Behind the push toward co-investing (Subscription Required)
By Bob O'Brien

Updated 04:06 PM, Dec-04-2015 ET

In the private equity universe, general partners and limited partners tend to be the kind of zoo animals that are commonly displayed, but best kept in separate enclosures.

The GP's role - sourcing deals and managing portfolios, collecting fees and a share of the profits from those functions - tends to be distinct from the LP's role: providing capital, collecting returns and, not incidentally, paying the fees that keep the lights on in the GP's offices.

However, increasingly, the two financial classes - distinguished by their sources of capital, their compensation structures and their very reasons for going to work in the morning - have been co-mingling. Their paths converge in an investment strategy called co-investing, a trend that has grown into an investment strategy that's become commonplace.

And while some trends in private equity have something of a faddish quality to them - how many club deals have been executed recently, especially versus a decade ago? - co-investing shapes up as an increasingly significant part of the PE landscape.

"The trend in co-investing has definitely started, and it's only gaining momentum," Kim Brady, senior managing director and co-head of principal Investing with Solic Capital LLC, a suburban Chicago investment bank, said in a recent interview.

According to a survey from Cambridge Associates, a Boston-based provider of investment advice and research to institutional investors and private clients, which recently published a study of co-investing, LP co-investment activity accounts for up to five percent of overall private investment activity? Anecdotal comments from PE professionals suggested that as many as half of all institutional investors are demanding co-investment opportunities of their general partner managers.

Nearly half of the buyout co-investments that Cambridge Associates surveyed proved to outperform the sponsoring GP's funds. Buyout-focused co-investment fund portfolios outperformed global buyout funds in seven of 10 vintage years, the firm learned.

A research report commissioned by Pepper Hamilton LLP concluded that 62% of the current investors in private equity funds are capitalizing on co-investment opportunities. "The survey results show that PE firms are becoming increasingly hungry to offer LPs the chance to invest and are being more proactive than reactive," the study concluded.

"Most of these investments are done with existing LPs," Bruce Fenton, partner in the private equity practice group at Pepper Hamilton, said in a recent interview.

"It's simply a matter of the PE sponsor being able to say, 'We're giving you an opportunity to invest alongside of us.'

"They're saying, in effect, that we're not just collecting capital from our LPs," he added. "Instead, they're saying 'We want you as an active investor, not a passive partner.'"

Of course, there are tradeoffs in this. When general partners offer co-investment opportunities to their limited partners, they're relinquishing the management fees and carry - the two percent and 20% that comprise the remuneration of the private equity business - that come with passive investments. Inasmuch as PE firms tend to be pretty devoutly capitalistic in nature - BMWs and Hampton's beach houses aren't generally given away in raffles, after all - emphasizing the profit motive tends to be a driving construct of the private equity model. So then why relinquish fees that they'd otherwise feel entitled to?

In part it's because limited partners have gotten increasingly aggressive in their demands for co-investment opportunities. "There's the obvious lure of averaging down fees and carry," David Brett, partner & head of co-investments at Adams Street Partners, a private equity firm with $27 billion assets under management, said in an interview. "It's become such a priority for those investors."
Co-investments also represent a good opportunity to finance transactions in ways that increase the equity and thereby limit the leverage on the underlying asset, an increasingly attractive characteristic in the face of the retrenchment of investment banks as financing sources, and the prospect that higher interest rates going forward could hinder financing terms.

"Private equity firms understand that's it's beneficial to gain access to a reliable source of capital in a way that allows them to increase their investments," Kimberly Mann, partner in the investment funds practice at Pillsbury Winthrop Shaw Pittman LLP in New York, said in an interview. "It's definitely an increasing trend that I'm seeing in our practice."

Especially for nascent fund-raising efforts, the option of co-investing heightens the appeal. "You'll see that some managers use co-investment opportunities as a carrot to get the LP to invest in the fund," said Scott Reed, head of U.S. private equity strategy at Aberdeen Asset Management PLC. "It's a way to court favor."

Co-investing also allows general partners to reduce their portfolio's exposure in an under-performing investment. "In this climate, it's a way for GPs to lay off some of their risk," said Andrew Apfelberg, corporate and finance partner with Greenberg Glusker Fields Claman & Machtinger LLP in Los Angeles. "On top of that, it allows them to effectively punch above their weight, as it were."

Meanwhile, club deals, the once-popular strategy in which two or more PE firms would partner up to buy assets, usually associated with big-ticket purchases, has virtually disappeared, hurt by the concept's occasionally colossal blunders - **Energy Future Holdings Corp.** and Toys R Us come to mind - changes in the regulatory backdrop and just a general distaste among PE partners to share management responsibility, not to mention profits. Co-investing helps fill the capital void that club deals once assumed.

"If you need to fill out the capital structure for an investment, some managers are relying on co-investing rather than embracing the club structure," said Aberdeen's Reed.

To be sure, co-investments aren't a replacement for club deals. Co-investment amounts tend to be significantly smaller capital commitments than the old club-deal structure. The overwhelming majority of co-investment opportunities, as described by Pepper Hamilton's Fenton, are what are referred to as "tag-along" deals in which the limited partner is a minority investor in the transaction.

Many of the investments are cropping up after the general partner has agreed to make the purchase, so the GPs are effectively syndicating the transaction to the investment community after having already sourced and negotiated the transaction.

Co-investing can also prove beneficial in closing the transaction. Sponsors negotiating with an asset's owners can point to their co-investing partners as a sign of stability, effectively saying, "No, we're not just buyout shop you don't know much about, we're also partnering with an insurance company or teachers' pension plan that you recognize quite well."

"Certainly, if the business owner is retaining a significant equity position in the asset, they'll care very much who their buyers' business partners are," said Greenberg's Apfelberg.

There are, of course, execution risks in structuring co-investment transactions. Not everybody takes the same approach to fashioning those investments. **HGGC LLC**, for instance, has adapted a somewhat pioneering approach. "Many GPs offer separate investment vehicles to their co-investment partners," Richard Lawson Jr., chief executive officer, managing director and co-founder of HGGC, said in a recent interview. "We've offered our partners fee-free co-investment opportunities within the structure of our principle transactions.

"We feel that, in the middle market, where we're focused, relationships with our capital sources matter," Lawson added.

If there's a risk to the co-investment concept going forward, it could be in the regulatory environment. Most PE professionals agreed that the SEC, in this post-Dodd-Frank world, is focusing more on disclosure and transparency in investing. Co-investing would only heighten those sensitivities. It remains to be seen where the SEC is going to come down on disclosure requirements or whether the Committee on Foreign Investment in the U.S. will scrutinize foreign LPs investing alongside GPs.

Nevertheless, given the benefits of the closer relationship between GPs and LPs that co-investment affords, there's no expectation that the concept is going to go the way of the club deals.

"In a co-investment context you can genuinely network in a way that allows you to get to know your limited partners in the context of an actual deal," said Pepper Hamilton's Fenton. As the firm's recent report concluded, "The PE industry must continue to look for creative ways to raise funds and generate returns." And it described co-investments as “one method of providing this opportunity."