Allocating Co-Investment Rights

FOCUS ON FUNDING // Demand for co-investment is high, but tread carefully

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For most private equity managers, co-investments are an essential part of attracting limited partner investors and funding investments. In a 2018 *Private Funds Management* survey, co-investments were front and center, with the vast majority of PE respondents saying they actively seek opportunities to offer co-investments.

But determining the amount to offer to co-investors is a sensitive topic not often discussed openly. On one hand, investors are looking for more opportunities to co-invest; on the other, managers want to earn fees that are often associated with fund investments, but not with co-investments.

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The types of fees and expenses leveled on co-investors varies across funds. According to the *pfm* survey, only 28 percent of co-investors pay the same management fees as the PE fund investors, while 22 percent pay a lower fee. Meanwhile, 31 percent of co-investors pay the same amount of carried interest as PE fund investors, while 30 percent pay less.

These scenarios pose potential conflicts of interest. Fees and expenses paid to the manager are an obvious incentive to reduce the PE fund's investment in the opportunity. Though less obvious, earning no fees and expenses is also an incentive to reduce the fund's investment.

When negotiating governing agreements, most fund managers will try to leave as much discretion in the manager's hands as possible. But LP investors often want to know exactly what their co-investment rights will be. Retaining discretion carries regulatory risk in allocating co-investment rights, but granting certainty carries investor relations risk, along with the risk of partnering with the wrong co-investors. And an issue often ignored is the duty a fund manager owes first to LP investors in the fund.

Fund limited partner agreements are getting more specific about managing these conflicts, and they often expressly require that managers not put their interests above those of investors. But what documentation can prove compliance? If managers are going to offer co-investments, the only clear solution is to offer all co-investments to all fund investors in proportion to their stake. If not all limited partners want to participate, funds should have clear procedures for allocating the remaining opportunity. That may include leaving room for strategic investors—and lenders—to co-invest.

There's also the question of what share of an investment to make available for co-investment, which ultimately comes down to what's suitable for the fund. Determining "suitability" is an art. It requires flexibility in the fund's governing documents and balancing investors' desire for attractive co-investment opportunities with the distractions and costs of putting together co-investments and the regulatory scrutiny that will test everything after the fact.

Finding that balance can be challenging, yet the market has shown that co-investments have become an integral part of PE investing, and they're likely here to stay. //

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