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FUND FINANCE FRIDAY

Spotlight on GP-Led Secondary Transactions

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As assets mature in aging funds, both GPs and investors alike are seeking ways to unlock this liquidity. GP-led secondary transactions have become an increasingly popular way of achieving this, accounting for over a quarter of all secondary transactions in 2018, and fund financiers are following suit to provide debt finance for these types of transactions.

Types of GP-led transactions

The main attraction of GP-led secondary transactions is that investors are offered an exit option, while managers are able to maximize the value of their mature investments. The four most popular types of GP-led transactions are fund restructurings (also referred to as fund recapitalizations), direct secondaries, stapled secondaries and tender offers. The common theme among all of them is that a secondary buyer purchases the existing investments and a new vehicle is established to hold those assets. The participation of the existing manager in the ongoing management of the assets and the participation of the existing limited partners are the key differences between the various types of transactions.

The primary characteristic of **fund restructurings** is that all existing investors are offered an opportunity to either sell their existing position in the fund or an option to roll their positions into the newly formed vehicle. The GP typically remains in place to manage the underlying assets, with the added benefit of a longer investment period and added capital to assist them in maximizing value. This option provides incentives to both the limited partners and the GP while allowing them to pursue their independent investment strategies. This can give rise to potential conflict-of-interest issues for the GP, who is on both sides of the table and continues to owe a fiduciary duty to the existing limited partners.

Direct secondaries involve the sale of all of the assets in a portfolio to a buyer along with the responsibility to manage the portfolio, thereby excluding the GP from future management of those assets. This is of interest to GPs who are looking to focus their attention on other matters or investments.

Stapled secondaries are a hybrid of a fund restructuring and offer investors the opportunity to participate in the GP’s new fund, thereby combining a secondaries and primary offering.

Tender offers are the least complex of the GP-led secondary transaction types. These involve a buyer (who could be an existing investor or an affiliate of the GP) tendering for all or a portion of the existing limited-partner interests.

Pros and cons

The incentives to structure GP-led secondary transactions primarily are:

- creating liquidity for limited partners;
- providing options for limited partners (i.e., to continue with their exposure or not);
- allowing limited partners to restructure their portfolio;
- providing additional time and capital for the relevant assets which, in turn, can lead to better returns on those assets, resulting in potential additional value; and
- reincentivizing the GP and allowing it to raise fresh capital for follow-ons.

The downsides and potential pitfalls of these transactions include:

- unsettling limited partners who may feel they do not have sufficient time and/or resources to properly evaluate the transaction;
- in respect of the GP, a material conflict-of-interest risk which has already caught the attention of various regulators, including the SEC. As there is no standardized approach to these types of transactions, ILPA has helpfully announced that it will be issuing guidance on GP-led secondary transactions, including the conflict of interest risk. We understand that ILPA will be considering how limited partners can push for better market testing on pricing, including an intermediary in the transaction, "full and frank" disclosure from the GP and whether a fairness opinion on valuation and the prospective deal should be required. The common theme here is transparency on the part of the GP with respect to the limited partners, particularly in respect of the information that the GP has on the value of the existing portfolio to which no third party has access.

We fully expect the volume of these types of transactions to continue to grow, as well as the use of debt finance to support them. However, it will be fundamental that the issues we raise above be addressed while the market is still relatively niche.