PRIME BROKERAGE PERSPECTIVES

Aligning Interests: The Emergence of Hedge Fund Co-Investment Vehicles

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In this edition of *Prime Brokerage Perspectives*, we examine the growing prevalence of hedge fund co-investment vehicles along with their applicable terms, structures and the strategies for which they are being used most frequently. The purpose of this *Perspectives*' piece is to provide an overview of hedge fund co-investment structures for managers interested in launching such vehicles and for institutional allocators considering them for investment. In doing so, this report seeks to identify common features of, and trends among, hedge fund co-investments in order to provide managers and investors with a cohesive organizational framework that they can use to assess co-investment opportunities. This report also explores the incentives for managers to bring such structures to market and for institutional allocators to invest in them.

Introduction

Although co-investments have long been a staple component of the private equity industry, they have become more prevalent in the hedge fund ecosystem only recently. For definitional purposes, a co-investment structure may be thought of as a vehicle that participates in an investment on a co-mingled basis or on behalf of a single investor alongside, or in lieu of, an investment manager's main fund, which may be limited in the extent to which it can deploy capital in the pertinent investment opportunity. Because co-investments have long been common among private equity firms, limited partners have established expectations as to how they will be structured and the mechanisms by which they will be offered. By contrast, because co-investment vehicles are a newer phenomenon in the hedge fund arena, they tend to be offered more episodically, and there is a dearth of standardization for hedge fund allocators when assessing such opportunities. Accordingly, hedge funds that offer co-investments to their investors – a trend that is becoming increasingly common – employ a range of non-standardized structures. Furthermore, the terms on which hedge funds offer such opportunities to allocators tend to be somewhat idiosyncratic depending on the underlying investment opportunity.

This report is based on interviews with hedge fund managers, institutional investors and investment fund attorneys. The piece first provides an overview of the private equity co-investment analogue. Part II discusses evidence of increased appetite among hedge fund allocators for co-investment opportunities. Part III examines the incentives for hedge fund managers to offer, and for investors to allocate to, co-investment opportunities. The report next discusses the range of structures available for hedge fund co-investment vehicles along with fee terms and other features. Finally, this *Perspectives* piece outlines certain legal considerations about which managers should be aware when considering such products.

The private equity precedent

Private equity co-investments provide an analogue for hedge funds that are pondering such opportunities. Private equity firms have traditionally offered co-investments to their fund limited partners along with their operating partners and, in certain instances, to other private equity fund sponsors. Private equity co-investments are typically structured as minority investments in portfolio companies that are platform acquisitions of the main fund. Certain private equity sponsors also sometimes launch dedicated

co-investment vehicles designed to make several such investments. These vehicles may have similar terms to the sponsor's main fund except with respect to fees, which almost invariably are lower. Private equity firms typically offer co-investments in instances where there is a capacity constraint, such as when a sponsor is seeking to invest in a company to take control but is limited in the amount of capital that it can invest either because of concentration limits in the fund's governing documents or because the fund lacks sufficient dry powder or scale to garner a control position. In such a scenario, the co-investors will invest alongside the main fund, thereby enabling the sponsor to achieve its investment purpose through added capacity.

In a standard private equity co-investment scenario, the co-invest vehicle will invest along with the sponsor's main fund in a holding company that functions as the parent of the portfolio company, which is the acquisition target. Alternatively, the co-investors may invest in the target directly at the operating company level rather than investing through a holding company, or "blocker" (*see figure 1*). Private equity co-investors are most typically existing limited partners in the sponsor's main fund, which have bargained for co-investment rights during the fund subscription process. Other existing limited partners may have the option to co-invest through most favored nation, or MFN, rights, which provide them with the option to benefit from any unique rights for which other limited partners have bargained.

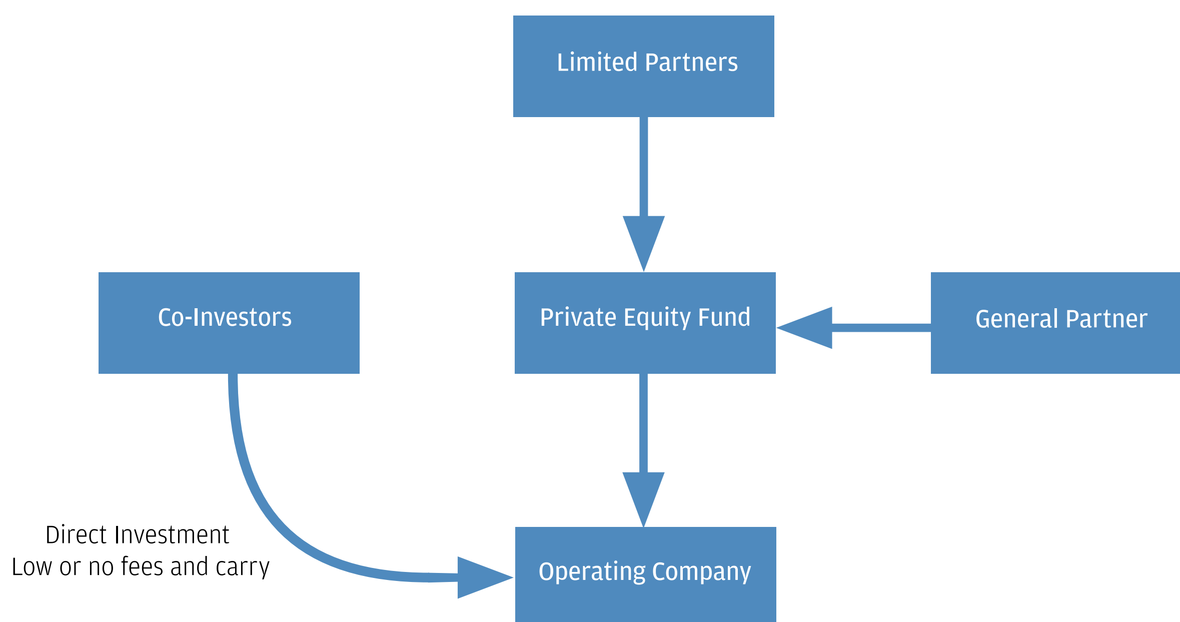
Private equity sponsors often use the potential for co-investments as an incentive to garner commitments from larger limited partners for their main funds. Consequently, private equity co-investment vehicles may choose to waive management and performance fees. Some private equity co-investment vehicles charge performance fees but no management fees since the effort needed to manage a co-investment vehicle is less significant than that needed to manage a sponsor's main fund with multiple underlying investments. Sizeable limited partners with larger potential fund commitments such as public pensions and sovereign wealth funds typically enjoy more bargaining power and can therefore insist on *de minimis* or no fees. Smaller investors with lower fund commitments have less leverage and often agree to some level of management and/or incentive fee in order to access co-investment opportunities.

The private equity precedent illustrates certain of the prospective synergies among managers and allocators with respect to co-investments:

- Managers can obviate capacity limitations that may exist for a variety of reasons and thereby achieve the scale necessary to attain control positions in target companies to effect leveraged buyouts or similar transactions.
- For private equity allocators, co-investments offer added access to potentially attractive investments with reduced fees. Such fee reductions may in turn result in improved economics for investors since the J-curve impact from the main private equity fund is mitigated.[1]

FIG-01

Private Equity Co-investment Structure



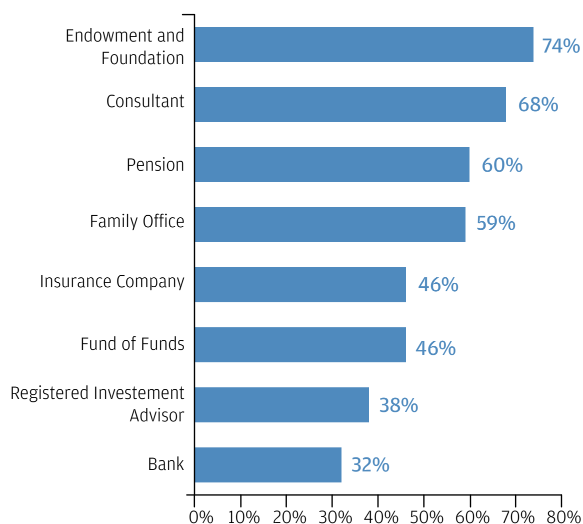
Hedge fund co-investments and investor interest

An emergent trend

Anecdotal evidence suggests that a growing number of hedge fund managers are coming to market with co-investment opportunities and that investors increasingly are seeking them out. In recent months during meetings with allocators across the U.S. and Canada, numerous groups have requested information from J.P. Morgan's Capital Introduction Group (CIG) on managers offering co-investments either for individual trades or on a more programmatic basis. Empirical data also suggests that such a trend is underway. According to the forthcoming J.P. Morgan Capital Introduction Group Institutional Investor Survey for 2014, 52 percent of the allocator respondents indicated a willingness to partake in hedge fund co-investment opportunities. The trend was most pronounced among endowments and foundations; 74 percent stated that they would participate in hedge fund co-investments. Similarly, 68 percent of the consultants surveyed indicated that they would partake in co-investment opportunities as did 60 percent of the pensions that took part in the survey (*see figure 2*). With respect to geography, 57 percent of the survey respondents in North America indicated a willingness to participate in co-investment opportunities as compared with 46 percent of the investors surveyed in Europe and the Middle East and 36 percent of those in Asia (*see figure 3*).

FIG-02

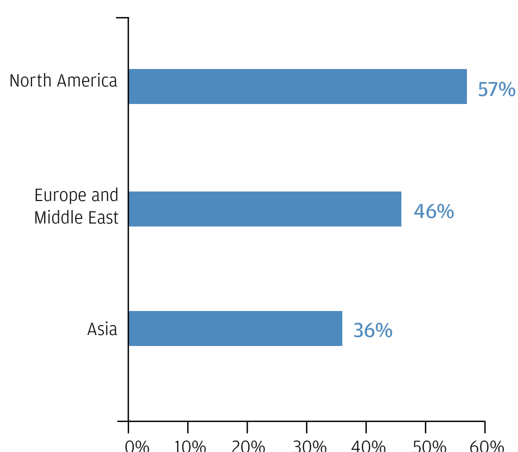
Investors Willing to Participate in Co-investments by Allocator Segment



Source: J.P. Morgan Capital Introduction Group Institutional Investor Survey for 2014

FIG-03

Investors Willing to Participate in Co-investments by Geographic Region



Source: J.P. Morgan Capital Introduction Group Institutional Investor Survey for 2014

Trend catalysts

Managers and investors interviewed for this report proffered several hypotheses as to the catalysts underlying the growing prevalence of hedge fund co-investments, one which seemed particularly salient given its historical context. Before the financial crisis, it was a common practice among hedge fund managers, including those with more liquid strategies, to run side pockets for less liquid assets alongside their main fund vehicles where those assets would be segregated until realization. Hedge fund limited partnership agreements (LPAs) contained provisions for those illiquid tranches but were rarely the subject of negotiations among investors.

In the years subsequent to the financial crisis, the practice of managers segregating assets in illiquid side pockets has become heavily disfavored. Today, fund LPAs typically do not allow managers to create side pockets and, in the rare instances when they do, investors are given clear opt-out rights. As one manager hypothesized, therefore, these developments have resulted in a relative dearth of equity capital available for hedge fund investments in less liquid opportunities. Consequently, a hedge fund manager seeking to target such investments must do so through a separate structure outside its main fund except for a *de minimis* portion of such investment for which there may be limited capacity in the primary fund vehicle. Accordingly, demand for such investment opportunities among allocators must now be satisfied to a significant extent via co-investment vehicles.

Incentives for co-investing: manager and investor perspectives

Managers

Hedge fund managers that have brought co-investment vehicles to market, or that are considering doing so, tend to fall into two general categories. First, among equity-biased managers, a number of shareholder activists have introduced innovative co-investment structures to allow them greater flexibility as they position size as part of corporate governance campaigns. Second, co-investment vehicles are also becoming increasingly common among credit-oriented managers that invest in less liquid, longer-duration assets, including various credits, special situations, reorganizations and capital structure arbitrage. Overall, managers in each category tend to be longer-biased and generally less trading-oriented, though there are certainly exceptions. While there are numerous incentives driving managers in both categories to offer co-invest opportunities, those drivers can be distilled into a few common themes:

1. **Position sizing and concentration limits**
   Activist investors seek to influence corporate outcomes by acquiring significant stakes in target companies that are sufficient to allow them to obtain board seats. Activist managers may be constrained in building such stakes because of explicit portfolio concentration limits in their governing fund documents and/or because of self-imposed position limits in their risk management guidelines. Offering investors the opportunity to co-invest alongside the main fund can obviate such constraints and allow the manager to achieve the scale needed to amass a large enough stake in a given company for board seat representation.

   Co-investment vehicles can help credit-oriented managers solve for similar problems. For example, in the restructuring context, a hedge fund may seek to acquire a control position in a company through various levels of the capital structure prior to a Chapter 11 proceeding so that it can guide the in-court reorganization. Concentration limits and risk management guidelines may again prevent such funds from doing so. Even absent such constraints, a fund may lack sufficient capacity to amass the necessary position. Offering co-investment opportunities can negate those impediments.

2. **Speed of execution**
   Irrespective of the underlying hedge fund strategy, investments that are suitable for co-investments frequently arise under time constraints and are required to be acted on in close to real time. A large fund of hedge funds (FoF) that actively seeks out co-investments recounted an instance where one of their underlying managers with a relative value fund was seeking to trade a new bond issue but had insufficient liquidity available for the trade. Because the manager needed to act on the opportunity with relative speed, the FoF was able to use a co-invest vehicle that was sufficiently capitalized to facilitate the trade.

   In the activist context, managers frequently seek to amass positions relatively quickly prior to a Schedule 13D filing. Having a dedicated co-invest vehicle with committed capital can enable such managers to act with the requisite speed where there are capacity issues.

Investors

Co-investments are potentially attractive for allocators because they offer access to high-conviction ideas with lower fees and, therefore, potentially enhanced returns.

1. **Speed of execution**
   Institutional investors typically lack the infrastructure to act with the speed that hedge fund co-investments often require. Therefore, by allocating capital to a dedicated co-investment vehicle – either directly through a manager or through an intermediary such as a FoF – institutional investors can essentially purchase, or "outsource," the ability to act with the requisite speed since such vehicles are structured to draw capital as needed when trades that are suitable for co-investments arise. (Whether institutional investors that allocate capital to co-investment opportunities do so directly or through intermediaries depends on investors' underwriting and diligence capabilities.)

   It should be noted that co-investment vehicles that are formed *before* the underlying investment opportunities arise can help allocators solve the aforementioned problems. By contrast, vehicles that are formed on a shorter timeline *as opportunities arise* will be suitable only for a subset of nimble investors that are flexible enough to act with the requisite speed such as certain family offices. For this latter category of co-investment vehicles co-mingled funds or funds of one will be appropriate but separately managed accounts (SMAs) will not since SMAs are more administratively cumbersome for investors. More specifically, with SMAs, investors bear responsibility for the selection of a prime broker, custodian and fund administrator and for debit risk. Given the speed with which co-investment opportunities sometimes arise, the SMA format will not be practicable.

2. **Reduced fee structures**
   As in the private equity context, hedge fund co-investment vehicles typically charge lower fees. Frequently, there is no management fee and a lower performance fee, often in the vicinity of 10 percent in excess of a specified hurdle or high water mark depending on how the vehicle is structured.

3. **Alignment of interests**
   Managers typically offer co-invest opportunities for higher-conviction ideas. Because those opportunities are offered along with advantageous fee terms, many investors believe that co-investing provides strong alignment of interest with fund managers.

4. **Enhanced transparency**
   Hedge fund co-investment vehicles frequently provide investors with opt-out rights or require affirmative consent for specific deals or trades. Accordingly, such vehicles often provide investors with heightened transparency.

5. **Underwriting and diligence**
   Although hedge fund managers typically offer co-investments to existing investors, in some instances such opportunities are offered to allocators that are not yet invested in a manager's primary fund. For such allocators, which may be considering an investment in a manager's flagship vehicle, co-investments offer a means to perform due diligence on the manager for its co-mingled fund product. This is particularly so for larger FoFs that run co-investment programs. In turn, co-investments may help managers develop a potential pipeline of investors for their flagship products.

FIG-04

Manager and Investor Incentives for Co-investing

Incentives	Manager Applicability	Investor Applicability
Speed and ease of execution	✔	✔
Overcoming concentration limits	✔	
Position sizing	✔	
Reduced fees (higher potential returns)		✔
Alignment of interests		✔
Enhanced transparency		✔
Product differentiation and access to unique opportunities	✔	
Opportunity for underwriting and diligence	✔	✔

Structures

Because co-investments are a relatively new phenomenon among hedge funds, the structures that managers are using tend to be idiosyncratic rather than standardized. However, certain patterns are evident for various manager types with respect to the structural permutations used for co-investment vehicles.

Activist models

Activist hedge funds that are using co-investment vehicles to present investors with high conviction ideas and overcome capacity limitations tend to employ truncated private equity-like structures rather than traditional hedge fund structures. Unlike true private equity funds, the durations of which can be up to ten years or longer, activist co-investment vehicles tend to have terms that are closer to three years. While the underlying investments are typically public equities and thus highly liquid, they tend to have longer durations since activists need to amass and then maintain sufficiently large positions to effect corporate changes through board representation over time. It would be typical, for example, for such a structure to have a one-year investment period followed by a two-year harvest. These vehicles tend to share other private equity-like traits, including:

- Specified subscription periods
- Capital calls (i.e., an equity draw-down structure)
- Defined commitment periods
- Distribution waterfalls for distributions of capital (including a manager hurdle rate)

With these vehicles, activists are generally seeking to lock up capital for a stated term, which will be called (i.e., drawn down) on an investment-by-investment basis during a specified commitment period. These vehicles frequently, though not always, permit recycling of capital during the investment period. Moreover, the durations, i.e., "terms," of such vehicles are often subject to one or more extensions of up to a year (typically subject to a vote of the limited partners).

Notwithstanding the private equity-like nature of these funds, activist managers that have sponsored co-investment vehicles have introduced a number of innovative features to allow for greater flexibility and to more closely align the structures of those vehicles with the underlying investment strategies and the instruments being purchased (typically publicly traded securities). Such innovations include:

- Open-ended (i.e., evergreen) commitment periods
- Limited redemption features subsequent to an initial lock-up period
- Opt-out or veto rights for individual investments

Illustrative example

One manager recently introduced a co-investment fund that provides a clear example of the innovations that shareholder activists are using. The vehicle is private equity-like in that it has a capital commitment and drawdown structure. However, the fund also permits limited partners to cancel any portion of their commitment that the manager does not draw down in the first year subsequent to the investor's subscription. Each investment (which is made to overcome capacity limits alongside the manager's main fund) is made through a separate special purpose vehicle (SPV), typically a Delaware LLC. Investors' capital in each SPV is locked up until the earlier of three years from the date of the investment or liquidation. The term of each SPV is subject to two one-year extensions – first at the manager's behest and, thereafter, subject to a majority vote of the limited partners. Risk limits provide for a maximum percentage of each investor's overall commitment that may be allocated to any single investment. Investors also have the right to opt out of any future investment subject to certain notice requirements.

Because of the investment-by-investment SPV structure, any new investors that commit to the fund are essentially buying into future deals only. Consequently, existing limited partners are protected from dilution in their current investments that were made through the co-investment fund. As is typical of co-investment vehicles, the fund charges reduced fees:

Management fees

- No management fee on committed capital
- 1% on net asset value (NAV) of invested capital

Performance fees

- 15% on realized profits (deal-by-deal basis) subject to high water mark on previously realized investments

Fees

While there is of course variation among the fee and related terms that activist co-investment funds charge to investors, certain patterns are evident and the fee levels tend to fall within a range:

Management fees

- 0-1% on invested capital only

Performance fees

- 10-15% on realized investments
- May be subject to high water mark

Hurdle rate

- 6-8% preferred return on contributed capital (when applicable)
- Hurdle rate typically depends on risk/return profile of underlying investment(s)

Single trade co-investments

At the opposite bookend to the private equity-like structures that activist managers tend to use are single trade, or single deal, co-investment SPVs, which typically are more purely hedge fund-like. As with the activist models discussed above, these co-investment vehicles are used mostly as overflow structures to obviate capacity constraints. Managers also use these vehicles when they have limited liquidity to execute a trade. Although not always the case, single deal co-investment vehicles are most often employed by managers with shorter-term, trading-oriented strategies.

Unlike traditional hedge fund structures, single trade co-investment vehicles have finite subscription periods. Redemption features vary, but investors usually have stated liquidity rights subsequent to an initial lock-up period, the length of which will vary depending on the duration of the underlying investment. These SPVs are run like separate hedge funds and therefore usually have their own prime brokerage agreements and investment management agreements between the manager and the limited partner(s).

Single trade co-investment vehicles are structured both as co-mingled funds and as single investor funds. While such vehicles could be structured as SMAs, this is less preferable since the underlying trades tend to arise and must be acted upon quickly. When an SPV is structured to accommodate a single investor, the fund documents usually provide a time by which the investment will be liquidated and capital distributed in lieu of a traditional redemption feature.

Certain investors interviewed for this report tend not to prefer single-trade co-investments because these vehicles lack the benefits of netting that a multi-investment vehicle provides. Single-trade co-investments also offer no recourse to the manager's main fund. A subset of those investors therefore will only invest in single trade SPVs on a fund of one or SMA basis where the investor typically has more leverage to negotiate and can therefore demand more advantageous terms. Because of the netting risk, single trade co-investments may be more appropriate for investors with more tolerance for risk and volatility.

Credit-oriented co-investments

In contrast to more trading-centric managers that tend to employ single deal co-investment vehicles, credit-oriented managers (including those that invest in less liquid credits, special situations, reorganizations and direct lending) generally use commitment-based structures that are a derivative of private equity.[4]

Like the activist examples, these co-investment vehicles resemble truncated private equity funds in that they have specified investment and harvest periods the lengths of which depend on the prospective duration of the underlying investment(s). For example, such a co-investment vehicle might have a one-year commitment period and a three-year harvest with two

FIG-05

Single Trade Co-investment Vehicle Representative Terms

	Standard Hedge Fund Structure	Single Investment SPV
Term	• Indefinite	• Specified liquidity provisions may apply
Subscriptions	• Rolling	• Fixed period
Commitment period	• Open-ended	• Open-ended • Subject to liquidity rights
Redemptions / other liquidity rights	• Allowed on rolling basis	• Not permitted during initial lock-up • Permitted periodically thereafter, or • Specified horizon for liquidation / distribution of capital
Management fee	• 1.64% (mean)[2] • Based on NAV	• None
Performance fee	• 18.99% (mean)[3] • Subject to high water mark	• Typically up to 10% above a specified benchmark

one-year extensions subject to a percentage vote of the limited partners. In contrast to the private equity precedent, however, co-investment vehicles in this category sometimes offer redemption features, thereby increasing their attractiveness for investors.

Illustrative example

In one instance, a manager launched a co-investment vehicle to accommodate overflow capacity for an investment in trade claims in a pair of distressed financial institutions. Investors in the fund have the right to redeem on a periodic basis during the life of the fund. Although none of the limited partners in the fund have thus far exercised their right to redeem, the manager arranged financing through a revolving bank credit facility to replace any commitments that were redeemed. Additionally, because the underlying investments are sufficiently liquid, the manager anticipates being able to sell positions to satisfy redemption requests if necessary.

Fees and other terms

Unsurprisingly, the terms and other features of co-investment vehicles in this category lack standardization. Nonetheless, the range of fees and other terms that managers and investors revealed for this report is distilled in *figure 6*.

Legal considerations

Co-investment vehicles offer managers a number of benefits, including the ability to make trades and take positions in which they otherwise would be limited because of capacity or other constraints. At the same time, though, co-investments may give rise to legal and regulatory issues about which managers contemplating such products should be aware. While a full legal analysis of hedge fund co-investments is far beyond the scope of this report, some key considerations are outlined below.

Allocation policies

The process of allocating investment opportunities between current and prospective investors is a key item for hedge fund managers to consider when launching a co-investment vehicle. Hedge fund managers have a fiduciary duty to their investors, which includes an obligation to allocate suitable investment opportunities to them. While certain managers interviewed for this piece offer co-investments to all of their limited partners on a *pro rata* basis, in many instances it will be impractical to do so. Accordingly, managers might consider having in place clear policies and procedures governing the processes by which they allocate investment opportunities to co-investments and clearly disclosing those policies and procedures to all of a manager's investors.

FIG-06

Credit-biased Co-investment Vehicle Representative Terms

	Standard Private Equity Structure	Credit-centric Co-investment Vehicle
Term	• Finite term (e.g., 10 years)	• Finite • Typically up to 6 years
Commitment period	• Fixed • Range: 4 - 6 years	• Fixed • Range: 1 - 2 years
Subscriptions	• Finite subscription period	• Typically fixed
Redemptions	• None	• None, or • Permitted on rolling basis • Manager use of revolving credit facility
Management fee	• 1.50% - 2.00% • Based on committed capital during investment period • Possible step-down thereafter	• Range: 0.00% - 0.25%
Performance fee	• 15% - 20% • Based on net realized gains • Distribution waterfall structure	• Up to 20% above hurdle rate (e.g., 8%) • Sliding scale also used - e.g., 10% on first 10% of any appreciation above hurdle; 20% on appreciation in excess of 10% thereafter

Liquidity rights

On a related point, hedge fund managers must ensure that all investors in a co-investment vehicle, whether they are new or existing investors in a main fund, have the same liquidity rights and redemption features.

Regulatory reporting obligations

As with a manager's main fund, any co-investment vehicle will need to be listed on Form ADV and may require filing a separate Form PF. Furthermore, a manager must ensure that the co-investment vehicle satisfies all of the exemptions pursuant to the Investment Company Act of 1940.

Conclusion

It is likely that investor demand for co-investment opportunities will continue to increase as part of the overall trend of customization within the hedge fund industry. As managers introduce co-investment vehicles with greater frequency, and as investor appetite for the flexibility that such vehicles provide continues to grow, the structures and terms used are likely to become increasingly standardized in the way that they have for private equity co-investments to some extent.

In the meantime, we welcome inquiries from both managers and investors regarding opportunities, terms and structures for hedge fund co-investments.

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1 There is typically a J-curve during the inception of a private equity fund as capital is drawn and limited partners are charged fees but are not yet receiving any return of capital in the form of distributions.

2 Source: J.P. Morgan Capital Introduction Group *2013 Hedge Fund Terms Analysis*, based on mean management fee across strategy types.

3 Ibid.

4 It should be noted that, for both the activist models and credit-centric co-investments, institutional investors tend to make allocations from their hedge fund programs, not private equity.

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