

## Finding what works for you

As investor demand for co-investment opportunities escalates, GPs are considering new ways to manage the process, including the creation of a ‘chief co-investment officer’, making less promises during fundraising and whether to raise separate top-up funds

by CLAIRE COE SMITH

There is no doubt that demand for co-investment opportunities has sky-rocketed among the limited partner community in recent years. But sponsors are struggling to keep up with investor demand to team up on deals, and with regulators baring down on them, many are re-thinking how to satisfy demand in a way that works for everyone.

In 2014, \$5.8 billion was raised for co-investment funds, while \$10 billion has already been raised in the first nine months of 2015 alone, according to data from PE Research & Analytics. LPs are queueing up for more opportunities to put additional capital to work alongside their favorite managers, leaving GPs in a quandary and in need of more sophisticated answers.

Crucially, dealing with sourcing extra capital to top up the fund’s commitment on larger transactional opportunities has moved from being a deal-team issue, to being a critical

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point of investor relations risk management.

### The IR factor

Stephen Cavell is head of investor relations at Graphite Capital, a private equity investor focused on the UK mid-market. He says: “In our experience almost all LPs want co-investment, and they increasingly ring up about it. But when you offer co-investment opportunities to LPs, it can be quite a cumbersome process, and it is not always harmonious. If you have a limited amount you can offer, do you offer that to X, Y or Z? Or do you offer it to everyone, and everyone ends up with tiny amounts? That can be very difficult to manage.”

David Smith, a managing director and co-head of co-investment at Capital Dynamics, a major investor in private equity funds around the world, echoes the sentiment. He predicts more GPs to allocate additional resources to systems and controls in co-investments, because it is an area that can no longer be primarily managed by the investor relations function.

In fact, the complexity of fundraising today, which requires careful management of various LP relationships and new regulatory burdens, is already a full-time job for IR staff. Adding co-investments to their list of responsibilities can start to “stretch their capacity,” says Smith.

He offers a solution to the problem: “I think we will see the advent of a



‘chief co-investment officer’ role, in the larger funds in particular, because interest in co-investment and its prominence is becoming such a significant aspect of business for most GPs.”

### No promises made

Co-investments offer several potential attractions to LPs, not least a chance to reduce fees. Private equity firms that ordinarily charge a management fee of 2 percent and take 20 percent of profits in carried interest will bring in partners on co-investments with much reduced fees, and sometimes none at all. Given that private equity remains a relative-



ly expensive asset class for investors to access, and returns are under pressure, that has a big appeal – as does the chance to get a bigger slice of the action alongside a popular manager, and deal-by-deal investment selection.

But as one investor relations partner at a private equity firm points out, investor demand for co-investments is becoming a challenge for GPs: “Our observation is that, firstly, LPs are quite often motivated by their own economics to do it: they either have carried interest deals or some other arrangements internally that are pushing them to do it. Secondly, they make out

to their investors that they are great at doing it and it will enhance returns, but really a lot of LPs talk the talk but then when you want them to get their act together and commit, they are busy doing something else or they are not set up to respond.”

Smith says there was a time when sizeable LPs such as Capital Dynamics could have bilateral discussions with general partners at fundraising stage and secure a co-investment rights agreement, guaranteeing them a true legal right to make co-investments. Now, he says: “As co-investment has become more popular – the demand for it and its profile within

**Co-investments:** GPs piecing together new ways to manage the process

the private equity industry has increased more than I would ever have imagined – now, no promises are made. It will come up in a fundraising conversation, and the GP will ask the LP whether they would be interested, but there is no legal right. Most serious LPs with a co-investment appetite and demonstrable execution credentials will make sure that that appetite is noted and described in a side letter.”

### Strategies pursued

But are GPs wise to keep things open-ended? Kate Simpson, a partner in the private investment funds practice at law firm Proskauer, says yes.

“The general approach is for GPs to keep a softer, more discretionary co-investment approach, so they say that they acknowledge the LP’s interest, but they will approach any opportunity on a case-by-case basis. There are people that do harder things in the limited partnership agreement, or offer co-investment rights as a first-close incentive, but most GPs want to try to exercise discretion.”

GPs have in the past sometimes promised co-investment rights pro rata to each LP’s commitment to a fund – some have delivered LPs as much as three times their fund commitment in co-investments.

Graphite’s solution is to set up and raise a separate top-up fund, at the same time as the main fund, that invests in the larger deals where syndication would be necessary. That blind co-investment pool is open to all LPs interested in such opportunities.

Cavell says: “The positives for the investors are that they get a bigger exposure to Graphite funds, which is attractive especially to larger global investors

who want to put larger checks to work. It also reduces their overall costs of being in our fund, because the top-up fund comes at a lower cost, with a fee that is only charged on invested money with deal-by-deal carry. The negative is that it's a blind pool, so they can't pick which deals they get in to."

He says Graphite decided some time ago that the classic co-investment model is ineffective in the mid-market for two reasons. One, the firm refuses to underwrite larger transactions and then sell them down in case circumstances change suddenly. And two, the alternative route of taking LPs along to deal meetings so that they can make decisions on whether to come aboard is too complicated to execute.

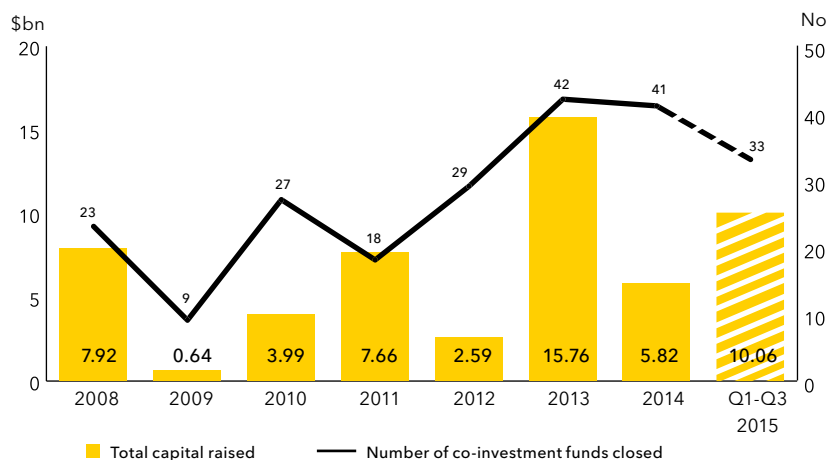
He adds, "We arrived at this decision because we looked at the structure of our 2007 fund and at the market, and we decided we didn't want to raise an enormous amount of capital, and we wanted to stay in the mid-market without the pressure of a huge amount of capital to deploy. We did see a lot of large opportunities, though, which we didn't want to put into the main fund for fear of risking that fund, but we saw no reason why we couldn't manage them."

The Graphite model deals with both the fundraising challenge and the allocation problems associated with LPs desperate to secure co-investment rights, and Cavell expects it to become more commonplace.

It also helps with the messaging, which can be a real challenge, as Guy Hands, founder and chairman of Terra Firma Capital Partners, recently set out in a speech at *pfm's Investor Relations and Communications Forum Europe*. He said: "You can't go to one group of LPs and say this is all about co-investment, we'll give you great co-investment, and go to another group of LPs

## Rebound enthusiasm

After experiencing a dip in 2013, co-investment funds experienced a resurgence in popularity during the first nine months of 2015



Source: PEI Research & Analytics

and say we are here to do deals that are the right size for the fund."

### Regulatory concerns

That challenge is compounded by regulatory scrutiny. In 2012, the US Securities and Exchange Commission (SEC) began taking an interest in conflicts of interest arising in co-investments, and it has since increasingly focused on the offering process, making sure all opportunities are represented clearly and fairly to all LPs.

In light of this, Simpson says the best way forward now is for GPs to have a very clear and well-documented policy on co-investment strategy, and to communicate that widely. She says: "All GPs should have a co-investment policy saying how they look at opportunities as they arise, and how they allocate them in the best interests of the partnership."

The first decision will always be whether it is in the best interests of the fund to do a deal that is of such a size

that it requires co-investors, and that has to be decided based on clear criteria before any consideration is given to which LPs might be offered the opportunity. Then allocations may be offered based on any number of criteria, ranging from the size of the LP and the size of its commitment, to the geography, industry sector or strategy of the target business.

"The SEC is very close to this at the moment," says Simpson, "and the expectation is that GPs will have a policy. Most people may not have it fully documented, but they have always had a policy, so the point is that they need to memorialize it now. Investor relations are important for all GPs, so there has long been the driver to be seen to be doing things fairly and reasonably, so as not to be risking relationships, not just so that they are doing things by the book."

As with all investor relations issues, transparency, clarity and good communication appears to be the order of the day. ■