KEYNOTE INTERVIEW

A good moment for continuation funds

Times of uncertainty offer the buyside a window of opportunity, while sellers can benefit from liquidity, says Miguel Zurita, a managing partner at AltamarCAM Partners

Q Has the decline in M&A activity impacted PE's view of continuation funds as an exit strategy?

The continuation fund has evolved into a credible exit route alongside the secondaries buyout, IPO or trade sale. GPs now expect sell-side advisers to look at all the exit options, including a continuation fund.

When the M&A market was booming, and it was relatively easy to sell assets at good prices, LPs had some concerns about whether a continuation fund solution was maximising value on exit. Now, in a more difficult time, I think LPs are glad to have this option for liquidity on the table.

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The continuation fund ecosystem has matured. There are competitive processes, independent advisers are involved and fairness opinions are provided to LP advisory boards. LPs that cash out are going to get a fair price.

Of course, there is a subtle distinction between securing a fair price and the maximum price. In an M&A process there is scope to find a buyer that is willing to make an offer over and above anything that any other bidder is willing to pay. In a continuation fund you are less likely to find that outlier buyer, but you will get a fair price, and in a choppy M&A market the continuation fund option provides superior certainty of execution.

The disruption of establishing a price for a continuation fund is nothing in comparison to the disruption of putting a company out for sale in the M&A market, or the risk of that sale process failing.

In a continuation fund, LPs know the manager, the asset and the strategy. It is much easier to form a view on valuation, so the level of execution risk is lower.

Q What factors are LPs taking into consideration when deciding whether to rollover or cash out?

The most obvious consideration is time. Do they have time to reinvest and hold for another four or five years or are they at a point where they need to make distributions?

Capital calls have outpaced distributions for the first time in more than a decade, so having more routes to liquidity is a good thing for investors. If you require liquidity, a continuation fund deal is a great option. Indeed, we are noticing an increase in the number of LPs that are opting to cash out.

It also important to form your own view on pricing. There are always going to be different views on valuation over the long term, but pricing for continuation funds is fair – there are issues for everyone if it isn't.

For an LP rolling over and putting in new capital, it is crucial that the GP is also reinvesting and still has skin in the game. Economic alignment is the foundation for a successful transaction.

The management team's alignment is also key. A continuation fund won't always trigger the management incentive plan, but often it will. If capital gains and cashflows are going to the management team it is important the team also reinvests and that a new incentive plan is put in place. It's reassuring for LPs to see the GP, management team and existing investors reinvesting.

Q We have seen discounts to NAV widen during the last year. Has that made LP secondaries more attractive relative to GP-led deals?

There are undoubtedly good opportunities emerging in the LP-stakes market, and we may well see more LP deals than GP-led deals this year, but it will still be around 50:50 between the two. Similar to the LP side of the market, we are increasingly seeing discounts to NAV widen on the GP side as well. We are more active on the GP-led side and remain comfortable focusing on that part of the market.

"History shows that in times of uncertainty there are opportunities to buy well"

There are different skillsets. In an LP-stakes deal you are buying large, diversified portfolios consisting of hundreds of companies. You are not doing a granular analysis of every company in the portfolio. In a GP-led deal, however, you are digging into the fine detail of each company.

In a time of uncertainty, it can be difficult to assess the immediate impact of inflation, energy costs and labour availability on a large portfolio of hundreds of companies. In a GP-led deal, where you are funding no more than five companies in most situations, we find that we can gain more visibility and develop greater comfort on the impact of the current environment on businesses.

Q Do you see leverage being used in GP-led deals?

Leverage is now standard for most LP-stakes deals. It is less common on the GP-led side, though we are seeing more of it.

If you look at wider capital markets, debt is more expensive and less abundant, so I wouldn't expect to see a big increase in the use of leverage for GP-led deals anytime soon. We don't use leverage in our GP-led deals and continue to generate our targeted returns without it.

Q Are there any issues you need to be mindful of when focusing on single-asset and concentrated deals?

We like GP-led deals because the assets that go into continuation funds are usually the trophy assets. In an LP-stakes deal there will be some assets you like and some you don't. That is not something you have to worry about in a single-asset deal – you select what you like.

That said, you do need to manage diversification. We have strict limits in place across our portfolios. No single asset should account for more than 2.5 percent of a portfolio, and on average we are well below that threshold.

You must also be aware of how carry waterfalls are structured, because with single-asset continuation funds you can end up effectively paying deal-by-deal carry. If you have a portfolio of multiple assets, you don't pay carry unless the whole portfolio clears the carried interest hurdle. But if you are running multiple single-asset continuation funds, you can end up paying out more if some assets do well but others do poorly, as the poorly performing assets don't reduce the overall carry you are paying out for the good assets.

Q Do you apply any sector or geographic filters to your deal selection?

We are sector agnostic, and our portfolios generally reflect the sectors that PE firms are active in, such as healthcare, technology and services. We invest globally, with the US and then Europe as the largest geographic exposures in the portfolio, but if we see something we really like in other regions, we will do it. We are extremely careful when it comes to managing downside risk and ensuring that we are not overexposed to any one asset or manager.

Overall, we feel this is a good moment for continuation funds. There is less competition from the traditional routes to liquidity, so in relative terms continuation funds become more attractive for vendors. On the buyside, history shows that in times of uncertainty there are opportunities to buy well, so we see a good window to invest in continuation vehicles too. ■