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Three considerations for aspiring co-investors

There is more to it than fee cuts and growth stories, warn experts at our co-investing roundtable.

For many private equity investors, co-investing has become integral to the process of building a relationship with their managers. But although industry adoption has been widespread, the strategy carries pitfalls for those who come unprepared.

In September, executives from BlackRock Private Equity Partners, Debevoise & Plimpton, Hamilton Lane, HarbourVest Partners, Lexington Partners and Neuberger Berman gathered in London to discuss the challenges faced by limited partners hoping to enter the world of co-investing.

Here are three things LPs should know before taking the plunge:

‘Fee-free’ doesn’t tell the full story

LPs are often drawn to co-investments as a means of avoiding fees and carry, but the process can still be expensive.

“Looking at the total drag of economics on a deal, the management incentive plan is usually a meaningful part,” said Raja Hussain, director at BlackRock Private Equity Partners. “There are certain GP costs and expenses that are implemented on to the portfolio company, like monitoring fees, that can result in dilution.”

Co-investors generally take a pro rata share of monitoring, refinancing and exit fees. There may also be broken deal expenses to bear if, as often happens, the transaction falls through.

“There’s scope to negotiate on those fees, particularly if, as a co-investor, your involvement is critical to that deal,” said Nick Kavanagh, vice-president at Hamilton Lane. “If you are an enabler, there’s likely enough value add from you as a co-investor to try to warrant navigating that cost dynamic.”

Expect the unexpected

Aspiring co-investors must be adequately prepared for harder times. According to Corentin du Roy, managing director at HarbourVest Partners, participants are likely to be called upon to make tough decisions on whether to provide follow-on capital in situations where they may no longer be fully aligned with the lead investor: “I advise our LPs, when they tell me they want to get into co-investment, that they need to have the resources to cope with a crisis and a market in which a number of their companies may struggle.”

Macro-headwinds aren’t the only eventuality co-investors need to consider.

“Even when investments are not in crisis, unexpected events occur,” said Kate Ashton, partner at Debevoise & Plimpton. “If you have a significant stake in a company, you need to monitor that and pay attention to it. I’m not sure everyone in the co-investment market is equipped for that.”

Timing is everything

Although execution speed has always been key to a successful co-investment, the pace has picked up considerably.

“We are talking days,” said Ashton about the time needed to assess a deal. “It’s really important for our [co-investor] clients to have a large and dedicated team. And as service providers we need one too.”

She added that it was crucial for any co-investor seeking to maintain a good relationship with GPs to be able to turn down an opportunity quickly, so the GP can then be free to talk to other interested parties.

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