

Co-investments — a primer

Private market insights



Co-investments — a primer

For many institutions active in the private markets, investing in co-investments has become a critical piece of developing a balanced private markets program. While co-investments potentially offer the promise of higher net returns, they also come with risks and other considerations that are different from investing through a private market fund. This primer explores the potential benefits and risks of co-investments, the various ways that limited partners (LPs) can implement co-investments into their program and critical factors for LPs that are considering co-investments.

What are co-investments?

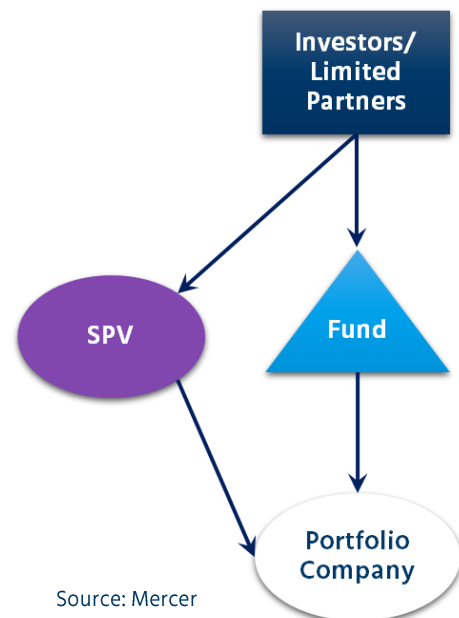
Co-investments are private market investments into a single company instead of a diversified blind pool portfolio, such as a primary private market fund. Co-investments are made alongside the general partner (GP) of a private market fund which is investing at the same time and principally on the same terms and conditions. Co-investments are made either directly into the target company or through a commingled vehicle or special purpose vehicle (SPV). The GP of the private market fund sponsoring the investment is typically also the GP of the SPV.

Co-investment opportunities arise when a private market manager identifies an attractive transaction requiring the private market fund to invest more equity than its diversification or other limits allow. Rather than missing an attractive opportunity, private market fund managers syndicate the excess equity investment to their funds' LPs or other strategic partners.

Allocations of co-investment opportunities vary based on the private market manager and/or the specific transaction. They have historically been offered only to a private market fund's largest and most sophisticated LPs or those who bring some strategic value to the transaction.

Co-investments are exited at the same time and on principally the same terms as the sponsoring private market fund exit.

Figure 1. Co-investment structure



Reasons for considering co-investments

Co-investments can be an additive part of a diversified private market program. Co-investments could provide multiple benefits to LPs:

1. Potential lower fees

- Co-investments can enable investors to access underlying investments at potentially reduced or zero management and performance fees.

2. Potentially improved net returns

- Due to potential lower fees, co-investments may drive higher net returns if certain multiples are achieved.

3. Accelerated capital deployment/J-curve mitigation

- Co-investments can facilitate a private market program reaching its target allocation sooner, through more rapid capital deployment.
- Upfront funding and potential fee savings can reduce the J-curve effect.¹

4. Diversification and control

- Co-investments provide flexibility to target investments by strategy, geography, industry or deal size, which helps to achieve the desired allocation while providing diversification, depending on deal flow.

5. Closer relationships with GPs

- LPs can develop deeper relationships with GPs by working directly with them on co-investment projects.

6. Knowledge transfer, transparency and alignment

- Co-investments allow LPs to obtain firsthand knowledge of how the GP executes the deal process, providing increased transparency and alignment of interest.
- LPs also can gain a deeper understanding of certain industry sectors.
- Co-investments help inform LPs' judgment and could potentially lead to improved fund selection.

7. Enhanced team retention

- LPs can expand their internal capabilities and acquire valuable experience in direct investments.

¹ See Mercer's paper: ["The flattening of the private equity J-curve"](#) September 2020.

Potential risks to consider

While the benefits associated with co-investing could be significant, confusion persists within parts of the institutional investor community about the downsides related to co-investing. The key risks associated with co-investing are summarized below:

1. Concentration risk

- In a portfolio with a more concentrated number of investments, a single investment's returns can dominate performance, positively or negatively.
- Concentration risk can happen across various dimensions (manager/industry/geography). The amount of capital invested per manager/industry/geography should be monitored. Many LPs institute a maximum percentage of commitments across the entire portfolio that can be invested in any one dimension.

2. Resource intensiveness

- A successful active co-investment program requires dedicated investment professionals.
- This can be costly and time-intensive.

3. Performance

- Risk characteristics differ from fund investing, and co-investments could have a greater dispersion of outcomes.
- Performance can vary (based on approach or GP relationships, for example).

4. Adverse selection

- A GP could execute deals that are above its normal investment range.
- An LP's desired investment size can limit the opportunity set.
- However, some experienced co-investors view adverse selection as more of a myth than a reality.

5. GP relationships

- Executed well, co-investments can enhance GP relationships. Executed poorly, co-investments can damage relationships and hinder future fund access and co-investment deal flow.





6. Headline risk

- Co-investments could expose LPs to headline risk if a high-profile investment goes bad or develops public relations issues.
-

Implementation options

There are various ways to implement co-investments into a private market program. Investors who actively participate in co-investments typically use one of the following implementation approaches:

Figure 2. Common co-investment implementation options

	Pros & Cons	Resource Requirements
	<ul style="list-style-type: none"> + Simplified reporting + Potential to pool deal flow + Ability to develop more fully diversified portfolios - No discretion or ability to tailor - Additional layer of fees 	<ul style="list-style-type: none"> • No additional resources required
	<ul style="list-style-type: none"> + Simplified reporting + Ability to tailor (portfolio & involvement) + Investor holds ownership of relationship - Additional layer of fees - Must rely on Investor's GP relationships 	<ul style="list-style-type: none"> • Depending on structure, some additional resources
	<ul style="list-style-type: none"> + Fully tailored approach + Investor is responsible for decision + Advisor assists in sourcing and diligence + Lowest cost - Must rely on Investor's GP relationships 	<ul style="list-style-type: none"> • Additional level of resources required • Ability to react quickly
	<ul style="list-style-type: none"> + Fee advantages - No discretion or ability to tailor 	<ul style="list-style-type: none"> • No additional resources required

Source: Mercer

When determining the appropriate implementation approach, LPs should assess various criteria, particularly if they are considering handling co-investments internally. LPs should have internal resources and experience available, as co-investments require additional resources, specific expertise and a proactive approach with GPs. To source co-investment deal flow from GPs, LPs must build strong GP relationships, maintain ongoing communication with the GP, establish their position as a “preferred” LP and have a reputation as a good partner.

Furthermore, transaction timelines for co-investments are typically much shorter compared to primary fund investments. Therefore, an LP’s process efficiency and ability to execute are critically important. LPs need to respond quickly to GPs, efficiently analyze the transaction and develop a definitive viewpoint. Missteps can result in the loss of further co-investment opportunities and potentially damage relationships with GPs, which could hinder future fund access.

Lastly, LPs need to recognize it is “co-investing,” not “co-leading,” and acknowledge the need to be a good partner with the GP.

Key factors for LPs considering co-investments

Mercer has participated in co-investments for many years. During this time, we have witnessed many approaches to co-investment — some successful, and some less so. As a result, we have developed critical considerations for LPs interested in co-investments, regardless of whether they are pursued internally or outsourced to a third party.

Partner with the right GP

In Mercer's view,² developing a strong co-investment program requires partnering with highly rated GPs. LPs should evaluate the GP's quality, the GP's angle on the deal and the GP's value-add experience to ensure the transaction is squarely in line with the GP's strategy, capabilities and historical success.

Adopt a disciplined approach

The most successful co-investment programs to date embrace a disciplined approach. LPs that have pursued consistent and diversified capital deployment in terms of vintage year and deal size have, we believe, typically fared better when economic and/or market conditions have changed.

² See Mercer's paper: ["Co-investments investments — Some Portfolio Management Considerations" September 2019.](#)

Important notices

References to Mercer shall be construed to include Mercer LLC and/or its associated companies.

© 2020 Mercer LLC. All rights reserved.

This contains confidential and proprietary information of Mercer and is intended for the exclusive use of the parties to whom it was provided by Mercer. Its content may not be modified, sold or otherwise provided, in whole or in part, to any other person or entity without Mercer's prior written permission.

The opinions expressed herein are the intellectual property of Mercer and are subject to change without notice. They are not intended to convey any guarantees as to the future performance of the investment products, asset classes or capital markets discussed.

Funds of private capital funds are available to sophisticated investors only who are accredited investors and qualified purchasers.

Mercer does not provide tax or legal advice. You should contact your tax advisor, accountant and/or attorney before making any decisions with tax or legal implications.

This does not constitute an offer to purchase or sell any securities.

For Mercer's conflict of interest disclosures, contact your Mercer representative or see www.mercer.com/conflictsofinterest.

This does not contain investment advice relating to your particular circumstances. No investment decision should be made based on this information without first obtaining appropriate professional advice and considering your circumstances. Mercer provides recommendations based on the particular client's circumstances, investment objectives and needs. As such, investment results will vary, and actual results may differ materially.

Information contained herein may have been obtained from a range of third-party sources. Although the information is believed to be reliable, Mercer has not sought to verify it independently. As such, Mercer makes no representations or warranties as to the accuracy of the information presented and takes no responsibility or liability (including for indirect, consequential or incidental damages) for any error, omission or inaccuracy in the data supplied by any third party.

Funds of private capital funds are speculative and involve a high degree of risk. Private capital fund managers have total authority over the private capital funds. The use of a single advisor applying similar strategies could mean lack of diversification and, consequentially, higher risk. Funds of private capital funds are not liquid and require investors to commit to funding capital calls over a period of several years; any default on a capital call may result in substantial

penalties and/or legal action. An investor could lose all or a substantial amount of his or her investment. There may be restrictions on transferring interests in private capital funds. Funds of private capital funds' fees and expenses may offset private capital funds' profits. Funds of private capital funds are not required to provide periodic pricing or valuation information to investors. Funds of private capital funds may involve complex tax structures and delays in distributing important tax information. Funds of private capital funds are not subject to the same regulatory requirements as mutual funds. Fund offering may only be made through a private placement memorandum (PPM).

Not all services mentioned are available in all jurisdictions. Please contact your Mercer representative for more information.

Investment management and advisory services for US clients are provided by Mercer Investments LLC (Mercer Investments). Mercer Investments LLC is registered to do business as "Mercer Investment Advisers LLC" in the following states: Arizona, California, Florida, Illinois, Kentucky, North Carolina, Oklahoma, and Pennsylvania; as "Mercer Investments LLC (Delaware)" in Georgia; and as "Mercer Investments LLC of Delaware" in Louisiana; and "Mercer Investments LLC, a limited liability company of Delaware" in Oregon. Mercer Investments LLC is a federally registered investment adviser under the Investment Advisers Act of 1940, as amended. Registration as an investment adviser does not imply a certain level of skill or training. The oral and written communications of an adviser provide you with information about which you determine to hire or retain an adviser. Mercer Investments' Form ADV Parts 2A and 2B can be obtained by written request directed to: Compliance Department, Mercer Investments, 99 High Street, Boston, MA 02110.

Certain regulated services in Europe are provided by Mercer Global Investments Europe Limited, Mercer (Ireland) Limited and Mercer Limited. Mercer Global Investments Europe Limited and Mercer (Ireland) Limited are regulated by the Central Bank of Ireland. Mercer Limited is authorized and regulated by the Financial Conduct Authority. Registered in England and Wales No. 984275. Registered Office: 1 Tower Place West, Tower Place, London EC3R 5BU.

Investment management services for Canadian investors are provided by Mercer Global Investments Canada Limited. Investment consulting services for Canadian investors are provided by Mercer (Canada) Limited.

September 2020