KEYNOTE INTERVIEW

Opportunities abound in continuation funds

From early engagement to a focus on key terms, Debevoise & Plimpton partners Gavin Anderson and John Rife share their top tips for investors

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Q How early should LPs be engaging with managers on continuation fund opportunities?

Gavin Anderson: Our advice to LPs is that they should look to engage as early as possible in the process, ideally before there is even a continuation fund in the offing. It is important to ensure you are at the top of the list when GPs start calling around, as this will give you a greater ability to help shape the transaction.

We are also seeing situations where LPs are pre-empting broad-based processes by expressing a willingness to act quickly from the outset, as well as situations where LPs have instigated the continuation fund project.

John Rife: I would agree that being early is key. LPs should be engaging with sponsors regarding the exit expectations for each underlying investment. That will make it easier to identify which assets are likely to be most appropriate for a continuation vehicle while also giving the investor the opportunity to think about any further information they may require when it comes to deciding whether to stay with the asset or take liquidity.

Q How well do LPs need to know the underlying assets going into a continuation vehicle and how should they be approaching due diligence?

GA: That largely depends on what the portfolio looks like. There is a limit to how much granularity investors can achieve when it comes to a diversified multi-asset portfolio, but with a single-asset deal there is greater scope for more in-depth due diligence.

The other variable here is the nature of the investor themselves. Some secondaries buyers rely on alignment with the GP to a great extent, while still kicking the tyres on the assets to a lesser degree. At the other end of the spectrum, we see investors with more of an M&A mindset. These investors want to get into the weeds of a transaction, getting a full suite of reps and warranties, akin to what you might expect in a traditional M&A process. This is not to say that either approach is innately superior – it all depends on the institution's preferences.

Q How should LPs be thinking about the rationale for a continuation fund and how can they communicate with GPs on this issue?

GA: This is probably the most important question that investors need to consider, given that these are inherently conflicted transactions. The good news is that there are many valid reasons why a GP may wish to pursue a continuation vehicle. It could be that the asset needs more time to reach its full potential. It could be that it needs a capital injection and either that capital isn't available in the existing fund, or this option isn't desirable from a portfolio composition perspective.

Equally, it could be that the fund is nearing the end of its life, in which case investors are often very supportive of the GP going down the continuation vehicle route.

Q What are the conflicts of interest that LPs need to consider, and how can these best be mitigated?

GA: The fact that the GP is on both sides of the transaction is the obvious conflict with these deals, but there are additional subtleties to consider, such as whether particular individuals at the GP are cashing out or buying in. The good news is that there is a well-established playbook in terms of how to manage that primary conflict, starting with referral to the LPAC for approval.

There are also risk mitigants that can be baked into the transaction itself in terms of alignment, most notably the requirement for a significant GP commitment. This commitment is likely to be greater than that in the original fund, and if carry is being crystalised it is normal for some or all of that to be rolled into the continuation vehicle for the GP to demonstrate conviction.

In addition, there will generally be a robust price discovery process led by a financial adviser. We are also increasingly seeing the sale of a stake to a third party to generate an externally validated valuation. The final high-level conflict mitigant involves the fact that the legal documents are usually negotiated by the lead investor to a large extent, so while the GP is on both sides of the transaction, there are other people involved ensuring that conflicts are being managed effectively.

JR: Sometimes sponsors will seek broad conflict waivers at the very beginning of a process, before the LPAC can really form a view about the merits of the transaction and whether the sponsor has adequately navigated conflicts. Other sponsors will go to the LPAC extremely late in the process, requiring them to wade through hundreds of pages of materials and come to an almost immediate decision. Process management is important.

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>
> **JOHN RIFE**

Q What are some of the key transaction terms that LPs need to focus on?

GA: First of all, LPs will want to think about the economics. There is a great deal of variety in economic terms in a continuation fund when compared to the standard 20 percent carry with an eight percent hurdle and management fee of below two percent for most blind-pool funds. With continuation funds there may be complex, multi-tiered waterfalls, for example, and there can be a wide range of management fees as well.

There is also the question of whether all LPs are paying the same economics. Sometimes, rolling investors may have a different deal to new money investors, or lead investors may have a different deal to syndicate investors. That is important because it can impact alignment with the GP.

Finally, investors need to ensure they understand the protections that are in place, including key person and GP removal provisions.

Q What other advice would you offer investors that are involved in a potential continuation fund situation?

JR: I would add that new money investors are increasingly focusing on what happens to the assets that are being moved into the continuation vehicle at the end of its term. There are sometimes concerns that once the sponsor has done one continuation vehicle transaction they will want to keep going, looking to move the assets into another continuation vehicle when the first has run its course.

There is therefore a growing emphasis on dialogue towards the end of the continuation vehicle term about what the potential exit opportunities are, and how value can best be maximised for investors. ■