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Co-Investment Heats Up, But Some Are Less Than Thrilled

Law360, New York (March 19, 2014, 1:29 PM ET) -- It seems that co-investment by limited partners is more popular than ever. According to a recent study by Preqin, 43 percent of limited partners tracked by Preqin are actively seeking co-investment opportunities, and 11 percent more are seriously considering such opportunities. The limited partner interest is also fairly widespread geographically (44 percent in North America, 31 percent in Europe, and 25 percent in Asia and elsewhere).

There are good reasons for this appetite for co-investment. First and foremost are the perceived reduced costs in co-investment transactions since the management fees and carry are generally waived or lower than in traditional private equity fund investing. Over a third (35 percent) of the respondents in the Preqin study identified lower fees as a principle motivation. In addition, in the Preqin study, limited partners cited better control of the investment, better transparency and an opportunity to gain direct exposure to new industries.

From the general partners' point of view, co-investing can help fill out investments, particularly where the investments may be too large for their funds. With fundraising more challenging for many funds in recent years, co-investment is a means of increasing available capital and expanding the range of prospective deal opportunities. In addition, according to the Preqin study, co-investment rights can sometimes be a hook to secure early commitments in a difficult fundraising market.

Not everyone is enthused over the growing trend toward limited partner co-investment. Some commentators have pointed out that the basic private equity model contemplates that the limited partner investors will focus on vetting the prospective general partners, and the general partners will spend their time finding good deals. And this model has worked well according to a recent report, with median public pension funds private equity returns exceeding total returns by about 3 percent (8.8 percent to 5.7 percent) over the past decade.

Moreover, most limited partners do not have the staff to review co-investment opportunities quickly or in much depth. And there is some concern that some general partners might be tempted to send out the riskier deals for co-investment.

Nevertheless, two thirds of the limited partners in the Preqin study reported that their co-investment returns exceeded the returns from their private equity fund portfolios and look upon co-investment opportunities favorably.

Variations

A common approach to co-investment is direct investment by the limited partners in the portfolio

company, in deals sourced by the general partners of the funds in which the limited partners are invested. Direct investment has a number of benefits for limited partners, including a reduction or complete elimination of fees and other charges, more control of the investment, and a direct relationship with the portfolio company.

However, there are also significant limitations. The investor may need an experienced staff that can perform the necessary due diligence, react relatively quickly, oversee the required documentation and monitor the investment on a more rigorous basis than as a passive investor.[1]

The cost of experienced private equity professionals may offset much of the savings in management fees. And the possible loss or significant write-down of the direct investment is not cushioned by other results as in a fund. A recent study by Harvard Business School professors that reviewed 391 deals by seven institutions, both co-investments and direct investments, covering more than 20 years found little evidence of outperformance of direct or co-investment deals in the sample.[2]

Another variation on the co-investment approach is the emergence of separate limited partner accounts that are maintained and managed by the general partner, often for a reduced fee. The general partner retains wide latitude in the choice of investments, and the limited partner may be offered an opportunity to pick the deals in which it wishes to participate.

Often, the capital returned to the limited partner will be reinvested with the general partner at the limited partner's discretion for more than the typical five- to seven-year time frame in the nature of a separate account, affording the general partner a more permanent form of capital commitment.

From the limited partner's perspective, in addition to reduced fees, the limited partner can make a more significant commitment to an investment strategy while avoiding managing many smaller fund investments. On the other hand, this structure likely involves a relatively large financial commitment, which creates risks inherent in concentrated investments.

Other Considerations

There are a variety of considerations relevant to a direct investment or co-investment program from both the general partner and limited partner perspective.

Structure. In a direct investment, the limited partner investor will of course hold a direct ownership interest in the portfolio company or its holding company (for tax reasons the limited partner investor may wish to organize a corporate “blocker” that would be interposed between the portfolio company or holding company and the investor).

The issue here is the degree to which the limited partner investor will directly enjoy the rights of an independent minority stockholder, including inspection rights, tag-along provisions, preemptive rights, registration rights and, perhaps, board representation or board observer rights.

Not surprisingly, the sponsor may be less than thrilled that the investor may act independently of the sponsor in executing its strategic plan, including the timing of any disposition. The general partner must consider whether it is practical in any specific deal to restrict the limited partner direct investor in the exercise of customary investor rights, including perhaps the negotiation of percentage thresholds on the exercise of various stockholder provisions.

Operating partners present another variation. Because they bring particular expertise to the investment and the ongoing operations (and have been selected by the sponsor for this reason) it may make more sense to permit them to invest directly in the operating company (rather than the holding company) and benefit directly from various stockholder rights.

Co-investment structured entities are generally more favorable to the general partner. As in a direct investment, the co-investor may invest in the holding company for the portfolio company. However, if there are likely to be multiple co-investors, it often makes more sense to set up a separate co-investment vehicle that is structured as a pass-through entity for tax purposes (such as a limited liability company or limited partnership with an affiliate of the sponsor acting as the managing member or general partner).

Corporate blockers can also be interposed if desirable for tax purposes. The separate co-investment vehicle could be set up for a specific portfolio investment or multiple portfolio investments. However, if not all limited partners with co-investment rights participate in every fund investment, the sponsor will probably be better off with a series of co-investment vehicles (i.e., one for each deal) despite the complexity. All the vehicles would be managed by affiliates of the sponsor.

The limited partner co-investor is usually looking to the general partner to manage the portfolio investments and is more open to allowing the sponsor to exercise a degree of control over governance issues and the timing and terms of dispositions.

In many cases, the limited partner co-investor is not staffed up to monitor its numerous indirect investments in many portfolio companies, and as a practical matter, is dependent on the general partner's expertise in any case. According to the Preqin report, of the limited partners they spoke to, 23 percent require board representation and 18 percent require board observation rights or a seat on the limited partner advisory board.

Conflicts. Once an investment opportunity is teed up, the general partner and limited partners with co-investment rights must be prepared to act quickly to complete appropriate due diligence and review and comment on the deal documents. Ideally, the limited partner co-investor has the depth of staff (with appropriate expertise) to respond in a timely manner, but the reality in many deals is that the investor's staff is already overburdened, and the limited partner relies heavily on the sponsor.

While such reliance speeds up the approval process, it does raise the question of the sponsor's obligations to the co-investor. At a minimum, the co-investor should be provided with all of the sponsor's due diligence materials and ample time to review and ask questions about the deal. Depending on the relationship of the parties, some sponsors have asked for "nonreliance" letters from limited partner co-investors to underscore that the co-investor is responsible for its own investment decisions.

In some co-investments, the co-investors (particularly larger entities with adequate staffs) will ask that various minority rights be passed through the co-investment vehicle, particularly provisions that directly bear on their investments, such as preemptive rights (to avoid dilution), information covenants, tag-along rights and various consent rights. A common provision stipulates that the sponsor will treat the co-investment the same as its own investment in the portfolio company in the fund, such as simultaneous proportional exits on the same terms and conditions.

What happens if the limited partner co-investor likes the deal but cannot get there in time? Typically,

the investor will purchase a portion of the sponsoring fund's investment at cost and the investor documentation should be drafted to permit this contingency.

Care needs to be taken, however, to close the later purchase quickly after the fund's investment and before the value of the portfolio investment has materially changed to avoid taxable gain issues for the investor and valuation issues for the sponsor. To avoid these issues, many fund documents contemplate that co-investors invest and exit at the same time and on the same terms as the sponsor's fund.

Conflicts can also arise in the allocation of co-investment rights and opportunities. Not all investors in funds are accorded co-investment rights, with such benefits frequently offered to investors in the fund above certain commitment thresholds. Sometimes the sponsor simply acknowledges the limited partner's expression of interest in co-investment opportunities.

The allocation of co-investment opportunities to co-investment participants can present another challenge — whether the general partner offers any co-investment opportunity to limited partner co-investors with co-investment rights and if so, how much. As noted, some commentators have dubbed this the "lemon" problem, suggesting that the sure-fire deals may stay in-house. However, it's much more likely that the size of the deal and the sponsor's funding capability drives the co-investment decision.

In any event, the general partner has a lot more to lose in laying off "lemons" or even in funding them in the first place. Ideally, the grant of co-investment rights and the allocation of opportunities to those limited partners who have them follows a clearly articulated formula (i.e., size of investment in the first place and proportional participation in the second), all of which is set out in the documentation.

Confidentially agreements with potential portfolio companies can also sometimes raise troubling issues. While a selling company may feel comfortable giving its confidential information to several funds under well-crafted confidentiality agreements, they may feel differently about circulating that information to a significant number of potential co-investors or direct investors who may or may not invest.

One approach is to wait until the fund and prospective portfolio company have signed a term sheet before going to the larger investment group under appropriate confidentiality agreements so that the portfolio company has greater assurances of a deal.

Costs and Fees

In a direct investment, the limited partner investor typically bears its own due diligence, legal and other costs, including the costs of forming and maintaining (i.e., filing fees, tax returns, etc.) an investment vehicle, if any. In a co-investment structured vehicle, the sponsor's fund sometimes pays the costs of forming and maintaining the co-investment vehicle even though the limited partner's investment would not necessarily participate in all of the fund's investments nor include all of the fund's limited partners.

As noted, direct and indirect co-investment arrangements are often structured without management fees or carry, or with greatly reduced fees, which is one of the significant attractions of these alternatives. General partners accept these arrangements because the co-investment opportunity was an attractive inducement for the limited partner's investment in the fund in the first place, and the co-investment arrangement is a good way for the sponsor to further solidify its relationship with the limited partner.

Nevertheless, some co-investors prefer that the sponsor benefit from some reduced carry on the co-investment to properly incentivize the general partner whose interests might be somewhat diluted in the context of a fund with many other investments. This carry could, in theory, be more valuable than at first expected since it is not impacted by possibly adverse results in the rest of the general partner's portfolio.

Where limited partners participate as a direct investor or co-investor, an understanding should be reached on the sharing of deal and transaction expenses, both going in and coming out. As a general rule, expenses incurred on behalf of the "deal" are shared in proportion to the relative investments, including legal fees to close and exit the deal, but not the separate legal bills of each of the participants.

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[1] Many investors in these situations informally rely on the general partner to guide them on these matters.

[2] Lily Fang, Victoria Ivashina and Josh Lerner "The Disintermediation of Financial Markets: Direct investing in private equity," INSEAD and Harvard Business School, October 2012
