KEYNOTE INTERVIEW

Positioned to take advantage

In order for savvy investors to capitalise on co-investment opportunities, there are many commercial, legal and advisory considerations they need to get smart on, say Ropes & Gray's Michael Gilbert and HarbourVest's Seth Palmer

What has been driving the phenomenal growth of the co-investment market over the past two decades? Michael Gilbert, counsel at Ropes & Gray, and Seth Palmer, managing director at HarbourVest Partners, sit down to discuss.

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Q How would you describe the growth of co-investments over recent years?
Seth Palmer: Co-investment is a sub asset class of private equity that we have seen grow tremendously since its nascency in the early 2000s, growing nearly tenfold over that 20-year period. That co-investment deployment growth has outperformed increases in broader market activity as sophisticated LPs increasingly made it a core part of their programmes, often committing as much as a third of their private equity allocations to co-invest opportunities. For HarbourVest, co-investment is an asset class where we have been allocating $5 billion-$6 billion per year, with the expectation of future growth and more opportunities.

There are a number of drivers of that growth: first, co-investment as an asset class can offer efficient and diversified access to top-quartile private equity opportunities. Co-investment allows LPs to invest in a way that can be highly diversified by deal size, geography, sector and manager, and at low cost because there tends to be a no-fee, no-carry entry point to those underlying businesses.

The other big driver is that co-investment allows an investor to effectively deepen relationships with its GPs, so it can see up close how they work, think and operate at the deal level.

Michael Gilbert: On the commercial side, in the infancy of co-investment, many LPs viewed single-asset co-invest as hard to evaluate compared with multi-asset fund opportunities. Working with advisers like HarbourVest has allowed many investors to find a route to access these valuable opportunities.

On the legal side, a historical challenge for smaller LPs has been around analysing co-investment legal documents, which can be highly bespoke. Many of these LPs don't have the desire to invest a lot of time getting up to speed on both the commercial and legal landscape for one-off opportunities like co-investments.

Today, given the growth of the asset class, we see agreements and structures becoming very similar to traditional fund investment terms. There are advantages and pitfalls as a result, but it does make them look more familiar to a wider range of investors and, to an extent, takes that barrier away.

Q What factors underpin a successful co-investment strategy?

SP: It is crucial to be intentional and practical when designing a co-investment programme. This means being thoughtful about your objectives and your GP relationships, and being realistic in terms of your internal resources and processes.

An LP needs to design decision-making and governance processes that allow it to operate at the pace of a deal and to be thoughtful about portfolio construction. A single co-investment is more concentrated than a single fund investment, so risks need to be managed and appropriately diversified. Typically, we see co-investment paired with a primary fund programme, as primary fund relationships open up co-investment dealflow.

Another factor is resources: many LP co-investors have one or two people focused on co-invest and it may be a portion of their job alongside fund investing. LPs need to be realistic about their internal capabilities for assessing companies rather than funds and, if they lack that capability, perhaps think about external providers that can deliver additional support.

Ultimately, a successful co-investment strategy comes down to communication and building trust with GPs through transparency: once you have established a programme, communicate it to the GPs you are hoping to receive dealflow from and be clear about what you are looking for.

MG: One of the goals on the legal side is making sure legal disputes don't get in the way of strong relationships. Fundamentally, both sponsors and investors are generally aligned. Co-investing LPs are generally happy to remain passive and are not expecting control rights or strategy input in light of the upside they are getting. They benefit from low or no fees, but in turn, they are expecting the same returns as the sponsor's primary fund. Sponsors, meanwhile, are often willing to make these opportunities available in exchange for flexible and reliable capital.

The legal focus is about making sure both the GP and the LP are getting their needs met. Where you have bumps is when you have either unsophisticated counsel or commercial advisers that don't appreciate the mutual opportunities available to both sides. It's not a positional grab.

Q How can GPs and LPs maintain a strong relationship when co-investing?

Seth Palmer: Philosophically, we think of GPs as clients. They are sharing dealflow that they have put a tremendous amount of work into and are offering that to us on a low-fee or no-fee basis. That needs to be respected.

In return, we commit to offering them speed and transparency. We endeavour to offer feedback on a process within 48 hours, sharing our key questions or giving them a 'no' early on. There is nothing worse than a slow 'no' for a GP; if we are going to say no, we tell them why.

You also have to deliver on your commitments: if you say you can close on a certain date, do that, and if you are going to focus on a certain area of due diligence, do that.

Michael Gilbert: Legally and commercially, the key element is not to fall into the trap of viewing the legal negotiations as adversarial. GPs and LPs will have their own priorities, but there are very few situations where those need to conflict. LPs want to give GPs flexibility to have control, to act nimbly, to grow investments and to increase value. LPs are expecting, in turn, to receive the same return and the same liquidity options as the sponsor's main funds. Both sides should be aligned on those priorities.

Q As the number of new market entrants picks up, how are firms differentiating their offerings from those of their competitors?

SP: There are really three categories of co-investors in the market today. Category one is the more episodic players, who are focused on the syndicated part of the market and often need to be

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more intentional about building out their platforms.

The second category comprises the more professional co-investors who are beginning to differentiate themselves from syndicated market participants. They do this by bringing resources to co-underwrite transactions, taking on broken-deal risk and helping GPs unlock opportunities that would otherwise not be available to them without a strong professional partner.

Finally, the third category is the market-leading co-investors who are taking things to the next level in terms of pushing the envelope and delivering solutions that GPs really value. This includes the ability to bring deep diligence resources and insights from portfolio companies.

Another tool that market-leading co-investors offer is different structuring solutions, such as warehousing, that allow a GP some process simplicity to interact with one party while shaping a transaction and then syndicate down that co-invest later. Market leaders can also facilitate the pricing and structuring of cross-fund investments, recapitalisations and growth financings.

MG: Certain co-investors' ability to offer features like warehousing or thoughtful underwriting of broken-deal risk has created a lot of opportunities that would not otherwise exist for GPs seeking alternative capital solutions. The willingness of an adviser to handle that really strengthens relationships.

As the market has grown, we have seen some legal terms in flux, with new developments being proposed by market-leading co-investors. Overall, their objective has been to maintain parity with GPs and maintain the fundamental co-investment dynamics. That means co-investment legal documents are starting to look similar to the legal documents on multi-portfolio-company funds, though that can mask some nuances.

For example, we worry about follow-on rights for a co-investor in relation to follow-on investment opportunities or even rescue financing situations. If the co-investment legal documents are not drafted correctly, co-investors can miss opportunities to make new investments or to prevent dilution.

The same is true on exit. Our goal is to make sure the co-investor receives the same return, exit opportunities and liquidity as the sponsor's main fund. As we see an increase in novel exit options, such as continuation vehicles or sales to successor funds, co-investment documents need to keep up. Sophisticated clients are aware of that, but some of those newer to the space are not. It is important to work with advisers that see how things are changing.

Q What are your predictions for co-investment trends over the next 12-18 months?

SP: Our main prediction is a real return to liquidity and distributions once again exceeding capital drawdowns. Private equity has historically been a self-funding asset class where drawdowns were exceeded by distributions. Based on the momentum we saw in the back half of 2024, we expect that positive flywheel to return.

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Last year had some really positive green shoots, with exit activity increasing year on year. In our own portfolio, we saw that pace accelerate into year-end, with second-half liquidity coming in almost double that of the first half of the year and meaningfully ahead of 2023. We take that as a positive indicator of what we can hope to see in 2025.

MG: With all the exits we are anticipating, there are going to be a lot of opportunities for new investment and more capital available to support them.

As we see an increase in co-investment opportunities, the best of those are going to arise on short notice and with short deadlines. Investors that have established programmes, work with strong advisers and are fluent in co-investment market dynamics are going to find they get preferential access to those opportunities. ■