

Secondaries transactions—will this be the future trend for private equity transactions?

by Michael Dodge, Partner, Arnold Bloch Leibler

The rise of secondaries transactions

The nature of secondaries transactions

Given the long-term, private and passive nature of private equity investment, private equity investment is an illiquid investment class. The need for a secondaries market has arisen as a means of providing private equity investors with an opportunity to exit their investments during the life of a fund.

Secondaries transactions can be generally divided into two basic categories. These are:

- **Sales of limited partnership interests:** In a transaction of this kind the investor will sell its interest in the private equity fund whether on its own or as part of a portfolio of interests in different private equity funds. A buyer of such interests would typically be another private equity investor (such as a superannuation fund) or a fund of funds.
- **Sales of direct interests in portfolio companies:** In a transaction of this kind, the general partner would arrange for the private equity fund itself to sell a portfolio of the direct interests that the fund holds in the portfolio companies that the fund has invested in. A buyer of a portfolio of direct interests would typically be another private equity fund.

General reasons for selling limited partnership interests

There are many reasons why investments in private equity would be sold during the life of a fund, including the following¹:

- **Changes in asset allocation:** The global financial crisis has negatively affected public equity holdings, therefore investors may be over-exposed to the private equity market. Selling private equity interests on the secondaries market is one way to re-allocate assets. This is referred to as the “denominator effect”². In addition, an active approach to the management of a portfolio will require the re-weighting and re-balancing of the portfolio on a regular basis.
- **Regulatory changes:** Banks and other financial institutions are required by law to set aside an amount of capital to protect against private equity losses. One way to recover capital is to sell some private equity interests.
- **Strategic positioning:** Private equity investors may wish to sell their existing investments and invest with other fund managers that are more likely to bring them investment opportunities in the future.
- **Management of financial results:** Private equity investors may sell their interests so as to increase earnings, improve short-term operating results and reduce future capital call obligations.
- **Cash flow needs:** Investors may be unable to make good on a capital call or may need liquidity for some other reason.
- **Reducing the administrative burden:** Private equity investors may want to reduce their holdings to sizeable portions, perhaps in certain industries or as a means of reducing monitoring obligations or managing costs.

¹ David Tegeler and Kristin Caplice, “Secondary considerations: an introduction to secondary funds”.

² Scott Peterman and Doris Lai, “From the Ashes Rise: Private Equity Secondary Funds Take Flight”, *The Journal of Private Equity*.

Factors that motivate the sale of direct partnership interests

The desire of one or more key investors in a private equity fund to exit from their investments may be a trigger for the general partner to seek to sell the assets of the private equity fund and close the fund.

The general partner may also have its own reasons for proposing to its investors that the private equity fund be closed early. Such reasons include:

- **Lack of capital for follow-on funding:** The general partner may determine that the unallocated capital left in the private equity fund is not sufficient to meet the fund's proportion of the follow-on capital requirements of all of its portfolio companies.
- **Greater IRR:** The general partner may consider that the opportunity to sell all of the private equity fund's investments at that time as a portfolio may provide a higher internal rate of return (IRR) for investors than could be achieved if the fund continued and the general partner sought to dispose of each investment separately at varying rates of return.
- **Lack of other exit opportunities:** The general partner may consider that due to unfavourable market conditions its ability to achieve an exit by means of an IPO will not be possible for a considerable period of time. (Leaving aside the \$2.2 billion IPO of Myer Holdings, the 2009 IPO market in Australia was considered to be the worst in a decade³). The general partner would then need to be considering the opportunities for achieving a trade sale for all of its investments. If credit is tight, as it has been for the last 18 months, this may mean that even trade sale opportunities may be few and far between.
- **Lack of management capacity:** The general partner will only have a finite number of professional staff capable of analysing, acquiring, managing and disposing of the investments in investee companies. These investments may be spread across a number of private equity funds, each of which is likely to be at a different point in its life cycle. The general partner may need to close out a private equity fund early in order to be in a position to dedicate management time to the raising and management of newer funds. This need might arise suddenly if key personnel leave the firm unexpectedly.
- **Demonstrating a track record:** The general partner's ability to attract investment in a second or a later vintage fund is often dependant upon its ability to demonstrate a successful track record. By closing out a private equity fund early, and thereby demonstrating its ability to generate a favourable IRR for the investors in an existing fund, the fund manager may then be in a position to complete the raising of another fund.

General reasons for buying in the secondaries market

The reasons for buying private equity interests directly, or for buying into an already established portfolio of private equity investments, include the following⁴:

- **Quicker returns on investment:** Buying on the secondaries market means the buyer invests later in the life of an investment. A buyer would therefore expect to receive a return on its investment faster than it would if it had made a primary investment.
- **No "blind pools":** One advantage of secondaries investments is that they offer the investor a degree of hindsight, in the sense that the investor can look to the private equity fund's performance history and assess the likelihood or otherwise of a profitable return.
- **Access to selective funds:** Some private equity investments are only open to certain classes of investor (e.g. those with a pre-existing relationship with the fund manager). Investing on the secondaries market provides an opportunity for investors to make investments they would not otherwise have had the opportunity to make or which they missed out on making.
- **Discounted price:** Typically secondaries investments earn a higher rate of return and are priced at a significant discount to primary investments.

³ HBL Mann Judd small cap IPO watch 2009.

⁴ David Tegeler and Kristin Caplice, "Secondary considerations: an introduction to secondary funds"; Scott Peterman and Doris Lai, "From the Ashes Rise: Private Equity Secondary Funds Take Flight", *The Journal of Private Equity*; Arleen Jacobius, "Secondary private equity markets booming as banks, others sell partnerships".

- **Diversification:** Secondaries buyers can diversify their portfolio holdings by investing across a wide range of industries in the secondaries market.

The size of the secondaries market

Historical overview

The secondaries market has grown substantially since 2005. According to Greenpark Capital, an independent investment firm with capital dedicated solely to secondaries, secondaries have been in existence since the late 1980s. Between 1995 and 2000, “less than \$10 billion was raised by worldwide secondaries funds, whereas \$15 billion was raised in the secondaries market in 2007 alone”⁵. According to Venture Economics, over \$15 billion was committed to secondaries funds during the first three quarters of 2009 (this figure does not take into account funds-of-funds and other institutions purchasing secondaries interests in private equity on a stand-alone basis)⁶. It has even been suggested that such figures may not actually reflect the full extent of the secondaries market since many secondaries transactions are conducted privately⁷.

The impact of the global financial crisis

Many commentators predicted that the secondaries market would benefit from the economic downturn, because sellers would be forced to sell their private equity interests. The two main reasons for this view were that sellers would need liquidity during the credit crisis⁸ and would also be impacted by the need to rebalance their portfolios as a result of the dramatic fall in the value of their public equity holdings (i.e. the so called “denominator effect”).

It was thought that as a consequence of these factors (which are unique to an economic downturn) the supply of secondaries would outstrip demand. However, the predicted boom in the secondaries market did not materialise in the first half of 2009 to the extent first thought. As Greenpark Capital observed, “the much anticipated secondaries boom of 2009 is edging towards 2010”⁹. Watson Wyatt, a worldwide business analyst and advisory firm, echoes this forecast. They note that although commentators predicted secondaries would benefit from the economic downturn, “the reality to date appears to have been somewhat different, with very few transactions clearing the market”¹⁰. So why is this?

It is thought that the secondaries market did not accelerate in the period between late 2008 and in to 2009, due to an inability of buyers and sellers to reach agreement on price. Over recent years, secondaries market pricing has fluctuated between a slight discount or premium to net asset value, but the end of 2008 saw a significant decline in prices to levels approximating a 60% discount. This led to a large bid-ask spread between buyers and sellers that resulted in many broken deals¹¹.

In addition, it is thought that the number of capital calls made on investors were lower than anticipated and this meant that there were fewer distressed sellers in the market than expected¹².

Outlook for the future

Greenpark Capital expects that 2010 will “be the best buyer’s market since secondaries began nearly three decades ago”¹³ with Probitas Partners estimating that secondaries volume will reach up to \$18 billion¹⁴. Watson Wyatt also remains positive. They consider that it is “reasonable to expect” “increased deal activity” in 2010¹⁵. These sentiments were reflected in a survey undertaken by UBS in which the majority of survey participants believed that the 2010 secondaries market transaction volume would be at least 50% greater than the 2009 level¹⁶.

⁵ Greenpark Capital, “Secondaries market—history and development”.

⁶ David Tom, “Is Black Friday syndrome invading the secondaries market?”

⁷ Arleen Jacobius, “Secondary private equity markets booming as banks, others sell partnerships”.

⁸ Watson Wyatt, “Secondary market in private equity”.

⁹ Greenpark Capital, “Will there be a secondaries boom?”.

¹⁰ David Snow, “Meet the Sellers”, *Private Equity International*.

¹¹ UBS Private Funds Group—Secondary Advisory Group: Presentation to the Adams Street Secondary Networking Event, February 2010.

¹² David Snow, “Meet the Sellers”, *Private Equity International*.

¹³ Greenpark Capital, “Will there be a secondaries boom?”.

¹⁴ Probitas Partners presentation to the Adams Street Secondary Networking Event, February 2010.

¹⁵ Watson Wyatt, “Secondary market in private equity”.

¹⁶ UBS Private Funds Group—Secondary Advisory Group: Presentation to the Adams Street Secondary Networking Event, February 2010.

There are several reasons for expecting the secondaries market to bounce back in 2010, with increased deal activity. These are¹⁷:

- **Ongoing need for liquidity:** The main advantage of having a secondaries market from the perspective of the private equity funds themselves, is that it provides liquidity for a traditionally illiquid asset. There will always be private equity investors who need liquidity.
- **Price dislocation:** With a more stable economic environment following the economic downturn, it may be easier for parties to agree on a price in 2010. However, Watson Wyatt makes the point that if liquidity concerns do not become more extreme for sellers by the year's end, buyers will need to increase their bid price to secure a secondaries transaction.
- **Capital investment in private equity:** The large amount of capital invested in private equity in the 1990s has contributed to the overall growth of the secondaries market. As Watson Wyatt observes, the "exponential growth in the primary market" can be expected "to filter through to the secondaries market over time". This is expected to continue in 2010.
- **Growing range of transaction structures:** There is now a greater range of transactions, with varying structures, designed to achieve different objectives. For example, non-cash transactions are now quite common in the secondaries market.

The Australian market for secondaries transaction

Given the smaller depth of private equity investment in the Australian market, the anecdotal evidence appears to suggest that in the Australian market the sales of direct investments in portfolio companies are likely to dominate the secondaries market.

The impact of the global financial crisis is likely, in my view, to encourage the emergence of additional dedicated secondaries fund managers in the Australian market. This is expected to be driven by the following factors:

- **Tighter credit limits are being applied:** Due to the tightening of the credit markets, the level of debt funding that banks will be willing to provide to private equity transactions will be reduced. As a consequence, private equity funds will need to apply more equity to maintain the size of investments, or, as is more likely to be the case, make smaller investments.
- **Government regulation is changing:** It has recently been reported that US President Barack Obama has recently sought to impose stricter limits on financial institutions, preventing them from investing in, owning or sponsoring a hedge fund or a private equity fund. If these rules are introduced by Congress in the United States, it is quite possible (given the increased co-operation between regulatory authorities around the world in response to the global financial crisis), that similar rules will be imposed in other jurisdictions as well. If this occurs, then private equity funds are likely to be smaller and the size of the equity investments that they will be able to make is likely to fall as a result.

If these responses to the global financial crisis do in fact lead to a fall in the level of debt and equity available for individual private equity investments, then—unless there is a greater level of co-investment between private equity funds—initial private equity investments will inevitably be smaller than has been the case in the past.

With less money able to be invested in the primary transaction, portfolio companies are likely to require a longer timeframe over which to achieve an exit. As it is unlikely that investors in private equity will be prepared to commit their capital for longer than the existing seven to ten year term, it is increasingly likely, in the absence of greater co-investment between private equity funds, that private equity investments will be held by more than one fund before an ultimate exit is able to be achieved by means of a trade sale or an IPO.

¹⁷ Watson Wyatt, "Secondary market in private equity"; Alternative Investor, "The Private Equity Analyst—Guide to the Secondary Market"; Greenpark Capital, "How is the secondaries market evolving?".

Common issues that impact on the ability of parties to complete secondaries transactions

In some respects, a secondaries transaction is no different from any other transaction involving the sale of partnership or equity interests. However, given that a secondaries buyer is buying into an existing investment structure in which the relationships between the parties have already been settled, there are a number of aspects of a secondaries transaction that needs to be handled with care.

Confidentiality

Confidentiality issues often arise in secondaries transactions. Sellers of limited partnership interests will be constrained by the confidentiality obligations imposed on them by the terms of the fund documents. The fund itself will be subject to confidentiality obligations imposed on it by the constituent documents of the portfolio companies. These obligations of confidentiality complicate the ability of buyers to undertake adequate due diligence.

It is important for sellers of partnership interests and direct portfolio interests to consider their confidentiality obligations so they know what information they can provide to buyers.

Due diligence and valuation

Secondaries sales of partnership interests are based on second-hand due diligence. Sellers will need to work with buyers to convey information to satisfy buyers that they know what they are buying. Of course, the buyer would expect to receive the financial statements, budgets and business plans of the portfolio companies. The financial information provided will form the basis of the valuation. In addition to reviewing the past performance of the portfolio companies, the buyer will be interested in analysing the likely future performance of the portfolio companies and ascertaining the hurdles that the portfolio companies will need to overcome in order to be able to achieve their forecast revenues and growth¹⁸.

The sale of direct interests in the portfolio companies may in theory provide the buyer with greater access to direct due diligence information regarding the portfolio companies. However, the management of the portfolio companies may not wish to get involved in the due diligence process, as their involvement is likely to be a distraction to the management of the business. In the absence of a commitment on the part of the buyer to invest further in the company, management's involvement will be of no real benefit to the company itself.

Representations and warranties

Private equity funds and their investors are often unwilling to provide representations and warranties in respect of the sale of their investments. In part, this is due to the fact that any claim under such representations and warranties will impact on the performance of their private equity investments. On an exit, it is often left to management and the other investors to provide the representations and warranties.

To overcome a secondaries buyer's need for comfort regarding the investment that it is making there are a number of different approaches that could be adopted. The available approaches include the following:

- If the buyer is able to conduct due diligence, the buyer could be made to rely on its own due diligence rather than on warranties provided by the seller.
- The buyer could rely on second-hand warranties. This could be done either by:
 - providing the representations and warranties solely on the basis of the truth and completeness of warranties provided by the portfolio company or other investors in the portfolio company when the primary investment was made; or
 - transferring to the buyer the benefit of the primary representations and warranties provided by the portfolio company or other investors in the portfolio company when the primary investment was made.

¹⁸ David Wachter, "Secondary Market Overhang Not Solely Due to 'Discount'".

- The warranties provided by the seller could be provided solely on the basis of the actual knowledge of the seller. As a consequence, the buyer would assume the risk of any matters that were not within the actual knowledge of the seller.
- Warranty insurance could be obtained to cover the risk of a claim being made under the warranties.

Of course, the provision of anything less than full warranties may have an impact on the price that a buyer is prepared to pay for the private equity interests being acquired.

Pre-emptive rights

The constituent documents of each portfolio company are likely to contain pre-emptive rights. Pre-emptive rights require each shareholder to offer any shares that they wish to sell to the other shareholders before offering them for sale to any third party. If exercised, such pre-emptive rights are likely to interfere with the sale of direct interests in that portfolio company.

Depending on the drafting of those pre-emptive rights, they may also impact on the sale of partnership interests in the private equity fund that holds that investment. Of course, the fund documents themselves may also contain pre-emptive rights that impact on the ability of a limited partner to complete the sale of its partnership interest.

As a consequence, secondaries transactions need to be undertaken with some care to avoid triggering these pre-emptive rights. A secondaries buyer may be concerned about incurring costs in undertaking due diligence and preparing the legal documentation necessary to complete the transaction if the transaction is at risk of being blocked by the holder of the pre-emptive rights. The secondaries buyer may therefore insist on being paid a break fee if the sale is unable to be completed due to the exercise of pre-emptive rights by another party.

Structural and documentation risk

A primary investor in private equity may have some ability to shape the terms of the fund documents, particularly if it is a cornerstone investor in the private equity fund. A secondaries buyer of a limited partnership interest will not have this ability—it must take the terms of the fund documents as it finds them.

The same is true of a secondaries fund manager acquiring a portfolio of direct investments in portfolio companies. The fund manager that made the initial investment will often have the ability to dictate the structuring of the portfolio companies as well as the terms of the constituent documents of the portfolio companies, particularly where it is the lead investor in a capital raising round. The secondaries fund manager acquiring the portfolio must take the structure of the portfolio companies and the terms of the constituent documents as it finds them.

In this respect, the secondaries buyer is at a disadvantage. By acquiring investments on a portfolio basis, a secondaries buyer seeks to average out the impact of any structural or documentary issues that affect one investment. Of course, the impact of any issues that the buyer identifies will need to be taken into account in the price that is paid for that portfolio. The onus is therefore very much on the buyer to consider the consequences of the structure and the documentation that it is inheriting through the acquisition.

Of particular concern to a secondaries buyer would be any terms of the documents that impose broader restrictions on the buyer's future activities. For example, a restriction on the ability of the buyer to acquire interests in competitors of the portfolio companies may constrain the buyer's future investment activities.

There may also be certain “side letter obligations” or “side letter benefits” that are private agreements made between an investor and the private equity fund. Under such “side letters”, an investor may be assured a seat on an advisory committee or lower management fees. Such “side letter” arrangements may not be transferable to the buyer.

Co-investor risk

A buyer of a partnership interest will need to be aware of who the co-investors in the private equity fund will be when buying on the secondaries market. There may be a risk that certain co-investors are liquidity constrained or that the co-investors views are not aligned with their own.

However the transaction is structured, the same analysis needs to be undertaken of the other investors in the portfolio companies. The more that the other investors are liquidity constrained or hold views that are not aligned with those of the secondaries buyer, the greater the risk of conflict between the parties in the future.

Taxation considerations

The taxation implications of the secondaries transaction need to be considered not only from the point-of-view of the buyer and the seller, but also from the point of view of the private equity fund itself and the portfolio companies.

The taxation considerations are complicated by the fact that the transaction may well have cross-border implications. The Australian Taxation Office's response to the taxation treatment of the Myer sale by TPG is evidence enough of this. The subsequent taxation rulings issued by the Australian Taxation Office (ATO) have received a strong response from the Australian Private Equity and Venture Capital Association (AVCAL). AVCAL considers that one ruling should be withdrawn and the other substantially revised. In its response to the ATO's rulings, AVCAL noted that in the case of the Australian private equity industry, the ten largest firms, with \$16 billion in funds under management (representing approximately 70% of the Australian industry), have sourced a little over half their funds under management from foreign investors. Given the significant investment in the Australian private equity market from foreign investors, cross-border taxation implications are likely to be a feature of many secondaries transactions.

Change in control provisions

An acquisition on the secondaries market may lead to a change in control of a portfolio company. This will occur where the transaction involves a sale (whether directly or indirectly) of an interest that is greater than the limit set for a controlling interest in the constituent documents of the portfolio company. This will also be more likely to occur where the acquirer already has an interest in the portfolio company or where drag-along or tag-along rights triggered by the transaction are sought to be exercised by the holder of those rights.

Apart from triggering pre-emptive rights, the change in control may also trigger rights in favour of third parties who have entered into contracts with the portfolio companies. The consent of the relevant counterparties to these contracts may therefore need to be obtained as a condition precedent to the secondaries transaction.

The availability of losses in a portfolio company may be affected if the change in control results in a change of more than 50 per cent of the equity in that portfolio company. If this is the case, then the losses in that company will only continue to be available if the company is able to satisfy the continuity of business test between the year of income in which the losses were incurred and the year of income in which the losses are sought to be utilised¹⁹.

Corporations law considerations

Depending on the nature of the secondaries transaction, the various provisions of the *Corporations Act* may also be relevant to the transaction. The relevant provisions could include:

- the requirement to create a disclosure document to investors about securities where any investor does not qualify for exemption, such as because they are a 'sophisticated' or 'professional' investor²⁰;
- the "takeover provisions" where a portfolio company is listed or has more than 50 shareholders²¹;

¹⁹ Division 165 of the *Income Tax Assessment Act 1997* (Cth).

²⁰ *Corporations Act 2001* (Cth) Chapter 6D.

²¹ *Corporations Act 2001* (Cth) Chapter 6.

- the requirements that need to be satisfied where a portfolio company is providing financial assistance in connection with the acquisition of its own shares²²;
- provisions that apply to “dealing” in securities²³ or in making “unsolicited offers for securities²⁴; and
- the “insider trading” provisions that apply to any transaction in which securities are disposed of and a party has information that is not disclosed to the other party²⁵.

To the extent that any of the portfolio companies are listed on the ASX, the requirements of the Listing Rules may also need to be satisfied. The completion of the transaction will be complicated and take longer to complete if the requirements of the ASX impose a requirement on the parties to seek the approval of the shareholders in that portfolio company. If that is the case, it is unlikely that the existing private equity fund will be able to exercise the voting rights attached to the shares that it holds in the portfolio company that is listed on the ASX.

Overcoming the issues that arise in secondaries transactions

A number of the legal issues that typically arise in a secondaries transaction can be overcome if attention had been focussed on these issues when the primary investment was made. For example, private equity fund managers would be prudent to ensure that their fund and transaction documentation are structured to include:

- an express exemption to the confidentiality provisions to allow them to share information with secondaries buyers regarding the private equity fund and its portfolio companies;
- an ability to transfer the benefit of representations and warranties provided in respect of the initial investment to a secondaries buyer;
- an exception to the pre-emptive rights provisions to expressly allow secondaries transactions to be undertaken without triggering the pre-emptive rights provisions; and
- an exception to the change of control provisions to expressly carve secondaries transactions out of the operation of these provisions.

Conclusion

The private equity secondaries market is clearly a growing market. The impact of the global financial crisis is expected to lead to greater activity in 2010. The tighter credit controls that banks are imposing and the push by the Obama administration to restrict financial institutions from owning private equity firms will only serve to bolster the need for an active secondaries market.

Given that the secondaries market is likely to provide an increasing source of exit opportunities for primary investors in the private equity market, private equity fund managers would be well-served in structuring both their fund documentation and transaction documentation in a manner that allows them to overcome more easily some of the legal issues that they currently face in structuring a secondaries transaction.

Important notice

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²² Corporations Act 2001 (Cth) Part 2J.3.

²³ Corporations Act 2001 (Cth) Section 766C, pt 7.6.

²⁴ Corporations Act 2001 (Cth) Part 7.9, Division 5A.

²⁵ Corporations Act 2001 (Cth) Part 7.10.