DUFF & PHELPS

Protect, Restore and Maximize Value

Secondary Market Advisory Newsletter

July 2018

INSIDE

IN THIS ISSUE

In the first edition of the Duff & Phelps Secondary Market Advisory Newsletter we cover the following topics:

1. Impact of U.S. tax reform on the secondary market

2. Best practices for navigating fund restructurings

3. Calendar of upcoming Duff & Phelps events

4. Secondary market demand interest summary

We look forward to discussing the contents of our inaugural newsletter with you and to receiving your feedback.

Market Commentary

Potential Impact of New U.S. Tax Regulation on Secondary Market Transactions

By: Richard Olson (Managing Director, Duff & Phelps Secondary Market Advisory), with contributions from Duff & Phelps Transaction Advisory Services.

As many of you may already be experiencing, the ability to transact secondary deals in the U.S. has become much more complicated since the U.S. tax code overhaul. Much ink has been spilled over the impact of reduced corporate taxes in the U.S. or the relatively minor changes to carried interest tax breaks, but there are secondary market impacts as well.

A quick review: non-U.S. investors that invest in both non-U.S. and domestic U.S. partnerships that then invest in pass-through businesses operating from permanent U.S. locations face a tax on the income and gains from those businesses (so-called "effectively connected income" or "ECI"). The U.S. Internal Revenue Service argued that this rule also applied to gains from the sales of interests in partnerships that conducted such businesses;[1] a view that went unchallenged until a July 2017 U.S. tax court decision removed the ability of the IRS to tax such sales.[2]

However, at the end of 2017, the U.S. Congress[3] effectively reversed that court ruling on taxes applying to gains from the sale of U.S. partnership interests. Without a corporate blocker, non-U.S. sellers of U.S. partnership interests are once again facing taxes on gains. The U.S. Joint Committee on Taxation estimates that the new tax will generate an additional $3.8 billion in cumulative revenue over the next ten years.[4] In addition, buyers (both non-U.S. and U.S.) are now obligated to withhold 10% of any gross sale proceeds to sellers who fail to provide a non-foreign affidavit – an obligation that could far exceed the actual tax imposed with respect to the sale. This brings new meaning to the phrase "caveat emptor."

Duff & Phelps routinely advises fund investors on tax situations. Contact us if you'd like to discuss your specific situation.

1. IRS Revenue Ruling 91-32, 1991-1 C.B. 107.
2. See also Grecian Magnesite Mining, Industrial & Shipping Co., SA, v. Commissioner, 149 TC No. 3 (July 13, 2017); The ruling excludes gains from the sale of U.S. real property.
3. United States House of Representatives bill H.R. 1, originally known as the "Tax Cuts and Jobs Act," was signed into law on December 22, 2017.
4. Source: "Estimated Budget Effects Of The Conference Agreement For H.R.1, The 'Tax Cuts And Jobs Act'", Joint Committee on Taxation, 2017, Page 5.
5. Consult your tax advisor (preferably Duff & Phelps) for more details and specifics. Duff & Phelps Transaction Advisory Services contributed to this article. This column should not be construed as advice.

Duff & Phelps Q&A

Q&A with Mathias Schumacher, Managing Director

For our inaugural Q&A, we are pleased to welcome Mathias Schumacher from our London Valuation Advisory Services practice. Mathias is the Valuation leader for the U.K. and London co-city leader, and is involved in Portfolio Valuation services across Europe. Mathias has over 20 years of international valuation experience advising private equity firms, hedge funds, BDCs, sovereign wealth and infrastructure funds. Mathias holds a B.B.A. in finance from the Verwaltungs und Wirtschaftsakademie in Germany and a degree from the Paris-Sorbonne University. Mathias also serves as an Associate Fellow of Said Business School at Oxford University, where he is a lecturer on the topic of valuation.

Q: You recently led a firm engagement to provide a fairness opinion in a high-profile secondary market transaction. Can you tell us a little bit about that?

A: The buyout fund came towards its end-of-life and still had over $1 billion of illiquid assets spread across multiple investments. The sponsor felt that holding the assets beyond the life of the fund would yield significant upside to the LPs. It therefore offered the LPs the opportunity to transfer the assets into a continuation vehicle or sell the investments to a new secondary investor in this continuation vehicle. This provided the LPs the choice between immediate liquidity or the opportunity to remain in the fund with an extended life. The Limited Partner Advisory Committee asked the sponsor to obtain a fairness opinion to ascertain whether the consideration received in the proposed transaction was fair from a financial point of view.

Over the course of three weeks, we assessed the fair value of each underlying investment of the fund, determined a range of value for all investments and on that basis determined the fairness of the proposed transaction.

Q: Are fairness opinions common for secondary market transactions? Why or why not?

A: Across the private equity industry it is now common practice to obtain a fairness opinion that the Board of Directors can rely on when a related party transaction is contemplated. Often, this may only include a single investment that is transferred between funds, but it may also encompass an entire portfolio that is transferred into a continuation vehicle.

As sponsors represent both sides of transactions, likely acting for different groups of LPs, they have to ensure that the transaction is fair to both sides so that they meet their fiduciary duties. We may be asked to provide a fairness opinion stating that the transaction is fair to the buyer and the seller (two-sided opinion), or we can provide an opinion to only one side, typically the selling entity.

Q: What are some of the pitfalls in providing a fairness opinion in these types of deals?

A: For multiple reasons, most sponsors try to avoid situations in which they benefit most from entering into a related party transaction. It is often viewed as a sign of weakness when it is best to hold on to the investment after a holding period of, say, five to seven years and transfer the investment to a new fund. There are, however, unique situations where the expected future return justifies the transaction. The sponsor is ultimately very familiar with the investment and can judge better than any outsider the future prospects of a company.

It is now critical to share the upside and associated risk between the selling and buying parties. We come in as an independent party and try to assess this very point.

Q: When you're not contemplating sky-high valuations, you are scaling Himalayan peaks – should we worry about spending long periods in low oxygen environments?

A: I will let colleagues and clients judge whether my exposure to low oxygen has had any negative impact on my judgement. I haven't noticed any yet, but I may be biased. What I can say with confidence: it provides a new view on the risk and reward equation.

Upcoming Events

The Duff & Phelps Secondary Market Advisory team invites you to join us at the below highlighted events. Send us an email or give us a call if you will be attending or would like to attend.

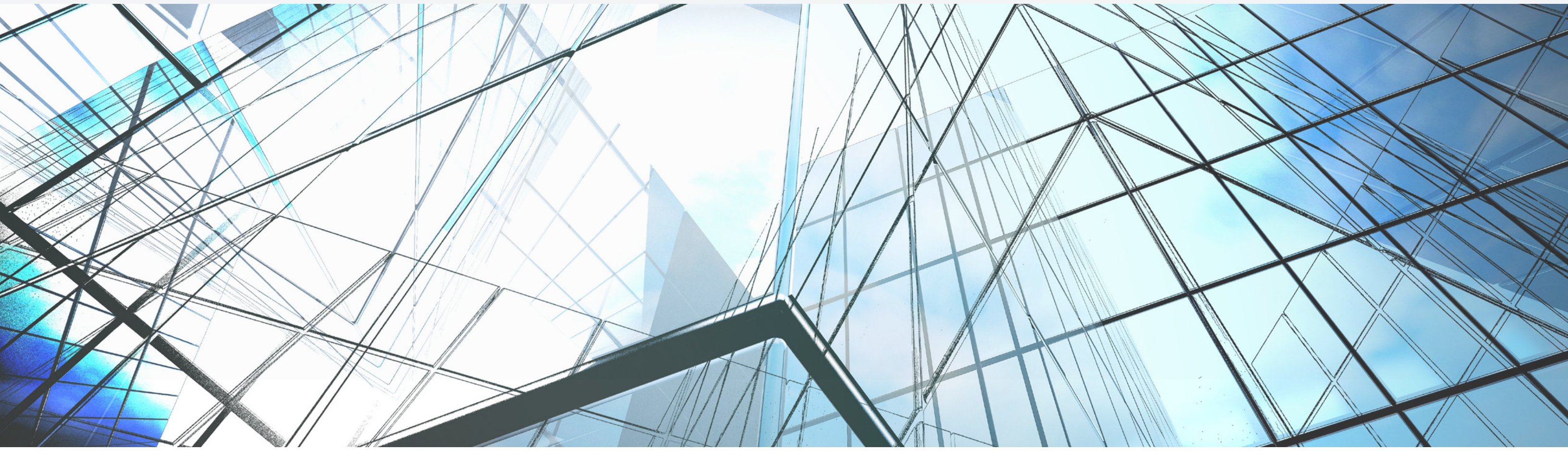
We look forward to connecting in person!

Start Date	End Date	Event
Nov 1	Nov 1	Duff & Phelps European Alternative Investments Conference
Nov 13	Nov 13	Duff & Phelps New York Alternative Investments Conference

Pricing

As in 2017, secondary market pricing remains strong in 2018. In our conversations with secondary market buyers, we noticed an eagerness to put capital to work in high-quality assets paired with a reluctance to over-extend in an environment that many consider to be extremely competitive. Many buyers are seeking to differentiate themselves by pursuing interests in specific investment strategies and middle-market managers.

Contact: Interested sell-side parties, please click here to request further private equity and hedge fund pricing information.



Disclaimer

This document has been prepared by Duff & Phelps Securities, LLC and Duff & Phelps Securities Ltd (together "Duff & Phelps") for informational purposes only. Although the information contained in this presentation has been obtained from sources which Duff & Phelps believes to be reliable, it has not been independently verified and no representation or warranty, express or implied, is made and no responsibility is or will be accepted by Duff & Phelps as to or in relation to the accuracy, reliability or completeness of any such information.

Opinions expressed herein reflect the judgement of Duff & Phelps as of the date of this presentation and may be subject to change without notice if Duff & Phelps becomes aware of any information, whether specific or general, which may have a material impact on any such opinions.

CONTACT

Americas

Dexter B. Blake, III
Managing Director
Secondary Market Advisory
T: +1 973 775 0069
M: +1 203 561 7682
dexter.blake@duffandphelps.com

International

Richard Olson
Managing Director
Secondary Market Advisory
T: +44 20 7089 4776
M: +44 7884 118 187
richard.olson@duffandphelps.com

About Duff & Phelps
Duff & Phelps is the global advisor that protects, restores and maximizes value for clients in the areas of valuation, corporate finance, investigations, disputes, cyber security, compliance and regulatory matters, and other governance-related issues. We work with clients across diverse sectors, mitigating risk to assets, operations and people. With Kroll, a division of Duff & Phelps since 2018, our firm has nearly 3,500 professionals in 28 countries around the world.
For more information, visit www.duffandphelps.com.

M&A advisory, capital raising and secondary market advisory services in the United States are provided by Duff & Phelps Securities, LLC. Member FINRA/SIPC. Pagemill Partners is a Division of Duff & Phelps Securities, LLC. M&A advisory, capital raising and secondary market advisory services in the United Kingdom are provided by Duff & Phelps Securities Ltd. (DPSL), which is authorized and regulated by the Financial Conduct Authority. M&A advisory and capital raising services in Germany are provided by Duff & Phelps GmbH, which is a Tied Agent of DPSL. Valuation Advisory Services in India are provided by Duff & Phelps India Private Limited under a category 1 merchant banker license issued by the Securities and Exchange Board of India.