Limited Partner Co-Investments in the Lower Middle Market

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Private equity professionals continue to see significant demands amongst limited partners ("LPs") for co-investment opportunities alongside funds in which LPs are invested. There is anecdotal evidence as well as limited market data that indicates that LPs see increased levels of performance when investing alongside the private equity sponsors ("Sponsors"). The last widely reported survey of such investments, conducted in August 2015 ("Prequin Survey"),[2] indicated that co-investments are actually outperforming fund commitments, with forty-six percent (46%) of LPs outperforming the fund by a margin of over five percent (5%). So it is no surprise LPs desire co-investment commitments in their governing fund agreements. In fact, the Preqin Survey found that thirty percent (30%) of the Sponsors included co-investment rights in 81%-100% of their most recent limited partnership agreements. Sponsors have also been incentivized to offer co-investment opportunities. According to the 2015 Pepper Hamilton-MergerMarket survey, *Joining Forces: The co-investment climate in private equity* ("Joining Forces Survey")[3], of the partners, directors and principals interviewed, a majority confirmed that they proactively offer co-investment opportunities. Joining Forces Survey also confirmed that a majority of co-investors are existing fund LPs, which makes sense given Sponsor rationale for offering co-investments—investor recognition, better chance of successful fundraising, building stronger relationships with LPs, gaining access to additional deployable capital, benefits to the portfolio company from LPs unique abilities, and better risk management.

THERE IS ANECDOTAL EVIDENCE AS WELL AS LIMITED MARKET DATA THAT INDICATES THAT LPs SEE INCREASED LEVELS OF PERFORMANCE WHEN INVESTING ALONGSIDE THE PRIVATE EQUITY SPONSORS

LIMITED AVAILABLE MARKET DATA

Due to the proprietary and unreported nature of a co-investment transactions, there are few, if any, deal studies that dive into the market terms of a co-investment opportunity (other than market studies noted above). This lack of information is compounded by the general notion that deal professionals in this space widely advise their clients: there is no one-size-fits-all co-investment model. A co-investment is usually determined on a deal-by-deal basis, driven by (i) the number of LPs co-investing, (ii) the size of the investment, (iii) the balance of leverage between the Sponsor and LP, and (iv) of the

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[2] Prequin Fund Manager Survey, available at www.ValueWalk.com (August 2015).

[3] Pepper Hamilton - 2015 Joining Forces: The co-investment climate in private equity, aggregated interview responses of 50 private equity partners, directors and principals from across the United States, managing funds between $250MM – $999MM.

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various advantages of co-investment model, which is most applicable in any given investment scenario. Of the publically available information in the market place, the Joining Forces Survey was a significant step forward in providing useful insight into the investment trends and general terms of a private equity co-investment. Notwithstanding that survey, there is still limited available data that legal counsel and private equity practitioners can use when negotiating a co-investment in a defined private equity market (i.e. lower middle market, middle market and upper middle market). Given the continued movement towards lower middle market transactions, the authors thought it would be helpful to have some guideposts, however limited the datapoints, for legal counsel and private equity practitioners when structuring and negotiating a co-investment in the lower middle market. Reviewing the transactions completed within the last five years by Koley Jessen, we found the results outlined below.

CO-INVESTMENT STRUCTURE IN THE LOWER MIDDLE MARKET

Typically, the Sponsor will propose the co-investment structure used for a specific transaction, with input from the LP. Factors the Sponsor, as well as LP, will consider when determining the optimal structure include: (i) the LP's desired level of involvement in management of the co-investment and/or portfolio company; (ii) how much access the LP will have to portfolio company information, as well as other transparency considerations; (iii) tax consequences; and (iv) the confidential nature of the LP's co-investment information (i.e., identity and investment amount). Our review of lower middle market transactions indicated two prevalent co-investment structures (that are consistent with the more traditional middle market private equity co-investment model): (A) a direct investment in the portfolio company, and (B) an investment in an aggregation vehicle that holds equity securities in either the portfolio company or the Sponsor's acquisition vehicle.

Direct Investment in Portfolio Company. In a direct investment, the LP makes a direct capital contribution to the portfolio company (or, alternatively, through a newly formed acquisition vehicle), in exchange for equity securities. Our lower middle market data suggests that an LP will typically secure a significant minority equity position to the Sponsor, averaging twenty-seven percent (27%) of the total equity investment. Under a direct investment structure, the LP can (i) exercise its management of the investment by voting the equity securities, (ii) negotiate minority investor protections (such as tag-along rights and registration rights) that may not be available in a co-investment aggregation vehicle, and (iii) secure access to portfolio company information not typically available to entities several levels above the portfolio company. Given the level of involvement, LPs making a direct investment typically employ experienced advisors or managers to monitor the co-investment. The Sponsor then receives the benefit of additional capital without the added cost associated with management of the co-investment vehicle. Additionally, the Sponsor can generally insulate itself from a potential conflict of interest, in particular between a Sponsor-managed a co-investment vehicle and the fund. In a direct co-investment, the LP is responsible for managing its own investment and the Sponsor is only responsible for the management of the fund.

Indirect Investment in Portfolio Company through an Aggregation Vehicle. Where there are multiple LPs, the co-investment can be structured such that each LP makes a capital contribution to an aggregation vehicle, which in turn will hold equity securities in either the portfolio company or the Sponsor's acquisition vehicle. Under a structure using an aggregation vehicle, the LP is a passive investor not actively involved in the management of either the aggregation vehicle or portfolio company; rather, the Sponsor secures management rights to act behalf of the vehicle. Further, our transaction data suggests that aggregation vehicles are used in lower middle market transactions where the Sponsor is offering a smaller or limited investment opportunity. Under this structure, LPs contributed, on average, sixteen (16%) of the total equity investment (as opposed to twenty-seven percent (27%) for direct investments). Additionally, typical with a small or limited investment where the investor may have less negotiating leverage, a majority of the co-investments we reviewed were presented as a "take-it-or-leave-it" opportunity using form co-investment documents.

CO-INVESTMENT TERMS IN THE LOWER MIDDLE MARKET

Examining our transaction data, co-investment trends and terms in the lower middle market tend to diverge from those in the general private equity market.

Tag Along Rights. In the co-investment context, tag along rights protect the interest of co-investors by affording the LP negotiating leverage at the time of a potential exit event. Our data indicates that a hundred percent (100%) of the transactions included tag-along rights (as opposed to sixty-eight percent (68%) of survey respondents in the Joining Forces Survey who reported including tag along rights). Where the co-investment was structured as a direct investment, the LP secured tag along rights at the operating company level as a typical minority protection provision. Where the co-investment was structured as an indirect investment through an aggregation vehicle, the LPs secured collective tag along rights at the operating company level through the aggregation vehicle.

Drag Along Rights. The drag along right acts as a control mechanism for the Sponsor, allowing the Sponsor to control the timing of an exit event. In our review, we again found that Sponsors secured drag along rights a hundred percent (100%) of the time. Anecdotally, authors have not seen a divergence on this datapoint, although

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acknowledge that only forty-six percent (46%) of survey respondents in the Joint Forces Survey reported securing such rights. From this comparison, it would appear Sponsors have greater leverage to secure protective rights (at least with respect to controlling the fund exit) when negotiating co-investment opportunities in the lower middle market, than the private equity market in general.

Management Fees. A typical benefit to an LP making a co-investment is reduced or eliminated Sponsor fees. Traditionally, a Sponsor will charge a two percent (2%) management fee on fund assets, as well as twenty percent (20%) on carried interest. Our transaction data shows that about sixty percent (60%) of the time, both the management fee and carried interest are eliminated on a co-investment opportunity. According to the Preqin Survey, about forty-nine percent (49%) of the Sponsors waived the management fee, and about forty-eight percent (48%) did not collect carried interest either on the co-investment piece.

Expense Reimbursement. Where the co-investment was structured using an aggregation vehicle with Sponsor management rights, in nearly every co-investment opportunity, the LPs were responsible for the expenses of the aggregation vehicle. Alternatively, in the general private equity market, thirty-eight percent (38%) of survey respondents confirmed that the LPs are responsible for the expenses of the co-investment vehicle.

Board Participation. In about fifty percent (50%) of transactions where the co-investment was structured as a direct investment, the LP was reserved a seat on the board of the portfolio company. Conversely, where the co-investment was structured using an aggregation vehicle, the no board seat was reserved for the LPs. According to the Joint Forces Survey, twenty-six percent (26%) of respondents did not reserve a board seat for LPs.

CONCLUSIONS

Our review of lower middle market transactions indicates that while the prevalent co-investment structures are consistent across lower middle-market as well as traditional middle market private equity co-investment model, the co-investment trends and terms in the lower middle market tend to diverge from those in the general private equity market. Again, we stress that datapoints included in this review may be a snapshot through a straw, so to speak, but nonetheless a helpful datapoint that will hopefully prompt a more robust study in the future that focuses on lower middle market transactions and provides a better vantage point for practitioners to follow. ■