Private equity coinvestment

David Greene
Amy Rigdon
Latham & Watkins LLP

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As the name implies, 'coinvestment' involves participation alongside a core investment programme (referred to in this chapter as the 'main fund'). While coinvestment is in a sense subordinate to the applicable 'main fund', it has grown into a regular feature of the private equity marketplace, with its own set of evolving norms and practices that can be assessed as a distinct category of private equity activity.

The typical private equity investment for an investor involves a capital commitment to a blind-pool private equity fund, or 'main fund'. Although investors typically hold certain customary protective rights – either individually or as a group – in their capacity as limited partners or other non-controlling participants, investment selection and management responsibilities are generally the province of the private equity fund manager (the sponsor). Fund investors are obligated to participate in each investment made by the main fund, subject to customary excuse remedies.

In contrast, coinvestment represents an alternative to the typical committed-capital private equity fund structure. As coinvestors, participants can play an active role as investors in the deal selection and portfolio construction process. Many sponsors also see value in offering coinvestment opportunities, in view of the potential relationship-building and other benefits for the sponsor. Coinvestment is, as a result, an increasingly common part of the private equity marketplace.

This chapter is intended as a guided tour of coinvestment in private equity: what it is, why coinvestment (from both the investor and sponsor view), common coinvestment terms, alternative coinvestment structures and current topics in coinvestment.

1. What is coinvestment?

In broad terms, coinvestment involves raising and deploying investor equity commitments for a specific transaction alongside a blind-pool private equity fund (the main fund). While private equity sponsors typically raise coinvestment to participate in a single portfolio company, coinvestors can also participate in multiple transactions as a subset of a private equity fund's overall programme, particularly as described below with respect to top-up funds.

Coinvestors typically participate in target transactions through capital commitments to a sponsor-controlled vehicle (the coinvestment vehicle) which is under common control with the main fund alongside which the coinvestors are participating. In this regard, the coinvestment vehicle and the main fund may share a general partner or similar controlling person. Capital commitments to a coinvestment vehicle are drawn down for investment based on the nature of the underlying portfolio transaction. For example, if the underlying investment involves a take-private transaction or other acquisition, most or all of investors' capital commitment available for investment may be drawn down at the same time as closing of the coinvestment vehicle. On the other hand, if the underlying investment is a build-up or platform investment, the capital commitment may be drawn down over time on an as-needed basis. Partnership expenses are usually handled separately, as described below.

The investment operations of a coinvestment vehicle, and sometimes its economic terms, are typically shaped by the governing agreements – including side letters – of the applicable main fund. For ease of operations, many sponsors seek to have the decisions of the applicable main fund control with respect to the coinvestment vehicle. In that regard, the main fund decides on dispositions and any other actions with respect to the portfolio company. In turn, the coinvestment vehicle acts or votes in tandem with the main fund. While the terms of the coinvestment vehicle as such can and will differ from the main fund agreement (as described below), the coinvestment vehicle typically invests in the underlying portfolio investment on the same terms and conditions as the main fund at the level of the underlying target portfolio company, subject to tax, legal, regulatory or other considerations. Such treatment is often referred to as 'lockstep' participation by the coinvestment vehicle alongside the main fund.

Notably, however, a coinvestment vehicle may not necessarily invest in the target company at the same time as the main fund. For instance, portfolio transaction dynamics may make it impractical to raise and deploy a coinvestment vehicle prior to the closing of the transaction. Instead, a sponsor may bridge – or, if permitted by the applicable fund agreement, cause the main fund to bridge – the investment participation by a coinvestment vehicle until such vehicle has had time to complete its own fundraising. When a main fund's governing documents permit bridging of coinvestment, a portion of the underlying investment is sold from the fund – or off the sponsor's balance sheet – to a coinvestment vehicle. The sale is usually accomplished at cost within a specified time from acquisition, and the coinvestment vehicle typically reimburses the seller for its share of transaction expenses and, potentially, an interest factor on invested capital.[1]

As with an investment in a blind-pool fund, tax-exempt coinvestors may be

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1 It should be noted that a transfer of a portfolio investment from a blind-pool fund to a coinvestment vehicle may implicate requirements under applicable transaction documents. In addition, filings under the Hart-Scott-Rodino Antitrust Improvements Act of 1976 may be required, depending on, among other things, the size of transfer and when the transfer is made.

sensitive to the incurrence of unrelated business taxable income (UBTI), and non-US coinvestors may be sensitive to the incurrence of income effectively connected with the conduct of a US trade or business (ECI). In general, the incurrence of UBTI by a tax-exempt investor or ECI by a non-US investor can generate a US tax payment and/or US tax filing obligations for investors who might not otherwise be required to make such payment or such filing. While a full discussion of these topics is beyond the scope of this article, main funds may incorporate covenants in respect of the avoidance of these types of income by partners who so elect. These covenants are usually operationalised through the use of 'blocker' structures, where an entity taxed as a corporation is interposed between electing partners and the main fund. Interposing this type of entity does not eliminate the tax payment or tax filing obligation but instead places the burden of paying any applicable US taxes and filing any applicable US tax returns on the interposed entity. A coinvestment vehicle may use similar blocker structures administered by the sponsor. The discrete investment strategy of most coinvestment vehicles typically allows investors to diligence the tax profile of the underlying investment and determine the most efficient way to invest in the specific coinvestment vehicle, potentially without requiring that the sponsor provide a blocker option. In addition, coinvestment offerings are typically smaller in size than a main fund, which may make a sponsor less willing to administer a blocker structure for coinvestment purposes.

2. Why coinvestment: the sponsor view

Sponsors raise coinvestment for three primary reasons:

- furthering investment management goals;
- favourable economics; and
- marketing and investor relations.

In all these scenarios, coinvestment can allow a sponsor to maintain control of the equity deployed in a transaction, as opposed to, for example, a consortium investing with other financial sponsors.

2.1 Investment management

Coinvestment can allow a sponsor to enhance the investment life and portfolio diversification of its funds. As a simple example, a sponsor may encounter an otherwise desirable transaction that is too large for its main fund. For example, the required equity investment may exceed the fund's investment diversification requirements (ie, contractually agreed limitations on the amount of capital contributions to any one transaction), or the sponsor may believe the fund is overweighted in a particular industry or type of investment. Any excess investment can be offered for coinvestment.

In addition, when a main fund reaches the end of its investment period, the sponsor may not be ready to raise its next main fund. Market conditions or other initiatives being pursued by the sponsor may make it difficult to pursue commitments to a new blind-pool vehicle, as compared with a focused coinvestment vehicle for an identified underlying portfolio investment. Coinvestment vehicles can provide a bridge between one fund to the next while the sponsor prepares for fundraising.

Similarly, a new sponsor can market a single investment through a sponsor-controlled vehicle as a means of generating a track record prior to launching a blind-pool fund. Potential investors may be more receptive to a narrowly defined investment vehicle initially, where potential investors can undertake enhanced due diligence on the assets or companies being acquired (as opposed to more broad-based diligence on the sponsor and investment programme in the case of a blind-pool fund offering).

2.2 Economics

A coinvestment vehicle that provides for 'carried interest' to the sponsor can provide favourable economics to the sponsor as compared with a diversified (ie, multiple-investment) main fund. Distributions from diversified funds are typically calculated across the fund's entire portfolio (whether the fund employs an American or European-style waterfall); the fund sponsor is only entitled to receive or retain carried interest if the fund's portfolio as a whole meets applicable benchmarks, such as a preferred return threshold. In comparison, distributions from a coinvestment vehicle are typically calculated solely with respect to that vehicle's underlying investment. That is, the investment results of a coinvestment vehicle are not cross-netted with the investment results of the applicable main fund or other coinvestment vehicles. As a result, a coinvestment vehicle with a carried interest in respect of a successful portfolio investment can provide superior financial results for the sponsor if the underlying portfolio company succeeds. Likewise, the risk of a carried interest clawback event is greatly reduced. In the authors' experience, current market trends favour 'no fee, no carry' coinvestment offerings, but that trend may reverse over time.

2.3 Marketing

Coinvestment can also offer relationship and marketing benefits to a fund sponsor.[2] As described below, many institutional investors look favourably on the opportunity to coinvest in particular transactions. As a result, coinvestment offerings can provide sponsors with the opportunity to broaden relationships with existing limited partner investors. Additionally, coinvestment opportunities can permit fund sponsors to broaden their prospective investor base by working with new coinvestors that may become future limited partner investors of their next main fund.

More broadly, coinvestment offerings can provide a sponsor with an attractive marketing point for its next main fund. Depending on the manner in which the coinvestment is offered, a fund sponsor may be able to describe its past practices regarding coinvestment offerings in marketing its next main fund. In doing so, the fund sponsor should be clear that past practices are no guarantee of future

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2 Sponsors should keep in mind that as investment advisers they must act in the best interest of their clients at all times. Any decision to allocate a coinvestment opportunity to a third party or an existing investor must be made with the best interests of the sponsor's clients in mind.

coinvestment offerings. Moreover, fund sponsors should exercise care if and how coinvestment investment results are included in the sponsor's overall track record presentation, as discussed below.

3. Why coinvestment: the investor view

Coinvestment is becoming increasingly popular among institutional investors. A 2014 survey conducted by Preqin noted that 52% of investor respondents intend to increase their coinvestment activity going forward. As practitioners, we have seen an increase in institutional investors requesting access to coinvestment consideration in connection with their investment in a sponsor's main fund. Institutional investors find coinvestment opportunities attractive for a variety of reasons, including control over investment selection and occasionally favourable fee arrangements.

3.1 Portfolio selection; knowledge transfer

Investors in a blind-pool fund are, subject to customary excuse rights, required to participate in each of the fund's underlying investments. Coinvestment, however, allows investors to choose investments – or increase their participation in investments – that fit within their overall portfolio objectives.

Potential coinvestors may also be in a position to perform enhanced due diligence on potential coinvestment opportunities. The due diligence process may include a review of sponsor-prepared materials and/or source documentation and financials. The opportunity to undertake target-specific due diligence allows the investor to more precisely gauge portfolio 'fit', while also permitting the investor to enhance its knowledge on a particular industry more generally.

3.2 Potential for favourable fee arrangements

A fund sponsor may offer more favourable fee and carry arrangements as compared with a main fund, depending on the motivations behind the coinvestment offering. For example, a fund sponsor seeking to deepen relationships with its limited partners or attract new investors may offer coinvestment on a reduced or no fee basis. The nature of the coinvestment, particularly whether it is a single acquisition or coinvestment in a series of acquisitions, will also dictate the variability of fee arrangements. Moreover, participation in one or more coinvestments on a no (or reduced) fee and carry basis will, on an average basis, reduce an investor's overall expense burden with respect to the investment programme of a given main fund.