Joining forces

The co-investment climate in private equity

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Methodology

In Q2 2015, Mergermarket interviewed 50 private equity partners, directors and principals from across the United States. The fund sizes managed by the interviewees are equally split between US$250m-US$500m and US$501m-US$999m. To qualify for the study, respondents must have co-invested with an institutional investor within the previous three years. The results are anonymized and presented in aggregate.

Foreword

The private equity (PE) industry has had an incredibly busy two years. According to Mergermarket data, there were over 2,700 buyouts globally in 2014, worth around US$386bn, the highest figure since 2007. While this year's PE dealmaking has not kept pace with last year's, both value and volume are still way ahead of the activity following the collapse of Lehman Brothers in the Fall of 2008. A combination of cheaper debt, hungry investors and attractive companies has ensured that buyout houses have remained an integral part of the dealmaking landscape.

However, this picture has been made less clear by the emergence of increasingly active and independently minded limited partners (LPs), stepping up from passive capital provision to investing alongside — or indeed instead of — buyout houses.

Co-investments are certainly not new. However, institutional investors are increasingly warming to them. At a conference in Paris last November, pension fund managers from around the world condemned what they see as excessive PE fees associated with passive investment. "You're not [investing] to make the senior managing partner of a private equity fund US$200m more this year," commented Ontario Teachers' Pension Plan's head of PE, Jane Rowe.

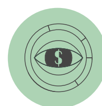
This changing attitude has seen several large co-investment deals in recent times. In September the California Public Employees' Retirement System (CalPERS), for example, plowed $900m into Institutional Multifamily Partners, a joint venture between CalPERS and affiliates of General Investment & Development. Elsewhere, the California State Teachers' Retirement System announced in July that it had made its first infrastructure co-investment.

The dynamic between PE firms and their LPs, then, has clearly changed. But exactly how has it changed? And, what does it mean for PE in practice?

With these questions in mind, Pepper Hamilton commissioned Mergermarket to survey 50 PE executives, asking them how co-investments fit into their respective portfolios' makeup, and on what basis they are doing deals together.

Key findings include:

Regulation hits hard. Over three-quarters of respondents see regulatory scrutiny as one of the biggest challenges to co-investments, 20 percentage points more than the next highest reported challenge, lower returns for sponsors.Thirty percent see regulatory scrutiny as the biggest hurdle facing PE co-investments.



The more you know. Providing deal information to prospective LPs was seen by nearly half of respondents as the most common type of arrangement to keep PE and co-investor interests aligned. This is critical, given that building investor goodwill is seen as the fourth-biggest driver of co-investments.

Tag teams. The deal term most often included in co-investment transactions — noted by 68% of respondents — is tag along rights, followed by the obligation to fund follow on investments proportionally (58%) and requiring a separate audit of the co-investment vehicle (52%). Interestingly, given the spotlight that has been on LPs' spending on PE, terms that reduced the carry of management fees were featured predominantly low on the list of respondents' top concerns.

As pressure increases from all sides, the PE industry must continue to look for creative ways to raise funds and generate returns. Co-investments are currently one method of providing this opportunity. But, to get the most out of them, buyout houses must learn to work with, not for, previously passive investors. We hope you enjoy this report and, as always, welcome your feedback.

State of play:
Co-investments in 2015

56%
of GPs look for co-investment opportunities from the outset

62%
indicate majority of co-investors came from existing LP pool

18%
of co-investors were referrals from LPs

As limited partners increasingly look for investment opportunities, private equity firms have been keen to provide them. What makes up these co-investments, how many are private equity firms conducting, and what are the terms involved?

Partnering up

General partners (GPs) are balanced when it comes to the extent their funds offer co-investment opportunities to LPs. Fifty-six percent look in particular for co-investment opportunities from the outset, while 42% do so more opportunistically.

The survey results show that PE firms are becoming increasingly hungry to offer LPs the chance to invest and are being more proactive than reactive. As the amount of cash they are managing now from private wealth increases — Blackstone, for instance, now manages US$43bn from private wealth, more than three times more than the total from five years ago — PE firms are courting these private wealth owners or managers with everything in their marketing tool box, including co-investment opportunities.

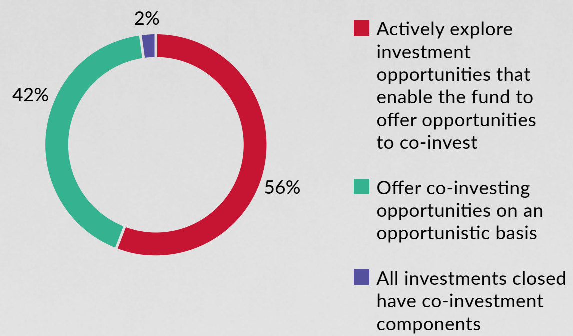
However, there is still room for growth; while they are clearly part of the investment landscape and are gaining traction, co-investments are still not the prevalent model. Ninety percent of respondents said that, at most, four of their last 10 deals had co-investor participation.

Expanding the pool

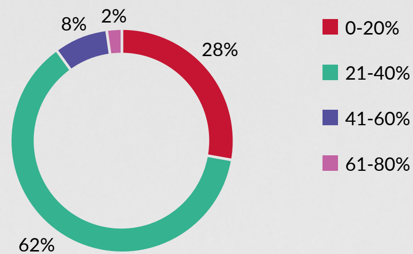
Looking more closely at these closed deals with co-investments, the majority of co-investors came from the respondents' existing LP pool (62%). Eighteen percent were referrals from LPs, while 10% were LPs from prior funds.

Reaching out to existing LPs can help to increase deal efficiency for PE firms. "To reduce the overall time for due diligence and to minimize risks we approached for co-investments through our existing LPs,"

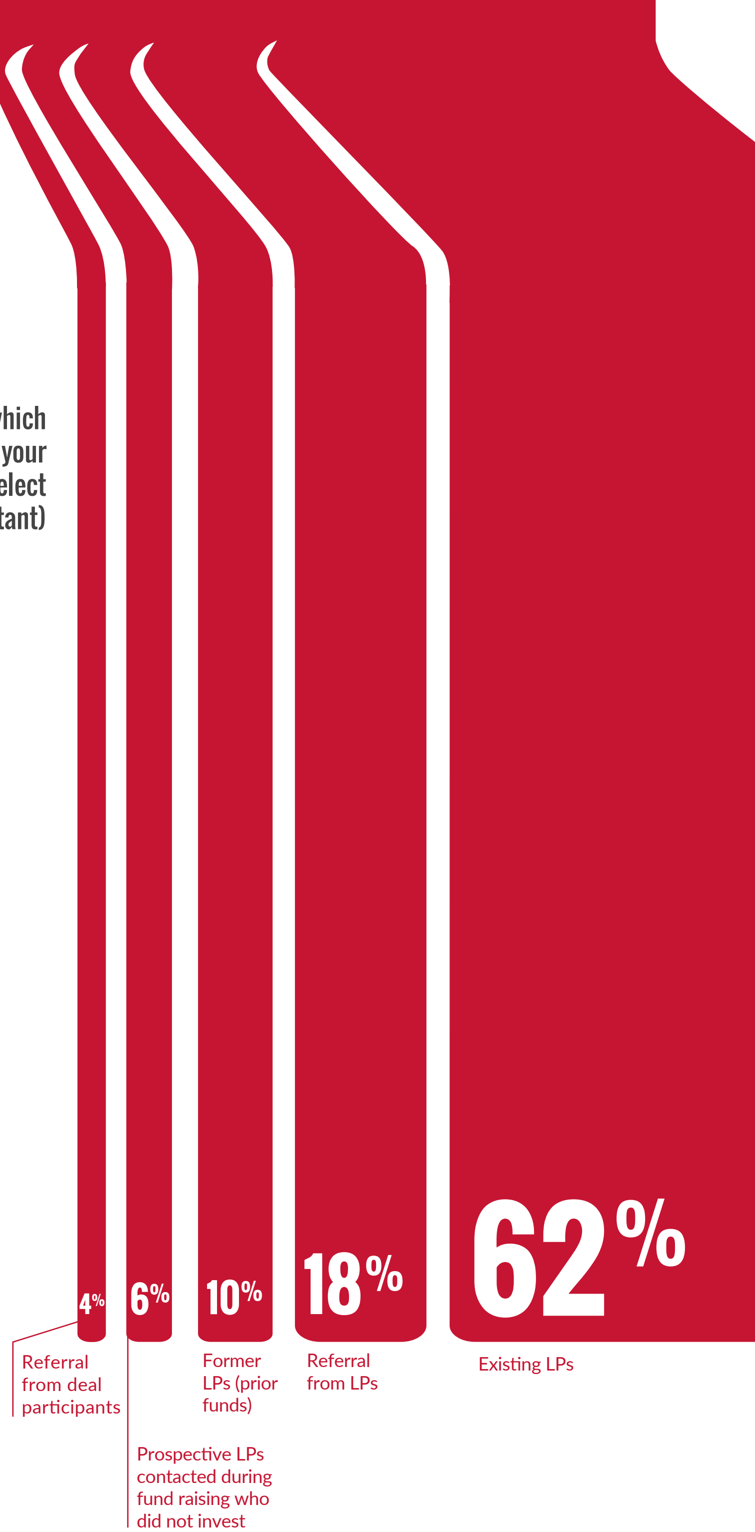
What is the extent to which your fund offers the opportunity to limited partnerships (LPs) to co-invest?



What percentage of the last 10 deals have you closed (in the current fund or a predecessor fund) with the participation of co-investors?



Looking at your closed deals which had co-investments, where did your co-investors come from? (Please select the most important)



says one partner. “This helped us to define our strategies well and to maximize the ultimate value.” Where handled properly, this system benefits both the PE firms and the LPs, leading to additional cooperation. For example, pension fund Illinois Teachers Retirement System recently committed an additional US$30m to a co-investment managed by Parthenon Capital Partners, an existing PE manager.

Some firms, however, prefer to identify co-investors from LP referrals as a means to help to broaden the firm’s prospective investor base. This can prove important as PE firms compete for new capital. “Most co-investors for the closed deals came through referrals from our LPs,” explains one partner. “These co-investors had a similar appetite to consume risks and similar investment objectives. That made it possible to invest and seek returns together.”

Terms and conditions apply

Tag along rights (68%), the obligation to fund follow on investments proportionately (58%) and separate

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> “While we understand the rationale for providing co-investment options to existing LPs, finding other investors for co-investments presents a chance for the firm and the other investors to develop a history of investing together. Firms can capitalize on this familiarity by offering these co-investors the opportunity to become an LP in the firm’s next fund.”

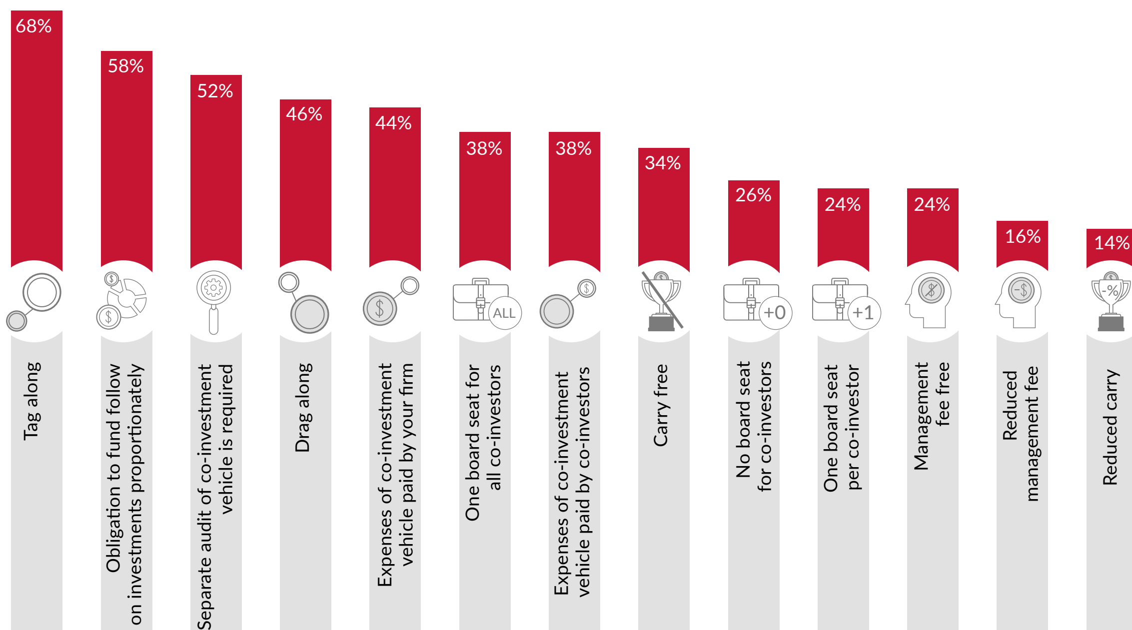
audits of the co-investment vehicle (52%) were the most common deal terms applied to a co-investment.

The preponderance of tag-along rights over drag-along rights suggests LPs are perhaps gaining the edge in co-investment deals, due to their general preference for these types of rights over drag along. “Tag-along rights are applied to the co-investment to protect the minority interests of the co-investors and to provide them with the necessary rights to negotiate during the time of exits,” explains one managing partner.

Some respondents, however, emphasized the need for drag-along rights in the deal terms in order to cater to large-scale investors as well. “The most common co-investment deal terms would be drag-along, which secures majority investor funds and tag-along which does the same for minority funds,” says another managing partner. “These are crucial offerings which help a PE business develop a reputation amongst investors and business has grown in investor support through such strategies.”

Interestingly, however, many terms that would reduce GP carry or management fees are much further down the list, indicating that, although the much-publicized clamor for lower fees and expenses has translated into some push back on these in the co-investment context, this push back is still far from the norm. In particular, just 34% had a carry free term in the deal, while terms such as management fee free (24%), a reduced management fee (16%) and a reduced carry (14%) were the last three in terms of term popularity.

Typically in a co-investment deal, what deal terms apply to the co-investment?



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> "This trend will continue: the best of both worlds benefits of the PE firm maintaining control and with it the opportunity to justify its carry and management fees, coupled with large enough investments from co-investors to ensure their involvement in managing the investment. At the same time, the PE firm benefits from the opportunity to work more closely with the deal people from the co-investor, thereby ensuring both another deal expert's focus on the portfolio company, and a closer relationship when the next fund is being raised."

The lack of fee and carry reduction could be due to the increasingly new number of investors entering the fray, with such fee waivers being reserved for long-standing clients. "Investors from our existing LPs are our major co-investors, so the fees are exempted," explained one partner.

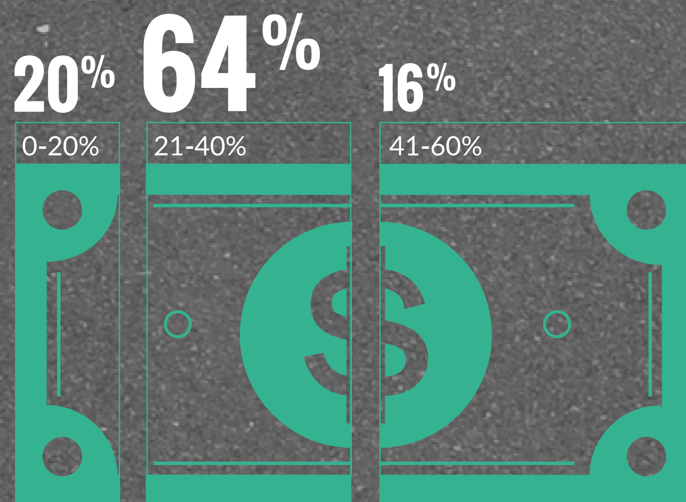
In addition, taking onboard costs and exempting co-investors from fees can help to ensure support. "These terms were reasonable and were accepted by co-investors. We kept their interests and expectations in mind and offered them security of funds, as well as exceptions in fees for their long-term commitment," says one managing partner. "As we were in need of finances, we decided to bear expenses of the co-investment vehicle as we were getting a chance to build positive business relationships."

Given the commonality of tag along rights in deals, it's unsurprising that the majority of co-investment equity was less than half of total equity. Sixty-four percent of respondents said that co-investors had contributed 21-40% of total equity, while 20% said co-investors gave less than 20% of total equity. Sixteen percent contributed 41%-60% of total equity.

Allowing a co-investor to take a majority stake can be advantageous when they have experience in a particular field. "Our co-investor had wide spread experience and proven track records that made us rely on their abilities and so we agreed to a majority equity for them," says one managing director.

Conversely, PE houses wishing for "silent money" are giving out very small stakes. As one managing principal explains: "Equity positions offered to our co-investors were below 20% of the total proportion as we wanted to retain the operational control through our efficient management expertise and experience."

For the majority of respondents, however, finding a middle ground in terms of co-investment equity stake is giving them the best of both worlds. "Of the total aggregate dollar value of equity invested in deals, we have offered approximately 25-30% of the equity portion to our co-investors to apply their relevant strategies and experience into the management of the portfolio business," says one managing director. "This was a good break-up between us and the co-investors as we still retain the controlling equity and also the co-investor has to get involved to justify their equity."


Of the total aggregate dollar value of equity invested in deals done by your fund thus far, what portion of this equity was taken by co-investors?
20%
0-20%
64%
21-40%
16%
41-60%

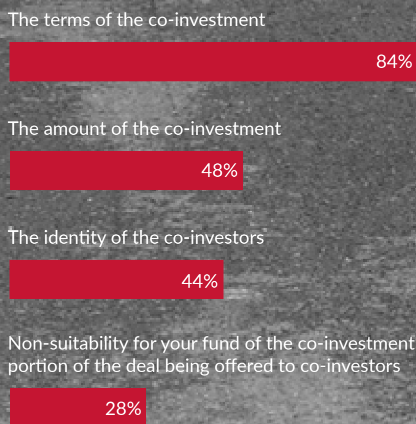
The terms of the co-investment were the most common aspect to be reviewed by a LP committee (84%), followed by the amount of the co-investment (48%) and the identity of the co-investors (44%).

Allowing term reviews is crucial, according to one partner. “The terms of the co-investment need to be reviewed so that there are fewer chances of the business receiving less for their efforts made in making the investment successful,” he says. “Terms need to be fair and should offer the right rewards and appropriate consideration to all involved in the investment as far as I know.”

Reviewing the identity of the co-investors will, for some respondents, allow for confidence in their ability. “We believe partnering with a reliable source is as important as when investors have a good track record of being a participant in successful co-investments,” according to one managing partner. “This makes it easier to choose an investor for co-investment and is thoroughly checked by our LP committee.”

For those who had LP committees consider the amount of the co-investment, reviewing this aspect helps to ensure both parties are aware of what is expected of them, solidifying business relationships. “The LP committee reviews the amount of the co-investment as there can be no chance of error in determining the amount expected from each co-investor,” according to one managing partner. “An error could result in a sour relationship between the co-investor and our business which is best avoided as most investments are made with the investors.”

When you make co-investments, do you have any of the following reviewed by a limited partner committee?



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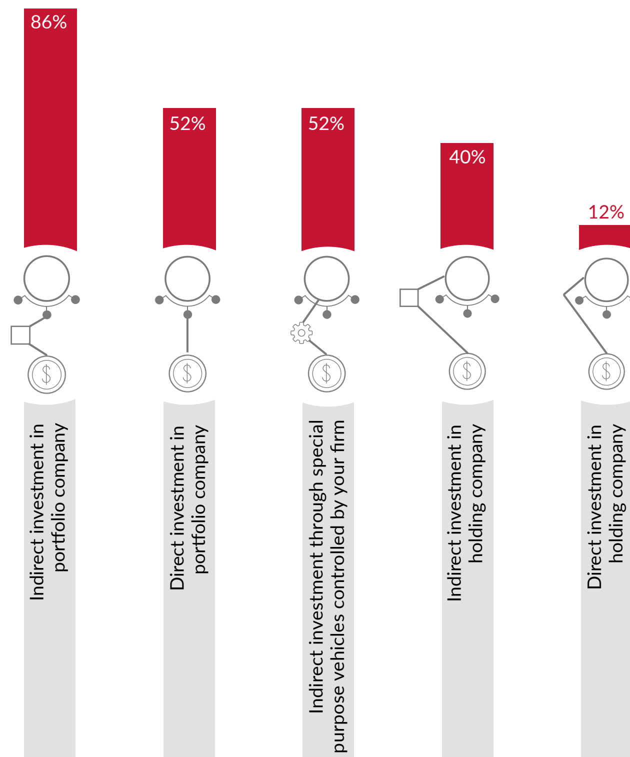
> “This request for direct involvement is interesting because direct ownership is not the only way of ensuring co-investor involvement; board seats can be contractually guaranteed up at the holding company level, so the trend that this managing partner identifies clearly goes beyond just board representation.”

The majority of PE houses offer potential co-investors, in the main, indirect investment in the portfolio company. For those houses that are sector-focused, this helps to retain control. “We have enormous experience in the healthcare sector and have been managing funds for decades now and through this span of time, we have undergone changes that have accounted to better judgment and investment perception,” says one managing director. “This is the main reason for us to take ownership of investments and allow only indirect investments to the co-investors.”

Nevertheless, although clearly not the preferred structure, more than half of respondents said they have offered co-investors the opportunity to invest directly into the portfolio company. One reason for this is to leverage not just the co-investor’s capital, but also their expertise. “The strategic excellence, experience and expertise of the co-investors enabled us to offer them direct investment in portfolio companies as we were sure about their abilities,” says one partner.

And while indirect investment is the most-offered structure, there are indications that this could be changing due to demand. “In previous investments, for most of them we offered only indirect investments in portfolio companies,” says one managing partner. “However, now the investors are asking for direct involvement and we will have to accept their interests in some of investments.”

What types of co-investment structures are you offering to co-investors? (Select all that apply)



Limited appeal

16%

of respondents see investors' strategic alignment with PE portfolio companies as the biggest driver of co-investments

12%

of respondents believe building a relationship/good-will with investors is the biggest driver of co-investments

Julia Corelli of Pepper Hamilton explains how private equity groups can reconcile priorities in order to maximize a co-investment's potential.

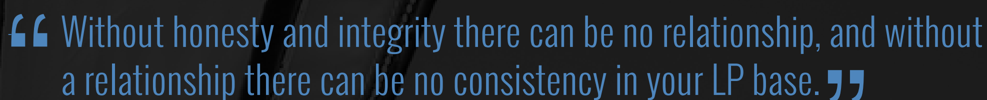
Enlisting a seasoned LP as a co-investor can prove very fruitful for private equity groups. Yet before getting the prize, sponsors need to understand the LP's perspective and balance their own and their LP's priorities in order to be co-investors and make the most of the relationship.

Away from the economics of a co-investment, the most important factor for LPs when it comes to deal terms is exit availability. They want to know how they will get out, whether it will be at the same time as the fund, and who is controlling the drag along. LPs are clearly focused on the exit, and while they will have the same terms as the fund going into the investment, they will review the governance mechanics very carefully so that the exit is protected.

Problems can arise in a situation, for example, where you might have a fund (e.g., Fund III) doing a follow on with its successor fund (e.g. Fund IV). If Fund IV brings in a co-investor, Fund IV will have a much different interest compared with Fund III. There is a three way conflict of interest here as the manager owes fiduciary duties to Fund III, Fund IV and the co-investor. The way the manager works out and discloses that potential conflict to investors in Fund IV, may not be the same as it handles the conflict of interest with the co-investor. Fund III is much closer to the end of its life than Fund IV, for instance. The fact that Fund IV is now in the deal creates different incentives about when to exit or not. Furthermore, co-investors generally are quite savvy and, while they recognize that everyone starts with the premise that all exit at the same time and on the same terms, in practice this might not be the case and they will seek appropriate protections for various contingencies that can make the basic plan stray. For example, suppose Fund III recaps its interest to gain liquidity. Does the co-investors have to participate? can it participate? can it do so if the manager leaves Fund IV as is? Can the co-investor exit before Fund III or IV?

Co-Investing presents many issues when reviewed through the private equity manager's prism. PEGs, for example, might have a key strategic interest in bringing a co-investor on board — a pharmaceutical company, for instance, that is looking to invest in a fund for drug development insights. That investor could be a real asset to a particular portfolio company. But what if the co-investor changes strategy or loses faith

> "While everyone will start with the premise that all exit at the same time and on the same terms, in practice this may not be the case."



in the ability of the portfolio company team to show it market insights? what if the co-investors do not want to support the company in a down round after the initial investment?

Above all, PEGs are looking to build relationships with LPs. They are trying to ensure that the LPs are getting the opportunities they want so they can enjoy the fruits of the relationship, including having them invest in their next fund. These two mindsets can clash, however, when it comes to thrashing out a co-investment deal's terms. In particular, access to information and pass through of voting and other rights are two issues that are frequently brought up.

On pass through voting rights, co-investors often want to exercise their own independent rights regarding the portfolio company, much like the fund would. The parties may not see eye to eye on the governance terms that embody this in the portfolio company charter, shareholders agreement and co-investment agreement, all of which must be carefully coordinated. These terms include the percentage needed to exercise minority protective rights, the ability to acquire stock subject to a right of first refusal, and tag and drag rights.

Regarding information rights, in some cases an LP may want or need specific information privileges that a portfolio company may not want to concede and which the fund has not requested, triggering a clash between the fund manager and the co-investor.

Managing these differences can be a tricky process for a PEG looking to solidify a relationship with LPs. Yet recognizing what the options are can help in smoothing things over. Information rights' disputes, for instance, can be relatively easy to reconcile once you figure out what the concern is. From there, you can keep sensitive information out of the loop altogether, or you can arrange for a third party to receive it under confidentiality and allow them to advise on what the strategic investor wants from that information.

Drilling down on the real motivation can similarly solve the governance friction. The PEG manager needs to understand which protective provisions are not perfectly aligned between the co-investor and the fund. The investor may want, for example, the ability to decide whether a merger should get approved if it would result in the co-investor's competitor having an interest or a conflict with another investment of the co-investor. On the other hand, it is highly likely that they do not really need or want the ability to approve an operating budget. Understanding these nuances is important to the relationship.

While these examples are useful for PEGs in specific cases, in the long term, gaining a reputation among LPs as being straightforward and equitable can help you attract and maintain investor relationships. Without honesty and integrity there can be no relationship, and without a relationship there can be no consistency in your LP base. The devil is always in the details.

The co-investment landscape:

Opportunities and challenges

26%
cite risk sharing as the main driver for PE firms to engage in co-investments

22%
see obtaining capital commitments as the second-largest driver

30%
claim regulatory scrutiny is the biggest challenge

As co-investments continue to prove popular, they offer an alternative way for a private equity house and investor to work together. However, after looking at what makes up these deals in terms of percentages and numbers, the question remains: Why are these deals so popular? And what are the challenges going forward?

Co-drivers

For respondents, risk sharing (26%) and obtaining capital commitments (22%) were seen as the main drivers for PE firms to engage in co-investments.

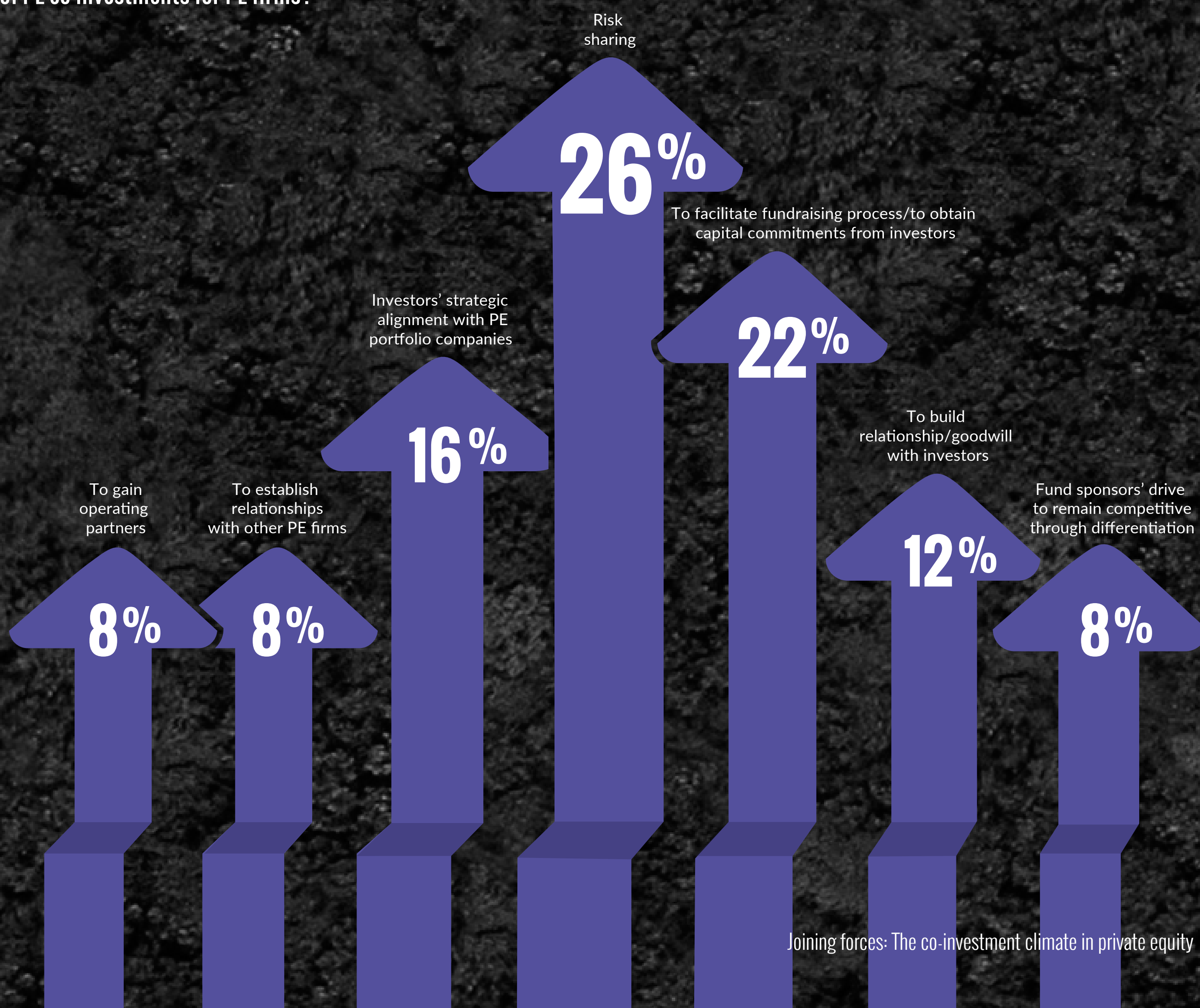
Hedging risk is particularly important in turbulent times. "The PE industry has been exposed to several risks considering regulations and business transparency, however investments have been consistent," explains one partner. "By creating co-investment terms and sharing investment criteria, PE firms will aim at sharing risks equally as returns which would help them in leveraging portfolios."

This year has been particularly tough regarding increasing regulations. In the United States, the Securities Exchange Commission (SEC) has become increasingly interested in PE fees and compensation, while on the other side of the Atlantic, the UK's Competition and Markets Authority has recently warned PE firms on breaching anti-trust rules.

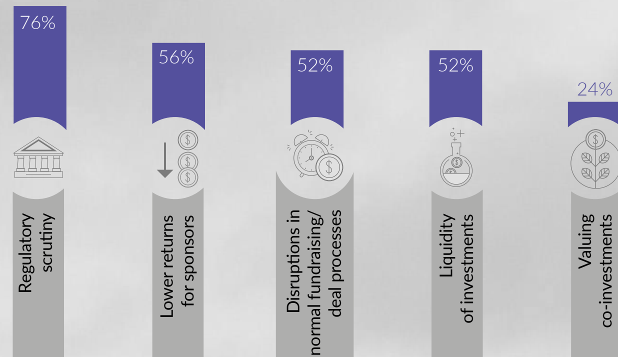
The increasing need for fresh capital is also driving co-investments. "The availability of investors to invest through the PE firms and the opportunity to facilitate fundraising is the biggest driver for PE co-investments," says one partner. "The increasing capital needs of the PE investors are forcing them to consider partnerships with co-investors."

Regulatory scrutiny is clearly the biggest challenge for PE in co-investments, according to respondents. It was selected

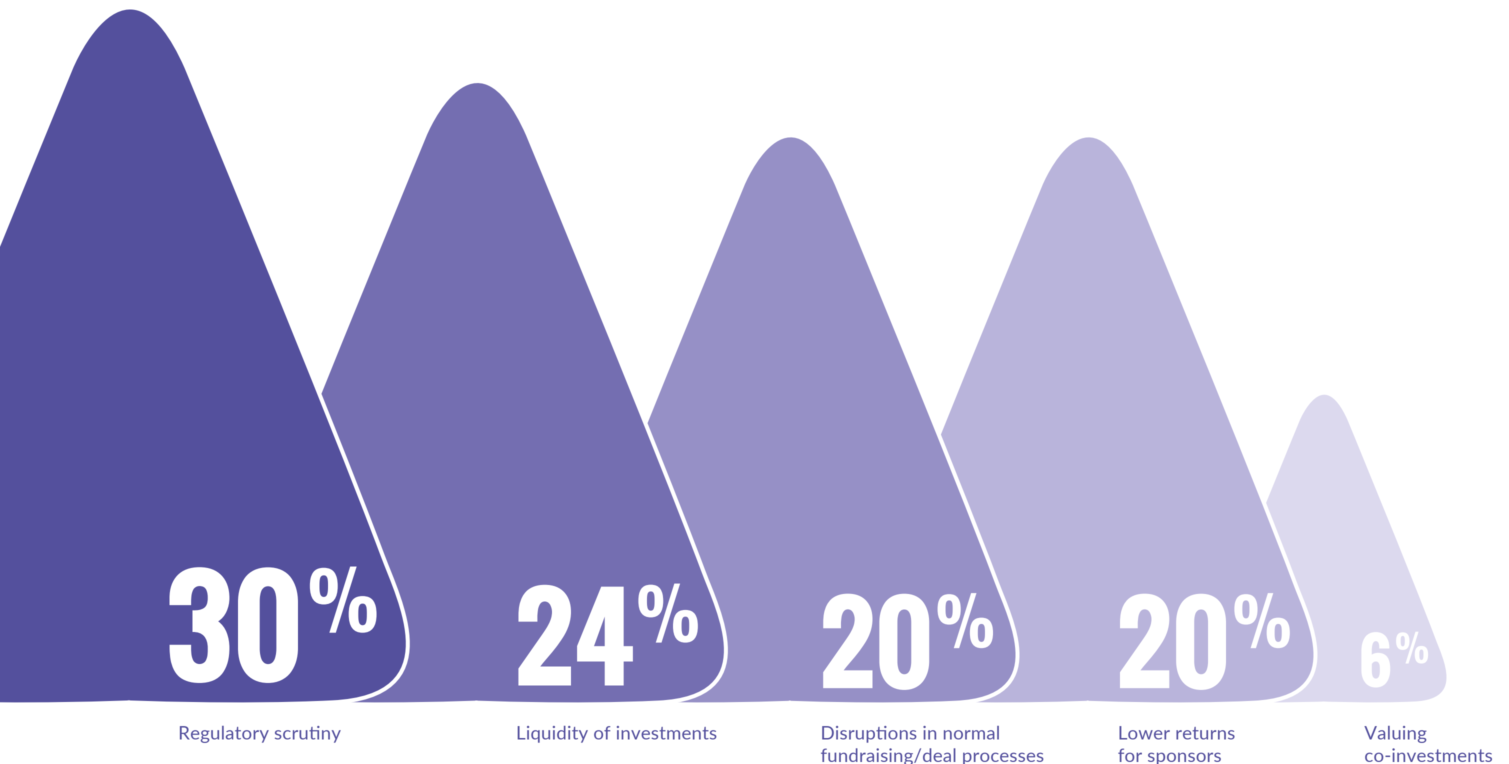
What is the biggest driver today of PE co-investments for PE firms?



What are currently the biggest challenges to PE co-investments? (Select all that apply)



What are currently the biggest challenges to PE co-investments? (Please select the most important)



Regulatory scrutiny

Liquidity of investments

Disruptions in normal fundraising/deal processes

Lower returns for sponsors

Valuing co-investments

by over 76% as an issue, and highlighted by almost a third as the most important.

Increased reporting requirements from government bodies was cited by many respondents as a key issue. “Regulators have been very hard headed with businesses competing in the PE industry, and will continue to seek more information that indicates transparency in terms of investments and the capital flow,” says one managing partner.

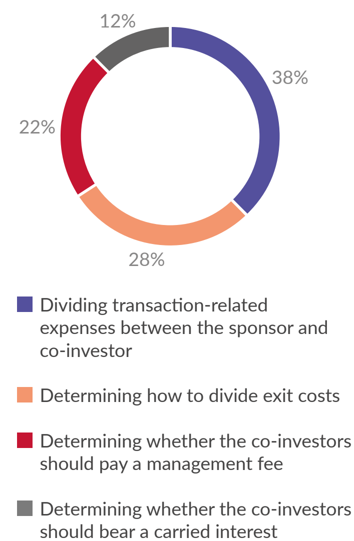
The acting director of the SEC’s Office of Compliance Inspections and Examinations, Marc Wyatt, has given particular attention to the issue of transparency. In a conference in New York in May, Mr. Wyatt said that as PE develops investment vehicles that will be open to retail investors, “full transparency [on fees and expenses] is essential.”

Elsewhere, the liquidity of investments was seen as the number one challenge by 24% of respondents. Liquidity is a key concern when it comes to reconciling both the sponsor and the co-investors who want to realize their investment. “Investing with a PE firm is a long lasting affair, as funds stay with the business until realized by the fund manager,” says one managing director. “This may not be a chance that all investors would want to take as most assign received funds to alternative investments and expect regular appreciation for their commitment.”

In terms of economic hurdles, dividing transaction-related expenses between sponsors and co-investors (38%) is seen as the most prominent issue by the biggest percentage of respondents. Determining how to divide exit costs and determining whether co-investors should pay a management fee were also mentioned by over a quarter and a fifth of respondents respectively.

Bridging the gap between sponsor and co-investor is one reason for these issues to arise. “The core reason to request capital by a PE firm is to participate in an investment by raising capital,” explains one managing partner. “However, sponsors and co-investors have different terms to adhere to, even though the risks are of the same level. This is creating conflict between the PE firm and the investors, based on the argument of having all investors pay fees, making it difficult to divide transaction related expenses.”

What is currently the most prominent economic issue with PE co-investments?



Taking the reins

Bruce Fenton of Pepper Hamilton explains why sponsors should take the lead in co-investments, and how they can do it.

Reaching out to other investors to provide co-investment opportunities can provide private equity groups (PEGs) with the extra expertise and capital they need to succeed. However, when you get into a co-investment situation, bear in mind that not all of the voting equity relating to control rights is in the PEG's hands. Rolled equity, for example, might make up 20% of the deal, leaving the PEG with a maximum of 80%. On top of this, if you start seeking alternative sources of equity capital, groups such as mezzanine investors, will want a piece of the equity as well. With so many constituents at play, it is vital in the majority of cases that PEGs retain control.

Not having control can be fatal. For one, having so many different parties involved usually means several different interests. PEGs themselves have three- to five-year investment windows, for example. Lenders, on the other hand, would look to protect their debt before preserving the value of the equity. The founder will have much longer time horizon than the PEG and co-investor. Consequently, when critical decisions have to be made, these interests emerge. Without effective control of the company, coalitions can be formed and votes can be taken in a manner where the outcome is uncertain.

PEGs also need control because, frankly, it's their reputations on the line. They are the ones with the co-investor and debt relationships, and they are the ones who convinced the founders to pick them to "partner" with. While a blockbuster co-investor can sometimes lead a co-investment, in most cases, it would be odd if the PEG turned control over to a third-party co-investor. The founders expect the PEG to lead.

There are many things PEGs can do to help them retain effective control, including the following:

Structural integrity. Using holding companies allows a PEG to structure investments so that it controls the company even though it has just a minority piece of the equity. For example, if you imagine a scenario where the sponsor owns 40% of the company and all other investors have smaller chunks, no one owns a majority. However, if you combine the PEG's piece with the co-investors, where the PEG owns for example 40% and the co-investors less than that (in the aggregrate), the PEG would then control that entity as its stake is larger. That company could then invest in a lower-tier company, where the other investors hold their equity, thereby allowing the PEG to control that lower tier entity as well. Just by structuring things properly, a sponsor can control the entire structure even with just a minority investment.

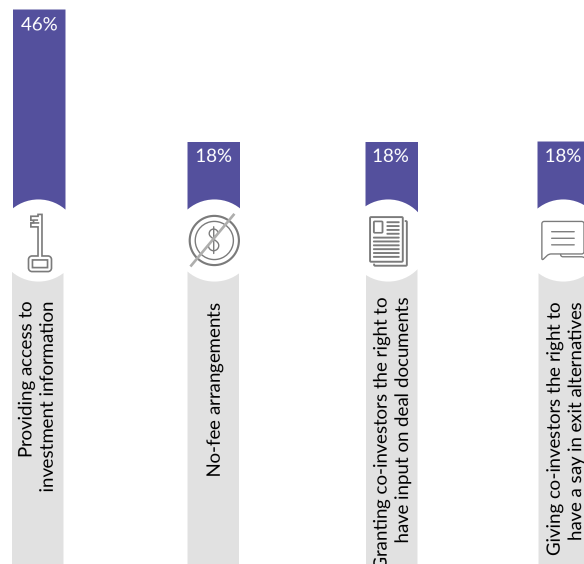
Point of contract. There are contractual protections that sponsors can use to limit control risk. Drag-along rights, give PEGs the chance to create an exit opportunity. This is useful for all PEGs, particularly for PEGs with a minority investment, as these rights enable the PEG to control the timing of the exit. Yet the fact that only 46% of respondents had this protection suggests PEGs could do more to safeguard control of their investment.

Board representation. Having one board seat for all co-investors is another protection. You don't want to have a huge board with five co-investor seats. By having one, you're saying to the co-investors that they are all in the same position, and can determine how they want to use that seat accordingly.

How fees should be split has become a critical issue, and again is something that has placed many PE firms in hot water with the authorities. KKR, for instance, agreed on a US$30m settlement with the SEC in June, after the regulatory body alleged that “it unfairly required the funds (i.e. co-investors) to shoulder the cost for nearly all of the expenses incurred to explore potential investment opportunities that were pursued but ultimately not completed,” according to a statement by the SEC’s enforcement division director Andrew J. Ceresney.

Keeping interests aligned can be key to maintaining a stable and value-maximizing co-investment. To facilitate this alignment, nearly half (46%) of respondents said that providing access to investment information was the most common type of arrangement PE firms have with co-investors. No-fee arrangements, granting co-investors the right to have input on deal documents and giving co-investors the right to have a say in exit alternatives were seen as the most common type of arrangement by 18% each.

What is the most common type of arrangement PE firms have with their co-investors to keep their interests aligned?



PEPPER HAMILTON VIEW

> "We believe that the parties should be able to agree on those allocation issues either in the definitive agreements between them, or as a result of adequate disclosure prior to the co-investment transaction, although the government at times seems willing to substitute its judgment as to 'fairness,' even when the co-investor has received clear notice (disclosure) regarding a different allocation approach."

Providing access to this information helps to enhance deal value as well as maintain a working relationship. "PE firms will offer co-investors necessary investment information to gain their trust and to restrict withdrawal at earlier stages so that there are no barriers in deriving deal synergies that offer positivity," says one managing partner.

Giving co-investors the ability to have input on deal documents can also help align interests – and also spread responsibility. "When the co-investor is given the opportunity to review deal documents and freedom to provide their insights, both parties can reach certainty in agreement of investment terms," says one managing partner. In a situation like this, if there are any changes that the investment goes through in the future, the PE firm will not totally be accountable as co-investors' inputs will have an equal influence on the outcome.

No-fee arrangements, though chosen by only 18% of respondents, are seen by some as a way to entice investor capital – something particularly acute in a tough fundraising environment. "PE firms have been finding it difficult to borrow capital from banks and other financial organizations," says one partner. "They have been seeking funds from investors to fulfill their investment appetite and in return are exempting fees as an encouragement to invest."

Giving co-investors a say in exit alternatives can also help to align interests – both in terms of relationship building and giving investors flexibility. "Giving co-investors a right to have a say in exit alternatives helps the PE firms to build up a good relationship with their co-investors," says one partner. "They can decide when to exit and get a profitable value rather than following the PE firm's decision."

The right side of the law

Pepper Hamilton's Julia Corelli examines mitigating risks

Regulatory concerns about co-investments have increased over recent years, driven by recognition that a co-investment vehicle is its own entity subject to compliance and oversight, just like the fund. For instance, regulators look at the co-investment vehicle as a separate client for custody rule purposes, so it will require separate books and records, must be audited (for RIAs) and is subject to examination. GPs also need to consider the regulatory implications of co-investments in at least three areas: the allocation of investment opportunities, stapled transactions and transaction fees and expenses.

Regulators will intensely examine suitability issues for the fund and allocation of the investment opportunity to the co-investment vehicle. If there is a carry in it, the perception may be of misaligned interests between the fund manager's duties to the fund and their duties to the co-investor. Or, if the fund manager is close to raising a new fund, having no management fee or carry in the co-investment can be viewed as throwing favors to the investor to get them to invest in the new fund. PEG managers need to navigate this dilemma with the regulator's perspective in mind.

Issues surrounding stapled transactions are also important, particularly regarding disclosures to LPs. A lot of times, investors in a fund purchase secondary interests in order to gain rights in a new fund, including co-investment rights. This can create problems. If an anchor or marquee investor negotiated for enhanced rights and the PEG manager wants to use that in the fund's marketing materials, the manager has to disclose what rights the investor obtained. Otherwise, regulators will claim the rights were an inducement to the anchor/marquee investor's investment, and not disclosing that misleads others.

Additionally, transaction fees and expenses have been under the spotlight for some time, and get complicated with co-investment vehicles. Unlike a regular fund where transaction fees generally offset management fees and accrue to the benefit of the LPs, a co-investment can be with LPs who have negotiated different terms as to the offset itself, or as to the management fee being offset. These need to be examined for conflicts of interest every time a fee or expense needs to be allocated between the fund and the co-investment vehicle.

In general, there are two key practices that GPs should consider when trying to navigate these issues:

Disclose, disclose, disclose. When fundraising, it's vital that you talk to your partners and get their experiences with the fund and its LPs out in the open. Use that to hone what you need to deal with in the fund documents (PPM and LPA in particular) and disclose all you can about your practices in the PPM. Be mindful, however, that too much could be viewed as burying the material elements and defeating the disclosure's purpose. Disclosure after the fact is – except in rare circumstances – not sufficient. Appropriately balanced disclosures ensure LPs make an appropriately informed investment decision.

Document, update and refine. GPs need to develop policies and procedures which reflect how they plan to act as stewards of investor funds. No written policy or procedure is perfect, so it is crucial that you document any variances with robust explanations, that you then review the policies and procedures every year, and that you update them to prevent or absorb the variances you experienced.

Conclusion: Joining forces

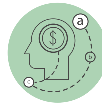
The rise of co-investments has changed the nature of private equity's relationship with its limited partners, as well as the buyout market in general.

These deals are benefiting private equity in several ways. The dispersal of risk – the biggest driver for the highest percentage of respondents — and the ability to extract more capital from investors is key, for example. On top of this, being able to collaborate with co-investors and tap their market knowledge is also a big plus.

However, private equity firms face challenges to make the most of these opportunities. Regulators, for one, have shown increasing interest in private equity and in particular co-investments, which is costing the industry both in terms of money and reputation. Difficulty in agreeing to transaction fees with co-investors is also causing additional tension. On top of this, the differences in investment length wanted by potential investors could cause issues down the line. With a competitive fundraising environment and a clear willingness among limited partners to do direct deals, PE firms must ensure they balance these factors to avoid being left with slim pickings.

To help with this, here are three key takeaways that can help PE houses get the most from their co-investments:

Be proactive. With capital sources harder to come by, PE firms are increasingly looking to investors interested in co-investments as a way to raise more funds. Given that more than half of companies surveyed in this report are actively exploring opportunities to co-invest, PE firms that do not take the lead and get out in the market to potential collaborators could miss out on crucial capital and great deals.



Be flexible. Investors are not one size fits all, and the deal terms that will suit one LP will not necessarily be accepted by another. PE firms should bear this in mind when looking for co-investors, and leave room to maneuver when it comes to negotiating the terms.

Be transparent. The increasing scrutiny PE faces over co-investments comes down in many respects to transparency. Being more open with fees and terms will increase trust between investors and with regulators both in the short term and long term.

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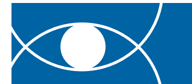

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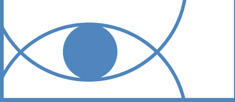

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