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Navigating conflicts of interest in the GP-led secondary market

BY ED FORD

Much of the private capital universe focuses on relatively long-term investments in illiquid assets. For investors who do not need short term, unplanned liquidity, which includes most institutional investors, the most efficient way to invest in such assets is through closed-ended pooled investment vehicles. As the private markets have grown, a huge number of assets across all asset classes, including venture capital, growth equity, private equity (PE), infrastructure, credit and real estate, are now held in this way, and – as European policymakers have acknowledged – that brings significant advantages for the real economy, as well as for institutional investors and their ultimate beneficiaries.

But investors need a degree of certainty around when their capital will be called and when they will receive liquidity, so conventional fund structuring relies on a fixed term within which fund managers can call a significant majority of capital from investors (referred to as the 'investment period' – for PE, this is typically five years from the start of the fund) and a fixed 'end date' for the fund, by which time investors should expect the fund to have exited investments and distributed them returns – for PE, this is typically 10 years from the start of the fund.

This model is widely used by the industry but can create some somewhat arbitrary effects; for example, later on in the life of the fund, the fund's assets may be undercapitalised, as the fund has deployed most of its capital during the 'investment period', and the fund manager may feel obliged to exit assets due to the time duration of the fund, rather than because exit conditions are optimal. Against this backdrop, the fund can effectively become a forced seller.

For most investments, that does not matter. The business model of PE assumes that significant changes can be made over the course of the expected holding period, and the asset made ready for sale within the fixed term of the fund. But when that is not the case, and an asset would benefit from more time and more capital, the secondary market allows a fund manager to offer a liquidity option – effectively the right for investors to receive cash within the existing fund term, or to retain exposure to the asset through a commonly-managed and longer-dated vehicle (a so-called 'continuation fund') that has greater access to follow-on capital.

When structured correctly, this can lead to a 'win' for all parties. Equally, it is, of course, critical to ensure that all investors are properly protected. There are robust and tried-and-tested processes, underpinned by Institutional Limited Partners

Association (ILPA)-driven investor-side guidance, which aim to ensure the conflicts are identified and transparently managed and, in particular, that there is an effective price discovery mechanism that ensures that any investors that want to exit the investments receive a fair price.

Fund managers also have contractual, fiduciary and regulatory responsibilities and are sharply attuned to the issue, while investors and regulators, including most recently, the US Securities and Exchange Commission (SEC), have been clear that these transactions will be closely watched. So how are these conflicts managed?

The first priority for a fund manager looking at a 'continuation fund' deal is to explain why it considers that to be the best option for investors. In many cases, a deal can fail at this first hurdle. But, often, the fund manager will be able to articulate why it has a compelling edge over the market. For example, the fund manager may know the asset and its sector better than anyone else, thus reducing buy-side risk, may have a well-established and productive relationship with a management team that wants to avoid the business disruption of an M&A deal, or have bolt-on acquisitions in the pipeline that will generate significant further upside but require additional equity financing. These factors should be price accretive – to the benefit of selling investors.

But having established that it may be able to pay more than other prospective buyers, the fund manager needs to demonstrate that it can structure and execute a transaction that works for all parties. In almost all instances, this will involve an intermediated auction involving the secondary market and, increasingly, this now involves consideration of third party PE sponsors and even trade buyers which may be interested in a minority sale (with the participation of the 'continuation fund' set with reference to the price established in this way). In most cases, the limited partner advisory committee (LPAC), a governance body set up within fund structures, will have to waive conflicts in respect of the deal and may insist on a third party fairness opinion.

Next, the fund manager should focus on future economics to build strong alignment of interest. Typically, cash received by the fund manager's team on the sale – carried interest and 'GP-commitment' – is reinvested. That helps to demonstrate to a secondary buyer that the fund manager believes in the upside, helping to drive up the price – again, for the benefit of selling investors.

It is also important that the terms of the 'continuation fund' are not price dilutive for the secondary buyer: typically, this means a low management fee and, perhaps, a higher hurdle, or a lower carried interest rate which ratchets up if there is outperformance. The standard '2 and 20' model is not generally in play here. The investors who choose to roll over or reinvest into the 'continuation fund', rather than acting as sellers, may take significant comfort from the fact that a highly sophisticated secondary fund is willing to commit alongside on similar, or sometimes worse, terms.

Getting ahead of the process is crucial. Since conflict waivers will be required from the LPAC, their early involvement is advisable, with regular updates as the deal progresses. LPs will also need enough time to properly consider the options, usually at least a month. Documentation should carefully, fully and fairly analyse and disclose all conflicts of interests and describe how they have been managed.

Single asset GP-led deals are not easy to do, and investors and regulators rightly expect an open and fair process. But, as long as some widely accepted principles are applied, there is no reason to inhibit deals from which everyone – including the underlying operating business itself – can do well. ■

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