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PRIVATE EQUITY NEWS & ANALYSIS

GPs and LPs push envelope on terms to allow continuation funds

The growth of secondaries and the realities of the market amid the pandemic have forced more flexibility into the classic PE fund model, according to a survey by Paul, Weiss, Rifkind, Wharton & Garrison.

Fund managers are increasingly rethinking fund terms to provide more flexibility around holding assets and capital use, an analysis by law firm Paul, Weiss, Rifkind, Wharton & Garrison has revealed.

A survey by the firm of approximately 50 recently raised private equity funds revealed that GPs and LPs are "pushing the envelope on terms in order to squeeze more flexibility into the traditional PE fund model" regarding fund-to-fund transfers, the use of continuation vehicles and recycling of capital, Marco Masotti, a partner at the firm, told *Private Equity International*.

"The pandemic has highlighted the liquidity needs of portfolio companies and underscored the realities of the marketplace and how long it takes to realise value," Masotti said.

The funds surveyed are mostly in the US and have a minimum fundraising target of $2 billion.

Transactions involving multi-asset and single-asset continuation vehicles represented 73 percent of total GP-led volume last year, according to advisor Greenhill's Global Secondary Market Review. This option has increased in popularity as GPs consider it a valid exit alternative to a trade sale, a sale to another sponsor or an initial public offering.

"We are sometimes squeezing the industry into this five-year commitment period, 10-year life model and it doesn't always work well, both with what the GPs want and the liquidity needs of the LPs," said Masotti. "This is why we are seeing this big, robust secondary market of people selling portfolio companies to continuation funds, which can make a lot of sense."

He said that, for GPs and LPs, there is also "a little bit more willingness to extend the life of the fund as well as increasing permitting flexibility for restructurings and the creation of continuation funds". He added that the rules for tackling fund-to-fund transfers are increasingly more clearly addressed in fund documents.

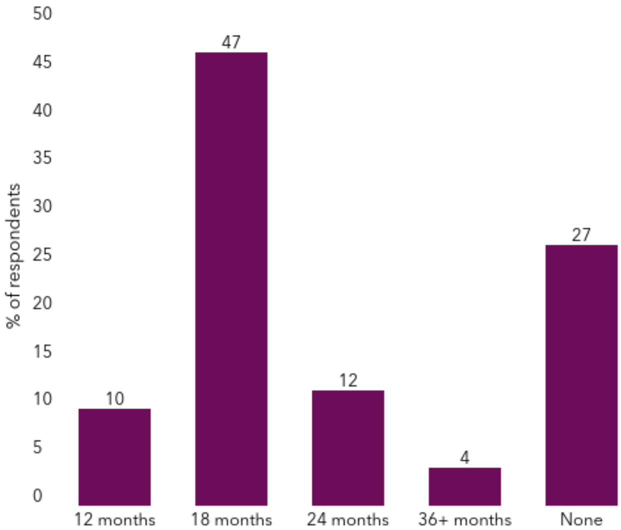
Asked whether the firm has seen pushback from LPs on portfolio restructurings, Masotti noted that the concept is well established in the marketplace.

"GPs and LPs are all trying to work out what the right contractual terms are and what the right procedures are to ensure that this is done – given the inherent conflict – in an appropriate way." He noted that in creating these provisions in fund documents, LPs want appropriate procedures in place, such as an LPAC approval or fairness opinions.

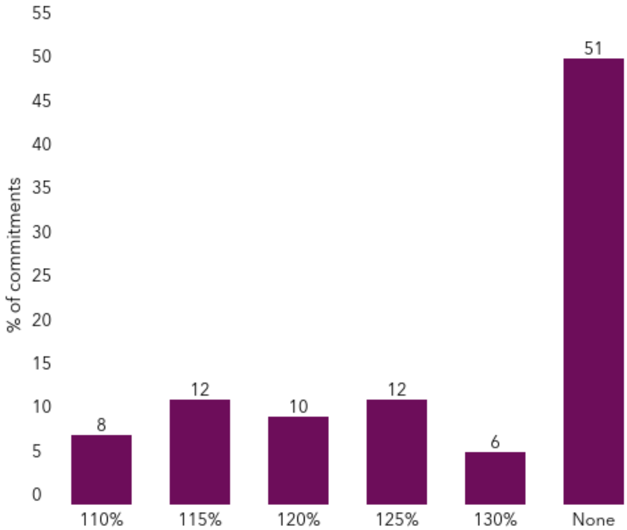
BC Partners, EQT and Blackstone are recent examples of firms that have either used continuation vehicles or transferred assets into successor funds. EQT continues to own Swedish enterprise software provider IFS via its two latest flagship funds. The firm first invested in IFS six years ago through its 2015-vintage EQT VII, and sold that fund's shareholding to EQT VIII and EQT IX last July in a deal worth more than €3 billion. BC Partners is making a €300 million investment in the continuation vehicle holding academic publisher Springer Nature. The capital is expected to come from its latest flagship fund,

BALANCING ACT

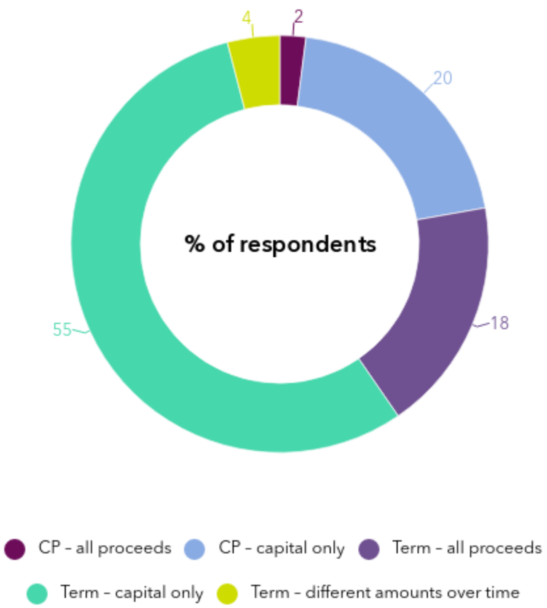
Nearly half of the PE firms surveyed allow recycling, where capital is returned within 18 months of investment



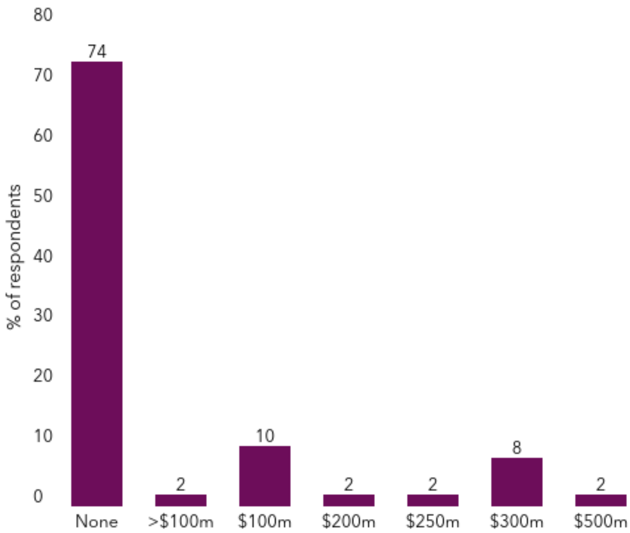
Almost half of PE funds cap the amount of capital that may be invested (including as a result of recycling) to between 110-130% of commitments



Most PE funds permit recycling throughout the term of the fund



About a quarter of PE funds offer tiered management-fee structures based on the size of commitment, beginning at $100m



Source: Paul, Weiss, Rifkind, Wharton & Garrison which has been in market since February last year with an €8.5 billion target.

Recycling proceeds beyond the investment period is one area that has seen more flexibility.

It used to be the case that GPs could only recycle dollars from an exit within 12 to 18 months, according to Masotti. "These days there's a little bit more willingness to allow recycling broader than the time period and throughout the commitment period subject to an overall cap," he said.

All the PE funds surveyed permit recycling. Nearly half allow recycling where capital is returned within 18 months of investment, and 16 percent allow it beyond 24 months, according to the report. The time period varies depending on the size of the fund and strategy.

Most PE funds (77 percent) also permit recycling throughout the term of the fund and cap the amount subject to recycling at the investor's initial commitment, the report found.

Masotti said the basic economics of management fees, transaction fees, carried interest and GP capital commitments remain reasonably consistent with pre-pandemic terms.

However, he noted that GPs are feeling more pressure on size-based discounts: that is, the more dollars invested, the more special or bespoke treatment LPs get on fee discounts or on co-investments. "Trying to fit that in with the traditional fund model where all LPs get the same terms has become increasingly hard."

A quarter of PE funds in the survey offered tiered management fee structures based on the size of the capital commitment, with most discounts generally offered for commitments above $100 million.