

Balancing Opportunities With Potential Conflicts

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Sponsors that choose to offer co-investment opportunities must be mindful of investor and co-investor dynamics, write partners Stephanie Pindyck Costantino, Julia Corelli and Patrick Bianchi

Co-investments can be a divisive topic, placing investors, sponsors and co-investors on three ends of a complicated and conflict-ridden triangle. For example, who should pay for broken deals or diligence expenses? How should co-investment opportunities be allocated among limited partners, third parties or sponsor personnel?

Co-investments offer sponsors and investors the opportunity to engage in larger transactions they might not be able to pursue independently. According to the Private Funds CFO Fees & Expenses 2024 survey (the “Survey”), offering co-investment is very common, as 82 percent of sponsors afford the opportunity to co-invest in a transaction with one or more of the sponsor’s parties. A co-investment strategy broadens potential investment targets by enabling the sponsor to participate in deals that would otherwise be inaccessible due to required equity size or diversification limits in the sponsor’s governing documents. A well-subscribed co-investment that performs positively may also greatly enhance the sponsor’s market reputation.

A co-investment allows an investor or third party to participate in a transaction that might otherwise be inaccessible due to its size or lack of dealflow. It may also provide an opportunity to deploy capital in several deals in a sector of particular interest.

Offering opportunities

Co-investment opportunities may be offered in several ways. Sponsors commonly include pro rata participation rights in fund-governing documents or side letters with certain investors. Significant investors often negotiate for larger participation rights. Subject to commitments to existing investors, co-investment opportunities may also be offered to third parties. Savvy co-investors will also negotiate for additional pro rata participation rights within the transaction documents for a co-investment. That is, if another co-investor declines to participate in a follow-on investment, the savvy co-investor may have an additional participation right.

A sponsor must consider the investor’s willingness and ability to support the opportunity, potential strategic

benefits and available capital when determining whether to offer co-investment rights. Some sponsors will simply offer pro rata rights to investors in a primary vehicle and afford certain investors first right at any overage.

Other sponsors may not guarantee any co-investment right to investors, opting instead to acknowledge only that the sponsor appreciates the investor's desire to co-invest. Sponsors must clearly disclose co-investment policies and procedures to fund investors, particularly regarding allocation policies between the primary investing vehicle and a co-investment vehicle.

Structure

Appropriately structured co-investment opportunities can be beneficial to all participants. According to the Survey, approximately 57 percent of the 82 percent of sponsors that offer co-investments create a separate entity for a co-investment opportunity. Alternatively, co-investors may invest directly into the portfolio company. These two common approaches differ significantly with respect to sponsor control and influence.

For many reasons, including impact on the track record and execution of exit strategies, sponsors want to retain control over co-invested dollars when it comes to management of the investment. Sponsors therefore prefer to aggregate co-invest capital into a separate entity with the sponsor controlling exercise of the co-invest entity's shareholder rights rather than having multiple investors at the investment level, each able to vote on shareholder matters.

Economics of co-investment vehicles

Separate co-investment vehicles often afford sponsors the ability to charge a management fee and a carried interest on a deal-by-deal basis. However, the co-investment vehicle may have preferred economics for the sponsor's existing investors, enhancing investor relations.

Most Survey respondents that offer co-investments reported that the economics charged by a separate co-investment vehicle are less than those charged by the fund. In many cases, carried interest is charged to the co-investment vehicle, but no fee is charged. It is important to appreciate that where a fee is not charged, the co-investment vehicle may not contain offset provisions. Therefore, the sponsor parties are entitled to receive transaction fees received in connection with the co-investment that may otherwise be subject to a fee offset in the primary fund vehicle. Apportioning a transaction fee between the fund and any co-investment vehicle often results in a portion of the transaction fees not offsetting the management fee, even if the fund has a 100 percent fee offset.

Broken deals

No one likes a broken deal. Co-investments allow investors to efficiently participate in a deal by leveraging the sponsor's due diligence. Sponsors must address cost allocation in governing documents, covering transaction, operating, compliance and regulatory costs, including expenses for unconsummated deals. According to the Survey, 53 percent of the 82 percent of sponsors that offer co-investments allocate broken deal costs to both the co-investment entity and the sponsor's fund entity. Sponsors who fail to address these costs risk bearing up to the entire expense of a broken deal.

Conflicts

The taking, or not taking, of fees from a co-investment vehicle is just one of many conflicts that may arise when a sponsor offers a co-investment opportunity. Co-investments increase the capital under management for the sponsor, which in turn could potentially decrease the time and attention to pre-existing vehicles. Many sponsors account for this by developing a dedicated co-investment team. Others account for the increase in necessary time and attention in their general hiring needs. Sponsors that have a dedicated co-investment team charged with raising capital and the oversight of the sponsor's co-investment portfolio rebut the argument from existing investors that co-investments divert attention from managing the primary portfolio due to the need to raise co-investment dollars, structure co-investments and attend to co-investors. But it does not change the fact that co-investments have one investment (usually), and fund entities have a diversified portfolio, which can be another source of conflict for the sponsor. This is particularly acute where the co-investment is a follow-on into an existing portfolio company of the fund.

Providing assurances

Some steps can go a long way to assist the sponsor in navigating what can be a difficult path. For instance, it is critical to appreciate the potential implications co-investments pose to the sponsor's policies and procedures, including allocation of investment opportunities, fee and expense allocations, valuations and conflicts of interest, including use of the fund's advisory board (if formed); utilizing clear and transparent disclosures around co-investment procedures and expenses (including with respect to broken deals and management fee offsets); and understanding the dynamics motivating all constituents (including advisory board members).

Proactively establishing, and making known to investors, robust policies and procedures for all these areas can provide significant assurances to both fund-level and co-investment investors that the sponsor will succeed in achieving its multiple goals of advancing its business, enhancing investor returns and treating investors fairly, equitably and with transparency.

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