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PRIVATE FUNDS SPOTLIGHT

GP-Led Secondary Transactions: A "New-Fashioned" Way of Achieving Liquidity

With several headline-grabbing GP-led secondary transactions, 2017 has witnessed the maturation of a relatively new feature in the private equity industry's liquidity tool kit. This past summer, Lexington Partners purchased LP interests from investors in BC Partner's ninth flagship buyout fund, while committing new capital to the fund's successor. Structured as a tender offer, the transaction value was reported to be around $1 billion. Meanwhile, Warburg Pincus announced that it engaged Lazard to consider a secondary transaction to facilitate the sale of up to $1 billion of Asian assets from its relatively recent 2013 vintage private equity fund. Partners Group was announced as the buyer in a stapled transaction involving EQT's 2011 flagship buyout fund and its latest Asia fund. The list goes on.

TYPES OF GP-LED SECONDARY TRANSACTIONS

Until recently, GP-led secondary deals have generally been associated with "zombie funds" with lingering, hard-to-sell assets. As described immediately below, these transactions have tended to take one of three forms. GPs have discovered recently, however, that these transactions may have broader applications. The nature of those applications and the best practices to ensure success and avoid potential pitfalls are also set out further below.

1 **The Tender Offer for LP-Interests:** In the simplest of secondary transactions, the GP facilitates offers from one or more buyers (sometimes, an existing LP or even an affiliate of the GP itself) to tender for all or a portion of the fund's LP interests. For buyers, the dynamics are similar to negotiating one-off LP transfers; apart from the price, the buyers must be prepared to assume the mantle of substitute LP. For sellers, the advantage is having the GP manage the process. That said, these transactions pose "prisoner's dilemma" issues for selling LPs, who must balance the risk of missing out on a liquidity opportunity against the risk of getting left behind — sometimes, with a new single, large investor. Indeed, very often these transactions are followed immediately by an LP vote to extend the term of the existing fund — a vote more easily facilitated if a new single, large LP remains after other LPs have decided to cash out. Few LPs want to find themselves standing next to an 800-pound gorilla.

2 **The Fund Recap:** This more complicated variant usually involves the sale of all or a significant portion of the existing fund's assets into a new special purpose vehicle (SPV) with buyer capital, but managed by the existing fund's GP. The fund recap can breathe new life into the existing fund, enabling the GP to continue to manage the assets beyond its prescribed term. Fund recaps also usually involve a "re-set" of the fund's economics — revised management fee (including fee offset) and carried interest (including clawback) terms to incentivize the GP's professionals to stick around to manage assets that would otherwise have been driven into fire sale. LPs are usually given the choice to simply "cash out" by remaining as LPs or to "roll over" into the new SPV on the new terms. These transactions, however, are often accompanied by tricky conflicts of interest for the GP, who maintains fiduciary duties to the existing fund and its LPs and is thus on "both sides" of the trade.

3 The Stapled Secondary: The "stapled secondary" is a variant of the two forms described above, though it is typically associated with fund recaps. In one variant, a buyer and/or any "roll over" investors commit "follow-on" capital in the event the GP decides to double down on the assets. In another, the buyer commits capital to the GP's successor fund. Until recently, this variant was usually associated with GP-driven transactions designed to ensure the survival of the GP's business with a successor fundraise as opposed to providing LPs with the best liquidity option. As such, these transactions have tended to fail and have attracted some regulatory scrutiny, particularly in circumstances where existing LPs aren't given many good options (e.g., cash out at a less than ideal price or roll over into the new fund).

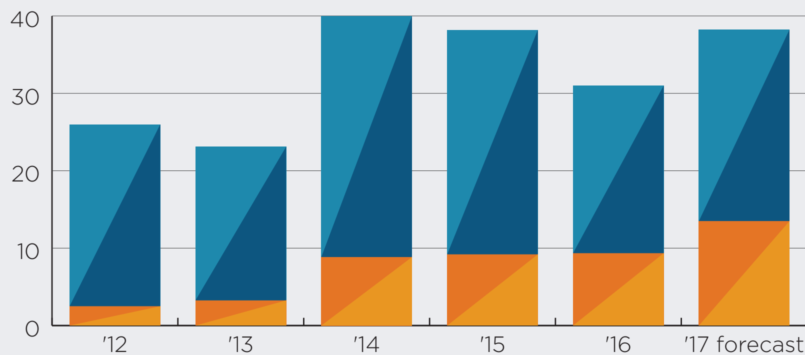
A "NEW-FASHIONED" LIQUIDITY APPROACH

This combination of the zombie fund and the stapled secondary initially caused such transactions to struggle to gain traction as LPs cited concerns over pricing and conflicts. But transactions like the Lexington / BC Partners deal signal a sea change of transactions with broader purposes and broader acceptance. These broader purposes include: mid-term secondaries, permitting investors with liquidity priorities to be separated from investors without such priorities; mid-term secondaries to spin off investments which the GP and certain investors believe will achieve full value only with a longer holding period than permitted by the exiting fund; secondaries that allow for the re-sizing of investment exposures across a sponsor's fund portfolio in a single deal; and secondaries (including any of the foregoing transactions) which can be stapled to a new fund, perhaps more focused on the type of assets being spun off.

The broader acceptance of these transactions is, in part, based on other trends in the private equity fund marketplace. First, GPs are recognizing, and certain investors are accepting, that there are investments that might benefit from the opportunity to build value over periods longer than the traditional 10-13 year Private Equity fund lifespan. The private equity market is beginning to see such opportunities being built into new funds with "market" terms. This trend helps with the acceptance of the economic and contractual terms of the spin-out of certain assets. Second, large private investors have been increasingly willing to be, and in some cases insistent on being, active in major business and value decisions of the funds in which they invest, as limited partner advisory committees or "LPACs" (or subcommittees of LPACs) begin to evolve, in some cases, to resemble boards of directors. This trend is reflected, for example, in their insistence on being able to hire financial and legal advisors at the fund's expense. Active large investors can, and have been, a critical step in leading fund investors to accept the price and terms of GP-led secondaries.

The evidence of this sea change is the growth of the GP-led secondaries. According to Credit Suisse, GP-led secondaries have grown from 10% of the market in 2012 to over a third of the market so far in 2017. Credit Suisse also predicts that private equity secondary transactions may approach $40 billion this year. Evercore predicts that $15 billion of that will be GP-driven. A GP would be well-served to understand what it takes to make these transactions a success.

TRANSACTION VOLUME IN PRIVATE EQUITY FUNDS, $BN



$40 BILLION in private equity secondary transactions in 2017

38% of these transactions are GP-driven

General Partner-led transactions

ENSURING THE SUCCESS OF A GP-LED SECONDARY TRANSACTION

Getting the Right Price: Early failures showed that if a transaction does not address the economic needs of the LP compared to those of the GP, it will fail. Thus, the first step is finding a price that LPs perceive as market-tested and, hopefully, value-creating. The prospect of "cash now" may not be good enough, particularly given the existing portfolio's illiquidity and buyer discounts that are a common feature of these transactions. An arm's-length negotiated valuation with a true third-party buyer in an LP-interest tender offer where LPs have the choice to cash out or stay put may more likely be viewed as legitimate compared to a valuation proposed by the GP in

a fund recap with a stapled secondary commitment from a prospective buyer who, like the GP, will be incentivized to keep the valuation as low as possible. It is here where the LPAC, if mobilized correctly, can play a crucial role by providing the appropriate negotiating counterweight in a scenario where the prospective buyer or the GP is on the other side. Furthermore, providing the LPAC — if not all prospective sellers — access to the same due diligence information as the prospective buyer may bolster the legitimacy of the process and the result. Achieving such legitimacy may also help stave off regulatory scrutiny after the fact. Allowing selling LPs to participate in any post-transaction upside can also be helpful.

Getting the Right Fund Terms: In the context of a fund recap, particularly for a fund near the end of its normal life, LPs must accept the business rationale behind the terms proposed for the new vehicle, particularly where the status quo is unappealing. Investors will object to transactions involving bad options, especially where poor performance is met with a "request" to put up more capital. Accordingly, creative carried interest structures which align performance with compensation through tiers (i.e., more carry for better performance) may be helpful, as well as fee structures that are operationally defensible (i.e., how much fee is truly needed and for how long?). The plea that an existing team must be incentivized in order to see the assets to liquidity isn't likely to generate much sympathy. And terms that effectively cleanse any embedded clawback in the existing fund are likely to be met with resistance and, instead, could be incorporated into the broader carried interest deal. Ensuring that transaction fees generated in connection with the fund recap are appropriately shared with existing LPs and as part of the "roll over" may also be a necessary step. Finally, discussing the allocation of transaction expenses among all deal participants in a fair manner early on may prevent a GP from being blind-sided by LPs demanding to know the answer later on, particularly where the benefits to the GP itself from the transaction are clear and obvious but the benefits to the LPs are less so.

Getting the Investors to "Yes": The nature of the role of the LPs — including the LPAC — will depend, in part, on the terms of the relevant fund documents. Generally, LP-interest secondary transactions are less likely to require LP or LPAC consent under those documents than typical fund recaps. Even if fund documents don't mandate consent, a GP's fiduciary duties, as well as good investor relations, point to a strong communication strategy as key to any successful GP-led secondary. In this respect, the LPAC can be a GP's friend rather than the enemy if used to stress-test options, gauge investor reaction, establish "buy in" and legitimize the result (see more on this above). For the latter two goals, minimizing both GP-LP asymmetries of information as well as LP-LP asymmetries may be helpful. Datarooms that are made available with enough lead time to all participants, may, at the same time, calm investor nerves and help support other aspects of the transaction. A clearly communicated process, with early access to proposed transaction documents, may also give LPs comfort and help level the playing field among prospective participants. Ultimately, LPs who are not confident in the process are more likely to reject it altogether. Moreover, equal access to information could be key to managing potential GP conflicts of interest.

Getting to Know Your Contract: This is an obvious step, but should not be taken for granted. For instance, in an LP-interest tender offer, right of first refusal or offer provisions embedded in transfer provisions that were originally intended to give existing LPs a first crack at acquiring the interests of selling LPs may nevertheless be implicated. A lack of awareness of terms early on might destroy options (e.g., obtaining a waiver from the requisite percentage of LPs to make the right go away might not be available if the right is discovered too late) or cause unexpected delays. For fund recaps (and as noted above), the transaction might require notice or disclosure to, or the consent of, the LPs or the LPAC given its related party nature. And everyone knows that seeking an amendment to fund documents takes time.

Getting Ahead of Problems: GP-led secondary transactions involve a great deal of upfront planning and strategy. GPs should consider consulting early with counsel and, potentially, a financial advisor to ensure that all are rowing in the same direction. Certain transaction forms may give rise to broker-dealer issues and, depending on the population of LPs and the domicile of the fund entities, non-U.S. legal issues. A GP should also consider comparing prospective buyers to existing LPs on the basis of features such as "benefit plan" status under ERISA and their respective tax sensitivities. A GP might also need to pay attention to what is occurring in the "upper tier" if the fund structure involves former employees or professionals expecting the secondary transaction to generate a liquidity event that might crystalize carry or justify the release of previously escrowed carry proceeds. Seasoned and experienced advisors are more likely to know where the pitfalls are and how to avoid them.

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