CO-INVESTMENT: THE ADVANTAGES OF A DEDICATED MANAGEMENT MANDATE

Co-investment in private equity refers to a transaction structure where a management company (or General Partner, GP) syndicates part of its investment to third-party investors, who then take minority positions in the deal. These third-party investors are most often institutional investors looking to invest alongside the management companies in the funds they have subscribed to (i.e., their Limited Partners or LPs).

For a management company, offering co-investment opportunities can be motivated by several reasons: increasing the size of its investment tickets to target higher company valuations, de-risking a transaction by spreading the investment, or – as is increasingly the case – responding to client requests.

For an LP, co-investment also offers numerous advantages: potential for outperformance, optimization of deployed capital, deeper knowledge of their network of GPs, and the opportunity for strategic portfolio rebalancing. While co-investment indeed seems essential in a private equity portfolio, it is important to consider how to implement it to choose the most suitable program.

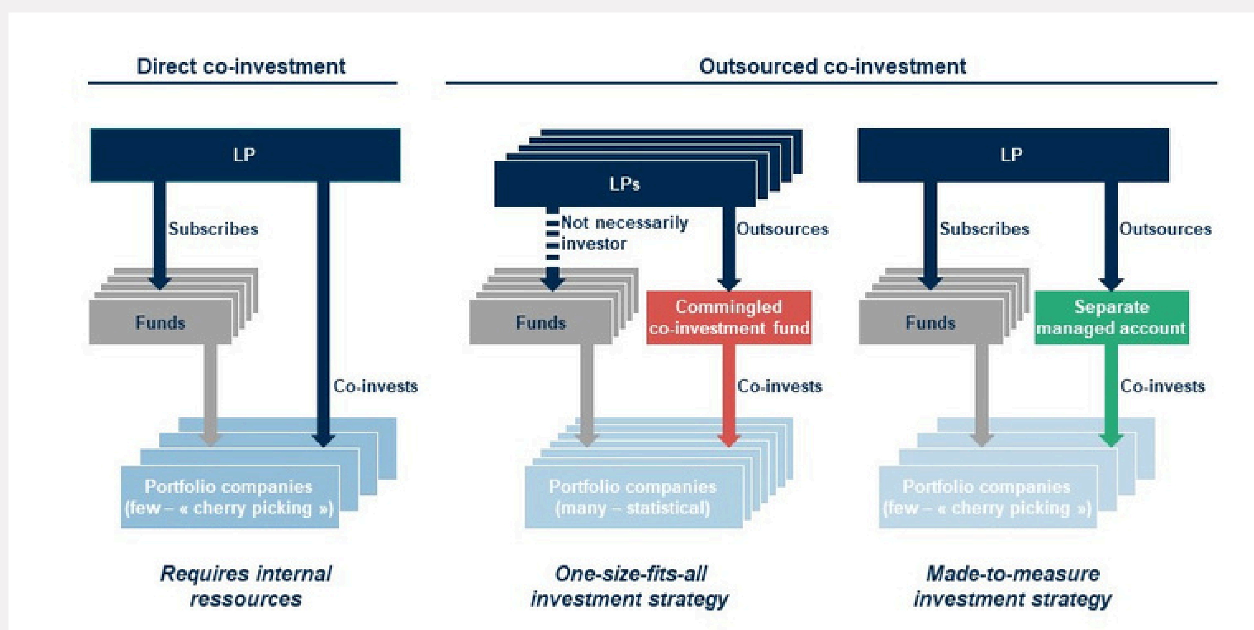
In this publication, after presenting the different co-investment structures, we will explain why it may be preferable for certain institutional investors to outsource the management of their co-investments. We will then analyze the advantages of a dedicated management mandate and the key points of attention for its implementation.

For more details, refer to the publication "Co-investment: Advantages and Potential Pitfalls."

Different Structures of a Co-Investment Program

In practice, LPs have several structuring options to participate in co-investments. The first is to invest directly in the target company alongside the GP's fund, handling the transaction execution tasks, as well as the selection of opportunities, monitoring of investments, and so on. This requires resources. The second, and most common, option is to subscribe to co-investment funds, which are investment vehicles pooling several LPs and managed by a third-party management company responsible for the origination, selection, and execution of transactions. In this case, the LP is exposed to a portfolio shared by all subscribers of the vehicle, without the ability to influence its investment decisions. Lastly, a third option involves delegating the management of co-investment opportunities, via a management mandate, to a management company that can create a tailor-made co-investment strategy and handle the origination, selection, and execution of transactions.

Different Structures of a Co-Investment Program



Why outsource co-investment management ?

While direct co-investment management may seem attractive for an LP (as it avoids intermediaries and their fees), it is important to keep the key market characteristics in mind before implementing such a co-investment solution.
A key aspect of the attractiveness of co-investment lies in its reduced cost structure compared to subscriptions to private equity funds. In comparison to a "classic" fund subscription, which typically offers subscription terms based on a model of a 2% annual management fee on committed capital and a 20% performance fee, co-investments generally feature a 1% annual management fee on invested (not committed) capital and a 10% performance fee (or, in the case of direct co-investments, no management or performance fees at all).

These reduced fees are usually negotiated at the time of subscribing to the main fund, often including a priority right for co-investments, and formalized through a side letter. Co-investing therefore represents a right to reduce average subscription fees, granted by the management companies of the funds to which an LP has subscribed. However, in practice, many LPs forgo this right, thereby failing to optimize the cost of their deployed capital.

Two main reasons explain this phenomenon. First, managing co-investments is resource-intensive. In a market where responsiveness and flexibility are key, it is essential to have the appropriate resources to ensure GPs receive the best response times throughout the co-investment process. Over time, GPs tend to offer co-investment opportunities to investors who can deliver quickly, whether it’s in terms of positioning for the opportunity, negotiating legal terms, or during the closing. Not only do the resources need to be available, but they must also bring together a variety of skills: financial, strategic, legal, compliance, and more. In practice, few investors have an organizational structure that can effectively guarantee this level of responsiveness to GPs.

> "Co-investing is a right granted to LPs to reduce their average subscription fees. However, few LPs take advantage of this opportunity due to a lack of internal resources."

Co-investing also requires experience in direct investment. Co-investment transactions are highly heterogeneous, just like private equity in general. Selecting these opportunities requires a different expertise than building a fund-of-funds portfolio. For the latter, the focus might be on selecting GPs with the best track record. However, when selecting a co-investment opportunity, this criterion is not as decisive. In addition to defined and rigorous analysis procedures to guard against selection biases (such as favoring GPs with the best track record), evaluating an opportunity requires a deep understanding of the transaction, which demands direct investment know-how.

The advantages of the dedicated management mandate

When outsourced management becomes necessary for investors with limited internal resources, two modes are preferred: the co-investment fund or the dedicated management mandate.

These two models have their own characteristics, summarized in the table below:

Characteristic	Co-investment Fund	Dedicated Management Mandate
Investment Autonomy	Low: the investor participates in a pooled vehicle	High: tailor-made strategy with specific transactions
Cost	Lower, standardized fees	Customized fee structure, potentially higher
Execution Control	Limited: management company handles all decisions	High: investor retains greater control over transactions
Resource Requirements	Minimal: outsourced management	Significant: requires internal expertise for oversight
Customization Potential	Low: standardized portfolio	High: ability to focus on specific sectors or regions
Responsiveness	Lower: dependent on fund manager's timeline	Higher: faster decision-making due to direct involvement

The dedicated management mandate, while requiring an existing network of GPs and already deployed capital, offers several advantages for an LP:

1) Customizability

With a dedicated management mandate, the LP is naturally the sole subscriber of the co-investment vehicle. This gives them significant flexibility in defining its characteristics. The type of vehicle (e.g., FCPI, SLP, etc.), geography, total commitment size, subscription period length, and other parameters can be tailored to the specific needs of the LP. This level of customization is not possible in a co-investment fund where multiple LPs subscribe.

2) Control over the investment pace

Unlike "classic" vehicles, where management fees are charged annually as a percentage of the commitment, co-investment vehicles generally apply management fees based on deployed capital. As a result, a slowdown in the investment pace does not impact the long-term net performance of the vehicle. This feature is valuable in times of unsuitable market conditions, such as the current health crisis, or when the LP wishes to temporarily retain liquidity to reallocate to another asset class. Being the sole subscriber once again guarantees the LP maximum flexibility in managing their overall private equity portfolio, which would not be the case in a co-investment fund.

3) Customized Portfolio Construction

Co-investing through a dedicated mandate also offers the LP the ability to guide the portfolio construction according to a multi-criteria strategy. For instance, they may aim for maximum diversification or choose to focus heavily on certain sectors, geographies, or company sizes. Once again, the flexibility of the management company is key to adapting the capital deployment to the client's specific needs. At Omnes Capital, the co-investment teams work on finding innovative solutions to meet the needs of LPs. The goal is to provide maximum flexibility, offering LPs an additional tool for their private equity deployment strategy. For example, for an LP wishing to gradually invest in co-investment, we designed an ad-hoc vehicle to accommodate a single transaction while maintaining maximum flexibility for its future development. The creation of a compartmentalized investment vehicle to accommodate different asset classes (e.g., LBO vs. infrastructure) is another example of the LP's ability to steer their investment strategy within the framework of a mandate.

4) Enhanced Knowledge of GPs and In

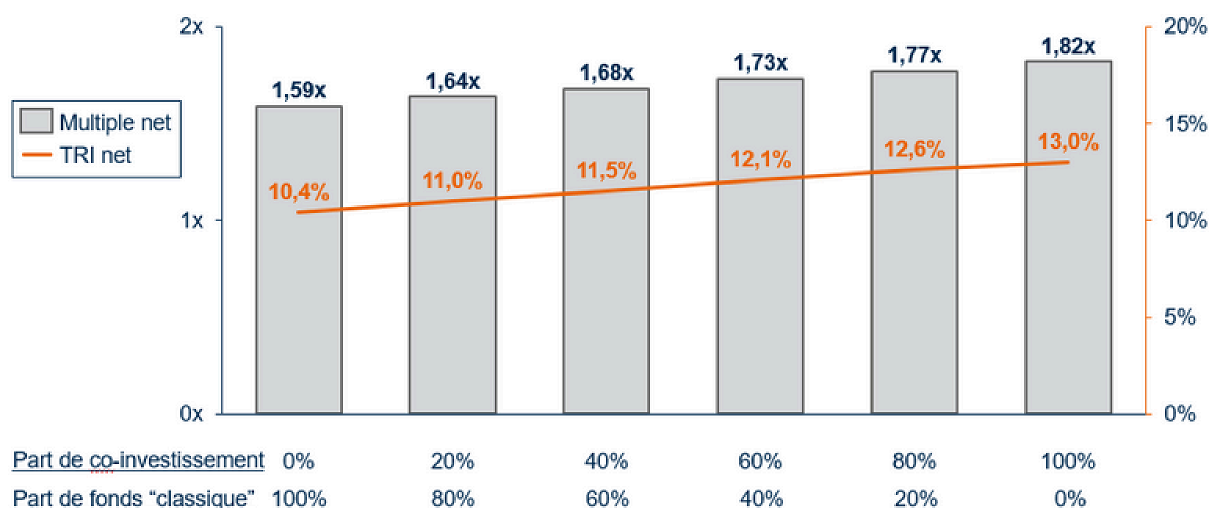
Moreover, a management mandate can have strategic value for an LP as it allows for better tracking of investments, thanks to more detailed and frequent reporting than what is typically provided in a fund report. Additionally, the co-investor may negotiate a board seat, providing even deeper insight. This increased level of information is particularly useful for decision-making regarding investments (e.g., reinvestments) and for better understanding the trends within underlying sectors.

How to Set Up a Dedicated Management Mandate?

1) What Allocation for Co-Investment

The first question an institutional investor needs to address is the volume of the allocation for co-investments. One initial answer is based on the potential that co-investment offers to "boost" the performance of an overall private equity portfolio. Due to its fee structure, co-investment helps optimize the returns on deployed capital. For example, allocating 20% of capital to co-investment could increase the performance of the entire private equity portfolio by 0.05x in multiple and 0.5% in IRR, assuming a structure through a dedicated vehicle with a management mandate, and that the gross performance is equivalent to that of the GP network's funds.

Private Equity Allocation Performance Based on Co-investment Allocation



Assumptions for the "classic" fund:

- 2% management fees on committed capital (on invested capital during the divestment period)
- 20% performance fees

Assumptions for the co-investment fund:

- 1% management fees on invested capital (during both the investment and divestment periods)
- 10% performance fees

Hypotheses:

- Total commitment: €100 million, evenly invested over 5 years
- Gross multiple: 2x after 5 years

If allocating 100% of private equity assets to co-investment theoretically enables significantly higher returns, it is generally impractical to allocate more than 20-25% to co-investment. For an LP, one of the key factors in the success of a dedicated management mandate is the volume of deal flow generated from their network of GPs. Therefore, it is crucial to have a substantial portion of the capital committed to underlying funds. Additionally, some GPs cap the total amount of co-investment allocated to a client based on their subscription amount in the GP's vehicle.

2) What is a Co-Investment Strategy ?

By nature, the LP increases their exposure to a transaction during a co-investment, since they are already indirectly involved through their subscription to the GP leading the syndication. Defining a co-investment strategy is essentially about determining the types of transactions in which the LP wants to overexpose.

Three main co-investment strategies can be identified:

Thematic Strategy

In this case, the goal is to focus co-investments on specific market segments. Selection (or exclusion) criteria may include:

- Industry sectors (e.g., healthcare, software)
- Geographic exposure
- The target's development stage: Venture Capital / Growth Capital / LBO
- The asset type: Infrastructure / Private Equity
- Transaction type: Primary / Secondary

This approach allows the LP to manage the risk/return profile of the private equity portfolio by targeting segments with specific characteristics in terms of return potential, resilience, or volatility. However, this strategy requires strong initial convictions about the characteristics of the market segments to be targeted, and could result in losses if those convictions are incorrect.

Diversification Strategy

Unlike the previous strategy, this approach aims to replicate the "natural" exposure of the LP's GP network by heavily diversifying the co-investment portfolio. With this strategy, the gross return of the co-investment portfolio will closely mirror the gross return of the LP's private equity portfolio. However, the net returns will be higher due to the reduced fee structure of co-investments.

The advantage of this strategy is its simplicity, as it requires little expertise in analyzing and selecting co-investment opportunities. Additionally, it is relatively low-risk, as it seeks to replicate the gross performance of the LP's private equity portfolio.

On the downside, this strategy is resource-intensive because it demands significant availability and flexibility from the team for the execution and monitoring of the portfolio. Moreover, the potential for outperformance is limited to the difference in fee structures between the underlying funds and the co-investment fund.

"Best-of-Breed" Strategy

This approach focuses on being highly selective with co-investment opportunities, aiming to target transactions with the most attractive risk/return profile. Although simple in theory, this strategy has several pitfalls.

First, a reduced selection rate implies a slower deployment pace and/or a smaller portfolio. Therefore, it's crucial to remain disciplined in selecting opportunities, avoiding the temptation to accelerate deployment by choosing less attractive deals. This bias, which can affect any private equity management firm, is particularly harmful in co-investment.
Additionally, this strategy requires extensive experience in co-investment. Like the private equity market, co-investment transactions vary greatly in their characteristics. Selecting the best opportunities requires different expertise than building a fund-of-funds portfolio. For the latter, one might focus on selecting GPs with the best track records. In co-investment selection, however, this criterion is less important. In addition to well-defined and rigorous analysis procedures to prevent selection bias (e.g., favoring GPs with strong track records), evaluating an opportunity demands a deep understanding of the transaction, which requires direct investment expertise.

Conclusion

Co-investment offers numerous advantages for institutional investors and seems essential in an asset management strategy. However, choosing the right structure for its implementation requires careful consideration. Although direct co-investment (i.e., internalized) may appear the most attractive in terms of associated costs, in practice, few LPs have the internal availability and resource flexibility to fully capitalize on their co-investment rights.

To optimize returns on deployed capital, an LP would therefore benefit from outsourcing the management of its co-investment portfolio, either by subscribing to a co-investment fund or through a dedicated management mandate. This decision will mainly depend on the LP's characteristics (e.g., asset volume under management, the size of its GP network) as well as its allocation strategy.

With a management mandate, the LP can enjoy a tailor-made service designed to best serve their interests. Co-investments require a deep understanding of transactions and significant expertise to avoid potential pitfalls.