THE
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GP-LED SECONDARIES: DEALING WITH CONFLICTS OF INTEREST

Goodwin's Halford and O'Neill explore complexities of GP-led secondary transactions, and how to handle them

Michael Halford, head of private investment funds for Europe and Asia at Goodwin, and associate Brian O'Neill, explore the complexities of GP-led secondary transactions, and how to handle them.

Funds approaching the end of their agreed terms while still holding substantial assets have for some years been an issue for private equity fund managers and their investors. Some managers have tried to establish longer term funds to reflect the likely hold period of their assets. Many others, meanwhile, have been requesting extensions from their investors, or more frequently looking at a "GP-led secondary" to provide liquidity, or continue managing the assets, or both. Investors will usually agree to an extension of the fund if the management fee can be negotiated, but this may provide only another two or three years.

The popular model for private equity funds – the ten-year closed ended fund – hasn't been effective for assets requiring a longer holding period. At the end of the life of the fund, investors are faced with a choice to wind-up the fund and receive back assets (possibly via an in-specie distribution); hold a fire sale of the remaining assets; or approve an extension. Not surprisingly, when asked by the general partners to continue, they almost always elect to extend.

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Increasingly, general partners are looking to alternative solutions for these scenarios. There are a few different options, which all fall under the wide definition of GP-led secondary, or GP-led restructuring.

It is a growing market with the potential to get even bigger. In 2017, the overall value of the secondaries market was in the region of $50-$55bn, with GP-led secondaries accounting for about 25% of that. With approximately $500bn of NAV still held in pre-2008 funds, the transactions we have seen so far represent only a small portion of that value. It is safe to say there will be many more of these transactions. But what exactly are they?

Various structures

Broadly, the general partner seeks a buyer who is willing to invest in the assets, and this new investment can then be used to release some or all of the current investors. Typically, current investors are given the choice to either roll their investment over or exit entirely. Various structures have been developed, such as creating a new fund to transfer the assets into. The new buyer then invests in this fund and some investors "roll-over" into the new fund.

An alternative is what is known as the stapled secondary, which not only provides liquidity for current investors but can also assist the general partner in raising a new fund. A stapled secondary sees the new buyer purchase fund interests from current investors, while also making a commitment to the new fund of the same general partner.

The liquidity offered to the existing investors may then free up amounts for them to invest in the new fund as well. If the existing fund has assets which require a longer holding period, the general partner can negotiate a new term and economics with the new buyer, or possibly roll the assets over into the new fund.

All these solutions rely on a new investor committing a significant amount. So without attractive assets that can realise value over time, these types of restructurings are unlikely to succeed. So-called zombie funds, which may be holding low quality assets the general partner still receives fees for, will only be able to carry out such a restructuring if they can show the assets can be turned around, which could be possible with new capital that the existing fund approaching the end of its life did not have available.

Conflicts of interest

Of course, there are numerous issues that arise with these sorts of transactions and careful guidance around valuation and conflicts of interest will be required to ensure they can be dealt with.

When transferring assets from one vehicle to another, there is an inherent conflict of interest for the general partner. However, the fact there is a third party buyer, possibly one of many bidders, and the use of an external valuer, can mitigate these conflicts. As general partner of both funds in a stapled secondary, the fact that existing investors require consent to transfer their interest, and such consent may be conditional on their buyer making a commitment to the new fund, also presents an issue.

Conflict issues such as this can be addressed to some extent by the use of the advisory committees. As these transactions come under increased regulatory scrutiny, however, new generations of funds will need full and clear disclosures that such transactions are possible. Regulators are particularly concerned about the treatment of existing investors, and want the GP to give them genuine options (one of which could be to maintain the status quo) rather than a choice of two suboptimal outcomes where they are forced to choose one.

In addition, care will need to be taken as to whether underlying transaction documentation permits the transfer of assets. These therefore require professionals with a unique combination of transactional and fund-structuring experience to be successful. The success will not just be restricted to the fund level, either: they are positive developments for the underlying assets as it can result in a new pool of capital to help grow these companies.

While the precise details of these transactions vary dramatically, the principles apply across the board. In the future, we may well see more standardisation in what has long been thought of as a bespoke solution.

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