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Co-investment program primer

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Co-investments have become increasingly popular among many private equity investors as a way to efficiently invest in private equity. As further detailed below, co-investments have features making them attractive for investors but come with their own sets of considerations. While we begin with a general discussion of co-investments, the execution and deployment portions of this paper focus on processes and considerations for investors that have investment staff. We recommend that investors looking to build their own portfolio of co-investments carefully review their capabilities to successfully execute co-investments and look to develop strategy and staffing to build and maintain a multi-year co-investment program. Alternatively, an investor can hire one or more managers to execute a co-investment program, either as a separate account or invest in a commingled co-investment fund.

What are co-investments?

Private markets investors typically access the asset class by making commitments to commingled, limited life investment vehicles, or "funds," that are raised periodically by managers or General Partners (GPs). In this case, a fund investor (limited partner or LP) will typically be required to participate pro-rata in each investment completed by the GP. Investors participate in the funds by making a subscription or commitment that the GP subsequently calls to make its investments. As a result, the investor does not know what specific investments will comprise the fund and is, therefore, committing to a "blind pool." By contrast, a co-investment allows an investor to actively choose in which investments to participate.

Specifically, a co-investment is an investment made alongside a private asset fund manager directly into a portfolio company. These investments typically involve investing capital as a minority equity stake in the underlying company but may, together with the private equity fund manager's shareholding, represent a majority stake. The co-investment is typically made in the same securities and in the same proportion as the main fund. Also, the GP will typically have control on the timing and form of the ultimate disposition of the target company, including both the main fund's interest and the co-investment. The following page includes a schematic for a typical co-investment.

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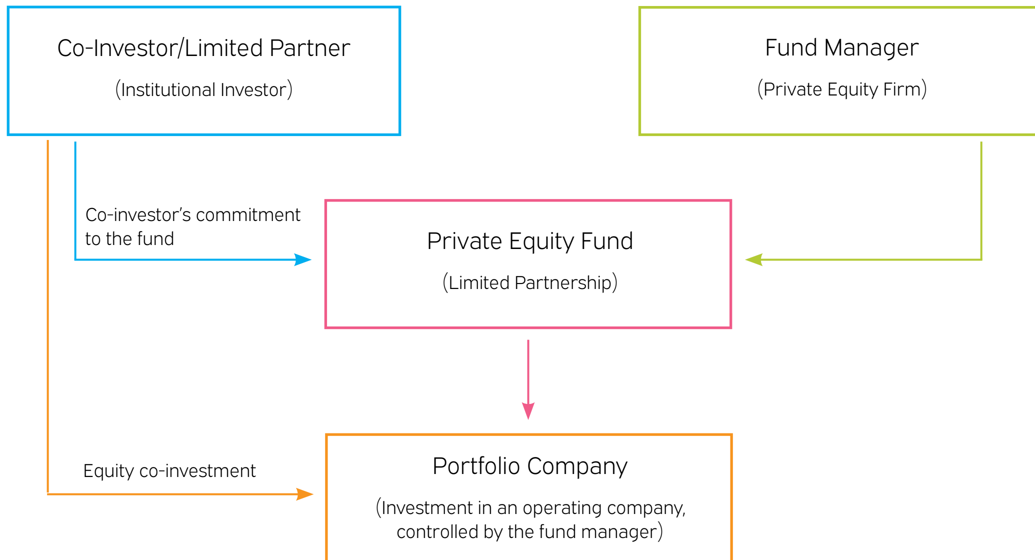

FIGURE 1

Co-investments can involve transactions across the various private market strategies (e.g., late-stage venture, growth equity, buyouts, infrastructure, real estate) that institutional investors support.

Why are investors interested in co-investments?

A recent survey indicated that 59% of LPs were interested in co-investments, while 24% were not.[1] A key feature of co-investments is lower fees and/or avoiding certain fees altogether. Unlike fund commitments, which charge a management fee (e.g., 2% per year) and carried interest (e.g., 20% of profits), co-investments often (but not always) charge no management fee or carry. This lower fee can make a meaningful difference in the overall profitability of the co-investment. Hence, the lower fees can directly contribute to higher net returns.

Co-investments may also offer additional control over portfolio exposures. Investors in a blind-pool fund are typically required to participate in each of the fund's underlying investments. However, co-investing allows investors to choose investments, or increase their participation in those investments, that fit within their overall portfolio objectives. The opportunity to undertake target-specific due diligence allows the co-investor to gauge portfolio 'fit,' while also permitting the co-investor to enhance its knowledge on a particular industry more generally.

[1] Private Equity International LP Perspectives Survey: Co-Investments, 2020.

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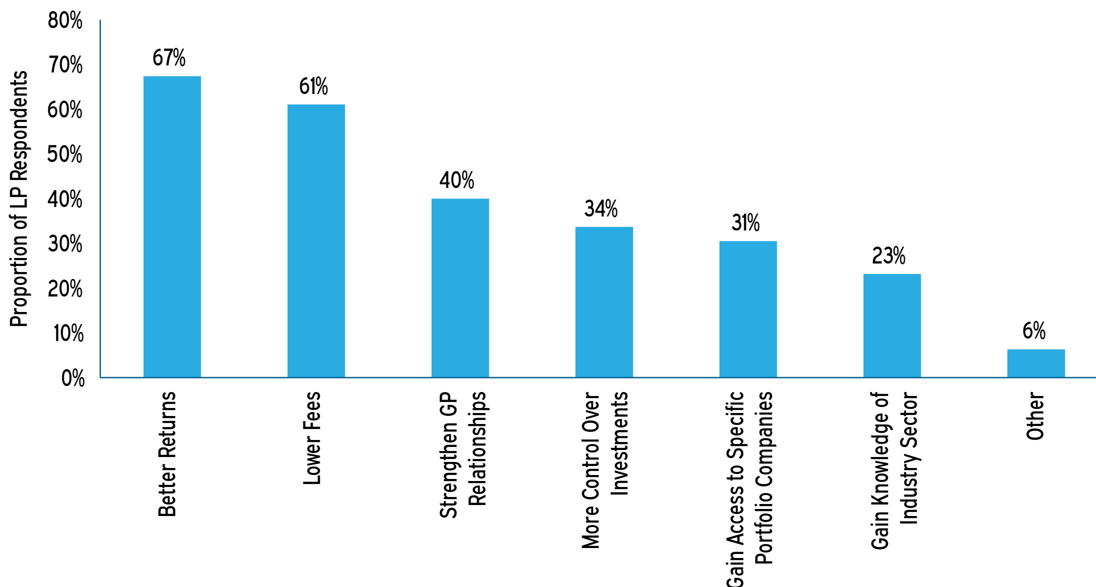

FIGURE 2
LPs' Perceived Benefits of Co-Investing

Source: Prequin Investor Survey, September 2015.

In addition to providing the opportunity to increase exposure to some of the most financially-compelling investments made by fund managers, co-investments can provide an essential first step to a direct equity investment program, as the co-investments could be used as a means to train staff in private markets deal sourcing, screening, underwriting and monitoring. Many public pension plans have growing co-investment programs and view it as an effective and efficient tool for deploying direct equity with managers of conviction.

Why do GPs offer co-investments?

GPs tend to offer co-investments for several reasons, including fund diversification requirements (e.g., the investment is too large to fit in the fund), maintaining control of an investment (as compared to having a consortium of GPs investing together), and building relationships with their LPs. GPs recognize that many LPs are seeking co-investments and some have developed in-house capabilities to execute on them. GPs believe that co-investments provide a way for them expand and deepen their relationships with their LPs.

Because co-investments can be attractive opportunities, GPs typically offer them preferentially to their fund investors (LPs), rather than broadly seeking co-investors. In some cases, the GP provides co-investments to its LPs as a contractual obligation in the commingled fund documentation; however, in most instances, co-investment rights are included as a specific clause in a 'side-letter' between the fund and an LP. GPs will often look to first offer co-investment rights to those LPs they consider to be their most important relationships. Often, this can mean those LPs making the largest dollar commitments to a fund, provided these LPs have demonstrated capability to execute co-investments.

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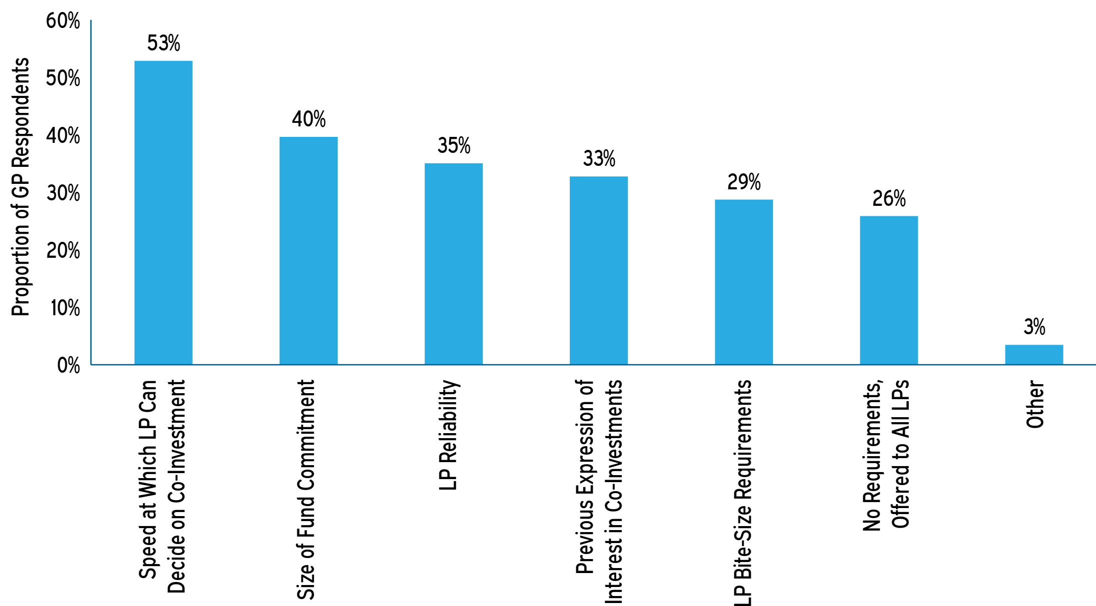

FIGURE 3

Requirements for Investors to Qualify for Co-Investment Rights

Source: Prequin Investor Survey, September 2015

Fund managers ("GPs") seek co-investors that can respond quickly and reliably (i.e., a "yes" means a "yes") to co-investment opportunities. Additionally, the fund managers will favor those LPs that have made meaningful contributions to the fund and, therefore, are considered to be important partners of the fund manager. The chart above shows responses from fund managers that identify certain characteristics of LPs that they find important in order to be considered for co-investment opportunities. Key attributes include speed of decision-making and LP reliability. Importance of the LP to the fund manager, as represented by the size of the LPs commitment to the fund, is also important.

How have co-investments performed?

One concern for co-investors has been if the deals offered for co-investment are of different quality than investments otherwise retained for the fund (and for which the GP would get full carried interest). In other words, do GPs engage in "adverse selection" when it comes to offering co-investment opportunities? A recent study[2] examined this issue by comparing the returns of transactions offered for co-investment and those that were invested by the fund only. This study used public market equivalent or "PME"[3] to compare the gross performance of each set of investments. The study showed that there was no meaningful difference in gross performance between deals offered for co-investment and those retained for the GP's commingled fund. Irrespective of these findings, the potential for this moral hazard should always be considered.

[2] Adverse Selection and the Performance of Private Equity Co-Investments; Braun, Jenkinson, Schemmerl; December 2018.

[3] Public Market Equivalent (PME) refers to the return an investor would have achieved if the private equity cash flows had instead been invested in a public equity index.

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Because co-investments are offered with more attractive economics, the net performance of co-investments can be higher. It is worth noting that the study focuses on co-investments that are made at the same time as the GP's investment. There could be issues if the co-investment is to be made at a different time or in different securities than held by the GP.

Considerations and risks of co-investments

Co-investments differ from commingled fund investments in several ways:

→ ***Concentrated exposure*** Co-investments represent more concentrated exposure to an underlying portfolio company or asset than the investor would obtain from its investment in a commingled fund. As a result, the valuation of any individual co-investment may be more volatile, both on the upside as well as downside, than an investment in a commingled fund.

→ ***Compressed decision timeframe*** While some co-investments will be syndicated by a fund manager after it has completed its investment, in most cases, the co-investment happens at the same time as the fund manager's investment, and therefore, the time between being shown a deal by a fund manager and having to approve and fund the deal is very short (e.g., frequently a month and sometimes as little as 15 days). In order for a LP to participate in co-investments, they need to have an efficient, streamlined internal review and approval processes in place so that they can meet these condensed deadlines. Given the complexities of managing a compressed timeframe, we note that, in virtually all cases, staff has discretion for co-investment decisions.

→ ***Direct involvement and risk*** In contrast to an LP's investment in a commingled fund, a co-investor is an actual shareholder of, and has a direct relationship with, the portfolio company. While the GP will lead the decision-making at a portfolio company, a co-investor can be more directly engaged with the management of the portfolio company and may have greater visibility into, and influence over, the direction and operations of the company while also receiving enhanced reporting.[4] A downside of more direct involvement in the portfolio company is that there is also potential for greater headline risk to the co-investor.

[4] Including, in certain circumstances, one or more seats on the company's board of directors.

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Co-investment approach

Due to the potential performance variation of any particular co-investment, the investor should seek to build a portfolio of co-investments that, over time, will be diversified by fund manager, industry, country, and vintage year. In order to achieve diversification, the investor should allocate capital and resources to making multiple co-investments in each vintage year, recognizing that this objective will depend upon both the quality of co-investment opportunities the investor receives as well as the total equity allocation to the program. The size and structure of co-investments should also take into consideration both the investor's risk and return goals for its broader portfolio and other policy considerations.

Fund manager selection

As with fund investments, perhaps the most important element of a successful co-investment program is investing alongside skilled private markets fund managers. The investor should consider the experience, team depth, investment strategy, value-add capabilities, and other characteristics of the fund manager with whom it would co-invest. The capabilities of the fund manager can be as important to the ultimate success of the investment as the fundamentals of the underlying deal.

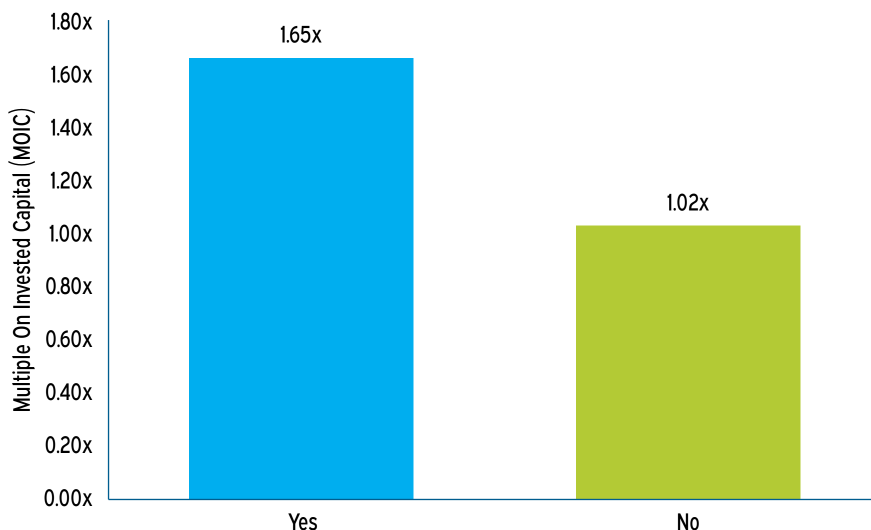

FIGURE 4
Co-Investment Performance in the "Strike Zone"

Source: Cambridge Associates LLC, as of December 31, 2013.

Note: MOIC is cumulative distributions plus current net asset value divided by cumulative invested capital.

Co-investments that reflect the fund manager's proven capabilities tend to perform better than those outside the fund manager's area of strength. A key measure of investment performance is "MOIC" or Multiple On Invested Capital. An analysis of co-investments that were executed within the manager's "strike zone" (target size, industry, geography) had a MOIC over 60% better than those outside the strike zone.

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Co-investment underwriting

Co-investment underwriting includes several steps.

→ ***Sourcing*** While there are some large, sophisticated limited partners that actively source co-investment opportunities alongside fund managers, the vast majority of co-investors are passive in that they underwrite only those deals that are sourced and shown to them by fund managers. An investor will first need to determine where it falls on the spectrum of active versus passive co-investment deal sourcing. In all cases, the investor should work closely with its fund managers to identify potential investment opportunities, and staff should clearly communicate the criteria, characteristics, size, and other features of a co-investment opportunity that the investor would find attractive. Additionally, the investor's underwriting and decision-making, legal review, and funding processes should be communicated clearly to the GP so that the fund manager is aware of these factors when considering the investor for a particular co-investment.

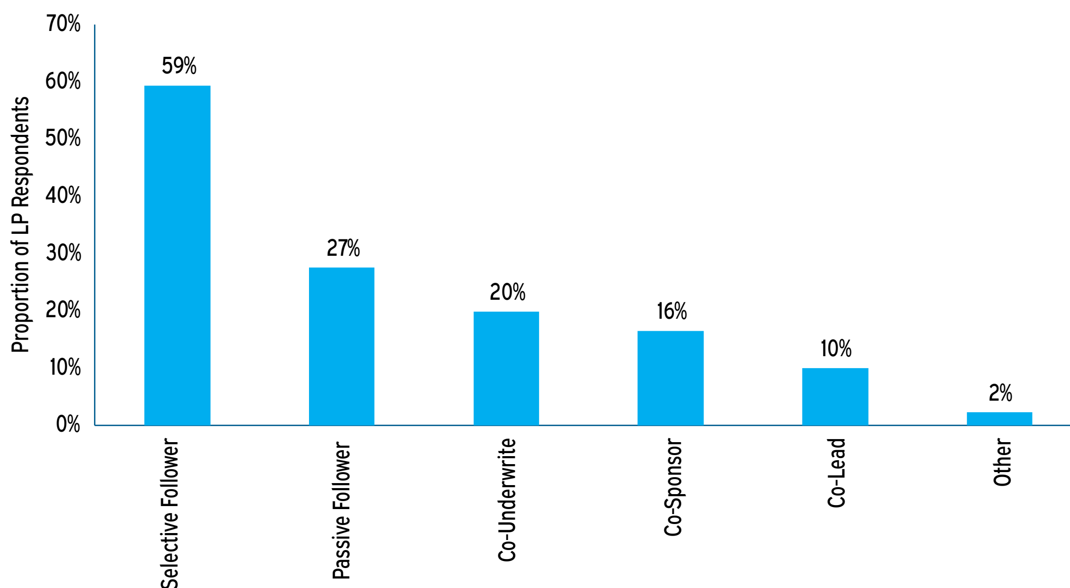

FIGURE 5
LP Approaches to Co-Investments

Source: Preqin Investor Survey, September 2015.

Co-investors utilize a variety of strategies in approaching co-investments. These can range from being a passive follower (i.e., investing in virtually every co-investment opportunity presented by the fund manager) to co-leading (i.e., taking a full leadership position in the investment on an equal basis alongside the fund manager). Based on a survey of institutional investors, the large majority of institutions that participate in co-investments are "selective" (i.e., choose co-investments based on their own assessment of the opportunity's quality or portfolio fit) or "passive followers" of fund managers. A very small percentage are co-leading deals.

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- *Screening* Some co-investors have developed an "investment assessment tool," a set of criteria they use to conduct an initial screen on investment opportunities. Such a screen would ideally include the following criteria:

  - Attractive economics - low or no management fees and carried interest;

  - Appropriate size - not so small as to not be worth the resources to investigate or too big and represent a disproportionally large position in the portfolio; and

  - Portfolio fit – the investment should fit within the investor's industry, geographic, and development objectives.

  Additional screening criteria can include investment valuation, fund manager caliber, underlying management team quality, investment risk, and other factors. Another consideration is whether to include a requirement that the fund manager receive a board seat and/or specific information rights with its investment in order for the co-investment to be considered by the investor.

  The assessment tool can provide a clear "playing field" to help make initial investment reviews efficient and transparent.

- *Review process* Co-investments are typically reviewed via multiple stages internally before the ultimate decision is made. These steps can be "screening," "preliminary review" (e.g., a decision to dedicate staff and potentially outside resources to the opportunity), and "final review." Often, the reviews are conducted by a committee composed of senior team professionals who can provide multiple perspectives on the co-investment. The committee would also need to have a flexible meeting schedule in order to react to the unpredictable schedule of the accelerated timeline required for co-investment opportunities.

- *Due diligence* For those LPs that choose the "passive follower" approach described above, due diligence on a particular co-investment tends to be more "top down" and focuses on using co-investments as an opportunity to deploy more capital with high conviction managers. For those LPs that undertake a "selective follower" approach, co-investment due diligence is a time-intensive process that often requires multiple professionals to complete. Often, these teams include both senior and junior professionals. Investors will generally utilize team members that were involved in the underwriting of the fund manager to lead the co-investment diligence from that fund manager, with additional team members that have particular expertise in the co-investment's industry sector or geography included as necessary.

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Also, many investors will utilize a third-party firm to review the co-investment alongside the investor. The third-party firm would focus on issues such as transaction valuation, industry trends, projected future growth of the company, and other issues specifically related to the co-investment. The third-party firm would ultimately provide a report that is included in the information package presented to the LP's committee as part of their final review. Including a third-party in the diligence process can present challenges in coordinating the information flow and review process, particularly for co-investments with a tight timeframe. Some investors establish a minimum dollar threshold for including a third-party review.

A successful co-investor will have a long-term strategy to source, review, and execute investments over a multi-year time frame.

- ***Approval*** As mentioned, co-investments typically have multiple review stages before a final decision. It is a best practice to have clear processes for decisions such as majority versus unanimous votes, committee membership and quorum, and how the decision will be communicated in the organization and to the fund manager.
- ***Legal*** A co-investment's legal documentation has certain key differences from fund investments. Additionally, there are often differences between one jurisdiction and another. The investor should consider at what point its legal team should become involved with a co-investment as there is a need to balance the legal team's resources with the transaction's rapid timing requirements.
- ***Closing and funding*** The process of closing and funding an investment needs to be clear in order to ensure that the required documentation is complete and the funds for the co-investment are in place in time for the closing.

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Investment monitoring

LPs need to monitor and evaluate their co-investments and related fund managers on an ongoing basis. Some LPs are actively engaged in managing these investments, and may even have a seat on the portfolio company's board of directors, while most LPs defer to the fund manager to manage the investment. Because board seats are reserved for only the largest investors, most co-investors typically do not have board seats associated with their co-investments. The investor should determine what level of involvement it would prefer and whether or not it will require board seats on all co-investments. With or without a board seat, co-investors typically seek specific information rights that may include, among other items, documents provided to the company's board members.

In order to track the development and financial strength of the co-investment, as well as the quality of interaction with the sponsoring fund manager, co-investors typically establish a regular monitoring rhythm (e.g., monthly, quarterly) as well as an established set of data and key metrics to be collected. Often, this is accomplished through both the delivery of a financial information package to the co-investor and a discussion with the fund manager and/or the company management team. Co-investors typically utilize a template to provide a framework for summarizing the key details of the co-investment, the fund manager's discussion, and staff's observations.

Structuring a program

Meketa Investment Group has the following suggestions for the successful launch of an investor's co-investment program:

Sourcing of co-investments Because the investor has limited resources and ability to actively source co-investment opportunities, the investor should rely on the most capable fund managers to source transactions. The investor will need to clearly communicate to fund managers the criteria, characteristics, size, and other features of a co-investment opportunity that the investor would find compelling. These criteria should also be included in the investor's side-letter with the fund. In order to increase the chances for the investor to complete their diligence, the investor should encourage the fund managers to involve the investor's team early in the underwriting of any potential co-investment opportunity.

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Fully-vetted fund managers The investor should seek co-investment opportunities from fund managers that have been underwritten and approved by the investor's Investment Committee or Board. By focusing on opportunities from fund managers on which the investor has performed comprehensive due diligence, and with which the investor has an active commitment, the investor will possess a more complete insight into the fund manager's underwriting process and strengths. However, the investor may wish to consider co-investments from high-quality, institutional fund managers on an opportunistic basis, especially in situations where existing fund manager relationships are not able to provide the level or type of co-investment desired.

Establish a process In order to effectively build a co-investment portfolio, an investor needs to have a process that reflects their strategy. This process should be flexible enough to accommodate different kinds of opportunities while adhering to the overall co-investor's strategy. Key issues include sourcing, screening, decision-making, execution, and monitoring. Importantly, co-investment decision-making needs to reflect the "on-the-ground" investment decision time frames required.

> Investors looking to build their own portfolio of co-investments should carefully review their capabilities to successfully execute co-investments and look to develop strategy and staffing to build and maintain a multi-year co-investment program.

Portfolio construction In order to maintain an active and balanced co-investment program, the investor may seek to execute at least three co-investments per year across geographies, strategies and industries. The total number will depend upon the amount of equity provided to the investor as well as the quality of co-investment opportunities available. All co-investments should be made taking into consideration the investor's Investment Policy Statement and portfolio construction model as well as the overall risk profile of the private equity and investment fund programs.

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Investment size The sizing of co-investments should be guided by an investor's Investment Policy Statement and guided by its portfolio construction and pacing model. At the outset of the program, the investor should cap co-investments alongside any one fund manager to a fraction (e.g., 33%) of the investor's commitment to that fund.

Co-investment structure To ensure alignment of interests between the investor and the fund manager, the co-investments should be made at the same time, using the same securities, and on the same terms as the fund manager's investment.

Underwriting process To maximize efficiency and decision-making flexibility, and minimize the time required to make investment decisions, investors should utilize a co-investment underwriting process that resembles what is already used for fund investments.

Monitoring Similar to investment underwriting, investors should utilize a co-investment monitoring program similar to their existing processes but include features focused on co-investments in order to strengthen and enhance the investor's monitoring capacity. The monitoring of co-investments should remain within and be managed alongside the monitoring of the fund by the staff.

Summary

Co-investments are becoming increasingly popular among institutional investors. LPs find co-investment opportunities attractive for a variety of reasons, including favorable fee structures and additional control over portfolio exposures.

As described above, there are several ways for investors to approach co-investments. While there is no single right way, we believe that a successful co-investment program will include the following elements:

- → ***Have a deliberate strategy*** The investor should make a commitment to build, manage, and maintain the co-investment strategy and recognize its particular benefits and considerations.
- → ***Take a long-term perspective*** While co-investments can seem somewhat random and opportunistic, a successful co-investor will have a long-term strategy to source, review, and execute investments over a multi-year time frame. Importantly, a co-investment portfolio should be a long-term decision and deployed over a number of vintage years.
- → ***Build in diversification*** In addition to seeking regular annual deployment into co-investments, the investor should pursue co-investment diversification among managers, industry, and potentially geography.

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