Co-investments – Friend or Foe?

Even more than the illiquidity (long lock-up periods), relative lack of transparency (initial black box in most cases), and complexity (difficult to easily assess options), private assets fund "fees" draw the most criticism. Management fees typically average between 1.5% and 3% of committed or invested capital annually. Additionally, incentive fees (or "carry") can range anywhere between 10% and 30% of excess returns. Private investing is not the place to find bargains when it comes to the price of admission. This explains why GPs and LPs alike try to find innovative ways to reduce the fee sting. Fee-sting-easing methods by GPs have historically included early admission fee breaks, fee reductions related to the size of the investment (the larger the investment the less the fee), termination of fees after a pre-defined term, and the provision of some benefits to help neutralize overall fee burden. The most heralded complimentary benefits granted to LPs is the offering of co-investments on a "no-fee and no-carry" basis.

In private assets parlance, a co-investment is generally defined as an investor (LP) investing alongside a fund manager (GP/sponsor) directly into a deal. Such investments give the LP the same level of transparency into deal dynamics/specifics as the GP. Also, since these co-investment deals are executed with no, or relatively lower fees than deals in the commingled fund vehicle, the return, if the deal is successful, will be higher than what trickles to the fund – some studies have shown that bundles co-investments outperform actual funds – researchers also assert that sizing co-investments thoughtfully in a well-diversified private assets portfolio can potentially increase overall returns by 150+ bps. These real and perceived advantages have made co-investing a major part of private assets portfolio building but despite all the sanguine sentiment, it is always good to take a little pause to check if the view is clear or slightly rose-colored.

Although faint murmurs of co-investments had been around for some time, it was after the GFC that their prominence started to noticeably show. GPs started to mention this investment angle more loudly because there was a need to stimulate increased investment dollars after many LPs had become gun-shy due to large write-downs and "denominator effect" ramifications. Although skeptical, most LPs were understandably still all ears. Questions like "How does this all work?", "Is this too good to be true?", and "How does due diligence differ in co-investments versus fund investing?" became popular discussion catalysts. The easy counterargument utilized by many (including myself) to defer taking co-investments seriously was the tried and true "adverse selection" rebuttal. The crux of the "adverse selection" rationalization was that based on a manager's investment strategy, only the biggest deals, the least optimal deals, and the deals the GP wanted the least exposure for itself would be put up for co-investments – so why would anyone want to double down on these? This excuse bought time while also subliminally underscoring intellectual rigor and practical acuity. However, others quickly jumped on the bandwagon.

Funds of funds used their embrace of co-investments as a way to soften the blow of their most stubborn critique – the double layer of fees. Primary GPs, through models and charts, depicted performance uplifts that LPs could gain from participating in co-investments, while also making the case for the advantages of keeping surplus (portions above optimal fund allocation) deal equity in-house rather than sharing with peers/competitors. Some LPs changed their whole private investing model to a more co-investment-heavy one, touting the fee advantage, the shorter j-curves (truncated time to exit), the transparency (reduction of black box effect), the potential for high returns, and the certainty of deployment as parts of their justification. Other LPs took an opportunistic approach, where they stayed open-minded and only executed co-investments if their internal due diligence signaled a green light. There was no doubt that co-investments were here to stay regardless of the wink-and-nod dynamics that surrounded many of the deals.

In the late 2000s, my good friends at 747 Capital (a small-cap buyout fund of funds) provided me with a very important nugget that has since formed the foundation for my thinking around and approach to co-investments. 747 Capital came to this conclusion not only because they are smart and thoughtful people, but also because they had to think of a logical and unbiased way to allocate limited co-investment dollars to underlying funds they had already committed to. Each fund sporadically throws off co-investment opportunities, so how do you choose? Their approach mentioned to me at the time was "In theory if a co-investment opportunity becomes available to an LP who has the capital to rationally allocate, and if that investment falls squarely in the sweet spot (size, sector, expertise, etc.) of the GP, then the answer should always be YES". This reasoning resonated with me because it takes the play acting out of the equation. What play acting you might ask? Well, here I mean LPs pretending that they can continuously pick which specific deals are worth their co-investment dollars by assessing deal dynamics, judging market conditions, and mastering/dissecting presented scenario models. This is an utterly different skill set compared to evaluating a GP's strengths and weaknesses around managing a basket of investments (a fund). The 747 Capital way of thinking removes the pseudo-analytical rigor and intellectual posturing and replaces them with a logical course of action. If the manager offering the co-investment is not straying away from its strategy in any way and needs extra dollars to consummate an increased majority in a deal, why would you say no to riding along with preferential fee terms? I still like this thinking a lot. However, the ecosystem of co-investments has changed so much throughout the years that all old tenets have to be re-examined.

The explosion of co-investments in the present day makes it something you cannot ignore. Almost every fund in every private assets sector offers some form of co-investments. Now, co-investment exposure and/or approaches take many shapes – through follow-on financing rounds via SPVs to help venture funds defend their pro-rata ownership, appear in "continuation vehicle" form where a deal or select few deals gain additional capital to lengthen the ownership period of prized assets, co-investment standalone funds – these are essentially funds solely made up of various co-investments from various sources, primary funds that raise companion funds that co-invest in surplus equity and/or follow-on rounds of deals in the flagship fund, fundless/independent sponsors (private investors who don't manage a commingled fund strategy but invest on a deal by deal basis) essentially execute ongoing co-investments, etc. – the list goes on and on. The evolution of co-investments which has led to numerous iterations makes it necessary for all LPs to hone their portfolio construction philosophies based on available options.

Although tempting from a cynical perspective, co-investments are too ingrained in the current private assets infrastructure to be indiscriminately criticized. Due to this, I believe the best ways to ponder co-investments are philosophically and logically. Here are some points:

- **Skills needed – are you active, pretending to be active, or just passive?**: Active investing seems to always draw more reverence than passive investing. Co-investments come with the seductive sentiment that the entity riding along is somehow now an active investor. But when you peel back the layers, other than saying "yes" to participate in the deal, and maybe having some say in some of the initial terms, how else are you active? Most of the value creation is executed by the sponsor, so let's please just call it what it is – maybe a term like "enhanced passive investing" is a more apt definition. Many LPs have separate teams to assess co-investments – these teams are usually described as composed of individuals with direct deal experience. This description gives investors the confidence that the team is looking at the right things and asking the right questions on a granular basis. But when you think about it a little more, why do these folks choose to wait for deals being done by others to apply their skills? Their questions are likely deeper than a generic LP's, but the information they receive, and the time allotted for a "yay or nay" answer is not much different from that given to all other co-investment prospects. I know there are exceptions to almost everything, and there are some

groups that can probably prove high selectivity correlated to high success rates, but we should not lose sight of the fact that the real value creators will always remain the sponsors and their teams.

- **Fund size increases**: GPs use the amount of co-investments that was available in a previous fund to make the case for a larger subsequent fund, only for LPs to eventually realize that the new larger fund will also have very healthy amounts of co-investments. So where does this end? Will deals just keep getting larger and larger as LPs seek ways to neutralize the sting of fees? How does an investment researcher assess the optimal deal size that GPs should be executing? Do large-cap buyout funds have free rein in the co-investment arena? These are all questions that need to be asked, and as you seek answers, the pesky "adverse selection" thought will keep break-dancing in your mind.

- **Current environment**: The current environment has made co-investments almost a necessity for GPs. This negates some portions of the previous argument, but only in the case of GPs who have shown restraint and honor when it comes to freewheelingly getting larger. The high cost of debt and the tough fundraising environment have reduced the amount of leverage that GPs (mostly buyout managers) can use and diminished the amount of LP capital coming into funds. This has in turn caused the use of higher equity ratios as well as higher outside (co-investment) capital to consummate deals. Additionally, co-investments give GPs the ability to raise capital for ongoing portfolio company capital needs and new fund investments without having to raise a new fund – in other words, they can ride out the current hard fundraising environment by avoiding it altogether – aka "buying time". There will be performance/returns ramifications from all this that will be interesting to watch.

- **Quid Pro Quo**: It always bothered me when a GP told me that some LPs make their fund commitments contingent on the receipt of a certain amount of co-investments. If the GPs acquiesce to this demand, what does this do to the types of deals a manager seeks for the fund? One or a few LPs could be getting a sweeter overall deal (fee-wise, when fund fees are combined with lesser or nonexistent co-investment fees) but to the potential detriment of the broader LP base.

- **Standalone co-investment funds**: By their sheer nature, funds of funds have an engine to generate numerous co-investment opportunities. It is logical for these funds to create vehicles to capitalize on the favorable terms inherent with co-investments. However, I have seen standalone (without the fund of funds engine) co-investment fund vehicles appear in the ecosystem preaching all the positives you would expect. I am not saying this is not a viable or investible option because there are ways to make it make sense such as focusing on fundless sponsor deals or funds with less deep-pocketed LPs, but I do think a higher amount of scrutiny is needed to get comfortable with these. I would apply the same caution to vehicles created by funds of funds that retain the option to execute co-investment deals from managers they did not invest with on a primary basis.

It is exceedingly evident that like nature, the investment universe abhors a vacuum. No matter how you slice it, the co-investment vacuum has been filled by many different players with diverse strategies. Amid this apparent bonanza, investors must be diligently cognizant of proper sizing, concentration risk, and the delusion of being an active investor.

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