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Investing in Co-investments

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WHEN CO-INVESTING, MAKE SURE INTERESTS ARE ALIGNED

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Most limited partners would agree that a primary attraction of co-investing is avoiding or significantly reducing the management fee and carried interest they pay when investing in private funds. But limited partners should be aware that the fees and carry associated with private funds do—to a certain extent—align their interests with those of general partners because both benefit financially when a fund produces healthy returns. Both groups share an interest in investing in companies on favorable terms, exiting investments at attractive prices, and keeping expenses in check, to name just a few common considerations.

In a co-investment dynamic, however—especially an investment made through a co-investment vehicle—the interests of general partners and co-investors are not as naturally aligned because general partners do not earn carried interest and therefore do not have as strong as a financial incentive to maximize the return on the co-investor's sleeve of capital. Many co-investors, however, either assume otherwise and fail to consider potential areas of misalignment or are simply content to rely on the general partner's good faith. While there may be reasons to believe that general partners will act in the interests of their co-investors, a failure to seek proper alignment could have significant negative consequences. For example, investors could receive a return that is materially lower than they expected, be left holding illiquid securities following an exit by the general partner's main fund, or be exposed to unanticipated and potentially uncapped liabilities. We will explore a few of the more common areas of potential misalignment, including the terms of the underlying investment, opportunities to exit, participation in follow-on investments, and managing expenses.

Looking beyond the fee and carry savings, a key question a co-investor should consider is whether it is investing on the same terms as the general partner's main fund. Most co-investors want to receive a return that is at a minimum the same as the return the general partner's main fund receives—minus the fee and the carry. Co-investors must be mindful of the type and mix of securities being offered to them and the terms of their investment. If a general partner's main fund is purchasing a different type and mix of securities, it could be receiving a materially higher return. Co-investors also need to review the co-investment's terms to determine whether they are being assessed additional fees, such as syndication, financing, or monitoring charges. These additional fees can have a material negative impact on returns over the life of a co-investment. As such, it is critical for co-investors to understand, and evaluate, any economic terms that differ materially from those of the general partner's main fund.

A co-investor should also think ahead toward an eventual exit. While many co-investors will want to exit the portfolio company in the same way as the main fund, general partners do not always guarantee this right. For example, a general partner may reserve the right to sell its main fund's stake in a portfolio company to a successor fund or in a roll-over transaction, which locks in the general partner's carry, without offering liquidity to co-investors. A general partner may also reserve the right to sell smaller stakes of the portfolio company without offering co-investors the right to sell at the same time. In these situations—and potentially despite their initial expectations—co-investors could be left holding illiquid securities when the fund they co-invested alongside has already exited the investment. By carefully negotiat-

ing co-sale rights—which are common in the underlying transactions but not typically a feature of private funds—co-investors can create exit opportunities that meet their needs and align with their co-investing strategy.

Co-investors also need to explore whether they will have the ability to protect themselves against dilution by participating in follow-on investments. In a private fund, limited partners rely on the general partner to vet follow-on opportunities, knowing that the general partner has an economic incentive to make a prudent decision. In co-investments, investors do not always have the right to participate in follow-ons because general partners lack a financial incentive to offer these opportunities. As a consequence, co-investors should consider negotiating anti-dilution protections, which could include broad preemptive rights over all future securities issuances by the portfolio company and its subsidiaries or a narrower scope of preemptive rights over only those issuances in which the general partner's main fund participates.

The potential for runaway expenses also poses a risk in co-investments. In a private fund, a general partner has an incentive to keep partnership expenses low to increase the return and its own carried interest. The same incentive typically does not exist in co-investments, so expenses merit extra scrutiny. For example, in some cases general partners assess partnership expenses on top of a co-investor's commitment, and in addition, they reserve the right to charge certain operating expenses of the portfolio company, such as indemnification costs, to co-investors. This creates a significant potential liability for co-investors who could, in theory, face unlimited demands for additional contributions. In contrast, liabilities at the main fund would always be capped at the investor's commitment. To keep expenses in check, a co-investor should consider asking the general partner to subject expenses to an annual or lifetime cap.

These are just a few of the many items a co-investor should consider prior to making an investment. A sampling of other issues that a co-investor may need to consider include the following:

- Should co-investors share in any consulting or monitoring fees paid to the general partner?
- In what circumstances should co-investors have the right to remove a general partner from the management of a co-investment vehicle?
- Are there restrictions on the general partner's use of the co-investor's capital?
- Does the co-investor have assurances that the general partner will continue to devote adequate resources to managing a co-investment vehicle?

In all cases, the important takeaway for co-investors is that, even though the demand for co-investments is strong, co-investors would be well-served to carefully review and understand the terms of their co-investments to make sure their interests are aligned with the general partner.

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