

Fund Finance Friday



Making the Most of Continuation Funds

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In light of lingering effects of the pandemic on many funds and uncertain and volatile markets, sponsors are increasingly looking for alternative solutions to generate liquidity for their investors. One such solution offered by the private equity secondaries market is the continuation fund. We discuss below what a continuation fund is, benefits of using this type of transaction and potential concerns that sponsors and investors may have with these transactions, as well as common solutions.

What Are Continuation Funds?

Continuation funds are newly formed special purpose vehicles created for the sole purpose of buying one or more assets from an existing fund (which is often near the end of its term) managed by the same sponsor. Investors in the existing fund may either sell their interests in the existing fund and be paid out or roll their interests into the continuation fund in order to remain invested in the same assets. Interests in the continuation fund are offered to new investors for purchase, and investors who have rolled their interests into the continuation fund may increase their commitments. These commitments are then used to purchase the assets from the existing fund and pay out the selling investors.

Benefits of Continuation Funds

While continuation funds have historically been considered a tool to transfer poorly performing assets out of funds to give them more time to provide value, they are now increasingly being used by sponsors to retain well-performing assets to sell in a more optimal market at a later date for better returns while still providing an exit option for investors in need of liquidity. These transactions can be beneficial for all parties involved.

With respect to investors choosing to roll their interests into the continuation fund, they have the advantage of continued investment in an asset they know well for a longer term than is permitted under the existing fund organizational documents. Additionally, they often may retain their existing terms of investment if preferred or they have the opportunity to renegotiate for new terms along with the new investors. For investors who choose to sell their interests and be paid out, these transactions provide an opportunity to receive liquidity that would otherwise be locked up. New investors, often market participants in the secondaries market, find these investments attractive because they enable investors to invest in known assets, usually with shorter holding periods than primary funds.

Continuation funds provide sponsors with increased optionality, as sponsors are able to retain control over well-performing assets and assets with high potential rather than selling at inopportune times in the market as required by the terms of an existing fund's organizational documents. Additionally, sponsors may benefit from the crystallization of their carried interest upon the effectiveness of the rollover of the investment to the new fund. Often, sponsors will commit a significant portion of this carried interest to the continuation fund, aligning their interests with the success of the assets. Continuation funds also permit sponsors to raise new capital for follow-on investments.

Potential Concerns and Common Solutions

While there are many benefits to utilizing continuation funds, they also present certain issues that sponsors must navigate to successfully manage these transactions, including perceived conflicts of interest and short timelines that

can hinder an investor's ability to determine whether to roll its interests into the continuation fund.

Conflicts of Interest

Continuation funds may be scrutinized by investors for perceived conflicts of interest, since the sponsor sits on both the sell and buy side of the transaction. Investors will look for the sponsor to provide a compelling business rationale for the transaction and to justify the transaction price as reasonable. Negotiation of ancillary economic terms, including management fees, can also raise questions from investors.

Sponsors must deftly balance profit and fiduciary duty to address these concerns. There are a number of common methods used by sponsors, including meeting with the fund's investment advisory committee to review the proposed transaction, disclosing fee details, explaining the rationale for the proposed transaction and obtaining the committee's approval. The Institutional Limited Partners Association (ILPA) has provided guidance on best practices for successful continuation fund transactions and recommends that sponsors involve the fund's investment advisory committee as early as possible to provide sufficient transparency and give enough time for the committee to make informed decisions. With respect to pricing concerns, a common approach is using an auction process to solicit competing offers. An additional measure that can be taken is requiring independent valuations of assets and related formal fairness opinions to show transparency and fairness in the valuation process. In regards to concerns about whether the transaction has a valid business purpose, requirements that should be met for creation of continuation funds are increasingly being hardwired into fund organizational documents to avoid this uncertainty.

Timing for Investors

Some investors have raised concerns about the amount of advance notice they receive to decide whether to sell their interests or roll them over into the continuation fund. Particularly for institutional investors, internal presentations and approval processes may take longer than the period given by the sponsor for a decision. If investors don't have time to complete those internal processes, they may be compelled to sell their interests rather than roll them into the continuation fund without regard to what their view of the continuation option is. To address such concerns, the ILPA has recommended that sponsors provide at least 20 to 30 days for investors to complete their diligence and conduct any necessary internal approval processes before requiring a decision on whether to sell or roll over their interests in the existing fund.

Conclusion

Continuation funds can provide helpful optionality for private equity fund sponsors and investors, and can be beneficial for all parties involved. However, these transactions require proactive steps from the sponsor to provide transparency and protect the interests of all participating parties.