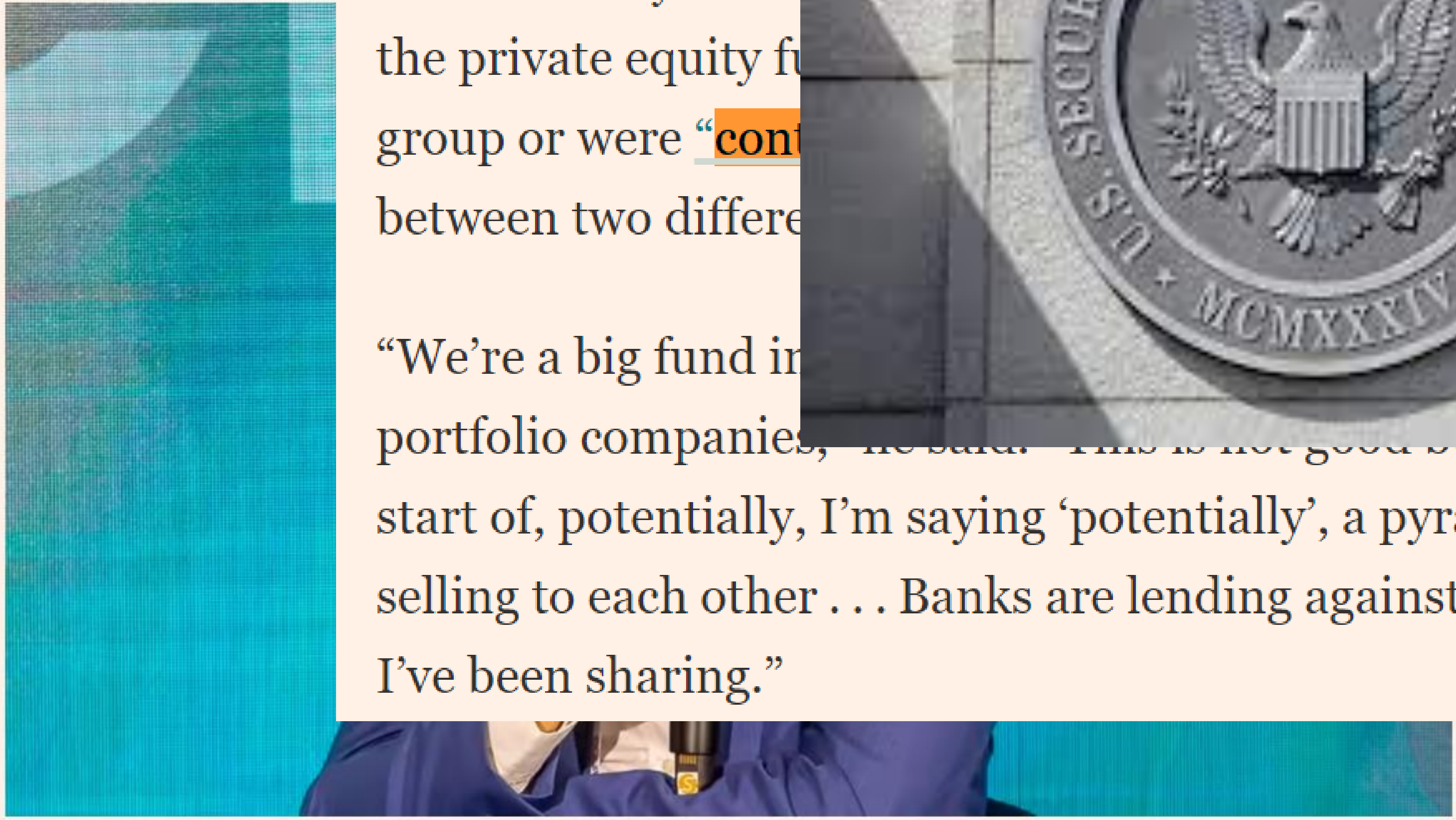
THE RISE OF CONTINUATION FUNDS

Kobi Kastiel & Yaron Nili

U. Pa. L. Rev. (2024)

Private equity may become a 'pyramid scheme', warns Danish pension fun

Tendency for buyout groups to sell companies to t
business', ATP execu



Mikkel Svenstrup says the 'exponential growth' of the private equity industry, as investors have poured cash into its funds, would stop 'at some point' © IPEM

Mikkel Svenstrup, c erned
because last year m npanies by
the private equity fu ther buyout
group or were "cont up passes it
between two differe

"We're a big fund in ds of
portfolio companies, is is the
start of, potentially, I'm saying 'potentially', a pyramid scheme. Everybody's selling to each other . . . Banks are lending against it. These are the concerns I've been sharing."

I

The article provides the first comprehensive examination of continuation funds (CFs)

II

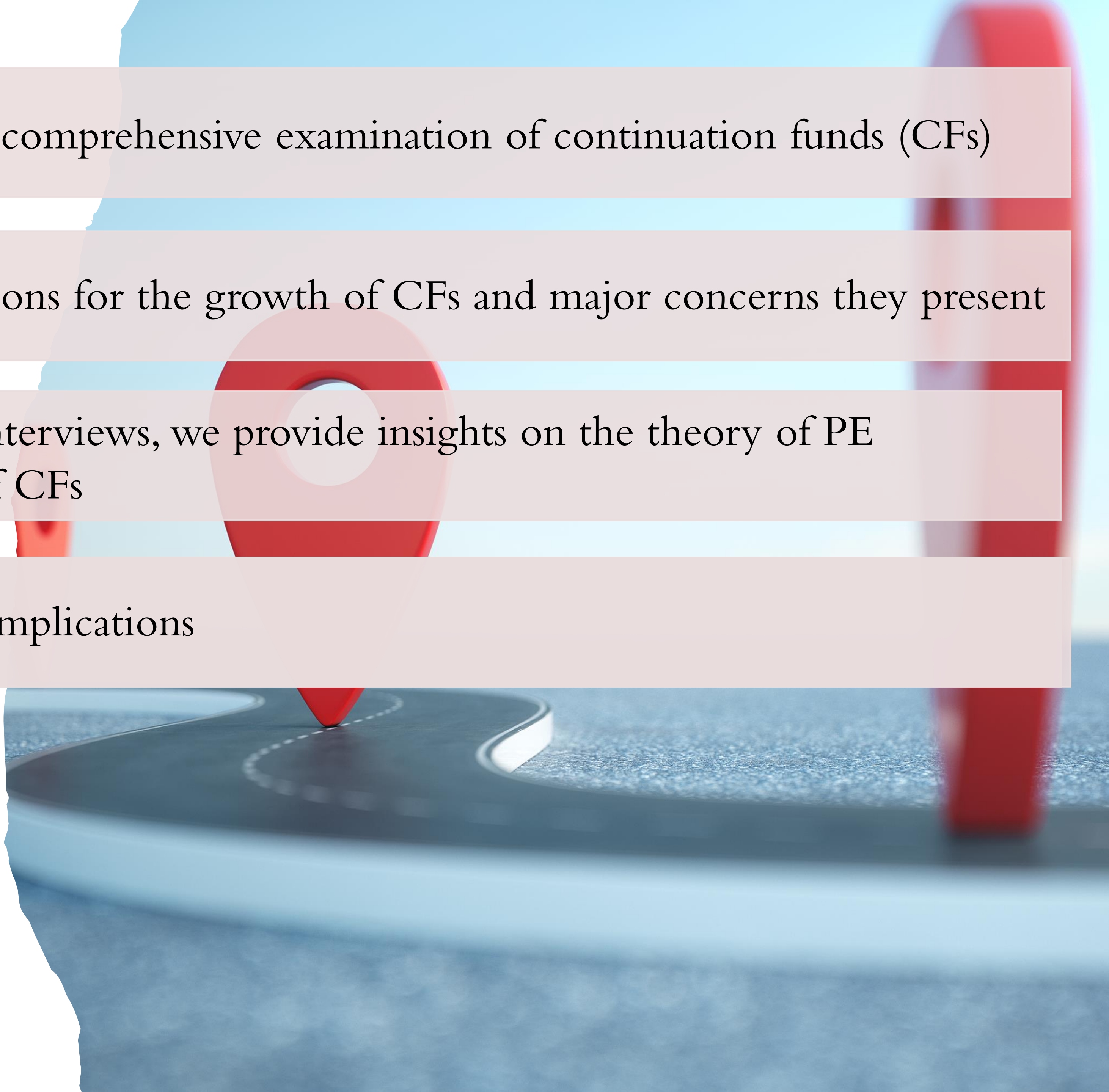
We analyze the potential reasons for the growth of CFs and major concerns they present

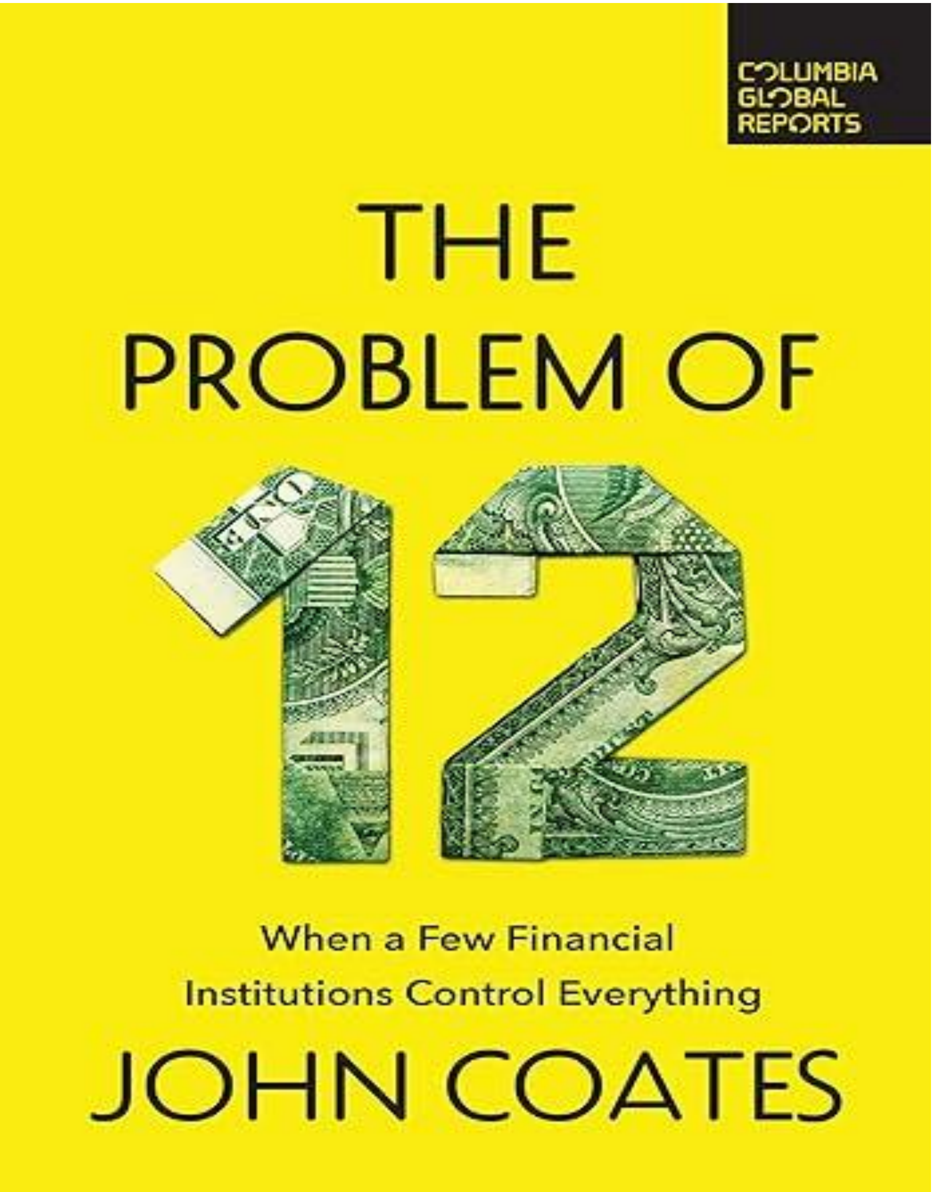
III

Using qualitative data from interviews, we provide insights on the theory of PE bargaining and the realities of CFs

IV

We explore potential policy implications





An Inconvenient Fact: Private Equity Returns & The Billionaire Factory

University of Oxford, Said Business School, Working Paper

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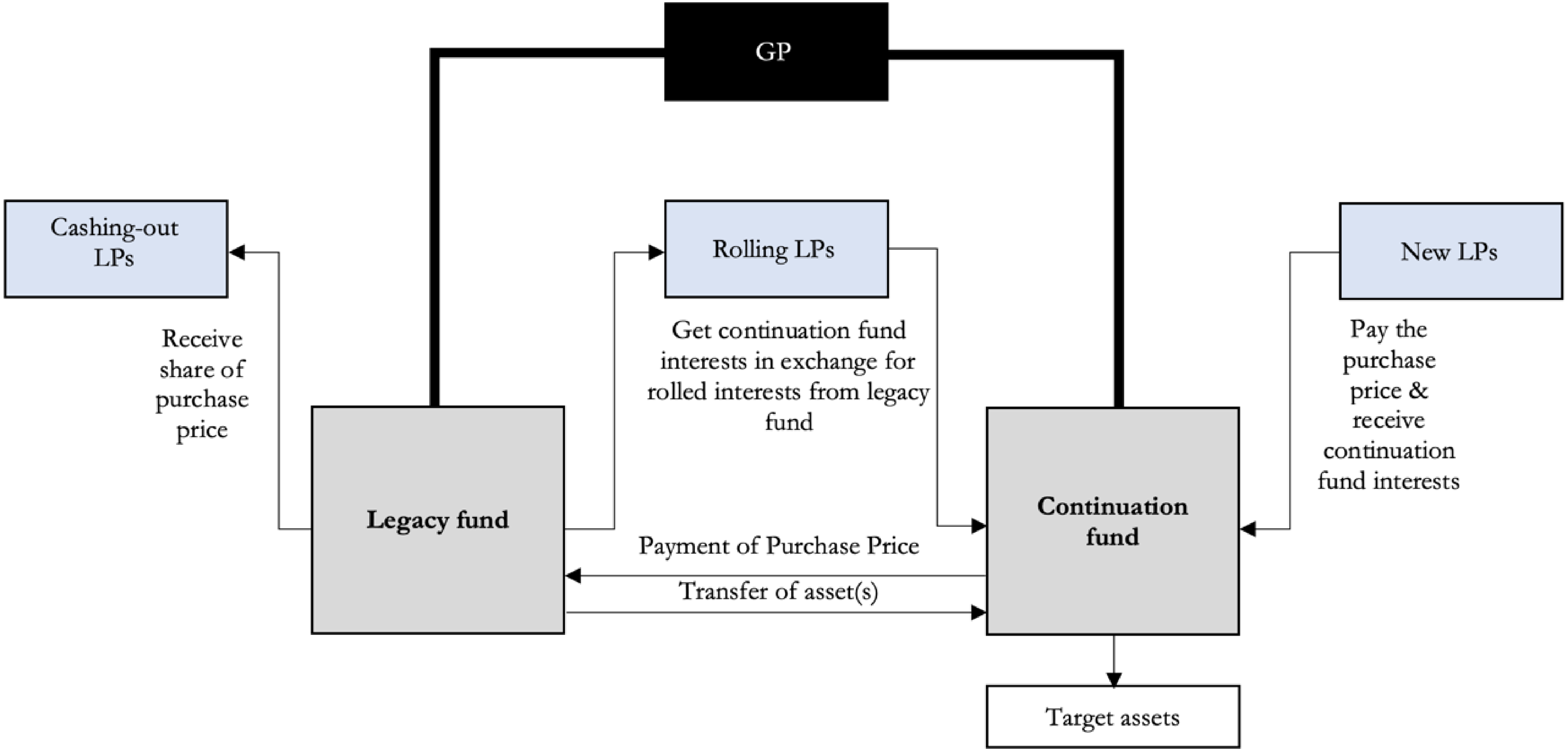
Abstract

Private Equity (PE) funds have returned about the same as public equity indices since at least 2006. Large public pension funds have received a net Multiple of Money (MoM) that sits within a narrow 1.51 to 1.54 range. The big four PE firms have also delivered estimated net MoMs within a narrow 1.54 to 1.67 range. Three large datasets show average net MoMs across all PE funds at 1.55, 1.57 and 1.63. These net MoMs imply an 11% p.a. return, which matches relevant public equity indices; a result confirmed by PME calculations. Yet, the estimated total performance fee (Carry) collected by these PE funds is estimated to be $230 billion, most of which goes to a relatively small number of individuals. If all vintage years are included to 2015, Carry collected is $370 billion, with a performance similar to that of small cap indices, but higher than that of large cap stock indices. The number of PE multibillionaires rose from 3 in 2005 to 22 in 2020. Rebuttals from the big four and the main industry lobby body are provided and discussed.

Keywords: Private Equity, Wealth Inequality, Financialization, Benchmarking

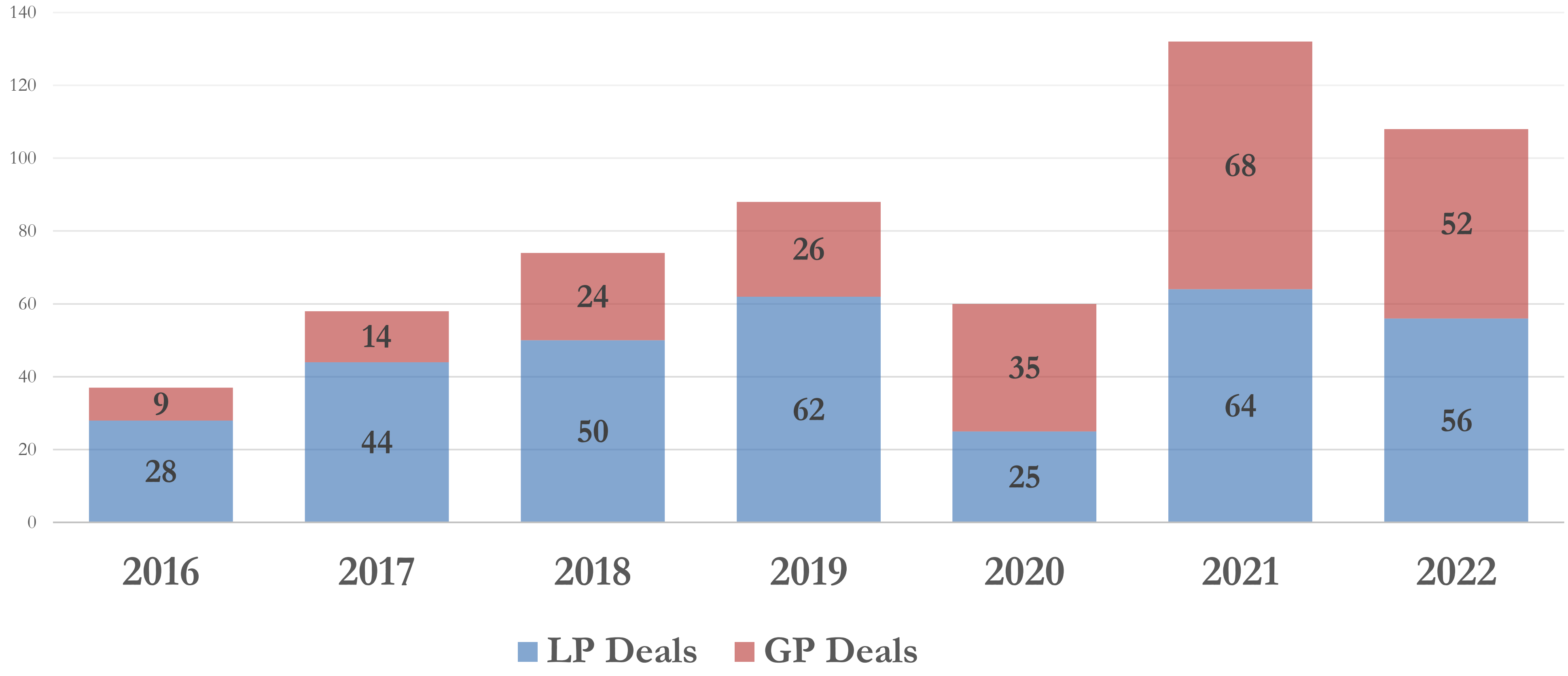
CONTINUATION FUND'S STRUCTURE



THE GROWING PREVALENCE OF CONTINUATION FUNDS

- One of the most popular trends in PE over the last few years:
  - In the past, CFs were used for struggling distressed assets ("*zombie funds*").
  - As of 2015, started to be used for high-performing assets that GPs wants to hold for longer periods.
  - **Their total deal value surged significantly within 5 years**, from $11 billion in 2016 to ~$68 billion in 2021.

The Growing Prevalence of Continuation Fund (2)



U.S. and European capital markets

THE BENEFITS OF CONTINUATION FUNDS

Supporters of continuation funds view them as a "**win-win-win**":

- **GPs** can hold assets for an extended period, without selling the company to another fund (and avoid management change).
- **LPs of legacy funds** can either realize gains or roll over their investments, gaining continued exposure to the assets.
- **Incoming LPs** can invest in more mature assets for a shorter period.

WEB OF CONFLICTS

GP'S PRIVATE BENEFITS

- GPs have a strong financial interest in establishing continuation funds:

  - **New management fees for an extended period.**
    - – Most meaningful investment work has been done
  - Enjoy the upside of **additional carry** on the same asset
  - **Resetting carry** (if unable to meet the original fund's threshold)
  - **Extended control** and delaying real market check

  Unique benefits for early-stage transactions:
  - **Crystallization of the carried interest** (reduces risk, provides liquidity, all without conducting a "real" exit)

GP'S DUAL LOYALTIES

- **The GP is on both sides of the deal**, being committed to two groups of investors whose interests are in direct conflict:

Existing LPs
Interested in ***selling*** at the ***highest*** possible price

Purchase Price

New LPs
Interested in ***paying*** the ***lowest*** possible price

- Since most Legacy LPs (80-90%) sell their interests, the conflict is severe.

THE GP (ALMOST) ALWAYS WINS

- Any loss on one side is offset by additional fees and other benefits from the continuation fund, ensuring the GP always wins (regardless of whether the sellers or buyers have the upper hand).

THE GP'S (POTENTIAL) BIAS TOWARDS THE NEW LPS

- They are the investors the GP must convince to come on board.
- Since many transactions include "staple commitment," the GP may prioritize its relationship with new LPs.
- The new investors in CFs are often other PEs or repeat players with ongoing, close relationships to GPs.

- Empirical insights on preferred investors being offered higher returns by GP support our analysis (Lerner et al., 2022).

THE POTENTIAL INEFFICIENCIES OF CONTINUATION FUNDS

Suboptimal utilization of capital:

- The GPs' private benefits may cause them to avoid more profitable exit options. These better alternatives are not known to LPs;
- Extended timeframe to maintain underperforming portfolios for fee.

CFs exacerbate the information asymmetry problem in PE:

- Removal of the 10-year yardstick: impairing LPs' ability to evaluate the GP; Remaining private for extended periods (Coates, 2023)

WHEN THEORY MEETS REALITY – **METHODOLOGY**

- Continuation funds are a "black box" (LPAs are not accessible).
- To overcome these informational limitations, we conducted **qualitative interviews** with senior officers at LPs and legal counsels for GPs.
- The partners we interviewed were involved in over 85 GP-led transactions during 2022 (aggregate transaction volume of +$60B).
- We supplemented the interviews with a review of publicly available sources & comment letters on CFs submitted to the SEC.

THE CHALLENGES FOR LIMITED PARTNERS

Information asymmetry

Lack of expertise

Lack of time

Additional constraints

PRIVATE EQUITY CONTRACTING

- Our findings are in line with recent scholarship sheds light on the **limited** bargaining power of many LPs (e.g., ***Clayton, 2022***):
  - *Weak incentives to negotiate collective protections in LPAs, as some LPs can negotiate individualized benefits.*
  - *Limited information*
  - *Fear of exclusion from future funds*
  - *Agency problems of asset managers*

THE ROLE OF REPUTATION AND ONGOING RELATIONSHIPS

Two distinct investor attitudes toward CFs -> Heterogeneity of LPs matters

- Small LPs expressed concerns about the GP's motives;
- Their ability to retaliate if the GP misbehaves is limited.
- However, for large & sophisticated LPs, relational contracting could work. The multiple interactions and enhanced trust and encourage them to roll over.
- No use of litigation

RESOLVING CONFLICTS

- Approval by LPAC
- Increasing GP's skin in the game
- Competition

THE SEC SUGGESTED REFORM

New rules (2022): requiring GPs to obtain a *fairness opinion* for these transactions

- Market participants strongly criticized the proposal.
  - *Sponsors:* it will add unnecessary costs.
  - *LPs* are skeptical of fairness opinions due to objectivity concerns (advisors are selected by GPs).

- As LPs rarely pursue legal action against GPs, these opinions are less likely to face scrutiny in court.

ALTERNATIVE PROPOSALS

- ***Enhanced mandatory disclosure*** and extended election period.
  - <u>But</u>, disclosure alone may not be enough to align the interests of the GP and the legacy funds LPs.

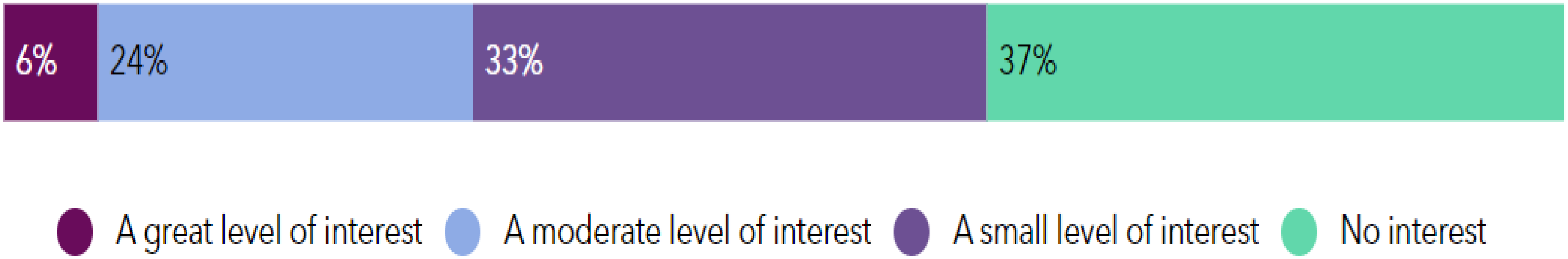
- ***Status-quo option*** *is* rarely offered in CFs transactions.
  - In a "real" status-quo option, the LPs keep the same stake & terms, and the GP cannot crystallize the carry.
  - But, it will likely reduce the number of CFs & prevent raising additional funds. It also would not work in multi-asset CF.
  - Consider it in the appropriate cases.

ALTERNATIVE PROPOSALS

- ***Empowering legacy fund LPs*** –
  - Bringing the decision to initiate a CF to the *LP base*.
  - Selection of financial advisors by LPs.
  - Inviting the largest LPs that objected the use of CF to serve on the LPAC to oversee the transaction.

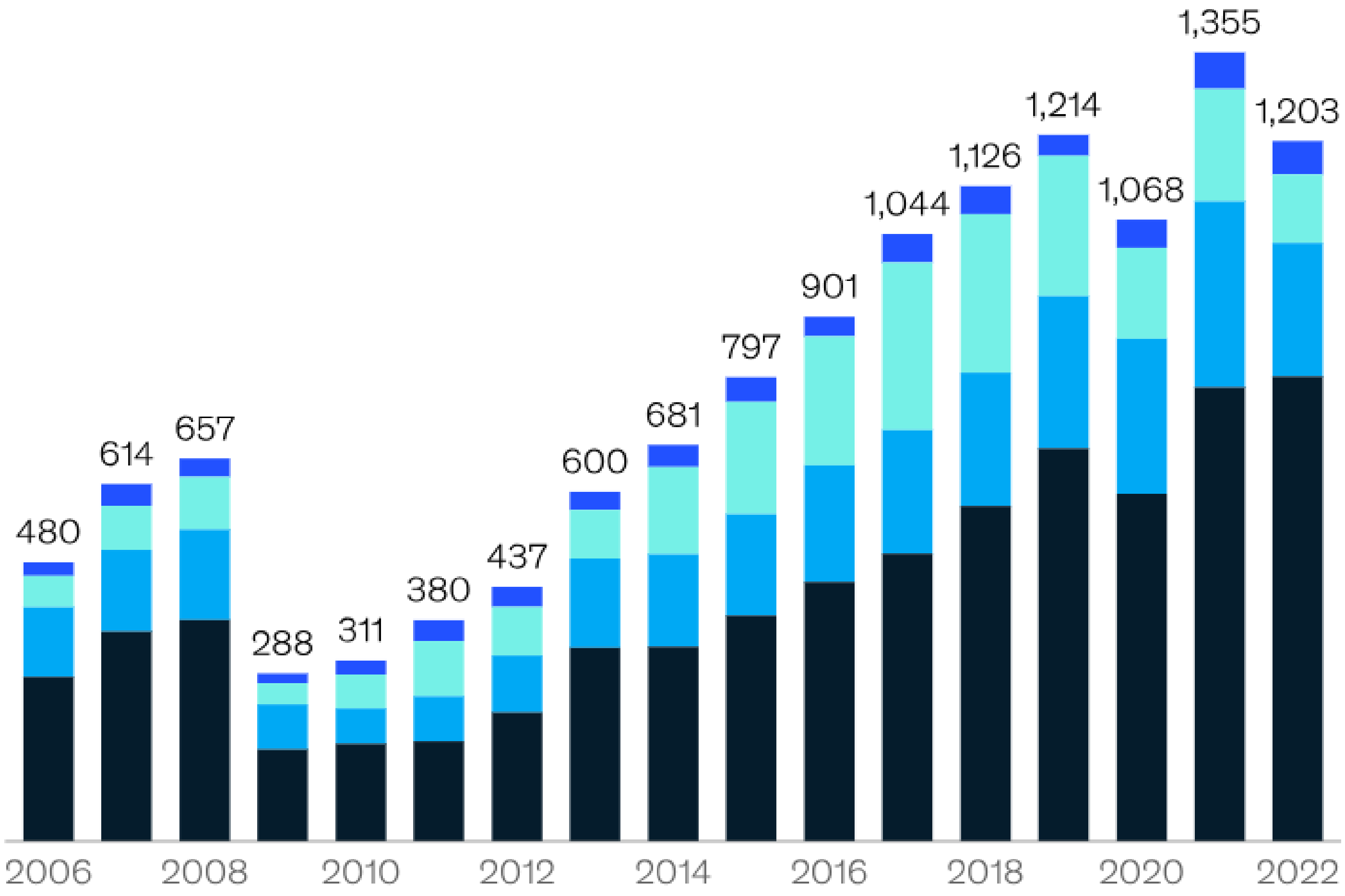
THANK YOU!!

What level of interest do you observe for continuation funds within your investor base?



North America was the only region to record positive fundraising growth in 2022.

Global private markets fundraising by region,[1] $ billion



	2017–22 CAGR, %	2021–22 growth, %
Total	2.9	–11.4
Rest of world	2.9	–9.3
Asia	–16.4	–39.0
Europe	1.6	–28.2
North America	10.1	2.4

REPUTATION AND REPEAT INTERACTIONS

There are limitations:

- **Information asymmetries**

  It may take a while until investors have all information to assess the GP performance;

  Evidence: underperforming GPs tend to inflate returns; LPs face challenges in identifying opportunistic behavior & punishing untrustworthy GPs

- **Power dynamics**

  LPs fight to get into the most sought-after funds ("superstar PE");

  Evidence: top GPs involved in misconduct (e.g., covenant violations) still attract new investors

- **LP Heterogeneity**

  Reputation works less well for small LPs with limited bargaining power

REPUTATION AND REPEAT INTERACTIONS

- **External competition / allocating more capital to public companies instead?**

Needs to invest in PE to maintain a diversified investment portfolio;

Internal agency problems:

Investment industry encourages PE investment (Phalippou) & the professionals want to secure their job;

Prevent negligence claims if investing in top GPs;

Opacity re returns prevents monitoring by beneficial owners

The Limits of Reputational Sanctions

- Reputation depends on the quality of available information.
  - PE investments are illiquid; it takes time to assess the performance.
  - Underperforming GPs tend to inflate reported returns.
  - Lack of performance data by third-party vendors on CF funds.
- Due diligence requires expertise in *specific assets*, which many LPs lack.
- **Phalippou**: the industry motivates institutional investors to invest in PE;
- Competition for accessing top-tier investments (Lerner et al., 2022)