EXPERT COMMENTARY

The future of private funds as a longer-term investment option has become a commonplace goal for the market, write Troutman Pepper lawyers Julia Corelli, Stephanie Pindyck Costantino, Patrick Bianchi and Theodore Edwards

Illuminating investment horizons

The growing prevalence of permanent capital vehicles (PCV), annex funds, and continuation funds demonstrate the current market need to align the interests of investors and managers with respect to investment horizons. At the same time, special purpose acquisition companies offer different avenues to liquidity for both. Managers are increasingly utilising these structures to invest over the longer term in portfolio companies and provide options compared to the traditional 10- to 14-year term investment.

Patient capital

Sequoia Capital's October move to a PCV model validated many managers' desire for freedom from external pressures on investment – primarily disposition – decisions. The traditional 10- to 14-year fund term can pressure a fund to either stop further investment in a portfolio investment, sell an investment before realising optimal returns, or avoid add-on or bolt-on opportunities that would enhance the value of the original investment. From the manager's perspective, a PCV relieves some (though not all) of the pressure of continuous fundraising and fund formation and allows more focus on optimising returns.

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The primary challenge in launching a PCV is often convincing investors to try something different. Because of their long-term nature, PCVs are viewed as offering limited opportunity for liquidity, but really it is just a different means to liquidity. Large shops such as Sequoia, Blackstone and Pershing Square may be able to secure commitments more easily due to their experience, track record, and of mostly long-term investor base, smoothing their transition to a PCV model. In the mid-market, PCVs are often launched by, or spun out from, family offices, managers of closely held investment vehicles, and managers with strategies that support this "new" frontier.

Annex funds

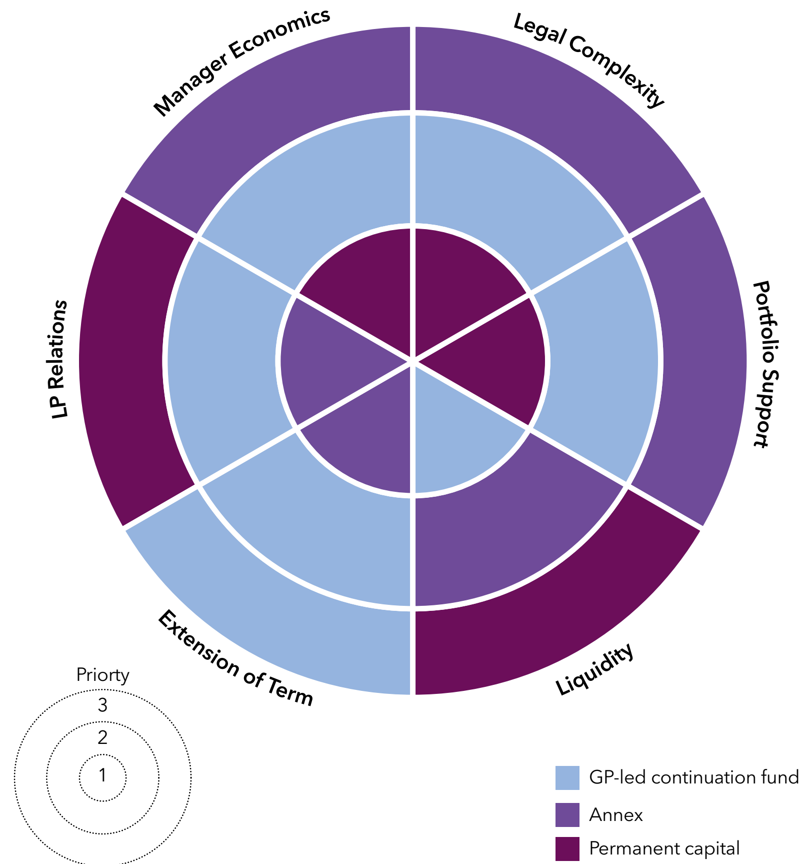
The PCV model may not be desirable or viable for a manager nearing the end of the original term of its fund. Instead, they may seek to create an annex fund or a continuation fund to maximise the value of portfolio holdings. Annex

funds are separate committed capital vehicles formed after the investment period of an existing fund that has insufficient follow-on capital to maximise return on investment. They typically invest only in the main fund's portfolio companies.

While annex funds gain popularity when it is hard to fundraise – such as during the covid-19 pandemic – they are also often used to provide growth capital. They usually seek to raise capital first from investors in the main fund pro rata, with any excess capacity being offered to full subscribers and then to third parties, and generally do not offer liquidity to investors. Investors that choose not to participate in the fund will be diluted with respect to their interest in the portfolio investment.

Annex funds commonly offer preferred economics relative to the main fund, such as zero management fee and a lower carry, but otherwise generally have terms similar to the main fund. The annex fund is typically required to exit portfolio investments at the same time, price and on the same terms and conditions as the main fund. Because the annex fund's potential portfolio is known, the disclosures to investors are similar to a private offering of securities in the underlying portfolio companies.

Annex fund managers also need to disclose how expenses will be allocated between the annex fund and the main fund, and how they will manage conflicts of interest when the annex fund invests in higher tiers of a portfolio company's capital stack than the main fund. Managers typically obtain a third-party valuation or fairness opinion with respect to the portfolio investment before investing in it. Other questions relate to the time and attention, ability to raise successor funds, and which investors a manager will invite to participate in the annex fund (it need not always be pro rata). Some issues may require approval by the investor advisory committee of the main fund.



GP-led secondaries and continuation funds

Continuation funds are pooled investment vehicles sponsored by the GP of an existing private fund to acquire one or more portfolio companies of the existing fund at the end of its term that the GP wants to continue to manage. While secondary transactions generally mean acquiring investor interests, when combined with a continuation fund, it is usually a purchase of the portfolio securities owned by an existing fund. The continuation fund purchases the portfolio company from the main fund, allowing it to be held under the continuation vehicle's fund agreement for a new fund term. The continuation fund may also be a blind pool positioned to invest in other companies.

For the GP, the continuation fund allows a successful exit from a valued portfolio company, which is important for its track record and marketing of future private funds, while keeping an established portfolio company that is positioned for growth within its assets under management. The continuation fund acquisition of the company could also offer the GP the opportunity to realise carried interest, though that varies considerably with partial carry rollover often required by the new continuation vehicle investors. The existing limited partners receive cash when the proceeds of the portfolio sale are distributed, though they are often given the opportunity to roll over their existing fund interests into the continuation fund. Careful planning is necessary to enable tax-efficient rollovers.

The continuation fund is generally funded with capital from new investors.

Unlike annex funds where the existing investors typically have first rights to invest, new investors generally anchor the continuation fund. The anchor negotiates the continuation fund's terms and conditions with the manager of the existing fund. The continuation vehicle charges a management fee and carry on its capital commitments or contributions as negotiated with the anchor investor.

A sponsor-led continuation fund will present a conflict of interest for the GP of the existing fund because its fiduciary obligations to existing limited partners need to be consistent with selling the portfolio company to the vehicle. The GP must manage the transaction carefully to avoid securities law violations, including disclosure materials specific to the portfolio companies being purchased by the continuation fund; the vehicle's proposed terms; the GP's conflicted position on both sides of the transaction; the options presented to investors; and all facts material to making an informed decision. A GP will need a valuation firm to support the business case and advisers to prepare the offering materials and legal documents.

A GP-led continuation fund transaction is really two transactions. The existing fund's LPs generally bear the sale transaction expenses, while the continuation fund generally bears its formation and offering expenses. The diligence process in the sale can be extensive and must be structured to allow the continuation fund to make its disclosures to its investors. Disclosure materials with respect to the continuation vehicle are heavily focused on the portfolio and the GP's conflicted position, in addition to the fund manager's track record and management philosophy and the terms of the fund.

"While the traditional fund term is alive and well, investors and managers alike are coming to appreciate the need for longer-term capital"

A continuation fund offers an attractive solution to the problem of a constraining fund term when a portfolio company is positioned for substantial future growth. However, the continuation fund must be carefully analysed to determine if it is right under the applicable facts and circumstances.

SPACs vs IPOs

For private equity funds investing in mature companies, the initial public offering has been a traditional exit mechanism. Special purpose acquisition companies have recently become a popular alternative. In 2021 alone, there were more than 600 listings of newly formed SPACs, according to data from Nasdaq.

A SPAC is an "empty" company that raises money from the public with a strategy to acquire or merge with a target company within a specified period of time, with the latter known as a de-SPAC transaction. Cash raised from the public is held in escrow pending shareholder approval of a target investment. Investors in the SPAC vote on the proposed transaction and may redeem their SPAC shares before the de-SPAC if they do not like the target selected.

In a de-SPAC transaction, most of the traditional IPO activities, such as engaging underwriters, diligence, preparing the prospectus and other securities filings plus their associated expenses, are the responsibility of the SPAC sponsor. As with IPOs, the de-SPAC results in the fund owning publicly traded securities. Managers must deal with numerous management, compliance, distribution in kind and, if the sponsor continues to have a member on the board, governance, fiduciary duty, inside information and conflicts questions.

Recent regulatory developments

As usually happens, innovation in the market tends to foment new regulations. Unsurprisingly, in February, the US Securities and Exchange Commission proposed new rules and amendments to existing rules and Form ADV under the Investment Advisers Act of 1940, as amended. The proposals significantly impact private funds, as well as compliance, cybersecurity risk management, and books and records requirements for all registered investment advisers.

On 30 March, the SEC proposed new rules relating to disclosure obligations for SPACs, aligning them more with those applicable to IPOs and requiring explicit conflicts disclosures, among other things. All of these proposed rules carry shortened comment periods and, if those hold, will be finalised in the second quarter of 2022. Whatever changes might come, the rules represent the codification of many market practices that were common in the upper tiers of the private fund space. The rules will equally apply to smaller managers and fundless sponsors, who are likely to see their compliance costs increase.

The tools outlined above are not new, but are increasing in use, especially in sectors where patient capital leads to greater returns. While the traditional fund term is alive and well, investors and managers alike are coming to appreciate the need for longer-term capital, alternative methods of exit and the ability to invest without the constraints of a fixed term. But optionality brings complexity, fiduciary responsibility to choose the right path and, inevitably, additional regulation. ■

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