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Continuations Funds in the European Union—Market Practice and Transaction Dynamics

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Although the "continuation fund" concept is not new, this type of fund transaction has been more widely applied in the European Union only in recent years. This growth can be explained by the difficult economic environment of the recent period, which often prevented a traditional sale or initial public offering (IPO) of portfolio companies. The use by US private equity sponsors and the wide acceptance of continuation deals in the US market, triggered increased awareness of this type of transaction also for European private equity players.

A continuation fund continues the business of an existing investment fund, by acquiring (certain) portfolio companies of the first fund. Both funds are managed by the same fund manager. This sets this type of transaction apart from a regular private sale whereby a portfolio company is sold to a private third-party buyer.

As the fund manager acts on behalf of both the buying and the selling fund there is a natural conflict of interest. In addition, the fund manager, but often also one or more of the investors, have their own private interests in concluding the transaction. Because of these conflicts of interest, it is important to carefully prepare and execute a continuation fund transaction. If the conflicts of interest are not adequately managed and mitigated, the required backing from investors may not be obtained and the transaction would be at risk.

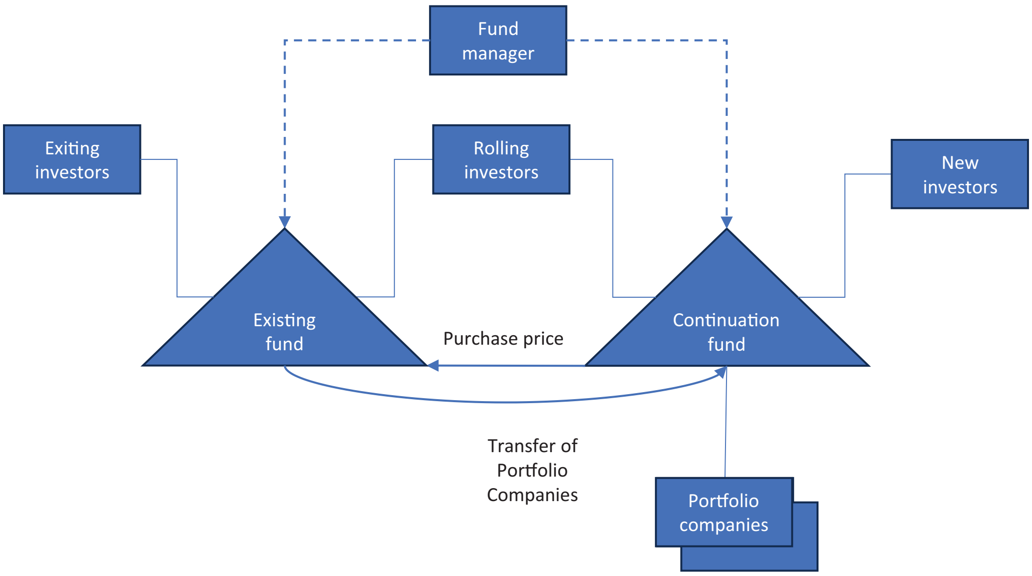
Given its increased popularity in the European Union and the complexity of continuation fund transactions, this article provides some practical general guidance on how to successfully complete this type of transaction within the European Union.

A Closer Look at the Continuation Fund Structure

The Continuation Fund Structure

The continuation fund finances the purchase price of the portfolio companies through capital contributions from its investors and, where appropriate, partly with a loan. The investors in a continuation fund generally are a combination of new investors and investors in the selling fund who want to remain invested in the underlying portfolio companies. The ability of an investor in the selling investment fund to participate in the new continuation fund is called the reinvestment option or roll option. Exhibit 1 outlines the transaction structure.

Exhibit 1



Drivers for a Continuation Fund Structure

The underlying reasons for the emergence of the continuation fund structure in the European Union mainly lies in the combination of the imperfections of the closed-ended fund model, a challenging exit climate and investors pushing for liquidity.

The illiquid nature of private equity investments drives the closed-ended nature of the fund. As private equity investments are illiquid (unlike for example, listed securities) investors cannot enforce cash redemptions during the fund's lifetime, as they can in an open-ended fund. The closed-ended nature avoids liquidity mismatches, but investors require liquidity at some point. A closed-ended fund therefore has a limited term of about 10 years. After 10 years all remaining portfolio companies must be realized and cash must be returned to investors, even if market conditions are unfavorable.

To avoid a forced sale in an unfavorable market, nowadays it is the rule rather than the exception that at the end of the fund's term investors are faced with a request to extend the fund's life. In such a situation there is not much to choose for investors as other options such as getting the portfolio companies distributed in-kind or selling the portfolio companies under pressure are unattractive. An extension of the term does however not generate liquidity for the investors, instead their cash is locked-up even longer than expected. Especially in the current climate, investors require liquidity as they may be over-allocated to specific strategies and must rebalance their exposure.

The traditional way for a fund manager to offer liquidity to investors in a closed-ended-fund is to organize a "GP-led secondary." Such transactions usually occur at the end of the fund's term. In its most basic form, a GP-led secondary has the form of a tender transaction organized by the fund manager in which the fund interest and any remaining commitments of investors who wish to exit are offered to the remaining incumbent investors or to new investors. If the investor takes the lead on the sale of its interest in the fund, the transaction is referred to as an LP-led secondary. A GP-led or LP-led secondary generates liquidity, but does not, in its simplest form, tackle the concerns on the fund's limited term and the potential need for a forced sale.

A continuation fund may resolve all three concerns. The fund manager continues to manage the same portfolio companies, despite the lapse of the

10 year period of the existing fund, through the continuation fund. Investors in the selling fund have the choice to either exit (and subsequently rebalance), or to remain invested in the underlying portfolio companies by participating in the continuation fund. The portfolio companies, but also the investors who remain invested, benefit from the continued relation between the portfolio companies and the fund manager. The fund manager can preserve the management fee on those portfolio investments as well as the possibility of a new carried interest fee if the continuation fund eventually successfully sells the portfolio investments. The major difference between a classic GP-led and LP-led secondary and a continuation fund is that the interests in the investment fund itself are not sold, but the interests in the portfolio companies are.

Continuation funds are not only driven by "end of term" concerns, but also designed to host "trophy-assets." A specific promising portfolio company that requires more capital and an extended investment horizon may no longer be hosting the selling fund as it would lead to an imbalance with regard to concentration limits and/or investment horizon. By transferring such an investment to a continuation fund, the fund manager secures continued control over the direction of the portfolio investment(s) in question and the value development that may accompany it.

While an end of term continuation fund is more driven by the sluggish exit market, a trophy continuation fund is more driven by the preference to keep the asset as it is expected to outpace the market.

Guidelines for Setting Up Continuation Funds

Continuation fund transactions are not governed by a clear EU legal framework. Despite several regulators being familiar with the complexity of continuation fund transactions, no specific guidelines have been issued by ESMA (the European Securities and Markets Authority) or by national regulators such as the CSSF in Luxembourg or the AFM in the Netherlands. In Europe there is also no soft law guidance on this topic. The European private equity investor organization Invest Europe—The Voice of Private Capital (Invest Europe), has not formulated any specific guidance on continuation fund transactions nor has, as far as we could establish, any other local investor industry body in the European Union. In this type of transaction, fund managers can therefore only rely on the general rules dealing with conflicts of interest and guidelines from the private equity industry itself. If the fund manager is authorized under the Alternative Investment Fund Managers Directive, which is usually the case if the existing and continuation funds are European Union-based, it will have conflict of interest management procedures in place which should provide for an infrastructure that can identify, mitigate, and when necessary, disclose these conflicts.

In April 2023 the Institutional Limited Partners Association (ILPA) published a guideline called "Continuation Funds—Considerations for Limited Partners and General Partners," in follow up of less specific guidelines "GP-led Secondary Fund Restructurings—Considerations for Limited and General Partners," published by ILPA in 2019. This latest guideline specifically addresses the issues surrounding continuation funds. In the introduction to this guideline, ILPA cites "growing investor frustration around these transactions" as a main reason for its publication.

In its guideline, ILPA formulates "best practices" in shaping continuation fund transactions for both the fund manager and investors with the aim of achieving a prudent process in which investors' interests are adequately safeguarded. For example, ILPA's guidance addresses how investors should be involved in the process and what information they should be provided with. ILPA also provides guidance on the position and rights investors should have in such a transaction. In doing so, ILPA distinguishes between the position and rights of investors in the selling fund who do not participate in the continuation fund and those who do (so-called rolling investors).

One of ILPA's best practices is to give all investors in the selling fund a so-called status quo option. This is the possibility for an investor to participate in the continuation fund for its *pro rata* share without changing the economic conditions. An investor in the selling fund may therefore not be diluted against its will or required to commit additional capital to the continuation fund. This also implies that, in respect of those investors, there should be no change in the attributable *management fee* (both in percentage and absolute terms) and their economic position should remain the same in other respects as well. Existing investors should therefore have the option to participate in the continuation fund without "settling" with the fund manager. To the extent that the fund manager is entitled to carried interest based on the transaction price, this will not be payable in respect of such "rolling investors." In the transactions we have been involved in we have not yet seen such a pure status quo option.

In its guidelines ILPA also provides some best practices with respect to the position of the fund manager. For instance, ILPA states that the fund manager should reinvest all carried interest received from the selling fund (that is, in respect of investors that do not roll over to the continuation fund) in the continuation fund. The latter is in addition to the reinvestment of proceeds received by the management team from the selling fund by virtue of its GP/team commitment.

Finally, ILPA focuses on the role of the adviser (usually an investment bank) involved in the continuation fund transaction. Issues discussed include the selection process, cost allocation, and the possibility for investors to obtain information from the adviser regarding the progress of the transaction.

All in all, ILPA's best practices aim to ensure transparency and investor involvement in the process so that investors are comfortable with the logic and outcome of the transaction. These principles also form key guidance for European investors. Their importance is underscored by the fact that in the most elaborate publication by Invest Europe on continuation funds frequent reference is made to these ILPA guidelines. Below, we will outline how this can be further shaped in practice.

Practical Guidance on Key Transactional Aspects

A continuation fund transaction is complex and roughly consists of three components: (1) the preparation, (2) the fundraising component, and (3) the M&A component.

The Preparation Component

The legal preparation of a continuation fund transaction often starts with a review of the fund documentation. Topics that require attention include conflict of interest provisions, approval requirements, key person provisions, deal flow allocation, and exclusivity provisions. In addition to the documentation of the selling fund, the fund documentation of other funds managed by the same fund manager also may be relevant. Indeed, the documentation of other funds may not allow the fund manager to manage such a new fund or certain persons (key persons) may not be free to devote management time to managing such a fund.

Nowadays fund managers often try to include preclearance for continuation fund transactions in the documentation for their new funds. Investors however are wary about these provisions and often push back. Detailed analysis of the legal framework and consent requirements therefore will remain an important preparational aspect.

The preparatory steps should also include careful consideration on the logic and justification for the transaction. A continuation fund transaction is relatively expensive and complex. It is therefore important to keep in mind less complex alternatives, such as an extension of the fund term. If a continuation fund transaction fails, the costs usually will fall on the selling fund as a broken deal cost. The fund manager must therefore be able to explain to investors why this type of transaction is preferable despite its cost and complexity.

Once the legal framework and justification for the transaction have been established, (a body of) investors should be involved. If there is a transaction in which the fund manager has a conflict of interest, which is the case with a continuation fund, the fund documentation usually requires such a transaction to be approved by the *investor advisory committee.* In a specific case of a continuation fund a broader investment approval may be required. Partly for this reason, process management is very important.

Early, open, and transparent communication is essential for assuring information symmetry and preventing investors from feeling passed over. In our experience, it is therefore preferred to provide a transaction memorandum to all investors in the selling fund and not just the members of the investor advisory committee. This memorandum contains a description of the background and logic of the continuation fund transaction. Other topics that may be covered include the proposed transaction structure, design of the bidding process, highlights of the portfolio of assets being acquired, and aspects such as proposed timing, key fund terms, and the reinvestment opportunity. A transaction memorandum, in adapted form, can also be used for fundraising purposes.

A continuation fund transaction usually involves an investment bank as advisor. Investors in the selling fund may have concerns about the independence, role, and cost of such an adviser as the advisor is selected by the fund manager and may lean towards the fund manager's interests. Whereas the Securities Exchange Commission (SEC) requires disclosure of the business relationships between the advisor and the fund manager in the past two years; no such disclosure requirement is promulgated by European regulators. As to the cost aspect we almost exclusively see advisors working on a success fee basis. Limiting possible broken deal costs helps to justify an exit through a continuation fund as compared to a less complex and costly third-party sale. To get investors comfortable on the process, it is recommended to involve the *investor advisory committee* in appointing the advisor and setting the terms, including the fee arrangement.

The Fund Raising Component

In a continuation fund transaction, setting the transaction price is a crucial element. After all, parties will only participate in the transaction if they are convinced that the transaction price corresponds to the fair market value of the portfolio companies to be transferred. This applies both to the investors in the existing fund, who must approve the transaction because of the fund manager's inherent conflict of interest, and to the new joining investors in the continuation fund. For this reason, the transaction price should be determined objectively and under market conditions.

There are roughly two ways to achieve objective pricing. First, prior to a continuation fund transaction, it may be possible to sell a significant minority stake of the portfolio companies to a third party. In that case, that transaction will serve as a "marker" for the price and other terms on which the sale to the continuation fund takes place. However, often such a sale is not realistic as most buyers prefer to control the portfolio companies, rather than owning a minority stake. For the fund manager this type of transaction also has a clear downside. The minority stake, once sold, is no longer under its management which means losing some control and possible further upside.

Another more common way to arrive at an objective price determination is by conducting a competitive bidding process (controlled auction) for an interest in the continuation fund. Both new parties and existing investors can participate in the bidding process. This bidding process is normally arranged by the adviser. If there has been no recent arm's-length transaction in respect of the portfolio companies, bidders have to form their own views on the value of those companies. Obviously, not every investor has the capability, or wants to do such an analysis. We therefore see several specialized secondary investors operating in the EU market, that often take the lead in these transactions. The lead bidder is usually willing to buy all, or at least a large (minimum) part of the interests in the continuation fund. The lead bidder may underwrite the entire transaction.

The price offered by bidders is set as a percentage mark-up or mark-down relative to the portfolio's NAV as determined by the fund manager, whether in consultation with the adviser or not. Sometimes a continuation fund transaction is preceded by an unsuccessful sale process of the portfolio companies. In such case, the bids made in that process may help to value the portfolio.

As noted earlier, the investors in the selling fund normally have the option to reinvest equal to their *pro rata* share in the existing fund. The fund manager usually has a pretty good idea which investors want to roll or exit. However, whether investors actually decide to waive their right to reinvest depends largely on the price at which a transaction takes place. Indeed, at a relatively low price, incumbent investors are more likely not to exit and thus reinvest. There is therefore no deal certainty for bidders while they must incur costs as part of the transaction, for instance in conducting due diligence. For this reason, the lead investor often negotiates an allocation preference for available interests in the continuation fund so that the winning bidder has more deal certainty. Only in one case have we seen that investors were not given the option to reinvest in the continuation fund for their entire *pro rata* share. This is to ensure at least a minimum allocation in the continuation fund for the lead investor.

In the bidding process, bidders set not only the price at which they want to do a transaction, but also the continuation fund's terms such as the amount of the management fee paid by the continuation fund, the carried interest structure and the amount of the investment by the fund manager and the team. Because the interests of the fund manager and the investors diverge on these points, and because the level of the fund manager's remuneration package co-determines the level of the transaction price offered (after all, these are mutually dependent up to a certain level), it is good practice to select the winning bid on the basis of the tied price, and not on the basis of the other transaction terms (price before terms). Only if the terms are not commercially acceptable to the fund manager, the winning price bid will be rejected. To ensure a transparent bidding process a key ILPA best practice is that the bids and the terms contained therein are shared with investors or the investor advisory committee.

Despite all the above safeguards to come to a fair price, there may still be insufficient certainty about the pricing. This may be the case, for example, if there are only a limited number of bidders. In such a situation, a fairness opinion on the transaction value from an independent financial adviser can be helpful. Unlike in the United States, these fairness opinions are not mandatory in the European Union and are, in our experience, only used sporadically.

The M&A Component

In preparation of the acquisition process the first step is a transferability analysis by the selling fund with respect to the underlying portfolio companies. Any contractual or regulatory approval requirements should be identified as early as possible in the process. Another point that needs to be assessed early on is whether the transfer of the portfolio companies to the continuation fund triggers a pay-out to the managers of such companies under their management incentive plans. To assure a smooth transaction the rights and expectations of the stakeholders at portfolio company level also need to be well managed.

In order to facilitate the bidding process the selling fund may perform vendor due diligence. That allows bidders to limit their due diligence efforts and enable them to make a binding offer without too much cost. The cost aspect is particularly important for bidders because, as mentioned earlier, due to the re-investment option there is no deal certainty yet. Another advantage of a vendor due diligence report is that it is helpful in taking out warranties and indemnities insurance (W&I insurance), which will be discussed further below.

The scope and focus of the due diligence depend on the type of asset that is the subject of the continuation fund transaction. In the case of a single-asset continuation fund, we often see parties approaching the transaction as an ordinary purchase with an associated fairly extensive due diligence process. If a broader portfolio of companies is involved, the bidders' diligence process is usually much more limited and primarily looks at the financials of the portfolio companies.

As the transaction should as much as possible be at arm's length, the purchase agreement will be drafted based on market standard provisions without a seller's or buyer's bias. In short, the transaction will be "neutrally" framed with standard terms and warranties. The lead investor takes the role of the buyer and, supported by its own legal counsel, comments on and negotiates the purchase agreement on behalf of the continuation fund and its investors. In fact, the lead investor acts as the counterparty of the fund manager acting for the selling fund. The role of the lead investor is important for the arm's length nature of the transaction and therefore also benefits the other investors in the continuation fund.

Obviously, a breach of the warranties or indemnities in the purchase agreement quickly puts the fund manager, as representative of the continuation fund and the selling fund, in a difficult position. In order to avoid the continuation fund, as buyer, having to claim damages from the selling fund in case of a breach of the warranties or indemnities under the purchase agreement, the risks and liabilities under the purchase agreement are insured as much as possible.

Taking out W&I insurance is common and there is a wide market in the European Union with providers for this type of insurance on quite flexible terms. Having sound W&I Insurance is also attractive to the investors in the selling fund because, with such insurance in place, the selling fund can pay out the purchase price directly and unconditionally to its exiting investors.

The Usual Terms of the Continuation Fund

The terms of a continuation fund generally are lighter than for a blind pool private equity fund as the fund's portfolio companies are known on day one. For this reason, there are no deal-flow allocation or exclusivity provisions and many of the other provisions such as those on investment policy can also be quite brief. The term of a continuation fund is usually around six years instead of 10 years for a regular private equity fund.

The financial conditions of a continuation fund also differ from what is usual for a standard private equity fund. Especially for rolling investors it is good practice that the management fee in absolute terms may not (significantly) increase. Therefore, the percentage management fee in a continuation fund is generally a lot lower than in the selling fund. The percentage management fee is calculated over the capital invested by the fund. As portfolio companies (particularly trophy assets) are transferred to the continuation fund at a significantly higher value than their acquisition costs, the lower percentage will quickly be balanced out by a higher calculation base.

If a continuation fund is established to take over the assets of a fund whose maturity has expired, the fund manager usually will have to settle for a lower management fee. Nevertheless, this is often still better than the situation where the existing fund is further extended as in such case investors usually also force a reduction in the management fee.

The profit-sharing structure between the investors and the fund manager also differs from what is common (80 percent for the LPs/20 percent for the fund manager) in a standard private equity fund. It is common to have a multi-tiered carry arrangement. It usually starts well below 20 percent while the highest profit percentage is well above 20 percent.

The hurdle is usually higher than in the selling fund and well above 8 percent. The relatively high hurdle and the multi-tiered ascending profit distribution of the continuation fund aim to mitigate the effect of the double carry (the carried interest paid by the selling fund and the future carried interest earned from the continuation fund), especially for the benefit of investors that roll over. Only if the continuation fund performs really well does the fund manager receive a substantial carried interest.

It is common for the fund manager to make a substantial team-invest commitment. This is because of the "put your money where your mouth is" argument, which plays even stronger in a continuation fund than in a regular fund because the continuation fund transaction is pitched with the promises of a second successful exit. Besides reinvesting all or a substantial part of the fund manager's team commitment proceeds from the selling fund, the fund manager is expected to reinvest some, or sometimes all, carried interest realized from the selling fund into the continuation fund.

Transparency of the Bidding Process, Accommodating the Closing

During the bidding process, the fund manager should keep investors and members of the selling fund's investor advisory committee informed on the progress of the bids. ILPA requires that investors should have access to the same information regarding the portfolio made available to the bidders. This information symmetry is important as it allows existing investors to form a proper view of the portfolio.

To enable investors in the selling fund to study the terms of the winning bid and the other information regarding the continuation fund transaction, such information should be made available to them well before the closing. In its guidelines, ILPA recommends a period of at least 30 days. In practice, the moment a transaction is in sight, the fund manager will provide the investors in the selling fund with the final terms. This is usually done through an "election pack" containing the pricing of the transaction, the final fund terms of the continuation fund and the option to reinvest or exit.

Even the 30-day period advocated by ILPA proves challenging for some investors. Certain institutional investors have long internal decision-making processes and appear unable to get timely approval from their internal investment committee for a reinvestment. For investors with smaller teams this timeline appears to be too tight as they lack the resources to assess the transaction. To avoid irritation among investors it is key to deliver the information early and in an accessible format. Adhering to these principles accommodates a smoother closing process.

Conclusion

Continuation fund transactions are an answer to the sluggish exit market, the push for liquidity and the limited term of the usual private equity funds. Following the trend in the United States, continuation funds have been widely used within the European Union in recent years. Due to the inherent conflicts of interest and complexity of continuation fund transactions, the fund manager needs to design the process carefully. By being transparent and involving investors early in the process, as well as by setting up a careful process around pricing and bidding, many of the concerns regarding a continuation fund can be mitigated.

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