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Private Market Primer I

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Who is afraid of the continuation fund?

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- Over the past years, private equity groups have increasingly sold assets not only to their peers but also to themselves by setting up so-called continuation funds (or GP Led secondaries).
- Originating initially from the need to find liquidity for the few stranded companies in funds that were reaching the end of their life, continuation funds are increasingly being launched to extend the holding period of top-performing businesses, sometimes even in a single asset vehicle.
- The practice has attracted regulatory and media scrutiny and some investor backlash over potential governance issues and conflicts of interest.
- We believe that despite all teething problems, GP Leds are the natural by-product of a maturing private market ecosystem, increasingly mirroring public markets in professionality.
- GP Led secondaries target similar returns to direct primary investments, and can be seen as a safer way to co-invest, because the seller is also the buyer and knows the market, the management, and the asset well.

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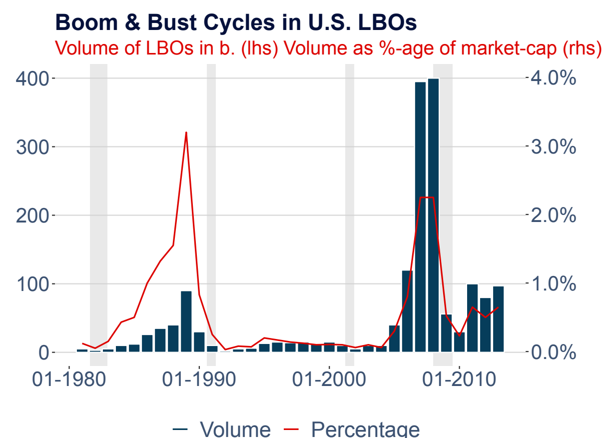
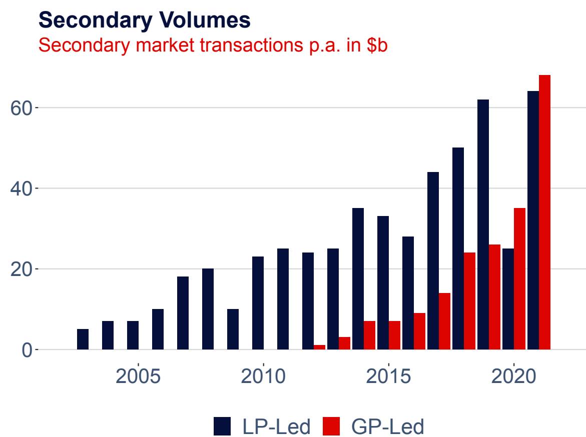
As the private equity industry has grown in size and captured an increasing share of investors' portfolios, it has become more and more common for managers to set up so-called continuation funds. The vehicles offer incumbent limited partners (LPs) the possibility to exit an investment after the pre-agreed period while the general partner (GP) continues to manage it, backed by new subscribers. While some market participants have embraced these funds as another refinement of the private market ecosystem, others have warned of the risks associated with the inherent conflict of interests and potential detachment of private asset valuations from public market vetting.



Source: *Federal Reserve Bank of New York [14]*
Figure 1: *Absolute figures can easily create wrong impressions. Relative to the stock market's aggregate capitalization, the LBO boom in the 80s was massive.*

1 From boom to bust to maturity

In 1989, Henry Kravis made headlines with a transaction that marked not only the rise of one of today's most admired companies but of a whole industry that has since gone through massive controversy and several boom-bust cycles but is exciting investors more than ever: private equity [21]. The 1989 leveraged buyout of New York-based food and tobacco empire RJR Nabisco has most famously been immortalized by the investigative journalist Bryan Burrough in his later picturized book "Barbarians at the Gate" [20]. KKR successfully acquired RJR Nabisco for $25b following a fierce bidding war and subsequently sold off six non-core packaged food businesses and a minority stake in a media conglomerate to various competitors and financial investors [22]. According to a report by the United States Department of Labor, the restructuring resulted in the temporary loss of 2,000 workplaces in the short term and significant salary cuts in the medium term. Just two years later, in March 1991, RJR Nabisco was listed on the stock exchange again. The Nabisco transaction followed a playbook still widely associated with private equity. A tactic scouting for value in inefficiently managed assets acquires them with substantial leverage and realizes gains by selling off businesses that generate no synergies and lifting margins, and cash flows through leaner corporate structures and reduced capex. After a few years, the transformed enterprise is listed again, and the private equity firm looks for a new target.



Source: *cf Private Equity [13]*
Figure 2: *For the longest time, secondary private equity transactions comprised investors selling LP stakes in search of liquidity and, increasingly, institutions actively managing previously static portfolios. GP Led transactions are a relatively new phenomenon but represent a fast-growing market attractive to new, specialized participants and generalists alike.*

Cash flow and capital expenditures of Buyout/Non-Buyout firms

	Buyout Firms	Other	Difference
1980-89			
Free cash flow ratio	8.1%	2.9%	5.2%***
Capital expenditure ratio	9.6%	15.5%	-5.9%***
1990-99			
Free cash flow ratio	4.9%	-1.8%	6.7%***
Capital expenditure ratio	10.3%	13.3%	-3%***
2000-12			
Free cash flow ratio	4.1%	-1.7%	5.8%***
Capital expenditure ratio	27.2%	46.2%	-19%***

*** Significant at the 1% level

Source: Federal Reserve Bank of New York
Note: Free cash flow ratio = after-tax net cash flow minus dividends and interest payments divided by net sales; capital expenditure ratio = capital expenditures divided by net sales

Source: *Federal Reserve Bank of New York [14]*
Figure 3: *Before the Great Financial Crisis, firms bought out by private equity reported significantly higher cash flows and lower capital expenditures than their non-buyout firms, resulting in backlash accusing managers of cutting the fat AND the bones. The industry's narrative has shifted during the latest boom, becoming more growth and long-term-minded.*
Source: Federal Reserve Bank of New York [14]

In recent years, as the list of undermanaged businesses got thinner and aided by a low-rate environment, private equity returns no longer came from a tedious business overhaul but rather from holding levered assets over an extended period of time (akin to real estate transactions) and benefiting from acquisitions multiple re-rating.[4]
The classic approach, often blamed for causing job losses and leaving behind crippled businesses unable to survive the long haul, contrasts sharply with the new trend in the modern-day private equity industry: sponsors holding companies for longer and ultimately selling to their peers or to themselves[18]. Many of the most reputed private equity groups now indulge in the continuation fund practice. Last year only, KKR was for instance involved in two such transactions: a $1.8b vehicle to extend the hold of seven Accel-KKR software assets, and a $2.2b vehicle to hold only Internet Brands, a web and software solutions company, that was one of the best performers of the KKR North America Fund XI [19]. The emergence of so-called GP Led secondaries is a phenomenon of the latest private equity boom that began following the Great Financial Crisis, but it really picked up in 2021, 2022, and 2023 as the industry, still awash with cash from the low-interest rate era, is facing tumbling deal volumes given the sudden change in financial conditions and sharply higher uncertainty [12].

2 A trend set to continue

No matter the reason for the current surge in GP Led secondaries, their steady expansion over the past years and the maturing of the ecosystem mean they are probably here to stay. We are, therefore, taking a closer look into the topic, exploring the question of how investors can benefit from this distinct asset class. The terminology around GP Leds can be messy. Industry members also occasionally use the terms “adviser-led secondaries” [19], “continuation vehicle” or "continuation fund". Essentially all synonyms describe a transaction in which a closed-end private equity structure reaches the maturity of its pre-determined lifetime, and the same manager launches a new vehicle (the continuation fund) purchasing one or several assets from the old fund. Existing investors are offered the opportunity to participate in the vehicle or walk away with the cash brought in by new partners.

Obviously, this kind of deal introduces a range of problems, most importantly the imminent conflict of interest the GP is necessarily subject to, sitting on both sides of the transaction. For existing investors, it raises the question of whether they can realize the best price for the asset(s) if the GP also has an interest in offering an attractive deal to the incoming subscribers and is potentially rolling over the majority of his carried interest. At the same time, new LPs may worry about overpaying for the asset if the GP is maximizing returns for incumbent partners to beef up his track record. While these concerns affecting both sides already indicate that GPs, although probably conflicted, may not inevitably lean toward one or the other stakeholder. Nevertheless, the absence of third-party involvement clearly induces the risk of sub-optimal price discovery and puts extra pressure on independent valuers already targeted by increased regulatory scrutiny [15]. Limited partners have also grumbled over tight deadlines given to them to take the decision whether they want to participate

in the continuation vehicle (usually only a 3 to 4 weeks election period), a topic recently addressed explicitly by a new guideline issued by the Institutional Limited Partners Association (ILPA) [11] [7].

More importantly, investors may legitimately ask whether continuation funds are merely a desperate emergency solution in an environment hostile to deal-making or, worse than that, conceal that private equity valuations have become detached from public market reality. In a worst-case scenario, continuation funds are helping managers hide for many more years that the exceptional paper gains they have reported may not be realizable. Lastly, as outlined earlier, the practice conflicts to some degree with the traditional idea of private equity firms existing to take over underappreciated assets to reap the benefits of its strong growth, sector consolidation, or of successful restructuring.

After ten years, when the organization has been optimized extensively, what can be left to do for the GP? Would another GP owner really add new value to the asset? Or have GPs become mere asset managers using leverage on otherwise flattish assets, similar to Core Real Estate investors?

Even though LPs seem to feel confident that GPs are likely to be good owners of continuation funds [2], we share some of these concerns and believe that the GP Led secondaries market needs to be monitored carefully to avoid abuses. Notwithstanding this, we welcome the development of the asset class and believe that continuation funds are a valuable part of the ecosystem, offering numerous benefits to GPs and LPs alike. We also think that GP Leds are the natural epiphenomenon of a maturing private equity industry that - employing more and more people in businesses that are massively outgrowing the average [5] - has successfully emancipated itself from the aggressive corporate raiders and debt-fueled gamblers of the 80s and early 2000s.

Ironically, the structure directly addresses one of the oldest and most influential criticisms of private equity: myopic short-term profit-seeking on the back of sustained commercial viability. As private equity has commenced to see itself not as a quick box stop but as a long-term alternative route for companies deterred by ever-expanding IPO prospectuses and extensive disclosure requirements, managers have started to up the equity portion in their deals and become substantially more growth-oriented. As a result, revenue traction, platform building, and reasonable margin expansion have become vocal points in most equity stories pitched to investors today. The ESG movement has introduced further incentives, such as Article 9 classification, to focus on business development rather than dismantling. Interestingly, the Harvard Review already found back in 1992 that the likes of KKR had implemented surprisingly plenty of good governance initiatives and continued to exert influence over companies they were now managing with for an extended time horizon [1].

> Private equity has successfully emancipated itself from the aggressive corporate raiders and debt-fueled gamblers of the 80s and early 2000s.

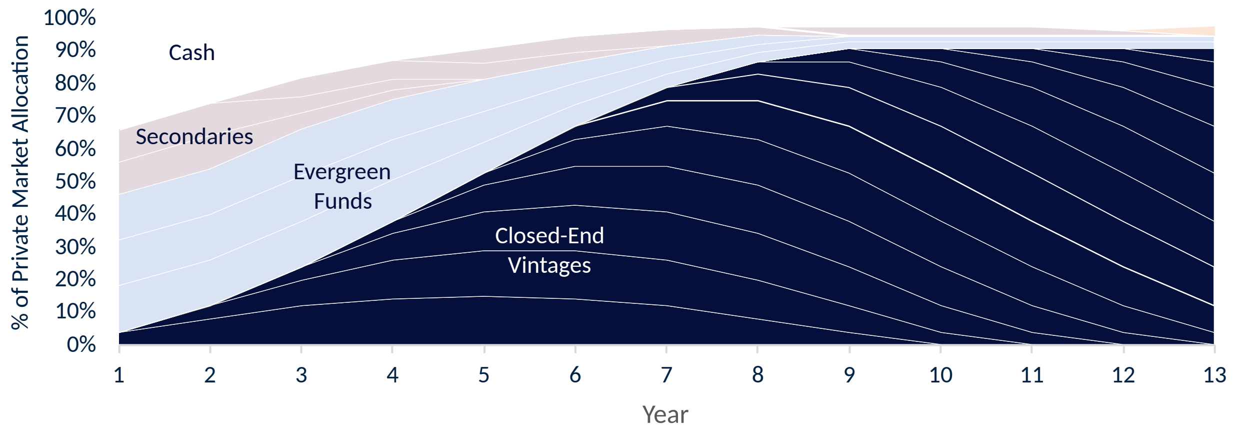
As the sleepy conglomerates that once dominated many Western economies have disappeared, the shift in style and focus in private equity also looks like a logical consequence of a secular trend that has already propelled corporate margins to record levels while leaving companies scrambling for labor. You can break up RJR Nabisco within a few years, but a high-quality growth story may continue to lay golden eggs much longer - so why change a running system?

3 An asset class with many merits

Continuation vehicles have experienced a significant surge in popularity, becoming widely utilized by both renowned investors and lesser-known funds. Blackstone, for example, has demonstrated their embrace of continuation funds with notable transactions, including BioMed Realty in 2020 ($14.6b vehicle) and Phoenix Power in 2019 ($1.4b vehicle) [9][8]. Other GPs such as CD&R, Hellman & Friedman, or Astorg are also involved in the trend with their latest continuation vehicles: Belron ($21b EV, 2021), Verisure (3 asset vehicle, 2020), and IQEQ ($1.3b, 2022) respectively [3][23][16]. Smaller funds have started to leverage continuation vehicles to achieve remarkable results as well. ArchiMed, the European Healthcare specialist, employed a continuation fund in 2020 for the acquisition of PolyPlus, which helped yield an astounding 300x money-on-money return from the initial price paid [6]. In 2022, GSquare, another European healthcare specialist, also used continuation vehicles for three of its investments (Accomplish, Keys Group, and Denteam) in a $550m transaction [17]. The widespread adoption of continuation vehicles across the investment landscape, irrespective of the profile or reputation of the investor, attests to its many merits for GPs.

For LPs, this opens up an attractive opportunity.

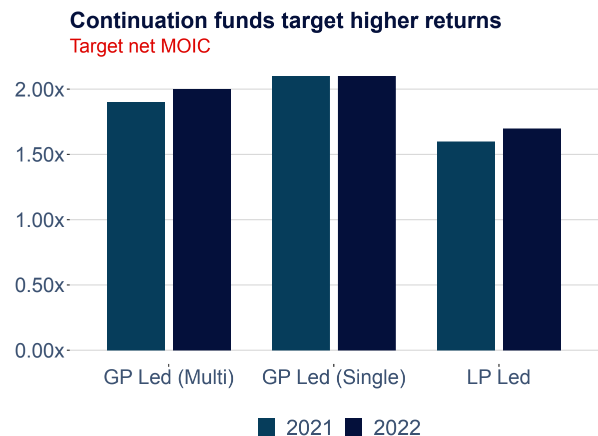
- Continuation funds are not subject to the typical J-Curve effect where capital is called in frequently unpredictable arrays and deployed over several years while cash returns are back-end loaded. Instead, money is usually deployed immediately in an already cash-producing asset, resulting in a faster payback.
- Continuation funds are typically launched with a reduced lifespan of usually 5 years vs. 10 for traditional investment funds, implying that investors benefit from shorter commitments and more frequent liquidity events. With their shorter time to maturity, GP Leds can also be an ideal complement to standard closed-end funds, allowing LPs



Source: *Amadeus Capital, Tioopo*
Figure 4: *The graphic above provides a stylized example of how investors can use different types of private equity products with varying maturity and liquidity profiles to construct an optimal private market portfolio with smooth cash deployment, regular liquidity, and minimized opportunity cost.*

to manage cash optimally, especially during the initial phase of a newly launched private market program.

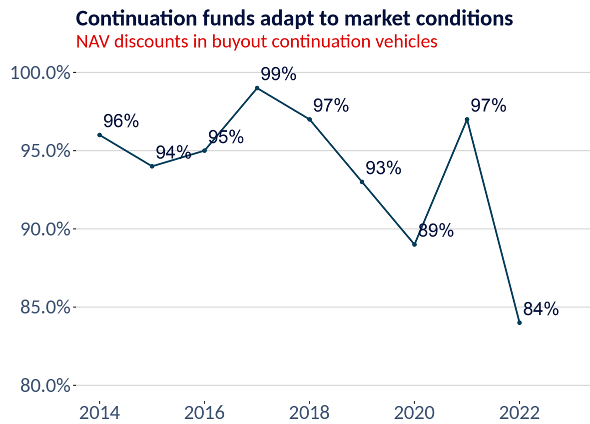
- Investors in continuation vehicles enjoy greater visibility: instead of subscribing to a blind pool, they buy into a pre-defined, well-known set of usually one to four assets that they can evaluate individually.
- Corporations held by continuation funds tend to be more mature, and LPs avoid the initial post-deal phase during which a new management team takes over, resulting in heightened uncertainty and potential disruption. They also mitigate the risk of a poor buyer due diligence, as the buyer is identical to the seller. Ceteris paribus, this feature makes the vehicles a significantly less risky choice.
- Continuation funds usually come with a reformed compensation structure, with managers charging substantially lower management fees (usually around 100bps on invested capital vs. the traditional 200bps) considering the fund starts with a higher invested capital base. LPs may thus profit from better incentive alignment. However, investors will generally scrutinize the GPs incentivization, most importantly, how much of the crystallized carried interest, or how much of managers' own money is reinvested into the vehicle.
- Continuation funds allow general managers to wait out cycles or phases of financial distress in public markets (e.g. energy prices, Covid, raw materials inflation), reducing pressure to get a deal done when transaction activity is subdued marketwide. This may allow investors to benefit from further return smoothing and reduce the risk of being forced to sell at fire-sale conditions during a downturn.
- In case favorable (debt) financing was put in place prior to the continuation fund transaction, it can be maintained in the new transaction as there is no change of control, effectively bestowing a portability feature to these transactions.



Source: *Lazard 2022 secondary market report [10]*
Figure 5: *Continuation vehicles' target returns are higher than traditional secondary transactions and have increased in 2022 to adapt to evolving market conditions.*

4 What's in for investors?

Continuation funds usually target high returns compared to traditional secondary transactions (LP led). Market data for buyout indicates that these returns are in line with direct investment, at around 2.0x to 2.1x Net Money on Invested Capital returns, vs. around 1.6x for LP Led [10]. The risk-return profile can also be considered to be superior to direct co-investment, as the GP knows the market, the company, and the management team. As a result, there is a lesser risk of



Source: *Greenhill data*
Figure 6: *NAV discounts in Buyout continuation fund transactions align valuations and target returns to real market conditions.*

management transition, poor Due Diligence, or overpaying for the asset. As the Buyer is also the Seller, valuations are often much closer to the real market environment. 2021 saw continuation vehicles trade at 97% of GP reported net asset value on average, sometimes even with a premium to NAV, whereas 2022 saw significant discounts to NAVs that had not been really adjusted from their 2021 levels, as shown in Figure 6.

5 Conclusion

As GP Led secondaries have become a more common exit route for private equity sponsors, public, investor, and regulatory attention has increased. While the potential conflicts of interest and mispricing risks associated with the rising prevalence of this kind of deal need to be taken seriously and addressed proactively by all stakeholders, we believe that continuation funds are there to stay and should be a part of every investor's private market toolbox.

Eventually, we believe that the private and the public market are set to become increasingly more integrated and structurally similar, with ever more sophisticated private equity managers, investors, service providers, databases, and tech creating an ecosystem that more closely mirrors the transparency and efficiency of the stock market while hopefully avoiding some of its shortcomings.

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We offer a one-stop solution to wealthy individuals and families including private office services, portfolio consolidation, and discretionary portfolio management and advisory.

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About Tioopo

Tioopo Capital is a multi-family-backed Private Equity firm that invests in Continuation Funds and SMEs in Europe.

https://www.tioopocapital.com/

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