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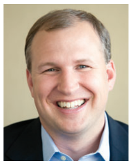

# Secondary Perspectives On Maintaining Confidentiality In A Secondary Transfer Process

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Consider the following scenario: A large institutional investor has decided to sell a portfolio of 15 private equity limited partnership interests. Since the plan sponsor wants to see where bids come in before notifying the underlying general partners, it distributes comprehensive due diligence materials to 30 potential bidders, including the funds' financial statements, limited partnership agreements, annual meeting presentations, and portfolio company details, including cash burn, revenue and profitability. The 30 bidders are explicitly instructed not to contact the general partner directly. The bids come back within an acceptable range, so the plan sponsor approves a short list of potential buyers to contact the general partners for confirmatory due diligence and to seek their consent to a transfer. A few of the GPs withhold their consent. Situations like this have sensitized sellers and intermediaries to better protect confidential information and collaborate in advance with GPs to find both an appropriate sales process and a short list of acceptable buyers.

Confidentiality is an important distinguishing characteristic of the PE market relative to the public equity market. It affords general partners and portfolio company management teams the opportunity to operate businesses without the fear of sensitive information reaching competitors, customers or the public domain. The expansion of the secondary market, the increased number of first-time sellers, and improvements in the digital exchange of information have increased the volume of confidential information provided in the transfer process from sellers of private equity holdings to a growing number of potential buyers. As a result, there is greater risk that confidential information can be compromised in secondary sales. The occurrence of many secondary transactions much like the anecdote above has sensitized sellers, intermediaries and GPs to act more prudently in the treatment of confidential information, while still allowing for orderly and economically appealing secondary transfers.

GPs typically distribute or present confidential information about their funds' portfolio holdings to their limited partners on a quarterly basis. This confidential information can include detailed reviews of fund performance, partnership financial statements, and portfolio company business initiatives, financials and liquidity prospects. The perspective that this information provides LPs is critical as they monitor the progress of their portfolios. Many LPs reference reporting transparency as a key metric upon which they evaluate new fund investments. In the context of secondary transactions, access to this information is the foundation for any meaningful initial pricing analyses by buyers.

In today's competitive investment environment, the unintended distribution of confidential information could be particularly damaging to PE funds and their portfolio companies. For example, the disclosure of a portfolio company's cash balance or future financing requirements could provide competitors with information that may impact a company's ability to add new customers or reduce a seller's negotiating leverage in an investment exit. Recent attention to state open records laws (often referred to generally as FOIA) has heightened GPs' sensitivity to the protection of this confidential information. Requests for information pursuant to FOIA have required some LPs who are public entities to disclose confidential information that GPs never intended to be disclosed in the public domain.

## GP Response To Greater Confidentiality Needs

GPs have recently begun to use several means to protect the confidential information regarding their funds and portfolio companies that is disseminated to their LPs. Limited partnership agreements, or LPAs, are the governing documents for the protection of confidential information between GPs and LPs (or sellers in the case of a secondary). The recent evolution of confidentiality terms in

LPAs has been significant. Historically, LPAs regulated the protection of confidential information loosely. LPAs drafted prior to the late 1990s often contained very few or no confidentiality provisions. Private equity was a smaller industry where there was a mutual understanding between LPs and GPs that no confidential information would be shared outside of the limited partnership. More recently, with maturity of the PE market and FOIA concerns increasingly pronounced, GPs have inserted more stringent confidentiality terms in their LPAs.

Malcolm Nicholls, a corporate partner with the law firm Proskauer Rose LLP, describes the greater protections that GPs are taking. “It is quite common for LPAs to provide very strict confidentiality provisions, which often require the express written consent of the general partner prior to disclosure of any fund information by a limited partner to a third party,” he says. “In addition, it is not uncommon for the general partner to have the unilateral right to restrict the information flow to one or more limited partners if the general partner believes that this is in the best interest of the fund.”

While GPs do not have a fiduciary duty to maximize the value of secondary sales for their LPs, many do attempt to facilitate the transfer in a value-maximizing way for their departing LPs. However, with the large increase in secondary market activity, GPs are taking additional steps to manage how their fund’s confidential information is being disseminated. In several of the transactions in which Adams Street Partners has participated recently, GPs have proactively limited the sale processes of their interests to a group of pre-qualified buyers who are either existing LPs or firms that they would be interested in strategically adding as new LPs. By limiting the parties with which they share sensitive information to a select, trusted few, they can be more confident that a secondary sale process will not impact the balance of their LPs. Although GPs are directing sales and limiting the number of potential bidders, we do not believe they are compromising the ability of sellers to maximize price.

## Intermediary Response

GP involvement in the protection of confidential information appears to have influenced the business practices of intermediaries in a meaningful way. The marketing processes for secondary PE sales can include more than 40 potential buyers, many with varying profiles, sizes and primary lines of business. To ensure a smooth GP consent process and preserve desired confidentiality, intermediaries are increasingly informing the GP of interests being sold at the outset of the sales process. Their goal is to pre-qualify the prospective bidder group.

Intermediaries have found ways to satisfy GPs’ understandable requests to limit distribution of sensitive portfolio information to existing LPs and trusted industry participants while maintaining competitive processes that are value-maximizing for their seller clients. For example, to allow for complete portfolio sale solutions, Adams Street Partners has seen intermediaries shape mosaic bids that divide the funds in a large portfolio into multiple transactions with multiple buyers, best matching assets with buyers. The result has often been a short list of highly engaged and pre-qualified buyers competing for certain interests within a larger portfolio. In these cases, only those potential buyers that a GP has explicitly pre-approved receive confidential information. While this technique requires more work on the part of the intermediary, it does allow more bidders to participate in the broad process while still preserving the confidentiality and limited distribution of sensitive information.

Intermediaries have also attempted to protect confidential information by executing non-disclosure agreements, or NDAs, with potential secondary buyers prior to sharing sensitive information about the partnership interests for sale. The more experienced intermediaries will first negotiate the NDA language with GPs and seek approval for pre-qualified groups of potential buyers. However, a technique that some sellers or intermediaries use to attempt to avoid the liability of disseminating confidential information is to have GPs agree to a blanket NDA, which includes representation that the intermediary will only show the confidential information to a “select” list of buyers, undisclosed. In response to this request, many GPs ask to approve specific lists of buyers and the exact materials that they plan to distribute.

## Impact On Buyers

The universe of potential buyers for secondary transactions is at an historic high. These buyers have varying levels of experience, reputations and objectives. GPs are able to place potential buyers of a secondary transaction on a spectrum of trust, and to prioritize and pre-qualify only those parties at the highest end of the spectrum. In today's environment of increased confidentiality and GP influence, Adams Street Partners has found that the buyer who has existing relationships with GPs or who has shown it is discreet in the use of confidential information has a strong competitive advantage in the marketplace. By providing options to sellers and GPs where incremental information transfer can be minimized, the trusted/discreet buyer is likely to become even more attractive in the coming years.

Another aspect of confidentiality in secondary transfers is the buyer's ability to protect against public disclosure of the transaction. Recent sellers in the secondary market are pension plans and endowments that need to be careful how they are viewed by general partners since they are not completely exiting the asset class. In fact, many sellers are motivated to sell so that they can free up capital for new private equity investments. As a result, the importance of discretion in a secondary sale has actually increased. In these situations, the potential buyer who is an existing limited partner, and/or highly trusted, will provide sellers with disposal solutions that have much less transaction risk, without having to increase the universe of industry participants who are aware of the sales process.

## Impact On Sellers

We believe that protecting a funds' confidential information does not restrict the maximization of value of secondary transactions for sellers. To the contrary, calling shorter lists of pre-qualified buyers is likely to improve potential outcomes and make transaction processes simpler for sellers. In broad auctions with many participants who possess varying access to information, a potential buyer may not want to allocate resources to the transaction due to a lower probability of being selected as the winning bidder. These auction dynamics may dissuade the most suitable buyer from putting its best bid forward or participating at all. Additionally, pre-qualified buyers typically have an information advantage relative to the marketplace. As a result, when bidding amongst each other, pre-qualified buyers know they need to price transactions more aggressively since all bidding parties share similarly strong information access, and they will not apply price discounts to account for information risk. As a result, limited auction processes are likely to actually maximize the economic outcome of secondary transactions for sellers.

The proper treatment of confidential information in secondary sale processes also provides sellers the ability to protect their relationships with the GP community. Particularly with the many sellers who intend to remain in the PE asset class following transfers, communication with GPs at the outset of a sales process can build goodwill or help alleviate strain that may have been caused by the transfers in the first place.

## Future Expectations

Currently, secondary market sellers are adapting well to increasingly stringent confidentiality terms in LPAs by communicating with GPs early in the transfer process and limiting the flow of confidential information to pre-qualified buyers. The result has been an attractive market where trusted/discreet buyers can efficiently deploy capital, and sellers can maximize the value of their assets. Robust secondary activity over the last few years has fueled record fund-raising in the secondary market. As the market expands, industry participants will continue to be faced with growing concerns about how to preserve confidentiality while still allowing for full value realization in the transfer. By maintaining the discipline exhibited in the current environment, secondary market participants can expect GPs to continue to be supportive of secondary transfers, and for attractive transfers to take place for buyers, sellers and GPs.


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