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PERSPECTIVE

Private fund secondaries: Your end, my beginning

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In the most traditional sense, private equity and venture capital funds make direct investments in companies. The fundamental goal in these investments is to realize return when the company is sold or goes public, an investment horizon that may take anywhere from five to 10 years on average to realize returns. But, secondary transactions give investors an expanded pipeline of opportunities by buying company stakes from a direct investor in a company or from another fund.

Historically, the market viewed secondary transactions as a sign of distress where sellers were pressured for liquidity and forced to sell assets at steep discounts. This is no longer the case and even some of the largest private equity buyout shops have formed funds and raised capital specifically to take advantage of secondary opportunities. In 2018, transaction volume crossed the $70 billion mark. In just the first half of 2019, transaction volume for secondaries was $55 billion. It is expected that the market for secondaries will continue to expand and grow as more buyers and sellers enter the landscape and the types of assets available for secondaries expands including such asset classes as real estate, natural resources and infrastructure.

Structure of Secondaries

The structure of secondary transactions may take many forms and many new and innovative solutions and transaction structures are emerging. A private fund may acquire an investment in a portfolio company directly from an investor that wants liquidity. In this structure, the direct investor transfers its interest, rights and obligations to the buyer and those interests, rights and obligations are directly in the company.

Another common type of structure is the acquisition of a fund interest that holds a particular portfolio company from an existing investor in a fund, thereby setting up a structure of indirect investment. In the case of a blind pool fund, the buyer is typically buying a portfolio of investments that includes several company investments made by the fund and the buyer steps into the shoes of the selling investor to assume its interest, rights and obligations in the fund, which often may include an unfunded capital commitment. In certain cases, a special purpose vehicle, or SPV, structure may allow this same type of indirect secondary from an investor but the underlying asset of the SPV is a single company rather than an entire portfolio.

While the above structures are initiated by investors, a general partner may also lead a secondary transaction. This could take the form of a GP-led tender offer, complete fund restructuring or a stapled secondary. When the transaction is GP-led, there is likely more things to consider including conflicts of interest, regulatory scrutiny and the role of limited partners in consenting to such transactions. In most cases, secondaries are still led by limited partners seeking liquidity. In 2018, such LP-led secondaries accounted for two-thirds of the transaction volume.

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Regardless of structure, there is often some type of process or procedure required by the portfolio company in the case of a direct secondary or by the general partner or advisor of the fund in the context of an indirect secondary. In addition to the sale and purchase agreement, the buyer and seller may be required to obtain consent from the company or general partner, as applicable, execute other transfer documentation such as an assignment agreement, provide a legal opinion (although these are often waived) and even offer a diligence period (although often the diligence is much more limited in scope than you would see in the context of an initial investment).

Reasons to Buy and Sell Secondaries

While there can be many factors that influence why someone participates in a secondary transaction, some of the predominant reasons include:

Faster Liquidity: In some cases, when a fund makes an investment in a portfolio company, depending on where that company is in their lifecycle, the fund may have to wait up to 10 years to exit the investment before producing a healthy return. In secondaries, the seller has already tolled a certain portion of this liquidity runway and a buyer is able to step in and capture upside on a much tighter timeframe often waiting just 2 to 5 years to realize. Obviously, for the seller, the same is true, they can cash out early by selling an asset at a meaningful price and avoid any downside risk from holding the investment longer.

Diligence Package: Since the seller already went through a significant process of diligence when the initial investment was made, buyers of secondary transactions may not require such an extended diligence period. Further, there is often much more information available either from the seller or in the market about the target company and a buyer may already be familiar with the company generally and comfortable with the risk profile. This often means that secondary transactions can get executed very quickly.

Portfolio Rebalancing: Especially for sophisticated institutional investors such as pension plans and sovereign wealth funds, the secondary market is often used as a portfolio rebalancing tool. Such investors often view secondary transactions as an alternative type of investment strategy, even to the point of dedicating specialized internal teams to handle secondary opportunities. Such investors may also view secondaries as a way to shift capital from one manager to another by being both a buyer and a seller in the secondary market.

Unique and Expanded Buyer Set: In addition to large specialist secondary funds, the potential buyer set has expanded to include family offices, endowments and pension funds because of the potential for near-term distributions with less overall risk. Often these types of buyers will pay higher prices than a secondary fund who may be more focused on discount and current net asset value of a target. This gives sellers more options and keeps pricing competitive.

Certainly, regardless of the reason, appetite for secondary transactions from buyers and sellers has increased over the last several years and this growth is only expected to continue.

Your End, My Beginning

While relative to the overall private equity and venture capital universe, secondary transactions still make up a relatively small portion of the overall market, that market is continuing to grow and expand with 2019 poised to be the largest year for secondaries yet. While the structure and execution of a secondary is relatively straightforward, it is likely that as these types of transactions mature both from a buyer and seller perspective but also from an asset class perspective, more complex transaction structures and innovative solutions will emerge that will fuel even more focus and attention on the secondary market.

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