The rise of continuation funds

In a post-pandemic world of increased competition and historic levels of dry powder, private advisers are increasingly using continuation funds to keep hold of trophy assets. *Debbie Reeve and Michelle McNaney* explore the history of these structures, why they make sense to managers and their LPs, and the key challenges to overcome in launching a continuation fund.

A type of GP-led secondaries process, continuation funds involve GPs moving one or more existing fund assets into a special purpose vehicle, in order to retain exposure to high-performing 'trophy' assets. By using continuation funds, private advisers can create liquidity for their LP base, while also crystallising any carried interest earned to date. These structures also provide existing LPs with an option to maintain exposure to the asset and their GP relationship through the continuation vehicle, often on their existing economic terms. Secondary market transactions have increased rapidly over the past few years fuelled by fundraising tailwinds and greater market acceptance from LPs and GPs.

We've seen growing interest in continuation funds in recent times because they act as a vehicle to negate forced exits from fixed-term funds, which would normally need to be wound-up within 7 to 10 years. While many funds do have the option to exercise extension periods, these are not indefinite and can cause friction with LPs where there is no clear rationale for their use. The use of a continuation fund has proven to be a welcome alternative to GPs; these structures enable managers to continue their ownership of assets, independent of the lifecycle of the original fund.

With IPO and M&A markets slowing during the pandemic, private equity firms looking at exit options for assets also faced significant challenges. As a result, continuation funds became an increasingly attractive option and have seen widespread usage over the last two years.

Last year, brand-name GPs such as General Atlantic (GA), Clayton, Dubliner & Rice (CD&R) and Goldman Sachs ran continuation fund processes on assets, with estimations that more than half of the top 50 GPs have led continuation fund transactions in the secondaries market already. These top-tier sponsors have

shown that there is capital available to underwrite multi-billion dollar deals. GA reportedly raised $3 billion for four portfolio companies and CD&R raised a $4 billion continuation fund in December last year to hold a stake in Belron, a company it initially backed in 2018.

Changing perceptions

Continuation fund structures are not new. In the past GP-led secondaries, known at the time as 'GP-led restructurings', were used by managers to transfer struggling assets out of funds and give them more time to turn their performance around. This resulted in these structures gaining a stigma in the market and being seen as an indication of an underperforming GP.

Several pioneering managers have realised that these structures offer something that has been lacking in traditional limited partnership funds: optionality. In trying dealmaking conditions, with increased competition and unprecedented levels of dry powder driving up asset prices, GPs now have the option to keep hold of high-performing and/or high-potential assets led by management teams they know well. The conviction that GPs have in these deals is reflected by the fact that they often roll a significant portion of their carried interest into the continuation vehicle, aligning themselves with the continued success of the assets. In more than two-thirds of continuation funds a leading advisory firm worked on since 2021, GPs rolled 100% of their carry and in more than 85% of vehicles at least half of the GPs' carried interest was rolled.

As well as extending holding periods, continuation funds also solve other problems that GPs face towards the end of a fund's life: liquidity. At this stage, with the majority of capital drawn, options for portfolio companies that need additional capital are limited. A continuation fund specifically addresses this issue, as they can raise additional capital earmarked for that business. Traditionally in the latter stages of a fund, GPs have one option to create liquidity for LPs: distributions following the sale of assets.

In addition to the positives that these deals hold for GPs, they also offer LPs benefits. LPs in the existing fund are given the choice of either taking liquidity by crystalising gains from the asset to date or rolling into the continuation fund. Rolling LPs gain continued exposure to assets they know well and reinforce their relationship with the GP. For these LPs there is often a status quo option, through

the ability to maintain their existing economics in the new fund. The third type of LP in this process are incoming LPs investing in the continuation vehicle for the first time, who get full visibility of the asset they're buying into (and an understanding of its track record), as well as beginning a new GP relationship.

Navigating the challenges

With a single GP being both the buyer and seller in these transactions, there is the potential for conflicts of interest to arise and GPs must be careful to navigate these.

In launching a continuation fund a GP will typically need approval from the LP Advisory Committee of the existing fund. Engagement at an early stage is key, showing transparency and alignment with the interests of their LP base. Clearly communicating the financial and commercial logic for a transaction will greatly increase the chances of a deal succeeding.

Another key area to consider is pricing. Since GPs are on both sides of the transaction, they need to show their current LPs, whether exiting or rolling, and incoming LPs, that the price discovery process has been fair and transparent. This can be done through a range of strategies, from running an auction process to soliciting competing offers, to appointing a panel of independent experts to provide a fair valuation.

In the US, there is increased scrutiny from the SEC around GP-led secondary transactions, so much so that they form part of the proposed reforms aimed at private fund advisers. If enacted in their current form, the reforms will require a fairness opinion on the GP-led transaction, from an independent opinion provider, to be distributed to all investors in the fund. This requirement will add an additional cost to managers establishing a continuation fund, but more than likely will be offset against the purchase price.

Here to stay

In its 2021 Sponsor-led Secondary Market Report, advisory firm Lazard noted that GP-led deals have become normalised as viable alternatives to traditional exit routes and liquidity. It estimated that these deals accounted for 50% of the $126 billion total secondary market volume, and that 83% of this GP-led volume was in continuation funds, either single- or multi-asset vehicles. Of these, more than 25

were greater than $1 billion in transaction size, underlining the appetite from secondaries buyers for these deals.

Despite the market volatility, global political uncertainty and high inflation that has characterised 2022 so far, the appetite for GP-led deals has continued, and secondaries buyers have continued to raise large funds dedicated to this strategy. Whilst valuations remain high and GPs see more value in holding current assets over new acquisitions, the trend towards increasing usage of continuation funds will continue.

Where they were once the hallmark of a struggling GP, continuation funds are now firmly established as a legitimate exit route for managers and LPs, as well as providing optionality to continue benefiting from high-performing assets.