Secondaries and Its Interests Surge

As volatility hits valuations the trinity of risk, liquidity and capital deployment is driving mid-life fund activity.

Whilst secondary M&A transactions have been commonplace within private equity for some time with many firms specialising in such deals, secondary fund transactions involving the buying or selling of interests in an investment fund has only recently become more popular.

These transactions can be LP, investor or GP-led, or involve preferred equity financing, and their popularity has increased in recent times following:

- The negative impact on valuations from rising macroeconomic and equity market volatility has caused asset managers to reconsider asset allocation and risk management strategies, as a result of the requirement to hold and manage more liquid investments in a continually changing liquidity and collateral requirements environment.
- Investment managers are increasingly seeking to diversify risk, with fund level investments being exited, and the capital proceeds being redeployed towards real assets, private debt, ESG, digital and financial technology.
- Newly launched funds have begun to deploy capital in an increasingly aggressive manner relative to previous and other more mature funds, generating higher NAVs in the short term as a result. This presents an opportunity to existing LPs to liquidate and benefit from the positive returns, and for prospective LPs to enter and generate returns through acquiring portfolios at an earlier stage in a fund's life.

Transactional Risks Insurers have adapted to provide solutions for the associated risks

As with any transaction, there is always a requirement to manage risk and the marked increase in secondary fund activity has led to LP's seeking ways to mitigate risks arising from active investments, as they have traditionally done with exited investments.

Potential exposures from active investments at their point of exit could be clawback provisions and excluded obligations and the Transactional Risks Insurance market is always looking to help investment firms and their advisors remove potential exposures in various transaction scenarios.

"*The development of a Transactional Risks Insurance product to cover excluded obligations will only serve to benefit secondary transactions at a time when many institutional investors are re-assessing asset allocation strategies.*"

Nikhil Shah, Associate Director, Transactional Risks, UIB

Transactional Risks Insurance Underwriters, such as CFC, have addressed these particular exposures through developing a specific secondary offering which has the capacity to underwrite the full suite of risks arising from secondaries.

Secondary insurance policies provide coverage for both current and exited investments, with exited investments covered in the same manner as exposures are through a Fund Liquidation Insurance policy entered into at the end of a funds life which covers identified or known issues surrounding the liquidation of an investment fund.

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Current investments benefit from the recent development by CFC of a novel approach with respect to secondary transactions which provides cover for the warranties and indemnities set out in the underlying transaction agreement as well as excluded obligations ("EO") which seeks to insulate the insured from liabilities of the original fund, including those arising by operation of clawback provisions. The warranties and indemnities are underwritten in a more streamlined manner thana typical M&A transaction, whilst underwriting of the clawback provisions is performed by way of assessment during the underwriting process based on the performance of the portfolio and distributions and carry to date.to insulate the insured from liabilities of the original fund, including those arising by operation of clawback provisions. The warranties and indemnities are underwritten in a more streamlined manner thana typical M&A transaction, whilst underwriting of the clawback provisions is performed by way of assessment during the underwriting process based on the performance of the portfolio and distributions and carry to date.

"*We pioneered our LP-to-LP and End of Fund insurance solutions to extend our secondaries offering beyond the typical GP-led deals and to provide cover for all players in the secondaries market. A key feature of our LP-to-LP solution is that we offer EO and synthetic EO cover which results in a significant coverage enhancement for a small AP and minimal additional underwriting*".

Angus Marshall, Head of Transactional Liability, CFC

Benefits of Tax Insurance

- Insurance can cater to a variety of issues for both active investment and past divestments, providing financial protection post exit for the period that liabilities may still exist.
- Each Secondaries policy is tailored to transfer the identified or unidentified liabilities on past divestments and risks pertaining to excluded obligations and clawback provisions on active investments to the insurer, ring-fencing the various issues, allowing the facilitation of the transfer of the LP's interest to take place on a risk-free basis.
- Allows the exiting LP to liquidate and crystalise its proceeds without holding monies back, in escrow, on the Group balance sheet or be subject to any other excluded obligations or clawback provisions.
- They are multiyear policies in line with any indemnity arrangements with the liquidator or the exposures being covered; typically, up to 7 years.
- Premiums are typically in excess of 5% and are calculated based on the exposures, portfolio, and jurisdiction(s).

Case Study

Scenario:
An institutional investor made the decision to exit its investment in one GP led fund to diversify its investment strategy and allocate a greater proportion of capital towards its private credit operations considering the greater certainty and currently available in this space.

Risk:
The fund which the investor was exiting was early in its lifecycle and as such had not divested of its interest in some high performing and profitable investments. This resulted in the risk of the clawback provisions in the sale and purchase agreement crystalising in the future dependent on how the investments performed during the period between the investors exit and when they were disposed of.

Policy:
An insurance policy was issued with the exiting institutional investor as the insured, for a limit of $50m. The policy covered not only the standard warranties and indemnities in the agreement, but the underwriters were also able to cover the clawback provisions by getting comfortable with the risk during the underwriting process. This positive result allowed the exiting investor the ability to reinvest the proceeds received by removing the need for a holdback or escrow style arrangement.

If you would like to discuss any of the points mentioned in this article or any other matters related to Transactional Risks, do not hesitate to contact one of our specialists at UIB.

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