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Continuation Funds: What You Need To Know

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Over the last 10 years, continuation funds have evolved to be a well-established potential exit route for private fund sponsors. According to advisory estimates, some $40 billion deals were completed in 2023, with more than $150 billion worth of transactions in the market in total.

As the continuation fund market matures, the structure and terms of these transactions have become increasingly complex, presenting challenges that should be carefully navigated by participants to ensure a successful transaction process.

In this article, we discuss some of those issues, and the dynamics we have observed as sponsors, existing limited partners (LPs) and new investors negotiate these transactions.

Rationale

A continuation fund can provide several advantages to sponsors and investors:

- It allows a sponsor to continue to own an asset and maximize its value without having to sell it to a competitor, while providing liquidity to its investors.
- It typically provides existing investors with a choice of whether to "cash out" (i.e., receive their share of the net proceeds from the sale) or retain exposure to the asset(s) by reinvesting in the continuation fund.
- New investors/buyers can gain access to known assets (as opposed to investing in a blind pool fund), which are often high performing, managed by a sponsor the new investor usually already knows.

Managing Conflicts of Interest and the Election Process

As the sponsor is on both sides of the transaction, there is an inherent conflict of interest which needs to be appropriately managed. It can be mitigated as follows:

- Firstly, the approval of the selling fund's advisory committee is typically sought and is often required by the selling fund's governing documentation. Sponsors are encouraged to

engage with the advisory committee as early as possible in the process. As continuation funds have become more mainstream, some investors are imposing particular requirements as part of fundraising negotiations when blind pool funds are formed, and those will also need to be considered.

- Secondly, the purchase price is typically determined by third parties (the buyers who will invest in the continuation fund), often through an auction process run by a financial advisor, to ensure a fair determination. In large transactions, this can sometimes be combined with the sale of a minority stake in the underlying asset to a third party through a traditional exit process.
- Thirdly, a fairness opinion or third-party valuation from an independent financial advisor is typically provided by the sponsor to the existing investors. This is now a legal requirement for investment advisers registered with the U.S. Securities and Exchange Commission (SEC), although many sponsors had already adopted this practice prior to the SEC rules coming into force.
- Transparency is also key and existing investors should receive the same level of information provided by the sponsor to the buyer(s).
- Finally, the sponsor should give enough time to the existing investors to evaluate its proposal and return their election forms. Investors are typically granted a minimum of 30 days, as recommended by the Institutional Limited Partners Association (ILPA).

Economics

Purchase Price

Although the bid-ask spread has narrowed in recent months, many sellers continue to struggle to align their expectations with the prices that secondaries buyers are willing to pay. A mismatch in pricing and valuation expectations is one of the primary reasons that continuation fund deals fail.

To help address these pricing pressures, transaction structures have become increasingly complex, with over 50% of continuation fund purchase agreements in 2023 containing deferred payment mechanisms, according to advisory estimates, allowing buyers to make payments over time (often with provisions for price adjustments). The terms of those mechanisms are deal-specific, but the deferral period typically ranges between six to 12 months.

Performance-related earn-outs can also be used to bridge the valuation gap between the sell-side and the buy-side, as well as to further incentivize the sponsor and enhance its alignment with investors.

Management Fee and Carried Interest

The management fee rate for continuation funds is typically lower (approximately 1%) than those for a blind pool fund and is based on invested capital. The distribution waterfall often includes several tiers of carried interest linked to the performance of the underlying assets. Existing investors may be offered the option to reinvest in the continuation fund on economic terms that are similar to those in the selling fund, or on the same economic terms as the new investors.

Allocation of Transaction Expenses

The allocation of transaction expenses between the selling fund and the continuation fund (and indirectly, the lead investor) is a heavily negotiated point between sponsors and lead investors. Certain types of expenses often treated as sell-side expenses (e.g., costs related to the election process and fairness opinion fees) or buy-side expenses (e.g., establishment costs for the continuation fund). Consequently, negotiations between sponsors and lead investors tend to focus on the allocation of transaction expenses that are typically split between the selling fund and the continuation fund, such as warranty and indemnity (W&I) insurance costs.

These days, it is customary for continuation funds to reimburse lead investors for their legal expenses up to an agreed cap, although the amount of the cap is deal-specific and can be heavily negotiated between the sponsor and the lead investor.

Regardless of the agreed split of such costs, expenses are often allocated among the various groups of investors on a non-pro rata basis. That may require the sponsor to use the election process to seek a waiver or amendment to the selling fund's limited partnership agreement to permit the proposed allocations.

In addition, ILPA recommends that the sponsor should also disclose to all LPs the allocation methodology for transaction fees and expenses between the buyer, selling LPs, rolling LPs and the sponsor, while SEC-registered investment advisers and exempt reporting advisers need to consider and describe in a written notice to their investors how their non-pro rata allocation of expenses is fair and equitable under the recent new private fund adviser rules adopted by the SEC under the Investment Advisers Act of 1940. (At the time of publication, a challenge to the rules was pending.)

Sources of Recovery

Over the past year or two, W&I insurance has become an essential tool in the secondaries toolkit. In 2023, a majority of the continuation fund deals we saw used W&I insurance as the primary source of recourse for buyers.

By eliminating the need for escrow and holdback arrangements, W&I insurance allows the selling fund to have a clean break by capping its liability under the purchase agreement at $1 and distributing the full purchase price proceeds to its investors at closing. Buyers also benefit by having recourse against insurers with A+ balance sheets instead of the sponsor, thereby preserving their relationship with the sponsor, with whom they may have other ongoing investments (e.g., a primary investment in the sponsor's flagship blind pool fund).

As the W&I insurance market for secondaries matures, insurers are also now offering top-up policies for losses up to 100% of the purchase price for fundamental warranty breaches and excluded obligations (thereby putting the buy-side in the same position it would normally be in for a non-W&I insurance deal), as well as synthetic cover for excluded obligations in certain limited situations.

Sponsor Alignment

For secondaries investors, alignment with the sponsor has become a crucial element for a successful continuation fund transaction. Buyers now expect sponsors to put meaningful "skin in the game." In the majority of continuation fund transactions that closed in 2023, sponsors reinvested 100% of their crystallized carried interest and undertook to provide their pro rata portion of unfunded commitments in the continuation fund, according to advisory estimates. That is in line with guidance issued by ILPA in May 2023. In cases where the sponsor has not rolled all of its carried interest into the new continuation fund, the ILPA guidance recommends that the sponsor provide a detailed explanation of why it did not do so and set out the alignment incentives for the new continuation fund.

More recently, we have also seen some sponsors agree to invest an additional amount of capital on top of their 100% carry rollover, whether as a top-up commitment by the sponsor itself or as an investment into the continuation fund out of their latest flagship fund, to further maximise the alignment of interest between the sponsor and the continuation fund investors. Of course, sponsors will need to balance the request for additional commitments against their capital requirements for potential future transactions.

There are occasions where the sponsor's carried interest will not have crystallised at the time of doing a continuation fund transaction — for instance where the selling fund uses a European-style waterfall and is not yet in carry. In these cases, the amount of the sponsor's commitment to the continuation fund is a key point of negotiation to get both secondaries investors and rolling LPs comfortable that they are sufficiently aligned with the sponsor.

Allocation of LP Interests in the Continuation Fund

The amount of the lead investor's commitment is often heavily negotiated between the sponsor and the lead investor. While the sponsor generally has the final say on the allocation of commitments to the continuation fund and will seek to have sufficient flexibility to re-allocate initial indicated commitments once the number of rollover LPs is known (upon the expiry of the election process), lead investors often condition their commitment on receiving a minimum allocation agreed to by the sponsor, with priority over other new investors and sometimes also over rollover LPs.

Some lead investors also request a cap on their commitment as a portfolio management tool to protect against potential over-exposure to the underlying asset if the sponsor were to over-allocate continuation fund commitments to the lead investor to cover a shortfall in the capital needed to complete the transaction, although this is less common and is often driven by deal-specific dynamics.

Another issue that can arise relates to the syndication of commitments to fund any shortfall in the capital needed by the continuation fund to complete the purchase of the transferring assets and to inject additional cash into the underlying businesses to maximize their upside potential.

Particularly in larger transactions, the total commitments being made by the lead investor, rolling LPs and the sponsor are unlikely to be sufficient.

Some sponsors are willing to grant lead investors a right of first refusal to increase their commitments to fund the shortfall amount, in full or partially. In other cases, some active lead investors may negotiate a right to offer continuation fund LP interests to its own clients or other investors sourced by the lead investor, thereby both helping the sponsor plug the funding gap and strengthening the lead investor's relationships with its own investor base by giving them access to otherwise illiquid high-quality assets.

Ancillary Transactions

The recent rise in single-asset deals has accelerated the evolution of highly structured continuation fund transactions. Sponsors may, for example, implement one or more additional transactions alongside the creation of a continuation fund, such as a simultaneous refinancing of the target company's debt, a reset of any existing management incentive plans or a bolt-on acquisition by the target company.

The impact of these ancillary transactions on the continuation fund transaction (for example, potential value extraction from the target company, increased liability risk for the continuation fund or delays to the timetable due to required regulatory approvals) should be carefully considered by

both sponsors and buyers to ensure that potential liabilities are allocated appropriately and to avoid over-commitment by lead investors at a premature stage of the continuation fund transaction.

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