



Morgan Lewis

**ADVANCED TOPICS IN
PRIVATE FUND PRACTICES
CONFERENCE**

Manager and Investor Perspectives

BOSTON

Thursday, June 15, 2023

Private Fund Trends and Terms

Speakers



Justine Le
+1.617.341.7589
[justine.le@
morganlewis.com](mailto:justine.le@morganlewis.com)



Ruoke Liu
+1.202.739.5583
[ruoke.liu@
morganlewis.com](mailto:ruoke.liu@morganlewis.com)



Daniel A. Losk
+1.617.341.7783
[daniel.losk@
morganlewis.com](mailto:daniel.losk@morganlewis.com)



Stephen C. Tirrell
+1.617.951.8833
[stephen.tirrell@
morganlewis.com](mailto:stephen.tirrell@morganlewis.com)

Morgan Lewis

Agenda

- Fundraising Environment
- Trends in Fund Terms
- Liquidity and Sources of Capital
- Other Fund Vehicles

Challenging Fundraising Environment

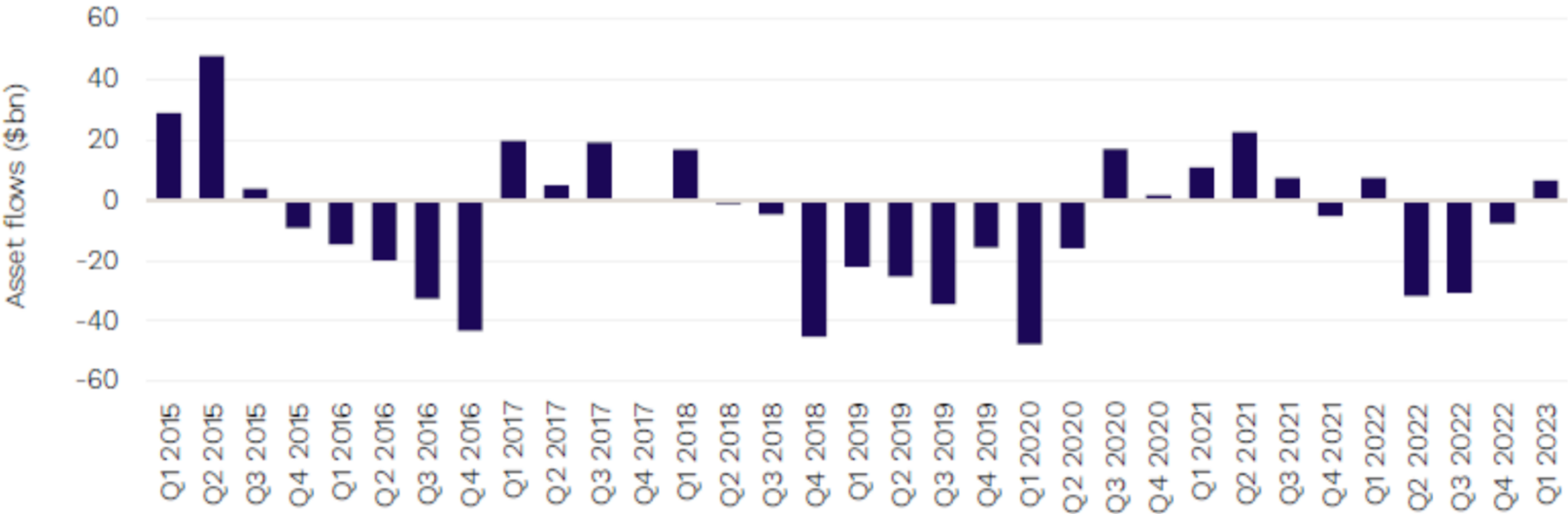
Fig. 2: Global quarterly private equity fundraising, Q1 2018 – Q1 2023



Source: Preqin – Q1 2023 Private Equity Quarterly Update

Challenging Fundraising Environment

Fig. 3: Hedge fund asset flows, Q1 2015 – Q1 2023



Source: Preqin

Source: Preqin – Q1 2023 Hedge Fund Asset Flows

Challenging Fundraising Environment

Challenging Fundraising

- Private equity funds raised \$405.6 billion globally and \$283.3 billion in the US through Q3 2022, a decrease of 28% and 8%, respectively, from the same period in 2021. (Preqin)
- Hedge funds started 2023 strong with a net capital inflow of \$6.7bn in the first quarter alone. This marks a reversal from the three consecutive quarters of outflows totaling \$69.8bn, ending in Q4 2022. (Preqin)

Manager Perspective

- **Consolidation of capital with a smaller number of GPs raising a larger portion of the total capital.** Funds targeting \$5 billion or more make up the smallest percentage of private equity funds by count (just 3.6%), but account for more than half of the capital raised through Q3 2022. (Pitchbook) The 10 largest private equity funds raised almost \$150 billion, with aggregate capital commitments ranging from \$9.7 billion to \$25 billion. (Private Equity International)
- **Crowded market.** A record number of private equity funds currently in the market (3,294). (Preqin)

Challenging Fundraising Environment

LP Perspective

- LPs strongly favor experienced and familiar GPs for PE funds. (Pitchbook)
- Denominator effect – Macroeconomic factors, such as rising interest rates and poor-performing public markets, have put pressure on the private markets and the valuations of private companies. This denominator effect is causing some LPs to exceed their private equity allocations, which adds to the difficulty in the fundraising market.
- Less distributions, fewer LP commitments.

Wealthy Individuals

- Traditionally underrepresented as LPs in private equity funds, now one of the fastest growing sources of capital in private equity funds.

Brief Overview of Trends in Key Terms

Management fee

- **PE funds**

- Historically, the smaller the fund size, the higher the management fee
- In the last 10 years or so, the largest fund sizes ($\geq \$3.5\text{bb}$) have had management fee rates around 1.5% (Colmore)

- **Hedge funds**

- Continued downward pressure on management fee rates
- Expanded use of multiple classes
 - Higher management fee rates tied to better liquidity terms (such as less notice, more frequency, and/or better or no lockups)
 - Higher management fee rates tied to lower rate of (or no) performance compensation

Brief Overview of Trends in Key Terms

Waterfalls (PE funds)

- Overall, American style is the majority in the US market
 - Newer and/or middle-market managers – European style more common
 - Well-established managers – American style more common
- 8% remains the most common preferred return
- 20% carried interest rate is still the norm, but the occurrence of funds with 20% carry have decreased
- 100% and 80% GP catch-up remain the most common

Performance Allocation (Hedge funds)

- Downward pressure on rates
- Big decision – multiple classes
 - Lower performance compensation rates tied to higher management fee rates and, at times, less frequent withdrawal rights or more frequent performance periods
 - At times, highest performance compensation rates tied to no management fee
- Some liquid funds not charging any performance compensation
- Loss carryforwards/high-water marks remain market standard

Brief Overview of Trends in Key Terms

Org expenses

- Cap on org expenses is typical for PE funds.
 - Over the last 10 years or so, org expense caps have increased, driven by increased regulatory and other setup costs.
 - Some trends are using contingent org caps: lesser/greater of (i) fixed amount or (ii) % of total fund commitments.
- Cap on org expenses is not common for hedge funds.

Fund expenses

- Expanded lists of operating costs.
- Some private equity firms establish a dedicated group of professionals (including employees of the firm and an affiliate entity) to provide operational expertise and related services to the fund's portfolio companies. The operating partners' compensation and expenses are borne by the portfolio companies and/or the fund.
- This is partly driven by SEC scrutiny of expenses and may also relate to the decrease in management fee rates over time.

Brief Overview of Trends in Key Terms

Liquidity (hedge funds)

- **Lockups**

- Some hard lockups
 - Startup funds, high performers
 - Typically one or two years
 - Sometimes tied to better fee rates
- Some soft lockups
 - Typically 2% to 5%, with trend toward lower rates
 - Investor pressure to change hard lockups to soft
- Better lockup terms sometimes tied to higher fee rates

- **Gates continue to be common, especially in new launches**

- 25% limit is most common
 - Some funds have lower limits, ranging from 5% to 15%
 - Some funds have higher limits, such as 50% for funds with performance track records
- 12 months out has developed into the market norm
- Fund-level gates are more prevalent than investor-level gates

Brief Overview of Trends in Key Terms

Governing

- GP Removal (PE funds)
 - **For cause**
 - 52% of funds required a simple majority (50% or 51% of LP interests), 45% of funds require a super majority (60% to 75% of LP interests), less than 10% of funds required LPAC approval (Colmore)
 - **No cause**
 - Many funds do not permit removal of GP without cause
 - 73% of funds required a super majority (60% to 75% of LP interests), 14% of funds required a higher super majority (80% to 85% of LP interests), 13% of funds required a simple majority (50% or 51% of LP interests) (Colmore)

Side Letters

- Cost of negotiating and complying with side letters can be sizable
- According to Colmore's analysis, only 5% to 10% of side letters have economic impact
- Terms set forth in side letters versus LPA

Creative Ways to Obtain Additional Liquidity and Sources of Capital

Morgan Lewis

End-of-Life Options

- Extend with new terms
- Distribution in kind of assets and/or liquidating trusts
- LP tender
- Annex fund
- Cross-fund trade
- GP-led transaction/continuation fund

GP-Led Restructuring/Continuation Fund

- LPs' concerns (ILPA guide May 2023)
 - The highly complex nature of these transactions demands a substantial amount of attention from LPs, and requires LPs to make decisions about individual assets, as opposed to PE funds or managers.
 - LPs can struggle with the speed at which these transactions are run. LPs are forced to make roll or sell decisions within a period as short as 10 days, during which they must undergo a reunderwriting of the investment that can often force LPs into a position to take the liquidity option if the timeline doesn't align with institutional requirements, such as investment committee meetings.
 - These transactions are conflicted by nature, with the GP sitting on both sides of the transaction.

Others

- **Co-Investments**

- Deal-by-deal
- Co-investment vehicles

- **Hybrid Funds**

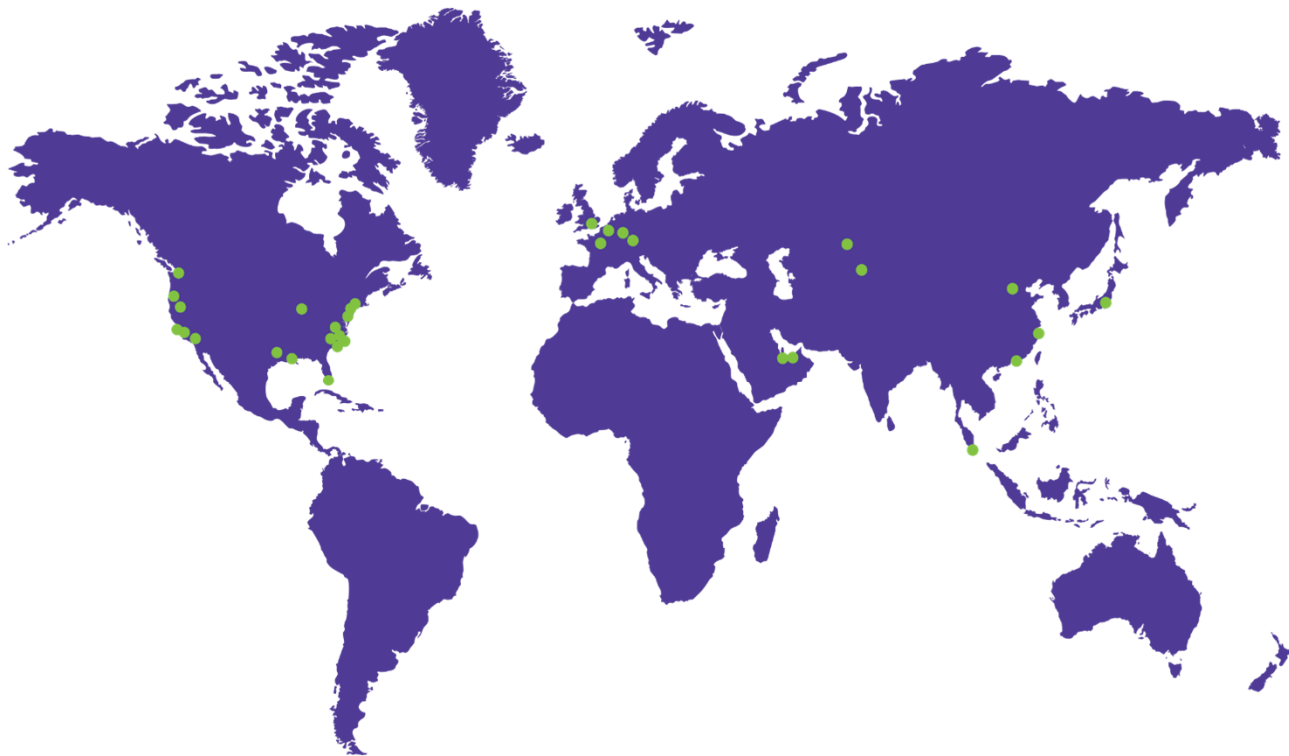
- A hybrid fund combines attributes of a hedge fund and a private equity fund
- A hybrid fund has various forms
- The hybrid fund label is affixed to it after it exists. The strategy in effect designs the fund terms
- Hybrid funds are bespoke

Our Global Reach

Africa
Asia Pacific
Europe
Latin America
Middle East
North America

Our Locations

Abu Dhabi
Almaty
Astana
Beijing
Boston
Brussels
Century City
Chicago
Dallas
Dubai
Frankfurt
Hartford
Hong Kong
Houston
London
Los Angeles
Miami
Munich
New York
Orange County
Paris
Philadelphia
Pittsburgh
Princeton
San Francisco
Seattle
Shanghai
Silicon Valley
Singapore
Tokyo
Washington, DC
Wilmington



Morgan Lewis

Our Beijing and Shanghai offices operate as representative offices of Morgan, Lewis & Bockius LLP.
In Hong Kong, Morgan, Lewis & Bockius is a separate Hong Kong general partnership registered with The Law Society of Hong Kong.

THANK YOU

© 2023 Morgan Lewis

Morgan, Lewis & Bockius LLP, a Pennsylvania limited liability partnership

Morgan Lewis Stamford LLC is a Singapore law corporation affiliated with Morgan, Lewis & Bockius LLP.

Morgan, Lewis & Bockius UK LLP is a limited liability partnership registered in England and Wales under number OC378797 and is a law firm authorised and regulated by the Solicitors Regulation Authority. The SRA authorisation number is 615176.

Our Beijing and Shanghai offices operate as representative offices of Morgan, Lewis & Bockius LLP.

In Hong Kong, Morgan, Lewis & Bockius is a separate Hong Kong general partnership registered with The Law Society of Hong Kong.

This material is provided for your convenience and does not constitute legal advice or create an attorney-client relationship.

Prior results do not guarantee similar outcomes. Attorney Advertising.

Morgan Lewis