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Understanding Co-Investments: A Guide to Private Market Opportunities

RESEARCH | JANUARY 2025

Co-investments have become an increasingly popular aspect of private markets investing, offering potential advantages for both Limited Partners (LPs) and General Partners (GPs).

By accessing investment vehicles that include co-investments, investors gain access to potentially attractive deals and can benefit from the private equity firms' expertise and deal-sourcing capabilities. Additionally, co-investing may enable investors to acquire exposure to high-quality assets at lower fees, enhancing the potential for superior returns.

In this primer, we review how co-investments work as well as the benefits and challenges of co-investing. While this paper focuses primarily on private equity, co-investing is available in other private market asset classes as well.

Key Takeaways

Definition and Structure: Co-investments allow limited partners (LPs) to invest alongside general partners (GPs) directly into specific portfolio companies. Unlike traditional private market fund investments, co-investments do not involve "blind pool" risk, as LPs can choose whether to participate in each opportunity.

Benefits to LPs: Co-investments offer several potential advantages to LPs, generally including lower fees, more targeted portfolio exposures, and mitigating the j-curve effect. Participating in co-investments often provides LPs with more control and flexibility over their portfolio.

Performance: Academic research has shown no significant difference in gross performance between co-investment deals and those retained solely by the fund.[1] Hence, co-investments potentially can be expected to offer higher net performance, on average, compared to traditional fund investments due to their more attractive economics (i.e., lower fees).

[1] Source: "Adverse Selection and the Performance of Private Equity Co-Investments", Braun, Jenkinson, Schemmerl; December 2018.

Considerations for LPs: While co-investments present potentially attractive opportunities, they also come with additional considerations. LPs must be prepared for compressed decision-making timelines and the need for more efficient internal review processes. There is also the potential for concentration risk, as co-investments may result in more significant exposure to individual portfolio companies.

GPs' Perspective: GPs offer co-investments for various reasons, including the need for additional capital for large investments, to reduce concentration risk in their fund portfolio, and a desire to maintain control over an investment. Offering co-investments can also help GPs build stronger relationships with LPs.

What are Co-Investments?

Private market investors typically build most or all of their private markets portfolio by making commitments to commingled, limited-life investment vehicles, or "funds," that are raised periodically by managers or General Partners. In this case, a fund investor (the limited partner or LP) will typically be required to participate pro-rata in each investment made by the GP for that fund. Investors generally do not know what specific investments will comprise the fund at the time they commit to it – so it represents what's called a "blind pool."

In contrast, a co-investment is a more collaborative investment structure in which an LP invests alongside a GP directly into a specific portfolio company that the GP is purchasing to include in a fund. In most cases, co-investors are also LPs in this fund, so they are essentially putting more capital into a deal that they will already have exposure to once the GP adds it to the fund. However, unlike a traditional private market fund investment, there is no "blind pool" risk, as the LP has the option not to participate in any given co-investment opportunity.

The co-investment is generally made in the same assets as the main fund. Therefore, the LP is typically investing capital as a minority equity stake in the underlying company. However, taken together with the GP's and other co-investors' shareholdings, they are likely to represent a majority stake. The GP will also usually have control over

the timing and form of the ultimate disposition of the target company, including both the main fund's interest and the co-investment. Figure 1 depicts a schematic for a typical co-investment.

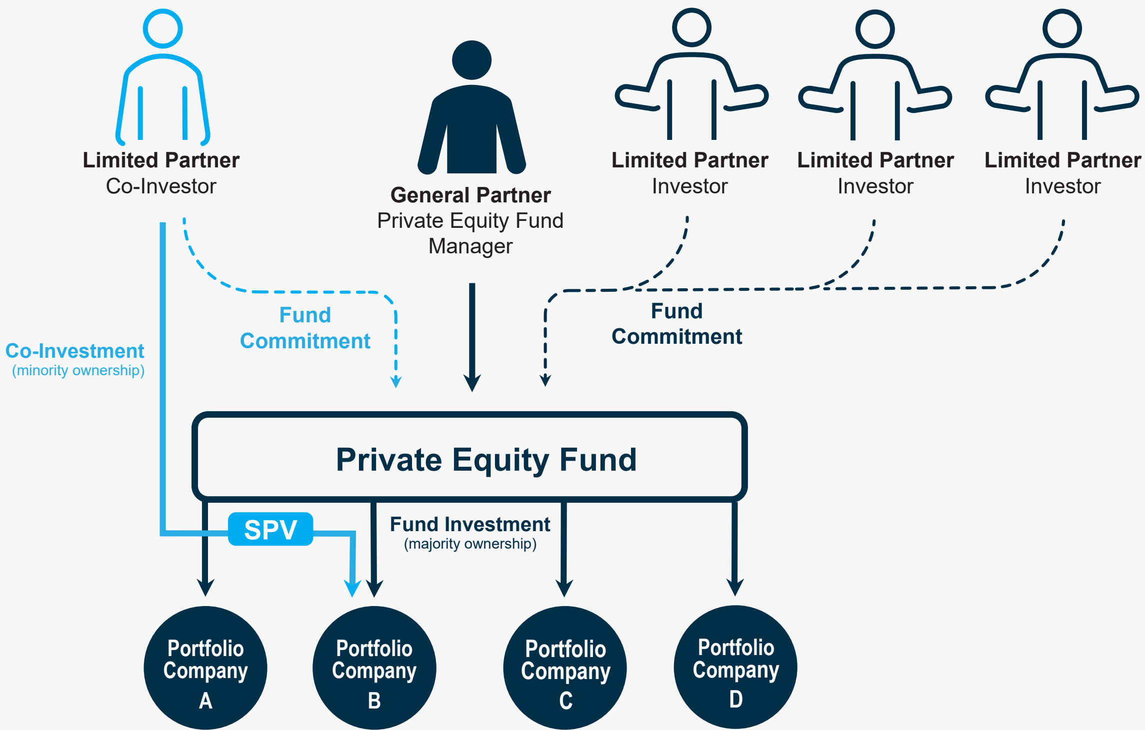

FIGURE 1
Typical Co-investment Structure
Source: Meketa Investment Group, 2024.

Steps of a Co-Investment

GPs typically seek to obtain co-investors during the late stages of their diligence or shortly after they have completed a transaction.

Step 1	Step 2	Step 3	Step 4
The GP selectively reaches out to LPs who are likely to be interested in a co-investment opportunity, provides a summary of the transaction, and requests indications of interest.	Assuming interest, the GP typically provides the potential co-investors with access to the full investment offering documents and the "data room," which contains due diligence materials pertaining to the transaction.	The GP may arrange site visits and/or meetings with the management team of the portfolio company or asset and potentially access to third-party consultants for interested LPs.	The GP and LP negotiate appropriate legal documents and close co-investment capital.

Since co-investments can be attractive opportunities, GPs typically offer them preferentially to their LPs, rather than broadly seeking outside co-investors. Most fund Limited Partnership Agreements ("LPAs") provide that the GP has significant discretion on whom they offer co-invest opportunities to.

What Characteristics do General Partners Seek in a Co-Investor?

There are certain characteristics of LPs that GPs may find important or preferential when considering an LP for co-investment opportunities. Key attributes include the LP's speed of decision-making, the potential size of their commitment, and their reliability. GPs will often look to first offer co-investment rights to those LPs they consider to be their most important relationships. Often, this can mean those LPs making the largest dollar commitments to an individual fund or series of funds. Large LP commitments also imply that the LP has the ability to take a meaningful portion of the available capital, another important characteristic as the GP will likely want to limit the number of co-investors. The GP is also likely to reach out to those LPs that have previously expressed interest in or participated in co-investments.

GPs value co-investors that can respond promptly and reliably (i.e., a "yes" means a "yes") to co-investment opportunities. Hence, the GP typically seeks LPs who have a defined investment review process. This allows the GP to more quickly determine potential interest in order to successfully syndicate the co-investment or complete the transaction.

The Co-Investment Universe

Co-investment fundraising has generally been on the rise over the last decade, peaking in aggregate capital raised for private equity co-investing in 2021 (see Figure 2). This peak coincides with the largest annual fundraising in traditional private equity in over two decades.[2]

[2] Source: Preqin, as of October 2024. Since 2000, the year 2021 had the highest aggregate capital raised and number of funds for private equity. There is no complete and reliable data set for private investments. The information is extremely limited, and most data is compiled from funds that elect to self-report and tend to be biased toward higher performing funds. Losses are underreported. Funds included in these measures lack commonality and transparency. Over time, components of the data may change. Funds may begin or cease to be represented based on these factors, thereby creating a "survivorship bias" that may additionally impact the data reported.

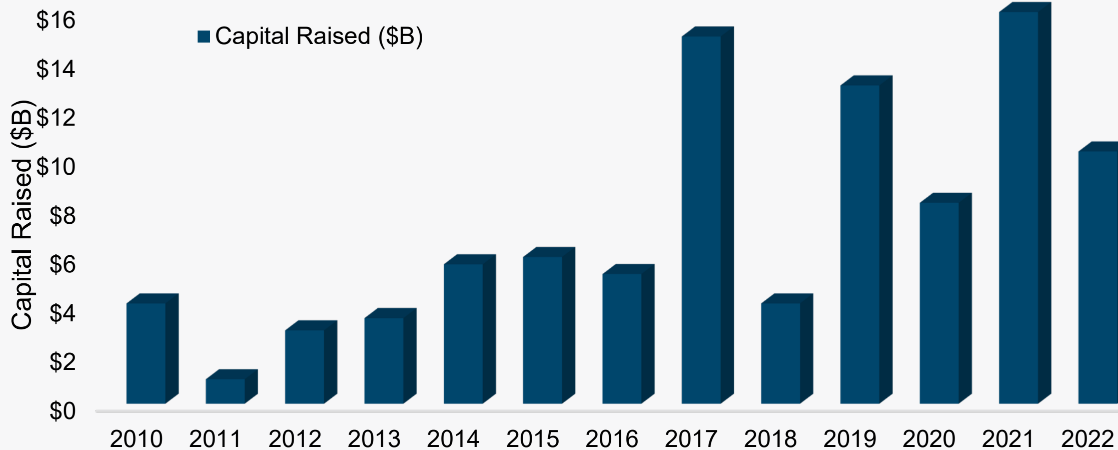

FIGURE 2
Global Private Equity Co-Investment Fundraising
Source: Pitchbook, as of March 30, 2023. Note, this is based on fundraising activity tracked by Pitchbook and may understate total co-investment fundraising.

Note: Past Performance is Not Indicative of Future Performance. May Lose Value.

LP Sentiment

Co-investments may involve transactions across the various private market strategies, such as private equity, private credit, private infrastructure, and private real estate. A recent survey (shown in Figure 3) indicated that private equity had the highest proportion of investors either currently investing or considering investing in co-investments, followed by private credit and private infrastructure.

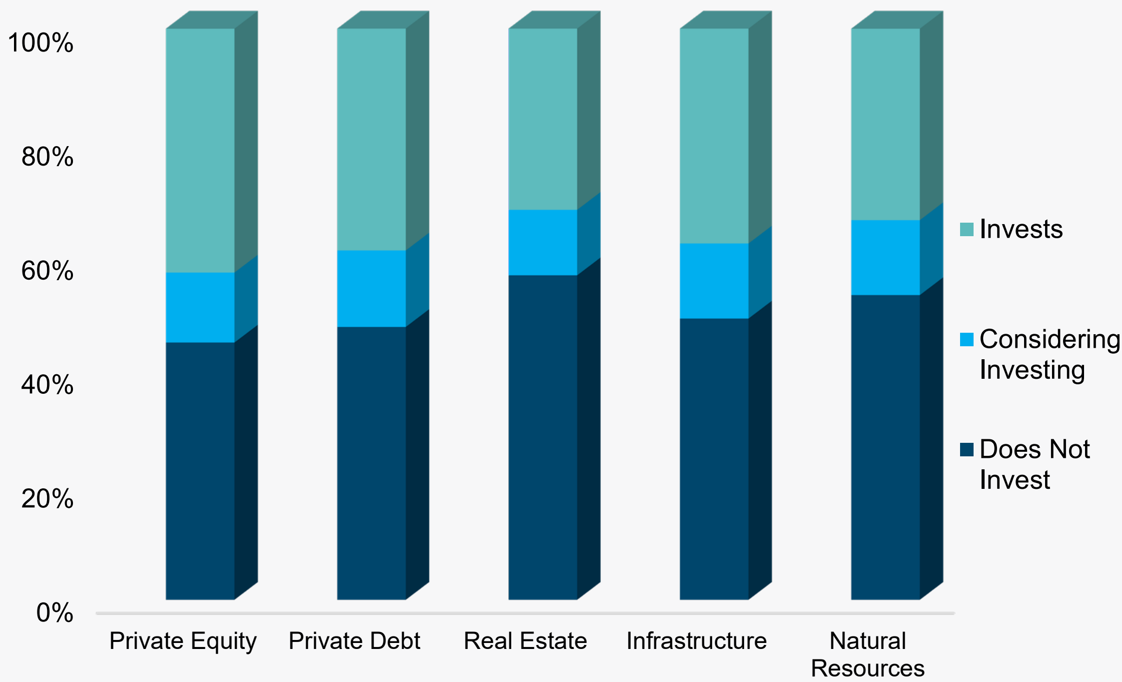

FIGURE 3

LP Participation in Co-Investments by Asset Class

Source: Preqin Fund Terms Advisor 2024, as of June 30, 2024. There is no complete and reliable data set for private investments. The information is extremely limited, and most data is compiled from funds that elect to self-report and tend to be biased toward higher performing funds. Losses are underreported. Funds included in these measures lack commonality and transparency. Over time, components of the data may change. Funds may begin or cease to be represented based on these factors, thereby creating a "survivorship bias" that may additionally impact the data reported.

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Unsurprisingly, the larger an LPs' allocation to private equity, the more likely it is that they participate in co-investments (see Figure 4). This is to be expected since co-investments require additional funds, due diligence, and monitoring, all of which is more likely to be present in a larger private markets program. These larger LPs are also likely to have assembled a deeper stable of GPs from which to source co-investment opportunities in addition to building an internal team for evaluating them.

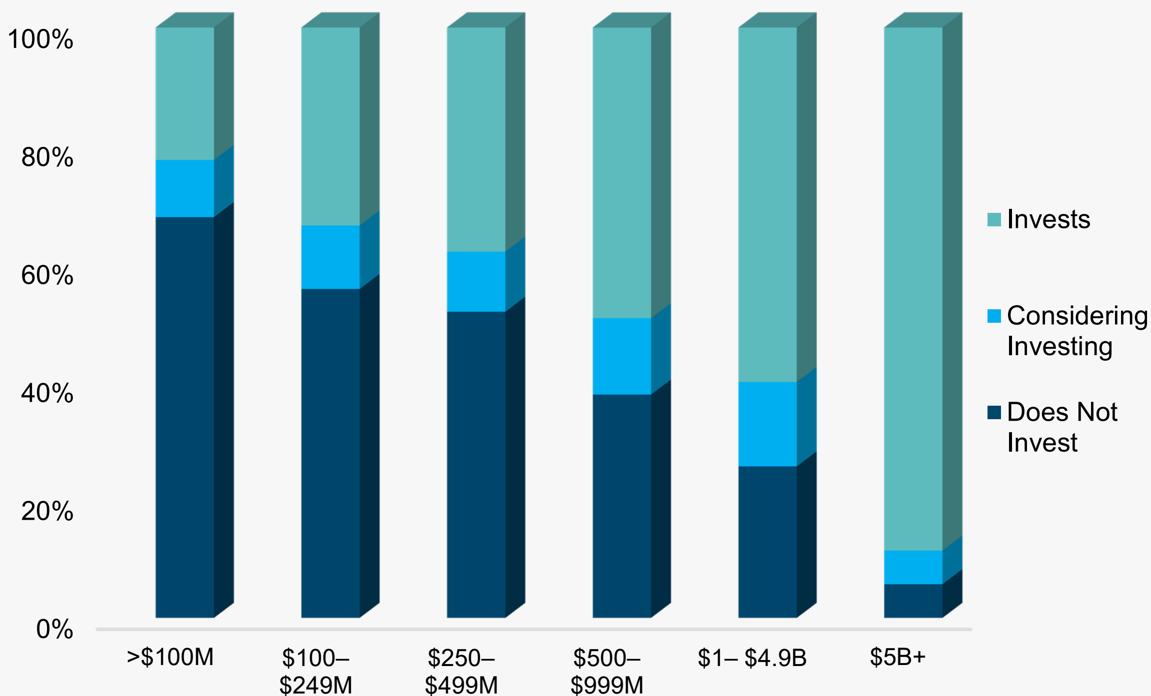

FIGURE 4

LP Participation in Private Equity Co-Investments by Current Private Equity Allocation

Source: Preqin Fund Terms Advisor 2024, as of June 30, 2024. There is no complete and reliable data set for private investments. The information is extremely limited, and most data is compiled from funds that elect to self-report and tend to be biased toward higher performing funds. Losses are underreported. Funds included in these measures lack commonality and transparency. Over time, components of the data may change. Funds may begin or cease to be represented based on these factors, thereby creating a "survivorship bias" that may additionally impact the data reported.

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Benefits to the Limited Partner

A key feature of co-investments is lower fees and/or avoiding certain fees altogether. Unlike fund commitments, which charge a management fee (e.g., 2% per year) and carried interest (e.g., 20% of profits), co-investments often (but not always) charge no management fee or carried interest.[3] This lower fee structure can make a meaningful difference by directly contributing to potentially higher net returns.

[3] Carried interest, also known as "carry," is a share of an investment's profits that is paid to the manager as compensation for their work. It's a performance-based fee that's typically only paid if the fund meets a minimum return. Carried interest is a key way to reward investment managers for generating returns for investors.

Co-investing can also allow for a more rapid deployment of capital, helping to mitigate the j-curve. In a traditional private markets fund, after an LP makes a commitment to the fund, capital is typically drawn over a multi-year period. This results in the early period of the fund's life having capital committed or partially deployed and, thus, fees are incurred without any distributions back to the LP. This period of negative returns early in a fund's life that are expected to turn positive with time is known as the j-curve. Because co-investments deploy capital immediately, they can potentially help mitigate the j-curve.

By being a regular and reliable participant in co-investments, an LP can strengthen its relationship with the GP. LPs may find this particularly valuable for those GPs whose funds are often oversubscribed. In addition, co-investments may provide an opportunity to increase exposure to some of the most financially compelling investments, as well as an opportunity for the LP's own investment team to develop experience in vetting co-investment opportunities.

Considerations for the Limited Partner

Co-investments present additional considerations for LPs beyond those of a traditional investment in a private markets fund. One concern for co-investors has been whether the deals offered for co-investments are of a lower quality than investments otherwise retained for the fund (and for which the GP would get full carried interest). In other words, do GPs engage in "adverse selection" when it comes to offering co-investment opportunities? The most comprehensive study to date examined this issue by comparing the returns of transactions offered for co-investment and those that were invested by the fund only.[4] The study showed that there was no meaningful difference in gross performance between deals offered for co-investment and those retained for the GP's commingled fund, on average.

[4] Source: "Adverse Selection and the Performance of Private Equity Co-Investments", Braun, Jenkinson, Schemmerl; December 2018. The study used public market equivalents or "PMEs" to compare the gross performance of each set of investments. PME refers to the return an investor would have achieved if the private equity cash flows had instead been invested in a public equity index

While some co-investments will be syndicated by a fund manager after it has completed its investment, in most cases, the co-investment happens at the same time as the GP's investment. Therefore, the time between when an LP is shown a potential deal by a fund manager and when the LP would have to approve and fund the deal is very short. Having efficient, streamlined internal review and approval processes in place can help LPs meet these condensed deadlines for decision making.

By co-investing, an LP essentially invests twice in a specific company or asset, and sometimes the size of the co-investment can be much larger than their stake in the company via their fund investment. Hence, co-investments represent more concentrated exposure to an underlying portfolio company or asset than the investor would obtain from its investment in a commingled fund. This may lead to concentration risk where private

market portfolios are less diversified and may have an increased risk of loss. This risk may be somewhat mitigated if an LP constructs a diversified portfolio and/or invests in a co-investment fund, which should offer increased diversification.

Finally, in contrast to traditional private equity fund structures, a co-investor has a direct relationship with the portfolio company. By more directly engaging in the management of the portfolio company, influencing its direction, operations, and strategy, the co-investor takes on both the upside and downside of the company's performance. This may result in greater headline risk to the co-investor.

Benefits to the General Partner

GPs offer co-investments for several reasons, the most basic of which is that the potential investment is too large for the fund, in that it requires more capital than the GP can commit. Utilizing a co-investment structure allows a GP to pursue a potentially attractive investment opportunity which otherwise may not have been feasible for the fund alone. Efficiently expanding available capital through co-investments also helps the GP maintain control of the investment, in contrast to having a consortium of GPs investing together or having to work with another financial sponsor.

Another benefit of co-investing from the GP's perspective is that it can, or may have the potential to, reduce portfolio risk. Having LPs invest additional capital can limit the fund's exposure to a large investment, allowing the GP to pursue high-capital opportunities without heavily concentrating the fund's risk into a single investment. This may allow the GP to more evenly distribute risk throughout the fund (or adhere to investment restrictions), while still being involved in attractive higher-capital opportunities.

Finally, co-investing may be used as a relationship-building tool. Offering co-investment opportunities can help to attract prospective investors, build loyalty with existing investors, as well as expand and deepen relationships with LPs. This may also explain why GPs do not just offer inferior investment opportunities for co-investing (i.e., the adverse selection issue) – GPs may be more concerned about their long-term relationships, and ability to raise capital, than the extra carried interest earned on a few individual investments.

Considerations for the GP

As with LPs, co-investments present unique considerations and issues for GPs. One such risk is the loss of unilateral control which may result in the potential dilution of rights and non-economic control in more active co-investment structures.

Other considerations include the additional time and cost that GPs (and their staff) must dedicate to raising co-investment capital, such as responding to co-investor due diligence requests and negotiating terms of investment. Similarly, co-investments often require additional investment management and reporting requirements to meet co-investor needs. Finally, while there is a potential benefit for the GP to deepen relationships with LPs, this may be a double-edged sword in that there is relationship risk and the potential for a loss of long-standing relationships should one or more co-investments be unsuccessful.

Accessing Co-Investments Through Interval Funds

Access to private market co-investments has traditionally been limited to large institutional investors given the high minimums, illiquidity, and investor restrictions. But with the advent of new product structures, that has changed.

Interval funds – which provide a measure of liquidity at regular intervals, such as quarterly – have provided individual investors with convenient access to private market co-investments, making it easy and efficient to access co-investments for client portfolios.

With an interval fund, advisors and their clients can have "point and click" access to private investments. These funds generally offer low investment minimums, no investor limitations, no subscription documents, no capital calls, and higher levels of liquidity. They are available on popular mutual fund platforms, with daily NAVs, simplified account opening paperwork, and 1099 tax reporting. Also, these funds can be tradeable in models and typically have lower fees than other private market investments like tender offer funds.

Co-Investment Vehicles Potentially Provide Unique Opportunities for Today's Investor

Co-investments offer a unique and advantageous opportunity for limited partners to invest alongside general partners directly into specific portfolio companies. This collaborative investment structure allows LPs to avoid the "blind pool" risk associated with traditional private market funds, providing them with greater control and flexibility over their investments. By participating in co-investments, LPs can typically benefit from lower fees, more targeted portfolio exposures, and the potential for higher net returns.

However, co-investments also come with additional considerations and risks. LPs must be prepared for the compressed decision-making timelines and the need for efficient internal review processes. There is also the potential for concentration risk, as co-investments often result in more significant exposure to individual portfolio companies. Despite these challenges, the ability to co-invest can strengthen relationships between LPs and GPs, offering valuable opportunities for LPs to enhance their investment strategies and gain deeper insight into private markets.

Ultimately, the success of co-investments depends on the careful selection of opportunities and the effective management of associated risks. Both LPs and GPs can benefit from this investment approach, with GPs gaining additional capital and LPs achieving more customized and potentially lucrative investment outcomes. Investors looking to build their own portfolio of co-investments should carefully review their capabilities to successfully execute co-investments and look to develop strategy and staffing to build and maintain a co-investment program. As the co-investment landscape continues to evolve, it remains a compelling option for investors seeking to optimize their private market portfolios.

Important Information

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