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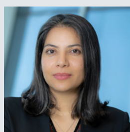
Understanding the Attraction of Continuation Vehicles

INSIGHTS

Continuation vehicles, an area of high growth in secondary private markets, can be an attractive investment option for limited partners if appropriate alignment, transparency and governance mechanisms are in place.



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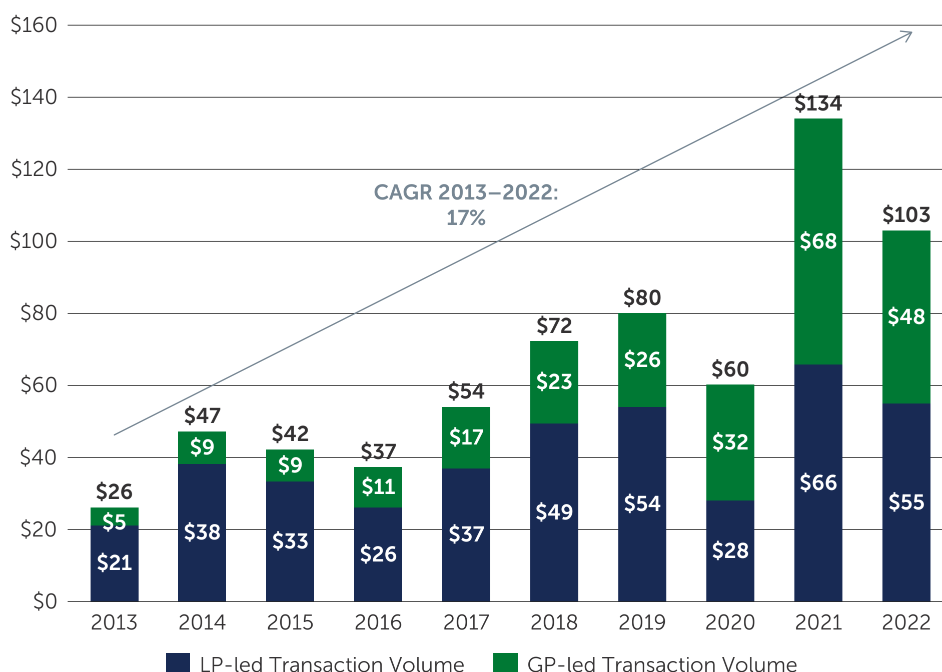
The last 24 months have seen a significant rise in the number of continuation funds. These vehicles allow general partners (GPs) to roll an asset or assets from one or more existing funds into a new investment vehicle with fresh or re-start capital. This is an alternative to selling the asset to an outside buyer. Historically, continuation vehicles were a way to give portfolio companies more time to deliver on expected returns. More recently, however, GPs are recapitalizing their higher-performing investments—the so-called "crown jewels" of their portfolios—to maintain exposure while providing additional capital for growth initiatives.

Figure 1: Secondary Market Transaction Volume Over Time ($B)



Source: Evercore 2022 Secondary Market Synopsis. As of January 2023.

While continuation vehicles involve risk, namely around potential conflicts of interest and GP alignment, they also offer potential benefits. They provide GPs with the ability to continue managing a high-performing asset in a format that offers a larger fee base and a resetting of the deal carry pool, which can re-incentivize the team for continued value creation. For limited partners (LPs), assuming the new asset has been fairly priced and that the GP's motivations are properly aligned, these vehicles can provide an attractive opportunity to maintain exposure to a successful company at a lower fee/carry basis. In addition, some LPs can invest secondary capital into what may be perceived as a less risky opportunity than buying a new, unknown asset. Over time, there is the potential for LPs to realize strong risk-adjusted returns, particularly with GPs and management teams that have worked together successfully in the past.

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Many LPs currently are not set up to participate in continuation vehicles, while others choose not to participate given structural constraints or the need for liquidity. Arguably, continuation vehicle transactions can force traditional fund LPs to be more involved co-investors, requiring them to undertake additional underwriting and monitoring processes. These additional responsibilities ultimately cause most LPs to sell their positions rather than roll their exposure into continuation vehicle opportunities, even when doing so could be attractive.

The decision to participate in a continuation vehicle involves a complex set of issues that are critical for an LP to understand. High-quality GPs typically have a strong value creation plan outlined on a particular asset or set of assets and often will commit a considerable amount of time and capital to each deal. A reasonable proxy to measure GP alignment is the amount of carried interest that the GP has created via the platform exit and any subsequent portion they may roll into the new vehicle. Additionally, it is critical for LPs to understand the business motivations and alignment of other LPs and limited partner advisory committee members who may be required to provide approvals to waive conflicts or to approve the actions of the GP. In some cases, for instance, there may be questions around whether an asset manager with both primary and secondary businesses would be more likely to approve a deal that benefits its secondary arm even if that deal is potentially less advantageous for primary fund investors perhaps unable to participate due to structural and/or timing limitations.

With appropriate alignment, transparency, and governance in place, continuation vehicles can be an attractive investment option for LPs to consider.

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