

Secondary Direct Investments – Opportunities and Challenges

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Secondary transactions have become an integral part of the Private Equity market in Germany over the past few years. Since the financial crisis began, the secondary market has been subject to even more attention. Investors are increasingly expected to seek to unwind positions in private equity funds in an effort to rebalance their assets and reduce their unfunded liabilities. Strategic investors and private equity funds may be motivated to sell interests, portfolios or direct investments in order to achieve liquidity and maximize their internal rate of return, reallocate and retol their investment strategy or eliminate nonstrategic investments. From the perspective of both the seller and the buyer, secondary transactions have specific impacts which distinguish them from “traditional” exit channels. Secondary transactions can generally be split into two basic categories:

Sale of Limited Partnership Interests

The first category is the sale of limited partnership interests. Particularly in light of the current credit crunch, the transfer of a limited partnership interest would allow an investor to receive some liquidity for its funded investments, as well as a release from any remaining unfulfilled funding commitment to the limited partnership. Buyers hope in turn to benefit from what they think is an undervalued interest. Almost any type of private equity fund interest can be sold in the secondary market: this includes venture capital, mezzanine, buyout and real estate funds.

Sale of Direct Investments

The second category is the sale of direct investments. This category refers to the sale of single companies or of a portfolio of direct investments in operating companies. If a single company is sold by a private equity fund to another private equity fund, such a transaction is commonly known as a secondary buyout. If an entire portfolio of companies or company participations is sold, such a transaction is commonly known as a direct secondary or a secondary direct investment. Such company portfolios often originate from either corporate development programs or large financial institutions. There are numerous examples of corporate sales in Germany over the last years,

such as Infineon, Daimler and T-Venture selling parts of their venture capital activities to Cipio Partners. Another notable example of a secondary direct transaction was the acquisition of the German venture capital portfolio of 3i by HeidelbergCapital in 2008.

Seller's and Buyer's Motivations

In the current market, the sale of private equity portfolios will – from a seller's perspective in particular – be motivated by a need for liquidity, unsatisfactory performance of several funds or, with respect to corporate sellers, by the drive to focus on core business activities. From a buyer's perspective, the motivation for participating in the secondary market will be determined by the specific sale situation. 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 of Secondary Transactions

There is neither an organized nor a formalized market for private equity financed companies. Unlike a strategic investor, an institutional investor does not normally intend to exploit potential strategic synergies and will consequently not factor such effects into its purchase price determination. A strategic investor, by contrast, may well take advantage of 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 investments or portfolios to a growing set of dedicated buyers, even below market value.

Legal Challenges in the Transaction Process

At first glance, the acquisition of a company or a portfolio of companies by way of a secondary transaction appears to be similar to a primary transaction. Particularly from a legal point of view, it makes little 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 a process and 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 detailed capabilities of the purchaser. 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.

In particular, there will 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 can only succeed if a structurally coordinated team with the appropriate knowledge and resources to undertake such due diligence is able to filter out such information from the plurality of documentation 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; such 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 purchase price-related facts. From a lawyer's perspective, particular emphasis should be placed on the existence of subsequent payment commitments, on the transferability of investor's privileges and the observation of preemptive and tag-along rights where a portfolio of companies is to be sold within a secondary transaction. As a result, the acquisition of a company portfolio often entails purchase price deductions (sometimes significant) compared with regular trade sale transactions.

Particulars of a Company Portfolio Sale

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 not possible, for example 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 must observe merger control mechanisms and potentially different jurisdictions. The same applies to preemptive and tag-along rights, as well as to 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 deal with 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 may be determined which will be applicable to all subsequent single transactions.

Summary

The credit crunch and underperformance of certain private equity funds may lead to an

increase in secondary transactions in the coming months, given that the impact of the credit crunch could still worsen or because investors can no longer comply with their contractual fund commitments. In such transactions, sellers might be more inclined to accept discounts on current valuations as they face the prospect of further asset write-offs in their existing portfolios or as they need to achieve liquidity in a short time frame. As a result, an increasing number of managers and private equity investors will recognize the advantages of secondary transactions as situational. From the perspective of a seller, a secondary transaction allows the seller to rebalance their asset allocation and to meet liquidity needs and bottom line objectives, or at least to sell non-core assets or investments that no longer offer strategic value. From the perspective of a buyer, the secondary transaction allows the buyer to exit more rapidly than in a primary transaction, to improve return on capital, or to expand the buyer's focus on certain segments over time. As the secondary environment grows, so it will 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 will most likely arise in the secondary market.



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- Asset management and transfers for family offices, entrepreneurs, investment banks and investors (including financial products, trusts and foundations)
- Real estate (primarily project development)

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