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FUND GOVERNANCE

How Good Governance Frameworks Can Optimize Outcomes in Continuation Funds

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The expansion of the secondary market has occurred alongside increased fundraising velocity and greater aggregate capital raises by fund managers. For example, McKinsey & Company reported that private fund managers raised $850 billion in 2020, while Forbes found that the global secondaries market exceeded $71 billion that same year.

The continued growth of the secondary market evidences a shift away from the initial stigma associated with secondaries. Both sponsors and investors have recognized that the secondary market may facilitate an expanding set of solutions for market participants, including through negotiated continuation funds (CFs). Although the efficiency and functionality of the market will continue to depend on trust and careful process management, it also stands to benefit from a range of good governance norms that can help transactions close efficiently and deliver favorable outcomes.

This article reviews the different roles that may be played by transparency, reporting, governance and trust at different phases of the CF process, as well as the distinct parts that those sponsor-investor relationship drivers may play during the design and launch phases of CFs.

See "Latest on Key Terms, Structuring Approaches and Trends in Secondary Transactions and Co-Investments (Part One of Two)" (Jan. 11, 2022).

Overview of the Secondary Market and Continuation Funds

There has been significant stability over the last two decades of many fund terms that impact a fund's ability to complete the full investment, hold and divestment cycle, such as the lengths of investment and disposition periods. The rigidities inherent in many fund structures are now viewed as opportunities that may be capitalized on, particularly in the later years of a fund's life. Further, large LP investment pools increasingly seek to directly hold investments, including in large-scale infrastructure assets.

In those contexts, secondaries and CFs are increasingly regarded as logical calibration tools with broad applications. The transactions can also offer investors and sponsors the benefits that drive formation of permanent capital vehicles for illiquid asset strategies. Specifically, CFs can allow a more suitable match between capital and assets when crucial information on end-of-life asset profiles and updated preferences of investors are discernable. In addition, CFs and secondaries may offer investors opportunities to distinguish de-risking benefits from cash and liquidity benefits. That may be accomplished through "strip" or "pref" transactions that deconstruct and isolate aspects of investor risk exposure, as compared to the bundled exposure profile of typical fund arrangements.

See "Current Trends in the PE Secondary Market and Key Differences Between Europe and the U.S." (Oct. 22, 2019).

As there is limited appetite in the marketplace for funds to include detailed prescriptions for CFs and other end-of-life solutions, CF formation practices are largely dictated by market relationship norms and ultimately also by negotiations, rather than pre-agreed frameworks. As a result, designing, launching and closing CFs can require different roles for transparency, reporting, governance and trust, as investors and sponsors take stock of their objectives with the benefit of crucial end-of-life information. Often, no mandatory, comprehensive contractual framework governs interactions or outcomes.

From Concept to Closing

Across the arc of the CF launch process, there are several considerations for sponsors to weigh, and opportunities for thoughtful solutions, to ensure that a CF launch be successful.

Pre-Launch Considerations

Sponsor-Investor Relationship

The process and negotiations leading to the formation of CFs are in many ways derivative of the sponsor-investor relationships of the preceding fund (Original Fund) that holds assets targeted for continued ownership through a CF (CF Assets). Parties generally only discuss forming a CF when the sponsor of the Original Fund has delivered on many investor expectations and the primary remaining uncertainty is the valuation and future prospects of one or more portfolio investments of the Original Fund.

Notably, a broad range of conventional arrangements may govern the sponsor-investor relationships of an Original Fund. For example, some sponsors may pursue and achieve relatively high levels of transparency that exceed formal reporting and information sharing, even if that poses certain risks. Other sponsors may prefer a more formal approach, however, and deliver customary reporting without much additional transparency. Although both approaches can generate different forms of trust and serve as suitable backdrops for CF negotiations, a CF process may need to depart from some Original Fund practices to be most effective.

See "Improved Technology, Transparency and Agility Are Among PE Priorities in 2021 and Beyond" (Mar. 2, 2021).

Fund Governance and Structure

Despite Original Fund documents often lacking any prescriptions that detail CF formation, the operation of the regular day-to-day governance bodies of the Original Fund (*e.g.*, its LP advisory committee (LPAC)) are critical background to the design and launch of CFs. For example, the Original Fund LPAC may have been tasked with various responsibilities, including:

- approving valuations;
- confirming valuation agent services;

- consenting to conflicted transactions or related-party transactions (with or without valuations); and
- considering other matters that directly or indirectly bear on LPs' expectations.

In addition, the engagement and roles of larger and smaller LPs in Original Fund governance can also shape options when designing and negotiating CFs. For example, even if the Original Funds' LPACs have the ability to bind all LPs, sponsors may instead choose to solicit all LPs – in lieu of recourse to an LPAC – for a variety of reasons during the life of an Original Fund.

Further, the interaction among governance bodies and investors in Original Funds with more complex structures may significantly influence the dynamics between larger investors best positioned to benefit from the extended holding periods achieved by CFs, and other investors with more traditional hold horizons. For example, an Original Fund structure with multiple vehicles may have more than one LPAC, and those bodies may meet separately and not report out deliberations to all investors. Those types of arrangements can change the potential for reliance or follow-on dynamics among LPs that may be critical to designing a CF launch.

See "LPAC by Design: Six Recommendations for GPs to Define LPAC Features During Fund Formation" (Feb. 25, 2020).

Information Sharing

Transparency by sponsors can be important for ensuring LPs understand the sponsors' incentives. CFs may be employed across a range of situations in which the sale or continued ownership of CF Assets may satisfy the preferred return or other fund waterfall performance thresholds. Historical transparency during the life of the Original Fund can help sponsors and LPs navigate some of the more complex issues that underlie those incentives and can also impact CF Asset valuations, including treatment of contingent liabilities in valuations.

Design of the CF Launch

The design of an optimal CF launch process is, inevitably, highly dependent on facts and circumstances. Sponsors may, as a result, consider grounding the logic of the CF offering in core factors, such as:

- the investment thesis of the CF Assets;
- the stage of waterfall of the Original Fund;
- the preferences of Original Fund LPs as to asset holding terms; and
- broader objectives, such as the sponsor's assets under management (AUM) growth objectives.

Asset Composition

Original Fund assets may become CF Assets for many disparate reasons, and the design of the CF process and the CF's terms may become more complex if different types of assets with different inclusion rationales are slated to be CF Assets, such as:

- *"Trophy" Assets*: assets that can have immediate LP appeal and be perceived as safe-haven assets;
- *Mid J-Curve Assets*: classic CF assets that require little change in the fundamental buy-and-hold strategy, but have a holding period that is longer than originally expected; and

- *Post-Development, De-Risked Assets*: assets that may have a lower internal rate of return (IRR) but are in the steady cash flow stage.

Sponsors may therefore seek to gauge the interest levels of the Original Fund LPs based on the sponsor's knowledge and understanding of each LP's different priorities and objectives, such as long-term IRR; stable, long-term cash flows; and short-term cash events that may come at the price of premature exit risk.

Carried Interest Entitlements

CF sponsors also pay attention to the status of carried interest entitlements under the Original Fund waterfall and the potential impact of a CF. Although deal-by-deal waterfalls isolate the performance analysis, the broader picture captured by both American and European waterfalls means that a CF holding only a single asset could impact carried interest entitlements under the Original Fund documents.

In addition, the transfer of the CF Asset(s) to the CF could result in carried interest being distributable to the sponsor. In that context, it is important to note that if certain Original Fund LPs are "rolling over" their investments, a portion of the carry otherwise distributable to the sponsor may only be available "in kind" as CF interests. Therefore, sponsors typically design CFs to accommodate sound sponsor-investor alignment in light of the carried interest consequences of the CF.

See "Investors Demand Variations to PE Management Fees and Distribution Waterfalls (Part One of Two)" (Apr. 16, 2019).

Investor Preferences

Other potentially important sensitivities (*e.g.*, the role of key investors in growing the sponsor's AUM) make CF design not only fact dependent, but also point to a role for informal initial investor outreach to allow sponsors to test certain options and clarify investor objectives. Sponsor patterns of governance, trust and transparency applicable to the Original Fund should, equally, be factored into planning and be carefully considered.

CF Launch Execution

Although well-designed CFs can vary considerably, they often share a number of key process elements for launching, offering and closing CFs, including:

- initial outreach by the sponsor to the LPAC of the Original Fund;
- the preparation and distribution of materials soliciting response to, or an indication of interest for, an investment in the CF;
- valuation comfort from recognized third-party sources (*e.g.*, valuation agents) or processes (*e.g.*, auction processes for certain types of assets that are sequenced to support the CF thesis);
- Q&A and diligence opportunities at the asset level;
- careful consideration of including non-Original Fund LPs within the process; and planned inclusion of LP feedback in the strategy to support an iterative process and that can accommodate inputs from LPs.

In certain cases, the launch-to-closing phase may – temporarily or over the long term – also involve notable departures from sponsor-investor practices that apply during the term of the Original Fund. Further, tailoring the CF launch and closing process to suit the particularities of the sponsor's strategy for leveraging underlying trust and communication patterns with LPs can also help address existing or potential stress points.

To manage risk, sponsors often invest considerable time in defining and planning the CF launch, including attention to the following process features that can be of particular importance for trust, suitable information flows and decision making.

Outreach to LPs Before a Formal Proposal

A common first step in the formal CF process is for the sponsor to present the Original Fund LPAC with a proposal for the CF transaction. Sometimes, that step follows a gradual crystallization of shared views by the sponsor and LPs of their common interest in extending the holding period of all or certain Original Fund assets, and in other cases, the sponsor may be charting some new territory.

See "The Dos and Don'ts of Investor Calls That Investment Managers Must Consider" (Jun. 16, 2020).

Although a CF sponsor may have used one-on-one LP discussions over the years to test, and perhaps lay the foundations for, the logic served by a CF offering, it may still be important to consider how a proposal will sit within patterns of consent solicitation; the LPAC's role in valuations for related-party transactions; and the Original Fund's history of disclosure and transparency. For example, early outreach to LPs can be crucial for discerning and managing tensions between longer-term hold tolerances and direct ownership objectives of some larger LPs, on one hand, and the cash exit goals of other LPs, on the other.

As part of preliminary outreach to potential lead investors, sponsors may consider the benefits for larger LPs of growing their relationship with the sponsor through a CF. That may require more careful exploration of CF design choices that would appeal to select LPs, such as club-structure governance and LP right-of-first-offer prerogatives. After a CF proposal is finalized, careful attention should be paid to ensuring the disclosure to prospective investors is adequate, including detailed coverage of structure, terms, valuation and other material matters.

Third-Party Sale Processes

In a range of important instances, a third-party sale process (*e.g.*, an auction) may not sit comfortably with a CF process even if thoughtfully sequenced. For example, the auction processes for some large, bespoke asset groupings may not be expected to generate a statistically relevant market response capable of informing the choices of prospective investors in a CF. Further, the CF transaction may, for related reasons, be properly regarded as itself a "market making" event that cannot be readily evaluated by reference to third-party benchmarks.

In other cases, a market process may make sense based on the sequencing of the process. Sequencing decisions can implicate a related process-decision point: what is the sponsor planning to say about next steps if there is insufficient LP adoption of the attempted CF process?

See our three-part series on independent valuation firms: "As Scrutiny of Valuations

Grows Throughout the Industry, so Does Their Importance" (Sep. 29, 2020); "Rising Prominence of Third-Party Valuations and Factors to Consider When Engaging a Firm" (Oct. 6, 2020); and "Tips for Overseeing the Process and Resolving Disputes Over Conflicting Valuations" (Oct. 13, 2020).

Carry Profile Communications

After Original Fund carried interest implications are analyzed, a sponsor should still consider how to communicate the CF alignment thesis and the impact of the CF transaction on the crystallization of carried interest entitlements under the Original Fund. Although carried interest disclosure must naturally be clear and timely, a range of other economic and commercial terms can be introduced alongside carried interest entitlements to aid alignment in CFs (*e.g.*, cash versus in-kind entitlements, conditionalities and timing modifications). Further, some of those other terms can, in certain instances, impact carried interest receipts.

As a result, a separate key communication decision is for a sponsor to determine the best way to communicate the core terms of the expected carried interest outcome for the sponsor and to decide what context should be provided to illuminate intended overall alignments. A sponsor may, for example, consider pre-dialogue with select prospective investors relating to the appeal of those other terms as a way of assessing options for – and the tradeoffs inherent in – different alignment structures.

Governance, Information and an Expanding Market

The success of CF deals remains rooted in:

- up-to-date asset pricing and asset life profile information;
- real-time information on LP-specific preferences for exposure and liquidity;
- accurate capital pricing; and
- good process management.

There is also an important role in the process for practical tools that can simplify the complex nature of decisions LPs face.

Those tools include, for example, focusing a CF deal on a small group of trophy assets that are not only well-understood and well-liked by LPs, but that also can be readily valued via market testing to obtain asset pricing information. At the same time, trophy assets are not always necessarily the best performing, and auction processes can, depending on the facts, vary considerably in their potential to clarify asset pricing. Accordingly, the role of each aspect of a CF process should be carefully considered across each stage, with attention also paid to Original Fund transparency, reporting, governance and trust patterns.

As a result, careful process management by sponsors, and the industry's growing focus on governance and transparency, are complementary supports for recalibrating the opportunities offered by CFs. Even as the CF market grows and evolves, CF transactions may be expected to continue to rest on a broad range of important norms and trust-based dialogues, including those that lie well outside the prescriptions of fund documents. That is in addition, of course, to the range of applicable laws, rules and regulations – as well as certain proposed rules and regulations – in relevant jurisdictions that may apply to secondary transactions, CFs and similar transactions.

See "SEC's Proposed Amendments to Form PF and Advisers Act Introduce Uncertainty, Increase Burden on Compliance Staff (Part One of Two)" (Mar. 15, 2022).

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