

# Common Considerations and Complications of Co-Investments

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- ▶ Has led a number of the world's most recognized mergers, acquisitions, public offerings and fund formation transactions



# Introduction

- ▶ Growing use of co-investment vehicles
- ▶ Legal Landscape
- ▶ Practical issues
- ▶ Economic Arrangements
- ▶ Governance Considerations

## *A Tale Of Two Surveys*

Private Equity International

# Fees & Expenses Benchmarking Survey 2018



# Fees & Expenses Benchmarking Survey 2018

Produced in partnership with *pfm*, Pepper Hamilton, PEF Services and WithumSmith+Brown.

The survey was launched in 2014 in response to fund managers' questions about who should pay for various fees and expenses and we have decided to produce the report every two years so that it can be used as a benchmark to compare and review fee-related practices across the industry.

**Interesting findings regarding co-investments.**

Mergermarket and Pepper Hamilton Survey (2015)

# The Co-investment Climate in Private Equity

# The Co-investment Climate in Private Equity

Pepper commissioned Mergermarket in 2015 to survey 50 PE executives from across the United States that have co-invested with an institutional investor within the previous three years.

Interviewees were asked how co-investments fit into their respective portfolio's makeup, and on what basis they are doing deals together. The results were very interesting and we saw that private equity firms were becoming increasingly hungry to offer limited partners the chance to invest and are being more proactive than reactive.

**Many of these findings are still valid today.**

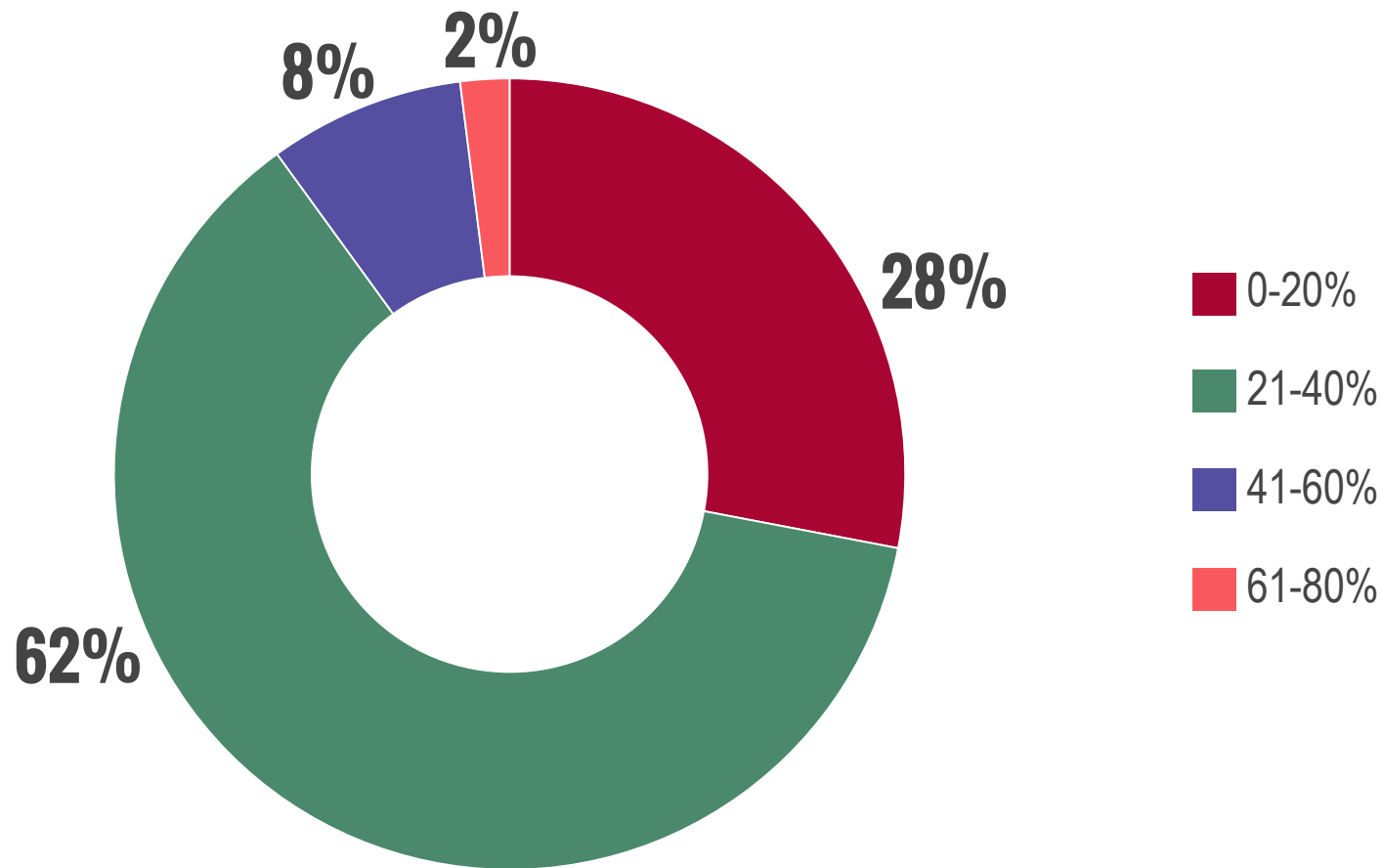


# Popularity of Co-Investments

Growing Use of Co-Investment Vehicles

# State of play - Co-investments in 2015

What percentage of the last ten deals have you closed (in the current fund or a predecessor fund) with the participation of co-investors?



# State of play - Co-investments in 2015

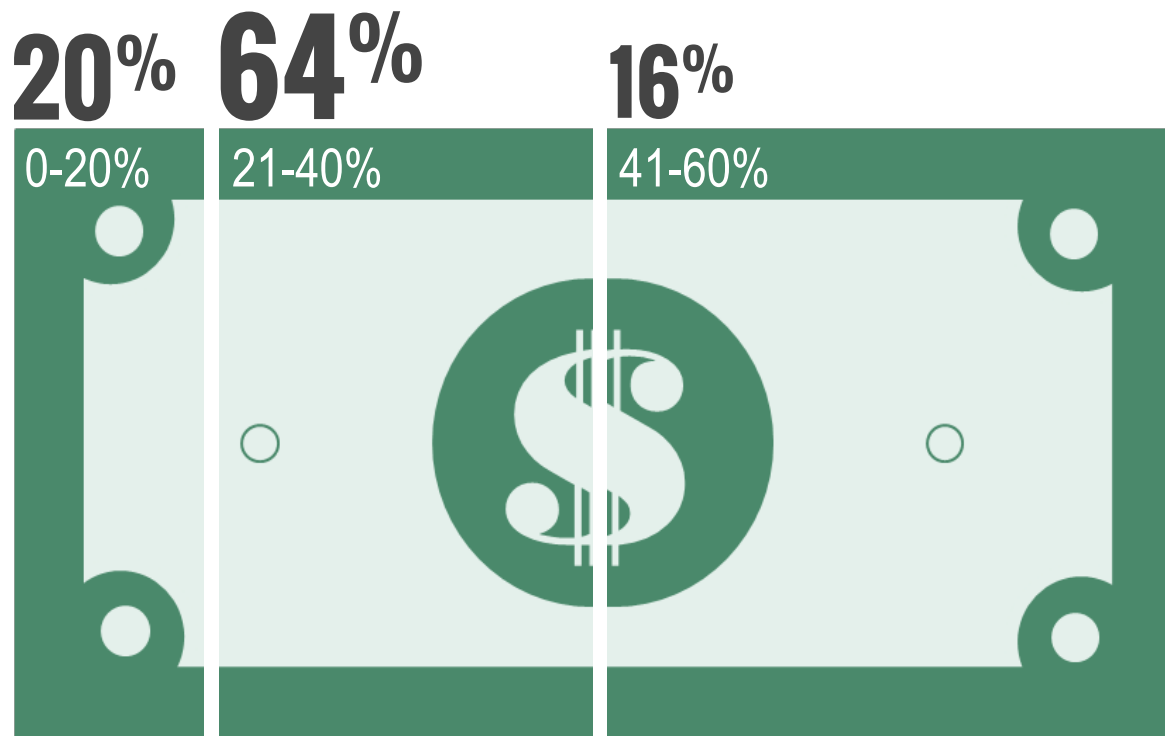
PEPPER HAMILTON VIEW

“ This trend will continue: the best of both worlds benefits of the PE firm maintaining control wand with it the opportunity to justify its carry and management fees, coupled with large enough investments from co-investors to ensure their involvement in managing the investment. At the same time, the PE firm benefits from the opportunity to work more closely with the deal people from the co-investor, thereby ensuring both another deal expert’s focus on the portfolio company, and a closer relationship when the next fund is being raised.

”

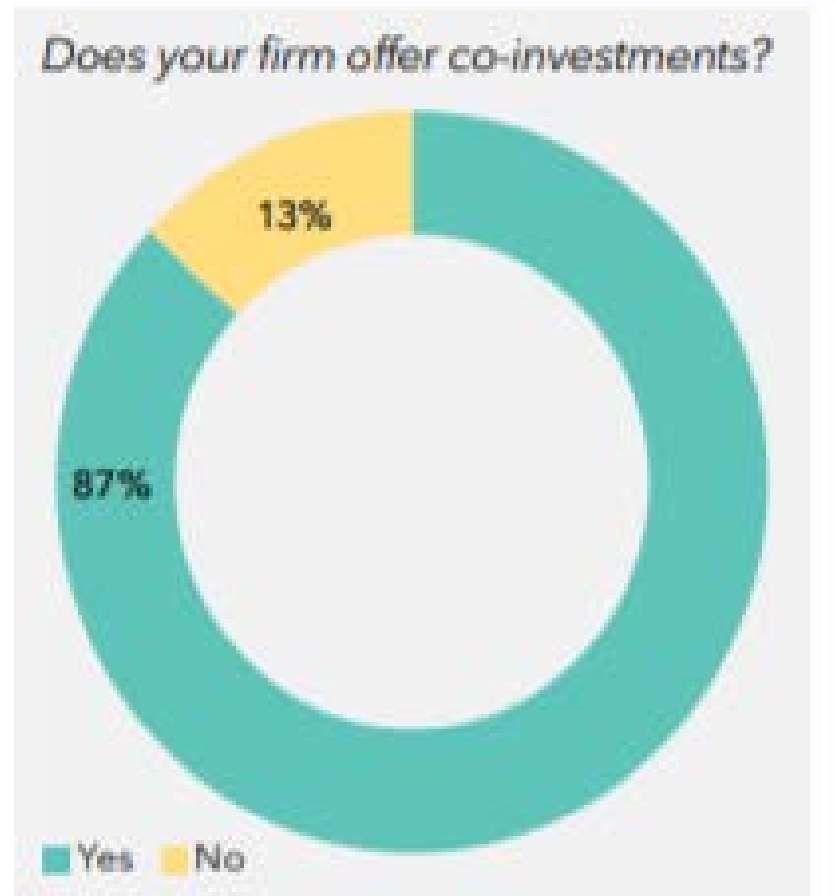
# State of play - Co-investments in 2015

Of the total aggregate dollar value of equity invested in deals done by your fund thus far, what portion of this equity was taken by co-investors?



# Fees & Expenses Benchmarking Survey 2018

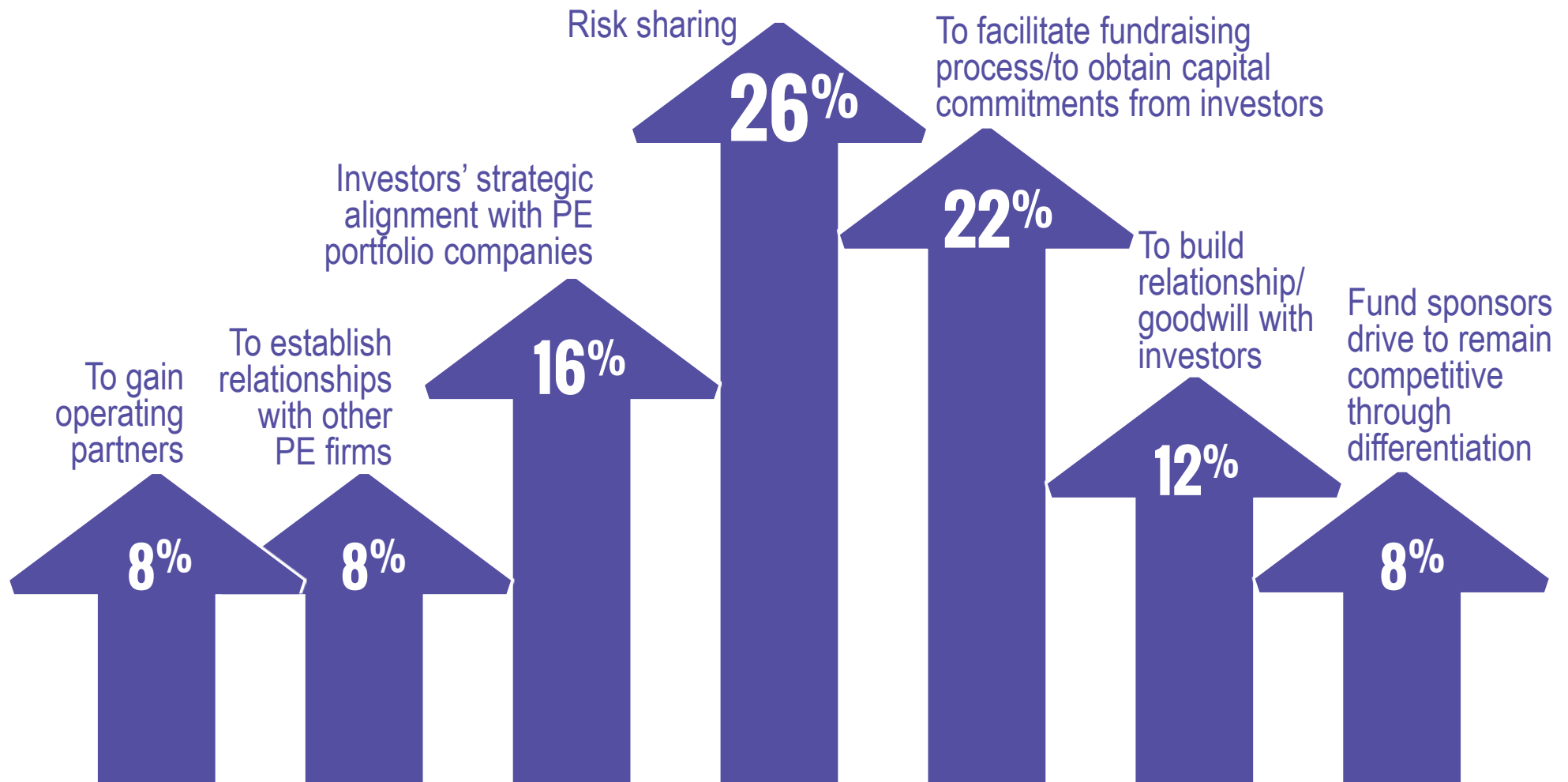
## Co-investment



# The co-investment landscape

## Opportunities and challenges

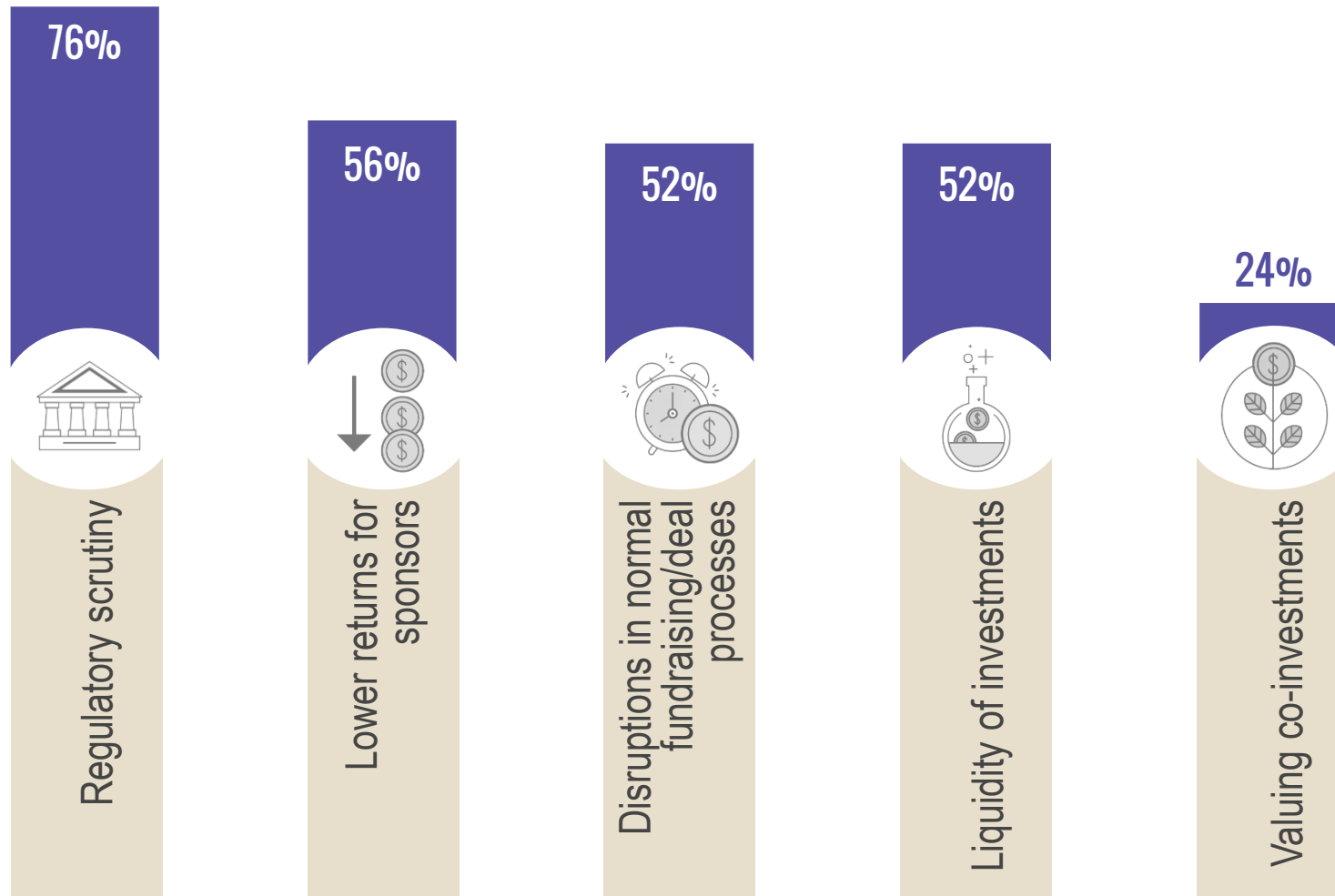
What is the biggest driver today of PE co-investments for PE firms?



# The co-investment landscape

## Opportunities and challenges

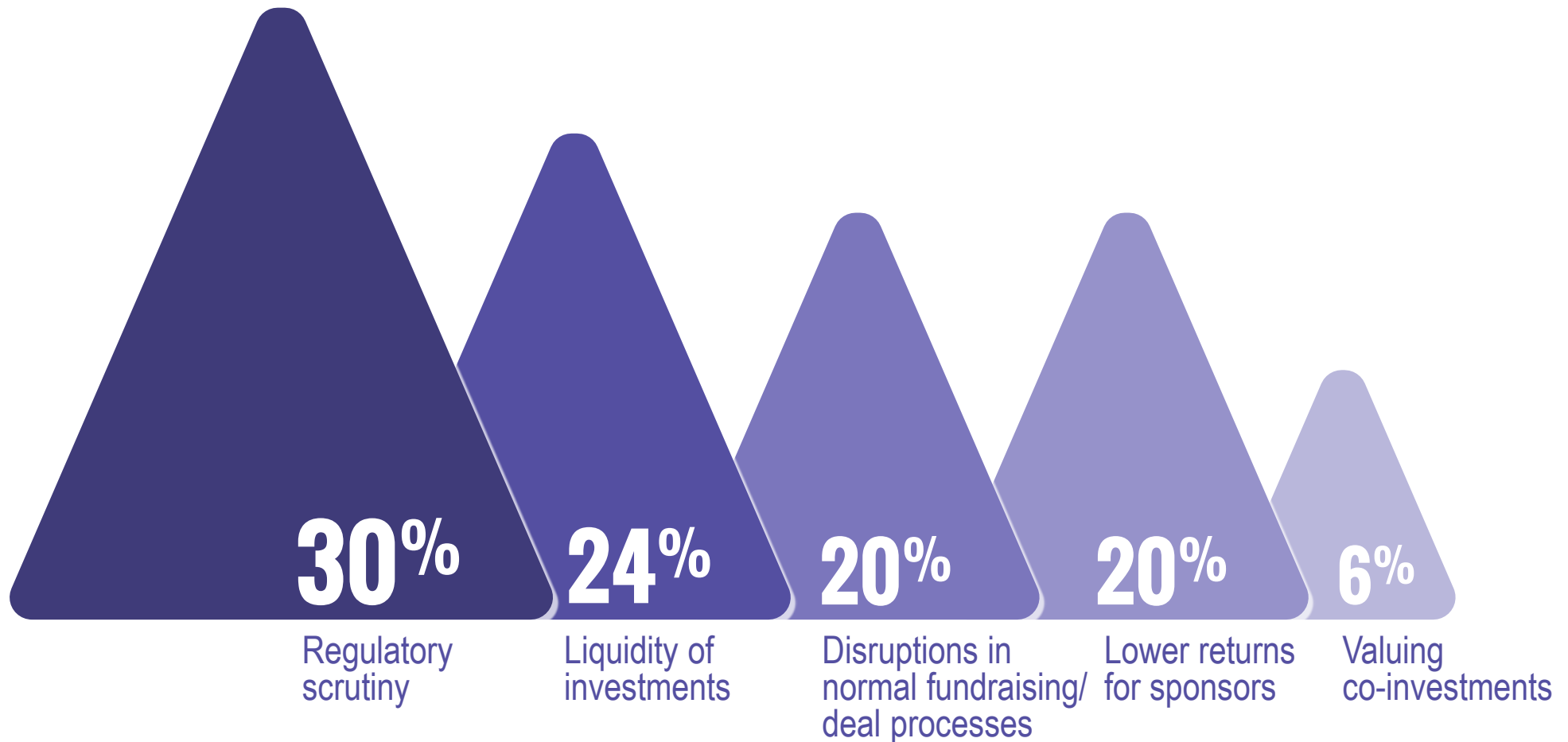
What are currently the biggest challenges to PE co-investments? (Select all that apply)



# The co-investment landscape

## Opportunities and challenges

What are currently the biggest challenges to PE co-investments? (Select the most important)





# And I quote...

## One Manager's view – May 2018

*“Regulators have been very hard-headed with businesses competing in the PE industry, and will continue to seek more information that indicates transparency in terms of investments and the capital flow.”*

# Legal Considerations

## Legal Landscape

# Sample Legal Issues

## Fund Level

- ▶ Documenting why the co-investment vehicle is being used
- ▶ Authorization to do the deal under the Fund LPA
  - Allocation of investment opportunity
- ▶ Side letters
  - Apply to co-investments?
- ▶ Fiduciary Duties and Compliance
  - Waivers customary
  - Compliance Manual
- ▶ Potential for conflict of interest; think about the “what ifs”
  - follow-on down round is classic example
- ▶ LPAC review needed
- ▶ Organizational costs
- ▶ Ongoing expenses
- ▶ Horizon to liquidity

# Sample Legal Issues

## Co-Investment Vehicle Level

- ▶ Direct or Indirect Investment
  - Direct in portfolio company (carry implications)
  - Holding company structure
  - GP controlled SPV
- ▶ Choice of entity
  - tax analysis
- ▶ Securities offering
  - Reg D and new rules
  - If simultaneous, close or sell off a piece afterwards
- ▶ Regulatory
  - Advisers Act “client”; custody
- ▶ Documentation
  - Negotiated or take-it-or leave it?
  - Pre-approved form?
- ▶ Control liability – shared

# Practical Considerations

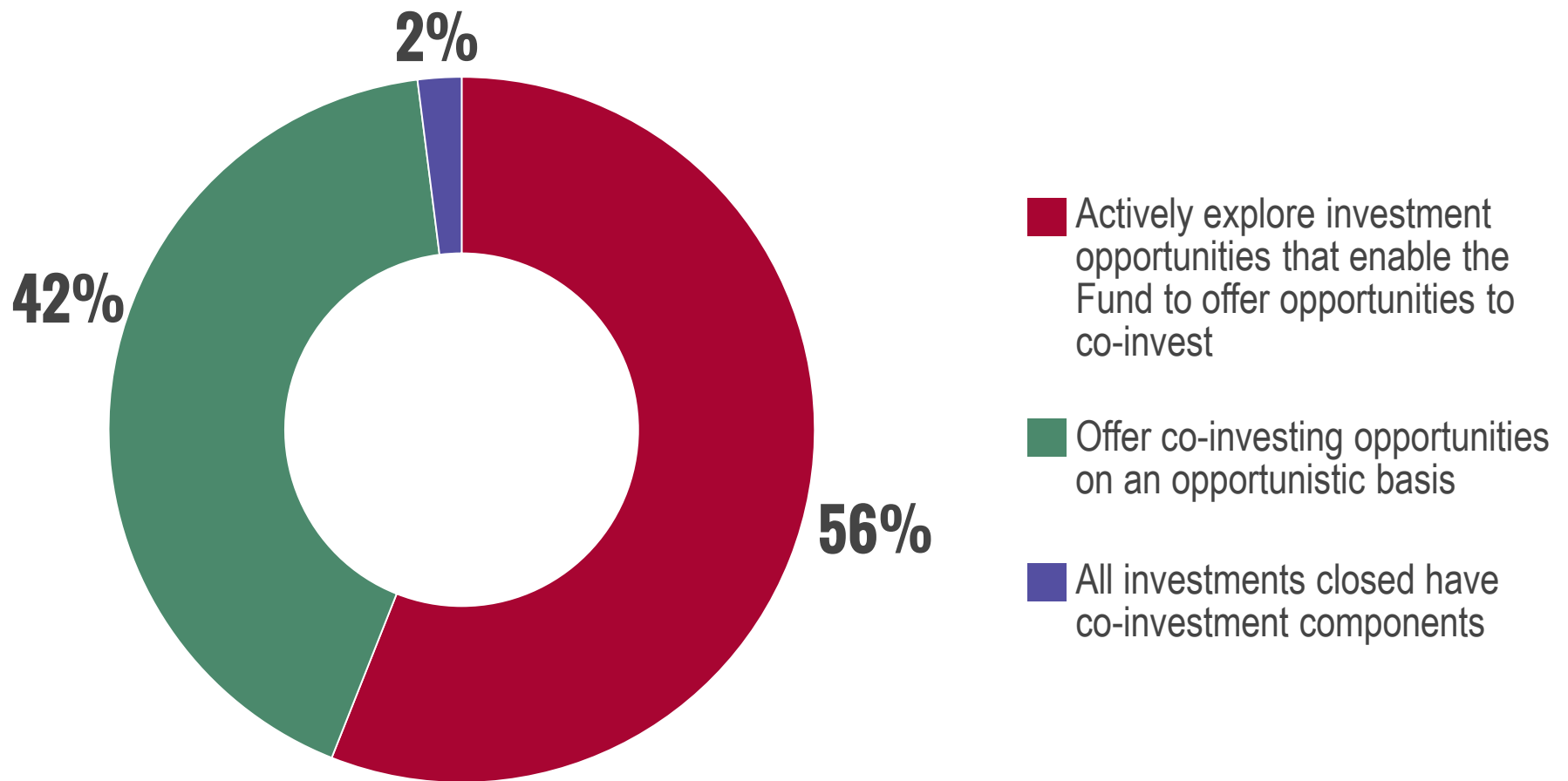
## Practical Considerations

# Practical Considerations

- ▶ Confidentiality Agreements
  - Sharing diligence materials
  - Including co-investors in “representatives”
  - Imposing non-solicits
- ▶ Timing of Closing on Co-Investment
  - Simultaneous close
  - Selling off piece afterwards
- ▶ To Whom to Offer Co-Investment Opportunity
  - Operating partner – most likely goes direct
  - Limited partners
  - Strategic investor
  - GP principals

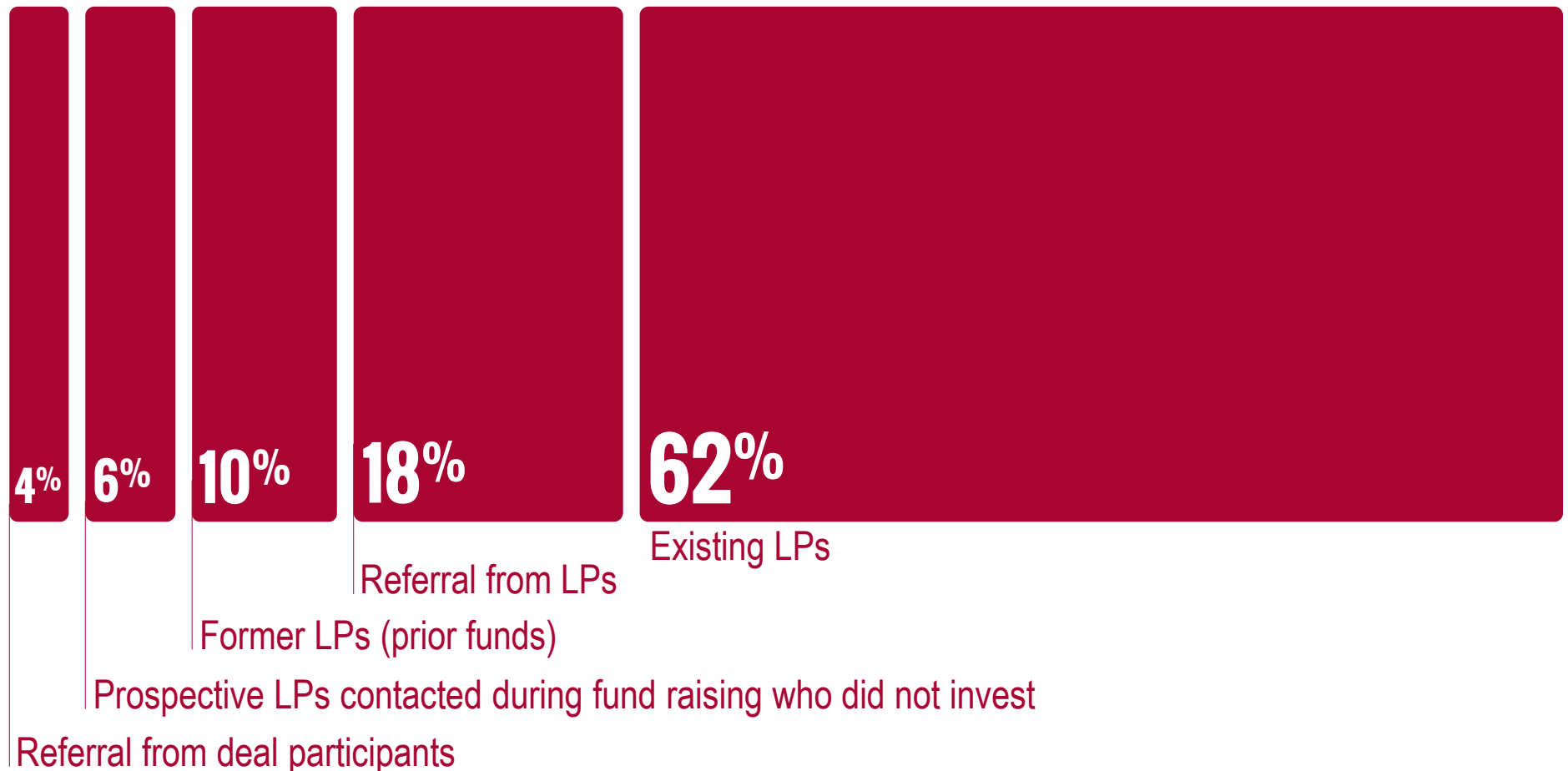
# Co-investments in 2015

What is the extent to which your fund offers the opportunity to Limited Partnerships (LPs) to co-invest?



# Co-investments in 2015

Looking at your closed deals which had co-investments, where did your co-investors come from?





# Co-investments in 2015

PEPPER HAMILTON VIEW

“ While we understand the rationale for providing co-investment options to existing LPs, finding other investors for co-investments presents a chance for the firm and the other investors to develop a history of investing together. Firms can capitalize on this familiarity by offering these co-investors the opportunity to become an LP in the firm's next fund. ”

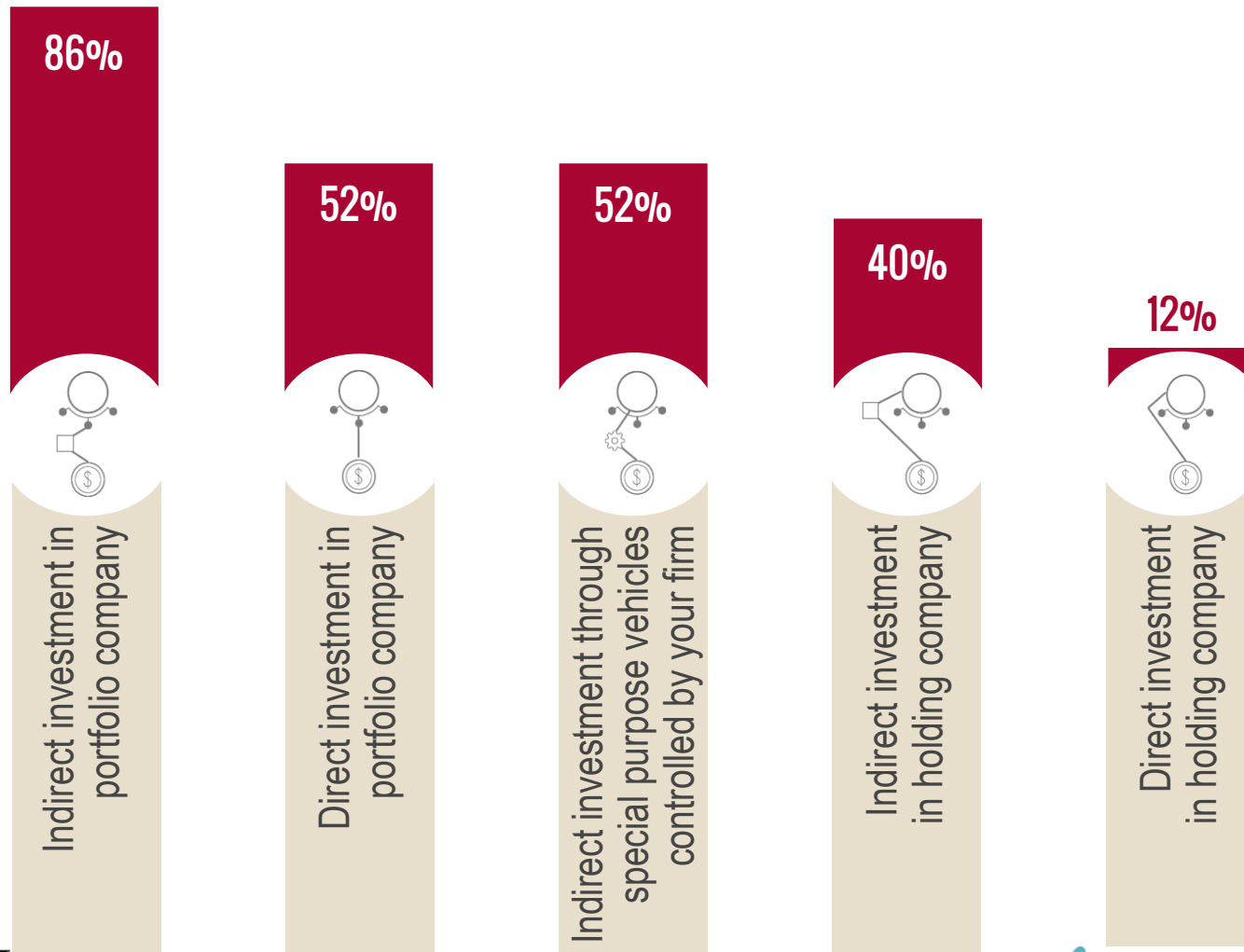
# Practical Issues

- ▶ Dealing With Potential for Conflicts of Interest
  - At the fund offering stage
  - In the deal documents offering co-investment rights
  - Compliance manual
- ▶ Structuring Complexities
  - Blockers needed?
    - Who bears expenses of these?
  - Term of co-investment vehicles
    - Co-extensive with fund?
    - Evergreen?

# Structuring Co-Investments

## Co-investments in 2015

What types of co-investment structures are you offering to co-investors?



# Economic Arrangements

## Economic Arrangements

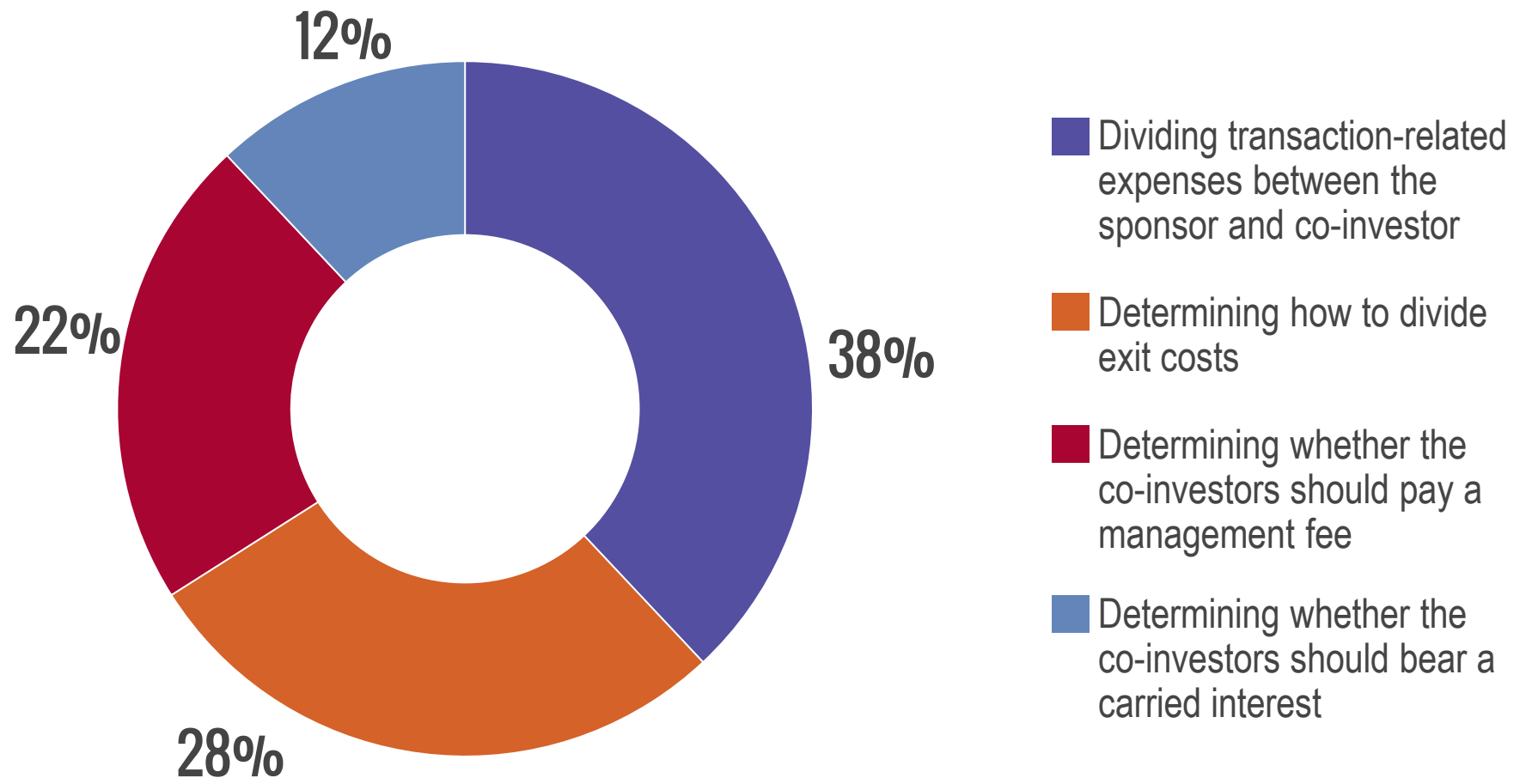
# Economic Issues

- ▶ Direct vs. indirect investment
- ▶ Transaction fees
- ▶ Fee on exit of the transaction
- ▶ Allocation of costs of making the investment between co-investors and funds
- ▶ Allocation of exit transaction costs
- ▶ Costs of operating the co-investment vehicle
- ▶ Funding follow-on rounds in the operating company
- ▶ Management Fees
- ▶ Broken deal costs

# The co-investment landscape

## Opportunities and challenges

What is currently the most prominent economic issue with PE co-investments?



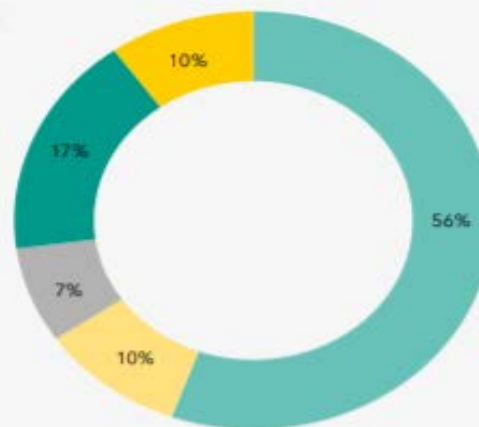
# Fees & Expenses Benchmarking Survey 2018

## How fees are structured

If you offer co-investments, are your co-investments structured as separate entities (as opposed to direct investments in portfolio companies):

- 100% of the time
- ~ 80% of the time
- ~ 50% of the time
- < 50% of the time
- Other (please specify)

Source: pfm



Which of the following do you charge to your co-investment vehicles? (select all that apply)

Management fee equal to the management fee that is paid by the fund



Management fee which is less than the management fee that is paid by the fund



Carried interest equal to the carry payable by the fund



Carried interest which is less than the carry payable by the fund



Organizational and/or set-up fee



Source: pfm

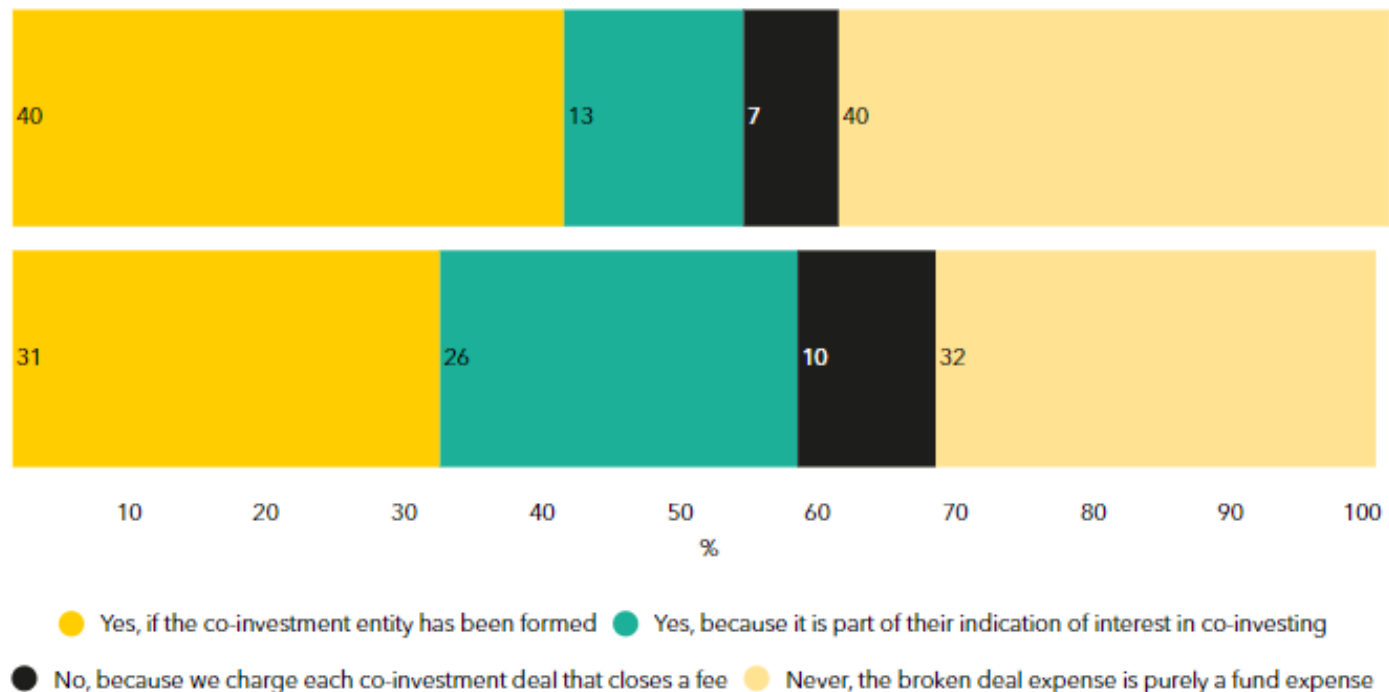
# Fees & Expenses Benchmarking Survey 2018

## Broken Deal Expenses

### Co-investments are another area of uncertainty

But investors are being expected to pick up a growing share of the burden

Do co-investors have any responsibility for broken deal expenses?



Source: pfm. May not add up to 100% due to rounding



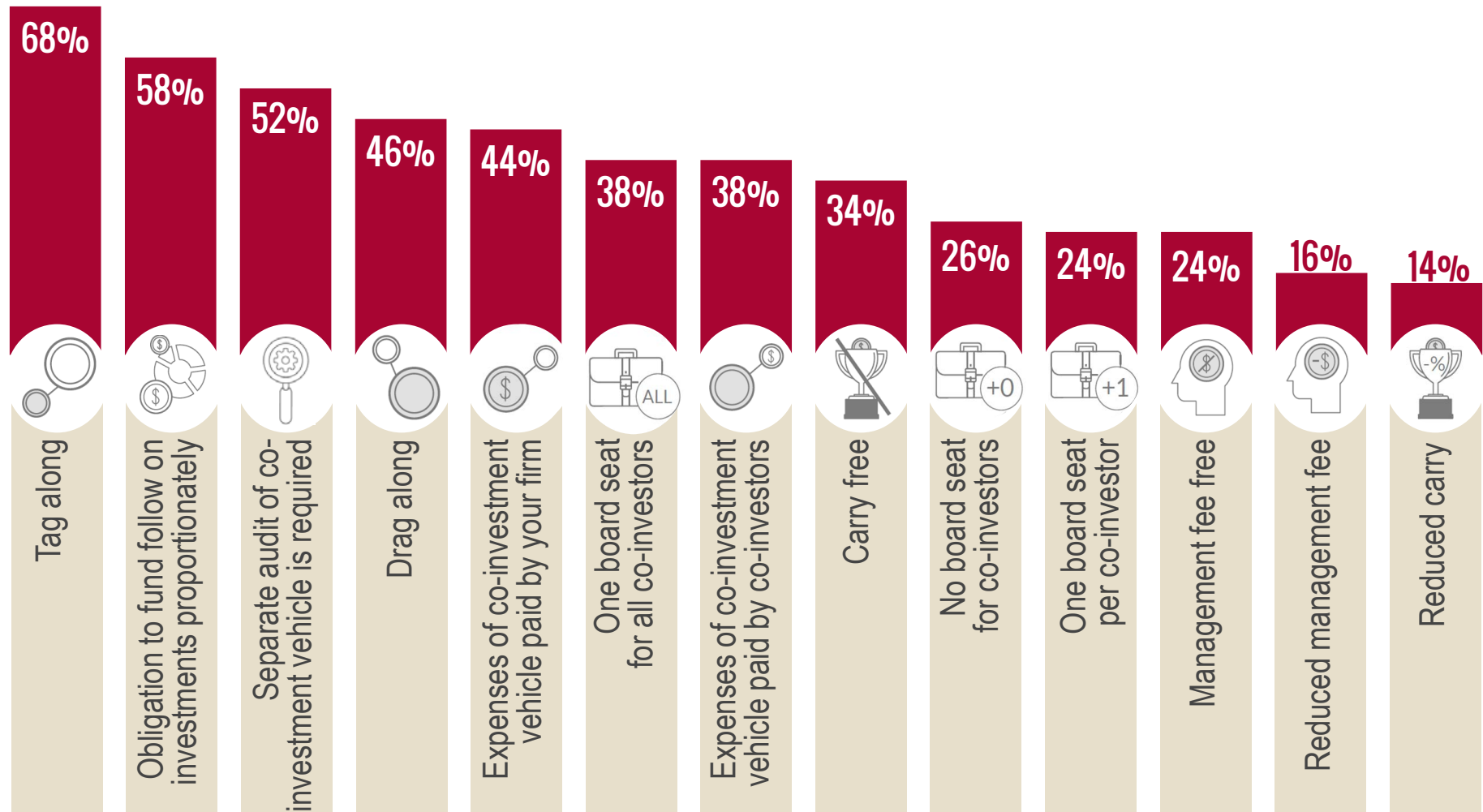
# Typical Deal Terms in Co-Investments

- Carry free ? or reduced carry?
- Management fee free? or reduced management fee?
- Tag Along/ Drag Along
- Obligation to fund follow-on investments? How to fund follow-on's?
- Separate audit requirement?
- Who bears expenses of co-investment vehicle
- One board seat for all co-investors? No board seat? More than one?

# State of play

## Co-investments in 2015

Typically in a co-investment deal, what deal terms apply to the co-investment?



# Governance Considerations

## Governance Considerations

# Governance Issues

- ▶ Should GP run the co-invest vehicle?
- ▶ Should principals make decisions for the co-invest vehicle?
- ▶ Rights investors have in funds: Do they apply in the co-invest vehicle?
  - Side Letters
- ▶ Voting its interests in the underlying operating company
- ▶ Fund and co-investment vehicle interplay in various rights
- ▶ LPAC oversight
  - Separate LPAC?

# State of play

## Co-investments in 2015

When you make co-investments, do you have any of the following reviewed by a limited partner committee?

The terms of the co-investment

84%

The amount of the co-investment

48%

The identity of the co-investors

44%

Non-suitability for your fund of the co-investment portion of the deal being offered to co-investors

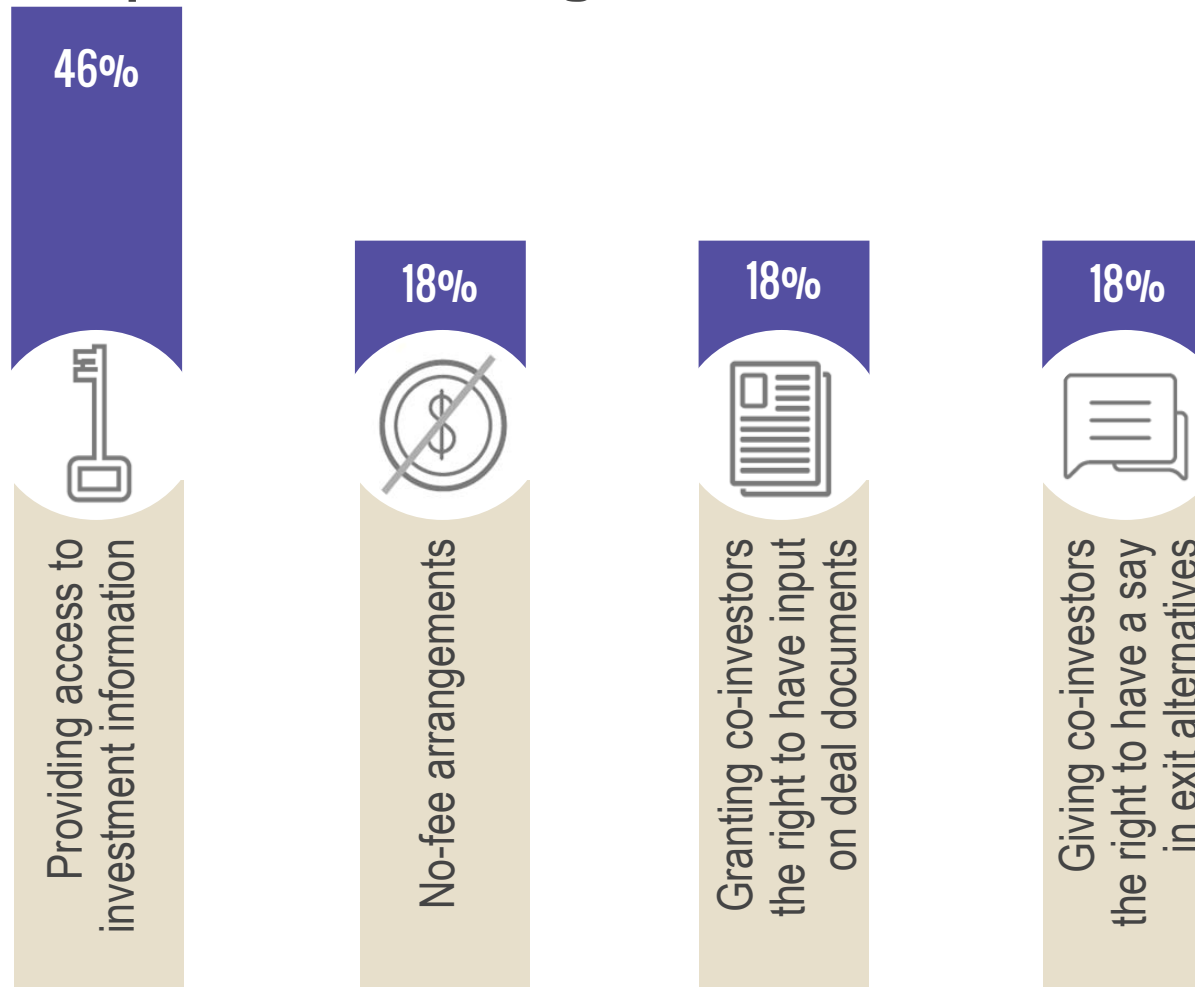
28%

# Governance Issues

- ▶ How many rights should pass through to investors rather than be controlled by governing body/persons?
  - portfolio company preemptive rights?
- ▶ Circumstances in which the fund and co-investment vehicle may diverge
  - holding period?
- ▶ Co-investment representation on portfolio company board?
- ▶ Alignment of Interests

# Taking the reins

What is the most common type of arrangement PE firms have with their co-investors to keep their interests aligned?



# Co-investments in 2015

PEPPER HAMILTON VIEW

“ This request for direct involvement is interesting because direct ownership is not the only way of ensuring co-investor involvement; board seats can be contractually guaranteed up at the the holding company level, so the trend that this managing partner identifies clearly goes beyond just board representation. ”



# The right side of the law

## Mitigating risks

- ▶ **Disclose, disclose, disclose**
- ▶ **Document, update and refine**
- ▶ **Report, report, report**

# Questions & Answers

# Capabilities

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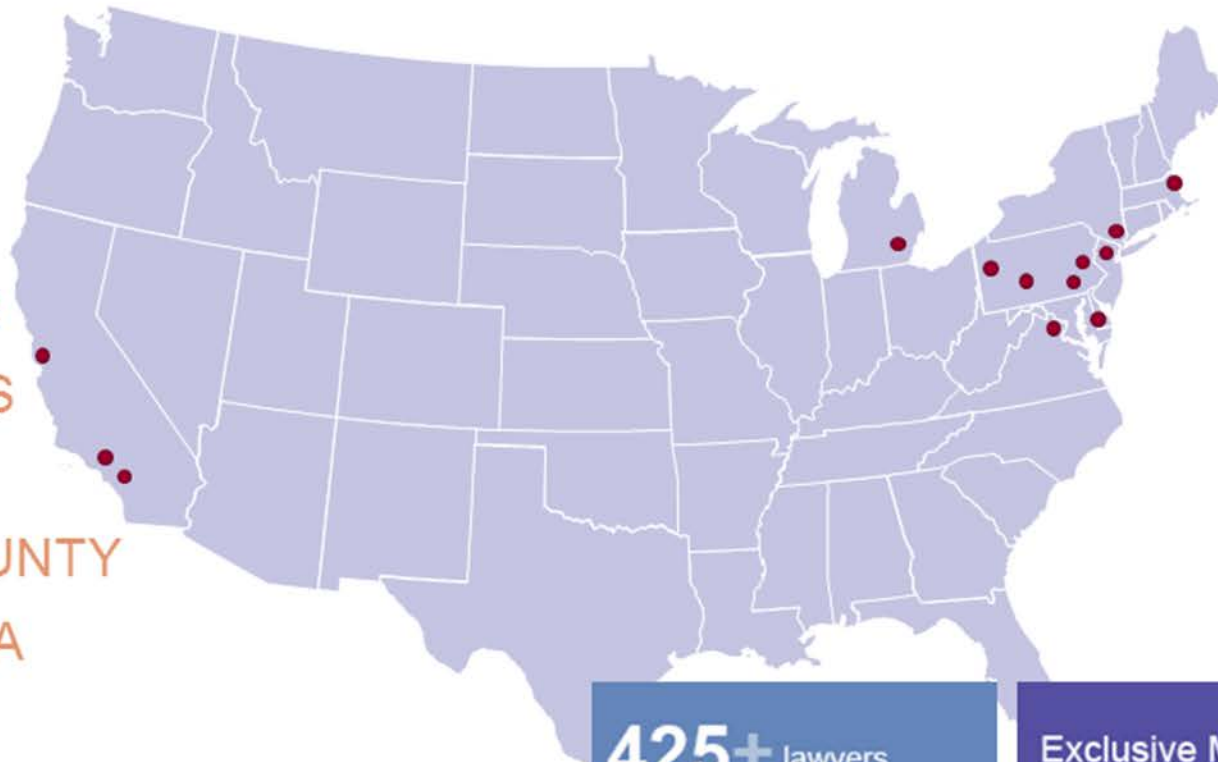
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