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# Co-Investments

## Co-Investments Enable Hedge Fund Managers to Pursue Illiquid Opportunities While Avoiding Style Drift (Part One of Three)

By Lily Chang

A co-investment offers an investor in a private fund or another investor the opportunity to participate in an investment to the extent that the fund (via its manager) elects not to pursue the entire investment. Historically, co-investments have been the province of private equity funds, managers and investors. However, as the range of hedge fund investment strategies has grown to incorporate less liquid approaches, the relevance and use of co-investments has grown as well. For example, in its 2014 Hedge Fund Manager Survey, Aksia found that nearly one-third of surveyed managers currently offer co-investment opportunities to their investors, and another one-third were considering doing so or would consider doing so if there was sufficient investor demand. See "Aksia's 2014 Hedge Fund Manager Survey Reveals Manager Perspectives on Economic Conditions, Derivatives Trading, Counterparty Risk, Financing Trends, Capital Raising, Performance, Transparency and Fees," The Hedge Fund Law Report, Vol. 7, No. 2 (Jan. 16, 2014).

This article is the first in a three-part series analyzing co-investments in the hedge fund context. In particular, this article discusses five reasons why hedge fund managers offer co-investments; two reasons why investors may be interested in co-investments; the "market" for how co-investments are handled during the negotiation of initial fund investments; investment strategies that lend themselves to co-investments; and types of investors that are appropriate for co-investments. Subsequent articles in the series will cover structuring of co-investments; common terms (including fees and liquidity); and regulatory and other risks.

### *From Private Equity to Hedge*

Stephanie Breslow, a partner at Schulte Roth & Zabel LLP, explained the rationale for the increasing prevalence of co-investments in the hedge fund context as follows: "Private equity fund managers have offered co-investment opportunities for a long time. The reason they have done that is because they are often buying private companies in which the fund itself is not able to take the full opportunity because of its size and the fund's concentration limits. So, the private equity fund may need other people to get to scale on an investment or, even if it doesn't need co-investors to achieve its own goals, may be able to win goodwill by offering co-investment opportunities from the portion of an investment the fund is not taking. In the hedge fund space, there historically were not a lot of co-investments because traditional hedge fund strategies, such as long/short equity strategies, led hedge fund managers to trade in public markets where the hedge fund does not have unique access to the opportunities that now can be offered to other people. As a result, traditionally, there was not a lot of co-investment activity, but we are seeing more of it now." For additional insight from Breslow on liquidity and related issues faced by hedge fund managers, see "Schulte Partner Stephanie Breslow

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Discusses Tools for Managing Hedge Fund Crises Caused by Liquidity Problems, Poor Performance or Regulatory Issues," The Hedge Fund Law Report, Vol. 7, No. 1 (Jan. 9, 2014).

### *Reasons Why Hedge Fund Managers Offer Co-Investment Opportunities*

Hedge fund managers may offer co-investment opportunities for at least five reasons: illiquid investment opportunities in liquid funds; concentration and capacity issues; cultivation of goodwill with investors and creation of track record in illiquids; expertise and access; and opportunity to distinguish product offering. Each of these reasons is explained in more detail below.

### *Illiquid Investment Opportunities in Liquid Funds*

Jeffrey Tabak, a partner at Weil, Gotshal & Manges LLP, noted, "Hedge funds over the course of the last ten years or more started becoming more convergent funds, being opportunistic and investing not only in liquid securities, but also in illiquid securities." In short, hedge funds no longer invest in just public equity, liquid bonds and other easily traded securities. Instead, the global group of investment pools that fall under the rubric of hedge funds includes funds that invest in distressed debt, derivatives, real estate, hard assets and other arcane and illiquid assets. Some hedge funds are explicitly structured to accommodate illiquid assets – normally by locking up investor capital for a time commensurate with the expected duration required to realize value in the portfolio assets. See "Hedge Fund Managers Turn to Hybrid Fund Structures to Reconcile Fund Liquidity Terms and the Duration of Assets," The Hedge Fund Law Report, Vol. 2, No. 5 (Feb. 4, 2009). Other funds are structured for liquid investing but reserve (in governing documents) the right to invest a limited percentage of the portfolio in illiquids via side pockets. See "Schulte Partner Stephanie Breslow Discusses Hedge Fund Liquidity Management Tools in Practising Law Institute Seminar," The Hedge Fund Law Report, Vol. 5, No. 43 (Nov. 15, 2012) (subsection entitled "Side Pockets"). And yet other funds are structured exclusively for liquid investing; any investment by such liquid funds in illiquids requires especially prudent cash and capacity management, and close scrutiny of investment restrictions and governing documents to avoid style drift.

However, when structuring a fund, it is difficult to anticipate the full range of investment opportunities that may present themselves during the life of the fund – especially a continuously offered fund like a hedge fund, which is theoretically perpetual. Thus, managers of liquid funds, with or without side pockets, may encounter opportunities that are attractive but less liquid than their structure can reasonably accommodate. For such managers, co-investments may offer a way to access such less liquid opportunities without creating a liquidity mismatch that can complicate redemptions, cash management and investor relations. See "PLI Panel Provides Regulator and Industry Perspectives on Ethical and Compliance Challenges Associated with Hedge Fund Investor Relations," The Hedge Fund Law Report, Vol. 6, No. 25 (Jun. 20, 2013).

As Robert Sutton, a partner at Kirkland & Ellis LLP, explained, "A fund may not be subject to express position limits or even informal investment guidelines, yet the manager may still determine that it is imprudent to allocate an illiquid position to the fund if the position would constitute more than a de minimis portion of the overall portfolio. At a small enough level in a large enough fund, a manager might get comfortable with some portion of the

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portfolio being devoted to an illiquid asset, although probably a fairly low number. But at a certain point, the size of the position may well be in excess of what the manager feels is prudent based on the fund's liquidity compared to the liquidity of the underlying asset." In such circumstances, Sutton noted, managers may allocate the illiquid position to a side pocket – if the governing documents of the fund explicitly permit the manager to do so. Or the manager may seek to access the illiquid opportunity via co-investments.

For managers of relatively liquid funds that routinely encounter relatively illiquid opportunities, yet another option involves creating a separate co-investment vehicle specifically to access those opportunities. Timothy Clark, a partner at O'Melveny & Myers LLP, explained the separate vehicle option as follows: "If the manager sees illiquid opportunities on a regular basis, the manager may set up a separate vehicle to deal with such opportunities. For example, we have a fund of funds client that has set up a specific co-investment fund next to its primary fund. Investors in the primary fund have been offered the right to opt into the co-investment fund."

## *Concentration and Capacity Issues*

The governing documents of a hedge fund typically limit portfolio concentration (and thus risk) by providing that the fund may not invest more than a certain percentage of AUM (e.g., 25%), typically measured by cost basis at the time of investment, in a single company, industry or geography. But circumstances sometimes arise in which it makes investment sense to exceed such concentration limits, even if only temporarily. In such circumstances, co-investments may offer the opportunity to obtain the required exposure consistent with concentration guidelines and governing documents. Jason Kaplan, a partner at Schulte Roth & Zabel LLP, provided the following example: "Even if the manager is an activist and wants to accrue a big position, the manager may not want to put the entire position in its main hedge fund, whether it's because of stated limitations in the fund documents or internal guidelines as to concentration. So, when there is a particular deal, especially for a large company, the manager may need to acquire more shares to gain the appropriate level of influence, and therefore may need to go out and offer the co-invest vehicle."

Similarly, a manager may perceive a unique investment opportunity that requires additional investment, but may not have sufficient investment capacity or "dry powder" in the primary fund. In such cases, the manager may be able to raise capital for the specific opportunity via co-investments, even if the relevant investors may not be interested – or at least currently interested – in investing in the manager's primary fund.

## *Cultivation of Goodwill and Creation of Track Record*

Quinn Moss, a partner at Orrick, Herrington & Sutcliffe LLP, noted, "The potential to cultivate stronger relationships with certain types of investors is a prime motivation for why hedge fund managers offer co-investment opportunities, as is the ability to execute quickly with sophisticated investors." Schulte's Kaplan also noted the ability of co-investment opportunities to generate goodwill (when they turn out well), and further noted the utility of co-investments in creating a track record for managers historically focused on liquid strategies. "If you are a firm that historically traded in more liquid securities, but has a small bucket for illiquids," Kaplan said, "you may find an attractive opportunity where you

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don't have a big enough illiquid bucket in your core fund to buy the entire deal. For instance, you may have a small side pocket that is not big enough. So, you need to raise co-investment capital. These deals can be used to build a track record in illiquids and build goodwill with your investors by offering participation in the deal."

### Expertise and Access

Co-investments also offer managers the opportunity to align investment interests with people and institutions that may provide high-level access, on-the-ground connections, relevant experience, follow-on deal sourcing, debt or other leverage sourcing and similar value. As Tabak noted, "When the fund makes a particular investment in a particular industry, the general partner may identify someone in that industry who it has a relationship with, or who helped find the deal, or is going to help them manage that particular portfolio company. The co-investor could be somebody who would add value to that particular company or has expertise in a particular industry." Moss provided an example: "If you are using the hedge fund model in a structured finance context, such as a collateralized loan obligation fund, there may be strategic partners that bring those loans to you, or offer administration, servicing or other expertise. You are seeing the hedge fund model used with things that are not quite liquid, or are semi-liquid, and it may be that the co-investor could add that value in connection with structured finance funds, infrastructure funds or other specialty funds." See "CLO 2.0: How Can Hedge Fund Managers Navigate the Practical and Legal Challenges of Establishing and Managing Collateralized Loan Obligations? (Part Two of Two)," The Hedge Fund Law Report, Vol. 6, No. 26 (Jun. 27, 2013). One note of caution: if a co-investor is a government official or provides access to one, the manager should evaluate the co-investment or the deal that is the subject of the co-investment for potential Foreign Corrupt Practices Act and other anti-corruption law violations. See "Anti-Bribery Compliance for Private Fund Managers," The Hedge Fund Law Report, Vol. 4, No. 39 (Nov. 3, 2011).

### Opportunity to Distinguish Product Offering

In a capital raising environment that remains intensely competitive, hedge fund managers need credible bases for distinguishing themselves from the wide range of other opportunities. Co-investments offer such a basis. As Clark observed, "Lots of managers are trying to differentiate themselves, and this is one of the classic ways they can differentiate themselves – where they can say, 'I can bring you an opportunity which no one else can.'" See "SEI Study Offers a Reality Check to Hedge Fund Managers on What Actually Works When Marketing to Institutional Investors," The Hedge Fund Law Report, Vol. 6, No. 15 (Apr. 11, 2013) ("SEI noted that hedge fund managers need to distinguish their products by developing a 'sustainable edge.' According to SEI, there are almost 8,000 hedge funds and 1,900 FoHFs. Hundreds of funds launch each year, while hundreds more fold. This makes fund selection an extremely challenging task for investors and highlights the need for funds to differentiate themselves. 70% of SEI survey respondents were concerned that 'too many hedge fund strategies seem to be more or less the same.' SEI observed that a hedge fund's success depends largely on effective marketing, not just investment results.").

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### *Reasons Why Investors May Be Interested in Co-Investment Opportunities*

The two chief reasons why investors may be interested in co-investment opportunities are that such opportunities are often perceived as, colloquially, better and cheaper.

### *Highest-Conviction Ideas*

As indicated above, co-investments are often used in connection with larger positions, and size of position is often directly correlated with a manager's conviction in the position. (A larger investment is only worth the commensurately larger commitment of time and effort if the expected return is higher.) Breslow explained how this logic might play out in the activism context: "If you are investing in an activist hedge fund, what you are hoping is that the manager is going to find a really attractive opportunity where it is going to come in and announce some sort of desired change; that is going to cause the target company to effect that change; and then the stock price is going to improve, which would make for a very profitable investment. That portion of the activist strategy is probably more profitable than the portions of the strategy that involve taking small positions in companies then deciding, for whatever reason, that an activist play is not going to make sense. So, the co-investment opportunity is actually the subset of the trades of that fund that potentially are the most profitable."

### *Blended Fee Rate*

Beyond the often high quality of investment ideas underlying co-investments, such investments are also typically offered under advantageous fee structures. As Tabak explained, "When the limited partners invest in a private fund, they pay a management fee and carried interest, but if they participate in a co-investment separate and apart from their investment in the fund, oftentimes, that is at a very reduced fee or no fee at all. Therefore, they get to participate in the investment at a blended fee rate." Sutton added on this point that "it is not uncommon to see a state pension plan asking a hedge fund manager, in a side letter, for a right to participate in co-investment opportunities on a no-fee, no-carry basis." On side letters, see "Eight Recommendations for Hedge Fund Managers That Utilize Most Favored Nation Provisions in Side Letters," The Hedge Fund Law Report, Vol. 5, No. 22 (May 31, 2012).

### *Request Rather Than Demand*

While co-investment rights are often a precondition of private equity investments, in the hedge fund world, co-investment rights remain in the nature of a request rather than a demand. Tabak explained, "It is more common these days for investors considering opportunities to invest in a fund to include co-investment rights in their list of comments. Are they making this a condition of their fund investment? It depends on the negotiation. There is usually no guarantee of a co-investment right. The general partner has a fiduciary duty to the fund that it manages. So, if it sees an investment opportunity where the maximum it can invest is $20 million, and it thinks that $20 million is an opportunity that should be provided to the fund, then it has to consider whether that whole opportunity should go to the fund." Clark shared his experience, which supports the typically nonbinding nature of co-investment rights offered to hedge fund investors. "I

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represent one large institution that manages an open-ended fund in which state plans have made very large investments, and essentially all of those state plans have asked to see co-investment opportunities. Some of them probably would not have made the investment if they were not allowed to see those co-investment opportunities. That being said, there is a lot of talk about co-investment opportunities, but they are still not very common for hedge fund managers to come across. So, generally I have not seen co-investment rights as an absolute pre-condition for investment."

### *Strategies That Lend Themselves to Co-Investments*

Activism and distressed debt strategies are conducive to co-investment opportunities. As Breslow pointed out, "In both cases, you are trying to influence the outcome of events of the underlying company, so the size of your position in the company matters." In the activism context, Breslow noted, "an activist typically has fairly small positions in a variety of companies. When the manager decides to take action with respect to one of those toeholds, that's when co-investments typically come up." And in the long-duration credit or distressed debt context, co-investments can make sense where the manager seeks to control a certain tranche of credit or influence a reorganization or restructuring process.

Conversely, co-investments are typically less well-suited to liquid strategies that involve frequent trading. Sutton noted, "If you are talking about a large-cap, large public float type of investment where the manager is simply trading in and out, co-investment opportunities tend not to come up."

### *Types of Investors That Lend Themselves to Co-Investments*

Typically, co-investment opportunities are offered to large institutional investors as opposed to high net worth individuals or other investors. Sutton reflected, "There is a range of investors. Some of it is driven by relationships that the manager has with existing investors. One typically tends not to see high net worth individuals. The typically complex nature of a co-invest arrangement and the nature of the types of investments which tend to be skewed more to the less liquid end of the spectrum (either because the investment is not a public security, or else because of long holding periods driven by the investment thesis), tend to make these less attractive for high net worth individuals."

Sutton observed that co-investment opportunities are typically better suited to institutional investors, rather than high net worth or other individual investors, because institutional investors are more likely to have experience dealing with highly-structured, illiquid and long-term investments. "Within the institutional spectrum," Sutton said, "the public pension plans, private pension plans, university endowments and sovereign wealth funds tend to be fairly regular participants in these types of investments. You will sometimes see family offices as well, depending on the level of sophistication and size of the firm. Possibly you will also see funds of funds, although for the same liquidity reasons, it would have to be a fairly narrow type of fund of funds, one whose capital structure could take on a less liquid investment – for example, one that is structured with a private equity-

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style, closed-end capital structure. In short, co-investments are suited to the types of investors that: are used to dealing with complex, individually-negotiated arrangements; know the issues they are likely to encounter; know the range of variance offered in the marketplace; and have a greater ability to comprehend and act upon those investment decisions when they come along."

Breslow observed that investment decisions typically take place more rapidly in hedge fund and private equity funds. Therefore, the ability to engage in rapid decision-making – or to complete relevant decision-making before an investment opportunity arises – is important in evaluating the eligibility of an investor for co-investments. "Hedge fund strategies in general tend to be more sensitive to timing than private equity investing," Breslow said. "In private equity investing, if you have begun to negotiate a deal with a private company, it could take months, and the price is not really moving in that timeframe. In hedge funds, on the other hand, if you are an activist, you are very sensitive to where the stock price is on your target now, and you are not going to wait months to get people together to acquire it. So, processes that are about talking to your investors and figuring out who wants to come in and who does not, and allocating to them pro rata – the sort of process you might follow in private equity – really does not happen for hedge funds."

Sutton provided color on decision-making with respect to co-investments by three categories of institutional investors. "Although most of the large state pension plans will have a number of hoops to jump through to set up initial relationships, once you have been approved, each incremental co-investment tends to be less difficult to get through than the initial one. That said, a particularly unusual co-investment structure may involve going back to certain decision-making bodies if it was outside the scope of what was originally approved. In the case of sovereign wealth funds, once you have established the relationship, such funds tend to be relatively quick to go through, although they can be demanding to negotiate with in regard to the terms they ask for. Among those family offices that invest in co-investments, there would not be layers of approval, but decision-making may be slower if they are not frequent co-investors."

Finally, Breslow emphasized that tax and regulatory concerns may slow an investor's ability to participate in co-investments. "For example, if you were investing in a regulated industry like media, there can be limits on foreign ownership. In a rare case, you would have to think about whether that investor is a competitor in the industry that you are dealing with."

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