

Be Prepared for Challenges and Opportunities!

Legal Aspects of Secondary Transactions

Secondary transactions have become an integral part of the market activities in Germany in past years. Over the last several months, due to the financial crisis, the secondary market has been the subject of even more attention. Investors are increasingly expected to seek the liquidation interests in private equity funds in an effort to clean their balance sheet, reallocate their assets and reduce their unfunded liabilities. From the perspective of both the seller and the buyer, secondary transactions have specific impacts which distinguish them from “traditional” exit channels.

Sellers' and Buyers' Motivations

Under the current market circumstances, the sale of private equity portfolios will – from a seller's perspective in particular – be motivated by the need for liquidity, the unsatisfactory performance of several funds or, with respect to corporate sellers, by the concentration on their core business activities. From a buyer's perspective, the motivation for participating in the secondary market will be driven by the specific sale situation in order to realize reasonable pricing; secondary market positions may usually be purchased at a certain discount. Furthermore, investments in secondary transactions are more mature than in primary transactions since secondary acquisitions invest in portfolio companies in which significant amounts have already been invested. This imminently reduces the risk of “blind” investments and creates more sustainability for the buyer. Finally, a secondary transaction offers a certain acceleration of financial returns, which gives more security to the purchaser.

Structural Challenges

There is neither an organized nor a formalized market for companies financed by private equity. Unlike a strategic investor, an institutional investor does not normally intend to use strategic synergy potential and will consequently not include such effects in the determination of its purchase price. A strategic investor, however, may use strategic synergies as well as market and value-enhancement potential and, as a result, such effects will

be (positively) reflected in the valuation of the target company and the purchase price accordingly. Therefore, secondary transactions rarely represent successful exits in IRR or multiple terms. Consequently, they are conducted with a greater level of secrecy than deals in other areas of the market. On the other hand, secondary investors may expect attractive investment opportunities, particularly in periods of market consolidation, reorganization or strategic reorientation. Specifically, financial institutions, pension funds and others affected by the current financial crisis might look to sell private equity interests or portfolios to a growing set of dedicated buyers, even below market value.

Legal Challenges

At first glance the acquisition of a company or a portfolio of companies by way of a secondary transaction seems to be similar to a primary transaction. Particularly from a legal point of view, it does not make any difference whether a shareholding is transferred by a strategic buyer or an institutional investor. However, compared to “ordinary” transactions, the auction process is of vital importance in secondary transactions. Because of the lack of a “real” market valuation indicated by a strategic buyer, the valuation of the interest or portfolio underlying the purchase price needs to be determined in the auction process. Considering this general framework, many advisors are prepared to conduct a vendor due diligence in order to standardize such process and to create a competitive environment between the bidding investors. If, for example, the pool of buyers is small and the seller is under pressure to dispose of its commitments, negotiations and due diligence will need to take place quickly. The time frame for the consummation of a secondary transaction is therefore normally very tight, which leads to a dynamic transaction process. Therefore, the detection of interesting, risk-adjusted and profitable investment opportunities requires purchasers who are detail-oriented. Competitive secondary managers and their advisors need fundamental experience in fund investments, as well as in private equity investments, in order to ensure successful secondary transactions.



There will, in particular, be little time for extensive due diligence related to the target portfolio. On the basis of such framework conditions, the specific determination of opportunities and risks related to the transaction may only succeed if a structurally coordinated team, which has the appropriate knowledge and resources to undertake such due diligence, is able to distil from the plurality of documentation such information which shall sufficiently and adequately serve to analyze the risks. It is often not enough to rely solely on the seller's valuation of an asset portfolio to price a secondary interest; their estimates can be biased, inaccurate or outdated. In particular, venture capital investments may be too immature to value and distressed assets may not have fully turned around yet. Therefore, due diligence needs to be focused on the essential transaction structure and facts related to purchase price. From a lawyer's perspective, particular emphasis should be placed on the existence of subsequent payments commitments, on the transferability of investors' privileges and the observation of pre-emptive and tag-along rights in the cases where a portfolio of companies is to be sold within a secondary transaction. As a result, the acquisition of a company portfolio is often connected with (partially significant) purchase price deductions as compared to regular trade sale transactions.

Particulars of a Sale of a Company Portfolio

In addition to the limited due diligence, the transaction structure for the purchase of an existing portfolio of companies is often a particular challenge for the parties involved. Ideally, the purchaser acquires a holding company in which the portfolio companies are concentrated in order to exclude the application of direct change-of-control clauses. If such concentration is, for example, not possible because the portfolio may not be transferred in due time into a special purpose vehicle, each single company participation has to be sold and transferred separately. Thus, the involved parties face a plurality of single transactions within "one" secondary transaction. As a result, for each single transaction the advisors have to observe merger control mechanisms

and potentially different jurisdictions. The same applies to pre-emptive and tag-along rights, as well as to gaining the required consent of third parties. The process of obtaining such consent from co-investors or minority shareholders may substantially slow down the closing process. To head off such problems and delays in advance, the closing procedure for each single transaction may be agreed upon in detail within a framework agreement. In such a framework agreement, mechanisms for the payment or adjustment of the purchase price, the allocation of dividend claims, transfer restrictions, rescission and information rights for the time between signing and closing, which will then be applicable to all subsequent single transactions, may be determined.

Conclusion

The credit crunch and lower performance of certain private equity funds may lead to an increase in secondary transactions in the next several months, given that the impact of the credit crunch could get even worse or because investors can no longer comply with their contractual fund commitments. As the secondary environment grows, it will also become more competitive. Therefore, the legal and business landscape is also likely to change. It is important for buyers, sellers and their advisors to be prepared for the challenges and opportunities that are likely to arise in the secondary market. ■

About the Author



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