GP-Led Secondaries in India – Considerations and Challenges

Key Takeaways

- GP-led secondaries have become fairly popular globally given that they solve for the liquidity concerns among some LPs whilst allowing the GP to capture more upside from an investment.
- In a GP- led secondary deal, it is important to find a pricing that works for the exiting investors but keeps the acquisition attractive for the incoming investors.
- Owing to the bespoke nature of a GP-led deal – where the seller as well as the buyer are controlled and managed by the same entity – LPs of both funds will want to be satisfied that the GP has acted fairly and in their respective best interests.
- Cat I and Cat II AIFs are generally not permitted to invest more than 25% of investible funds in a single investee company. This could make AIFs unworkable for GP-led secondaries if the continuation fund cannot house the assets proposed to be rolled over.
- The tax and regulatory frameworks applicable to AIFs do not currently provide for a tax-neutral rollover of assets. As a result, 'continuing' investors may suffer some tax leakage.

Introduction

The secondaries market constitutes an important facet of the global alternative investments ecosystem. At its core, the secondaries market seeks to address two fundamental issues: (i) providing liquidity to investors (limited partners); and (ii) avoiding premature disposal of promising assets. The existence of a robust secondaries market has had a ripple effect on fundraising since sponsors are able to raise funds with longer lifespans. Over the last couple of years, some of the leading secondaries firms such as Ardian and Coller Capital have raised multi-billion-dollar funds.

In this piece, we introduce the two primary categories of secondaries transactions in the private funds world – LP-led secondaries and GP-led secondaries – and closely examine some of the considerations and challenges involved with GP-led secondaries in India.

Types of Secondaries

Secondaries are of two kinds – LP-led secondaries (where an investor seeks to transfer / withdraw its interest in the fund); and GP-led secondaries (where a GP seeks to transfer / roll over some of the fund's assets into a new vehicle with a view to capturing additional upside).

LP-led Secondaries

Fund documents generally stipulate that an investor will not be permitted to transfer or withdraw its interests in the fund without the prior written consent of the general partner (or the manager). This is to ensure that the fund remains 'privately placed' where interests of the fund are not held by persons or institutions that the GP / manager had no intention of offering interests to. Thus, while an LP is free to identify a potential buyer, the transfer can only proceed with the consent of the GP. The transfer documentation will usually involve the transferee agreeing to adhere itself to the terms and conditions of the fund (as set out in a limited partnership agreement, shareholders agreement, indenture of trust or contribution agreement) and making a host of representations and warranties along the lines of those that the transferor was required to make at the time of subscribing to the interests of the fund.

GP-led Secondaries

In a GP-led secondary, it is the GP (or the manager) that initiates and drives the transaction. Whilst there are several ways of structuring a GP-led secondary, such transactions usually involve the transfer of one or more assets in the fund to a new vehicle (a continuation fund) that is managed and/or controlled by the same GP. The sale of assets from the fund to the new vehicle is funded through the capital raised from the investors of the new

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vehicle (which may include new investors as well as existing investors who have 'rolled' into the new vehicle). The proceeds arising from the transfer of assets to the new vehicle are applied towards outstanding expenses and liabilities and then distributed to investors in accordance with the distribution waterfall.

Key Drivers of GP-led Secondaries

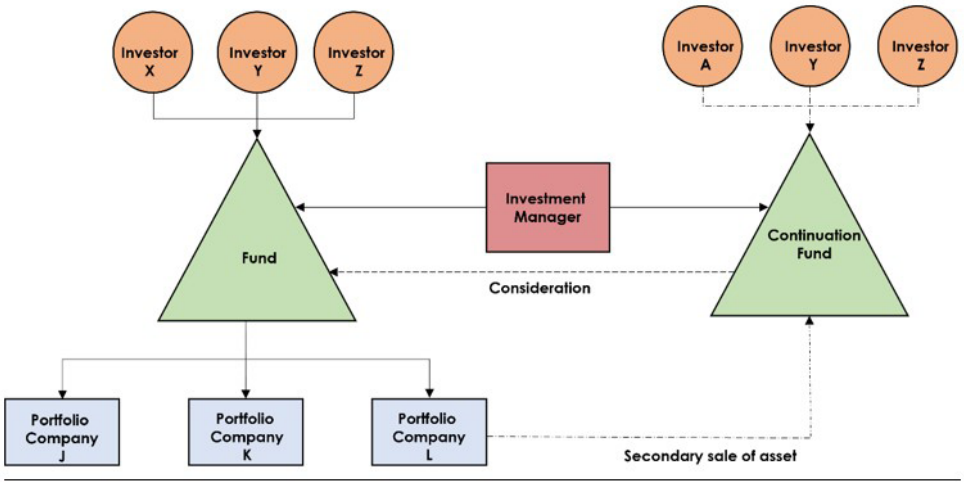
A summary of some of the key drivers behind GP-led secondaries transactions is set out below:

A. Potential for higher upside: As mentioned above, a GP-led secondary generally occurs where the GP takes the view that the remaining life of the fund is inadequate to maximise the value of one or more of its assets. In such circumstances, the GP is inclined to move these assets to a vehicle where it is relatively free from the pressure of having to dispose of the assets at a steep discount.

B. Investor relations: While some existing investors in the fund may share the GP's view on the upside potential of the assets being transferred and may wish to 'roll' their interests into the new vehicle, other investors may be pressed for liquidity. A secondaries deal allows the GP to extract more upside whilst ensuring that distributions are made to investors that want to 'check out'. This is particularly important in the context of future fundraises.

C. Asset familiarity: The assets that are the subject of a GP-led secondary are assets that the GP has managed for a number of years and is thus well acquainted with. It is precisely because of this that the GP is willing to take a view on the future upside potential of these assets. This instills a lot of confidence among potential investors in the continuation fund and makes them more likely to invest with the GP.

Illustration of a GP-led Secondary Deal



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Top considerations for GP-led Secondaries

A GP-led secondary is a unique transaction and presents a unique set of considerations for the various stakeholders involved in the process. Some of these considerations are discussed below:

1. Management of Conflicts: The single most important consideration in a GP-led secondary deal is conflict management. This is owing to the unique structure of a GP-led deal where the seller as well as the buyer are controlled and managed by the same entity – the GP (albeit on behalf of different sets of investors). Conflict may rear its head in various forms. The most obvious is to find a pricing that works for the exiting investors but keeps the acquisition attractive for the incoming investors. Both sets of investors will want to be satisfied that the GP has fulfilled its fiduciary duties (as the investment manager), acted fairly and in their respective best interests. To minimize such conflict, GPs should build in adequate justifications for rolling over the assets and the valuation for the sale price of the assets.

   Another prominent conflict that a GP may encounter is the question of allocation. Often, a GP will have multiple funds that are active and the assets that the GP seeks to transfer to a continuation fund may well fall within the investment strategies of such funds. In such circumstances, the GP must be careful not to trip its allocation policies and guidelines.

2. Ensuring alignment of interests: Given the bespoke nature of a GP-led secondary, the buy-side investors (i.e. the incoming investors) will expect to receive some demonstration from the GP with respect to alignment of interest. This will usually take the form of a larger-than-normal sponsor commitment to indicate the GP's confidence in the upside potential of the assets that are rolled over.

3. Re-setting economics: Besides a larger-than-normal sponsor commitment, buy-side LPs will expect favourable terms on fee and carry. This is often a source of tension during negotiations. Whereas the GP tends to view the GP-led deal as providing a fresh slate, LPs are conscious that most of the effort involved in managing the assets has already been discharged and therefore the GP should not look to profit at the cost of the LP. Similarly, carried interest calculations may involve multiple tiers and hurdles.

4. Due Diligence: Owing to a host of reasons, buy-side investors are generally not in a position to undertake a holistic diligence on the assets being rolled over. In practice, legal diligence will only cover matters such as title, taxation, capitalisation and financials. The diligence gap is at least partially bridged through the size of the sponsor commitment.

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5. Minimum Sell Requirements: Buy-side investors will generally expect comfort that a sufficient chunk of the asset will be made available to them so that they are able to properly participate in the upside potential of the asset. This will mean that a portion of the existing investors in the fund will not be able to roll over to the new vehicle. This in turn casts an emphasis on the GP to be fully transparent with its investors and thorough with its internal housekeeping and management.

Challenges for GP-led Secondaries in India

India is perhaps one of the few major jurisdictions which has a tightly regulated private funds regime. Whilst a detailed exposition of the regulatory framework is outside the scope of the piece, it is worth reviewing some features that may impede the growth of the GP-led secondaries market in India.

1. Diversity Requirement: Under the Securities and Exchange Board of India (Alternative Investment Funds) Regulations, 2012 (the "AIF Regulations"), Category I and II AIFs (which comprise all venture capital funds, private equity funds, debt funds and other funds with a primarily illiquid asset strategy) are not permitted to invest more than 25% of investible funds in a single investee company. This could make AIFs unworkable for GP-led secondaries where very few assets (often only one 'trophy' asset) is rolled over to a continuation fund. Although, the regulator introduced a new 'large value funds for accredited investors' regime last year under which up to 50% of investible funds can be invested in a single investee company, the entry point for investors in such funds is a minimum capital commitment of ₹70 crores, which again is not very helpful given that such an entry barrier could preclude several existing investors from rolling over their interests.

2. Vehicle Registration Timelines: Under the AIF Regulations, an AIF must be granted specific authorization to operate as such. This requires an application to be submitted to the securities regulator, SEBI, along with accompanying documents including a placement memorandum. The regulator will then scrutinize the documentation and may invite the management team to answer questions and offer clarifications, following which a certificate of registration may be granted to the applicant. This process can take anything between 2 – 4 months, which may prove to be a fairly long time period in the context of GP-led deals, which are transactions that need to close fairly rapidly to ensure that investor interest does not dissipate.

3. Tax Leakages for Rolling Investors: Under the AIF Regulations, units of an AIF may only be issued against cash. It may not possible for an investor to swap (i.e. exchange) its pro rata share of an underlying asset for units of the new vehicle (i.e. the continuation fund). In any event, Indian tax law does not permit a taxpayer to transfer its basis in units of an AIF. As a result, existing investors that wish to roll over to a continuation fund may suffer some tax leakage (representing their pro rata share of capital gains

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tax on the assets that are transferred) and will thus have a proportionately lower amount of proceeds to reinvest into the continuation fund.

Conclusion

The securities regulator and the tax authorities in India must be alert to global innovations, developments and practices that may have a positive spillover on the growth of alternative investment funds and the deepening of capital pools in India. Some of these developments (such as GP-led secondaries) have instilled confidence in investors since they are at least somewhat secure in the knowledge that their investments in the fund will not be sold on the cheap simply to facilitate distributions prior to the end of the life of the fund. AIF investors sadly do not have the same comfort.

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Adhitya focuses on the structuring and negotiation of private funds, managed accounts and other investment platforms, representation of LPs in bespoke transactions and advising sponsors on governance and fiduciary issues. He has acted for sponsors in India, the U.K. and the E.U. and is conversant with the various economic and governance issues that are hotly contested during the fundraising process and is familiar with a range of asset classes. He has experience dealing with secondaries transactions and has regularly advised on co-investment deals.

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