Private equity


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Compelling case for co-investment

For global alternative fund managers, the fundraising environment has been challenging in recent years, but one area is surging in popularity: co-investments. A recent industry survey shows that 88% of institutional investors plan to allocate up to 20% of their capital to this strategy.

At its heart, co-investment is simple: investors step into the deal alongside the sponsor, usually when the flagship fund managed by the sponsor cannot take the entire exposure due to size or diversification limits. Some of these opportunities are structured through deal-specific vehicles, others through overage funds, being dedicated pools raised alongside the main fund to invest opportunistically. These may involve a single or multiple investors, with the option to opt in or out of each opportunity.

For limited partners (LPs), the case for co-investment is compelling. The economics are often far more favourable than blind pool investments, with 'no fee, no carry' offers increasingly common – a recent industry survey found two-thirds of co-investment deals charged no management fee, and over half charged no carried interest. Beyond the cost savings, co-investments open the door to direct deal participation, offering greater visibility, tactical allocations and faster capital deployment compared with blind pool funds. LPs who are able to act swiftly or with significant expertise can strengthen relationships with sponsors, sometimes negotiating more advantageous terms or acquiring a stake in the sponsor business.

The growth of co-investments, however, is not solely driven by LP demand. Sponsors have strong incentives. Offering 'no fee, no carry' co-investment opportunities helps sponsors maintain ties with existing investors and attract new ones. Co-investments also provide access to larger pools of capital. For emerging managers, the ability to deploy additional capital through co-investments accelerates track-record building. And even when offered on fee-free terms, co-investments can still generate revenues for sponsors through charging performance fees and administration charges or retaining transaction fees.

Co-investments present a number of recurring issues for all parties. One of the most fundamental is alignment. Because co-investors are typically passive participants, they rely on the 'in together, out together' principle. This ensures that co-investors acquire and dispose of the same securities, in the same proportions, and on the same terms as the main fund, avoiding conflicts.

Fees and carry treatment are another area where market practice continues to vary. Around two-thirds of managers offer co-investments with no management fee at all. Of those who do charge, most apply a reduced fee, although roughly one in 10 charge the same management rate charged to the main fund. More than half of the respondents indicated they do not charge carried interest.

Broken-deal expenses remain a contentious subject. Sponsors often argue that co-investors should bear their pro rata share of broken deal expenses, but co-investors view their involvement as supplementary to the investment made by the main fund, and consider their commitment to be contingent upon the completion of a deal. While this discrepancy has led to tension, primary funds continue to bear a significant portion of broken-deal costs. The Private Funds CFO Fees and Expenses Survey 2024 reveals 73% of broken-deal costs are borne by the main fund at data room review stage.

Transaction fees are another contentious topic. These are fees received by the sponsor and its affiliates as a result of services performed for the benefit of the fund or any portfolio company. In traditional blind pool funds, these fees are generally offset against the management fee. In co-investments, where no management fee exists to offset, sponsors often retain these fees, turning them into compensation. Increasingly, co-investors are pushing back, demanding detailed information about these fees and related monetary agreements. In some instances, they may request consent rights over any significant changes to such agreements.

Allocation of investment opportunities is another topic of interest. Determining the appropriate size for the main fund without knowing the exact amount of co-investment capital that will be raised is a complex task and requires careful planning to ensure that the allocation of opportunities aligns with the sponsor's written policies. Proper documentation and disclosures (such as in Form ADV Part 2) are crucial to avoid conflicts and maintain transparency.

Finally, many co-investors want clarity on whether follow-ons are elective or mandatory, and frequently negotiate pre-emptive rights to ensure they can participate in follow-on investments made by any fund vehicle managed by the sponsor or its affiliates, not just those 'offered' to the co-investment vehicle. Co-investors often request that pre-emptive rights apply to any opportunities (both equity and debt investments) in the portfolio companies as well as subsidiaries.

Other key terms that LPs tend to consider:

- How much will co-investors be required to commit? If the co-investor is scaled back, will other co-investors and main fund be scaled back pro rata?
- Will expenses be on top or within the co-investor's commitment? Are there caps on organisational and operating expenses?
- Does the LP need to conduct its own regulatory analysis and/or monitor aggregate holdings to avoid being named in anti-trust, foreign direct investment or Committee on Foreign Investment in the United States filings?
- On exits, will co-investors have the right to participate proportionally and on the same price and terms? Are there any restrictions on selling their interest?

Regulatory bodies such as the FCA and SEC are increasingly scrutinising sponsors' activities in this area. On 25 February, the FCA sent a 'Dear CEO' letter addressed to asset management and alternatives firms, announcing a multi-firm review focusing on conflicts of interest, allocation and valuations. The industry anticipates that the FCA and SEC may introduce additional rules regarding the allocation of investments and valuations in the near future.

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