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"DECODING" THE SECONDARIES MARKET

PART III: ANNEX FUNDS AS AN ALTERNATIVE LIQUIDITY SOLUTION

JULY 2020

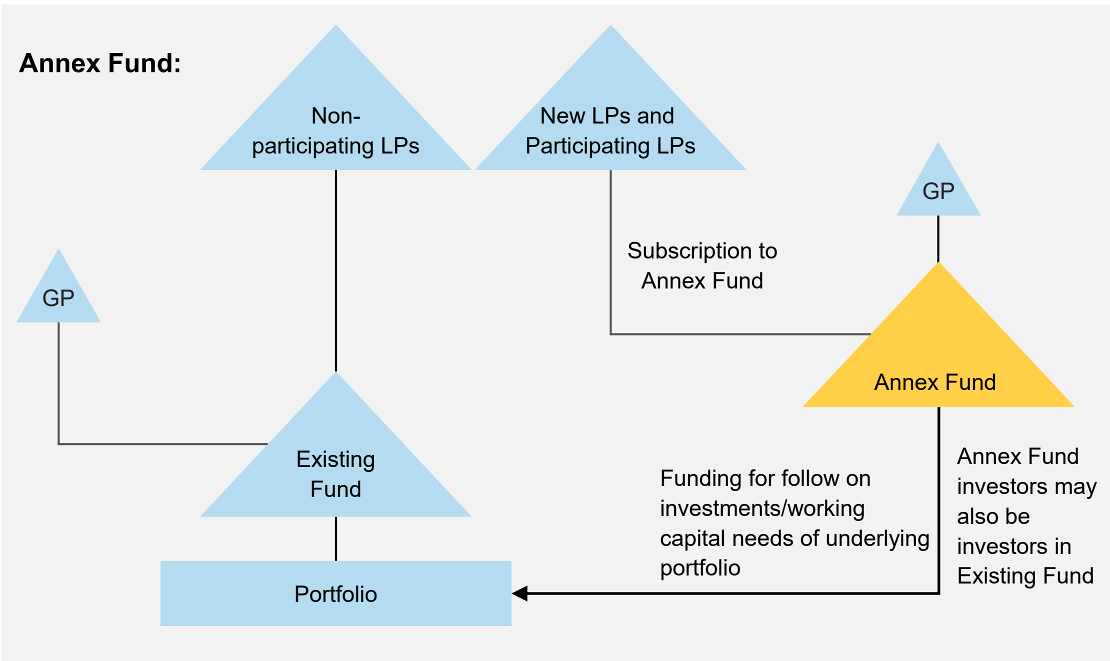
‘DECODING’:
ANNEX FUNDS

The need for additional sources of capital is a topic repeatedly raised by GPs in light of the COVID-19 crisis. Tools are available for GPs to meet their liquidity needs where all available commitments have been drawn, and/or where traditional fund borrowing is not possible. The growth of the secondaries market over the last decade has encouraged a diversity of structure and deal types that can now be employed during times of market dislocation.

As Part III of Clifford Chance’s series on ‘Decoding’ The Secondaries Market, we explore some of the key features of annex funds, as solutions to GP liquidity needs.

What are Annex Funds?

Newly established fund vehicles, additional to the existing fund structure, where investors are often, but not exclusively, investors in the existing fund. The annex fund will invest into existing portfolio companies with near-term capital needs.



Co-Investment:

A variation can involve the GP offering co-investment to one or more key investors who would act as “co-investor(s)” in place of the Annex Fund.

Typical Structuring Steps:

1

GP offers annex fund opportunity to existing or new investors (subject to any co-investment, allocation, successor fund or other restrictions in the fund documents).

Often, annex fund opportunities are offered firstly to existing investors on a pro-rata basis, then to those investors who took up the initial offer, with any remaining capacity offered to new third-party investors.

Alternatively, GPs may choose to involve a small number of key investors who can move quickly.

2

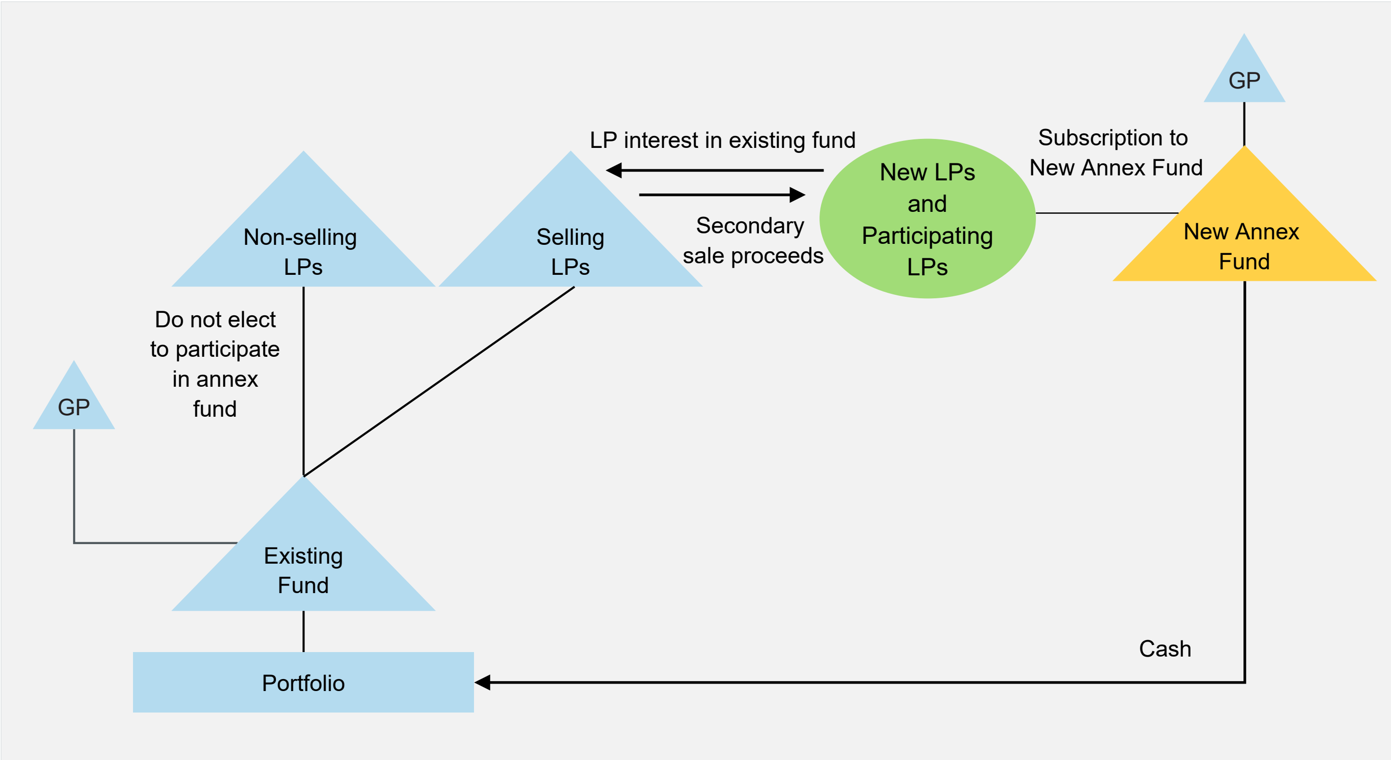
Capital drawn from the Annex Fund to make new investments into one or more existing companies with near-term capital needs.

3

Valuation of existing portfolio will often be supported by an independent valuation report. Investments will usually be made with no preference, however there is scope to rank ahead of the fund.

ALTERNATIVE STRUCTURE
GP-LED SECONDARY WITH NEW ANNEX FUND

GPs can use an annex fund in combination with a GP-led secondary transaction to create optionality and offer early liquidity for existing investors.



Structuring Steps:

1

GP or financial advisor solicits bids from new investors.

2

Existing investors have optionality to:

a) remain invested in the fund without participating in the annex fund;

b) remain invested in the fund and participate in the annex fund; or

c) sell their interest to existing and participating investors, or new investors, who typically provide a stapled commitment to the annex fund.

3

The additional capital raised by the new annex fund provides new capital to support existing investments.

4

"Stapled" commitments into the new annex fund are increasingly considered to be the norm and regarded by secondary purchasers as a legitimate tool to provide liquidity.

KEY DRIVERS
ANNEX FUND STRUCTURES

For GPs:

- provides additional unfunded capital – GP has increased flexibility to maximise value of underlying portfolio companies
- GP may earn economics (management fees and carried interest) on the additional capital managed, but not guaranteed
- can offer existing LPs option to participate

For LPs:

- liquidity at the fund level without sell down of fund position
- LPs invited to participate (as annex fund investor)
- GP-led secondaries arrangement favourable for LPs seeking liquidity or looking to de-risk from certain sectors/geographies and deploy capital elsewhere
- ability for secondary buyers to diligence single assets in GP-led transactions provides greater comfort on valuation

COMPARISON WITH OTHER LIQUIDITY SOLUTIONS

	STRUCTURE		
	Annex Funds	**Preferred-Equity**	**Senior Debt Financing**
DRIVERS			
Potential for new GP economics on capital raise	Yes	No (but can reset carry)	No
Additional capital has preference	No (but deal-dependent)	Yes	Yes
Exposure to future upside in the portfolio	Yes	Yes	No
Optional liquidity for LPs	Yes (with GP-led secondary)	Yes (with GP-led secondary)	No
Generates follow on capital	Yes	Yes	Yes
Ability to execute in short time-frame	Potentially (less in a GP-led secondary)	Yes	Yes
Flexibility – does not require covenants, security or fixed term	Yes	Yes	No

OTHER CONSIDERATIONS
ANNEX FUND STRUCTURES

Best Interests

- The proposed transaction must be in the best interests of the existing fund and its investors. GPs should ensure that all alternatives have been properly explored and dismissed before such a transaction is pursued.

Allocation and Priority

- Fund documentation should be closely reviewed to determine whether LPA restrictions (such as priority co-investment rights afforded to some LPs) apply to these types of transactions. Care should be taken to identify potential subtleties in the drafting and to ensure relevant provisions have not been drafted more broadly (e.g. do related-party or successor fund provisions apply?)

GP Economics

- The GP may earn carried interest and management fees on the additional capital managed, but not guaranteed. Ability to do so may be more pronounced in deal-specific co-investments, where waterfalls are usually not crossed.

- In the GP-led secondaries structure, management fees are typically 1-1.5% of invested capital, based on the value of the transaction, and may be slightly higher with respect to any “stapled” position of the commitment to the new vehicle.

Valuations

- Determining the valuation at which the new fund invests may cause significant conflict in annex fund transactions. Valuations are likely to cause increased tensions particularly in light of the current crisis where different approaches to valuations are being adopted across different firms. It is important to consider whether any level of investor/LPAC review is mandated by the fund documentation.

Conflicts

- GPs have a fiduciary duty to existing investors to seek the highest value for assets, however if a new annex fund is established, either the same GP or another group entity is likely to have a fiduciary duty to the investors in the annex fund to achieve the best price. In the context of GP-led transactions, conflicts are inherent in the transaction and GP’s should ensure extensive disclosure of the transaction (including the business rational for the further investments in the portfolio companies by the annex fund), the roll-over rights, pricing, conflicts and the annex fund terms to existing investors.

Tax Considerations

- Tax considerations will include the ongoing tax efficient repatriation of cash to existing LPs and the new annex fund: is everyone aligned, or, for example, would the annex fund participate at a different level within the holding structure for reasons such as existing bank security?

- Fund-level exit options can give rise to transfer and withholding taxes - US taxes, in particular, are an issue in most transactions regardless of the identity or tax profile of the selling or new LPs.

- Participating LPs will often hope for a form of tax "rollover" if their on-going participation is to be structured through a new vehicle.

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