPPEX.[1]

In this article, we seek to (i) identify driving forces behind the growth of the secondaries market by analyzing the motivating factors for each of the main players in the market, (ii) provide a high level overview of the mechanics of a standard secondary transaction, and (iii) discuss a few of the current trends and issues in the market.

Market motivation

As with any other purchase and sale transaction, secondary purchasers and sellers are looking for opportunities for attractive returns on their investments. However, the growth of the private equity secondaries market has been driven by a number of factors that go beyond IRRs and cash flows. Each of the main players in the secondaries market (secondary sellers, secondary purchasers, and general partners) has its own set of interests which have contributed to the rapid expansion of the market.

Secondary Sellers. Traditionally, sellers of private equity interests fell into two categories: (i) distressed investors who needed liquidity, and (ii) investors who were unsatisfied with the performance of their fund investments. While secondary sales can still be motivated by the need for liquidity or underwhelming fund performance, in the current landscape there are numerous factors at play, including:

- *Active portfolio management.* The increase in the popularity of secondaries transactions among sophisticated investors has coincided with a desire among these investors to take a more active role in managing their investment portfolios. Sellers on the secondary market are often looking to dispose of certain existing fund interests as a means to rebalance their overall exposure. The result has been a defined, yet non-public, marketplace for sellers to shop their interests and actively manage their holdings of traditionally illiquid assets. For example, an investor may seek to exit a fund investment before the end of the term of the fund where:
  - The fund has a strategic overlap with other funds in the investor's portfolio and the investor wishes to diversify its holdings;
  - The investor has decided to reduce the overall number of funds in its portfolio;
  - The investor desires to reduce the overall number of sponsors that it maintains investment relationships with; and/or
  - The investor has decided to shift its investment focus in terms of strategy, geography, or industry-sector.

- *Liquidity in tail-end funds and the desire for increased dry powder*. A large number of recession-era fund vintages have reached the end of their terms in recent years, and more will continue to reach their terms limits in the coming years. As these funds have reached the end of their terms, general partners have increasingly looked for ways to continue holding certain remaining investments where they have determined that they need more time to maximize the value of such investments. Existing investors may not be interested in continuing these remaining investments for a number of reasons, but particularly in view of a lack of confidence in their performance or their age in their portfolio. These investors may now look to dispose of these interests, often to buyers who are looking to add these fund vintages to their portfolios or who place a higher value on the remaining investments or the sponsor's ability with respect to such investments. Additionally, the growth and attractiveness of the private equity market as a whole has driven the desire for investors to have sufficient dry powder to take advantage of new investment opportunities, which has led to an increase in the number of secondary sales of existing interests.
- *Realization of gains and premiums over NAV*. Interests in certain high performing funds and/or in funds managed by highly coveted sponsors often price at premiums over the net asset value of the remaining assets in such funds, and the ability to lock in premium returns while achieving liquidity may entice certain investors to dispose of these interests prior to the end of the term of these funds.
- *Regulatory regimes*. New regulatory regimes (e.g., Basel III[2] and Solvency II[3] for banks and insurances companies) have prompted significant secondary selling in the last few years by legal necessity, and future regulation may have a similar impact on other market participants.

Secondary Purchasers. Purchasers in the secondaries market have also been driven by the desire to actively manage their portfolios. The secondaries market provides the opportunity for investors to actively diversify their holdings by acquiring interests in funds and with sponsors that fit their desired portfolios. The market has also seen a growth in the number of funds that are focused on engaging in secondaries transactions, which has provided investors with an additional means to achieve their diversification ends (see, *Secondary-devoted funds,* below, for additional discussion of these funds). Sophisticated institutional investors, including pension plans and sovereign wealth funds, are increasingly treating secondary private equity as an alternative investment strategy, committing to secondary managers in their investment allocations and devoting resources to build out secondary investing platforms. These platforms are becoming more robust as the market matures, reflecting a growing shift away from traditional passive investing in private equity to more active market participation. In addition to the growing desire to actively manage their portfolios, sophisticated secondary purchasers are typically driven one or more of the following factors:

- *Strong returns and lower risk*. Acquiring an interest in an established fund with an existing portfolio often carries less risk than making a primary commitment to a new fund which does not hold assets that can be evaluated. When an investor makes a primary commitment into a private equity fund, it is investing on the belief that the sponsor will be able to identify strong performing investments during the fund's investment period, however an investor purchasing an interest in the same private equity fund on the secondary market has the ability to diligence both the fund's existing portfolio and the sponsor's prior performance, and is thus often better positioned to evaluate the fund's potential future returns.
- *Access to preferred sponsors*. An investor who desires to develop a relationship with a highly-coveted sponsor may look to the secondary market for an introduction to the products offered by that sponsor. In order to cultivate such a relationship, sophisticated investors may structure their secondary purchases as "stapled" transactions where the investor purchases an interest in an existing fund from an existing investor and simultaneously makes a new commitment to the new fund being raised by the sponsor.
- *Shorter runway to liquidity*. Secondaries transactions can offer investors a shorter time frame for receiving fund distributions from investments. An investor who acquires an interest in a mature private equity fund that holds a portfolio of investments that are close to exit may be able to realize the return on its investment in a shorter amount of time as compared to a traditional primary commitment to the same fund. Moreover, if the

secondary purchase occurs later in the fund's term, the purchaser may be able to avoid the "J-curve" effect on returns that is often associated with private equity investments (i.e., the historical tendency of private equity funds to deliver negative returns in early years and investment gains in later years as their portfolios mature).

- *Discounted NAV and hidden value*. While sellers of fund interests naturally look for premium returns when disposing of their interests, secondary purchasers will look to acquire interests that are being sold at a discount to the net asset value of the fund. If a purchaser believes that the potential value of the portfolio of investments (NAV) underlying a fund interest is greater than its current NAV, such purchaser may be able to unlock hidden value in the portfolio if the purchaser can find a willing seller at the right price.
- *Single asset opportunities*. The secondary market not only provides investors with the opportunity to access preferred sponsors, but can also provide investors with the opportunity to obtain exposure to highly-coveted assets. Sponsors incentivized to maximize the value of unrealized assets late in the life of a fund may look for capital from outside of the fund to fuel its value-building activities. These transactions may often take the form of general partner-led restructurings where the general partner spins out a fund's remaining asset(s), which asset(s) are capitalized by a new fund of third-party investors and also by those investors in the prior fund who elect to roll their interests over, either into the new fund or into a separate rollover vehicle. This arrangement provides the general partner with opportunistic growth capital and additional time to maximize the value of the asset. Single-asset transactions with a high quality sponsor may also enable a secondary investor to effectively leverage the general partner's intimate knowledge of the underlying asset, to collaborate with the general partner in enhancing the value of the asset and to negotiate deal terms that closely align the interests of the general partner and the investor.

General Partners. More than ever before, larger and higher quality sponsors are initiating and leading secondaries transactions to unlock value in their platform. No longer solely the domain of distressed sponsors or ancient "zombie funds," general partner-led secondary transactions are becoming more common and complex arrangements that are designed to solve potential issues and create value (e.g., by providing liquidity for limited partners or securing a pre-emptive extension of the fund term to maximize the value of a fund's assets). Moreover, as the competition for private capital continues to intensify, sponsors are increasingly leading secondary processes with an eye towards the primary capabilities of interested buyers. As described above, general partner-led "stapled" transactions, in which general partners allow prospective buyers access to existing funds only if they make commitments to new funds, enable sponsors to actively manage their investor bases and to lock in new fund commitments. Thus, the secondary market has become both a tool for general partners to clean up older, tail-end funds and investments, as well as opening channels to a differentiated capital pool.

Mechanics for buyers and sellers

In a typical secondary transaction all parties first perform diligence on the underlying fund documentation. A secondary purchaser will typically be provided with three agreements: (1) the subscription agreement; (2) the operating agreement (or limited partnership agreement) of the fund; and (3) a side letter, to the extent there is a side letter between the fund and seller. At a minimum, these are the three main documents that a buyer will need to review to understand how a secondary transaction can be effected for the specific fund in question. Certain issues to look for in these documents include:

- Whether or not there is a requirement to notify the general partner of the proposed transfer before effecting the transaction;
- Whether or not there is a right of first refusal, right of first offer, or similar transfer restriction;
- Whether the seller will retain any residual liabilities in connection with its transferred interest;
- Whether the seller's side letter (if any) transfers to the purchaser in the transaction; and
- Whether the transfer otherwise meets all of the requirements for a valid transfer (including whether an opinion of counsel will be required to be provided by the purchaser).

The purchase and sale agreement (PSA) between a seller and a purchaser is the key document that governs the actual secondary sale. The PSA governs the terms and conditions of the sale between the seller and the purchaser, sets forth the closing process, and sets forth other rights the parties may have in connection with the transaction. Given that the PSA typically only addresses issues between the seller and the purchaser, it is unusual for the fund or its general partner to be a party to the PSA; however, the fund or the general partner may be party to the PSA in the case of certain GP-led secondary transactions (including tender offers, restructurings, and strip sales). The material issues that are heavily negotiated in most PSAs include: (i) the purchase price and adjustments thereto, (ii) obligations of the seller that the purchaser is not required to assume (such as liability for seller breaches of reps and warranties, taxes related to the sale of the seller's interest, and clawback obligations that existed prior to the effective date of the transaction), (iii) material adverse change provisions that allow for termination of the transaction between signing and closing if certain material adverse events happen at the fund, (iv) who bears transfer costs, (v) clawbacks, (vi) reps and warranties (including survival thereof), (vii) indemnification with respect to the transaction, and (viii) confidentiality.

Due to the complex nature of secondary transactions and the breadth of creative structures that have been utilized to effect such transactions in recent years, the mechanics behind secondary transactions have become highly bespoke, and each transaction will inherently have unique nuances. While parties will likely encounter fund documents and PSAs in almost all secondary transactions, these more nuanced structures will typically require additional documentation. For example, a tender offer for existing limited partner interests will include an offering document and disclosures similar to tender offers in the public securities context, and a general partner-led restructuring may include a "framework" agreement that sets forth what needs to be accomplished by the parties in order to close the transaction.

Trends and hot topics

The growth and maturation of the secondary private equity market has brought with it new opportunities for investors and sponsors and a new host of issues for these parties to consider, including:

General partner-led deals. General partner-led secondary transactions have accounted for an increasing percentage of secondary market transaction volume in recent years, and there is no reason to believe that the trend of general partners being increasingly active in the secondary market will not continue in the coming years. Increasingly, general partner-led secondaries are being used to create value for both fund sponsors and their limited partners in the form of liquidity solutions with more attractive valuations than regular dispositions of the funds' assets. As the GP-led secondary market has become more complex, the list of strategies available to GPs has expanded and has created new fundraising, exit and investment structuring opportunities. These strategies include, but are not limited to:

- *General Partner Tender Offers.* Typically, a general partner will "tender" all or a portion of the existing limited partner interests of a fund to a buyer who could be an existing investor, an affiliate of the general partner or a third party. These transactions are typically designed to (i) provide a liquidity option to existing limited partners, (ii) extend the fund term to optimize exit values, and/or (iii) provide follow-on capital to the general partner.
- *Stapled Secondaries.* As described above, stapled transactions offer secondary buyers the opportunity to (i) gain exposure to an existing fund and (ii) participate in the general partner's next fund. These transactions are structured to provide optional liquidity to existing investors while simultaneously providing primary capital to a general partner for future vintages.
- *General Partner-led Fund Restructurings and Asset Continuation.* In these types of transactions, a general partner may sell one or a number of assets from one vehicle in order to generate liquidity for existing limited partners to a new vehicle financed by secondary capital therein, enabling a general partner to maintain control of the asset(s) for continued growth. Existing limited partners are typically provided with options to: (i) sell their interests and receive a pro rata portion of the cash purchase price of the asset sale, (ii) roll their pro rata share of their fund interests into a special purpose vehicle established to continue holding an interest in the assets in parallel to the new vehicle, or (iii) engage in a partial sale/partial roll (a combination of (i) and (ii)). Like tender offers, these transactions provide a liquidity option to existing limited partners, provide the general partner with additional time to optimize exit values, and provide follow-on capital to the general partner to put towards such value optimization.

While these transactions are often designed to provide value and/or solutions to general partners and their existing limited partners, they can also present conflicts of interest that existing limited partners should be wary about, especially where the benefits of the transaction primarily accrue to a party or parties other than the existing limited partners (such as in the stapled transaction or asset continuation contexts). In order to address these conflicts of interest, general partners should endeavor to provide purchasers and existing limited partners with symmetrical information, including financial information about the projected value of remaining assets in the fund. The issue of conflicts of interest in this space continues to evolve and will be something to watch as the market continues to grow and mature.

Funds reaching their PTP limitation. According to estimates, a record number of funds will reach their annual publicly traded partnership (PTP) limitations in 2019. A fund that reaches its PTP limitation will likely withhold approval for additional transfers of the fund's interests until a subsequent year in order to avoid triggering PTP status (i.e., potential U.S. corporate tax classification) and the additional tax obligations imposed on PTPs. Such consent withholding may cause such a fund to have a backlog of pending secondaries transfers that may not receive approval for several years. Investors looking to engage in secondary transactions should confirm that their transaction will not be held up by the fund's PTP limitation early on in the process in order to avoid sinking time and effort into a transaction that they may not be able to complete.

Secondary-devoted funds. Private equity funds devoted to engaging in secondary market transactions have accounted for a large majority of the secondary private equity purchases in recent years. These vehicles allow investors to access the secondary market without needing to actively pursue deals, and are attractive to investors for a number of reasons, including but not limited to:

- *Accelerated exposure and earlier return of capital.* Secondary funds acquire interests in more mature primary funds (i.e., that are typically a few years into their investment periods or outside of their investment periods) and often deploy capital quicker than a typical primary fund, thereby providing investors with a more accelerated exposure to private markets. By purchasing more mature stakes, secondary investors also receive a return of capital earlier than that of a typical primary fund investor and reduce overall holding times.
- *Efficient diversification.* Secondary funds typically purchase interests in primary funds to build a diversified portfolio, with each interest being exposed to a large number of holdings. The resulting secondary portfolio can provide the investors in the secondary fund with exposure across numerous geographies, strategies, and vintage years in a more efficient manner than if such investors engaged in the secondary market on their own behalf.
- *Compelling risk-return profile.* Secondary funds exhibit attractive historical returns when compared to primary buyout funds. While purchasing more mature holdings may limit upside potential, secondary strategies can potentially mitigate risk and can be viewed as a more conservative way to build exposure to private markets.

This Sovereign Investor Insights is a summary for guidance only and should not be relied on as legal advice in relation to a particular transaction or situation. If you have any questions or would like any additional information regarding this matter, please contact your relationship partner at Hogan Lovells or any of the lawyers listed below.

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Endnotes

1. https://www.pionline.com/private-equity/secondary-market-sees-surge-volume-first-half-2019

2. Basel III is a set of international banking regulations developed by the Bank for International Settlements to promote stability in the international financial system. The Basel III regulations are designed to reduce damage to the economy by banks that take on excess risk.

3. Solvency II is a European Union legislative program that aimed to harmonize EU-wide insurance regulatory regimes.

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