Co-investment alongside discretionary funds: a growing trend

SUMMARY OF AN IPF PANEL DISCUSSION

Organisations co-investing in the funds they manage is a well-established path. What is new is the increasing number of investors who are making co-investment commitments alongside their allocations to discretionary funds.

The IPF organised a panel discussion in October 2015 to explore the rationale for this emerging trend and to take a look at the strategies for securing and deploying co-investment capital.

The participants were:

Chairman: **Justin Cornelius**, Berwin Leighton Paisner (JC)

Panel members: **John Harding**, BlackRock (JH)
Damien Smith, The Townsend Group (DS)
Rob West, Clearbell Capital (RW)

JC: TO WHAT EXTENT HAS CO-INVESTMENT FEATURED IN YOUR RESPECTIVE ORGANISATIONS?

DS: Townsend is a large advisor to the US pension fund community with approximately $150bn of capital under advice, which is invested across all forms of real estate investment. Townsend's discretionary business has approximately $14bn of assets under management (AUM) and has approximately 20% in non-primary fund investments including co-investments.

RW: Clearbell Capital manages two private equity funds. The second fund, which closed in 2014 and focuses on fringe London, South East offices and UK-wide logistics, has now committed to about £100m of co-investment, of which about 25% is UK-based.

JH: BlackRock currently manages about $4.5tn in assets, of which $22bn is held in private and public real estate across the equity and debt spectrum on behalf of investors worldwide. We frequently invite investors to co-invest alongside our funds.

JC: WHAT ARE THE ATTRACTIONS OF CO-INVESTMENT TO FUND MANAGERS AND INVESTORS?

DS: Co-investment can be additive to managers, particularly at the start and at the end of the fund life to assist with capital management and portfolio construction. We do see discrete differences in approach between US and European fund managers – the former tend to be more proactive in seeking co-investment partners.

> *"...there is an opportunity to build very productive relationships."*

RW: All capital is 'good' from a manager's perspective. Some limited partners insist on co-investment rights. It has a number of benefits, including access to

additional capital. The most recent Clearbell transaction at £150m+ was too big for the fund on its own so it was helpful to be able to draw on £35m from two co-investors. Also there are the additional fees and the opportunity to build relationships with co-investors, including making presentations to co-investors' boards and so on.

DS: I agree there is an opportunity to build very productive relationships. Three years ago, Townsend was involved in a deal in Paris with a sovereign client and a local fund manager. The client and manager are exploring other opportunities to do more together.

JH: The desire for co-investment also poses challenges for managers. For example, during the fund raising process, if everyone says, "I want to co-invest but not be part of the fund itself", then the fund will never launch. Managers may require some investment in the fund as a prerequisite for being able to co-invest but this is not always case. Managers are also commercial and will accept co-investment capital, particularly when conditions are such that it is hard to raise capital in the market.

> *"Managers may require some investment in the fund as a prerequisite for being able to co-invest"*

RW: Also there has not been the same recovery in fee levels that were seen in previous cycles so currently co-investors have a lot of influence.

DS: Co-investment is attractive to large investors who feel investing in funds has its limitations when problems arise, as we saw in the last crisis. Some of these groups are now investing to build their own in-house investment teams but co-investment does offer access to expert management teams and the ability to invest with conviction and fix problems should they arise.

> *"..co-investment does offer access to expert management teams and the ability to invest with conviction and fix problems should they arise."*

JH: Co-investment can also be a solution to certain limitations. For example, some investors have a limitation on their concentration within a certain fund. Co-investments can allow them to access deals they believe in with managers they trust.

JC: ANY THOUGHTS ABOUT ISSUES ARISING DURING SPECIFIC CO-INVESTMENT TRANSACTIONS IN WHICH YOU HAVE BEEN INVOLVED?

RW: Clearbell has done four co-investment deals in the current fund. The most recent (August 2015) was the purchase of the Amber portfolio of 29 assets for £153.5m (as previously mentioned). This was funded by £70m of equity, being co-investment from a client of Franklin Templeton Real Asset Advisors and an overseas pension fund (each took a 25% stake), and a five-year senior loan at 65% loan-to-value. The key issue was getting decisions made quickly enough, given that there was only six weeks between having the offer accepted and going unconditional, with needing to do due diligence and get all approvals in place. At the start, there was a third potential co-investor but it decided not to proceed in light of the tight timescale and equity allocation.

JH: This underlines one of the challenges for fund managers – co-investors often do not have the resources to be able to respond in time. I am aware of a number of instances where investors have been keen to co-invest in a deal alongside the fund but when the time comes to act, they cannot drop everything else they are working on in order to perform the necessary due diligence in the allotted time.

DS: As a co-investor we do very comprehensive due diligence, even though the fund has already done this. Others are happy to rely on the manager's due diligence. It comes down to an investor's level of internal resource, the level of due diligence and underwriting by the manager and whether the deal under consideration fits their investment strategy.

Townsend is increasingly being asked to undertake the due diligence and underwrite the deal. We look at:

1. Is the deal attractive from a risk/return perspective;
2. Are we happy to underwrite the level of risk in the deal itself; and
3. Are we happy to underwrite the abilities of the fund manager.

Currently, the conversion rate from the deals in our pipeline is about 10%.

JC: WHAT ABOUT CO-INVESTMENT BY THOSE NOT IN THE FUND?

DS: Limited partners who commit to the fund should expect to have first rights. However, if existing investors cannot commit in a timely manner to secure the investment, external co-investment should be considered.

RW: We offer co-investment opportunities to our investors in the fund first and we will also look to use the monies in the fund first.

DS: We are seeing funds sharing a deal where their respective co-investors have said 'No'. In these club deals each group has a 'voice' proportionate to its investment.

RW: It is much easier to work with co-investors rather than another fund. Having said that, we have just done a deal on a speculative development, 50:50 with another fund and are using an external development manager.

"It is much easier to work with co-investors rather than another fund."

JC: WHAT ABOUT MANAGEMENT FEES?

JH: I have seen a range of fees. It seems to depend on where we are in the cycle and the purpose of the co-investment capital. Some say the fees should be 50% of what they would be for investors in the fund but I have seen other institutions offer a range from full fees to no fees for co-investment.

DS: In the US, the rule of thumb is 50% of fund fees. We have not participated in deals where the fund managers demanded full fees. We've seen examples where competing managers have co-invested into deals together where clearly no additional fees are payable. One has to have an open mind. If the deal is immensely sensible after tax and on a risk/return basis, then one should be more flexible on fees.

JC: DO YOU EXPECT THE TREND TOWARDS CO-INVESTMENT TO CONTINUE AND WILL IT PUT MORE PRESSURE ON MANAGERS TO DEPLOY CAPITAL?

JH: I think it is cyclical but also a factor of market maturity. In the US, it is standard practice – in Europe it is still developing and we are learning from our private equity counterparts. At certain points in the cycle it is easier to raise capital so managers give away fewer concessions.

DS: I think co-investment is a trend that is here to stay. I do not think it should put pressure on managers to deploy more capital but should be additive to both the manager and the fund to access investments that may otherwise be too large for the fund.

RW: From a short-term perspective, we would like to do more co-investment as it enables us to build strong relationships and access to capital when we need it. There has not been a noticeable slowdown in demand as yet but, as the market strengthens, we have to remain disciplined as to how we underwrite returns.

"At certain points in the cycle it is easier to raise capital so managers give away fewer concessions."

JC: HOW DO YOU MANAGE A GROUP OF INVESTORS, EACH OF WHOM WANTS THE RIGHT TO CO-INVEST?

RW: It is not an easy process to manage. However, in practice, not all investors go ahead, particularly given that one has to impose strict timetables. Also, the pro-rata share may be too small – as was the case for one of our co-investors on a deal we did near Canary Wharf.

DS: One does get to the stage where the allocation is too small. For us, anything less than $10m does not make sense. The 'sweet spot' to invest is circa $50m. We can go higher or lower but this level provides guidance to fund managers.

JH: It is important to have a strong relationship with ones co-investors such that you know what they are likely to do. It makes the whole process a lot more efficient.

QUESTION FROM JOHN FORBES (IN THE AUDIENCE): IN 2008, THINGS DID NOT GO WELL DUE LARGELY TO LACK OF ALIGNMENT. HOW CONFIDENT ARE YOU NOW WITH CO-INVESTMENT/FUNDS RELATIONSHIPS THAT THERE ARE PROVISIONS IN PLACE TO DEAL WITH SITUATIONS, WHERE, FOR EXAMPLE, THERE IS NEED FOR NEW CAPITAL AND SOME INVESTORS ARE UNABLE OR UNWILLING TO GO ALONG WITH THIS?

RW: Pretty comfortable that we are aligned. Also we have a different leverage perspective (compared to 2006); we are at 50-60% now.

JC: Current fund documentation better addresses the issue of managers not performing as expected. Co-investors now have recapitalisation rights where the they can put in more money even if the fund does not.

DS: Recapitalisation rights exist at fund level but these differ between funds. Some co-investors have control rights so they can amend an individual investment business plan to allow for problems, but not at the fund level.

JC: Funds have a fiduciary duty to revert to their investors and it is essential that they communicate openly with them. There is a big difference between investors being unhappy with the investment they made and the fund manager itself.

RW: If a deal goes wrong it is a test of the co-investors/fund manager relationship. I would like to think that should it happen to us that we would come out of it positively.

> *"...big difference between investors being unhappy with the investment they made and the fund manager itself"*