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# Co-investments: what investors should know

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## Key Takeaways

- Co-investments permit fund investors to invest directly in a sponsor's portfolio company alongside a private fund.
- Key concepts include alignment of interest with the sponsor, sponsor economics, governance and information rights, liquidity protections, pre-emptive rights and funding of expenses.
- Don't overlook tax and regulatory issues — engage legal counsel early.

A co-investment is a direct investment opportunity presented by the sponsor (manager or general partner) of a private fund in which the investor may already be participating. The sponsor creates a special purpose vehicle (SPV) through which all co-investors invest, pooling capital into a buyer entity that acquires the portfolio company.

For many fund investors, the opportunity to make co-investments alongside a fund investment is attractive, as the investor can put more money to work in investments which it selects and often with reduced fees or carried interest payable. For sponsors, co-investments are a source of funding for investments that are too large for the fund to provide all of the equity, and they will generally favour co-investors who are able to move quickly in providing their capital.

## Review existing fund documents

Before entering into a co-investment, an investor should review the investee fund's limited partnership agreement (LPA) and the investor's side letter to determine whether co-investment terms, fees or carried-interest provisions have already been agreed to as part of the fund investment. Prior co-investments with the same sponsor also merit review, as sponsors often reuse the same documentation, potentially streamlining the review process.

## Entity choice

Many investors will use the same entity that invested in the investee fund to make the co-investment.  This can avoid repeating know-your-client requirements. However, there may be tax or regulatory reasons to consider using a separate entity.

## Typical structure and documentation

The SPV that aggregates the co-investor capital is most commonly structured as a limited partnership (with co-investors as limited partners and a sponsor entity as the general partner), though limited liability companies and corporations are also sometimes used. This structure places co-investors at least one level up from the target, often invisible to other investors at the portfolio company level, including founders, management and other third-party investors.

Investors are typically asked to sign a subscription agreement (through which the co-investor commits capital and provides limited representations) as well as the co-investment agreement. In most deals, all capital is funded at closing; co-investors may be asked to provide an equity commitment letter to the sponsor in advance to provide certainty of funding. If an investor has a side letter for the investee fund, sponsors will normally agree to provide a side letter for the co-investment that carries over the applicable provisions from the investee fund side letter.

The degree to which investors will review the underlying portfolio company purchase documentation varies. This typically depends on the investor's relationship with the sponsor, the size of the co-investment and whether the investor's investment committee is independently assessing the opportunity.

## Governance, liquidity and pre-emptive rights

Sponsors generally prefer that co-investors are passive, and may not be willing to grant substantive governance rights in the context of a co-investment. Instead, investors may be expected to rely on the sponsor's management of the investment alongside the investee fund's position in the portfolio company and a requirement that the co-investment be made on the same economic terms as the fund's investment and be acquired and disposed of at the same time. However, co-investors do sometimes secure certain governance rights such as approval rights over identified fundamental matters like the making of additional acquisitions, related-party transactions or material changes to the portfolio company's business, and/or enhanced information rights. Typically, co-investors will also have pre-emptive rights to invest more capital if it is proposed that the co-invest SPV issue more securities.

On exit, co-investors typically sell their interest in the portfolio company alongside the investee fund and on the same terms; this alignment should be documented explicitly. Transfer rights are often limited to affiliate transfers and sales under tag or drag-along rights. If independent sale rights are available, they may be applicable only after a set period and may be subject to a right of first offer (ROFO) or right of first refusal (ROFR). If an initial public offering (IPO) is a possible exit, piggyback registration rights are advisable.

Co-investors can take comfort that the investee fund will generally exit its investments within its LPA's time limits, and therefore the co-invest SPV will achieve liquidity at the same time. However, with increasing frequency, sponsors have been selling investments to continuation

vehicles managed by the same sponsor, thereby extending the life of the investment. Co-investors may want to negotiate for specific rights to address this. Such rights may include the right to elect to exit the investment and receive liquidity at the time of the transfer, the right to roll over into the continuation vehicle (in whole or in part) or a combination of both, giving co-investors optionality while allowing the sponsor to preserve the co-invest structure within the new vehicle.

## Fees, carry and expenses

Co-investments may be offered on a "no fee, no carry" basis, or with a management fee and/or carried interest (often at rates below those that apply at the investee fund). Some sponsors will charge a one-time transaction fee instead; others offer reduced fees, but only up to a set amount of co-investment opportunities. Expenses on completed deals are typically shared *pro rata* by the SPV and the investee fund based on capital invested. Practice varies on broken-deal expenses: co-investors may be asked to share costs, but often the investee fund absorbs them, sometimes in exchange for any potential break fees. Ongoing expenses of the SPV are generally funded by ongoing distributions (if any) from the underlying portfolio investment, or a small reserve is created from co-investors' capital commitments to fund these expenses.

## Tax and regulatory watch-out

Like any investment, the making of a co-investment may have tax and regulatory implications, which may vary from the issues considered at the time of the investee fund investment. Address these considerations early with legal counsel.