

# Rise of secondary transactions?

**Dr Michael Inhester and Christian Tönies of P+P Pöllath + Partners argue that secondary transactions should no longer be seen as a makeshift solution**

Private equity and venture capital funds have a limited life cycle, and the partners who run them generally have their eyes on the exit from the moment of their initial investment. For such funds, the preferred path to liquidity – the exit option – has been to take an initial public offering or a trade sale. In this regard, secondary transactions provide an alternative path to liquidity for private equity and venture capital fund investments in portfolio companies. A secondary transaction differs in one essential aspect from a traditional transaction: the nature of the buyer. The buyer within a secondary transaction is another financial investor (for example, a private equity fund) and not a strategic investor. If a single company is sold to another private equity firm, 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. Secondary transactions have become an integral part of the market activities in Germany. In the past three years, there have been numerous examples in which secondary transactions have been an alternative exit channel for private equity investors. From the perspective of a seller or buyer, and from the management point of view, secondary transactions have a specific impact that distinguishes them from traditional exit channels.

## Structural issues

### *An alternative exit channel*

Secondary transactions have in the past often been associated with disadvantages when compared with a regular trade sale to a strategic buyer or an initial public offering. In particular, there is neither an organised nor a formalised market for private equity-financed companies. Consequently, the common understanding is that such disadvantages have a negative impact on the valuation of the respective target company. Unlike a strategic investor, an institutional investor does not normally intend to use a strategic synergy potential, and will consequently not include such effects in its purchase price determination. A strategic investor, however, may use strategic synergies as well as market and value-enhancement potential. As a result, such effects will be (positively) reflected in the

valuation of the target company and the purchase price. 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, the secondary investors may expect attractive investment opportunities, particularly in periods of consolidation, reorganisation or strategic reorientation. Specifically, examples of such opportunities are if funds have reached the end of their life or if a company decides to focus on its core business by selling its portfolio.

### *Challenges*

On the one hand, the acquisition of a company or a portfolio of companies by way of a secondary transaction seems similar to a primary transaction. In particular from a legal point of view, it does not make any difference whether a strategic buyer or institutional investor transfers the shareholding. 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 target company underlying the purchase price needs to be determined in the auction process. Considering this general framework, many M&A advisers are prepared to conduct a vendor due diligence in order to standardise the 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 timeframe for the consummation of a secondary transaction is therefore normally very tight, which leads to a dynamic transaction progress.

In particular, there will be little time for extensive due diligence related to the target, or a number of targets in case of a sale of a

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 the information from the documentation, and can sufficiently and adequately analyse the risks. It is often not enough to rely solely on sellers' 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 focus on the essential transaction structure and purchase price-related facts. From a lawyer's perspective, a special emphasis should be placed on the existence of subsequent payments commitments, on the transferability of investor's privileges (for example, liquidation preference) and the observation of pre-emptive and tag-along rights if a plurality of participations 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 in contrast with regular trade sale transactions.

### *Company portfolio*

Besides the limited due diligence, the transaction structure for the purchase of an existing portfolio of companies or company participations is often a particular challenge for the parties involved. Ideally the purchaser acquires a holding company in which the portfolio participations are bundled in order to exclude the application of direct change of control clauses. If such a concentration within a holding company is not possible – for example, because the company portfolio may not be transferred in due time for tax or other reasons, into a special purpose vehicle before closing – each single company participation must be legally sold and transferred separately. Thus the involved parties are facing a plurality of single transactions within one secondary transaction. As a result, for each individual transaction the advisers have to observe merger control mechanisms and potentially different jurisdictions. The same applies to pre-emptive and tag-along rights, and to required consents of third parties. The process of obtaining the consent of co-investors or minority shareholders may substantially slow down the closing process. To face such problems and delays in advance, the closing procedure for

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## Author biographies



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each single transaction may be agreed on in detail within an umbrella agreement. In an umbrella 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 apply to all subsequent single transactions.

## Role of management

### *The management team*

A management team that has already participated in a buyout process will have a positive influence in a secondary buyout for each side, buyer and seller. The management is already accustomed to the exit-oriented thinking and focus of an institutional investor from a different line of business. In particular, it is possible to accelerate the due diligence process and increase its efficiency, as the management may use its experience from the primary buyout to focus on essential issues that are of particular interest for an institutional investor. Furthermore, in practice, contract negotiations are often facilitated because the management is familiar with the structure of the respective purchase agreements and can understand the complex English documentation.

### *Buyout structure*

In contrast with a usual buyout structure, within a secondary buyout the institutional investor will not directly but will indirectly invest in the target company through an investment vehicle. The investment is made in this context by interposing a corporate enterprise (limited liability company or stock corporation) that is collectively held by the institutional investor and the management team. The management team's stake in the investment will range from between 10% and 15%. The management stake is either acquired by a purchase from the institutional investor or by subscription of new shares after consummation of a capital increase. The purchase or the subscription price for the shares acquired by the management generally corresponds to the price the institutional investor is required to invest. As the managers are often not in a financial position to pay the whole purchase price immediately on closing of the management participation, certain legally admissible mechanisms of deferred payments may be agreed on. However, in general, the managements' purchase price becomes due and payable simultaneously upon transfer of the shares to the management. If a deferred payment is not possible under applicable corporate law, financial resources may be provided by financial institutions or by the institutional investor itself. If the

acquisition vehicle is financed with shareholder loans by the institutional investor, the management may also be required to participate in such loans according to their share ratio in the acquisition vehicle.

### *Representations and warranties*

As a consequence of the fact that the institutional seller will only accept a limited catalogue of representations and warranties, the buyer has its own vital interest in conducting the due diligence together with the management team. To motivate the management team to disclose facts relevant to the determination of the purchase price, the management participation programmes often contain guarantee provisions in favour of the buyer reflecting the accuracy and correctness of the due diligence results and the provided business plan. In addition, the buyer might require the issuance of a catch-all guarantee by the management which shall ensure that no manager has knowledge of any material adverse effect on the business as projected in the business plan of the target company. However, the liability amount for the management team is generally limited to the reinvested amount of the management within the management participation programme or the purchase price for shares in the acquisition vehicle of the buyer.

### *Conflicts of interest*

In a secondary buyout, the management is frequently forced to simultaneously act as seller and buyer. On the one hand, the management might (as a result of the primary buyout) already be a shareholder of the target company. On the other hand, the acquiring institutional investor might have an interest in ensuring that the management reinvests in the new acquisition holding, in particular with respect to the disclosure of risks lying within the business model of the company. Such a constellation contains an inherent conflict of interest for the management. As sellers, the managers are interested in achieving the highest possible price for their shares. As buyers in the course of a re-investment after the secondary buyout, they are interested in paying the lowest possible purchase price. However, from a legal perspective the management will be obliged to preferentially observe the interests of the seller.

### *Reinvestment obligation*

It has become common practice that buying institutional investors oblige the management to reinvest within the secondary buyout parts of the funds which the managers have usually generated from the primary buyout. A considerably high reinvestment rate is of major importance for the buying institutional investor. Firstly, the reinvestment will be decisive in whether the management acts as seller or buyer during the buyout. Secondly, a reinvestment is a reliable sign that the management believes in the development of

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the company. Furthermore, the motivation and efforts of each single manager will increase proportionately to the decrease of his cash flow and resulting financial satisfaction from the primary buyout.

### *Tax impacts*

To align the management's interests with those of the institutional buyer, a management equity participation programme is usually set up. Such programmes aim at structures according to which the managers shall participate in the growth of value in the company in a tax-efficient way. In this regard, the intention of straight equity participation schemes is to keep the managers' capital gains tax-free or at least on a tax-reduced basis. Under the current tax regime, capital gains taxation may be avoided if the manager holds his share as a private asset, provided the shareholding does not reach 1% of the total stated share capital over the past five years and is held by that manager for at least 12 months. If these conditions are not met, the manager will be subject to the so-called half income taxation (*Halbeinkünfteverfahren*), which means that only half of the capital gain income will be taxable at the individual tax rate of the manager. According to the tax reform, which shall be applicable on shares acquired on or after January 1 2009, income derived from capital investments will be subject to a flat tax, irrespective of the holding period as well as the size of the interest in the shareholdings of the company. Under the current legislation, there are two critical points to bear in mind regarding the issuance of shares to the management. If the management acquires shares at a discounted rate, this benefit will immediately be subject to tax in full upon existence of the shares. The other risk relates to vesting schedules. If such schemes lead to the assumption by the tax authorities that the manager has not become beneficial owner of the respective shares, full taxation is threatened with respect to value increases.

Until recently, secondary buyouts were neglected or considered a makeshift solution for an alternative exit by managers and investors, due to their assumed disadvantages compared with a strategic sale or an initial public offering. The assumption that strategic synergies could not be realised in a secondary offering and were therefore not reflected in the purchase price, was a reason why secondary transactions were regarded as an unfavourable exit channel. But the

developments in the last years indicate that the secondary market is no longer solely the refuge of the distressed. In fact, the secondary market has markedly evolved and is no longer the last consideration. As a result, an increasing number of managers and private equity investors predominantly recognise the advantages of secondary buyouts as situational. A secondary transaction allows the seller to rebalance its 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. It allows the buyer to exit more rapidly than in a primary transaction, to improve return on capital and to complement its existing portfolio and to increase its focus on certain segments over time. The secondary transaction also enables the managers to contribute their experience from the primary buyout to the negotiation and due diligence process, and increase their market value through a successfully accomplished exit.