C L I F F O R D
C H A N C E

"DECODING" THE SECONDARIES MARKET

PART IV: CONTINUATION FUNDS

SEPTEMBER 2020

‘DECODING’:
CONTINUATION FUNDS

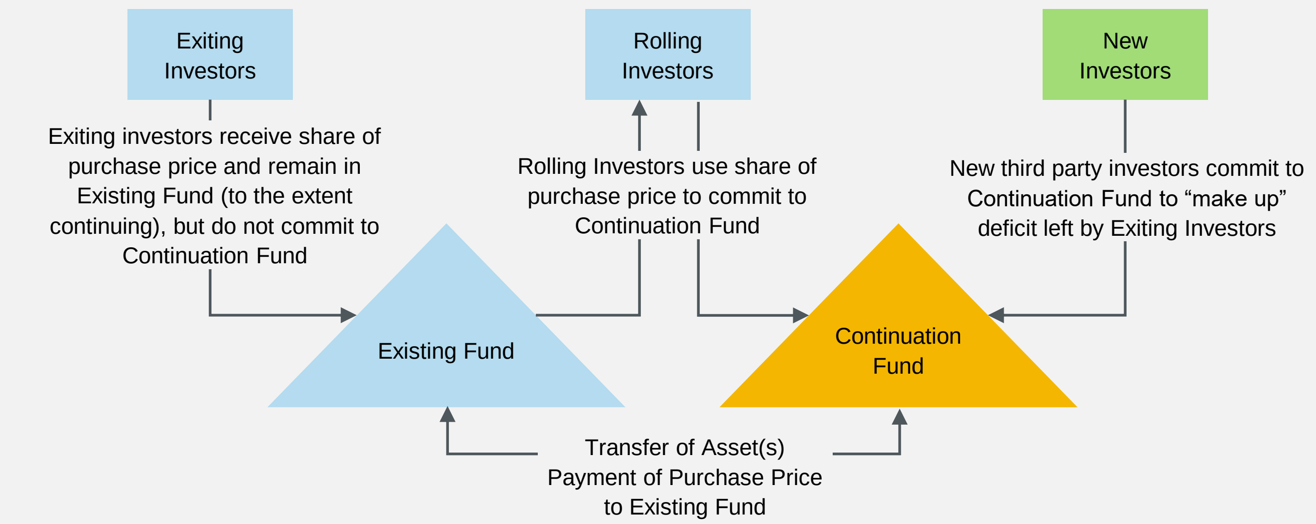
As a result of COVID-19 and the subsequent market impact, scheduled exit windows for portfolio assets may no longer be viable. As was the case in 2011-13, post the GFC, continuation funds can be a useful tool for GPs looking to extend hold periods for assets, where they are unable to be realised at optimum value in the short term and have potential for future upside.

As Part IV of Clifford Chance’s series on “Decoding” The Secondaries Market, we explore the key features of continuation funds, which extend hold periods for portfolio investments and provide LPs with liquidity.

What are Continuation Funds?

New fund vehicles set up to acquire one or more assets from the original fund and are continued to be managed, typically by the same GP/manager.

Typical Structuring:



Steps:

1 Cash-Out or Rollover:

Typically, investors in the Existing Fund are given the opportunity to “cash-out”, “rollover” or increase their stake into the new longer dated Continuation Fund.

Investors who choose to “cash out” will remain in the Existing Fund (to the extent continuing) but will not commit their share of the purchase price to the Continuation Fund.

The shortfall in the Continuation Fund left by the “Exiting Investors” will be met by Rolling Investors who want to increase their exposure to the transferring asset(s), as well as new “secondary” investors. Existing and Rolling Investors may also provide additional capital for follow-on or additional investments.

2 Single or Multiple Vehicles:

The type of vehicle used for the Continuation Fund will often follow that of the Existing Fund (subject to investor requirements, tax and regulatory considerations).

Either a single continuation fund holding multiple assets, or multiple continuation funds holding single assets, may be used. Considerations such as timing, cost, investor base, characteristics of asset(s) and flexibility to raise new capital will determine the optimum approach.

3 Transfer of Assets:

One or more asset(s) of the Existing Fund will be acquired by the Continuation Fund under a sale and purchase agreement.

SPA terms may include:

- Pricingadjustments for post-record date cashflows
- Ownership representations
- Holdbacks for Existing Funds/ Existing Investors

4 Valuation:

To determine the valuation of the asset(s), a vigorous approach is required to manage conflicts of interest.

Mechanisms for determining price (or indicative range) include:

- circulation of information memorandum and invitation of bids from the market;
- an independent expert determining fair market value or providing a fairness opinion;
- a book-building process derived from investors submitting prices and sizes of interests they are looking to acquire; and/or
- pegging the sale price to a minimum “reference price” determined by a third-party sale of an equivalent interest in the asset (where possible).

CONTINUATION FUNDS

Commercial objectives:

GP benefits

- Continue to manage investments.
- Extract future value/may fit better with optimum holding period for Investment.
- May benefit from ongoing fees and carried interest (depending on negotiating power, nature of fund, term of continuation fund – see below).
- Opportunity to obtain new capital/make new investments.

LP benefits

- Creates liquidity option for existing LPs.
- For rolling LPs, the continuation fund offers the opportunity to benefit from the upside of a second phase of value creation and retain exposure to one or more asset(s) – in peak markets these will generally be well-performing asset(s) with upside to holding for the longer term, whereas in a downturn there may also be assets needing a longer hold period.

New Money Investor benefits

- Fund structure can cater for needs of new investors.
- Know what the assets are.
- Many align well with proposed hold periods.
- Mature assets with potentially shorter hold periods.

Common Terms:

There is no "single-approach" to the terms of continuation funds. Terms will vary depending on factors such as the nature of the fund assets, fund term, investor base, investor bargaining power and appetite for sponsor economics.

Economic	
Provision	**Implementation**
Carried Interest	Deal Dependent – different mechanisms such as NAV based performance fee and carry reset can be put in place. Approach is generally dictated by the nature of the underlying asset(s) (e.g. yield based, capital appreciative) and the term of the continuation fund. Carry may in some strategies be less common in this context, particularly where the transfer to the continuation fund results in a carry event in the existing fund. In any case, unusual to see pure 80/20 carry splits in the first instance. May be tiered carry that begins from 10-15% rate for lower returns and increases to 15-20% for higher returns (with a catch-up or without it) after certain IRR and/or MOIC thresholds are met. May alternatively be replaced by a performance fee, particularly for longer term, yield-based funds.
Management Fees	Typically lower or budget-based. May have a performance element in place of carried interest (see above).
Term	Dependent on asset class. In private equity/special situations, term is often shorter than a typical primaries fund (5-7 years) but for infrastructure funds may be longer (15-35+). Recycling/ Re-investment/ Follow-on period is also typically short (e.g. 18-30 months).
Investor Liquidity Options	Linked to term (i.e. longer term requires more provision for liquidity), but typically more flexible transfer rights.
Follow-ons	Provisions generally more restrictive than in a blind-pool primaries fund.
Fees, costs and expenses	Paid from income, reserved or capital increase. If capital increase for costs, these will likely need to be identified and quantified upfront.
Reinvestment	Provisions generally more restrictive than in a blind-pool primaries fund in light of limited available capital.
Governance	
Provision	***Implementation***
Advisory Committee	Useful to form (made up of participating existing investors and new investors).
Key Person	Generally not negotiated where all assets pre-identified.
No fault removal	Often not included where assets all pre-identified. If included, generally longer lock-in period and higher compensation for removal than in primaries context.
Removal for cause	Similar to initial fund

Additional Capital Requirements:

As the "rollover mechanism" only relates to the acquisition cost of the rolled-over asset(s), GPs may require additional capital for follow-on investments or additional further investments. GPs may look to fulfil this capital requirement in one or more of the following ways:

Dry Powder:

requesting that "rolling" investors provide additional cash commitments to the continuation fund at the outset

Reinvestment:

including a provision in continuation fund documentation to permit scope for some reinvestment of proceeds

Capital Increase:

incorporating mechanism into continuation fund documentation for increasing investor commitments at the time of a relevant further expense.

CONTINUATION FUNDS
KEY LEGAL CONISDERATIONS

Conflicts of Interest

GPs should ensure that conflicts of interest inherent to the transaction can be appropriately and properly managed. Such conflicts can include: same sponsor for both existing fund and continuation fund leading to competing obligations to “sell high” and “buy low”; the sponsor benefits (ongoing fees etc.) arising from the continuation fund as opposed to an alternative sale option; the continuation fund economics, which are likely to affect the purchase price paid to selling investors; one or several investors acting as buyers. LPAC engagement will likely be a key point as well as the establishment of procedural protections. In some cases and jurisdictions, it may additionally be appropriate to bring the ultimate approval to the LPAC vote.

Management of Duties and Regulatory Obligations to Investors

Fair Treatment: GPs should ensure that processes are put in place so that interests of one group of investors (e.g. the selling investors) is not prioritised over another group of investors (e.g. the rolling investors).

Best Interests: it is important that GPs are able to demonstrate that full and rigorous consideration has been given to all other available sale options prior to committing to the proposed transaction. This is to ensure that the transaction is genuinely in the best interests of the existing fund and its investors.

Regulatory Obligations: the manager must be able to comply with any regulatory obligations (e.g. “treating customers fairly”, TCF) in effecting the transaction. For example, consideration should be given as to how participation in the continuation fund will be offered.

Tax Considerations

Different tax issues can arise depending on the structure adopted and the type of underlying asset(s). Rolling LPs (and the fund management team) in a continuation fund structure will be keen to ensure efficient tax roll-over treatment where possible. Similarly, New Investors (and any new members of the fund management team) will want to ensure that they are not acquiring a built-in taxable gain. Fund-level costs may need to be shared between Exiting and Rolling Investors. It will be necessary to consider how this can be dealt with under the existing fund documents. The impact on tax structuring of portfolio companies’ holding structure will also need to be analysed to ensure investment proceeds can continue to be repatriated tax efficiently.

Fund-Level Contractual Considerations

The existing fund’s documentation should be reviewed to determine whether any level of investor/LPAC review is mandated with respect to the transaction (e.g. conflicts of interest, related party clauses), and the documentation of other funds managed by the sponsor should be considered with a view to whether any Successor Fund or Allocation provisions may apply to restrict the establishment and/or operation of a continuation fund.

Transaction-Level Contractual Considerations

Pre-emption or counterparty consent rights might limit the ability to transfer the asset(s) to a continuation fund (or require the continuation fund to take a particular form to avoid triggering them).

If there are *tag-along rights* in the underlying deal documentation, either a waiver of these should be obtained in advance or the continuation fund should be flexible enough to acquire these extra interests if required.

Where *investors have co-invested alongside the existing fund* into the asset(s) to be transferred, GPs should ensure the effect of a disposition is considered and catered for. For example, does the co-investment share also have to be transferred and/or are consent rights triggered?

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