

By: Guest writer  
PUBLISHED: 14 January, 2020

## COMMENTARY

# The case for fairness opinions in GP-led secondaries

The best way to determine if net asset values reflect reality is to perform a fundamental valuation of each of the individual assets in GP-led process, writes Duff & Phelps's [David Lee](#)

GP-led secondaries restructurings continue to gain momentum as a solution for assets not yet ready (or suitable) for M&A or IPOs. And the liquidity provided by GP-led secondaries should be welcomed by LPs, provided the transactions are priced correctly. Yet, the tendency to anchor the pricing of a GP-led secondary recap on GP-determined net asset value can lead to confusion, and even disbelief, when the bids start coming in. We believe it is prudent for LPACs, LPs and fund counsel to recognise the limitations of using NAV as a basis for pricing in GP-led secondary recaps.

The first pitfall is that NAV may not fully reflect current value. NAV might be stale. GP-led secondary recaps are complex transactions with long completion times, which can extend six months or even longer from initial pricing. Value might have changed materially over the reference date NAV. In addition, GPs taking into consideration the performance of the fund in aggregate may be reluctant to fully mark-up outperforming assets, and at the same time may be hesitant to adequately mark down underperforming assets. The resulting NAV – primarily used for financial reporting purposes – could deviate materially from intrinsic value.

Another snag comes with how a buyer uses NAV. Consider a group of portfolio companies



Lee: Independent valuations and fairness opinions are “risk-mitigating tools”

in a GP-led recap with geographic concentration in an emerging market, one that is experiencing political and social turmoil. In this situation, a secondary fund buyer might be expected to value the overall portfolio at a discount to NAV. Other than the question of whether NAV is right, how big should the discount be?

The portfolio companies might be quality assets operating in industries with limited exposure to the current local events. In situations like this, our impression is that secondary fund buyers sometimes “bid” a discount to NAV based on certain attributes of the underlying assets

(geography, industry), the vintage of the fund and the brand name and historical performance of the GP. In this way, the investment decision-making process is sometimes more akin to fund-of-funds investing – ie, picking the best managers and not explicitly ascribing value to the specific assets within the portfolio.

## ILPA recommends independent analysis and fairness opinions

In our view, the surest way to determine if NAV reflects reality – and if the secondary fund buyer is applying an overly punitive discount to NAV – is to perform a fundamental valuation of each of the individual assets in the GP-led recap. In fact, the Institutional Limited Partners Association's April 2019 guidance on GP-led restructurings recommended that selling LPs may benefit from an independent assessment of the value of the underlying portfolio, together with a formal fairness opinion, even in transactions where the GP engaged a financial advisor to solicit bids for the assets.

A credible fairness opinion is based on a fundamental valuation using traditional methodologies, including a discounted cashflow analysis, public company market multiples and precedent transaction multiples – leading to highly informative advice that provides the LPAC and the LPs of the existing fund with a truly independent

view of current “fair value”.

Independent valuations and fairness opinions are also risk-mitigating tools for the GP. Since the GP is on both sides of the transaction in a GP-led secondary recap, the GP essentially gets a “second bite at the apple”. A sceptic would point out that this creates an incentive for the GP to agree to sub-optimal asset pricing. In Duff & Phelps’ experience, GPs consider our analyses and fairness opinions to be evidence that they ran the right process and treated all involved fairly; in other words, that they discharged their duties to LPs with due care.

Notwithstanding clear conflicts of interest

and the potential hazards of NAV-anchored pricing, GP-led secondary recaps have become an important liquidity alternative to regular-way sales or IPOs of portfolio company assets. We believe that independent valuations and fairness opinions play an important supporting role in these deals. A fairness opinion and the underlying analysis clarifies the economics by de-tethering the deal price from NAV, it provides valuable information to the LPAC and the LPs and it supports the GP’s rationale for orchestrating the transaction and accepting the price.

While it has become customary for GPs to obtain fairness opinions on GP-led secondary

recaps in the US, based on anecdotal evidence provided by our clients, we estimate that fairness opinions are obtained in approximately 50 percent of GP-led deals in Europe. However, similar to other corporate governance practices that are initially introduced in the US, this percentage is growing quickly, and we believe it will likely converge with the prevalent rate in the US. ■

---

David Lee is a senior member of Duff & Phelps’ Transaction Opinions practice in New York and part of the firm’s Global Corporate Finance practice. He regularly advises clients on GP-led secondary recaps, and executes fairness and solvency opinions and valuations for mergers and acquisitions, private placements and recapitalisation transactions.