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Co-investment: Maintaining the right access

Candice Choh and Andrew Friedman of Gibson Dunn outline how firms should manage their LP co-investment programmes.

Many private equity investors today view a bite – or several – at the co-investment apple as an integral piece of a sponsor's overall value proposition, providing an opportunity to reduce the advisory and performance fees paid to the sponsor as a percentage of dollars invested.

When it comes to feeding investor hunger for enhanced direct exposure to investments, a robust and well-managed co-investment programme can be an important competitive differentiator for private equity sponsors. By the same token, a poorly defined or managed co-investment programme may frustrate investors and undermine a sponsor's reputation.

Sponsors should take care to administer co-investment opportunities in a manner that will be viewed – by investors and regulators alike – as organised and fair. In particular, on multiple occasions, the Securities and Exchange Commission has publicly announced an enhanced focus on co-investment allocations by private equity sponsors.

An ad hoc approach runs the risk that limited partners will perceive the process as arbitrary. A consistent set of standards, even subjective ones, systematically followed and proactively communicated in advance, may help sponsors effectively navigate demand for co-investment opportunities while aligning parties' expectations.

Of the 25 largest private equity sponsors in the PEI 300 in May, most disclosed in their 2015 Form ADV brochures some version of a formalised co-investment policy. The features of a co-investment policy differ from firm to firm and will be subject to any specific allocation requirements and procedures set out in the fund's governing documents, as well as to any rights pre-negotiated with particular investors in side letters. However, when designing a policy to govern those situations where the fund documents either do not include specific allocation procedures or allow the sponsor discretion in making allocation decisions, firms should consider addressing, among other things:

- whether allocations will be pro rata or at the sponsor's discretion (and if so, what criteria the sponsor will use and how they will be weighted);
- whether particular investors or categories of investors will have first priority;
- how the fund intends to allocate fees and costs (in particular broken-deal costs) associated with the co-investment.

Based on our survey of Form ADV brochures filed by the 25 largest private equity sponsors, more than half of surveyed firms also expressly disclaimed any guarantee as to the availability or size of co-investment opportunities for the investors who express interest in them.

The co-investment policies we reviewed commonly described the following discretionary factors that a sponsor would consider in allocating co-investment opportunities:

- whether the investor has previously expressed interest in co-investment opportunities;
- the investor's financial resources and ability to invest within a particular time frame;
- the sponsor's past experiences and relationships with the potential co-investor and assessment of its long-term commitment to the firm;
- whether participation of the potential co-investor may provide strategic benefits to the investment, the fund or future funds of the sponsor, including increasing the likelihood that the co-investor would invest in future funds of the sponsor;
- whether the potential co-investor's participation may implicate legal, regulatory, reporting, public relations, media or confidentiality concerns.

By adopting such a policy on co-investment, sponsors may benefit from the discipline of an overall framework without necessarily foregoing a significant degree of discretion to allocate co-investment opportunities within the overall framework as they see fit. This appears to be the favoured approach among today's largest sponsors. ☐

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