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Co-investment Primer

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Co-investments have become increasingly popular among many private market investors, particularly among large institutional investors. The primary reason is that co-investments offer investors the ability to maintain or increase their private markets allocations at a lower expense.

In this primer, we review how co-investments work as well as the benefits and challenges of co-investing. We also discuss ways in which an investor may access co-investments and considerations when structuring a co-investment program. While this paper focuses primarily on private equity, co-investing is available in other private market asset classes.

Key takeaways

→ **Definition and structure:** Co-investments allow limited partners (LPs) to invest alongside general partners (GPs) directly into specific portfolio companies. Unlike traditional private market fund investments, co-investments do not involve "blind pool" risk, as LPs can choose whether to participate in each opportunity.

→ **Benefits to LPs:** Co-investments offer several potential advantages to LPs, including lower fees, more targeted portfolio exposures, and mitigating the j-curve effect. Participating in co-investments provides LPs with more control and flexibility over their portfolio.

→ **Performance:** Academic research has shown no significant difference in gross performance between co-investment deals and those retained solely by the fund. Hence, co-investments are expected to offer higher net performance, on average, compared to traditional fund investments due to their more attractive economics (i.e., lower fees).

→ **Considerations for LPs:** While co-investments present attractive opportunities, they also come with additional considerations. LPs must be prepared for compressed decision-making timelines and the need for more efficient internal review processes. There is also the potential for concentration risk, as co-investments may result in more significant exposure to individual portfolio companies.

→ **GPs' perspective:** GPs offer co-investments for various reasons, including the need for additional capital for large investments, to reduce concentration risk in their fund portfolio, and a desire to maintain control over the investment. Offering co-investments can also help GPs build stronger relationships with LPs.

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What are co-investments?

Private market investors typically build most or all of their private markets portfolio 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 (the limited partner or LP) will typically be required to participate pro-rata in each investment made by the GP for that fund. Investors generally do not know what specific investments will comprise the fund at the time they commit to it (i.e., it represents a "blind pool").

In contrast, a co-investment is a more collaborative investment structure in which an LP invests alongside a GP directly into a specific portfolio company that the GP is purchasing to include in a fund. In most cases, co-investors are also LPs in this fund, so they are essentially putting more capital into a deal that they will already have exposure to once the GP adds it to the fund. However, unlike a traditional private market fund investment, there is no "blind pool" risk, as the LP has the option not to participate in any given co-investment opportunity.

The co-investment is generally made in the same assets as the main fund. Therefore, the LP is typically investing capital as a minority equity stake in the underlying company. However, taken together with the GP's and other co-investors' shareholdings, they are likely to represent a majority stake. The GP will also usually have control over the timing and form of the ultimate disposition of the target company, including both the main fund's interest and the co-investment. Figure 1 depicts a schematic for a typical co-investment.

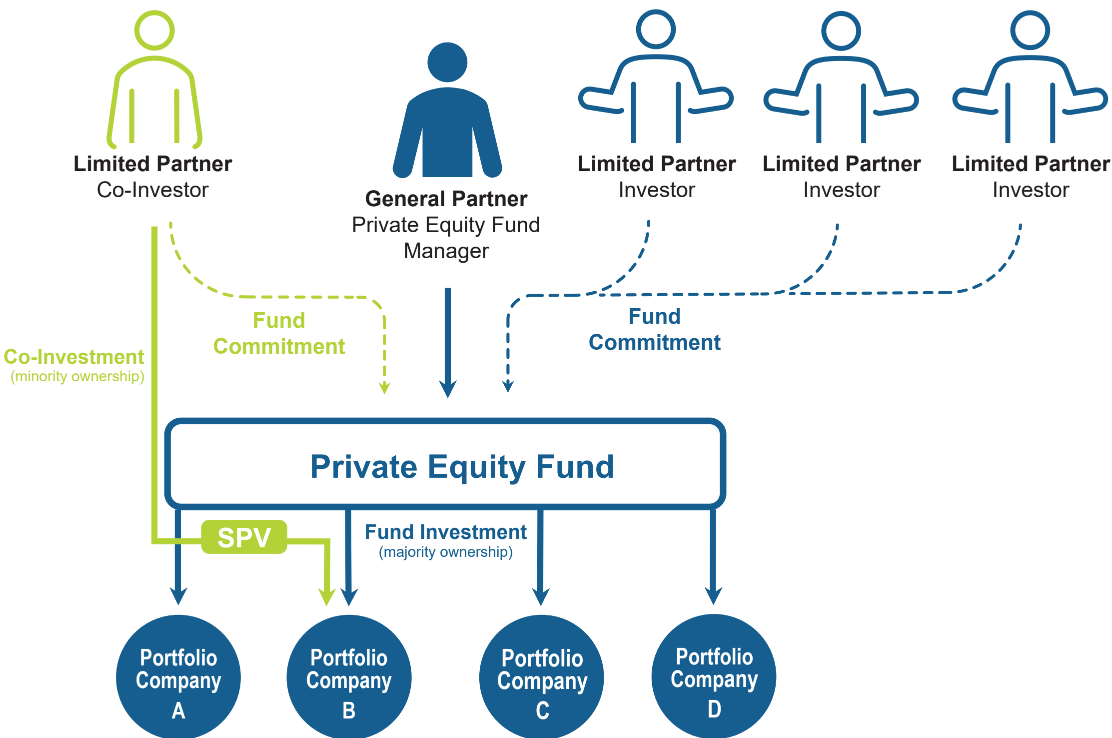

FIGURE 1
Typical Co-investment Structure

Source: Meketa, 2024.

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Steps of a co-investment

GPs typically seek to obtain co-investors during the late stages of their diligence or shortly after they have completed a transaction.

Step 1	Step 2	Step 3	Step 4
The GP selectively reaches out to LPs who are likely to be interested in a co-investment opportunity, provides a summary of the transaction, and requests indications of interest.	Assuming interest, the GP typically provides the potential co-investors with access to the full investment offering documents and the "data room," which contains due diligence materials pertaining to the transaction.	The GP may arrange site visits and/ or meetings with the management team of the portfolio company or asset and potentially access to third-party consultants for interested LPs.[1]	The GP and LP negotiate appropriate legal documents and close co-investment capital.

[1] For more information on the underwriting process, see the Appendix.

GPs recognize that many LPs are seeking co-investments, and some have developed in-house capabilities to execute on them. Since co-investments can be attractive opportunities, GPs typically offer them preferentially to their LPs, rather than broadly seeking outside co-investors. Most fund Limited Partnership Agreements ("LPAs") provide that the GP has significant discretion on whom they offer coinvest opportunities to.

What characteristics do GPs seek in a co-investor?

There are certain characteristics of LPs that GPs may find important or preferential when considering an LP for co-investment opportunities. Key attributes include the LP's speed of decision-making, the potential size of their commitment, and their reliability. 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 an individual fund or series of funds. Large LP commitments also imply that the LP has the ability to take a meaningful portion of the available capital, another important characteristic as the GP will likely want to limit the number of co-investors. The GP is also likely to reach out to those LPs that have previously expressed interest in or participated in co-investments.

GPs value co-investors that can respond promptly and reliably (i.e., a "yes" means a "yes") to co-investment opportunities. Hence, the GP typically seeks LPs who have a defined investment review process. This allows the GP to more quickly determine potential interest in order to successfully syndicate the co-investment or complete the transaction. Some, though not all, GPs may not have any requirements and may offer co-investment opportunities to all LPs.

The co-investment universe

Co-investment fundraising has generally been on the rise over the last decade, peaking in aggregate capital raised for private equity co-investing in 2021. This peak coincides with the largest annual fundraising in traditional private equity in over two decades.[2]

[2] Source: Preqin, as of October 2024. Since 2000, the year 2021 had the highest aggregate capital raised and number of funds for private equity.

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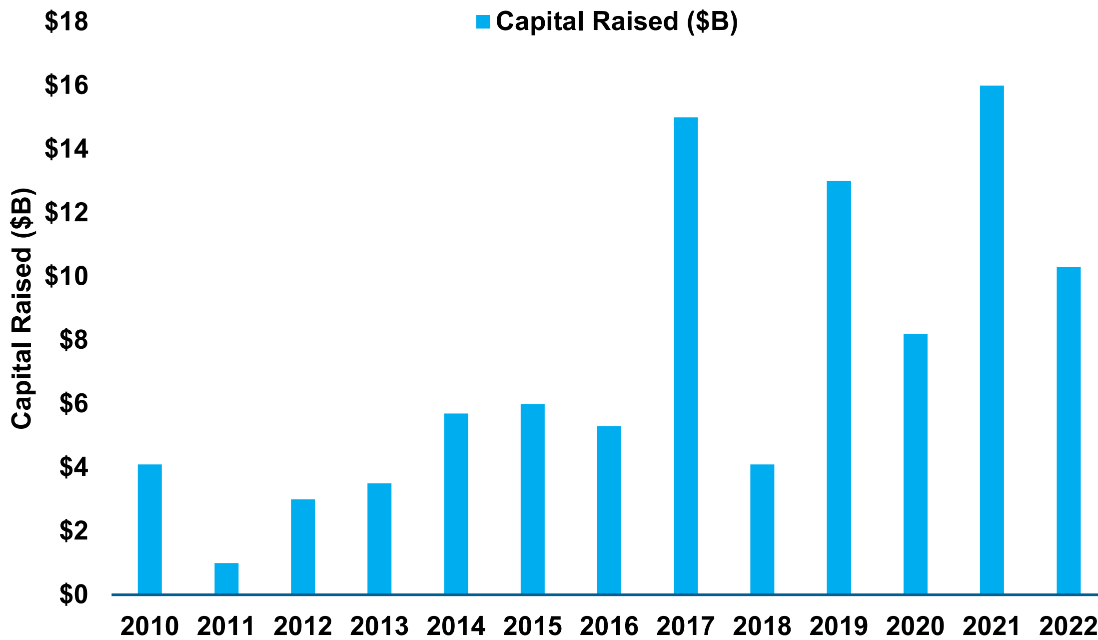

FIGURE 2
Global Private Equity Co-Investment Fundraising

Source: Pitchbook, as of March 30, 2023. Note, this is based on fundraising activity tracked by Pitchbook and may understate total co-investment fundraising.

LP sentiment

Co-investments may involve transactions across the various private market strategies that institutional investors support, such as private equity, private credit, infrastructure, real estate, and natural resources. A recent survey (shown in Figure 3) indicated that private equity had the highest proportion of investors either currently investing or considering investing in co-investments, followed by private debt and infrastructure.

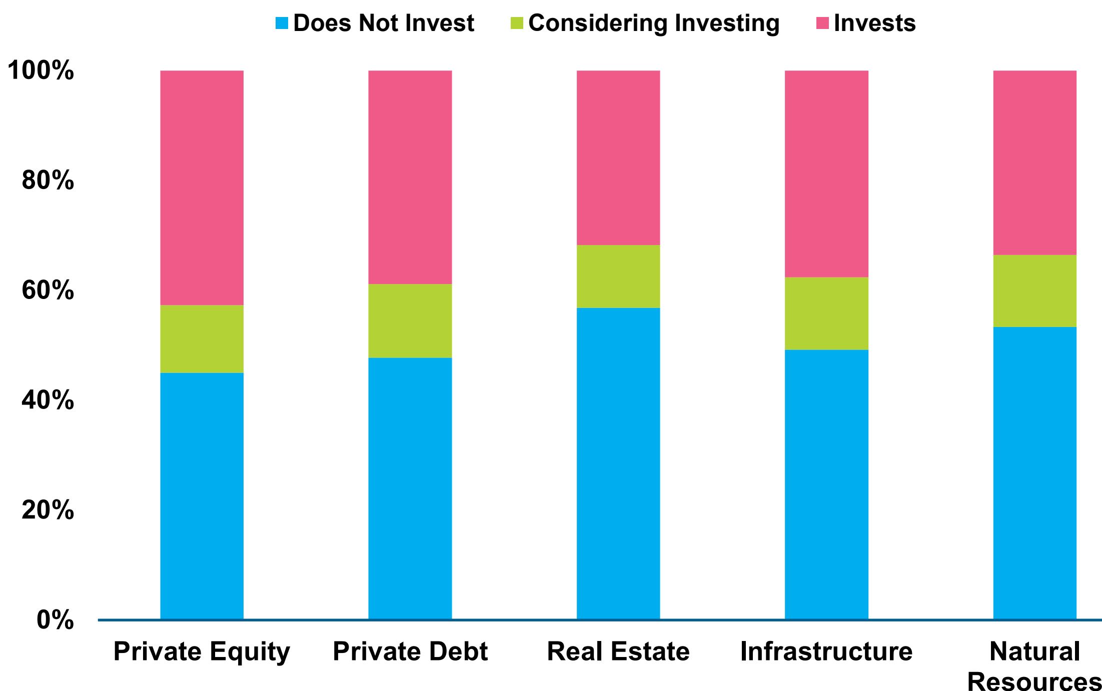

FIGURE 3
LP Participation in Co-Investments by Asset Class

Source: Preqin Fund Terms Advisor 2024, as of June 30, 2024.

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Unsurprisingly, the larger an LPs' allocation to private equity, the more likely it is that they participate in co-investments (see Figure 4). This is to be expected since co-investments require additional funds, due diligence, and monitoring, all of which is more likely to be present in a larger private markets program. These larger LPs are also likely to have assembled a deeper stable of GPs from which to source co-investment opportunities in addition to building an internal team for evaluating them.

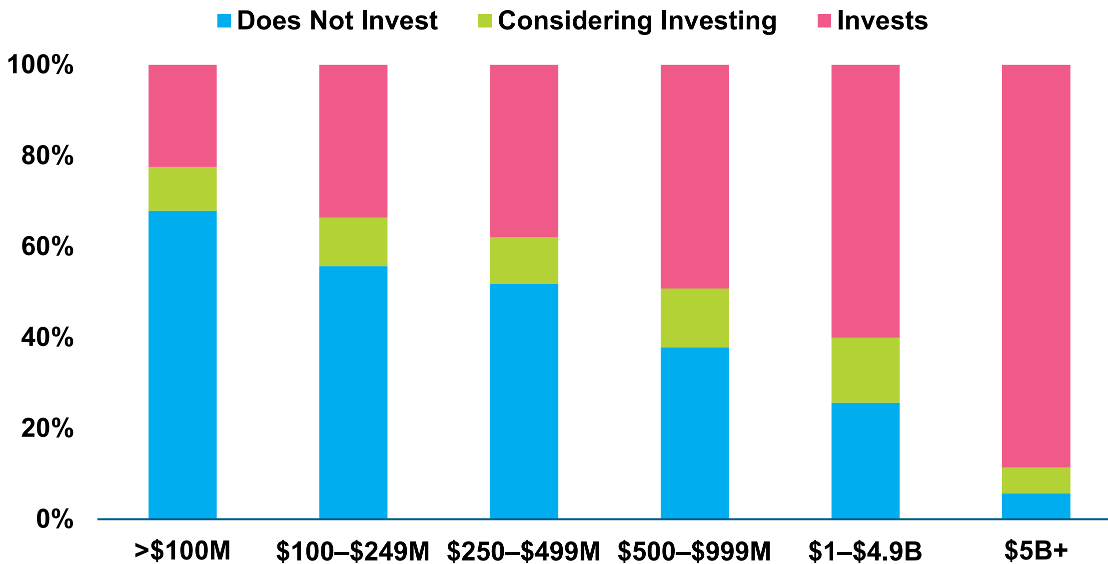

FIGURE 4
LP Participation in Private Equity Co-Investments by Current Private Equity Allocation

Source: Preqin Fund Terms Advisor 2024, as of June 30, 2024.

The co-investor's perspective

Benefits to the co-investor (the LP)

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 structure can make a meaningful difference by directly contributing to higher net returns.

Co-investments may offer **additional control** over portfolio exposures. Investors in a blind-pool fund are required to participate in each of the fund's underlying investments. However, co-investing provides investors with some added flexibility to customize their portfolio by increasing their participation in those investments that are a better fit within their overall portfolio objectives. The opportunity to undertake target-specific due diligence lets the co-investor **tailor their portfolio** to focus on the particular strategies, industries, and geographies of interest to the LP.

Co-investing can also allow for a more rapid deployment of capital, helping to **mitigate the j-curve**. In a traditional private markets fund, after an LP makes a commitment to the fund, capital is typically drawn over a multi-year period. This results in the early period of the fund's life having capital committed or partially deployed and, thus, fees are incurred without any distributions back to the LP. This negative returns early in a fund's life that are expected to turn positive with time is known as the j-curve. Because co-investments deploy capital immediately, they can help mitigate the j-curve.

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By being a regular and reliable participant in co-investments, an LP can **strengthen its relationship with the GP**. LPs may find this particularly valuable for those GPs whose funds are often oversubscribed. In addition, co-investments may provide an opportunity to increase exposure to some of the most financially compelling investments, as well as an opportunity for the LP's own investment team to develop experience in vetting co-investment opportunities. Co-investments could be used to train staff in private markets deal sourcing, screening, underwriting, and monitoring. As such, co-investments can also provide an essential **first step to a direct equity investment program.**

Considerations for the co-investor

Co-investments present additional considerations for LPs beyond those of a traditional investment in a private markets fund. One concern for co-investors has been whether the deals offered for co-investments are of a lower 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? The most comprehensive study to date examined this issue by comparing the returns of transactions offered for co-investment and those that were invested by the fund only.[3] 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, on average. Irrespective of these findings, the potential for this moral hazard should always be considered.

[3] Source: "Adverse Selection and the Performance of Private Equity Co-Investments", Braun, Jenkinson, Schemmerl; December 2018. The study used public market equivalents or "PMEs" to compare the gross performance of each set of investments. 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

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 GP's investment. Therefore, the time between when an LP is shown a potential deal by a fund manager and when the LP would have to approve and fund the deal is very short. Having efficient, streamlined internal review and approval processes in place can help LPs meet these **condensed deadlines for decision making**. Given the complexities of managing a compressed timeframe, in some cases, institutional investors have delegated discretion for co-investment decisions to their investment staff. Discretionary authority for staff often comes with limitations and guidelines, such as the amount that can be invested in a single deal or exclusion of co-investments in particular industries or geographies.

By co-investing, an LP essentially invests twice in a specific company or asset, and sometimes the size of the co-investment can be much larger than their stake in the company via their fund investment. Hence 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. This may lead to **concentration risk** where private market portfolios are less diversified and may have an increased risk of loss. This risk may be somewhat mitigated if an LP constructs a diversified portfolio and/or invests in a co-investment fund, which should offer increased diversification.

Finally, co-investments may have a **large deal or company bias**, since most co-investments tend to be in larger companies and transactions. This may also lead to **headline risk**, as a co-investor may be more easily identified with a particular investment.

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The GP's perspective

Benefits to the GP

GPs tend to offer co-investments for several reasons, the most basic of which is that the potential investment is too large for the fund, in that it requires more capital than the GP can commit. Utilizing a co-investment structure allows a GP to pursue a potentially attractive investment opportunity which otherwise may not have been feasible for the fund alone. **Efficiently expanding available capital** through co-investments also **helps the GP maintain control** of the investment, in contrast to having a consortium of GPs investing together or having to work with another financial sponsor.

Another benefit of co-investing from the GP's perspective is that it can, or may have the potential to, **reduce portfolio risk**. Having LPs invest additional capital can limit the fund's exposure to a large investment, allowing the GP to pursue high-capital opportunities without heavily concentrating the fund's risk into a single investment. This may allow the GP to more evenly distribute risk throughout the fund (or adhere to investment restrictions), while still being involved in attractive higher-capital opportunities.

Finally, co-investing may be used as a **marketing and loyalty tool**. Offering co-investment opportunities can help to attract prospective investors, build loyalty with existing investors, as well as expand and deepen relationships with LPs. This may also explain why GPs do not just offer inferior investment opportunities for co-investing (i.e., the adverse selection issue) – GPs may be more concerned about their long-term relationships, and ability to raise capital, than the extra carried interest earned on a few individual investments.

Considerations for the GP

Like with LPs, co-investments present unique considerations and issues for GPs. One such risk is the **loss of unilateral control** which may result in the potential dilution of rights and non-economic control in more active co-investment structures. Other considerations include the **additional time and cost** that GPs (and their staff) must dedicate to raising co-investment capital, such as responding to co-investor due diligence requests and negotiating terms of investment. Similarly, co-investments often require **additional investment management and reporting requirements** to meet co-investor needs. Finally, while there is a potential benefit for the GP to deepen relationships with LPs, this may be a double-edged sword in that there is **relationship risk** and the potential for a loss of long-standing relationships should one or more co-investments be unsuccessful.

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How have co-investments performed?

There is no comprehensive database for co-investments like there is for the broader private equity fund universe. Hence, investors can evaluate the opportunity set by examining academic studies that are independent and fairly comprehensive, but unfortunately do not include the most recent years.[4] And they can potentially complement this by examining the track record of institutional investors who have engaged in co-investing for a prolonged period and have built (and published) a track record, while acknowledging that this will be far more anecdotal and subject to idiosyncratic risks.

Because co-investments are offered with more attractive economics, the net performance of co-investments will be higher than fund investments if the gross performance is the same. Hence, many investors who seek co-investments do so not necessarily in the hope of better gross returns from co-investments (i.e., favorable selection), but rather in anticipation of earning the same gross returns that they do, on average, in their fund investments, and thus a higher net return via lower fees.

[4] See for example the paper cited earlier: "Adverse Selection and the Performance of Private Equity Co-Investments", Braun, Jenkinson, Schemmerl; December 2018.

Ways to access co-investments

Investors have several ways that they may be able to access co-investments, the most common of which are listed below along with some of their key benefits and considerations.

Partner with existing GPs. Private market investors who have built out their portfolios will often have investments in many different funds, and the LP has likely had years to develop relationships with their GPs. Hence the LP already has a partnership established with the fund and GP, as well as familiarity with their management team, strategy, and investment prowess. Therefore, the LP likely believes they have performed significant due diligence on the GP, though due diligence will still be needed on individual co-investment opportunities. The LP may have more leverage to get a better fee structure based on their fund commitment size.

Partner with GPs not in the portfolio (one-off transactions). In order to broaden the opportunity set of potential co-investments, a private market investor may pursue co-investments with GPs they are familiar with but in whose most recent fund they are not invested. This approach often requires more work, as due diligence may be needed on the investment manager in addition to the underlying co-investment opportunities. The LP generally has less leverage for fee negotiations. Still, this approach has the benefit of expanding the pool of potential co-investments.

Utilize third-party intermediaries. If an LP does not feel they have sufficient relationships or resources/staff to build and monitor a co-investment program on their own, they can hire an intermediary to source co-investment opportunities. The intermediary likely has relationships with many GPs and experience in evaluating co-investments. The LP may or may not retain discretion on individual co-investment decisions. The LP must vet, select, and monitor the intermediary. This structure allows the LP to define their investment preferences/sensitivities, veto rights, etc. The LP will pay an added layer of fees (i.e., to the intermediary).

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Invest in a dedicated co-investment fund. In this structure, full responsibility and discretion for sourcing and vetting of co-investments, along with building a portfolio, is delegated to a fund manager. The LP must still vet and select the fund manager. The LP will pay an additional layer of fees (i.e., to the fund).

Structuring a co-investment program

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.

When structuring a co-investment program, there are some considerations for which an investor may want to be aware:

Sourcing: If the investor has limited resources and ability to actively source co-investment opportunities, they may want to rely on only the most capable fund managers to source transactions. The investor should clearly communicate to fund managers their criteria, characteristics, size, and other features that they find compelling. These criteria should also be included in the investor's side-letter with the fund. To increase the chances for the investor to complete their diligence, investors may also encourage fund managers to involve their team early in the underwriting of any potential co-investment opportunity.

Fully vetted fund managers: Investors should aim to seek co-investment opportunities from fund managers they have already underwritten and approved. By focusing on opportunities from fund managers on whom the investor has already performed comprehensive due diligence and with whom they have an active commitment, the investor can possess a more complete insight into the manager's underwriting process and strengths. However, the investor may also wish to consider co-investments from other 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 should have a process that reflects their strategy. This process should be flexible enough to accommodate different kinds of opportunities while adhering to the overall investor's strategy. Key issues include sourcing, screening, decision-making, execution, and monitoring. Importantly, co-investment decision-making should reflect the "on-the-ground" investment decision timeframes required.

Playing to strengths: LPs will likely be best served by emphasizing co-investments that reflect the fund manager's proven capabilities. This could mean giving greater consideration to co-investments that fall within the manager's "strike zone" (e.g., target size, industry, geography).

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Portfolio construction: In order to maintain an active and balanced co-investment program, the investor may seek to execute co-investments that are diversified by fund manager, industry, geography, strategy, and vintage year. Making multiple co-investments in each vintage year can help to improve diversification, though this objective will depend upon both the quality of co-investment opportunities the investor receives as well as the total allocation to the program. All co-investments (as well as their size and structure) should be made taking into consideration both the investor's risk and return goals for its broader portfolio.

Investment size: The size of co-investments should be guided by an investor's Investment Policy Statement and their portfolio construction and pacing model. At the outset of the program, the investor may want to cap co-investments alongside any one fund manager to a fraction of the investor's commitment to that fund.

Co-investment structure: To help ensure alignment of interests between the investor and the fund manager, co-investments should typically 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 to minimize the time required to make investment decisions, it may be beneficial for investors to utilize a co-investment underwriting process that resembles what is already used for fund investments.

Monitoring: Investors should consider utilizing a co-investment monitoring program similar to their existing processes, while including features focused on co-investments. In other words, the monitoring of co-investments should remain within and be managed alongside the monitoring of the GP. This includes LPs monitoring and evaluating their co-investments and related fund managers on an ongoing basis. Some LPs may defer to the fund manager to manage the investment, while others may be actively engaged and may even have a seat on the portfolio company's board of directors (though this is somewhat rare). 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) and a set of data and key metrics to be collected. Often, this is accomplished through both a financial information package and discussion with the fund manager and/or company management. 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.

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Conclusion

Co-investments offer a unique and advantageous opportunity for limited partners to invest alongside general partners directly into specific portfolio companies. This collaborative investment structure allows LPs to avoid the "blind pool" risk associated with traditional private market funds, providing them with greater control and flexibility over their investments. By participating in co-investments, LPs can benefit from lower fees, more targeted portfolio exposures, and the potential for higher net returns.

However, co-investments also come with additional considerations and risks. LPs must be prepared for the compressed decision-making timelines and the need for efficient internal review processes. There is also the potential for concentration risk, as co-investments often result in more significant exposure to individual portfolio companies. Despite these challenges, the ability to co-invest can strengthen relationships between LPs and GPs, offering valuable opportunities for LPs to enhance their investment strategies and gain deeper insight into private markets.

Ultimately, the success of co-investments depends on the careful selection of opportunities and the effective management of associated risks. Both LPs and GPs can benefit from this investment approach, with GPs gaining additional capital and LPs achieving more customized and potentially lucrative investment outcomes. 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 co-investment program. As the co-investment landscape continues to evolve, it remains a compelling option for investors seeking to optimize their private market portfolios.

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Appendix | The underwriting process

Co-investment underwriting typically includes several steps which are detailed below.

Sourcing

One of the first steps of the underwriting process is determining where an investor falls on the spectrum of active versus passive co-investment deal sourcing. The general strategies for approaching co-investments by LPs are listed below:

Passive follower: investing in virtually every co-investment opportunity presented by the fund manager.

Selective follower: choosing co-investments based on their own assessment of the opportunity's quality or portfolio fit.

Co-leading: taking a full leadership position in the investment on an equal basis alongside the fund manager.

No matter where they fall on the spectrum, the investor should work closely with 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.

Screening

Some co-investors have developed an "investment assessment tool," which is a set of criteria they use to conduct an initial screen on investment opportunities. An assessment tool can provide a clearer "playing field" to help make initial investment reviews efficient and transparent. 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 invest, and not so big as to 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 may 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 the investment in order for the co-investment to be considered by the investor.

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Review process

Co-investments are generally reviewed via multiple stages by LPs before the ultimate decision is made. These steps may include "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 likely need 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 can be a time-intensive process that often requires multiple professionals, both junior and senior to complete. Investors may choose 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 expertise in the potential industry, sector, or geography included as necessary.

Given the tight time constraints for making a decision on the co-investment, it is critical to identify key attributes and risks during initial stages of due diligence. This may include qualitative considerations such as the overall track record and industry experience of the sponsor, the quality, track record of success, and succession planning of management, as well as the competitive landscape, position in the industry, customer base, and growth potential of the company/industry. Additionally, quantitative valuation models that start with a GP base case and stress test model with various assumptions (e.g., growth rates, margins, exit multiples) may be employed. Finally, diligence should be conducted in terms of both comparable public and private transactions (if available).

Many investors also may utilize a third-party firm to review the co-investment alongside the investor. They would likely focus on issues such as transaction valuation, industry trends, projected future growth of the company, and other issues specifically related to the co-investment. Other diligence may also be done in areas like legal, accounting, insurance, employee benefits, and tax considerations. 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.

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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 internal/external 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.

Approval, closing, and funding

As mentioned previously, co-investments typically have multiple review stages before a final decision. It is generally 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 within the organization and to the fund manager.

The process of closing and funding an investment needs to be clear to help ensure that the required documentation is complete and the funds for the co-investment are in place in time for the closing.

Other considerations

In creating a co-investment program, the investor must address important issues in order to help ensure the proper implementation and success of the platform. Co-investments require their own legal review, and have significant structuring considerations that LPs should consider, including, but not limited to:

- Information rights to monitor the investment;
- Preemptive rights which give them the ability to invest more equity, particularly to avoid dilution;
- Tag along rights, or the ability to sell their interest at the same time as the GP;
- Limitations on transfer/right of first refusal to purchase another investor's interest before going to outside parties; and
- In some limited circumstances, they may include a Board seat (with vote) or observer right. However, this could bring additional fiduciary concerns that the investor would need to consider.

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