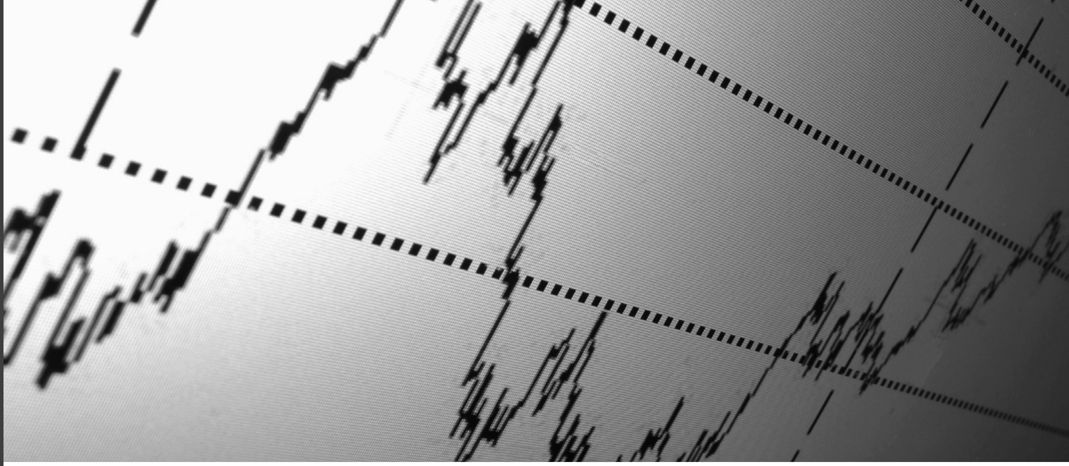
Financial Insights

Is Investing in **Secondaries Right for You?**



FOR YEARS, SECONDARY FUNDS WERE THE POOR, FORGOTTEN cousin of alternative investment funds. The secondaries market had limited activity, mainly from limited partners (LP) trying to exit their investments in old closed-end funds. Transactions in the secondary market were typically at deep discounts.

The secondaries market today is very different. Institutional investors are pouring money into these funds. General partner (GP) restructurings, in addition to LPs trying to make an early exit from their commitments, have spurred growth in the secondaries market. Preqin reports that transactions in the secondary market have grown since 2013 at a compound annual growth rate of 40%, reaching an estimated $75 billion last year. The aggregate target size of 43 private equity secondary funds was $72 billion as of July 2019, with an average fund size of $757 million for funds that closed in 2018.

With the current strong fundraising market, compounded by the rise of GP-led transactions, LP deal flow, and more nontraditional buyers entering the fray than ever before, the future for secondary funds is looking bright.

What Makes Secondaries So Attractive?

FOR EXISTING CLOSED-END FUND INVESTORS, selling their LP interest and remaining commitments in the secondary market is an opportunity to get liquidity. This is especially important given the long time horizons of the closed-end funds.

For investors seeking secondary deals, the advantages are numerous:

- Investments can be bought at a discount on the book value from an existing investor in a fund, which could result in a gain on investment as of the purchase date.
- Secondary investors can gain access to funds that are closed to new investors by buying existing LP interests in these funds from exiting LPs.
- These funds offer vintage year diversification and access to top quartile funds that have high subscription minimums.
- Since investors are buying at a later stage of the existing fund's lifecycle, they can see how the existing portfolio has historically performed and price their investment accordingly. Buying a stake in an investment fund that is closer to an exit and further along the J curve gives the investor a higher internal rate of return (IRR). In some instances, a new secondary investor is able to start receiving distributions from the fund right away.

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Challenges

OF COURSE, THERE ARE A FEW CHALLENGES as well when it comes to investing in secondaries:

- For investors that focus only on secondaries, the supply of good deals is currently limited, but that's likely to change in the not-so-distant future.
- Given the scarcity of good deals, valuations are high and discounts are thin. The market five to ten years ago was very different than it is today, as more investors are flocking to the secondary market in pursuit of good deals.
- Although the IRR is sometimes higher for secondary investors, the multiple of invested capital tends to be lower since the investments are purchased further along a fund's lifecycle, hence the time horizon is shorter.

Operational Considerations

WHEN BUYING LP INTERESTS in a secondary transaction, these are some points to ponder:

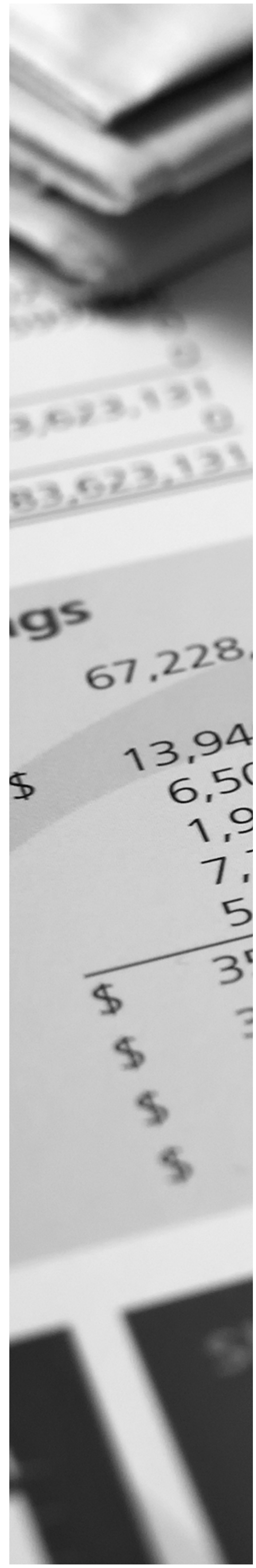
- Focus on quality of investments remaining in the portfolio.
- Consider using consultants to determine the value of the LP interest or the value of the underlying portfolio.
- Reach out to your network to get feedback on the GP as well as the underlying assets of the fund you are targeting.
- Ensure that the target investee fund provides audited financials on a fair value GAAP basis prepared by a reputable audit firm. Ideally, those financials should be available by April 30.
- Understand the rationale for any GP-led restructurings that gave rise to the secondary transaction opportunity. Is the restructuring intended to provide liquidity to existing LPs in the fund, or are there other hidden agendas?

Tax Considerations

Types of Income

If you are investing through a fund structure, review the private placement memorandum to understand and assess the type of income it may generate. If the investment involves unrelated business taxable income (UBTI) or uses leverage as part of its investment strategy (which can give rise to unrelated debt finance income, which is taxed as UBTI), consider the impact to your tax-exempt investors. Is the prospective investment fund's strategy to invest in U.S. operating businesses, which can give rise to effectively connected income (ECI)? Is that a sensitivity for your non–U.S. investors? Understanding the nature of the underlying investments and the expected type of income expected to be allocated to your fund is important for evaluating its impact on your fund's LPs, possible structures, or alternative investment vehicles that may need to be set up as investment considerations.

It's also important to gather an understanding of the expected character of income that is to be allocated from the prospective investment for your U.S. taxable investors. Will the investment generate interest income taxed at ordinary rates, or, will there be ordinary trade or business income in which there may also be an associated 20% 199A deduction from the 2017 Tax Cut and Jobs Act? Will the income consist of qualified dividends and capital gains taxed at preferential rates, or will it be rental and royalty income with its own set of reporting requirements and limitations?



Foreign Reporting Requirements

As part of the tax due-diligence process, request information on any foreign reporting requirements. Sometimes this may be discussed in the offering materials, or disclosed in a prior-year Schedule K-1. Is the prospective investment a foreign partnership? Does it have holdings in foreign corporations that could be considered passive foreign investment companies, which require separate tax elections and disclosures? There may also be reporting requirements for direct or indirect contributions or ownership in foreign corporations that your LPs may need to report on their own returns. These should all be considered, as there are stiff penalties imposed when certain foreign reporting requirements are not met. They can also considerably increase compliance costs for you and your LPs.

Electing Investment Partnerships

When acquiring a partnership interest in the secondary market, ask the exiting LP whether the prospective investment is an “electing investment partnership,” or EIP, under IRC 743(e). If so, a transferor notice should be requested from the exiting LP (transferor). This notice must contain certain information, including the amount of loss recognized, if any, by the transferor on the transfer of interest. If the prospective investment has elected to be an EIP, and a transferor notice is not received from the transferor, gross capital losses allocated from the investment may be disallowed. Rules related to IRC 743(e) and EIPs are complex, but you and your investors should be aware that the tax impact could be meaningful if gross capital losses are disallowed.

Other Tax Considerations

- When will the Schedule K-1 from the prospective investment be received? How will that timing affect your own fund’s timeline for delivering Schedule K-1s to investors?
- Are there state tax considerations to address? If the prospective investment has multiple state operations and generates state-sourced income, you should ask about composite filings, state withholdings and whether state withholding exemption certificates will be provided.
- Can you obtain a copy of the prior year Schedule K-1? This schedule will provide key insights into many of the potential tax issues, such as UBTI/ECI disclosures, character of income generated, and insights into possible foreign reporting requirements.

> **Secondary funds** can provide excellent opportunitites for investors seeking **bargains, diversification, high IRR** and **access to closed funds**. However, investors should first carefully examine potential operational and tax considerations.

While investing in secondaries is an attractive option for many investors, it’s important to make sure you address these operational and tax considerations first to avoid investor relations issues.

If you have questions on investing in secondary funds, including the operational and tax considerations, contact Weaver to request a consultation.

CONTACT US

Sindhu Rajesh, CPA, CFE
Partner
Audit Investment Funds
sindhu.rajesh@weaver.com
310.382.5386

Blayne Lowary
Partner
Tax Services - Investment Funds
blayne.lowary@weaver.com
817.882.7506

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