# Jon Moulton's Diary

What are the options when private equity managers need to close a fund?

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There are a lot more funds coming to the end of their terms than there used to be. There are, of course, lots more funds than there were in prior times and portfolio company exits are often later than they used to be. Covid did not help. The same factors have resulted in slow and weak distributions that are reflected in there being quite a lot of portfolio investments left at the end of the traditional 10 year term.

How should managers deal with the issues of closing a fund? Well, first you have to look at the manager's motivations.

## Fund extension

If the fund is nicely profitable then investors may be content to extend the fund — perhaps for five years — to enable the residual investments to be realised. Management fees will probably be reduced a little, but not always.

This route is nice for the manager – the extra fees for managing typically a not very busy portfolio are pleasant. In an extreme case the continued management may be very slight. If you hold small minority holdings in a well syndicated venture deal you may have little to do. And it is often easy to get the extension.

Of course, you could sell the residual portfolio to a secondary investor provided the portfolio is of worthwhile size. This involves quite a bit of work for the buyer to value the portfolio so that they can make a decent return. Share transfer restrictions in the individual portfolio companies can be troublesome too.

However, the outcome is a clear finish which is good — and bad. It's bad if the sale is only doable at a significant discount to the fund's stated value, which does not reflect well on the manager and will hurt the raising of a new fund. Another obviously unattractive feature for the manager is that they do not continue to harvest management fees.

If investors are really fed up, then you might find that they will not vote for an extension and would want to pass the problem portfolio to a secondary investor or another fund manager — or even, where relationships have broken down, appoint a liquidator.

## Few options

Things can be worse — the fund may have done badly with the residual investments still needing new capital. The fund will run the risk (probable, I think) that it will be diluted by the other investors in the deals. In this case, options are few — you can perhaps raise some cash from your investors — if they are persuadable of the merits of the remaining investments. Another option sometimes available is to raise money from a loan supported by the portfolio's value.

If the manager is unable to raise a new fund, then they will have to explore all of the options above if they want to keep the lights on.

***'Managers love the [continuation fund] deals as they may get a carry on the "sale" and the fees roll in. And they don't have to do new deals'***

## Amazing structures

Then we have a masterpiece of financial engineering — the "Continuation Fund". The variety of structures is amazing. Essentially some or all of the fund's assets are sold to a new entity which is funded by new (and often old) LPs. The new entity can be levered and/or raise fresh capital for acquisitions or other "value maximisation" actions. Investors can roll, and at their choice deploy fresh capital, into a new vehicle if they choose to or cash out. Fixing a price on the portfolio has very clear conflicts.

Typically, minority investments are valued less than whole company sale transactions — the investors who do not roll into the new continuation vehicle will not get that premium.

Managers love the deals as they may get a carry on the "sale" and the fees roll in. And they don't have to do new deals.

In the LBO world, continuation funds are now normal. A few years back they were rare and mostly done by struggling private equity firms. Now they are done by most of the market.

It would save a lot of time and legal bills if funds extended their lives to say 15 years – after all, we have permanent capital vehicles.

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**There are several ways for buyout firms to exit their portfolio and close their fund — but will the investors be happy?**

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