Co-investments — a primer

Private market insights
Co-investments — a primer

For many institutions active in the private markets, investing in co-investments has become a critical piece of developing a balanced private markets program. While co-investments potentially offer the promise of higher net returns, they also come with risks and other considerations that are different from investing through a private market fund. This primer explores the potential benefits and risks of co-investments, the various ways that limited partners (LPs) can implement co-investments into their program and critical factors for LPs that are considering co-investments.

What are co-investments?

Co-investments are private market investments into a single company instead of a diversified blind pool portfolio, such as a primary private market fund. Co-investments are made alongside the general partner (GP) of a private market fund which is investing at the same time and principally on the same terms and conditions. Co-investments are made either directly into the target company or through a commingled vehicle or special purpose vehicle (SPV). The GP of the private market fund sponsoring the investment is typically also the GP of the SPV.

Co-investment opportunities arise when a private market manager identifies an attractive transaction requiring the private market fund to invest more equity than its diversification or other limits allow. Rather than missing an attractive opportunity, private market fund managers syndicate the excess equity investment to their funds’ LPs or other strategic partners.

Allocations of co-investment opportunities vary based on the private market manager and/or the specific transaction. They have historically been offered only to a private market fund’s largest and most sophisticated LPs or those who bring some strategic value to the transaction.

Co-investments are exited at the same time and on principally the same terms as the sponsoring private market fund exit.
Reasons for considering co-investments

Co-investments can be an additive part of a diversified private market program. Co-investments could provide multiple benefits to LPs:

1. **Potential lower fees**
   - Co-investments can enable investors to access underlying investments at potentially reduced or zero management and performance fees.

2. **Potentially improved net returns**
   - Due to potential lower fees, co-investments may drive higher net returns if certain multiples are achieved.

3. **Accelerated capital deployment/J-curve mitigation**
   - Co-investments can facilitate a private market program reaching its target allocation sooner, through more rapid capital deployment.
   - Upfront funding and potential fee savings can reduce the J-curve effect.¹

4. **Diversification and control**
   - Co-investments provide flexibility to target investments by strategy, geography, industry or deal size, which helps to achieve the desired allocation while providing diversification, depending on deal flow.

5. **Closer relationships with GPs**
   - LPs can develop deeper relationships with GPs by working directly with them on co-investment projects.

6. **Knowledge transfer, transparency and alignment**
   - Co-investments allow LPs to obtain firsthand knowledge of how the GP executes the deal process, providing increased transparency and alignment of interest.
   - LPs also can gain a deeper understanding of certain industry sectors.
   - Co-investments help inform LPs’ judgment and could potentially lead to improved fund selection.

7. **Enhanced team retention**
   - LPs can expand their internal capabilities and acquire valuable experience in direct investments.

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¹ See Mercer’s paper: “The flattening of the private equity J-curve” September 2020.
Potential risks to consider

While the benefits associated with co-investing could be significant, confusion persists within parts of the institutional investor community about the downsides related to co-investing. The key risks associated with co-investing are summarized below:

1. **Concentration risk**
   - In a portfolio with a more concentrated number of investments, a single investment’s returns can dominate performance, positively or negatively.
   - Concentration risk can happen across various dimensions (manager/industry/geography). The amount of capital invested per manager/industry/geography should be monitored. Many LPs institute a maximum percentage of commitments across the entire portfolio that can be invested in any one dimension.

2. **Resource intensiveness**
   - A successful active co-investment program requires dedicated investment professionals.
   - This can be costly and time-intensive.

3. **Performance**
   - Risk characteristics differ from fund investing and co-investments could have a greater dispersion of outcomes.
   - Performance can vary (based on approach or GP relationships, for example).

4. **Adverse selection**
   - A GP could execute deals that are above its normal investment range.
   - An LP’s desired investment size can limit the opportunity set.
   - However, some experienced co-investors view adverse selection as more of a myth than a reality.

5. **GP relationships**
   - Executed well, co-investments can enhance GP relationships. Executed poorly, co-investments can damage relationships and hinder future fund access and co-investment deal flow.

6. **Headline risk**
   - Co-investments could expose LPs to headline risk if a high-profile investment goes bad or develops public relations issues.
Implementation options

There are various ways to implement co-investments into a private market program. Investors who actively participate in co-investments typically use one of the following implementation approaches:

Figure 2. Common co-investment implementation options

<table>
<thead>
<tr>
<th>Pros &amp; Cons</th>
<th>Resource Requirements</th>
</tr>
</thead>
<tbody>
<tr>
<td>+ Simplified reporting</td>
<td>• No additional resources required</td>
</tr>
<tr>
<td>+ Potential to pool deal flow</td>
<td></td>
</tr>
<tr>
<td>+ Ability to develop more fully diversified portfolios</td>
<td></td>
</tr>
<tr>
<td>- No discretion or ability to tailor</td>
<td></td>
</tr>
<tr>
<td>- Additional layer of fees</td>
<td></td>
</tr>
<tr>
<td>+ Simplified reporting</td>
<td>• Depending on structure, some additional resources</td>
</tr>
<tr>
<td>+ Ability to tailor (portfolio &amp; involvement)</td>
<td></td>
</tr>
<tr>
<td>+ Investor holds ownership of relationship</td>
<td></td>
</tr>
<tr>
<td>- Additional layer of fees</td>
<td></td>
</tr>
<tr>
<td>- Must rely on Investor’s GP relationships</td>
<td></td>
</tr>
<tr>
<td>+ Fully tailored approach</td>
<td>• Additional level of resources required</td>
</tr>
<tr>
<td>+ Investor is responsible for decision</td>
<td></td>
</tr>
<tr>
<td>+ Advisor assists in sourcing and diligence</td>
<td></td>
</tr>
<tr>
<td>+ Lowest cost</td>
<td></td>
</tr>
<tr>
<td>- Must rely on Investor’s GP relationships</td>
<td></td>
</tr>
<tr>
<td>+ Fee advantages</td>
<td>• No additional resources required</td>
</tr>
<tr>
<td>- No discretion or ability to tailor</td>
<td></td>
</tr>
</tbody>
</table>

Source: Mercer

When determining the appropriate implementation approach, LPs should assess various criteria, particularly if they are considering handling co-investments internally. LPs should have internal resources and experience available, as co-investments require additional resources, specific expertise and a proactive approach with GPs. To source co-investment deal flow from GPs, LPs must build strong GP relationships, maintain ongoing communication with the GP, establish their position as a “preferred” LP and have a reputation as a good partner.

Furthermore, transaction timelines for co-investments are typically much shorter compared to primary fund investments. Therefore, an LP’s process efficiency and ability to execute are critically important. LPs need to respond quickly to GPs, efficiently analyze the transaction and develop a definitive viewpoint. Missteps can result in the loss of further co-investment opportunities and potentially damage relationships with GPs, which could hinder future fund access.

Lastly, LPs need to recognize it is “co-investing,” not “co-leading,” and acknowledge the need to be a good partner with the GP.
Key factors for LPs considering co-investments

Mercer has participated in co-investments for many years. During this time, we have witnessed many approaches to co-investment — some successful, and some less so. As a result, we have developed critical considerations for LPs interested in co-investments, regardless of whether they are pursued internally or outsourced to a third party.

Partner with the right GP

In Mercer’s view,² developing a strong co-investment program requires partnering with highly rated GPs. LPs should evaluate the GP’s quality, the GP’s angle on the deal and the GP’s value-add experience to ensure the transaction is squarely in line with the GP’s strategy, capabilities and historical success.

 Adopt a disciplined approach

The most successful co-investment programs to date embrace a disciplined approach. LPs that have pursued consistent and diversified capital deployment in terms of vintage year and deal size have, we believe, typically fared better when economic and/or market conditions have changed.

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