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Continuation Funds: Five Questions To Get Right Before You Launch

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Continuation funds now sit at the center of the private capital industry. They account for a growing share of secondary market volume and are now a well-established and legitimate exit route for high-quality assets. However, despite this growth, some processes stall or never formally launch. Successful launches are often distinguished by careful and considered early preparatory work, and this note sets out five questions every GP should be able to answer before moving from idea to market.

1. Is the asset and the business plan a good fit for a CV transaction?

As the CV market has matured, lead secondaries buyers and LPs have become far more sophisticated and selective, and the level of commercial and legal due diligence conducted by buyers is increasingly comprehensive. Buyers are backing continuation funds primarily where the underlying asset(s) combines a convincing historic growth story with a clear thesis for future value-creation. Deals that have priced well and have been oversubscribed typically feature proven assets where the CV exists to facilitate genuine potential upside, not to postpone a difficult exit.

It is therefore important for sponsors to pressure-test this story and future thesis before engaging the market, primarily, (i) why is a CV transaction a more preferable exit route than a traditional exit and (ii) does the future plan rely on realistic capital requirements, achievable M&A and credible operational milestones?

The earlier sponsors build conviction on these questions, the more able they will be to move decisively, whether that means proceeding with a CV transaction or choosing an alternative and more appropriate exit route.

2. Can you demonstrate alignment and transparency on valuation and conflicts?

A CV transaction ostensibly puts the sponsor on both sides of the transaction. That potential conflict means having robust and transparent valuation and conflicts processes are key to ensure a smooth process with investors and the selling fund LPAC. Sponsors who invest time in well-documented processes will benefit from credibility with target investors and less friction in legal negotiations.

A price obtained by a competitive auction process validated by an independent fairness opinion should reflect genuine market appetite and market-tested price discovery - the single strongest mitigant against any suggestion of undervaluation.

Managing potential conflicts effectively and transparently is also critical in CV transactions. Sponsors should be clear at an early stage of their legal obligations under the selling fund governing documents as well as having a view to industry guidance and best practice. Being on the front foot with this process and considering in advance questions which may arise will help ensure a smoother process with the LPAC as the transaction nears completion.

3. How should you manage LP communications and timing?

While there is no ‘one size fits all’ approach, sponsors who invest in clear, well-structured communications and realistic election and execution timelines experience fewer complications. Conversely, compressed timelines or poorly-structured communications can result in friction with LPs which may ultimately cause delays.

Pre-launch discussions with key LPs and the LPAC regarding the transaction rationale, alternatives considered, timing, pricing and reinvestment options can help ensure an orderly and informed process.

When managing the selling fund investor election process, providing investors with a detailed transaction memorandum and election pack is critical. These materials will typically include transaction information, an explanation of conflict-mitigation measures, key fund terms and documentation agreed with the lead investor, and the rational for pursuing a continuation vehicle rather than alternative liquidity options.

4. What are the key terms to consider from the outset?

The lead investor will negotiate the terms of the transaction on behalf of the CV and the wider investor group. Sponsors should still give thought to key terms early in process.

One key term is whether to offer reinvesting selling fund investors a status quo option with respect to economics. While investors are generally expected to participate on new terms, sponsors have increasingly offered status quo management fees to reinvesting investors. This aligns with the ILPA guidance and is therefore receiving greater scrutiny from selling fund LPACs.

For carried interest, all investors typically participate in the same arrangements, often through tiered profit structure with a number of return multiple and/or preferred return tests. This promotes alignment between sponsors and buyers and demonstrates sponsor conviction in the underlying asset.

On the transaction side, the allocation of costs and expenses among the sellside and the buyside is often a key negotiated point. Some costs clearly belong on one side or the other: CV establishment and lead investor costs are borne on the buyside by the CV, and election-process and other sellside process costs borne by the selling fund. Some costs however, are not so clearly apportioned, and the precise apportionment of those can become heavily negotiated. Having a clear idea of the broader transaction budget and the apportionment of costs is therefore an important consideration, particularly to the extent allocated to the sellside where those costs will usually impact the net proceeds available for reinvesting selling fund LPs.

5. How do you demonstrate sponsor alignment convincingly?

Secondaries investors have become increasingly sophisticated in assessing alignment and their expectations have risen. What once may have been considered a differentiator is now increasingly seen as a requirement. It is therefore important for sponsors to consider the level of GP commitment they may be expected to make and how that will be funded, particularly in light of their commitments to their other funds and products.

The baseline expectation of investors will be that all crystallised carried interest (allocable to the remaining team, if there have been leavers) should be reinvested into the CV. Some sponsors are now investing top-up capital in addition to full carry rollover, either directly or via a co-investment in the assets alongside the CV by their latest flagship fund, to demonstrate further alignment. Moreover, the level of sponsor commitment carries particular weight where a selling fund operates a European whole fund waterfall and if carry has not yet crystallised, as a meaningful sponsor commitment in a pre-carry situation will still be expected to demonstrate conviction in the asset.

Closing

Continuation funds are now an important and well-established part of the the private capital industry landscape, providing sponsors, investors and portfolio companies with a collaborative process and outcome with potential upside for all parties. As the secondary GP-led market continues to mature and become more sophisticated, engaging in early preparatory work and considering key questions such as these will help make a difference between processes which complete swiftly and successfully and those which experience more friction. Finally, as ILPA has recently released updated its guidance for continuation fund transactions, it is likely that what the market agrees constitutes ‘best practice’ will evolve over the coming 12-14 months.

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