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A Guide to Continuation Funds

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When structured successfully, a fund continuation transaction can create benefits for all relevant parties. For GPs, the benefits in doing so are fairly obvious. A GP can retain stakes in a well-performing business that they are already familiar with, against a scarcity of new and attractive targets in a fiercely competitive market. Simultaneously, GPs can achieve an exit from an existing fund and feed this into its track record, and retain future upside as well (or at least re-align interests and introduce new incentives).

Depending on the deal structure, LPs have the opportunity to cash out or roll their stake (or a combination of the two). Existing LPs could take advantage of a liquidity opportunity and realise gains that to date may have only existed on-paper, or stay invested and seek further upside alongside a GP that it has an existing relationship with. Some LPs would like to monetize their interest, whereas others would prefer to continue to hold a longer-term investment.

New third-party investors will have the potential to generate quicker returns (as the transferred investment will be further along in its life cycle than a new investment) compared with traditional secondary deals, and can invest knowing additional capital is being contributed (whether by the GP, existing LPs increasing their commitments, or other new investors).

What are the key documentation considerations?

Fund continuation transactions can be complex, and close consideration of the legal documentation is critical. Important documentation and legal issues to consider include:

- The terms of the limited partnership agreement (**LPA**), including (i) any LP and/or LP Advisory Committee process and approval, (ii) any relevant succession fund provisions, and (iii) any investment/divestment restrictions.

- Any side letters with existing LPs should be reviewed, and GPs should be aware of LPs using the opportunity to renegotiate terms.

- The economic provisions of the new fund LPA would also need to be considered closely and structured carefully, possibly incorporating differing rates of carry and management fees for rolling assets compared to new assets, and detailed return mechanics. Undrawn commitments for new investments (including follow-ons), and whether these commitments are made by legacy LPs or new investors – and on what terms – would also need to be considered.

- The due diligence process and how detailed the parties expect the acquisition documents to be (e.g., with regard to contractual protections) will need to be understood.

- If the transaction involves both a continuation fund and new third party investors, typical governance and control rights between the parties will need to be considered, negotiated and documented.

What are the potential conflicts of interest? Is it truly a prized asset?

Conflicts of interest arise in fund continuation transactions as both existing fund (as seller) and the fund continuation vehicle (as buyer), while technically distinct clients for regulatory purposes are controlled by the same GP and likely to include some different LPs.

Such conflicts of interest manifest primarily during the price discovery process. Some LPs may have concerns regarding the GP's rationale: is the GP seeking to hold on to a great portfolio company or divest from a poorly performing portfolio company? Further complications may arise where portfolio companies of varying quality are being purchased. GPs have a number of options to manage an effective price discovery process including:

- *An institutional process* – A financial advisor could be engaged to manage a formal price discovery process and possibly solicit bids from the market. Existing fund LPs may argue that such advisor should be engaged to represent interests of the fund itself, as opposed to the GP, in an effort to obtain an independent assessment.

- *Ensure a robust disclosure* – GPs could seek to provide transparency regarding the price discovery process and any favorable economics being proposed. Subject to confidentiality and other obligations, disclosures should be symmetrical between existing LPs and investors.

- *Early engagement*– GPs should endeavor to involve the existing fund's LP Advisory Committee (and more broadly its LPs) as early as possible. GPs should also carefully consider the impact of fees, carry, transaction costs and dilution with respect to any LPs on "both sides of the deal" (i.e. those rolling their interest or a portion thereof).

Why do we believe this trend is likely to continue as an option?

The traditional model for GPs to exit a business and sell to either a strategic, another sponsor or the public markets is likely to remain standard market practice, however, fund continuation transactions will continue as an alternative option (even after the coronavirus pandemic subsides).

Such transactions, when structured effectively, offer positives for new third-party investors, existing LPs, as well as GPs. The key to a successful fund continuation transaction is early and ongoing engagement with LPs, supported by a formal transparent price discovery process, and future alignment both with LPs and new third-party investors.

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