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Beyond the Basics

Secondaries Go Bespoke

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The secondaries market for private fund interests has grown at great scale over the last few years, with dry powder and fundraising at record levels. The 2023 secondary market volume stood at an estimated U$115 billion and the average flagship secondaries fund grew 48% from its predecessor fund, both according to PJT Partners. The market has long since bifurcated into the classic LP-led transactions on the one hand, and the more innovative, yet well established, GP-led secondaries market.

A number of institutional investors are now looking to rebalance their private market holdings – this has been driven in part by the correction in public markets starting 2022, but has been delayed by soft pricing in the secondaries market. Bid/ask spreads on secondaries are narrowing and the average discount price on a portfolio asset has edged back closer to net asset value (NAV), or par value, opening up opportunities.

In this article, we explore how outside thinking and creativity can help sellers achieve optimal outcomes in the LP-led secondaries market.

Creativity

Creative transaction structures enable a seller in special situations to achieve liquidity on one part of the portfolio being sold, even if it cannot dispose of the investment. Disposal in the ordinary course is preferable, but an example of a creative solution is an economic transfer agreement, by which a seller agrees to pass forward future cash receipts to the buyer in return for cash up front. The seller retains ownership of the interest. This solution can help where GP consent is withheld from the transfer; for example, when the underlying fund is being liquidated and the proposed transfer is too much administration for the GP or liquidating trustee.

Care must be taken to ensure that the agreement does not breach any transfer provisions of the relevant fund's limited partnership agreement (LPA) that extend to indirect transfers. Buyers, if being asked to part with their capital upfront without taking ownership, will naturally scrutinise the proposed terms carefully to ensure the seller's obligations are tightly drafted, and that the seller is subject to robust covenants on nondisposal and the flow of information to the buyer about the underlying interest (such as quarterly and annual reports). The agreement should consider US tax and other withholding tax implications on both the amounts received by the seller and the amounts paid on to the buyer. As these agreements often apply to tail end interests, provision should also be made for the distribution of assets in kind and any clawback obligations.

Challenges With the Tail

Tail end considerations do not just apply to portfolio interests that may be at the end of their term; risks can arise if a seller that is itself an investment fund is at the end of its term. In some circumstances, as determined by the relevant LPA, the law of the applicable jurisdiction, or a combination of both, the end of a fund's term can trigger dissolution. We have found that a partnership in this circumstance may no longer be "validly existing" under its local law, requiring a modification of the typical, but fundamental, representation in the purchase and sale agreement (PSA).

Fortunately, these considerations do not typically affect the capacity to enter into transfer agreements and dispose of the assets, so it is often a question of a quick clarification of the "due authorisation" representation to ensure there is no otherwise innocuous breach of the representation that could be the basis of a future claim. Similarly, transaction counsel need to keep this issue on their radar during the course of a long portfolio sale, especially where the transaction timing is being governed by publicly traded partnership rules. A representation that was correct at the time of the PSA's publication may not be in 12 months' time when the seller is required to repeat its prior representations as of a closing date.

Strength in Breadth

The market is mature – there are a range of buyers out there. Some operate at scale acquiring large portfolios, others are niche operators, picking up single interests at a time. There are then the specialists, acquiring in certain asset classes or industry sectors, and generalists, who acquire a broader range of LP stakes. This quadrant of different types of buyers enables sellers to find the right buyer for the right assets more readily – a real strength in the market that has helped to mitigate the impact of the post-COVID-19 dip in valuation confidence.

It is possible for sellers of larger portfolios, with help from their intermediary, to build up a book of suitable buyers for the interests being taken to market. Even better, the portfolio can be carved up into parcels that are positioned to certain categories of buyer to maximise outcomes in the auction process. These parcels can be distinguished by asset class, vintage, geography and fund size, among other considerations. Diversity leads to greater success and returns on the portfolio for the seller.

This article has outlined some of the areas of secondaries transactions that require or enable more creative thinking. Naturally, however, specific circumstances apply to each transaction, which ought to be taken into account by new sellers in this market. Our lawyers can of course help, and in the event you would like to discuss any of these matters further, please do not hesitate to reach out to us.

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