Hogan Lovells

Secondary Portfolio Sales

A Guide to Pension Funds Selling Fund Interests

May 2021

Pension briefing

HIGHLIGHTS

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Secondaries offer pension funds an opportunity to assess and rebalance their portfolios (for example, if they are over-committed), to generate liquidity, and to manage their cash flow.

This article covers the key stages that pension funds will need to consider when they undertake an auction sale of fund interests, so they are in the best position to take advantage of the market re-opening and pricing improving.

WHAT IS A SECONDARY?

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WHAT HAPPENED IN 2020?

The secondaries market for the sale of fund interests is large, even after the impacts of COVID-19 are taken into account. However, many industry commentators have noted that the volume of secondaries in 2020 was down around one third from the volumes achieved in 2019. In addition out of the volume of secondaries that did take place in 2020, there was an increased proportion of "GP led" transactions (according to a recent report produced by Private Equity International, GP-led deals accounted for 44% of overall market share in 2020 – up from 30% in 2019) in which a general partner (a "**GP**") sells one or more portfolio companies to a new fund managed by the same GP with existing investors being able to cash out or rollover into the new fund. This means that the real reduction in secondary sales of fund interests in 2020 may have been even greater.

However, we are beginning to see an uptick in the volume of fund interest portfolio sales and it is likely that many investors, including pension funds, will look to manage their portfolio of fund interests over the remaining period of 2021 as the market recovers. Secondaries offer pension funds an opportunity to assess and rebalance their portfolios (for example, if they are over-committed), to generate liquidity, and to manage their cash flow.

This article covers the key stages that pension funds will need to consider when they undertake an auction sale of fund interests, so they are in the best position to take advantage of the market re-opening and pricing improving.

STEP 1: APPOINTMENT OF INTERMEDIARY

It is customary to appoint a specialist intermediary who will help with the selection of the fund interests being sold, the auction process and, after one or more preferred bidders are selected, the sale process itself. They will act as a broker between the pension fund and the buyer. They will also help facilitate the interaction with the GPs or managers of funds in which the seller has fund interests it wishes to sell. The intermediary will typically seek to be remunerated based off a percentage of the net asset value ("**NAV**") that the funds represent in the sale.

STEP 2: SELECTION AND PRICING OF FUND INTERESTS

It is important to clearly define the portfolio of fund interests being sold, and for the pension fund to set internally a floor price to be established for each fund interest, below which the pension fund will not sell. What may in the past have made a portfolio more attractive to a range of buyers was its diversity - particularly in its vintage, location and sector. However, sales processes since the pandemic have often been more concentrated, with more recent fund vintages being easier to sell than older funds with little or no undrawn commitments (ie, "tail end funds"). Bidders in auctions have also tended to focus their efforts more on funds that they already know rather than expend resources on undertaking due diligence on funds that they don't know. The underlying economic conditions affecting portfolio companies in certain sectors may also have had an effect on the fund interests in certain sectors (ie, it has been a better time to sell infra or debt funds than PE funds focused on consumer and retail). As the market recovers from the effects of COVID-19, there will be renewed interest in those sectors hardest hit by the pandemic (eg, retail, hospitality and travel).

Pricing on secondaries runs off the most recently available NAV reported by the GP of the relevant fund (such reports being issued by the GP quarterly) and the pricing for a fund interest in a fund could be at NAV, a discount to NAV, or a premium to NAV - with all cash or with a deferred element. Ultimately, the valuation will depend on a number of factors, including:

- the sector;
- the brand of the GP and the success of the funds in question;
- the geography;
- the funding ratio;
- the fund vintage;
- the amount of any leverage at portfolio level; and
- the general state of the economy.

STEP 3: CREATION OF DATA ROOM AND VENDOR DUE DILIGENCE

Our experience is that it is becoming more important to undertake some level of vendor due diligence so as to minimise the risk of any fund interests falling out of the transaction or any disruption to the sale process, and to ensure that any pre-transfer processes are fully understood and complied with. At an early stage in the process, it would be prudent to:

- collate the key documents for the fund interests being sold (eg, limited partnership agreements ("**LPAs**"), any side letters, subscription documents, and (if applicable) any AIV documents);
- populate an electronic data room with the key documents;
- instruct lawyers to prepare a limited scope sell-side due diligence review of the key documents for the fund interests being sold, in order to identify any material issues that may impact on the sale (eg, LPA transfer restrictions, confidentiality requirements, and any limited partner ("LP") giveback obligations);
- seek the consent of each relevant GP to key materials being made available to bidders;
- prepare a non-disclosure agreement ("**NDA**") that bidders will be asked to sign (and which is ideally in a form approved by the GP); and
- undertake an initial review for tax issues that the seller and buyer may encounter, in particular, whether there are any fund interests which may require the buyer to withhold amounts from the purchase price and whether such withholding can be mitigated (for example as a result of U.S. tax issues such as ECI and FIRPTA for non-U.S. sellers where certificates from the seller/GP may be required by the buyer – see below). Please see here for our client note on this topic.

Unless the GP is involved in the transaction (eg, tender offer intermediated by the GP), the buyer of the interests will not be able to amend the LPA terms. However, the buyer may negotiate a side letter with the GP to deal with some types of issues arising from the LPA as well as any special requirements for the buyer. The seller may wish to control any side letter process taking place prior to closing of the transaction, to prevent the buyer's own requirements creating a delay to closing.

STEP 4: LAUNCHING OF AUCTION PROCESS

This phase of the process is very much led by the intermediary. The data room will be opened up to potential buyers (who have each signed an NDA), who will undertake due diligence on the performance of the underlying investments in the fund and the key terms of the fund documents. A vendor due diligence report will help in this regard. The pension fund may wish to consider if it wishes to keep its identity confidential at this stage of the process.

The seller and intermediary will decide how they wish to balance a swift execution, maximising of price and minimising of legacy liabilities. This could involve dealing with one or more preferred buyers, who would be granted a limited exclusivity period. Alternatively, it could involve dealing with a large group of bidders, with none granted exclusivity or preferred bidder status until final form documents are agreed. The process could also involve multiple bidders for different parts of the overall portfolio, some of whom will be relying on leverage.

STEP 5: NEGOTIATION AND SIGNING OF THE PURCHASE AND SALE AGREEMENT ("PSA")

The PSA is the main transaction document pursuant to which the trustees of the pension fund (as the seller) agree to sell the fund interests to the buyer, and will almost always require a split exchange and completion to allow time to obtain consent/s from the GP/s and to implement any other actions required at fund level (eg, a right of first refusal process) or otherwise to effect the completion (see Step 6). In some auctions, the seller requires bidders to mark-up the draft PSA as part of the offer process - whilst this can increase the amount of legal input required, it can significantly improve the seller's legal position to negotiate the PSA while bidders are still in a competitive auction process.

The key terms of the PSA to be considered are:

- limitations on the trustees of the pension fund's liability under the PSA – ideally their liability would be limited to the value of fund interests at the point of sale;
- the purchase price mechanic, under which the purchase price for each fund interest being sold is adjusted for "calls" and "distributions". This means that (i) the amount of any distributions received by the trustees in respect of a fund interest in the period from the date that the NAV of the fund interest was determined up to closing under the PSA is deducted from the purchase price and (ii) the amount of any drawdowns paid by the trustees in respect of the fund interest for the same period is added to the purchase price;
- the parameters of "excluded obligations" (ie, obligations that will remain with the trustees after the sale, such as certain tax liabilities or any LP give back obligations);
- any currency issues;
- the conditions precedent to completion;

- protections during the period between exchange and completion;
- warranties and indemnities (extensive warranties are not common on portfolio sales);
- material adverse change clauses (although rare on portfolio sales);
- the split of GP costs and any transfer taxes; and
- risk allocation and practicalities in respect of any withholding tax, in particular, as the trustees are not U.S. based entities, will any certificates be required from either the trustees or the GP to mitigate the obligation on the buyer to withhold tax from the purchase price for tax reasons. Please see here for our client note on this topic.

Trustees of pension funds will want to manage their exposure to legacy liabilities after the sale of the fund interests has completed, through the time periods under which the buyer can make a claim under the PSA and through limitations on the quantum of claims that the buyer can make (see above). These and other limitations will be heavily negotiated in the sale process. Trustees need to determine at the outset of the sale process what legacy liabilities they are able to retain commercially and legally. If the trustees are required to provide limited indemnities to the buyer under the PSA, they will need to check their trust deed and rules to determine whether sponsoring employer consent is required to the granting of such indemnities.

On a portfolio sale, the PSA will need to provide a mechanism for a scenario where not all of the fund interests can be transferred (eg, because a fund interest is taken up during a right of first refusal process, or where a GP does not consent to the transfer). Some buyers may want all of the fund interests transferred or none at all (ie, one closing) which will be impractical on larger portfolio sales. More often, we see a construct where either (a) a certain number of fund interests, expressed as a percentage of the base purchase price, need to transfer at first closing, or (b) certain specified, key fund interests need to be transferred at first closing.

Some thought will be required in relation to the signing process for the PSA and any assignment and assumption agreement (or transfer agreement), to ensure that the risk of UK stamp duty applying to the sale of the fund interests is minimised. Please see here to read a client note.

STEP 6: COMPLETING THE TRANSFER PROCESS

The PSA does not transfer the fund interest. Completing the transfer process largely involves negotiating and settling the assignment and assumption agreement (or transfer agreement) for each fund interest that is being transferred. In nearly all cases, the form of agreement will be provided by the GP for the seller and the buyer to jointly mark-up prior to negotiation of any material points of difference. Some key issues to look out for are:

- warranties and indemnities to be given by the seller and buyer to the GP should ideally be given on a several (not joint) basis;
- ensuring that provisions on allocation of distributions and assumption of liabilities are either consistent with the PSA or are appropriately backed off in the PSA;
- ensuring that the transfer cannot be voided by the GP at a later date; and
- ensuring that as between the seller and the buyer the PSA terms prevail in the event of a conflict. This will be especially important where the GP refuses to accept any changes to the terms of the transfer agreement (eg, costs – the transfer agreement may provide that the seller covers all of the GP's costs, but the PSA may have a different arrangement).

An assignment and assumption agreement will commonly also contain the representations usually found in a fund subscription agreement. If not, the buyer may need to enter into a separate subscription agreement .

At the conclusion of this process, the transfer by the seller of title to the relevant fund interest(s) needs to be carefully coordinated with receipt of payment from the buyer. Time zone issues can often make this process more complicated and fraught than it ought to be.

HOGAN LOVELLS SECONDARIES TEAM

The above is a starting point for any pension funds considering any secondary sales process. Each process will have its own dynamics and drivers. If you are considering a sale process of fund interests and have any questions relating to the issues raised in this article please contact one of the Hogan Lovells Secondaries team.

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