Evolving together: Latest trends in co-investments

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Co-investment transactions have become a staple of today's private equity landscape.

A strong private equity market has helped fuel co-investment activity as co-investors look to increase their private equity exposure on a reduced-fee basis and sponsors look to attract additional capital to access larger deals. Here are some of the latest trends we are seeing in the co-investment market.[1]

Fee terms

One of the primary selling features of co-investments for investors is the reduction or no management or carried interest fees at the co-invest level. This remains true for traditional co-investments in which the co-investors invest alongside the sponsor's primary fund. However, we are seeing an increasing number of co-investment-type transactions by "fundless sponsors"—sponsors that have not raised a fund but instead raise capital on an investment-by-investment basis. These transactions often have terms much like those of a traditional co-investment.

Since the fundless sponsors do not benefit from a management fee or carried interest from a fund, however, these co-investments often provide for both. This does not mean co-investors are being charged the 2% management fee with a 20% carried interest typical for an investment in a private equity fund. Instead, fundless sponsors are charging investors a lower management fee and a range of carried interest (usually, from 5% to 20% or higher) that is tiered based on the investment meeting specified performance metrics such as IRR or MOIC. In these structures, once a performance target is achieved, the carried interest increases to the next tier. To investors, the benefit of this approach is getting access to these transactions at lower fees than if they were to get their exposure through a fund investment, while the tiered carry structure incentivizes the sponsor to properly manage the investment.

Dedicated co-investment vehicles

Typically, once a sponsor has sourced a deal with a co-investment opportunity, it will set up a special purpose vehicle to pool the co-investors' capital and make the investment in the target. The co-investors will negotiate with the sponsor with respect to the terms of the special purpose vehicle and their equity allocation for each specific co-investment opportunity. A phenomenon we are seeing more often, however, is sponsors setting up dedicated co-investment vehicles, with co-investors committing a specified amount in the vehicle upfront, before any deal opportunities are sourced. It is then at the sponsor's discretion to allocate co-investment opportunities to the dedicated co-investment vehicle, at which time capital is drawn pro rata from all co-investors committed to the vehicle.

Dedicated co-investment vehicles give co-investors access to a stream of co-investments with just a single negotiation on terms, but the cost is giving up the discretion over co-investment selection and allocation.

The dedicated co-investment vehicles typically reflect the standard co-investment fee arrangement of reduced or no management fee or carried interest. This structure facilitates deal execution as it eliminates the need for sponsors and co-investors to negotiate co-investment terms for each transaction. It also gives the sponsor another pool of committed capital from which it can draw to complete a transaction, which means that the sponsor's primary fund does not need to fund in excess of its target equity allocation at closing and then rely on a successful syndication to achieve its target allocation. While this structure gives co-investors access to a stream of co-investment opportunities with preferential economics, the drawback for co-investors is that they lose the ability to choose the co-investment opportunities in which they would like to participate. Instead, they automatically participate in all co-investment opportunities the sponsor allocates to the dedicated co-investment vehicle.

Co-investment timing

The majority of co-investments still involve a syndication of the interest of the sponsor's primary fund in the period either after signing the M&A agreement or after closing the transaction. However, as the average size of private equity-led buyouts increases (due in part to the rise of mega-deals), sponsors are looking for commitments earlier during the transaction process in order to pay larger purchase prices. Sponsors are therefore increasingly approaching co-investors before the transaction is signed, asking them to commit to funding the transaction through an equity commitment letter either in favour of the seller or the sponsor. Committing pre-signing introduces a new set of issues that syndication co-investors do not have to deal with, such as liability for payment of any termination fee, sharing in broken deal expenses and the conditions that must be satisfied before co-investors are required to fund the transaction. These types of transactions often take place on a compressed time frame as the pressure of signing the transaction looms.

As a result, typically only large and experienced co-investors come in at this stage of the transaction. An upfront commitment gives sponsors committed capital to go after larger deals than they normally would. In exchange for signing an equity commitment letter in advance of the transaction signing, and thereby sharing in the uncertainty the deal may not ultimately sign or complete and potentially sharing in a termination fee, anchor co-investors can get a larger equity allocation and better terms in the underlying investment than syndication co-investors who come in later in the process.

Stapling

The superior economics of co-investments puts them in high demand among investors. Sponsors have capitalized on this by using co-investment opportunities as an incentive for investors to commit to their primary fund. One way that sponsors do this is by approaching potential co-investors who are not already limited partners in their primary fund with an attractive co-investment and offering participation in the co-investment with an expectation, or in some cases on the condition, that the co-investors also commit a fixed amount to the sponsors' primary fund.

Quasi-stapling is about relationship building, enabling a co-investor to gain comfort with the sponsor's investment team, process and reporting—and potentially leading to investment in their primary fund.

This stapling of the co-investment allocation to a fund commitment allows sponsors to increase the capital committed to their primary fund where they receive full management fees and carried interest. Investor appetite for co-investments is so strong that investors are often willing to make the commitment to the primary fund in order to get their desired co-investment allocation. We are also starting to see sponsors use co-investments to build or grow relationships with prospective or existing limited partners through quasi-stapling. That is, sponsors offer co-investment opportunities to investors who are not currently limited partners in their primary funds with the aim of

securing an investment in one of the sponsor's primary funds in the future. This approach does not require the investor to commit to investing in any of the sponsor's funds; it is about relationship building, allowing a co-investor to become more comfortable with the sponsor's investment team, process and reporting. In turn, this can lead to participation in the sponsor's next fund.

Conclusion

As the building interest in alternative investment structures shows no signs of slowing down, co-investments will remain popular. We expect transaction structures to continue to evolve to meet market needs. As we have advised both investors and sponsors on numerous co-investment transactions in the past several years, our team will remain at the forefront of any new developments.

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[1] These trends apply to passive co-investments. For an overview of the differences between passive and active co-investments, see "Side by Side: Navigating Co-Investments."