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CO-INVESTMENTS

# The Co-Investment Continuum: Structures That Give GPs More Control and Discretion (Part One of Two)

By Dietrich Knauth, *Private Equity Law Report*

Prospective investors frequently demand access to co-investments to average down their management fees and take greater control of their allocation pacing. GPs are often willing to meet that demand, but they occasionally become frustrated by ad hoc approaches that depend on LPs performing diligence on co-investment opportunities and providing capital in tight time frames to close deals.

GPs that want to meet investor demand while also mitigating those risks can structure their co-investment programs in various ways that put them more firmly in the driver's seat on deals. Although those approaches may not provide enough control for exceptionally proactive LPs, they can be a good solution for investors that want to increase their co-investment allocations without needing high levels of involvement in each deal.

This two-part series examines common co-investment structures PE sponsors can pursue and notable factors to be weighed when selecting a path forward. This first article addresses key questions a fund sponsor must consider when structuring a co-investment, as well as certain approaches that give GPs more control over the co-investment process, such as syndicated co-investments. The second article will outline structures that grant LPs more active roles in controlling and participating in co-investment opportunities.

See our two-part series on PE co-investments: "Investment Vehicles, Investor Rights and Restrictive Covenants" (Jun. 18, 2019); and "Regulatory Risks and Important Tax Considerations" (Jun. 25, 2019).

## Co-Investment Overview

### Typical Arrangements

The typical co-investment scenario is best explained through the following hypothetical. A GP with a $200-million PE fund wants to buy a company for $40 million. The GP is unable to buy the company with its PE fund commitments alone, however, because the fund documents only allow the GP to concentrate up to $20 million in any single portfolio company. That type of restriction is designed to protect LPs by ensuring their capital is used for prudent, diversified investments in several portfolio companies.

Not wanting to forgo the opportunity entirely, the GP could offer its existing LPs the ability to bridge the $20-million gap with additional capital committed as a co-investment in the company. In theory, everyone remains aligned, and both the co-investors and the other fund LPs benefit when the portfolio company is later sold at a profit.

"By its very nature, a co-investment is pari passu with the main commingled fund and intended to operate in lockstep with that fund for purposes of the ongoing investments in, and dispositions from, the underlying portfolio investment," said Latham & Watkins partner Amy R. Rigdon.

See "Current Scope of PE-Specific Side Letter Provisions: Co-Investment Rights, LP Advisory Committee Seats and Parallel Funds/AIVs (Part Two of Three)" (Mar. 26, 2019).

The LPs committing $20 million in the above co-investment scenario help the deal close while also securing key economic benefits by avoiding the payment of management fees or carried interest on their co-investments. "The economic terms at the level of the co-investment vehicle itself – *e.g.*, management fees, carry, etc. – may differ completely from those of the main fund. There are numerous structures possible; the sky can be the limit," noted Rigdon.

## Co-Investment Vehicles and Fund Structures

A PE fund will typically invest in a portfolio company through a holding company. When bringing co-investors into a deal, a fund sponsor can either allow co-investors to invest directly in the holding company or the underlying business, or it can create an indirect co-investment vehicle (*e.g.*, a limited partnership) that invests in the holding company.

Further, a co-investment vehicle can be structured to invest in a single opportunity or multiple portfolio companies. Co-investment arrangements can also be structured to allow varying levels of investor discretion and participation in each underlying opportunity.

See our two-part series on structuring PE club deals: "Overview of the Process, Possible Structures and Their Recent Evolution" (May 7, 2019); and "Key Deal Documents and Eight Essential Practice Tips to Navigate Deals" (May 14, 2019).

## Variations in Co-Investment Features

There are many variations on the typical co-investment scenario, and those all play into how the co-investment dynamic is structured.

"First, look to your LPs," advised Pepper Hamilton partner Julia D. Corelli. The traits, objectives and relative bargaining power of potential co-investors weigh heavily into how a co-investment is structured.

"Do you have foreign investors? Do you have pension funds that don't want to be bothered with small company investments? Or, are they high net worth individuals interested in tracking a single portfolio company?" Corelli queried. Investor characteristics clearly factor into the way a sponsor structures a co-investment, she concluded.

Fees and expenses can factor into the decision as well. If a sponsor has fewer co-investors, they may balk at paying a relatively higher portion of the costs of setting up and maintaining a separate LLC or limited partnership as a co-investment special purpose vehicle. In addition, an LP may desire a more active role in the co-investment process to justify having lower or zero management fees or carried interest charged by the GP on that commitment.

In addition, factors related to the specific portfolio company to be acquired should also be considered, noted Corelli. "If the company is an LLC with a pass-through structure, you don't want to force that LLC to suddenly have to issue different Schedules K-1 to each of your 90 co-investors," she explained. "They'll want the sponsor to assume that administrative burden."

See "What Critical Issues Must Fund Managers Understand to Inform Their Preparation of Schedules K-1 for Distribution to Their Investors?" (Mar. 14, 2013).

Beyond those core considerations, an array of other items can factor into how a GP approaches its co-investment process. Those can include, among others, co-investors' access to information, tax considerations and the ability to offer opportunities to outside investors (*i.e.*, not current LPs in its PE funds).

## Co-Investment Tensions

For all their appeal, however, co-investment programs can often become sources of frustration for GPs in their relations with LPs.

First, it can be difficult to get LPs to commit to co-investment opportunities made available to them by GPs. "There seems to be a disconnect between the number of investors that say they want co-investments during the fundraising process and how many investors actually take co-investment opportunities offered to them later during the life of the fund," said Rigdon, "There's a lot of negotiation over co-investment opportunities at the outset of a fundraise, but those negotiations can become of little importance if GPs can't find any takers when they offer co-investments."

See "Recent Trends in Key PE Terms Impacting Alignment of LP and Manager Interests" (Nov. 19, 2019).

In addition, some co-investment opportunities can be structured in ways that give the participating LPs more control over their investment decisions and a voice in negotiations. A problem, however, is that some LPs are not sophisticated enough or equipped with sufficiently robust personnel to exercise those rights without impeding the acquisition process. The result is that ill-prepared LPs can impede the timing of an underlying acquisition or jeopardize the deal altogether.

## GP-Controlled Co-Investment Structures

Fundamentally, before initiating any co-investment opportunity, a fund sponsor needs to consider its ability to retain control over the operation and exit of a portfolio company, suggested Corelli. With that in mind, GPs may need to explore co-investment structures that allow them to realize benefits while mitigating certain potential downsides of LPs having too much autonomy.

To that end, the following are several approaches that empower GPs in the co-investment process.

### Committed Co-Investment Fund

The most structured approach involves a fund sponsor creating a dedicated co-investment fund to provide additional capital to transactions. Often called a "top-up fund" or sidecar, the approach allows LPs to earmark capital in advance for co-investment opportunities that arise during their investments in the primary PE fund.

In some instances, a sponsor with a top-up co-investment fund will still offer additional co-invest opportunities to other investors. In those situations, the top-up co-investment fund typically receives priority allocation rights to each acquisition. Those priority rights may apply to all co-investments sourced by the GP, or they may be limited to a certain size or type of co-investment, explained Rigdon.

**Unique Variations**

When choosing a top-up fund structure, GPs have a lot of customization options – including the ability to establish the fund's terms based on their needs and negotiating leverage. "In terms of fee arrangements, top-up funds are all a little different," observed Rigdon. "A top-up fund may charge no fee and no carry, or it may charge a reduced fee and reduced carry compared to the primary PE fund."

One consideration is setting the scope of co-investment opportunities that will be made available to the top-up fund, observed Rigdon. A sponsor can design its top-up fund to invest side-by-side with all co-investments sourced through a particular primary PE, she explained. Alternatively, the investment mandate of the top-up fund can focus on only co-investments of a certain size or that are located in a certain geography or industry. Further, sponsors can structure the top-up fund to match opportunities across multiple funds as well, she continued.

In addition, sponsors can structure co-investment funds to provide investors with limited rights to opt out of certain investments without being as flexible as a pledge fund, suggested Corelli. "Sometimes there are limitations on how often those opt-out rights can be exercised, such as providing three opt-out opportunities over the course of the vehicle," she explained.

"The above approach is rarer because it requires LPs to provide up-front commitments, but then they are hard pressed to opt-out of individual investments – there has to be a good reason," Corelli noted. "A committed top-up fund with well-defined excuse and exclude provisions can get you to the same result."

See our three-part guide to pledge funds: "High Upside Fee Structure and Other Incentives for Adoption" (Apr. 9, 2019); "Key Investment Management Agreement Provisions" (Apr. 16, 2019); and "Deal Uncertainty Issues and Three Investment Vehicle Structures" (Apr. 23, 2019).

**Potential Benefits**

Securing top-up fund commitments at the outset provides GPs with flexibility to pursue deals without worrying about having enough cash on hand to complete them. "A top-up fund with pre-committed capital helps the GP be more efficient and nimbler when seeding deals and being able to execute on them," observed Rigdon. "Fund sponsors can avoid needing to 'pass the hat' for capital commitments, which they need to do for every single-asset co-investment vehicle."

In addition, top-up funds address some of the challenges that GPs have with managing co-investment allocations, noted Winston & Strawn partner Bradley S. Mandel. "With a dedicated co-investment fund, PE sponsors don't have to worry about allocating co-investment opportunities on a deal-by-deal basis," he said. "A sponsor gives everyone an opportunity upfront to participate in a committed co-investment vehicle, and that allocation then becomes fixed."

Although an LP relinquishes some control and discretion over its co-investment allocation upon committing to a top-up fund, the LP's investment committee is also relieved of some of its concomitant burden. "Top-up fund LPs do not decide on a deal-by-deal basis whether to co-invest – once they're committed, they lose that control," Rigdon explained. "That is preferable for some investors because they don't need to go to their investment committees for every potential co-investment. Deals usually move quickly, and some investors can struggle to align those timelines with their investment committee timing."

**Challenges to Overcome**

Despite the conveniences they offer, top-up funds bring their own unique challenges. For one thing, a GP may be forced to fundraise for the top-up fund in parallel with fundraising for its main PE fund.

In addition, top-up funds introduce several potential conflicts of interest that need to be disclosed to investors and addressed in the associated fund documents. "Accordingly, top-up funds typically require a little bit more forethought at the fund-formation stage than a one-off co-investment," said Simpson Thacher partner David J. Greene.

For example, PE funds typically have a covenant restricting the sponsor from operating a fund with a substantially similar investment objective until a certain percentage of the main fund's capital – typically 75 percent – has been invested, observed Greene. "If you're raising a top-up fund before you have achieved that investment percentage, you might need consent from the main fund's LPs or its LP advisory committee unless those permissions were already included in the main fund's limited partnership agreement (LPA)."

See "Sadis & Goldberg Seminar Highlights the Ample Fundraising and Co-Investment Opportunities in the Private Equity Industry, Along With Attendant Deal Flow and Fee Structure Issues" (Dec. 8, 2016).

## Single-Investor Co-Investment Account

Some LPs want bespoke co-investment exposure without the frequent contact of an ad hoc co-investment approach or the lack of discretion in a committed top-up fund. In those instances, a single-investor co-investment fund may offer a reasonable solution that is becoming a bit more common lately, suggested Rigdon. "There's a very recent trend of investors saying, 'I want more co-investment opportunities with you, but I don't want to have to go to my investment committee over and over again.'"

LPs find single-investor co-investment funds appealing because they retain control over their portfolios without the day-to-day management of an approach that requires more active approvals. At the outset of forming the fund, each LP can customize the size of its overall commitment, fee structure, concentration limit and investment strategy. With that said, that level of customization naturally requires an increased amount of negotiation when forming the vehicle.

Further, GPs favor the approach because they have discretion post-launch – within the scope of their investment mandates – about which co-investment opportunities the single-investor fund pursues. That gives the GP flexibility to have the single-investor fund pursue specific co-investment opportunities involving the GP or to simply invest alongside a main PE fund. There is also some flexibility in how that type of vehicle can be structured, whether as a fund of one or as a GP-managed LLC or limited partnership with a single capital source.

See "Considerations for Advisers to Properly Classify Single-Investor Funds Under the Custody Rule and Form ADV" (Feb. 4, 2020).

## Syndicated Co-Investments

Another relatively common approach is for a GP to have a main PE fund complete a deal in its entirety first and then sell a portion of the investment to co-investors in the future, Greene summarized. Known as a syndicated co-investment, the primary appeal for GPs is that it enables them to acquire larger portfolio companies while also controlling the timing of acquisitions. "That can make it easier to close an underlying investment because you're not worried about getting the co-investment in place before the closing date," he noted.

That approach can also be appealing to LPs, depending on the level of involvement they want to have when negotiating the terms of a deal. At some level, that type of co-investment is even more passive than the typical indirect co-investment because the deal is already closed before a portion is offered to prospective co-investors. Therefore, LPs have no room to shape the deal terms and little leverage to extract information rights or other concessions from a GP under pressure to raise capital quickly to fund an imminent deal.

Notably, GPs may bridge the gap between the purchase price of the underlying investment and syndication to co-investors with their own capital or, depending on the terms in the associated LPA, with capital from their PE funds. If the latter, PE sponsors should address the process in advance in the funds' LPAs, as well as in their policies and procedures. Among other items, sponsors should delineate clear processes for determining the price for selling to co-investors and an outer date by when syndication of the co-investment would need to occur, advised Greene.

There are risks, however, as acquiring an investment on the books of a GP's main fund could temporarily violate its diversification and concentration limits. That could result in future problems if a GP is unable to syndicate a portion of the acquisition to its co-investors to reduce the main fund's final investment under the limits set forth in its LPA, cautioned Corelli.

"The GP is in trouble if it doesn't work out because the 'reasonable expectation' is always tested in hindsight," Corelli noted. "Human nature being what it is, someone will say, 'How could you have had a reasonable expectation? That was an illegal deal.'"

For coverage of other types of syndicated transactions, see "Credit Fund Specialist Discusses Trends in Fund Formation and the Credit Fund Space" (Aug. 23, 2018).