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ADVANCED TOPICS IN

**HEDGE FUND PRACTICES**

**CONFERENCE**

MANAGER AND INVESTOR PERSPECTIVES

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# Continuation Vehicles and Co-Investments

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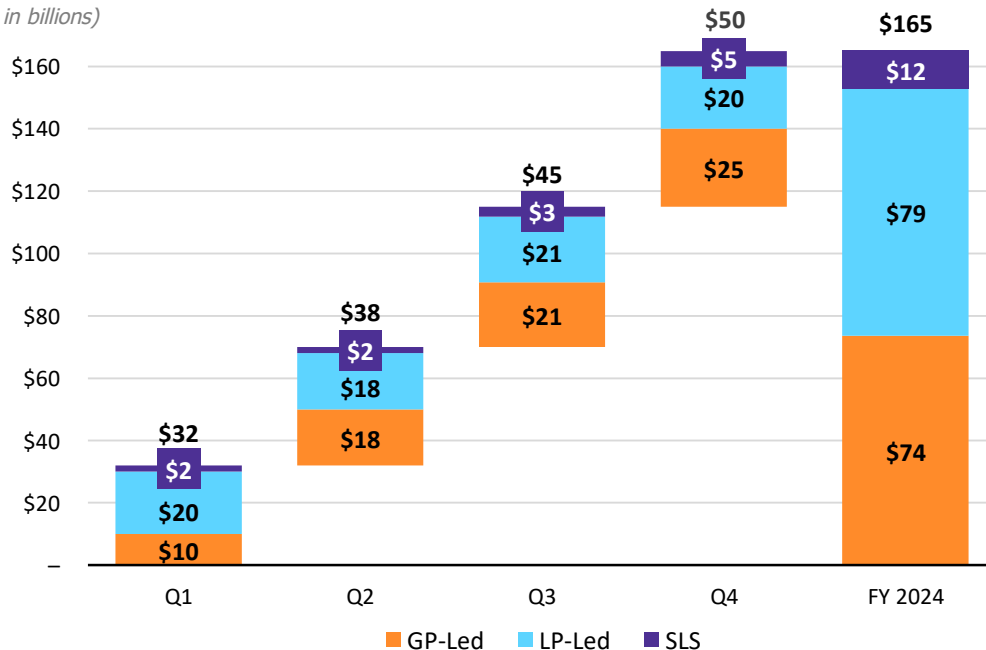
# Continuation Vehicles

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# Brief Overview of the Secondary Market

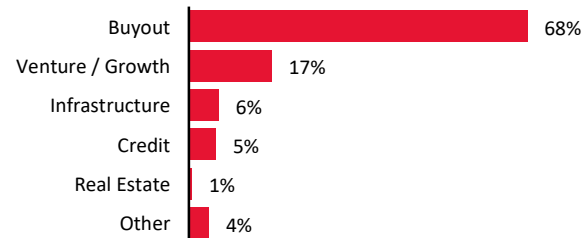
## 2024 CLOSED SECONDARY MARKET VOLUME BY QUARTER

(\$ in billions)



- FY 2024 volume of \$165 billion represents a ~40% YoY increase with a strong forward pipeline entering 2025
- GP-Led transactions accounted for \$74 billion (45%) of FY 2024 volume**
- LP-Led transactions accounted for \$79 billion (48%) of FY 2024 volume

## Secondary Buyer Average Deployment Percentage Split by Asset Class<sup>(1)</sup>

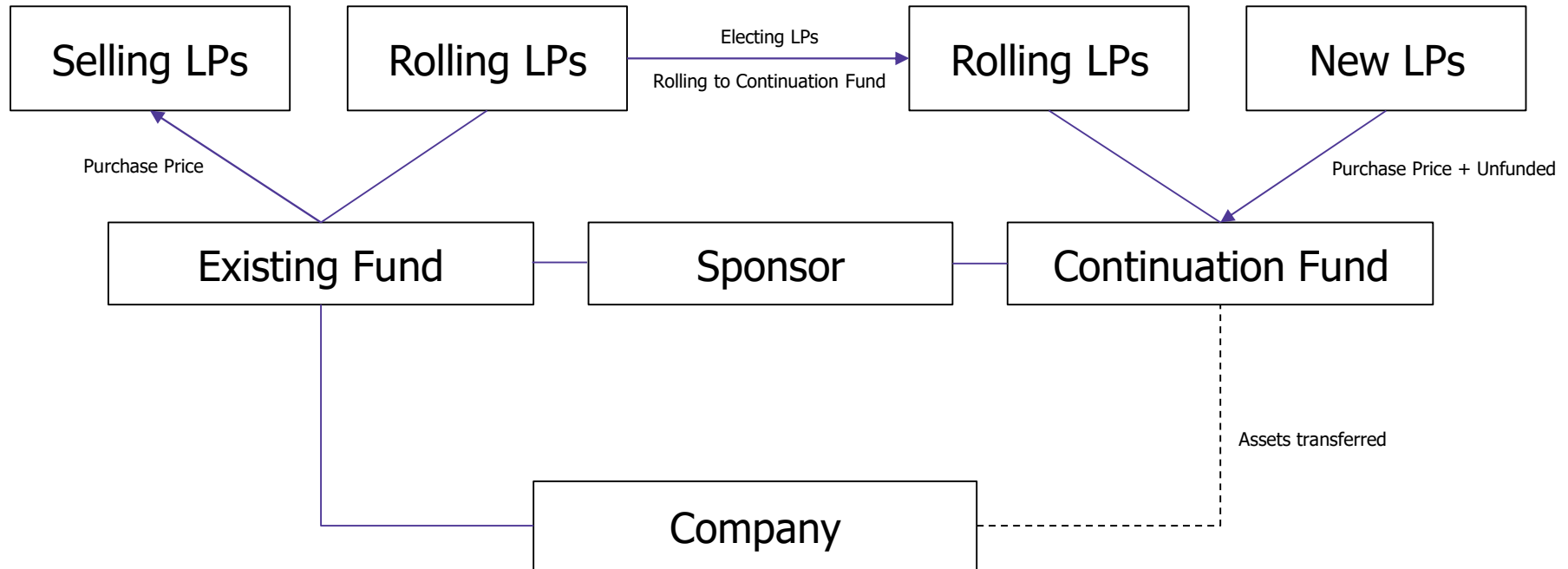


## **What is a Continuation Fund/Vehicle?**



Asset(s) transferred from existing fund to new fund managed by same sponsor with new secondary market capital; initial LPs elect to cash out or roll over.

# Continuation Funds: Simple Structure



\*This structure chart is simplified for illustrative purposes only and does not show any tax steps or structuring.

# Continuation Funds: Rationale

- ▶ Slowdown in M&A and IPO market (no other “traditional” exit route)
- ▶ Provide liquidity to existing investors
- ▶ Provide liquidity and carry to former employees; provide new economics to current team
- ▶ Wind down existing funds
- ▶ Maximize value of assets (longer holding period plus additional follow-on capital)
- ▶ Opportunity to make additional investments for the continuation fund
- ▶ Accelerate and “lock in” returns and carried interest
- ▶ Earn additional carry and fees at the continuation fund level
- ▶ Offer exposure to strongest performing assets and reduce blind pool risk
- ▶ “Brand building” for GPs through syndication process

# Continuation Funds: GP Conflicts of Interest

## Conflicts of Interest

- Fiduciary duties to existing (selling) fund vs. new (buying) fund
- Sponsor incentive to generate additional carried interest and fees with the new fund
- Sponsor negotiation of the purchase and sale (or contribution) agreement
- Does an independent fairness opinion support the price?
- Transparency and disclosure issues
- Are LPs presented with a status quo option? (*SEC concern that LPs are provided two bad options*)
- Selection of intermediary and buyer

## Mitigation

- Auction Process
- LPAC Consents
- Representation and Warranty Insurance
- Valuation or Fairness Opinion
- Disclosure in the Confidential Information Memorandum
- Lead Investor Role (Negotiation and Enforcement of Transaction Agreement for Continuation Fund)



# Continuation Funds: Key Transaction Agreement Terms

## Closing

Purchase Price Terms  
(including deferral or  
holdback)

Capacity Rights  
(minimum amount for  
lead investor)

Carry/Commitment Roll  
by the GP

## Protections

Representations and  
Warranties

Indemnity and/or RWI  
Insurance

Survival Period

Lead Investor Rights –  
e.g., notice rights and  
enforcement rights

## Expense Split

RWI Policy Expenses

Transaction Expenses

Placement Fees

## Excluded Obligations

Liabilities relating to other  
assets

Breaches of fiduciary  
duties

Breaches of operative  
documents or securities  
laws

Taxes

Broker fees

# Continuation Funds: Partnership Agreement Terms

## Economics



- Sufficient hurdles and carry thresholds in waterfall; approx. 50% of CVs have both MoIC and IRR hurdle; rates typically range from 10-30%
- Often lower management fee than typical PE fund; convergence of fee rate to 1% or lower; possible step downs after term; based on invested capital
- Recovery of RWI/indemnity proceeds in New LPs' waterfall only

## Expenses



- Organizational, offering, and transaction expenses (including broken deal expenses); broker fees (may be significant)
- Cap on contributions for follow-ons and investments?
- Reimbursement of Lead Investor expenses

## GP Alignment Provisions



- (i) Roll of 100% of crystallized carry, (ii) GP commitment, (iii) key person provisions with appropriate consequences, (iv) time and attention standards, (v) prohibition on GP transfers (of control and economics)

## Removal Rights



- Cause rights (may match main fund LPA or be broader if there are no no-fault rights) and often a carry haircut
- No-fault rights – rare to see, especially in a single asset continuation fund

## Lead Investor Rights



- Enforcement of Transaction Agreement and indemnification; disclaimer of fiduciary duties; consent over disclosure in CIM; minimum capacity; mop-up rights; MFN; preferential reporting, veto, consulting, notice and governance (e.g., Board seats)

## Other Terms



- Term and extension periods
- LPAC – often weighted by commitment amount
- Follow-On and Preemptive Rights
- Exit rights – e.g., triggering a sale process; no future CVs permitted

## Scan to access our ANNUAL CONTINUATION VEHICLES REPORT

Our secondaries practice has published its annual Continuation Vehicles Report, identifying notable trends in the key legal terms and provisions of the continuation vehicles advised on by Morgan Lewis from Q1 2024 to Q1 2025.



# Co-Investments

# Structures and Arrangements

**Aggregation structures vs. “direct” co-investments**



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graph TD; A[Aggregation structures vs. “direct” co-investments] --> B[Co-investment “funds” vs. co-investment “SPVs”]; B --> C[Co-investment “clubs” with preset terms for participation]; C --> D[Precedent co-investment vehicle documentation utilized or alignment with “main fund” documents is common to make document review and diligence process efficient, but it is not always the case]; D --> E[Separate holdings structures and legal documentation need to sync with “main fund” and/or additional vehicles and accounts that participate];
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**Co-investment “funds” vs. co-investment “SPVs”**

**Co-investment “clubs” with preset terms for participation**










**Precedent co-investment vehicle documentation utilized or alignment with “main fund” documents is common to make document review and diligence process efficient, but it is not always the case**

**Separate holdings structures and legal documentation need to sync with “main fund” and/or additional vehicles and accounts that participate**

# Typical Co-Investment Access Points by Stage

Co-Investment Access Point	Investment Vehicle	Break Fee Risk (pro rata)	Level of Due Diligence Review	Equity Commitment Letter (pro rata)	Limited Guarantee of Reverse Break Fee (pro rata)	Global Regulatory Review	ML Team Staffing
<b>Post-Closing: Sponsor Deferral</b>	Co-Investment Vehicle	No break fee risk, deal has closed	None	No	No	Limited	Led by Private Funds Team
<b>Post-Closing: Confirmatory</b>	Co-Investment Vehicle	No break fee risk, deal has closed	General confirmatory due diligence	No	No	Yes	Led by Private Funds Team with Corporate Team support
<b>Pre-Closing (Post-Signing)</b>	Co-Investment Vehicle (typically)	Break fee risk sometimes shared with sponsor	Enhanced confirmatory due diligence	No	Not typically	Yes	Led by Corporate Team with Private Funds Team support
<b>Pre-Signing "Co-Underwriting"</b>	PE sponsor Holdco or Co-Investment Vehicle	Break fee risk often shared with sponsor	Review sponsor's due diligence combined with primary due diligence for heightened focus areas	Yes, typically, but this is negotiated	Yes, typically, but this is negotiated	Yes	Led by Corporate Team with Private Funds Team support

# Select Issues and Pitfalls to Navigate

-  Understanding the fee structure
-  Understanding what commitments can be used for
-  Regulatory focus and filings – ML Regulatory SWAT Team
-  Reporting and information rights
-  Anti-dilution protection
-  Investor givebacks
-  Continuation vehicles and investor consent
-  Urgency/timing
-  Key persons/removal for cause

# Developments in Negotiation of Terms and Conditions

- ▶ No fees, no carry – but what about other fees such as acquisition costs and closing fees?
- ▶ Expenses – move toward higher caps
- ▶ Fewer tag-along/co-sale rights
- ▶ Side letters
- ▶ Co-underwriting commitment letters
- ▶ Closing co-investments pre-acquisition/timing of funding
- ▶ For large institutional investors, the process may entail the input of many internal stakeholders and external advisers