Co-Investments Go Mainstream Thoughts from the co-head of SRZ's leading investment management group

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Co-investments may have been conceived by the private equity industry, but they are now moving into the mainstream of the hedge fund industry. As many as 68% of hedge fund allocators with AUM above $5bn are now allocating to co-investments, according to the Credit Suisse Hedge Fund Investor Survey, which gathered data from more than 310 allocators running over $1.12trn. The Alternative Investment Management Association (AIMA)'s latest research, "In Harmony – how hedge funds and investors continue to strike the right note in aligning their interests" (carried out with RSM), which interviewed 440 hedge fund managers running $440bn globally, also highlights a strongly increased interest in co-investments, partly in the context of growing customisation.

"Co-investment offerings have increased at the initiative of the manager and at the request of investors. This is part of the broader trend toward customisation of particular flagship strategies. We are seeing many co-investment vehicles across a lot of strategies," says David J Efron, partner at Schulte Roth & Zabel, who serves as co-head of the Investment Management Group and as a member of the firm's Executive Committee.

Expanding strategy coverage

Co-investments were originally well known in less liquid strategies such as private company investing. In these cases, a key motive was often obtaining a control or fulcrum position, but now they are being offered across the full spectrum of hedge fund strategies, including more liquid ones.

"In the past 18 months, we have seen an increase in co-investment offering in strategies like activism and technology," says Efron. "In activism, it is now common for managers to set up a commingled fund to take toehold positions and then to upsize through an SPV co-investment when pursuing a strategic transaction, such as a proxy contest, merger or going-private transaction. On the technology side, co-investments are being used especially for pre-IPOs, sometimes because the fund lacks side pocket mechanics, and sometimes because the investment would be too large in light of the fund's investment guidelines. We have also seen them used for large positions in liquid, public companies that, if held by the fund, would exceed the fund's investment parameters," he explains.

"Occasionally, co-investments are being used for more exotic areas, such as emerging market debt and distressed debt deals involving countries such as Puerto Rico, Argentina and Venezuela," he adds.

By their nature, co-investments have almost entirely been related to discretionary strategies. "Where systematic and quantitative managers offer investors access to a subset of their suite of strategies, this is more likely simply to be a concentrated or customised fund, without a PE-style distribution waterfall," he points out.

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Structures, terms and fees

Structures, terms and fees are evolving. "Structures are often modelled on a private equity fund structure in what is dubbed a 'PE lite' model, with usually shorter durations: typically 18 months to three years, possibly with the option of one or more one-year extensions. Withdrawal rights or preferential liquidity terms before the completion of the term are atypical, but transfers to other investors approved by the manager can sometimes be offered, possibly in cases of hardship," Efron says. From a governance perspective, he adds, "control rights on investments usually reside with the manager."

A wide range of fee structures are being offered. Efron sees "zero management fees with a 10% carried interest quite typical for co-investments offered to existing investors; those marketed to outside investors may also have a management fee, which will not usually be above 1%. The carried interest with respect to outside investors will sometimes be as high as 15%, often (but not always) with a preferred return of 5-6%, and a carry of 20% will definitely involve a preferred return."

Making co-investments conditional upon investments in the main fund (known as "stapled") is rare; it is more common that lower fees on co-investments for investors in the flagship fund provide an incentive to invest in it.

Co-investments may be designed to take advantage of ephemeral opportunities, so decisions often need to be made in a matter of days or weeks. Investors may already be familiar with co-investment opportunities from the main fund, or they may need to carry out deeper due diligence. Data rooms can sometimes be opened up to facilitate this. "To expedite decision making, managers and investors will often prepare and pre-negotiate structures, such as partnership agreements, subscription documents and so on so they can hit the ground running when a co-investment opportunity does arise."

Some investors may demand a Most Favoured Nation (MFN) clause tailored to co-investments opportunities and may also seek side letters guaranteeing capacity rights. Minimum subscription amounts for co-investments are generally higher than on flagship funds.

Disclosure and potential conflicts

Potential conflicts of interest often arise anytime a manager manages accounts with overlapping positions, including in the case of a flagship fund and a co-investment vehicle. Appropriate disclosure of co-investment policies and those for addressing potential conflicts of interest is essential. "The allocation of co-investment opportunities, expenses and termination fees or broken deal expenses have been, and continue to be, hot-button issues with the SEC," says Efron. "Hedge fund managers in the past did not pursue co-investment opportunities. Today, however, we regularly work with hedge fund managers to design and implement policies and procedures to eliminate or mitigate such conflicts of interest and to make sure these managers have adequate disclosure of these policies and the potential conflicts in their fund documents." THFJ