THE RISE OF CONTINUATION FUNDS

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RISE OF PRIVATE EQUITY

The Nabisco Battle's Key Moment

By JAMES STERNGOLD

The key strategic moment in the battle for RJR Nabisco may have been a few days before a Nov. 18 bidding deadline when H. John Greeniaus, chief executive of the conglomerate's Nabisco Brands subsidiary, telephoned Kohlberg, Kravis, Roberts & Company and said he wanted to meet.

What Mr. Greeniaus told the buyout firm, according to people with knowledge of the discussion, was that he wanted to provide more information about the company's operations than its managers had given it to come up with its bid, in keeping with a directive from the company's board that all managers cooperate.

The underlying message was that some of the company's managers had not been forthcoming in providing critical financial data. "Some of those guys could hardly remember their names," Henry R. Kravis, a senior partner of the buyout firm, said in an interview yesterday.

Without the information, Kohlberg, Kravis was put at a disadvantage compared with its chief rival in the battle, an investment group led by RJR Nabisco's top executives. Thus, the tipoff might have changed the course of the battle, eventually allowing Kohlberg, Kravis to persuade the RJR Nabisco board of the problem and to get the needed information. It also then become warier of its rival and employed some tough tactics of its own to win the largest corporate auction in history.

plex series of securities rather than cash to pay for the acquisition, they believed the deal would be far less risky than some outside experts believed. "It's as conservative a deal as we've ever done," Mr. Raether said.

Mr. Kravis added: "We want to [illegible] company [illegible] possible, [illegible]rly, w[illegible] have [illegible] assets."

He said his group would need to sell $5 billion to $6 billion worth of food operations in the next two years.

As the outline of the intense bidding battle was pieced together from a number of interviews, it became clear that the telephone call from Mr. Greeniaus was important in preparing Kohlberg, Kravis for what lay in store and how it would proceed. (Mr. Greeniaus did not return a phone call seeking his comment yesterday.) For this was to be a battle of perceptions as much as a straight bidding contest.

The bidding began when F. Ross Johnson, RJR Nabisco's chief executive, announced on Oct. 20 that he was leading an investor group that wanted to buy RJR Nabisco for $75 a share, or $17 billion.

After Kohlberg closed the data gap, it crafted a winning strategy.

tee would remedy the problem. "Quite frankly, we didn't have all the information we needed," Mr. Roberts said. "The projections we received the first time were way too low."

Responding to the accusation, a company executive said yesterday: "That's absolutely [illegible]." But [illegible] of the special committee's financial advisers, [illegible] to evaluate the company's worth, have told colleagues that they did not believe they were being given sufficient information at first.

Perceived as an Also-Ran

Perceived as an also-ran, Kohlberg, Kravis went out of its way to encourage that view with subtle comments that it hoped would filter back to the management group.

It seemed to have worked. On the next deadline of Nov 29, Kohlberg, Kravis showed up with a $106-a-share offer, $5 higher than the management group. The firm was thus invited in and spent the night negotiating a final merger agreement with the board.

The management group, outraged that it was being left out, came back Wednesday morning with a new bid of $108 a share. By midday, the two groups had been put into separate conference rooms and told they should present a final bid. The management group went to $112 a share.

Kohlberg, Kravis eventually bumped its offer to $108 a share, and then $109, but it applied some pressure of its own. It told the special committee that if a merger agreement was not signed by 1 P.M. Wednesday, it would withdraw it[illegible]

The New York Times/Chester Higgins Jr.

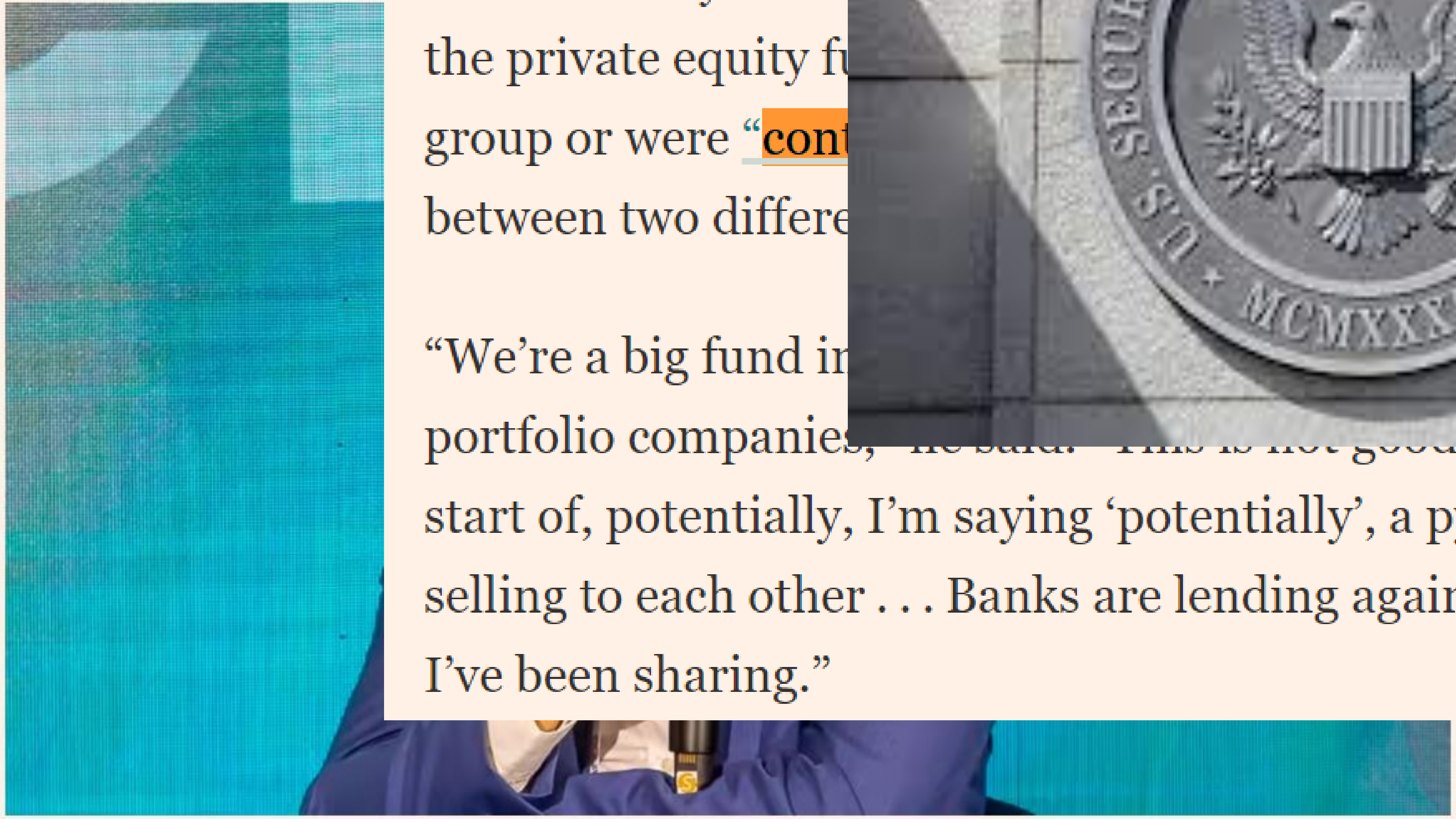
The winners in the bidding for RJR Nabisco in the offices of Kohlberg, Kravis, Roberts & Company's law firm in Manhattan yesterday. From left: Richard I. Beattie, the chief lawyer in the negotiations; George R. Roberts and Henry R. Kravis, the firm's senior part[illegible] Paul E. Raether, a partner.

Private equity may become a 'pyramid scheme', warns Danish pension fund

Tendency for buyout grou[...] to sell companies to the[...] business', ATP executive

Mikkel Svenstrup, c[...]cerned because last year m[...]npanies by the private equity fu[...]ther buyout group or were "cont[...]up passes it between two differe[...]

"We're a big fund in[...]ds of portfolio companies," he said. "This is not good business, right. This is the start of, potentially, I'm saying 'potentially', a pyramid scheme. Everybody's selling to each other . . . Banks are lending against it. These are the concerns I've been sharing."



Mikkel Svenstrup says the 'exponential growth' of the private equity industry, as investors have poured cash into its funds, would stop 'at some point' © IPEM

I. The article provides the first comprehensive examination of continuation funds (CFs)

II. We analyze the potential reasons for the growth of CFs and major concerns they present

III. Using qualitative data from interviews, we provide insights on the theory of PE bargaining and the realities of CFs

IV. We explore potential policy implications

THE RISE OF CONTINUATION FUNDS

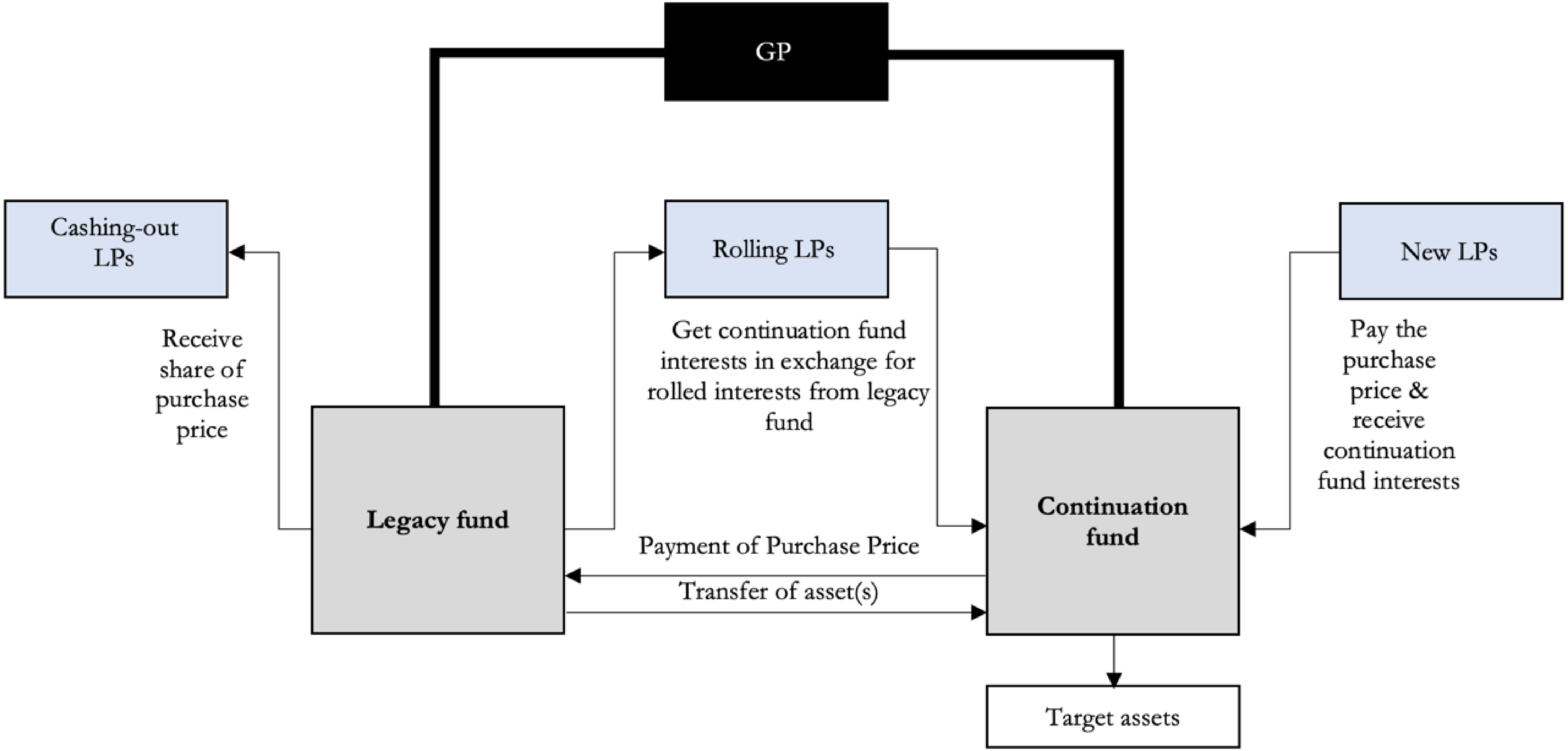
- Structure
- Advantages
- Growing prevalence and significance
- The web of conflicts

STRUCTURE AND ADVANTAGES

CONTINUATION FUND'S STRUCTURE (1)

- **The optionality**: LPs of the legacy fund can (i) *sell* their interests, (ii) *roll* them into the continuation vehicle, or (iii) sometimes both.
    - A rollover can either be on a "**reset**" or a "**status-quo**" basis.
- New LPs infuse new capital into the fund and buy the interests of the selling LPs.
- Continuation funds usually last for up to 6-7 years
- CFs usually offer the GP new terms.

CONTINUATION FUND'S STRUCTURE (2)

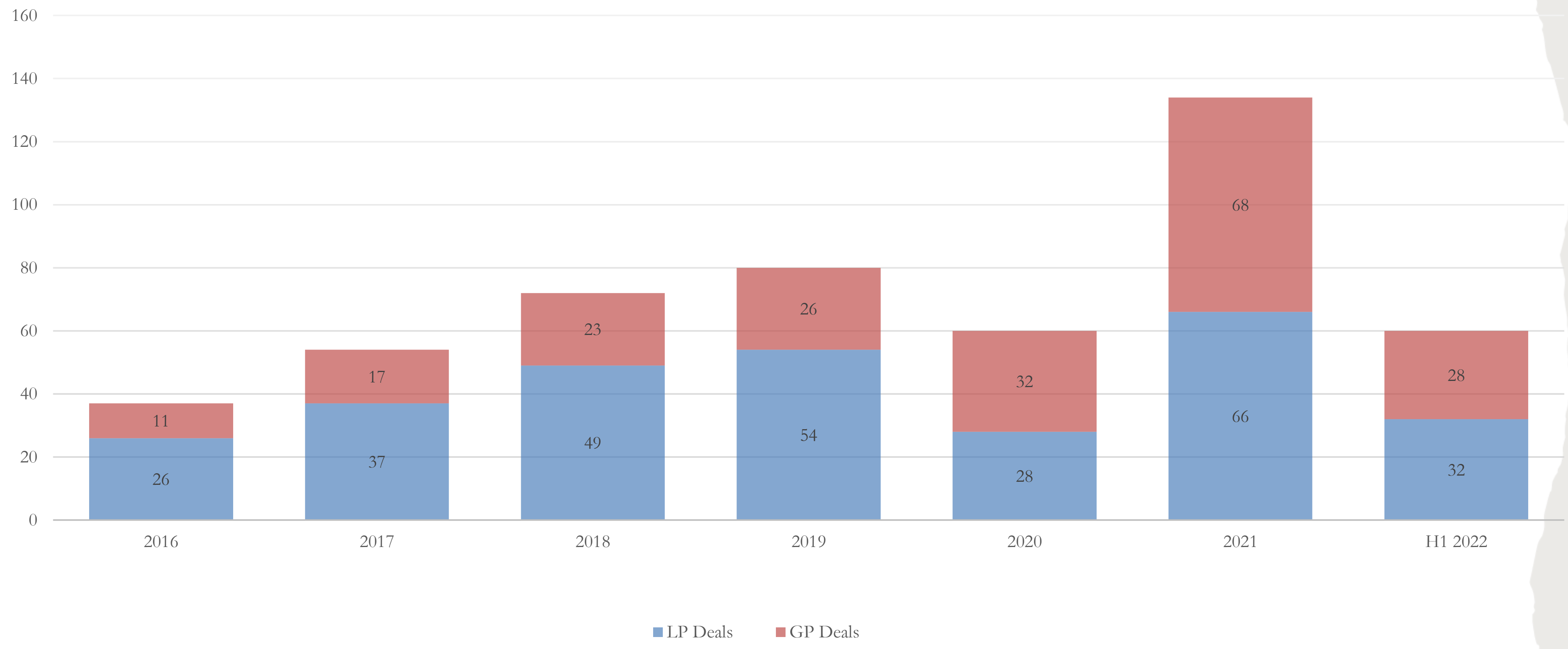


GROWING PREVALENCE AND SIGNIFICANCE

THE GROWING PREVALENCE OF CONTINUATION FUNDS

- One of the most popular trends in PE over the last few years:
  - In the past, CFs were used for struggling distressed assets ("*zombie funds*").
  - As of 2015, started to be used for high-performing assets that GPs wanted to hold for longer periods.
  - **Their total deal value surged significantly within 5 years**, from $11 billion in 2016 to ~$68 billion in 2021.

The Growing Prevalence of Continuation Fund (2)



THE BENEFITS OF CONTINUATION FUNDS

Supporters of continuation funds view them as a "**win-win-win**":

- **GPs** can hold assets for an extended period, without selling the company to another fund (and avoid management change).
- **LPs of legacy funds** can either realize gains or roll over their investments, gaining continued exposure to the assets.
- **Incoming LPs** can invest in more mature assets for a shorter period.

WEB OF CONFLICTS

GP'S PRIVATE BENEFITS

- GPs have a strong financial interest in establishing continuation funds:
  - **New management fees for an extended period**.
    - Calculated as a % of committed capital
    - Most meaningful investment work has been done
  - **Crystallization of the carried interest** (reduces risk, provides liquidity, all without conducting a "real" exit)
  - Enjoy the upside of **additional carry** on the same asset
  - Improving the GP track record & undermining investors' ability to accurately measure the GP's performance

GP'S DUAL LOYALTIES

- **The GP is on both sides of the deal**, being committed to two groups of investors whose interests are in direct conflict:

Existing LPs
Interested in ***selling*** at the ***highest*** possible price

Purchase Price

New LPs
Interested in ***paying*** the ***lowest*** possible price

- Since most Legacy LPs (80-90%) sell their interests, the conflict is severe.

THE GP ALWAYS WINS

- Any loss on one side is offset by additional fees and other benefits from the continuation fund, ensuring the GP always wins (regardless of whether the sellers or buyers have the upper hand).
- See also **Phalippou (2020)** on the magnitude and cumulative impact of the fee.

THE GP'S (POTENTIAL) BIAS TOWARDS THE NEW LPS

  - They are the investors the GP must convince to "come on board."
  - Since many transactions include "staple commitment," the GP may prioritize its relationship with new LPs.
  - The new investors in CFs are often other PEs or repeat players with ongoing, close relationships to GPs (*see*, evidence re the increased cooperation among PEs).

- New empirical insights on preferred investors being offered higher returns by GP support our analysis (Lerner et al., 2022).

THE ADVISORS' INCENTIVES

Advisors are critical players, setting market standards and gaining financially from the development of CFs.

For many advisors, CFs present an opportunity to collect fees *twice* for the sale of the same asset(s).

Advisors' interests in CFs may lead them to emphasize these funds' benefits & downplay their drawbacks, potentially encouraging excessive usage of CFs.

THE POTENTIAL INEFFICIENCIES OF CONTINUATION FUNDS

Suboptimal utilization of capital:

- The GPs' private benefits may cause them to avoid more profitable exit options. These better alternatives are not known to LPs;
- Extended timeframe to maintain underperforming portfolios for fee.

CFs exacerbate the information asymmetry problem in PE:

- Removal of the 10-year yardstick: more time to overstate performance; impairing LPs' ability to evaluate the GP.

WHEN THEORY MEETS REALITY – **METHODOLOGY**

- Continuation funds are a “black box” (LPAs are not accessible).
- To overcome these informational limitations, we conducted **qualitative interviews** with senior officers at LPs and legal counsels for GPs.
- The partners we interviewed were involved in over 85 GP-led transactions during 2022 (aggregate transaction volume of +$60B).
- We supplemented the interviews with a review of publicly available sources & comment letters on CFs submitted to the SEC.

THE CHALLENGES FOR LIMITED PARTNERS

Information asymmetry

Lack of expertise

Lack of time

Capital allocation, diversification, liquidity

PRIVATE EQUITY CONTRACTING

- Our findings are in line with recent scholarship sheds light on the limited bargaining power of many LPs (e.g., Clayton, 2022):
    - *Weak incentives to negotiate collective protections in LPAs, as some LPs can negotiate individualized benefits.*
    - *Limited information about market terms*
    - *Fear of exclusion from future funds*
    - *Agency problems of asset managers*

THE ROLE OF REPUTATION AND ONGOING RELATIONSHIPS

Two distinct investor attitudes toward CFs -> Heterogeneity of LPs matters

- Smaller LPs have expressed concerns about the GP's motives (double-dipping on fees; fast liquidation in 20% of the cases).
- The ability of these LPs to retaliate if the GP misbehaves is limited. Thus, they are more likely to cash out.
- However, for larger & sophisticated LPs, relational contracting could work. The multiple interactions and enhanced trust & encourages them to roll over.
- No use of litigation

RESOLVING HIGH-CLASS CONFLICTS

- Approval by LPAC
- Increasing GP's skin in the game
- Competition

THE SEC SUGGESTED REFORM

New proposed rules (2022): requiring GPs to obtain a *fairness opinion* for these transactions

- Market participants strongly criticized the proposal.
    - *Sponsors:* it will add unnecessary costs for investors.
    - *LPs* are skeptical of fairness opinions due to objectivity concerns (advisors are selected by GPs).

- As LPs rarely pursue legal action against GPs, these opinions are less likely to face scrutiny in court.

The Continuation Fund Debate: Market Outcome or Failure?

The Limits of Reputational Sanctions

- Reputation depends on the quality of available information.
  - PE investments are illiquid; it takes time to assess the performance.
  - Underperforming GPs tend to inflate reported returns.
  - Lack of performance data by third-party vendors on CF funds.
- Due diligence requires expertise in *specific assets*, which many LPs lack.
- Competition for accessing top-tier investments (Lerner et al., 2022)
- Phalippou: the industry motivates institutional investors to (re)invest in PE

ALTERNATIVE PROPOSALS

- ***Enhanced mandatory disclosure*** and extended election period.
  - But, disclosure alone may not be enough to align the interests of the GP and the legacy funds LPs.

- ***Status-quo option*** *is* rarely offered in CFs transactions.
  - In a "real" status-quo option, the LPs keep the same stake & terms, and the GP cannot crystallize the carry.
  - But, it will likely reduce the number of CFs & prevent raising additional funds. It also would not work in multi-asset CF.
  - Consider it in the appropriate cases.

ALTERNATIVE PROPOSALS

- ***Empowering legacy fund LPs*** –
  - Bringing the decision to initiate a CF to the *LP base*.
  - Selection of financial advisors by LPs.
  - Inviting the largest LPs that objected the use of CF to serve on the LPAC to oversee the transaction.

- ***Transaction costs*** –
  - GPs should incur a portion of costs, while not participating LPs should not incur any costs.