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New form of exit, new set of issues: continuation funds and co-investments

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Continuation funds or vehicles (CVs) have become ubiquitous in a macro environment in which exit options for private equity-held assets are scarce. As we've previously noted, in 2023, CVs represented 12% of global sponsor-backed exit volume, compared to only 5% in 2021. Co-investments—both passive co-investments through sponsor-managed vehicles and "co-underwritten" transactions—present a distinct set of issues when it comes to fund exits via CVs.

Tied at the hip?

Generally, "passive" co-investments (syndicated or otherwise) involve the use of co-investment vehicles that feature a "tied at the hip" clause, meaning the GP of the vehicle (typically an affiliate of the sponsor) is obligated to make the co-investment vehicle exit on the same terms and conditions (subject to certain carve-outs) as the main fund that is also invested in the asset. This requirement has the potential to cause unexpected results when applied in a CV exit context. For example, if 60% of the main fund's investors elect to roll over to the CV while 40% elect to cash out, could the sponsor argue that the "tied at the hip" provision permits it to force the co-investment vehicle into the CV on the same 60/40 basis (i.e., transfer its interest in the asset to the CV for consideration of 40% percent cash and 60% interests in the CV)? That would seem a noteworthy outcome for co-investors, particularly because the CV may be a fee-bearing vehicle while the co-investment vehicle may be economics free (or feature reduced economics as compared to the CV). It is perhaps unlikely from an investment relations perspective that sponsors would force their co-investors into a fee-bearing vehicle against their will—though standard documentation for many co-investments would seem to permit this outcome.

Complicating matters further, many passive co-investment vehicles exempt affiliate transfers from the "tied-at-the-hip" clause. When that is the case, although the sponsor may not be able to force a portion of the co-investment vehicle's equity into the CV through legal mechanics, the co-investment vehicle would nonetheless stay invested in the underlying asset notwithstanding that the sponsor fund has itself exited the investment.

Many passive co-investments also permit the sponsor to enter into affiliate transactions so long as they are on arm's length terms. This could create legal wiggle room for a sponsor to introduce fees and carry (or both) to co-investment equity, arguing that those types of arrangements are typical for CVs (though again, it may be somewhat unlikely that sponsors avail themselves of that discretion).

Further considerations

Even leaving aside the question of economics, co-investors may have other significant misgivings about extending the hold period of an asset in a CV exit via affiliate transaction provisions. For one thing, co-investors may not want to remain invested in an asset for an additional cycle, particularly in scenarios where the sponsor realizes a significant portion of its carry as part of the transaction. For another, there may not be economic alignment between co-investors and the investors in the CV given the different underlying valuations between the two vehicles. Finally, it may not be always clear how the "tied at the hip" legal mechanics would work when considering future potential dispositions of the underlying asset to a third party.

Co-underwritten transactions—in which a co-investor invests alongside the sponsor in a holding company (as opposed to through a sponsor-controlled vehicle)—pose similar issues. These deals often have drag-along rights in favor of the sponsor and tag-along rights in favor of the co-investor. If, in such a deal, the main fund's investors decided to roll 60% of the equity held by the fund to a CV, the co-investors could, depending on the wording of the drag-along provision, be "dragged" into a CV (including one that charges fee and carry), resulting in a situation akin to the passive "tied at the hip" scenario. And if the co-investors' tag-along right is subject to an affiliate transfer carve-out in favor of the sponsor (as is often the case), the co-investment vehicle could similarly remain "stuck" in the asset, with the same knock-on issues as described above for passive co-investments.

The above concerns—both for passive co-investments and co-underwritten transactions—would be heightened even further in a potential sale to a multi-asset CV where the co-investment relates to a single portfolio asset, given the combined valuation applied to the sale and the comparatively different investment underwrite determination to be made in respect of a CV holding multiple portfolio assets.

Establish legal protections from the outset

These examples illustrate that "standard" co-investment documentation, when applied to CV transactions, tends to produce results that sophisticated transaction participants may not have intended, as well as significant conflicts of interest. In the absence of legal protection on these points, co-investors can rely only on the fiduciary duties of the GP to ensure that these determinations are being made in good faith on behalf of all participating investors (though co-investors frequently are asked to waive these duties to the extent legally possible in the co-investment documentation) and on the main fund's limited partner advisory committee (LPAC) to look out for the co-investors' interests (although co-investors may not always be represented on, or aligned with the perspectives of, the LPAC).

Accordingly, co-investors should consider seeking proper legal protection at the time of their investment in the co-investment vehicle (or co-underwritten deal). One approach may be to negotiate for the same optionality for co-investors as is given to fund investors at the time of the CV exit (that is, giving co-investors the right to decide whether to monetize or to roll). While this approach will, at the time of the CV exit, present co-investors that previously benefited from an economics free arrangement with an imperfect choice to either "cash out" in full at the price agreed by the sponsor (which is inherently an affiliate transaction) or to roll into a new, possibly fee-bearing vehicle, at least it puts co-investors in the driver's seat. Co-investors may also attempt to negotiate the economics of their participation in a CV in advance, for example by insisting that the fee and carry structure applicable to the co-investment be carried forward to the CV in the event they choose to roll.

Similarly, fund sponsors should consider how they will handle CV exits based on their existing co-investment documentation and make any necessary improvements to future agreements to account for these deals. While different sponsors may not be uniform in their approach to dealing with CV exits, most sponsors will likely wish to preserve as much optionality as possible, given that it is difficult to anticipate the contours of a CV exit with any specificity at the time the co-investment documentation is signed (often many years before any potential GP-led sale transaction).

For sponsors and co-investors alike, the devil is—as always—in the detail. But for both, it will be important to bring renewed focus and attention to this particular form of exit transaction as part of the co-investment process moving forward.