NAVIGATING CONTINUATION FUNDS IN PRIVATE EQUITY

PURPOSE, CONSIDERATIONS AND CHALLENGES

WEBBER WENTZEL
in alliance with Linklaters

Continuation funds are rapidly becoming a game-changer in private equity, representing a more nuanced approach to managing investments beyond their original term. They provide fund managers with a variety of opportunities, while also presenting complexities that demand careful navigation.

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PRACTICAL REASONS TO FORM A CONTINUATION FUND:

Continuation funds have a growing presence in the secondaries market. Globally, continuation funds represented approximately 12% of sponsor-backed exit volume in 2023, up from 7% in 2022. Continuation funds are expected to hit critical mass in 2024, with Pitchbook projecting exits via continuation funds to surpass 100 such transactions in 2024. This rapid rise can be attributed to the numerous advantages they offer both managers and investors.

CONTINUATION FUNDS ARE ESTABLISHED TO:

EXTEND INVESTMENT HORIZONS

Continuation funds provide a mechanism to extend the investment horizon, enabling fund managers to hold onto assets for an extended period, potentially maximising returns. This extension is particularly valuable when market conditions make traditional exits difficult (as seen during the coronavirus pandemic). Furthermore, if an asset still has considerable growth potential, extending the holding time enables managers to seize the opportunity and create additional value for investors.

MANAGE PORTFOLIO WITH AGILITY

Continuation funds allow managers to be more agile in their portfolio management. Managers can navigate market shifts and optimise portfolio performance by providing flexibility in exit timing. This strategic approach minimises risks and maximises returns in the face of evolving economic landscapes while expanding their product offering to new clients who seek this flexibility.

SERVE AS A LIQUIDITY SOLUTION

Continuation funds serve as a liquidity solution, that caters to diverse investor needs. For investors seeking to exit, continuation funds offer a path to monetise their investments, while investors who believe in the future potential of an asset can remain invested and continue to benefit from its growth.

PROVIDE CONTINUED EXPOSURE

Both managers and investors can benefit from continuation funds as they may wish to hold onto an asset to benefit from a second phase of value creation and retain exposure to the asset. Holding onto prestigious assets can also enhance a manager's brand during the interim period.

PROVIDE CERTAINTY

For new investors, continuation funds provide valuable certainty. Unlike blind pool funds, continuation funds are transparent about the specific assets they are investing in and their ownership stake. These investments are often mature assets with shorter holding periods, further reducing risk for new investors. The existing relationship between the manager and the portfolio company is also advantageous, as the manager already understands the business and its strategies, potentially positioning them to guide the company through its next phase of growth.

CREATE VALUE

The flexible nature of continuation fund strategies allows managers to explore various avenues for value creation throughout the fund's lifecycle. Some funds may even transact at a discount to the net asset value (NAV) due to the accelerated liquidity option that a continuation fund provides compared to other exit alternatives. This discount can ultimately lead to a near-term valuation increase after the initial investment.

PROCESS FOR ESTABLISHING A CONTINUATION FUND:

Creating a continuation fund requires precise preparation and collaboration. Here is a breakdown of the key stages:

STEP 1

PORTFOLIO EVALUATION AND STRATEGY PLANNING
Conduct a comprehensive assessment of the existing portfolio, evaluating the performance, growth prospects and market conditions of each investment. Using this information, determine which assets should be moved to the continuation fund. Next, define the strategic objectives for the continuation fund, considering factors such as desired investment horizon, targeted returns and alignment with the overall fund strategy.

STEP 2

INVESTOR CONSULTATION AND CONSENT
Engage with existing investors and any applicable Limited Partner Advisory Committee (LPAC) to gauge appetite for participation in the continuation fund and, where required, secure consent for the proposed strategy. Determining how many investors intend to roll over their interest will help you organise the fund more efficiently. Furthermore, an initial LPAC approval is important to encourage investor confidence in the transaction. Be open about the rationale for the continuation fund, potential risks and rewards, and implications for existing investors.

STEP 3

LEGAL AND REGULATORY FRAMEWORK ESTABLISHMENT
Work with legal counsel to establish the legal and regulatory framework for the continuation fund. This includes deciding on the best structure to use. For example, is a single continuation fund holding multiple assets appropriate or would it be better to have multiple continuation funds each holding a single asset? Multi-asset strategies, while once uncommon, made up approximately 59% of the volume of continuation fund transactions in 2023 - a significant increase from 41% in 2022. The best structure to use is often determined by considerations such as timing, cost, investor base, characteristics of asset(s) and flexibility to raise new capital.

Additionally, verify compliance with relevant laws and regulations by creating necessary fund documentation, such as partnership agreements, offering memoranda, and subscription documents.

STEP 4

ASSET VALUATION AND PRICING, INDEPENDENT FAIRNESS OPINION
Conduct a thorough valuation of the portfolio assets being transferred to determine their fair market value. This provides the pricing mechanism for the continuation fund. The most important aspect is avoiding conflicts of interest, a solution to this is for managers to rely on buyer valuations through an auction guided by a financial advisor. Determining the final purchase price can be difficult and continuation funds are increasingly using methods such as deferred payment mechanisms. These allow investors to make payments over time, with the asset's performance influencing the final cost.

An independent fairness or valuation opinion can provide an unbiased assessment of the terms of the transaction, helping to build trust and transparency between GPs and LPs, and mitigate against potential conflicts of interest. A third-party validation may facilitate securing the necessary consents from LPs, streamlining the process and enhancing the chances of a successful transaction. In certain jurisdictions, an independent fairness opinion may also be necessary to ensure compliance with regulatory requirements.

STEP 5

INVESTOR ONBOARDING AND CAPITAL COMMITMENTS
Secure capital contributions from existing and new investors. Facilitate the onboarding process for new investors, while ensuring regulatory compliance and conducting due diligence.

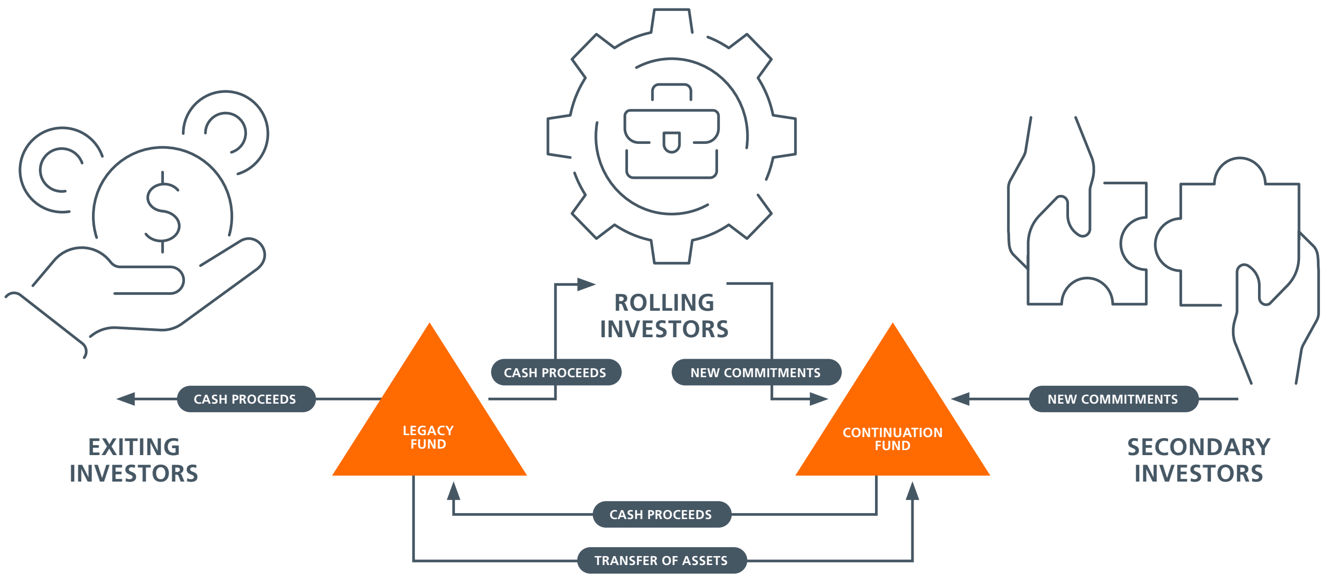
STEP 6

GOVERNANCE FRAMEWORK ESTABLISHMENT
Set up a strong governance framework for the continuation fund, describing the decision-making authority, reporting requirements and accountability mechanisms. Appoint a governing body, such as an LPAC, as early as possible to oversee fund operations and ensure alignment with investor interests.

3

ROLLOVER

Investors who wish to increase their exposure to the transferring assets will rollover their interests in the legacy fund to the new fund. This is achieved via committing to the continuation fund with their share of the proceeds from the transferring assets.



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SALE AND CASH-OUT

The asset is sold from the legacy fund to the continutation fund. Investors will then receive their share of the purchase price in order to buy them out of the original asset. Investors who do not wish to rollover their interests to the continuation fund will remain in the legacy fund.

1

FRESH INVESTMENT

Secondary investors commit to the new continuation fund to make up any potential deficit left in the asset's value by the previous investors who have chosen not to rollover and to facilitate new invesments.

TYPICAL TERMS OF A CONTINUATION FUND:

TERM	DEFINITION
Management fee	Usually structured as a percentage of the cost of the transferred assets (around 1%) or as a cost recovery fee (with or without a mark-up). The fee after the first year is often settled from fund income rather than as a draw down of commitments.
Carried interest	Carry structures vary significantly from those used in traditional funds. A tiered carry is more prevalent, starting with a rate for lesser returns (around 10-15%) and increasing to around 15-20% once certain MOIC and/or IRR thresholds are reached. Alternative mechanisms such as a NAV-based performance fee and a carry reset can also be utilised (which may be necessary if a carry event has occurred under the legacy fund's documentation).
Duration	The term varies depending on the asset class. Private equity normally has a term of 5-7 years, but infrastructure funds may have a much longer term.
Hurdle rate	Adjustments may be made to reflect the existing portfolio's risk profile and the expected returns from holding these assets.
Clawback provision	When determining clawback conditions, the existing portfolio's performance as well as new investments may be taken into account.
Waterfall structure	The waterfall may be modified to accommodate distributions from existing assets and new investments separately.
Removal	In general, removal is only for cause. When no-fault removal is included, longer lock-in periods and higher compensation will apply.
Key person provisions	May have unique considerations regarding key personnel's involvement in managing the existing portfolio versus new investments.
Expenses	Usually include expenses, such as monitoring fees and transaction costs related to establishing the continuation fund and managing and maintaining the existing portfolio. The allocation of transaction costs for the first transfer of assets between the legacy fund and the continuation fund must be carefully managed.

CONSIDERATIONS FOR FUND MANAGERS:

ONE

Continuation funds require clear and consistent communication and alignment with existing investors. Managers must explain the rationale for the continuation strategy, addressing concerns about extended holding periods, dilution and potential conflicts of interest. Securing investor buy-in and obtaining necessary approvals are paramount to the success of the fund. Furthermore, continuation funds introduce unique valuation challenges due to the extended investment horizon and evolving market conditions. Ensuring transparency and accuracy in valuation processes is critical for maintaining investor confidence.

TWO

Implementing robust governance structures and oversight mechanisms is essential for managing continuation funds effectively. Clear delineation of the decision-making authority, reporting standards and accountability frameworks fosters transparency and investor confidence. Independent oversight, including the establishment of a dedicated LPAC, enhances governance and mitigates potential conflicts of interest.

THREE

Continuation funds should incorporate comprehensive exit planning strategies to manage liquidity and optimise returns. Managers should evaluate alternative exit scenarios, including IPOs, strategic sales or further secondary transactions and maintain flexibility to adapt to changing market conditions.

FOUR

Many investors expect managers to invest significant house commitments into continuation funds, due to the risks involved. In 2023, most managers in continuation fund deals reinvested 100% of their crystallised carried interest and committed to providing their pro rata portion of unfunded commitments in the continuation fund, which aligns with investor expectations.

FIVE

Capital injections from new investors into continuation funds may dilute existing investors' ownership stakes, potentially eroding their returns in the new fund and triggering tax implications. Additionally, the introduction of new investors can complicate the fund's capital structure and governance dynamics, resulting in disagreements over decision-making authority and distribution policies. Managers must implement equitable allocation mechanisms, consider the legal, tax and regulatory impact on existing investors, and communicate transparently to address concerns about dilution and fair treatment.

Continuation funds represent a strategic tool for private equity managers, offering avenues for portfolio optimisation, liquidity management and value enhancement. However, their effective deployment requires a nuanced understanding of investor dynamics, valuation principles, regulatory landscapes and governance imperatives.

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