EXPERT COMMENTARY **CAPOLINO PERLINGIERI & LEONE**

Co-investing with fund sponsors

Taking the passenger seat does not necessarily make for a bumpy ride, writes Dante Leone

As is emblematic of an industry that is approaching a considerable degree of maturity, private equity sponsors have been making slow, steady but sure progress on the path of specialisation.

Partly as a way to add another choice to their product menu, and partly as an independently rewarding strategy, an increasing number of sponsors have been offering prospective investors opportunities to make co-investments. For their part, investors – ever more mindful of the need to find ways to increase their net returns – have been seizing those opportunities.

Co-investments give rise to several concerns and possibilities. In this commentary, we will describe the typical co-investment structures, look at the rationales behind them, explore perceived dangers and suggest a range of protections appropriate in each situation.

Leone: *co-investments give rise to several concerns and possibilities*

> *Co-investing provides a very direct window onto the sponsor's modus operandi*

ONE EXPRESSION TO CAPTURE QUITE DIFFERENT ARRANGEMENTS

The concept of co-investing encompasses a number of remarkably different situations.

Basic Portfolio Company Co-investments:

Starting from the level that is closer to the portfolio companies, sponsors of primary private equity funds frequently provide their fund investors with opportunities to co-invest with the fund in specific deals.

Co-investment Programmes:

Moving up along the chain, a number of institutional investors, which have traditionally been providers of capital to primary private equity funds, have recently been creating stand-alone co-investment programs, dedicated exclusively to making co-investments in portfolio companies.

These programs are often managed by separate teams, and rely on sourcing both from managers of funds in which the institution already serves as an investor – indeed, formal internal structuring on the part of the institutional investor may be a strategic response to an increase in the deal-flow from managers of those portfolio funds – and from other private equity managers that are aware of the dedicated co-investment platform.

In a fundamentally similar variation on the same theme, a large percentage of sponsors of private equity funds-of-funds have now set up specialised vehicles – organised as proper co-investment funds or as customised account solutions – with the sole mandate to make co-investments in portfolio companies.

Co-Investing in Private Equity Funds:

Moving yet further away from the portfolio companies, there are instances in which fund-of-funds sponsors allow their fund investors to increase the assets allocated to a specific primary fund manager by co-investing into a private equity fund, alongside the fund-of-funds.

THE RATIONALES

As is clear from the description of the range of possible co-investments, they are meant to cater to various constituencies of investors, operating on the basis of different premises.

First and foremost, co-investing is an effective way to deploy more capital at a cost that is less than that of investing through a normal private equity fund: in addition to smaller organisational costs and the absence of fees on uncalled capital, private equity sponsors typically charge lower management fees on co-investments (although they may require standard carried interest arrangements), and even dedicated co-investment vehicles generally have economics that are more favourable to investors. Lower costs may of course lead to better net returns.

Not unlike a secondary program, co-investing is also one of the options available to institutional investors looking to jump-start a private equity programme or to accelerate an increase in exposure to the asset class.

Along the same lines, there are situations in which an investor has identified a particular preference for a small space comprising very specific industries, geographic areas or types of investments, and co-investing may represent the best strategic way of capturing those specific opportunities and achieving a desired allocation.

Moreover, co-investing – in a portfolio company or in a portfolio fund – is an effective instrument in fostering familiarity with a fund sponsor (and vice versa, for the fund sponsor, in fostering familiarity with current or prospective investors). Co-investing provides a very direct window onto the sponsor's modus operandi, from the sourcing and structuring phases to the execution and disposition phases.

This familiarity and experience *in action* makes it possible for an investor to contextualise wins and losses by a sponsor, and that in turn is a prodigious supplement to due diligence when confronted with the choice of whether to make a future commitment to a fund managed by that sponsor.

Partly as a result of such closer relationships with fund sponsors, co-investing is often a valuable training tool for investors, and it provides a path to building more direct in-house capability to assess, execute and monitor direct deals.

Finally, looking at the other side of the coin, there are plenty of rationales behind the offer of co-investments by a fund sponsor. In addition to the abovementioned familiarity argument, co-investors may represent a stable source of capital, enabling sponsors to complete deals than they would not otherwise be able to fund and/or to maintain an optimal level of diversification in their portfolio while at the same time remaining in control of the investment. This principle holds true even for co-investments in a portfolio fund: a fund-of-funds sponsor will benefit greatly from the ability to corral its investors in order to put together the capital commitments necessary for closing new underlying portfolio funds.

THE MUCH FEARED PITFALL: ADVERSE DEAL SELECTION

What with all the advantages described above, investors in private equity funds often express to fund sponsors their keen interest in looking at co-investments.

A widely perceived danger in this respect is that of adverse deal selection; that is, the possibility that fund sponsors may not make their best potential deals available for co-investment, leading to below-average quality in the universe of deals available for co-investment.

Fund sponsors and seasoned co-investors have learned to explain away these anxieties by pointing to a very clear argument, which is the by-product of the rationales already discussed above. Basically, it boils down to the fact that it would be nothing but counter-productive for a fund sponsor to offer an especially weak deal opportunity to an existing or prospective investor in its fund.

This would reflect adversely on the sponsor's relationship with that specific investor, quite possibly even if the investor were to pass on such an opportunity. And the reputational ripples generated by systematic subpar offers would make it more and more difficult for the sponsor to secure co-investors.

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KEY PROTECTIONS: GOVERNANCE, TRANSFER, INFORMATION RIGHTS

Another commonly perceived danger in co-investing is the alleged scarcity of legal protections.

Of course, there is no getting around the fact that another party is in control of the investment. But that does not mean a co-investor should not enjoy reasonable, appropriate, solid rights safeguarding its investment.

In order to reach this result, co-investments require proper structuring. As with many other areas of fund arrangements, there is no hard and fast rule; different co-investment situations, and different kinds of co-investors, may require distinctive balances of rights and protections. These balances are typically achieved by entering into suitable shareholders' agreements or by forming holding vehicles – in the form of partnerships or other corporate entities – and customising their organisational documents.

In general, with respect to co-investments in portfolio companies, there are three key subject matters that ought to be covered in the agreements with the leading sponsor: governance, transfer and information.

Governance:

Different co-investors will look for varying degrees of governance protections. On the one hand, there are co-investors which, while performing thorough due diligence and careful monitoring of their co-investment, truly see themselves as passive players and shy at the thought of being exposed to potential liability, for example as a result of serving as board directors. These co-investors, conscious of their own skill-sets and limitations, do not wish to be involved in the management of portfolio companies.

On the other hand, probably a larger number of co-investors believe that certain governance rights constitute basic appurtenances of co-investments. These rights may include:

– the right to appoint one or more directors or observers to the board (or equivalent body) of a portfolio company;
– the right to veto certain key decisions at the level of the board of directors of the portfolio company, such as those on (i) incurring high levels of financial indebtedness, (ii) entering new lines of business, (iii) making new very large capital investments, (iv) divesting material core assets, or (v) removing the CEO; and
– the right to veto key actions at the level of the shareholders' meeting, such as mergers, initial public offerings, significant changes in the by-laws of the portfolio company or certain kinds of capital increases (such as dilutive ones below a certain implied value for the company, or those reserved for specific shareholders or third parties).

Transfer:

As regards transfer rights, there is less of a diversity of opinions among co-investors, chiefly because they all wish to make sure that they can exit at the same time and under the same conditions as the investment's sponsor. Standard transfer rights include:

– pre-emptive rights to fund a pro rata portion of future capital increases and pro rata rights of first refusal on transfers of shares by other investors;
– tag-along rights; that is, the co-investor's right to sell its shares to third parties together with (and on the same terms as) the leading sponsor; and
– registration rights; that is, the co-investor's right to sell a portion of its shares, again pari passu with the leading sponsor, upon an initial public offering.

Sometimes, securing stronger transfer rights may require giving something in return on the part of the co-investor, most typically in the form of a drag-along right – which enables the leading sponsor to force a sale of the co-investor's shares in the event of a sale of the portfolio company to a third party.

Drag-along rights also come in a variety of shapes, although the most balanced ones are subject to a minimum implied valuation for the transfer (often in the shape of a multiple on acquisition cost) and/or require procuring a sale of 100% of the portfolio company to the third party (which avoids the situation in which the co-investor might be left with a very small stake in a company led by a new purchaser).

Finally, there are instances when co-investors are able – often as a result of the size of their co-investment relative to the entire deal – to obtain the ultimate transfer right: the ability to force a sale of the entire investment, including the stake held by the sponsor, through a managed process such as an auction or a mandate to an M&A adviser. This is a remedy of last resort, and as such it is granted only in connection with a very limited set of circumstances, characteristically (i) in case of departure of one or more key sponsor principals (not unlike a key man clause in a fund agreement) or (ii) if there

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has not been an exit for a certain number of years from the date of the investment.

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Information:

A proper information package as a co-investor will customarily be much richer than standard fund-level reporting on underlying portfolio companies.

First of all, prior to the investment, the leading investor will probably have shared extensive data and research on the investment opportunity with the co-investor. After completion of the investment, the information package for co-investors would comprise not only quarterly reports including detailed financial results and management data, but also investment memos or other analyses on key business actions generated for the benefit of the board of directors of the portfolio company. Furthermore, if the co-investor has a representative on the board of the company, it would not be unusual to receive further budget documentation, monthly management accounts and other periodic statements for senior management.

In addition, co-investors may necessitate the preparation of special tax or other information supplements, depending on their jurisdiction and accounting requirements, and occasionally they might even obtain auditing or inspection rights on the portfolio company.

PECULIARITIES OF CO-INVESTING IN PORTFOLIO FUNDS

As discussed above, there are instances in which the co-investment is made in a portfolio fund, alongside a fund-of-funds sponsor, rather than in an operating portfolio company. In these situations, the co-investor is most likely relying on the ability of the sponsor to access underlying fund managers focusing on a very narrow strategy, industry or geographic area, thus requiring a degree of specialisation or a particular dedicated team that is not otherwise available to the co-investor.

Transfer and information rights for co-investments in portfolio funds do not raise particularly critical issues.

Transfer rights will often be designed along the lines of market standards, although the leading fund-of-funds sponsor may enjoy rights of first refusal over transfers by other smaller investors in the portfolio fund.

As for information, the leading fund-of-funds sponsor will again often share its due diligence analysis on the underlying fund sponsor, and the information package at the portfolio fund level will reflect industry standards.

Given the fundamental distinction in structure from co-investments in portfolio companies, these co-investments in funds warrant instead quite a different approach to governance arrangements.

Naturally, governance rights held by investors in a portfolio fund are much more limited than control rights in a portfolio company, and they are typically restricted to a subset of circumstances, such as waivers of fund limitations, approvals of conflicts of interest and instances of termination of the investment period or removal of the sponsor. Normally, depending on the specific fund, these rights are exercised by the fund's advisory board or by a majority of investors.

However, co-investments in portfolio funds are likely to take place in situations in which the fund-of-funds sponsor will serve as a cornerstone or leading investor in the portfolio fund. Indeed, the leading fund-of-funds sponsor may be the driving force behind the fundraising success of the portfolio fund, also thanks to its ability to bring in potential co-investors from its network of institutional fund-of-funds investors.

As a result, the co-investor may have to accept that the leading fund-of-funds sponsor will enjoy a rather dominant role: for instance, when it comes to the definition of the composition of the advisory board of the portfolio fund, the thresholds for triggering removal or no-fault divorce provisions, and the granting of consents in general. In fact, the dominant role of the leading fund-of-funds sponsor may extend so far as to establishing a unilateral right to exercise removal or no-fault divorce provisions. This peculiar balance of rights and control shows once again that co-investments in portfolio funds really belong to the same universe as co-investments in portfolio companies.

In a nutshell: the co-investor's rights are important, protections are crucial; but the essence of co-investments is that somebody else is in the driver's seat. ■