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The art of a successful co-investment

Investor appetite for co-investment is at an all-time high – but it's not as easy as it looks, write Amy Carroll and Carmela Mendoza

Investor appetite for co-investment is booming. According to *Private Equity International's LP Perspectives Study 2026*, 21 percent of investors access private equity via co-investments, up from 18 percent a year earlier. Similarly, Adams Street Partners' latest *Global Investor Survey* shows that an overwhelming 88 percent of LPs intend to allocate up to 20 percent of capital to co-investment between now and 2030 – a figure that has been climbing steadily for the past five years.

The ability to blend down fees by accessing co-investment on a fee-free, carry-free basis is clearly a major driver – but it is not the only one. Diversification is another compelling advantage.

"The biggest benefit that a co-investment fund offers compared with a buyout fund is diversification," says Faruk Amin, deputy head of US co-investment and senior managing director at Ardian, speaking on *PEI's* annual co-investing roundtable. "That

diversification comes from a greater number of investments in the fund, as well as diversification with respect to GP partner, sector and size. This reduces the overall risk profile of the portfolio."

Benjamin Hur, managing director and co-head of direct equity at Future Standard, adds that diversification is more important than ever today, particularly with respect to vintage-year diversification.

"Over the past 10 years, we have seen a huge amount of activity taking place in whatever industry happens to be the flavour of the day. But the window in which an investment in a certain sector makes sense from a risk-return perspective is getting narrower because valuations in a sector could increase considerably very quickly," he says. "In today's fast-changing market environment, having vintage-year diversification, and partnering with sponsors who can identify attractive industries and companies early before they become consensus plays, will be

key in generating consistent and attractive returns."

A question of control

When it comes to sculpting the ideal portfolio, the added control that co-investment provides is a major selling point for the strategy, particularly as investors have become more proactive about honing their exposures.

"The ability to control portfolio construction is a key benefit of co-investment. You can tilt by sector, geography, vintage and value creation strategy," says Karin Hyland, partner and head of European co-investments at Patria Investments. There are also softer benefits, she adds: "Co-investment strengthens GP relationships, which supports our primary and secondaries platforms. There is no better due diligence that you can do on a manager than undertaking co-investment alongside them, particularly on a co-underwriting basis."

"There is a lot less inertia in co-investment and a greater ability to



Faruk Amin

Deputy head of US co-investment and senior managing director, Ardian

Prior to joining Ardian, Faruk Amin worked at Juna Equity Partners. He was previously a managing director in the private equity and principal investment group at Lehman Brothers.

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Partner, Davis Polk

Luke Eldridge advises private equity sponsors, co-investment vehicles and separately managed accounts at Davis Polk, covering numerous sectors and strategies.



Omar Jabri

Managing director, Lexington Partners

Omar Jabri focuses on the origination, evaluation and execution of equity co-investments at Lexington Partners. He joined the firm from Evercore in 2011.



Benjamin Hur

Managing director and co-head of direct equity, Future Standard

Benjamin Hur joined Future Standard in 2010. He was previously an investment banking analyst in the global consumer group at Citigroup.



Thomas Roche Toussaint

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Thomas Roche Toussaint is responsible for the selection, execution and portfolio management of private equity secondaries and co-investment transactions globally, as well as leading the investment team at UBS Asset Management.



Karin Hyland

Partner and head of European co-investments, Patria Investments

Karin Hyland has 20 years' experience in private equity and is responsible for sourcing, evaluating and executing co-investments and continuation fund opportunities at Patria Investments.



control portfolios dynamically than committing to a blind pool fund,” adds Thomas Roche Toussaint, head of private equity secondaries and co-investments at UBS Asset Management. “When markets shifted in February with everything that was happening around software valuations, we were able to quickly pivot to other sectors while continuing to closely monitor software names, their resilience and the companies starting to emerge as winners. Those transactions are now coming back to market in H2, and we have a clearer understanding and proof points on which companies are pulling away from the pack.”

Co-investment also gives investors more control over their deployment pace. “A lot of funds are taking longer to deploy capital. Co-investment allows LPs to deploy more efficiently and in a more controllable way,” says Roche Toussaint, adding that co-investment funds typically target deployment completion a year earlier than the average primary fund. “A co-investment strategy can help offset some of that delay in getting cash in the ground faster.”

Furthermore, co-investment can help offset the current slowdown in exits. “Investing selectively into high-conviction opportunities through co-investment should lead to a quicker return of liquidity,” says Hyland.

The protracted exit drought of recent years, coupled with associated challenges with fundraising, has also heightened GP demand for co-investment dollars. “GPs are allocating more co-investment to preserve dry powder if they think their next fundraising may be delayed due to a lack of exits,” says Amin.

“I think this is a durable trend and a reflection of the maturation of private equity,” says Omar Jabri, managing director at Lexington Partners. “A lot of large investors have achieved their target allocations in private equity already, so now it is all about how they shape their

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BENJAMIN HUR
Future Standard

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THOMAS ROCHE TOUSSAINT
UBS Asset Management

portfolios going forward without adding too many new primary relationships.”

Luke Eldridge, a partner at Davis Polk, agrees the co-investment trend is here to stay: “As part of their underwriting of any primary fund relationship, LPs increasingly expect sponsors to clearly articulate their approach to co-investments, including their allocation framework and how opportunities will be presented to investors.

“Sponsors are responding by building the structures they need to facilitate that. As that happens, co-investment is moving from something that was historically relationship-driven and largely ad hoc to something more formal and programmatic. That will continue to encourage more and more co-investment deployment.”

How to be a good partner

The level of appetite for co-investment means that accessing the best opportunities can be a competitive business.

Would-be co-investors need to position themselves as reliable partners in order to be invited into an investment process.

“Deal timelines are shrinking, and LPs looking to co-invest need dedicated teams that can analyse transactions in just a couple of weeks,” says Roche Toussaint. “If you miss closing, you are not going to get another call. That is how reputations are destroyed in this business.

“It’s not just about execution speed. Co-investments need to be viewed through a different lens – you can’t rely solely on the GP’s perspective or evaluate a co-investment through the same lens as a diversified fund. A dedicated deal team allows you to conduct deeper diligence, form an independent view and identify the opportunities that are best aligned with your own investment strategy.”

“A quick no is always better than a long yes. The ability to make that call decisively comes from a long track

record of investment experience and knowledge of the GPs you are working with, which allows for pattern recognition,” adds Hyland.

“Our dealflow is pre-qualified based on our relationship with the GPs, most of which we have known for 10 or even 20 years. We have also built up a lot of wider industry data and insights which we can leverage to help make those quick decisions. I recently worked on a deal where I made four phone calls over two days to GPs that own assets in a similar space, and I learned more than I could through weeks of work with an external due diligence provider.”

Hyland says being user-friendly is also critical: “The whole co-investment process needs to be as frictionless as possible. Ask questions, but don’t ask the same 100 questions on every deal. Don’t waste the sponsor’s time. And be useful – provide your own diligence and help position the GP to win.”

Helping the GP manage syndication risk is another strong selling point for a co-investor. “We will sometimes make a larger commitment pre-signing when we co-underwrite than what the GP intends to ultimately allocate to us, so we take a cutback to allow the GP to syndicate post-signing,” says Amin. “That means we are helping the GP take syndication risk off the table at signing, but then allowing other smaller LPs to participate. That is really helpful to the GP.”

“GPs really value that kind of flexibility,” agrees Rouché Toussaint. “In those situations, you are acting as more than an LP: you are helping the GP manage their book and their other relationships. It is that kind of behaviour that ensures you will get the next call.”

In addition to helping secure additional co-investment, being a value-add co-investor could help with gaining access to the best-performing flagship funds as well.

“As we continue in this high-interest environment, it is inevitable that we

are going to see winners and losers in the private equity fund space,” says Hur.

“Investors will obviously gravitate towards the winners. In order to gain access to those funds and co-investment opportunities, you will have to prove yourself to be an LP that is more than just a primary capital allocator – and that includes being a value-add co-investor who can bring insights during due diligence, especially in the mid-market.”

Co-investment challenges

None of this is to say that co-investment is easy. “A successful programme has to overcome three barriers – finding opportunities, accessing those opportunities, and then selecting the right ones,” says Hyland. “You need to have those identification, access and

selection capabilities, because when co-investment goes wrong, it can go badly wrong.”

“Taking too much co-investment without understanding the risk you are building up is something that allocators need to be mindful of,” says Jabri. “Just look at what happened with technology in 2021: we are seeing a lot of activity taking place in certain sectors again today, and that can present real vintage risk.”

“A lot of mistakes were made in 2021 by co-investors making bets based on their faith in particular GPs,” adds Rouche Toussaint. “This is why it is so important to separate co-investment underwriting from primary underwriting. Both the underlying asset and the GP have to be validated independently; then the fit between the GP and the asset must also be assessed.”

Hyland agrees that while a primary relationship can act as a pre-qualification, you still need to have dedicated resource to underwrite the transaction itself.

“For example, we have US clients that are very sophisticated co-investors in their core market, but they recognise that they don’t have the resources or relationships to extend that into Europe. They therefore choose to invest via a dedicated co-investment programme like ours in order to get diversification in a part of the world where they don’t have that access and expertise.”

Hur, meanwhile, says LPs who are executing on co-investments on their own also need to be thoughtful about how their portfolio of co-investments fits within their overall private equity strategy.

“To select the best possible co-investments in a crowded market... you need a sponsor that is not only going to win that deal in a competitive landscape, but can also do something special with that business”

OMAR JABRI
Lexington Partners

Tips for a frictionless co-investment

Governance structures can streamline the co-investment process, provided they don't create unintended conflicts

There are many steps that both LPs and GPs can take to ensure the co-investment process runs smoothly, particularly from a legal and governance standpoint. Davis Polk's Luke Eldridge points to identifying areas of potential friction upfront, including investment and disposition terms, pre-emptive rights for follow-on investments, fees and other key economics.

"Then there are issues to consider around governance and control. Co-investors have different interests and rights than investors in a main fund, so it is important to establish clear parameters around decision-making, information rights and conflicts," Eldridge says.

Sponsors, meanwhile, need to make sure governance structures don't create unintended conflicts between flagship funds and co-investment vehicles that may impair their ability to manage the underlying investment.

"Clear allocation policies are essential in terms of which deals get syndicated, which LPs receive

co-investment opportunities and how those opportunities are allocated between key stakeholders when demand exceeds supply," Eldridge explains.

More generally, it is important for GPs to understand the preferences of each co-investor and what their criteria are well ahead of any time-pressured deal process.

"That could mean gauging their appetite with respect to sector, geography or size, for example. That can really help GPs identify the right co-investors efficiently, particularly as the number of potential co-investors proliferates," Eldridge says.

"It can also be helpful to come up with a list of pre-agreed diligence requirements in terms of the core information that a co-investor requires. That enables GPs to quickly put together a standardised package of reporting and financial information, reducing friction in the diligence process."

"This will help determine how much risk they are willing to take. Co-investments are chunkier in nature, and that increases concentration in certain sectors. It could be that they are looking to generate alpha with their co-investments and rely on the more diversified portion of their private equity book for overall risk mitigation."

The challenges associated with co-investment have only been exacerbated by several years of near-perpetual macro volatility.

"It is challenging," admits Hyland. "Investors focus a lot on private company transaction comparables, but that can be difficult in a sector such as software where market conditions are very different today, even when compared to six months ago.

"Instead, we have to focus on the fundamentals. We also find it helps to work alongside sector specialists – that improves the quality of deals going into the funnel and gives us a

lot more confidence in the manager's value creation capabilities, as they have often been operators in the space themselves."

One emerging area of potential risk involves the proliferation of evergreen vehicles launched by large private equity sponsors targeting the wealth channel.

"That could have significant implications for co-investment supply, especially in the larger part of the PE market, as they no longer need to provide fee- and carry-free co-investments to their LPs," says Hur. "It could also increase demand, of course, but it remains to be seen where that equilibrium will settle."

Hyland says some GPs have spoken openly about their intention to give co-investment to the wealth channel, given that those funds are paying fees, while traditional co-investors pay nothing.

"It seems likely that evergreen vehicles will take some of the allocation

that has previously gone to institutions in that large-cap market, which is a good reason to focus on smaller deals, as we do."

Jabri, however, points out that there could also be some positives associated with an increase in evergreen funds. "Evergreen capital could help digest some very high-quality, very large assets that don't necessarily have many other exit alternatives outside an IPO," he says.

Recipe for success

Despite the challenges that exist in this space, some clear patterns have emerged around the co-investments that ultimately prove to be successful and those that do not.

"First and foremost, what we see is that if you overpay, you are dead in the water. We can also see that if deals underperform in the first two years of hold, they are likely to continue underperforming. It is difficult to dig your way out of that lack of momentum,

particularly in a higher-interest-rate environment,” says Hur.

“Suddenly, you start getting uncomfortably close to the debt covenants, leading the sponsors and the management teams to become risk-off. We have seen – even in a zero-interest-rate environment, when M&A was a very effective value creation lever – that organic growth has been the strongest indicator of ultimate success.”

Amin adds that for a long time, multiple expansion played a significant role in generating returns. “Now, multiples may not even remain stable. In some sectors, they are starting to come down. That means it is more important than ever to make sure you are not overpaying.”

Hyland, meanwhile, says sponsor quality is paramount: “As co-investors, we are not driving value creation in these businesses. You need to ensure the sponsor you partner with is the right one for the business. If you have good

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Davis Polk

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Patria Investments

companies but they are managed by the wrong sponsors, you are not going to get the results you are looking for.”

Jabri agrees: “To select the best possible co-investments in a crowded market, you need to be able to identify and underwrite a value creation plan that you trust a specific sponsor to deliver. You need a sponsor that is not only going to win that deal in a competitive landscape, but that can then do something special with that business.”

He adds, however, that a co-investor’s objective is not to maximise the gross return on every individual deal – rather, they need to generate an attractive risk-adjusted net return. “That means giving yourself the opportunity to capture outliers – some really big winners – but also managing your loss ratios across the portfolio.”

“Risk-adjusted returns and consistency are what matter in co-investment. If you are taking more concentrated bets, you may be a top performer in one vintage and then down in the third or fourth quartile the next,” agrees Amin. “That is not what a co-investment strategy is about.”

Fee pressure

Co-investment returns are, of course, significantly helped by the fact that they generally don’t command economics. However, there are occasional rumblings emanating from the GP community that suggest some are unhappy with the fee-free, carry-free arrangement.

Hur is unperturbed by this: “Co-investment is essentially a cost of doing business for many sponsors at this point. Managers get their two-and-20 from the main fund; they also now have the fee stream from continuation vehicles. Furthermore, GPs need co-investment in order to close deals. It is not just a giveaway.”

Roche Toussaint adds that GPs now need to offer co-invest in order to attract LPs: “They understand that, and this is why even those GPs that were reluctant to offer co-investment five or 10 years ago are now doing so. Co-investment is now a cost of doing business and an important way to strengthen partnerships with LPs.” ■