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Co-investment rights in private equity funds: Here to stay

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As we close out 2016 with deal volume down in the private equity space, much attention is being paid to PE's so-called "dry powder" – their unspent cash reserves on hand. According to Preqin's "2016 Preqin Global Private Equity & Venture Capital Report", the global amount of dry powder has now topped US$1.3 trillion, the highest since the data provider's records began in 2000. This growing pile of cash reserves is not surprising given that the buy-out space is becoming increasingly crowded. Not only are there new private equity firms emerging all over the globe, but the competitive landscape is also shifting with Chinese multinationals, sovereign wealth funds and pension funds all wielding their financial clout and confident in their ability to make direct and often solo investments.

Case in point was the October announcement that the Ontario Teachers' Pension Plan had agreed to buy the Canadian operations of Constellation Brands for $1.03 billion. The dominance of the Canadian pension plans in the domestic and international M&A game is nothing new. As *The Economist* explored in its October 22, 2016 article "The Barbarian Establishment," many "other kinds of entities with access to cheap and often state-related capital have entered the buy-out market." Given their investment capability and expertise, not to mention their deep pools of capital, these buyers are more and more often seen as direct single buyers when quality assets and businesses are put up for auction.

Data over the past several years show that appetite for direct investments by limited partners in private equity and venture capital deals has remained elevated. PitchBook Platform data found that in 2015, limited partners were involved in 168 completed deals, a 23% rise from 2012. This appetite for direct investing can be troubling for the general partners of private equity funds who have historically relied – and continue to rely – on investments in their funds from institutional investors such as sovereign-wealth funds and pension plans.

What does it mean when your investor client becomes your competitor? For most funds, it means continuing to allow co-investment rights (and accompanying lower fees) in the hope that the large LPs will decide not to invest directly but rather be alongside the fund as a co-investor. To withhold co-investment rights or structure or price them in a manner inconsistent with the market gives rise to the risk that these deep-pocketed limited partners walk away from the fund. According to Preqin's report on private equity co-investment, 69% of general partners actively offered co-investment opportunities to their limited partners, and a further 18% are considering doing so in the future. On the other hand, according to the report, 26% of limited partners are actively co-investing and 24% are opportunistically co-investing.

Historically, investors agreed to commit monies to a fund sponsor (the general partner) and the partnership agreement would, among other things, dictate how the general partner would allocate capital, requirements for asset diversification, the target investment size and the timing for exiting investments. While this is still the process, it is now increasingly common for limited partners to require that the fund documents contemplate co-investments. Co-investments allow limited partners to effectively by-pass the fund and invest directly in the targeted company. Co-investments are still coordinated and agreed to by the general partner and the co-investor, but the terms, including the fees payable to the general partner, will vary from those applicable to the limited partners in the fund.

The fees payable to the general partner on co-investments vary from fund to fund and in some cases are zero. Funds with formal co-investment programs will often attempt to set the fee structure at the time of the establishment of the fund. In other funds, the fee and/or carried interest payable will be a matter of negotiation with co-investors at the time of the investment. In either case, the overall fee package for co-investors will usually be lower than the incentive income-sharing arrangements in the main fund (with some funds still commanding the classic 2% management fee and the 20% carried interest arrangement). The availability of co-investment rights can also be a matter of negotiation when funds are being launched; some general partners may grant such rights only to select investors (generally, its largest or most loyal, or those that are perceived to be strategic investors), while others have conceded that all limited partners will be entitled to co-investment rights.

While co-investment rights are gaining in popularity and many LPs demand them in order to invest in a fund, in reality there are still only a limited number of LPs that are able to deliver, given that timing to get the deal done is often tight and the required cheque size can be large. Private equity transactions that anticipate co-investors participating should provide for appropriate deal mechanics and conditions, such as an appropriately drafted non-disclosure agreement permitting disclosure to potential co-investors, and ensure that enough time is given to bring the co-investors to the table.

Some general partners might have preferred the passive money of old. However, most are willing to accept the new state of play and accompanying overall lower fees to ensure the availability of flexible and committed capital**.** Participation by large institutions in a co-investment capacity provides private equity funds with the flexibility to execute large transactions without having to look outside their investor group for third party capital. In a world where deal flow is slowing, committed capital and the ability to show up at the table with a big cheque can make all the difference.

From the limited partner perspective, co-investments can improve their prospects of boosting returns with more favourable fee arrangements and in a more controlled manner. For some, in particular those building out their own internal investment teams, co-investments offer the opportunity to invest alongside experienced general partners, and can give them experience in direct investment disciplines. Given all these positives, it is difficult to imagine that the co-investment trend will slow any time soon.