Summary: This is the final installment in a series of three White Papers that explore the costs of unintended portfolio illiquidity and the possible benefits of selling less-liquid and illiquid Hedge Fund LP interests in a secondary market transaction. As we discussed in two prior White Papers, "Hope is Not a Strategy" and "The Bullfighter Doesn't Always Win" (available by request and at www.Dorchestercapital.com), investors have responded to loose monetary policy and aggressive fiscal stimulus by seeking yield wherever they can find some and most notably, in less-liquid alternative investments like Private Equity, Private Credit including Direct Lending, Hedge, and Real Estate Funds. As a consequence of these allocations, investors are now contending with elevated exposure to less-liquid and illiquid investments during a time of increasing uncertainty, heightened volatility and the possible need to redeploy capital but find themselves with less flexibility to manage their portfolio.

As this White Paper and the two prior White Papers discuss, the secondary market for less-liquid and illiquid Hedge Fund LP Interests has matured over the last decade since the 2008 Great Financial Crisis and now has infrastructure and counterparties in place to allow even novice sellers to access liquidity in this market. Secondary sales for all types of Limited Partner Interests, e.g. Hedge, Private Equity, Venture Capital, Real Estate, etc. LP Interests have climbed to over $85 billion annually[1], with a wide range of funds, managers, institutions and other sellers, and potential buyers and other market participants.

This White Paper explores how thoughtful planning can help avoid common pitfalls when seeking secondary market liquidity. While earlier White Papers examined both the direct and other costs to holding onto less-liquid and illiquid LP Interests, as well as other reasons investors may wish to sell residual LP Interests, this White Paper examines characteristics of successful secondary sales, offering guidance on counterparty selection and describing differences between certain types of secondary buyers.

"By Failing To Prepare, You Are Preparing to Fail[2]"

The Difference Between Goals and Priorities

Abraham Lincoln once said, "Give me six hours to chop down a tree and I will spend the first four sharpening the axe." As we noted in previous White Papers, "Hope is Not a Strategy" and "The Bullfighter Doesn't Always Win", there are many reasons to consider a secondary market sale in addition to the need for liquidity, be they limited upside, administrative or monitoring costs, resource limitations, optical/reputation risk, or other reasons. Therefore, investors must assess their "real" costs and their unique needs and potential benefits to pursue a secondary market sale when considering and selecting the right sales process for their circumstance.

If you need liquidity and recognize the need to achieve this through a secondary market sale, but are unsure of how to approach the market, it is important to define at the start your goals and priorities for this process. Your specific LP Interests can be highly nuanced, and their sale may require some creative solutions to achieve meaningful liquidity. It will help to have a thorough understanding of your organization's priorities to determine which are more flexible and which are not. Effective sellers of their LP Interests should approach the market with a number of priorities in mind, such as a clear reserve price or transaction structure, knowledge of the assets and/or of the fund and manager related factors, thoughtful preparation of due diligence material or

[1] Setter Capital Volume Report – FY19
[2] Quote attributed to John Wooden

arrangement with the underlying manager to make these available, and a time line or expectation of when the process should conclude. Secondary buyers are reluctant to spend time on transactions where the seller lacks clear expectations or motivation to complete the sale, i.e. "fishing expeditions", and vice versa, some buyers may lure sellers into a transaction only to lower the price or otherwise take advantage of a naïve seller through non-standard terms as the process moves forward towards closing. Some common questions sellers should ask themselves prior to offering their Limited Partner Interests include, but are not limited to:

1. *Should I optimize for price, and are my expectations realistic?*

Price is obviously the starting point for most sellers and if achieving the highest sale price is top priority, sellers should consider being flexible on payment terms such as through a staggered payment scheme, i.e. some may refer to this as "seller financing". However, sellers should consider optimizing not just the sale price but also seek reliable or quick execution, discretion, or other structuring considerations of the potential sale transactions. Prioritization of these factors is important because it will drive the nature of the process and the types of buyers who might participate in the transaction.

Sellers with a price expectation in mind should first consider the GP's "brand", as while some highly desirable, marquee Private Equity brands might trade better, most Limited Partnership Interests in lesser known managers will trade at a discount. In addition, the characteristics of the underlying assets in those funds also plays a part in determining the potential sale price. These factors include: asset quality, fund and asset/company level leverage, the mix and type of assets like whether senior or subordinated debt or equity or "equity-like" and whether these are in highly levered capital structures as well as, any unfunded commitments or potential liabilities at the fund. As a result, specialist buyers, for instance Hedge or Credit Fund secondary specialists for these kinds of funds, are likely to offer a better price versus the broader secondary market that prefers the comfort coming from familiarity with certain managers or underlying assets (and in turn, the GP's comfort with them as your counterparty).

Purely price motivated sellers may have to compromise on other aspects of the transaction to achieve the best outcome. For example, in order to achieve the highest price for a complex portfolio especially ones with many types of underlying Hedge Fund LP Interests, the seller should anticipate transacting with multiple counterparties simultaneously to achieve the highest price on each underlying asset for sale. Facing multiple counterparties means managing simultaneous negotiations for purchase and sale agreements, compliance, and settlement, as well as coordinating the process with all the underlying managers and their legal and operations teams. As a result, a multi-buyer sale process can drive up the amount of time, administration, legal and other costs of the transaction while increasing the risk that one or more may fail to trade. For these reasons, many sellers tend to prefer a single buyer, which though it may yield a lower price, does simplify the closing process. Sellers may also striate their sale portfolio by type of fund type, (i.e. Hedge, Private Equity, Venture Capital, etc.) and then chose a single buyer for each fund type.

2. *How marketable is my portfolio?*

The "type" of fund for sale often attracts (or deters) certain prospective buyers. Keep in mind that currently, approximately 68% of secondary market volume involves the buying and selling of Private Equity Fund Interests[3]. It goes without saying then that the secondary market for Private Equity Funds is much deeper than other categories, but it does not necessarily mean that LP Interests in other types of funds are not salable in a

[3] Setter Capital Volume Report – FY19

thoughtful and well-run secondary market process, and especially when approaching the right counterparty, including ones that specialize in specific asset classes like Hedge or Credit Funds. Therefore, it is important at the start of a sales process for the seller to form a reasonable expectation for how much “demand” there may be for the particular LP Interests they wish to sell and who may be the right targets for them. Factors that can limit the salability of a Fund’s Interest include knowledge of the General Partner, quality of the General Partner, the geographic or industry focus, the asset category (i.e. debt, equity, structured product, hedged, levered, etc.), litigation issues, or structural problems, as well as, the amount of remaining unfunded commitments to the fund. Like with other types of Limited Partner Interests, in some cases, the General Partners involved may have a right of first refusal to prevent a transfer from occurring or otherwise limit transfers to a select group of pre-approved buyers such as limiting transfers only to other LPs already in their fund. As to this latter point, it makes sense that General Partners do not wish to be burdened with due diligence inquiries from new parties and therefore prefer buyers whom they already know and are already familiar with their portfolio. Would be sellers may be well served to learn about any of these or other potential General Partner’ constraints prior to offering a portfolio to the market.

Sellers will further avoid future pitfalls by qualifying a counterparty’s ability to underwrite and successfully transfer specific LP Interests. If a seller is seeking liquidity for a Hedge Fund side-pockets, or for a Credit, Energy, Real Estate or other more niche strategies, it is helpful to approach specialist secondary buyers, or fund managers with flexible mandates. Pre-qualification can help avoid wasted time and unwelcome surprises deep into a sale process.

In thinking about how different fund types attract different buyer types, take a look at the differences between traditional Private Equity secondary buyers and Hedge Fund secondary specialists and the difference in deal dynamics between these two secondary markets. Comparing them side-by-side, different outcomes become more evident:

Figure 1. Secondary Market Dynamics Comparison

	Hedge Fund + Credit Secondaries	Private Equity Secondaries
Pricing	Generally, between 60-90% of NAV	Generally, between 90-110% of NAV
Leverage	Generally, buyers do not use leverage and the funds in which they invest, are generally, unlevered as well	Generally, buyers do use leverage at the secondary fund level and there is often already leverage at the underlying funds’ levels
Duration	Generally, fund is already in liquidation, intermediate duration of 2-4 years but can take longer	5 – 10 year expected duration
Transparency	Opaque transparency depending on underlying manager. Hedge Fund managers are not motivated to provide information. Generally, secondary buyers must work with imperfect information as well as, find information from other sources	High level of transparency from the underlying manager leading to relatively “perfect” information. Managers often supportive of secondary buyers. Secondary buyers accustomed to relative “perfect” information and supportive manage relationship

Approaching the right kind of buyer has an impact on an asset’s salability. Most traditional Private Equity secondary buyers will not make compelling offers, if any, to buy Hedge Funds, Credit Funds, or niche strategies due to a different under-writing methodology, lack of manager relationships, discomfort with less transparency, and duration preferences. Approaching the wrong type of buyer can result in odd price behavior or total disinterest from the market, dooming a sales process from the start.

3. How flexible am I regarding transaction structure?

Many inexperienced secondary sellers assume that transactions are straightforward, involving a simple trade of cash for an LP Interest. Buyers who are open to alternative structures are more likely to achieve other goals, including perhaps even a higher overall price. The secondary market has seen a proliferation of different deal types, ranging in complexity from simple LP transfers, to structured or partial liquidity solutions, and even lending or preferred equity against a portfolio of LP Interests.

Increased flexibility does not necessarily have to add to the complexity of a transaction, so it is important to select counterparties with extensive transactional histories and experience in bespoke structures. A sophisticated, collaborative buyer can reduce the time and expense of what may appear as added complexity and may be worth a trade-off in absolute dollar price.

Said another way, what may appear as customized liquidity solutions can be used to navigate wide bid-ask spreads, satisfy non-economic considerations (such as optics), or even permit sellers to retain upside and still remove the asset from their balance sheet, or at least, create a floor price for future recoveries. In other cases, partial liquidity through an NAV based loan might achieve the seller's liquidity goals while preserving exposure to well liked assets, including ones where buyer and seller may disagree on values today.

4. Should I consider a "bespoke" liquidity solution?

The secondary market for LP Interests is an increasingly innovative corner of the capital markets. The advent of General Partner led fund restructurings or of debt and preferred equity liquidity solutions for a Limited Partner, has made financial engineering a potential liquidity tool for all participants. Potential sellers should consider "bespoke" structures including portfolio financing options with secondary funds willing to provide these, when traditional sales are either not feasible or do not fully satisfy you portfolio management goals.

For instance, some specialist funds may lend against a portfolio of LP Interests. Some secondary buyers blur the line between secondaries and specialty lending. Secondary buyers with credit backgrounds will even lend against a mix of illiquid LP Interests including those with illiquid direct investments. These situations can allow for partial liquidity while preserving upside participation. They also may have a lower cost-of-capital versus more traditional leverage sources.

Price is only one of several important factors to consider. Once the priorities are set and the approach to the market has been made, there are several important considerations to bear in mind when the offers come in, and it is time to select a counterparty. Whatever a seller's motivation, having a clear understanding of goals and priorities can make for a smoother transaction. By explicitly determining your priorities ahead of time, be they price optimization, assurance or speed of settlement, or other aspects that require more bespoke solutions, sellers can greatly reduce the time and expense involved with a secondary sale.

"He chose . . . poorly"[4]

Criteria For Making a Better Choice

In a pivotal scene of *Indiana Jones and the Last Crusade*, the film's arch-villain, Donovan, is presented with dozens of chalices that might be the Holy Grail. Blinded by greed and false preconceptions, Donovan selects a grand bejeweled golden cup, and is promptly reduced to skeletal remains after drinking from the poison chalice. "He chose… poorly," opined the Grail's guardian.

The Holy Grail in a secondary transaction is selecting a counterparty that can meet all your needs. While you might not end up like Donovan if you choose poorly, a few considerations will take you a long way toward selecting the ideal counterparty.

1. Reliability/Reputation of Counter Party

The best price might not actually yield the best result. It might be more beneficial to accept the second or even third highest bid in order to deal with a proven counterparty, thereby reducing the risk of potential deal failure.

Secondary funds have proliferated over the last few years as Private Equity fundraising has boomed. As a result, there are liquidity providers with limited transaction records. The closing stages of a transaction involve delicate negotiation, sometimes in tandem with final investment due diligence. The risks of deal failure are more pronounced for niche assets, such as with Hedge Fund LP Interests, esoteric strategies, or funds that have some elevated level of complexity due to structural or legal issues. It is important to select more experienced buyers in specialist niches, as less-specialist secondary buyers occasionally bid on such assets, only to re-trade once it is evident that they are outside of their core expertise. It is not solely the number of successful transactions, but also the quality and relevance that matters. Strong buyers will readily provide support for their track record, and even references.

2. Flexibility

Alternative investment portfolios are complex by nature, and organizations' liquidity needs may not be necessarily straight forward. Whether the asset mix is complex, or the organization has non-economic constraints that must be addressed, selecting a collaborative and flexible counterparty can make all the difference. Potential sellers can have a smooth transaction by seeking out buyers who have flexible investment mandates and a history of structured, bespoke transactions. Some buyers might have a willingness to collaborate with sellers to find unique structures but could be limited by their fund documents. Funds with less restrictive mandates can be more effective sources of liquidity.

3. Knowledge

Secondary Private Equity is full of bright and creative investment professionals, but in some cases deep, specialty knowledge is required to achieve a good outcome. For instance, Hedge Fund side-pockets are often more opaque than Private Equity Funds; they are also sometimes managed by General Partners that are hostile to secondary buyers. In such cases, it is usually worth seeking out buyers who have pre-existing relationships with the manager, have purchased the asset in the past, or have direct knowledge of the fund's investments through other existing investments or relationships. The secondary market is fairly siloed by expertise, even

[4] Indiana Jones and the Last Crusade, 1989

within larger investment styles. Private Equity secondary buyers tend to stick with Buyout and Venture Funds and their LP Interests, and rarely overlap with Hedge and Credit Funds secondary buyers. Even within Private Equity secondaries, there are specialists who focus solely on different market caps, geographies, and investment stage or style.

"If you don't know where you are going, you'll end up somewhere else.[5]"

In Conclusion

Our earlier White Paper, "Hope is not a Strategy", highlighted the financial and non-financial costs of unintended illiquidity. Residual fund Limited Partner Interests tend to exhibit lower upside potential, which is accompanied by high opportunity cost. Perhaps more costly, organizations waste time and divert the attention of investment staff, operations professionals, and even the board oversight to monitoring these investments. In addition, poor optics and pronounced reputation risk are often features of these assets. Proactive liquidity management can help mitigate these other costs and risks.

As we discussed in "The Bullfighter Doesn't Always Win", potential secondary market sellers often go through an adapted Kubler-Ross Grief Cycle prior to seeking liquidity. Initially, investors with unintended illiquidity exist in a state of denial, which eventually gives way to anger, bargaining, depression and, finally, acceptance. The most effective investors work through that process quickly. Reluctant sellers may hold off because they overwhelmed by the possibility of a secondary sale and reluctant to pursue secondary liquidity. However, a little preparation can make for a smooth liquidation of long duration LP Interests. Sellers should have a clear set of goals in mind when approaching the secondary market.

Finally, in this White Paper, "By Failing To Prepare, You Are Preparing to Fail", we discuss characteristics of successful secondary sales. Namely, sellers must define at the start of the process the criteria by which they can judge the success of the sale and while price may be at the top of the list, other criteria like payment terms, transaction structure and counterparty reliability could make a difference in the ultimate outcome of the process. Counterparty selection is an important element of a successful transaction. As potential secondary buyers are usually focused on a single fund type, style or asset class, it is incumbent on the seller to seek out the most appropriate type of secondary buyer as this can result in better pricing, lower costs and reduced transaction risk.

In 2020, much of the stock market's run-up can be traced to a handful of technology companies, especially those able to have accelerated their product adoption due to Covid-19 related economic shutdowns. Some investors miss that many industries and companies are actually in some form of economic purgatory, where their survival is not a certainty especially as limited government stimulus and their lenders' reluctance to recognize credit defaults were to abate. Some aspects of the current environment may give some portfolio managers and GP's false confidence, delaying their move toward what Kubler-Ross describes as "acceptance" and towards a sale process. Would-be sellers may be best served seeking secondary market liquidity sooner than later as it seems as though more and more buildup of would-be supply of LP Interests are being offered for sale in the secondaries market, whether due to underlying macro and industry fundamentals, personnel changes within ones organization and/or liquidity needs.

[5] Quote attributed to Yogi Berra

About Dorchester Capital Advisors: Founded in 2001 as a Fund of Hedge Funds by two former Hedge Fund managers to manage their own and friends' capital, Dorchester has evolved over the years. Through its primary multi-manager platform, Dorchester has been an early and ongoing investor with many Alternative Investment Funds. Since 2008, Dorchester is among the first firms to participate in size in the secondary market for Limited Partner Interests in Hedge, Credit, Private Equity, Real Estate, and other Alternative Investment Funds. Dorchester works with Limited Partners, Institutional Investors, Brokers and General Partners to proffer customized solutions as well, including investing in GP-led tender and buyout offers, fund restructurings, and fund level debt and preferred equity financings. Dorchester has invested in direct, carve-out and co-investments with General Partners, Limited Partners, and other investors. Dorchester believes it is one of the few firms with the requisite size, insight, analytics, sourcing, intermediate term capital, experienced personnel, and track record to be an important counterparty in this ongoing and evolving secondary market for Limited Partner Interests. Over the years, Dorchester has earned its reputation as a reliable and collaborative counterparty and Limited Partner.