

Global Private Equity

Update

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Key Issues for General Partners and Limited Partners in Private Equity Co-Investment Transactions

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There has recently been a significant increase globally in the number of private equity transactions completed with co-investments by limited partners (LPs). We expect this to continue as a large number of LPs seek to drive down the costs involved in investing and gain more control over their investments. However, co-investments can be challenging and make executing deals more complex. As a result, many sponsors are having to think carefully about how to accommodate co-investment opportunities while managing this additional transaction complexity, as well as the fund and regulatory considerations that arise. This article provides some background on the development of the market for co-investments, highlights some of the challenges in these transactions, and suggests some solutions.

Background

According to Preqin, somewhere between 43% to 75% of investor LPs are actively requesting co-investment rights from their general partners

(GPs) when considering whether to invest in a new fund. LPs have been reporting a rise in the quality of the co-investments in which they have been able to participate. This increase in co-investment activity is occurring across various transaction sizes – including both mega-funds and the middle market – and across various geographies.

Incentives for LPs and GPs

LPs have many incentives to co-invest alongside funds. In addition to seeking a means by which to build direct investment capabilities and increase internal capabilities, co-investments offer LPs an opportunity to drive down their overall portfolio costs, as most co-investment arrangements involve low- or no-fee structures. Co-investments also provide LPs with the ability to diversify their portfolios, align interests between partners and gain exposure to quality private equity assets. Some LPs also report higher rates of return or, at minimum, similar returns on their investments when they co-invest.

GPs have differing incentives to offer co-investment opportunities to their LPs. To a large degree, co-investment opportunities are driven by investor demand and market conditions. The additional capital that LPs can provide may sometimes also mean that GPs can gain access to larger transactions in which they would not otherwise be able to participate alone.

Finally, co-investments by LPs present arguably less challenges to GPs from a control perspective than club deals, where co-investors are typically comfortable to accept more limited rights.

1. Challenges of Co-Investments for LPs and GPs

While the benefits of co-investments from both LP and GP perspectives are fairly clear, there are a number of challenges to co-investment arrangements that might not be immediately obvious. These challenges are relevant for both GPs and LPs. It is also worth noting that as co-investments become more prevalent and more LPs become familiar with the process, GPs and LPs have been able to find ways to manage the challenges discussed below so that they do not become an impediment to any transaction. However, this mostly happens by experience, and having a well thought out plan and strategy is key, especially if co-investments are being considered for the first time or in the context of a complex transaction.

Structure. A threshold question for LPs and GPs is whether a co-investment will be direct or through a vehicle managed and controlled by the GP. In most cases, the GP will expect to control the co-investment in tandem with the fund's investment and thus, will mitigate potential conflicts. However, sophisticated LPs and those that make significant investments may prefer to invest directly, and monitor and manage the investment, alongside the GP. These direct investments raise a plethora of deal control issues, rights issues and potential conflicts of interest, some of which are discussed below. These issues will increase as LPs push for more direct control or influence over the co-investment.

Timing and Process. GPs should not underestimate the additional time and process involved in LP co-investments. While some LPs are sophisticated direct investors and operate like traditional private equity fund sponsors, many LPs are new to direct investing, and it may take additional time for those LPs to gain comfort with a transaction. Many LPs do not have the staffing resources to either conduct

the appropriate amount of diligence on the deal or else monitor the investments on a go-forward basis. Distributing the relevant deal information, soliciting comments and negotiating the terms of the deal can involve additional delays to the process when LPs are involved. As a result, the additional time it takes to run LPs through the investment thesis and diligence considerations must be done in tandem with the regular deal process, and can be a significant time commitment that can potentially delay the process.

The timing of the decision to bring in co-investors can also be important. Among other things, the GP must decide whether co-investors will stand behind their pro rata portion of the equity for the deal and any reverse termination fee. While the GP often stands behind the full equity commitment for the deal, in cases where the fund is limited due to check size or for other reasons, the GP may be forced to have co-investors provide an equity commitment earlier or otherwise have a co-investment fund structure set up and complete before any equity commitments are due, so that the co-investment fund itself can provide an equity commitment (just like a traditional fund) and stand behind a pro rata portion of any reverse termination fee.

Diligence. Given time and resource constraints, LPs typically rely on the GP to conduct thorough diligence. However, the GP will often conduct diligence with its own scope and goals in mind, and LPs will need to consider whether there is a need to conduct their own independent due diligence. Having LPs conduct separate due diligence can also yield delays in the process or make it more cumbersome for the target. Where any co-investment is considered, it will be important to identify a co-investor's particular diligence requirements early.

Social Issues. For GPs, having LPs as direct co-investors in deals may raise a number of potential areas for conflict. First, the co-investment deal structure requires that the GP negotiate directly with key LPs on the deal, which can introduce a new dynamic to the relationship. The negotiation process for the actual deal may place added stress on the relationship between the GP and LPs. While

negotiating, the GPs must take into account the larger relationship with its LP as well and balance the trade-offs between getting what they need in the particular transaction and preserving the overall relationship with the fund.

GPs must keep in mind that many LPs have different investment horizons and guidelines than those of the GP. These philosophical differences and, in some cases, cultural differences, must be taken into account when deciding to syndicate equity and setting the terms for the investment.

Deal-Specific Issues. In connection with any transaction, the parties will have to come to an agreement on certain minority stockholder rights to which the LP will be entitled. Information rights will typically always be included, and then depending on how the co-investment is structured, there may be a question as to whether LPs receive inspection rights, tag-along rights, preemptive rights, registration rights, and board designation or observer rights. The GP's ability to negotiate such rights may be problematic when such rights undercut the GP's own goals, particularly for the fund. If an LP is given board rights, it can introduce yet another new dynamic to the GP-LP relationship that will need to be navigated. If LPs act independently of the sponsor's strategic plan, this can cause a number of issues. The ideal for many GPs is to obtain the LP co-investment capital with as few strings attached as possible. While customary levels of co-investor control still remain low, it is worth noting that with increased board and other control rights, consideration will need to be given to the extent of that control from an antitrust and regulatory perspective.

LP-Specific Issues. LPs interested in direct co-investments come in all varieties, from state and foreign governments to pension plans and family offices. Different LPs have different requirements and legal characteristics. Among other things, the GP will need to deal with each LP co-investor's tax sensitivities, which may lead to setting up one or more vehicles for tax purposes. Some LPs are subject to public information requirements, which require them to publish certain financial data about their investment

holdings. This may also require setting up additional entities to keep the name of the ultimate target company confidential. The range of tax, regulatory and other LP specific considerations can make deal execution more challenging.

2. Fund and Regulatory Considerations

In addition to the corporate and transactional considerations that arise, co-investments raise a number of fund documentation and regulatory considerations.

GPs generally have a duty to act in the best interests of their client – the fund. As such, determinations of allocations of investments should generally focus first on the appropriate allocation for the fund client, and any additional available allocations can be offered to co-investors thereafter. A GP should also be cognizant of how co-investment opportunities are allocated among its LPs. Many GPs prefer to retain full discretion on allocation. This provides flexibility and can increase transactional efficiency by reducing the number of involved parties. Where allocation of co-investment opportunities remains solely a GP decision, fund offering documents should generally include robust disclosures on this subject.

In certain circumstances, investor pressure makes retaining complete discretion on co-investment impracticable. Where co-investment rights need to be granted to certain investors, GPs should be mindful that such rights may become subject to “most favored nations” (MFN) rights in the side letters of other LPs. If as a result of MFN rights, many or most LPs are assured equal co-investment priority, the incremental administrative burden of offering and negotiating co-investment opportunities with numerous LPs can become a challenging, iterative process of offering the co-investment opportunity over multiple rounds. This can adversely impact the timing and add complexity to a transaction. Where the process becomes unduly burdensome, this can have the unintended effect of reducing the number of available co-investment opportunities as the GP struggles to reconcile transactional timing and process with a cumbersome co-investment mechanic. To avoid this outcome in



















circumstances where the GP is not able to retain discretion, GPs either typically try to carve co-investments out of MFN provisions or seek to legislate a tiered priority structure for co-investment rights in the fund documents, often based on the size of the LP's commitment.

3. Conclusion

Although some LPs have reported high rates of return from their co-investments compared to their typical fund investments, the findings on overall co-investment performance have been conflicting. As GPs continue to raise capital for new funds, it is likely that the number of LPs requesting co-investment opportunities will continue to increase. However, this general rise in co-investments will still

be subject to swings and roundabouts, depending on the state of the private equity market. As more opportunities arise for co-investments, LPs will need to continue to assess their budgets, monitor the staff needed to participate in the deal process and develop the expertise and skills needed to monitor their future investments. It is clear that there are many advantages for LPs that participate in co-investments, and when most GPs weigh the incentives and challenges of such arrangements, many will find that it is an advantageous arrangement for them as well. Our own experience reflects this reality – co-investments are a common part of deal dynamics today and they can be undertaken in a way that is beneficial for both GPs and LPs.

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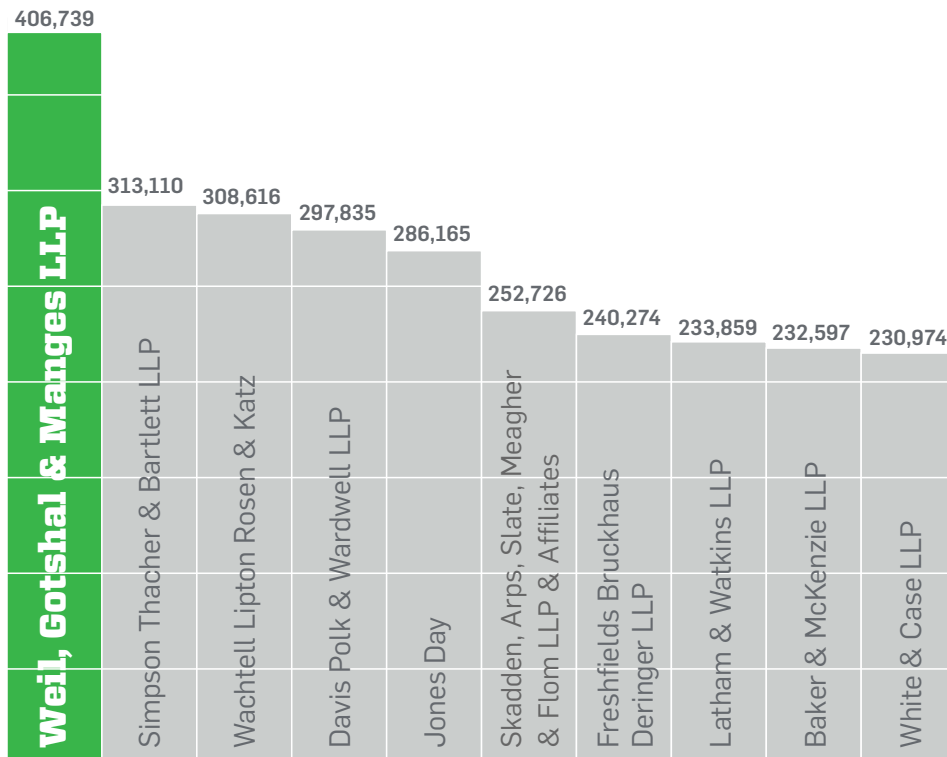
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