SIX THINGS TO KNOW ABOUT CO-INVESTMENTS

Scott Martin
Managing Director,
Co-investments

Nick Warmingham
Managing Director,
Co-investments

Jacquelyn Klehm
Associate Investment Director,
Co-investments

Published September 15, 2023

LET'S GET SMARTER AS CO-INVESTING GETS HARDER.

Investor interest in co-investing has grown in recent years, given the benefits (discussed in more detail below) for both general partners (GPs) and limited partners (LPs). The co-investment universe has grown rapidly, with Cambridge Associates (CA) estimating total private equity co-investment activity in 2022 to have been ~$50 billion.[1] The objective of this paper is to address some of the most frequently asked questions by clients as they think about pursuing co-investments.

Key Takeaways

- Consider adding a strategic allocation to co-investments. Setting a target range allows for tactical flexibility since co-investments are inherently opportunistic in nature.
- The most suitable implementation plan will be informed by a few key factors, chiefly: co-investment deal flow; in-house expertise; bandwidth; and decision-making capabilities.
- Adverse selection is a risk that can be mitigated by thorough evaluation of the deal as well as GP fit. Moreover, co-investing is an active discipline. Investors need to be responsive and transparent to strengthen the relationship with and deepen their understanding of the GP.
- When appointing a co-investment manager makes sense, investors should focus on finding a partner capable of accessing a robust deal flow and constructing a co-investment portfolio that is concentrated in best ideas from high conviction managers without being overdiversified.

#1 What Are Co-investments and How Do They Work?

Co-investing is when LPs invest in a company alongside a GP. Traditionally, co-investment opportunities arise when a GP seeks to syndicate a portion of their investment in a company it recently acquired as part of its private investment (PI) fund. At their discretion, GPs invite certain LPs (typically those that have expressed interest in co-investment opportunities via a side letter or participated in prior co-investments) to indicate interest in the opportunity.

1 Cambridge Associates LLC Private Investment Database. Co-investment activity is based on CA co-investment deal flow as of December 31, 2022. Private equity includes buyouts and growth equity.

The LPs that proceed are generally given a few weeks to evaluate the information available and usually have an opportunity to speak with the deal team. A typical syndication process lasts four to six weeks from initial contact to binding legal agreement and investment.

A more recent development is for GPs to invite LPs into situations where the GP is still in a competitive process for an asset (and may not even be in exclusivity). This situation is referred to as "co-underwriting." Unlike a syndication process, the GP conducts due diligence in real time and shares it with LPs. These processes can require LPs to work toward a commitment even more quickly (three to four weeks) with no certainty that the GP will win the deal and a co-investment will materialize.

Most often, the GP will set up a special purpose vehicle (SPV), to which LPs make a commitment (akin to the primary fund structure but designed to hold only a single asset, and where the majority of the capital is called and invested immediately). In other situations, the co-investment could be structured in such a way that LPs must acquire equity in the company directly. The latter situation is not uncommon and brings with it additional considerations around tax and governance. Notwithstanding how a co-investment is structured, LPs are generally expected to be passive investors.

#2 What Is in it for the GP and LP?

There are three primary reasons for GPs to offer co-investments. First, using LP co-investment capital enables GPs to better manage concentration risk and control the pace of deployment of their fund. Second, LP co-investment may also allow a GP to acquire larger assets. This is particularly helpful to GPs that employ a buy-and-build strategy. In these situations, a portion of a co-investor's commitment is drawn at the outset to acquire the "platform" and the remainder is reserved for future add-on opportunities. Finally, LPs are asking for co-investment and GPs want to keep them happy or risk losing a future LP fund commitment.

For LPs, the principal benefit is that co-investment opportunities generally have lower fees than fund commitments.[2] In fact, GPs typically offer co-investment opportunities to their LPs on a no management fee, no carried interest basis, but are more likely to charge some form of economics to non-LPs. Sometimes there is a one-off transaction charge, and in other situations, the manager may charge a management fee and/or a carried interest (often tiered, especially in the case of single-asset continuation vehicles, which may be construed as co-investments). However, while no fee, no carry is always preferred, it should not be the sole criterion for investment. Paying some level of economics for performance and access to high-quality deal flow is something LPs should be comfortable doing.

A second benefit for LPs is portfolio management. Co-investments can help LPs to control deployment pace as well as increase exposure to certain GPs, geographies,

2 According to CA data for mature private equity funds, the average difference—as calculated on a dollar basis—between the gross fund total value to paid-in multiple (TVPI) and the net fund TVPI multiple is approximately 0.20x. Due to the variables in the internal rate of return (IRR) calculation, including timing of cashflows and the impact of management fees, the average return spread between gross fund IRRs and net fund IRRs is approximately 7% to 8%, but ranges from 2% to 25%.

market segments, or sectors. A third benefit is that co-investing provides a better understanding of the GP's sourcing and due diligence process and can help to create or or strengthen a relationship.

#3 How Do Investors Set the Right Co-investment Policy?

Regardless of the maturity of a PI portfolio, co-investments can play an important role. To begin, investors must set an allocation target to co-investments in their investment policy statement, which can take the form of a dedicated strategic allocation or a more tactical one that provides the ability to lean in, for example, during periods of dislocation. While tactical allocations can be part of an opportunistic bucket, all too often, that means not co-investing at all. To maximize the benefits of co-investing, we recommend a strategic allocation to co-investments that represents 15% to 30%[3] of an investor's total allocation to private investments. Individual co-investments should be sized to have a meaningful positive impact if they meet (or exceed) underwriting targets, but not to disrupt the portfolio in case of underperformance. A fraction (circa 25%) of a typical fund commitment is a good rule of thumb to start.

Similar to fund commitments, it is important to keep a steady and consistent pacing of co-investments to ensure diversification and maintain (or build) exposure. We recommend setting a range, since co-investments are inherently opportunistic (timing is uncertain) and it is important not to default to a "fill the bucket" approach. Setting a range enables an investor to retain tactical flexibility. For investors already at (or above) target for their total PI allocation, it is possible to begin incorporating co-investments by scaling back commitment amounts for fund re-ups.

#4 What Are Some Implementation Approaches?

Having set a co-investment allocation, devising an appropriate implementation approach to meet it is the next challenge.[4] Several factors, including the ability to source sufficient co-investment opportunities; dedicate resources to evaluate them appropriately; and make decisions in a timely manner, combine to complicate implementation.

Investors with large PI portfolios (greater than $1 billion of net asset value [NAV]) will likely have a sufficient number of GP relationships and they are also likely significant LPs in funds such that GPs will oblige when they start asking to see co-investment opportunities. For these LPs, the limiting factor is more likely the time and resources to evaluate them. Investors that lack the capability to evaluate co-investments within their team and/or that cannot spare their human capital might look to external solutions. These can include appointing a specialist co-investment manager to oversee a separately managed account.

3 Andrea Auerbach, Rob Long, and Scott Martin, "Ready, Steady, Co-invest," Cambridge Associates LLC, March 2019.

4 For more on co-investment implementation, please see Andrea Auerbach and Priya Pradhan, "Making Waves: The Cresting Co-investment Opportunity," Cambridge Associates LLC, March 2015, and Andrea Auerbach, Rob Long, and Scott Martin, "Ready, Steady, Co-invest," Cambridge Associates LLC, March 2019.

Investors with medium-sized PI portfolios ($200 million to $1 billion of NAV) might find it difficult to source sufficient co-investment opportunities, depending on the composition of their PI portfolio. It helps to be a larger LP in a smaller fund, but oftentimes the co-investment process with a smaller GP can be less smooth—large GPs typically have investor relations teams to serve the needs of LPs, which might not be the case for smaller firms. Resources and decision making are considerations for these investors as well. Even if they have a team with the skills and bandwidth to prosecute co-investments, investors may still benefit from partnering with a specialist co-investment manager to augment deal flow (with the benefit that opportunities have already been vetted).

For investors with PI portfolios below $200 million of NAV, sourcing sufficient co-investment deal flow will be difficult. Some GPs have egalitarian co-investment allocation policies that ensure smaller investors are not overlooked, but ultimately GPs retain discretion. It is less work (and provides more certainty) for a GP to fill a co-investment allocation with two to three large LPs than ten smaller ones. Investors in this category are also most likely to lack the internal capabilities to oversee a co-investment program. The alternative could be to make a commitment to an externally managed, commingled co-investment fund. LPs should seek managers with a focused strategy, a demonstrated track record, and access to robust deal flow. As the capital trade-off is likely a commitment to a traditional PI fund, a commingled co-investment fund can provide access at a lower fee base to a diversified roster of sector specialists and/or managers targeting the middle- and lower-middle-market space.

#5 What Are the Most Common Pitfalls/Challenges?

Even with a policy and implementation plan in place, co-investing is not easy. Beyond the challenges we have already touched on, there are several other common pitfalls.

Deal selection is critical, given co-investing comes with the risk of adverse selection. We advise against a "do every deal approach," as it can dilute overall returns and limit the ability to be tactical with portfolio construction, particularly as co-investing is a lever that LPs can actively pull to adjust exposures. LPs that take this approach end up "doubling down" on exposures they already have through their fund commitment. To reduce the chance of adverse selection, an investor's diligence should include a review of a GP's co-investment track record as well as a deal's match to the GP's stated strategy (aka strike zone). Even then, past performance is not indicative of future returns and investors should underwrite both the team working on the transaction and the specific deal merits and considerations.

Next, and as mentioned earlier, we believe it is a mistake to dismiss investment opportunities because a GP is charging some level of economics. The "free lunch" concept is great, but co-investors should be comfortable paying fees for outperformance and access. When fees are charged, however, they should still be lower than traditional fund commitments.

Finally, co-investments offer LPs the opportunity to build or strengthen relationships with GPs. However, they can sometimes have the opposite effect, notably when an investor backs out at the last minute (by far, GPs prefer a quick "no"). LPs should communicate their co-investment process to GPs and maintain transparency throughout their investment process to make the experience a positive one.

#6 What Else Should Investors be Aware of?

Co-investing is a multi-faceted discipline and there are many aspects we have not addressed. Although not an exhaustive list, in this section we highlight other factors that investors should consider when it comes to co-investing.

Inevitably, when building a co-investment allocation, things will crop up that require input or consent from LPs. The path of an individual co-investment is rarely a straight line. For example, some companies may require additional financing (for positive reasons, such as add-on opportunities, or less positive reasons, such as underperformance). Further, GPs may introduce curveballs (continuation vehicles, mergers with other portfolio companies, etc.). Co-investment portfolios require active monitoring and responsive LPs (otherwise, as alluded to earlier, GP-LP relations can fray).

The level of due diligence information and ongoing monitoring provided by GPs varies enormously. Investors should avoid co-investing with GPs unwilling to provide sufficient due diligence materials and who will not provide some level of quarterly reporting beyond simple capital statements. Further, co-investors need to be upfront if there are certain metrics (e.g., environmental, social, governance and/or operating) they would like reported.

This paper has been written from the perspective of private equity co-investments (buyouts and growth equity). While there are areas of overlap, other private asset classes have important areas of difference.

- Venture co-investing presents challenges beyond higher binary risk relative to other asset classes. Early-stage venture capital may bring in co-investors to support financing of late-stage rounds. This can present alignment concerns as the bulk of a GP's capital in a deal was likely invested at a lower valuation. Venture co-investments are also more likely to come with fees attached.
- Real estate co-investments commonly involve economics. While fees are generally tiered based on performance, their inclusion is a legacy of the joint ventures many GPs set up with real estate operators and developers.
- Co-investments with fund-less sponsors (in any asset class) will also charge economics but with greater justification, given this is their primary source of income.

Lastly, we have observed that investment committees can become hyper-focused and spend an inordinate amount of time reviewing single line items on quarterly performance reports. Every GP has investments that are not performing as expected, but when reviewed as part of a fund, these do not often attract undue attention (unless the overall fund is performing poorly). Itemized co-investments can prove to be a distraction so to maintain focus on the *program*, we recommend aggregating all co-investments into a single line item.