THE NEW MAINSTAY IN PRIVATE MARKETS DEALS: CONTINUATION VEHICLES

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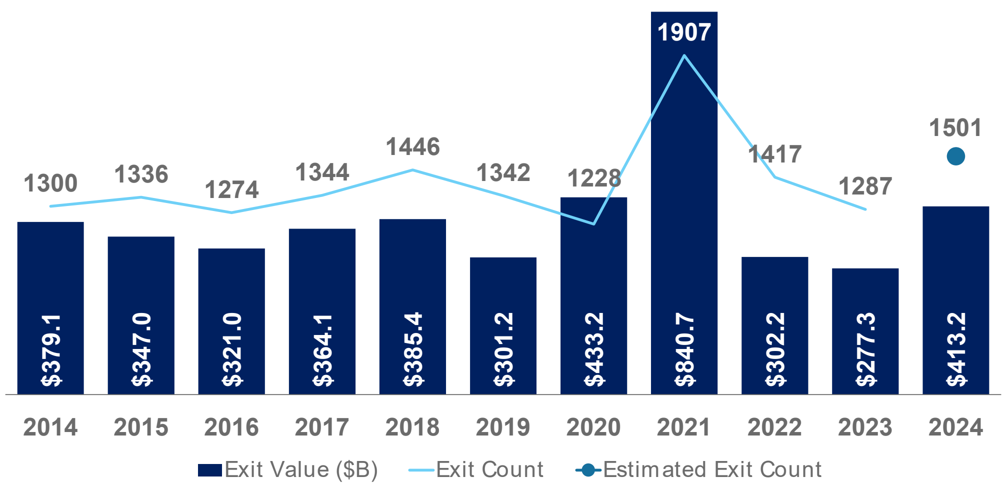
Private market participants are increasingly turning to continuation vehicles as a means to provide liquidity to their investors.

The struggle of General Partners (GPs) to sell fund portfolio assets has disrupted exit activity and complicated the timely distributions they typically make to their limited partners (LPs). LPs rely on these income streams to make other investments, and meet their financial obligations which could range from paying pensions to retired firefighters and teachers, to supporting the operating budget of a college. A change in the pace of distributions has meaningful implications for not only future commitments to private markets, but also the LP's mission and goals. Amid this liquidity squeeze, continuation vehicles offer the option to extend a GP's holding period of the portfolio assets from a fund that is approaching the end of its cycle, while giving LPs the choice to either exit their investment—often, but not always, at a discount to net asset value—or roll over to the new investment vehicle. In 2024, U.S. and Europe private equity exits to continuation vehicles totaled 96, a 12.9% jump from 2023, according to data from PitchBook.

PRIVATE EQUITY EXIT ACTIVITY



Source: Pitchbook; Geography: US; As of December 31, 2024

WHY DO CONTINUATION VEHICLES EXIST?

These private investment vehicles have been around since well before the start of the liquidity issues experienced by private markets participants. Continuation vehicles picked up momentum when liquidity was flowing five years ago. Towards the end of the life of a fund, they allowed GPs to hold an asset(s) they believed in and could add further value to within a new fund with an extended investment period, while letting the existing LPs roll their position into the new investment vehicle or cash out.

Starting off as simple transactions, they have evolved into more structured and complex deals, including deferred payments. Some say continuation vehicles offer the best of both worlds: GPs can hang on to performing portfolio assets to further grow value, while LPs have a choice to stay invested with the potential to earn higher returns or opt for liquidity. This theoretically expands LPs' portfolio management capabilities, allowing them to de-risk their positions, elect liquidity and redeploy capital into higher returning investment alternatives. Others believe these private investment vehicles are more beneficial to GPs than LPs as the onus is on the LPs to take a call within a compressed time period with asymmetric information. LPs may also take on increased concentration/ single asset risk with some structures, and whether they roll or cash out, valuation practices of the asset(s) may not be optimal.

At NEPC, we expect continuation vehicles to be a mainstay in 2025 and beyond even as private equity exits somewhat recovered in 2024 from their lows in 2022 and 2023. A significant portion of the secondary capital raised last year were GP-led CVs, and we have even seen funds raised solely to invest in these investment vehicles. A record high of $97.5 billion was committed to secondary funds during the one-year period ending September 30, 2024, an increase of over 30% year over year, according to PitchBook.

For LPs, we believe each situation is unique, and clients should seek independent legal, regulatory, and tax advice before making any decisions. We encourage clients to make their decision to roll or sell based on their individual liquidity situation, alternate investment opportunities and risk profile. Our investment team has created a process to evaluate the puts and takes of continuation vehicles impacting clients, and we will provide a framework for LPs to evaluate these investment decisions.

GUIDANCE TO LPS AND GPS

GPs need to be prepared to answer questions from their LPs. In addition, transparency and forecasting of plans are important, and GPs should provide enough lead time for LPs to make an informed decision. At a minimum, we look for the following in any process involving continuation vehicles: a proper valuation process with an investment bank, the soliciting of multiple bids with the best bid winning, and providing transparency to the Limited Partner Advisory Committee (LPAC) and LPs.

As deal structuring gets increasingly complicated, including the timing of cash flows and deferred payments, we encourage LPs to seek the information they need in order to reach a decision on whether to stay in a continuation vehicle or cash out. For example, a GP might create a continuation vehicle of a handful of assets priced between 90-to-93 cents on the dollar, but a portion of the payment of the proceeds to LPs could be deferred a year after the deal closes, bolstering the internal rate of return of the CV (and effectively creating a larger discount to NAV). Meanwhile, the selling LPs may not see capital for up to a year.

As a starting point, we recommend LPs ask the following questions if presented with the option of a continuation vehicle:

- What is the rationale for the CV and the credibility of the new valuation plan? Does the deal need more time to grow or more capital? How will the GP continue to add value?
- How is the transfer price set? Is it through an independent valuation provider, auction or internal pricing mechanism?

- GP commitment/ alignment: Is the GP committing to the CV? Who is the lead investor?
- Return expectations: What is the GP's expected multiple on invested capital (MOIC)—a key performance metric—and IRR for the CV?
- Fee/ carry arrangements: Are fees and carry reset or do they remain unchanged?
- Valuation: Is there a discount to NAV?

At NEPC, we are standing by to answer your questions if you are faced with the decision to stay in or leave a continuation vehicle. Our investment team will conduct its due diligence, outlining the details of the transaction and the options for investors. While our investment expertise is in evaluating and recommending private investment funds rather than individual portfolio assets, we will apply a framework to assess and summarize the facts of each continuation vehicle in order to provide clients with the information they need to make their decision. Please reach out to your NEPC consultant if you would like to learn more about our research process for continuation vehicles.

IMPORTANT DISCLOSURES

Past performance is no guarantee of future results.

All investments carry some level of risk. Diversification and other asset allocation techniques do not ensure profit or protect against losses.

This memo should not be considered customized investment advice. Please contact NEPC for advice specific to your investment program.

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