

MACFARLANES

Private Capital Solutions

Continuation Fund Structuring and Terms

Introduction

Secondaries have long presented an attractive route to liquidity for limited partners (LPs). Increasingly, general partner (GP) led secondaries are also becoming an effective tool in sponsors' portfolio management toolkits. Continuation funds now account for the vast majority of transactions in the GP-led secondary market.

However, as these funds have evolved from a niche to a widely deployed strategy, they have also become more complex. To successfully navigate this complexity, sponsors must get to grips with a number of legal and commercial considerations at the very outset of a continuation fund transaction.

Structuring of GP-led Secondaries

GP-led secondaries represent a departure from the "traditional" LP-led secondary, which provide a liquidity solution for LPs seeking to exit their existing interest in a fund, but which are of limited strategic value to sponsors. GP-led secondaries are typically structured in one of three ways.

LP Tender

A LP tender is initiated by the GP, who organises a competitive process to identify a secondary buyer to purchase one or more existing LP interests in a fund. This facilitates LP liquidity but is of little benefit to the GP unless the secondary buyer also makes a "stapled" commitment to the sponsor's next primary fundraising. The terms of the fund are left untouched and there is no opportunity for the GP or the secondary buyer to restructure economics.

Continuation Fund

Continuation funds – where one or more underlying assets of a "legacy" fund are sold to a new fund, managed by the same sponsor – offer GPs the opportunity to crystallise valuations and extend the lifespan of top performing assets, as well as to generate growth through the participation of secondary buyers who commit capital to the new fund. At the same time, continuation funds provide optional LP liquidity: existing LPs may choose to "cash out" of the legacy fund or "roll over" their interest into the new fund, albeit on new terms and economics which may differ significantly. Carry allocations will reset, giving sponsors the opportunity to restructure awards to favour those they deem to be adding real value.

The "Hybrid" Model

The "hybrid" model seeks to offer the best of both worlds: a new GP-sponsored vehicle is established which tenders for existing LP interests in a legacy fund, rather than directly for the legacy fund's underlying assets. For existing LPs who may stay put, exit or "roll over" into the new fund, this offers a full "status quo" option. For the GP and secondary buyers, however, this model lacks certainty: existing LPs may entertain the tender at their discretion and there is no guarantee of transaction size.

Continuation Funds: challenges and considerations

Continuation funds now dominate the GP-led secondary market – and for good reason. They offer sponsors the opportunity to extend the holding period of “trophy” assets, reinforce relationships with “rolling” LPs and introduce new investors to their platform, thereby injecting additional capital. It would, however, be a mistake for sponsors to approach continuation funds without some degree of caution. Continuation funds are complicated transactions, involving a range of stakeholders, each with different, often competing interests. Successfully navigating this complexity requires sponsors to address the following challenges and considerations at the beginning of a continuation fund transaction.

Conceptual Challenges

In a continuation fund, the sponsor sits on both sides of the transaction. The risk of conflict is therefore inherent, as is pressure on pricing; a secondary buyer on a GP-led process is unlikely to benefit from the same strategic pricing it might on a “straight sale”. The sponsor must be able to demonstrate that the process has been conducted in a fair and transparent manner, which will necessitate an independent valuation of FMV. Securing LPAC consent may go some way to mitigating conflict concerns, but a strong underlying transaction narrative and upfront communication are pre-requisites to gain the confidence of secondary buyers and maintain the support of existing LPs. A growing tendency for sponsors’ flagship funds to co-invest alongside the continuation fund might also be touted by the GP as evidence of GP-investor alignment.

Continuation funds are likely to constitute a “permitted affiliate transfer” in the underlying equity documents. As such, they can prolong the exit and pay-out for management of the target asset(s), a barrier to liquidity that managers are becoming increasingly wary of. Sponsors may wish to bake a “sweetener”, such as a MIP, into the transaction to preserve alignment of interests with management.

In addition, upon the sale of the asset(s) to the continuation fund, legacy fund carry will be crystallised and sponsors will have the opportunity to “reset” allocations in the new fund. This “reset” provides the sponsor with flexibility to reward those team members who are driving performance of the asset(s), but may entail a reduction in carry for others, engendering friction within deal teams. Secondary investors will often mandate that sponsors commit a large proportion of their accrued carry (50%-100% of carry arising from the transaction) to the continuation fund as evidence of GP alignment.

Key Considerations

Secondary buyers are showing less and less appetite to shoulder the risk of continuation fund transactions. GP promises of alignment no longer suffice: vendor due diligence, business warranties and meaningful recourse for breach – often in the form of a buy-side W&I policy – are the new normal, particularly on single-asset deals where buyers are liable to adopt an M&A mindset.

Transferability considerations are fundamental and should not be overlooked. Sponsors must be clear from the outset whether third party consents are required, particularly where change of control clauses are to be found in the underlying equity or banking documents. The misguided belief that continuation funds will not trip up anti-trust concerns should also be corrected.

A desire for tax neutrality amongst the existing investor base will necessitate thoughtful structuring. Shorter holding periods of continuation funds should also be considered when modelling to avoid IBCI treatment, and executives may wish to consider the benefits of triggering a carry reset before long-touted changes to the UK tax treatment of carry are enacted. Due consideration should be paid to the nature of the assets being transferred and to any transfer taxes which might arise.

Continuation Funds: terms

As continuation funds continue to evolve, so do the standard and variance of their terms. There is no “one size fits all” approach: the nature of the underlying assets, investor base and balance of bargaining power all play a role. For investors, the priority is GP-alignment. For sponsors, it is fundamental that the protections and governance rights LPs might expect to receive in a primary fund are not appropriate where investors are not taking on “blind pool” risk.

A summary of the ways in which the terms of a continuation fund might differ from those of a legacy fund is set out below.

Topic	Legacy Fund	Continuation Fund
Key person	Suspension of investment period following a key person event	Not included: investments already made.
No Fault Divorce	No fault removal of GP.	Not included: investments already made.
Waterfall	Full repayment model plus preferred return and catch up.	Often two waterfalls: (i) for rolling investors, a waterfall replicating the economics of the legacy fund and (ii) for new investors, a separate waterfall (often more complicated, with use of ratcheted preferred returns (IRR and MOIC) and catch up).
Management Fee	2% p.a. on committed capital during investment period, then 2% p.a. of acquisition cost of invested capital.	c.1% p.a. of acquisition cost of invested capital throughout term.
GP Commitment	1%-2% of total commitments.	GP required to ‘roll’ 50-100% of carried interest received from legacy fund (as a result of the secondary).
Expenses	Establishment expenses capped at e.g. 1% of fund size.	Deal specific: transaction costs are often included, including a portion of lead investor costs and a share of the corporate finance transaction fee.
Follow On Capital	20-30% for follow-ons post investment period.	10-30% as additional commitment (on top of purchase price) to finance follow-ons over the term.
Term	10 + 1 + 1 including 5 year investment period.	Asset specific, but likely 5 + 1 + 1 including 2 year investment period.

Conclusion

A successful continuation fund is a “win-win” for all parties. For LPs, continuation funds offer a route to liquidity. For GPs, they are a means of capturing future growth in trophy assets and raising top up capital for those assets which are in need of it. However, sponsors should not lose sight of the intricacy of these transactions. Managing conflicts and navigating numerous, often competing stakeholders requires a strong process to be put in place, and engaging expert legal and financial advisers from the very outset of a continuation fund transaction can prove key in this regard.

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