EXPERT COMMENTARY: CAPOLINO-PERLINGIERI & LEONE

Giancarlo Capolino-Perlingieri and Dante Leone of law firm Capolino-Perlingieri & Leone look at a still-flourishing part of the private equity market.

Structuring successful secondaries

Unlike fundraising for large primary funds, the supremacy of financial engineering and purchases of minority stakes in listed financial firms, there is one trend in the global private equity landscape that is not likely to be quashed or even temporarily halted by the current turmoil in the financial markets: the steady growth of the secondary market.

In the last few years, the development of the secondary market had been at first predicted, and then observed as an expected upshot of the unprecedented increase in private equity fundraising.[1] But few had focussed on the equally predictable continuing resilience of the secondary market.[2]

Market drivers have changed, particularly as a result of the most recent liquidity crisis and the general slowdown in the fundraising of primary funds. These days, key engines of growth are the rebalancing of portfolio allocations by large institutions faced with a decline in their public equity holdings or a desire to pare down GP relationships, as well as the need to free up resources for new fund commitments.

Yet the trend continues to be that of a rapidly expanding marketplace in which interests in primary private equity funds are valued, priced and transferred. There also exists a less structured but equally thriving trade in portfolios of direct private equity investments, fueled by a more composite environment of factors, including the need to liquidate the tail end of older vintage funds and the progressive emancipation of managers from financial sponsors.

Giancarlo Capolino-Perlingieri

In the Italian secondary market, the most recent macroeconomic developments are consistent with global market trends. And, from our perspective as counsel, Italian secondary transactions raise structural concerns similar to those typical of the global markets.

Particular attention should always be paid – in the Italian as well as in the global market – when sales of both fund interests and portfolios of direct private equity investments take the shape of fundraising for stand-alone investment vehicles into which these interests or portfolios are reorganised.

LEGACY MANAGEMENT AND ALIGNMENT OF INTERESTS

The purpose of a secondary sale may be to generate liquidity for an institutional investor, while allowing its management team to continue to be remunerated and maintain a vested interest in the eventual outcome of the original investment.

Given this objective, pooling and segregating assets generally assists the process of balancing the conflicting interests of the investors taking a position in the new stand-alone vehicle (buying low with plenty of protections), the seller of the portfolio (selling high in a final sale with no downside risks), and the team of legacy managing professionals (retaining control of the investments, maximising their incentives and gaining more independence from the original fund sponsors).

Striking the correct balance in the search for an optimal alignment of interests never fails to add the most value for all parties involved.

For buying investors in particular, the alignment of interests is crucial when the seller acted in the original deal as a core investor (in the case of a secondary transaction for the sale of fund interests) or lead investor (in the case of a secondary transaction for the sale of direct investments). In these instances, the managers' interests may be easily aligned with those of the investors, to the extent that the new separate structure improves the calculation and tax-efficient payment of management fee and carried interest to the professionals tending to the portfolio.

Dante Leone

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Instead, the higher operational danger for the buyers in the new stand-alone vehicle may be compounded by risks that the seller may not be able to shed, including the risk that an unsuccessful outcome of the investment might affect the reputation of the seller in the market.

INVESTORS WITH DIFFERING APPETITES FOR THE UNDERLYING TARGETS

Pooling and segregating several primary fund interests or direct private equity investments together in a stand-alone vehicle may also attract groups of investors with different investment strategies and broaden the chances of a successful secondary fundraising, especially in the face of a difficult market.

In most instances, each investor may wish to acquire a *pro rata* participation in the whole portfolio, thus gaining equal exposure to all of the assets, so that the new investment vehicle will resemble a standard fully- or mostly-invested fund.

Conversely, there are scenarios, often promoted by sellers trying to maximise total pricing for the portfolio, in which investors may be interested in specific parts of the portfolio (by industry, sector, geography or stage or strategy of investment). In this instance, the stand-alone investment vehicle enables the achievement of varying degrees of exposure to individual assets, while maintaining a meaningful level of diversification and reaping the benefits of a unified management. This may be attained through the creation of different classes of fund interests or of tracking stock, by the adoption of waterfall models that take into account the provenance of the proceeds, or by the use of umbrella structures.

Similar arrangements may also be used, in stapled transactions, to allow the opting-in of investors on primary commitments, sometimes through the recycling of part or all of the proceeds of any dispositions.

Despite the benefits of this kind of structure, one key issue that must never be overlooked is the degree to which the value of each underlying asset is fully segregated, and whether there is complete downside protection throughout the portfolio.

A FUND BUT ALSO AN ACQUISITION

Whatever the purpose for the creation of a new stand-alone investment vehicle, it inevitably comes with an acquisition. In fact, this kind of fundraising in the secondary market involves agreeing on both an investment in a new pooled vehicle and the terms for the acquisition of the portfolio of directs or fund interests by the vehicle.

By their very nature, secondary sales are not accompanied by deep-level due diligence by new investors. This underlines the importance of the terms and conditions of the acquisition, especially in situations in which the seller had a core or lead role in the original investment, and may therefore be more amenable to granting broader representations and warranties to the new investors.

A further layer of complication is added when, as discussed above, the seller offers a liquidity-generating spin-off of a portfolio that continues to be managed by the same investment professionals originally acting for the seller. In the event any representations or warranties should fail to pass muster, the managers of the investment vehicle may be hesitant to direct the fund to act against the seller. Consequently, counsel is often asked to provide investors with specific enforcement tools, such as the right to direct recourse to the seller, or the right to compel the managers to act pursuant to the directions of the investors (most often under penalty of removal).

Notwithstanding any possible complications, in one fashion or another, secondary transactions will likely continue to dominate the private equity scene for the next few years. The key for all parties involved will be to improve the features that have the potential to add the most value to transactions, while staying true to the simple ingredients that have made secondaries such a success story. ■

1. The volume of global secondary market transactions grew from approximately $1.9 billion in 2002 to approximately $18 billion in 2007, with a compound annual growth rate of more than 53 percent. Source: Cogent Partners, September 2008.

2 Volume of secondary transactions in 2008 is expected to be at least $30 billion, with a further 67 percent growth from 2007. There also is an estimated $50 billion of capital currently devoted to the secondary market, including secondary funds, funds of funds and non-traditional buyers. Source: Cogent Partners / Private Equity Analyst / Venture Economics / Private Equity Intelligence, September 2008.