There is significant interest in co-investing, but not everyone has the skills and resources required to successfully execute a co-investment program. Investors in recent years have been drawn to co-investing for its potential to generate outperformance at reduced costs, as well as the opportunity it brings to be more actively involved in managing their portfolios. As more investors consider establishing programs, or adding to their existing allocations, it is critical that they fully understand both the dynamics of co-investing and the range of competencies required to be successful.

Throughout this series, HarbourVest’s global co-investment team—which has invested over $6 billion of co-investment capital since 1989—will share its collective insights and experiences to help make you a more successful co-investor. Part I of the series focuses on the basics, including a look at the benefits and risks inherent in co-investing.

Private equity has experienced spectacular growth over the past three decades as institutional investors have been drawn to the asset class by its consistent ability to outperform public market benchmarks.

As the industry has grown, it has expanded rapidly in terms of strategic offerings, regional and industry coverage, and stages of investment. Growing investor demand for private investment opportunities has also compelled the industry to develop new ways for investors to access these transactions, and to become more engaged in the actual deal process.

HarbourVest’s global investment team has invested more than $6 billion of co-investment capital since 1989.

Historically, the most common way to participate in private investing has been through commingled funds, or “blind pools” of capital structured as limited partnerships. The investors in these funds—known as limited partners (LPs)—delegate investment decision-making authority to the general partner (GP), or lead manager. In return for making investments into portfolio companies and managing these investments throughout their life, the GP is paid a management fee and receives carried interest, or a percentage of the profits that are generated by its investments. The funds themselves typically have life spans of 10 or more years.
While commingled funds remain the dominant vehicle for accessing private markets, more GPs are offering co-investment opportunities to their LPs. In a single company co-investment, an LP invests in a private or public operating company alongside, and typically at the invitation of, a GP. The lead manager is generally responsible for managing the portfolio company and may offer co-investment opportunities for a number of reasons—including to bridge a funding gap or to bring additional skills and resources to an investment.

While the potential for higher returns and more direct involvement has generated significant interest in co-investing, investors need to understand the risks that come with co-investing as well.

**WHY CO-INVEST?**

Many investors are familiar with the headline benefits that co-investing can offer. Strong performance track record. Lower fees. The chance to be more involved in the day-to-day management of their portfolios. Let’s take a deeper dive into the different ways co-investing can enhance your private markets portfolio.

**ADDED CONTROL OVER CAPITAL DEPLOYMENT PACING.** Commingled funds will always be an attractive method by which investors can gain exposure to private markets. However, unlike committing to a commingled fund—where the lead manager has full discretion on when, where, and with whom to make investments—co-investing provides the flexibility to further customize your investment strategy. For instance, an investor can use co-investments to efficiently deploy capital to deals in a specific region, industry, or manager that they wish to target, allowing it to better take advantage of short-term trends and tailwinds, as well as match its investment pacing to its cash flow needs.

**OUTPERFORMANCE POTENTIAL.** Gaining access to top-tier GPs and a large number of opportunities can be a major performance driver, and when you select well the potential for outperformance grows. Co-investing also provides a less expensive fee structure compared to traditional private equity funds. Recent research shows that while average gross returns for co-investments are similar to gross returns for GP-led funds, co-investment returns are meaningfully higher on a net basis.¹ The following chart compares the performance of a co-investment fund to a traditional PE fund.

STRONGER RELATIONSHIPS WITH TOP-TIER GPs. Because co-investing requires a hands-on approach, investors get the chance to work closely with top GPs to foster deeper relationships and gain a better understanding of their investment strategies and processes. For the co-investor, building these relationships is essential for gaining access to future deal flow and for building their own investment skills.

ACCESS TO PRE-QUALIFIED DEALS. The opportunities made available to co-investors are typically pre-screened by the lead manager, who performs extensive due diligence and vetting to ensure that the highest quality deals are selected. As a result, the opportunities that a co-investor is offered tend to be high-quality transactions.

*Invested capital includes any investments funded through a financing facility. In the event that cumulative capital committed to investments, including reinvested capital, ever exceeds total committed capital, then the management fee will be based on the lower committed capital number.

Shown for illustrative purposes only. Not intended to project performance. Assumes 100% of committed capital invested and 2.25x gross portfolio return in both scenarios. Management fees are paid through portfolio proceeds beginning in Year 5. Both scenarios have an identical schedule of gross distributions. IRRs are calculated based on annual cash flows, assuming capital called in mid-year and NAV as of year-end. IRRs reflect assumption of 18.4% NAV increase in Years 2 through 10. Does not reflect organizational costs and other fund level operating expenses. No cash balance is modeled, i.e., all fund excess cash is distributed to LPs. The carried interest accrues to the general partner’s account as it is generated and is paid to the general partner in Years 9 and 10. Co-investment fund fees and carried interest are based on HarbourVest Co-Investment IV Fund terms.

Co-Investment Fund vs. Traditional PE Fund

**Example:** $1.0 billion fund, invests $200 million per year evenly over 5 years, generates a gross portfolio return of 2.25x.

<table>
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<tr>
<th>Co-Investment Fund</th>
<th>Traditional Fund</th>
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<tbody>
<tr>
<td><strong>Fee:</strong> 1% of invested capital*</td>
<td><strong>Fee:</strong> 2% of committed capital</td>
</tr>
<tr>
<td><strong>Carry:</strong> 10% up to 2x, then 20% with no catch up</td>
<td><strong>Carry:</strong> 20%</td>
</tr>
</tbody>
</table>

Return $215 million more cash to LPs representing 53% less fees and carry paid than a traditional fund structure.
KNOW THE RISKS

While the benefits of co-investing can be substantial, long-term success requires a thorough understanding of the potential risks. Co-investment deals are generally complex, require extensive resources, involve multiple steps—from deal sourcing to post-investment monitoring—and often need to be completed in a short period of time. Knowing the caution flags to look for, and responding accordingly, is essential. Potential risks may include:

RESOURCE-INTENSIVE PROCESS. Executing a co-investment strategy requires significant resources to create a large pipeline of opportunities; evaluate both the lead manager offering the opportunity as well as the company in which they may invest; and to close and monitor the investments as they mature. For smaller investors with limited resources and due diligence experience, this can be a significant challenge. Many co-investors address skill-set voids by working with third-party advisors or outsourcing their programs entirely to an external co-investment manager.

POTENTIAL ADVERSE SELECTION BIAS. One common concern centers on whether the GP has a bias in allocating its own capital to the most attractive deals, while making the less appealing transactions available to co-investors. A recent study analyzing a large sample of buyout and venture capital co-investments found no evidence of adverse selection, concluding that average gross returns for co-investments were similar to gross returns for funds. Since enhancing relationships with LPs is one of the reasons GPs offer co-investment, they are consequently deterred from offering what may be perceived as less attractive opportunities. While it is impossible for GPs to predict the future, their relationships with LPs—and therefore the success of their next fundraise—may be negatively impacted by offering co-investment in what ultimately turns out to be a poor-performing investment.

HIGHER INVESTMENT CONCENTRATION. While investing through a fund-of-funds provides investors with exposure to hundreds of underlying companies, co-investing involves investing directly into a single company. LPs can counter this concentration risk by building a diverse portfolio of co-investments to supplement their broader private equity commitments.

DEAL EXECUTION. While the lead manager will have performed a thorough assessment of contingencies that might prevent a deal from closing, there will always be unforeseen events that can cause a transaction to fail—including a change in the operating performance or the appearance of another bidder. Co-investors thus run the risk of dedicating resources to a transaction that is ultimately not completed, sometimes incurring broken deal expenses.

Part II in our co-investment series will discuss the separate aspects of executing a co-investment.

GP/LP RELATIONSHIP DYNAMICS. As discussed in the merits section, co-investments can be an attractive way to cement a positive GP/LP relationship. However, poor execution of a co-investment, particularly any action that may jeopardize a lead manager’s ability to complete a transaction, can be one of the quickest ways to sour an otherwise good relationship. Examples of poor execution include an inefficient diligence process, communicating interest in a deal then passing on the opportunity, and adding complexity or risk to the closing or management processes.

KEY TAKEAWAYS

Given the attractive features discussed earlier, it is understandable why many institutions are pursuing co-investing. The performance has been strong and investment opportunities are growing in number. That said, investors who begin co-investing without having the requisite knowledge of what it takes to be successful are likely to be disappointed with their results. Developing a full understanding and appreciation for the rewards and risks of co-investing is an essential first step.