

Co-investment: Why Canadian GPs should take note of SEC's guidance

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Co-investment was a hot topic at last month's PartnerConnect East 2018 conference in Boston. Whether general partner or limited partner, co-investment issues elicited much debate and deliberation—and for good reason.

Guidance by the U.S. Securities and Exchange Commission (SEC) on how co-investment opportunities should be allocated by U.S. private equity fund managers has been the subject of much discussion south of the border and has implications for American GPs and their investors.

Although the SEC guidance, which calls for written policies and greater transparency on how GPs designate co-investment rights, does not technically apply in Canada, Canadian GPs should consider proactively how they might comply with the framework.

Canadian GPs should develop clear, robust, written co-investment policies of their own, adhere to these policies, and be transparent with their LPs about what their policies are about. There is flexibility regarding the co-investment policy-making, but the spirit of the policy is to provide transparency in detailing when, how and to whom co-investment opportunities will be presented.

There are also potential financial implications to consider in terms of the cost and allocation of failed deal expenses of investments, which may be the object of a co-investment with a subset of LPs from a given fund.

For example, in the case of a broken co-investment deal, the GP might cause the main fund to absorb 100 percent of the associated expenses, while only a certain number of LPs might have participated in the benefit of that co-investment; hence, an uneven cost and sharing of opportunity among unit-holders.

Why should Canadian GPs adapt?

There are several reasons why Canadian GPs would be advised to adhere to an SEC-inspired co-investment disclosure and compliance policy framework.

For one, in Canada, just like the United States, there is a general fiduciary obligation on the part of GPs to LPs. Compliance with the U.S. standards encourages a more level and transparent playing-field and increases fairness for LPs, potentially discouraging the tactical allocation of preferential rights, which has been the subject of SEC and LP scrutiny.

Additionally, as U.S. GPs comply with SEC guidance, Canadian GPs may face criticism from American LPs for non-disclosure or lack of transparency around co-investment policies.

Finally, many Canadian GPs are actively involved in transactions in the United States, either fundraising or investing. They may therefore be subject to the purview of the SEC and thus well-advised to comply with U.S. standards. Since Canadian GPs are competing in a market where U.S. GPs are following the rules, it would be strategic for them to follow suit.

Growing demand for co-investment rights

Co-investment rights are now one of the most negotiated terms of fund investment.

The economic benefit of reduced management fees and cherry-picking direct deals associated with co-investment rights, compared to traditional indirect fund investments, makes them an attractive adjunct to fund investing.

Co-investment rights and terms are fiercely negotiated at the time of fund investment. These negotiations can take time, offering another reason why having a transparent set of policies in place can help streamline the process.

Terms of negotiation for co-investment rights include the allocation of fees and expenses, governance, investment vehicles, etc. Legal counsel should be consulted throughout to help facilitate this process and ensure best practices are met.

Unfortunately, the process of implementing co-investment negotiated rights is quite problematic in the real world.

That's because the investment thesis, speed of decision-making and investment characteristics of the GP and participating LPs all come into play in any new investment, and they are not all necessarily the same or aligned. As a result, GPs are finding that it isn't always easy to action those rights when co-investment opportunities arise.

In today's deal climate, with large pools of capital chasing few opportunities and inflating valuations, the economic pendulum has swung back in favour of GPs. With so much LP money chasing direct investments, and demand for co-investments intensifying, we have a scenario in which GPs might potentially increase their ask for fees and/or carry or other concessions in exchange for these coveted co-investment rights.

Concluding thoughts

In this era of increased interest in co-investment vehicles worldwide, Canadian GPs would be best served to implement their own policies and align themselves with the SEC considerations as outlined above.

As more LPs want direct access, GPs appear to have increasing leverage. This could eventually translate into a return to better economics and/or terms for the GPs over the next 12 to 18 months.

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