INVESTMENTS

by Roy Schneiderman

Investment Manager Co-investment

Does Co-investment Really Help to Align the Interests of Investors and a Manager?

One widely held belief of institutional investors is that co-investment from a manager serves to align the interests of the manager and the investor. This article presents some challenges to this belief.

While requiring manager co-investment in institutional real estate ventures may sometimes serve to align manager and investor interests, there are cases where it has negligible impact as well as cases in which its impact is counterproductive. From an institutional investor's perspective, the challenge is to distinguish the cases where co-investment is a benefit from those where it is merely "alignment-candy" — or worse. It also means that LPs need to examine co-investment on a case-by-case basis and should not rely on simple quantitative or qualitative formulations such as "X percent of capital" or "meaningful co-investment."

Unfortunately, there is little empirical evidence with respect to this issue. The few studies from other disciplines tend to be inconclusive or not applicable. But during the recent precipitous market downturn, we have yet to hear anyone claim that ventures with a higher level of co-investment outperformed their counterparts.

Executive Summary

- **Aligning interests between a manager and investors is often easier said than done.**
- **In some cases a manager co-investment can lead to a misalignment of interests.**
- **Under certain circumstances, co-investment can increase manager alignment with investors.**

CO-INVESTMENT AS IRRELEVANT

The implicit assumptions that link co-investment to alignment with investor are two, typically unstated, premises:

1. A manager will work harder if its own money is invested.
2. A manager will be smarter (make better judgments) if its own money is invested.

Neither of these premises stands up to scrutiny in many cases.

As to the "work harder" premise, we would argue that the manager promote provides ample financial incentive for hard work. It is difficult to understand how co-investment dollars, which earn the same returns as limited partners earn, add any incremental motivation to work harder. Furthermore, of all of the possible complaints that LPs have with their GPs, "they did not work hard enough" is not heard very often unless a fund is out of the money and the manager's attention is diverted to other pursuits.

As to co-investment inspiring better judgment, it is very difficult to see the nexus here. One would think that the profit to be made from promote earnings would be more than sufficient to generate the best judgment that the manager could muster. Even out of the money managers would be incentivized to use their best judgment as they would be interested in achieving the best possible performance for their investors to protect their track record and relationships for future fund raising.

Only in the case of an out of the money venture where the manager is contemplating exiting the investment management business do we see a scenario where co-investment capital might serve to align interests. However, in such a case, removing the manager altogether might be a better option, a process that is often much easier in ventures where there is no co-investment.

In addition, particularly with larger managers (and, ironically, with larger co-investments), co-investment capital is not even coming from the people who are spending the time and energy and making the judgments. Or if it is, it is money borrowed from the parent corporation.

The bottom line is that a manager's financial interests are dominated by a) potential incentive fees, b) asset management fees and c) the prospects of raising future capital. At best, receiving an LP-like return on co-investment capital is a distant third.

CO-INVESTMENT AS MISALIGNMENT

Leo Tolstoy, in *Anna Karenina,* wrote, "Happy families are all alike; every unhappy family is unhappy in its own way." Similarly, the ways in which co-investment can create problems are each unique in their own way.

The easiest situation to see where co-investment can lead to misalignment is in the case of small or emerging managers. These may be local or regional firms that are trying to raise institutional capital, or they may be firms managed by people that have spun out from a larger management firm. Either way they are unlikely to have substantial co-investment capital.

Such a firm would have three basic choices when faced with a co-investment requirement:

- Seek a third-party financial partner to provide the co-investment capital.
- Raise the co-investment capital from friends and family.
- Put in the co-investment capital from their own savings in an amount meaningful to the manager.

None of these three approaches increases alignment of interest with institutional investors, and all have substantial likelihood of creating misalignment.

Seek third-party capital. Obviously this is co-investment in name only and does absolutely nothing to increase alignment between the individuals managing a venture and institutional investors. In fact it likely misaligns in that it introduces a new party to the mix who is often unknown to the institutional investor. Ironically, such third-party providers of capital could be even more counterproductive if they also provide seed capital to a small manager for overhead and working capital. Rather than covering initial overhead with sweat equity (which it might be able to do if there were not a co-investment requirement looming), such a financial partner makes it even easier for a small manager to be playing exclusively with other people's money, while simultaneously minimizing the need for sweat equity, which we do believe increases alignment. In addition, these funding sources would likely want some element of control. So, the institutional investor is no longer investing solely with the visible management team but also with an initially silent investor that they might have little understanding of, whose motivations are uncertain, and qualifications are unknown.

Friends and family. Second, a small manager could raise its co-investment capital from friends and family, which capital is likely to be more passive than the third-party capital posited above. However, this also introduces considerable emotion into the equation — particularly to the extent that it is more from family than friends. This option also is limited to people whose friends and family have substantial investment capital available, which is a small subset of potentially qualified managers. This source of co-investment capital also might inhibit a manager from proposing to invest additional capital in deals that might otherwise warrant rescue capital, as going back to friends and family and asking for additional money can be problematic. Further, each set of friends and family brings with it its own peculiarities, personalities and emotion — none of which are likely to do much in the way of aligning the manager with an institutional investor.

In addition, institutional investors are tax-exempt entities, while managers and the people that comprise management teams are taxable entities. … It is easy to see hold/sell decisions being influenced by personal tax considerations if the amount co-invested is truly meaningful.

Meaningful investment directly from the manager. Finally, let's examine the holy grail of co-investment: the situation where the individual people that comprise the management team actually invest their own capital in an amount that is personally meaningful to them. Although on the surface, this is appealing, it too is likely to create more misalignment than alignment.

Meaningful to the manager by definition means that we are talking about an amount of money that is *meaningful*. Perhaps it is borrowed from the equity in the manager's home … and interest rates are rising. Perhaps five years into an investment the manager has children entering college … or graduating. Perhaps a manager has elderly parents that need financial assistance … or will be seeding a trust fund.

An institutional investor achieves no alignment of interest with a manager when hold/sell or rescue/abandon decisions are influenced by a) the second mortgage on a manager's home, b) the age and academic achievement of their children, and/or c) the health and wealth of their parents. And yet by looking for co-investment that is meaningful to the manager, this is exactly what is being achieved.

In addition, institutional investors are tax-exempt entities, while managers and the people that comprise management teams are taxable entities. This tax differential also adds a divergence of economic interest that could get more significant if changes to the tax code increase marginal tax. It is easy to see hold/sell decisions being influenced by personal tax considerations if the amount co-invested is truly meaningful. Financial restructurings also can be problematic as different options may trigger tax consequences for individuals, but have no impact on institutional investors.

At the end of the day, institutional investors achieve alignment of interests with small managers by a) undertaking sufficient due diligence to have confidence the people they are investing with will be good fiduciaries, and b) knowing that the individuals that make up a small management firm are betting their professional careers and professional reputations on their endeavor. Sweat equity is far more aligning than co-investment capital.

The situation with large managers is a bit more complicated, and there are probably more instances where co-investment does make sense. But the past 20 years are rife with examples of large firms that were able to tout large co-investments as leverage to raise multibillion-dollar funds. Although data is sketchy, the majority of these megafunds performed no better, and arguably worse, than funds with lower co-investment percentages.

In addition, in some cases, co-investment was not provided by the manager or its parent at all. Rather co-investment capital was provided by other funds that were raised by the manager. While this certainly exposed the manager to reputational risk, it created little or no-skin-in-the-game alignment.

But even in cases where a large firm is truly putting up its own money, there are just as many scenarios for no alignment or misalignment as alignment. Some examples:

- In the case of regulated financial institutions, regulatory compliance may influence buy/hold/sell/rescue decisions.
- Any public company could use gains or losses embedded in co-investment capital to smooth earnings.
- Tax issues could cause misalignment.
- Large institutions may believe that portions of their co-investment return comes from ancillary services/fees that they may be able to provide such as financing, capital raising or investment banking.
- Finally, for really large companies, an investor needs to ask the question whether the amount of capital committed to a particular fund or venture really makes a difference to the parent.

WHERE CO-INVESTMENT CAN WORK

While we do not generally believe that requiring a manager to invest its own money will make them any smarter or work any harder, we can imagine some scenarios in which that could occur.

First, if managers have multiple areas in which they can devote their time and best resources, those managers might choose to devote more time and better resources to those areas in which they have their own capital invested — at least initially. However, over time, we believe that a manager without a fiduciary mindset would be routinely doing a calculus to determine where its time and effort are most likely to produce future financial benefit. Future promotes and fundraising opportunities would likely outweigh sunk cost recapture in most cases. While there may be some psychological influence from having skin in the game, we think it is generally not material.

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Another area where requiring manager co-investment makes sense is driven by the nature of the manager itself. The key characteristic that makes requiring co-investment a good idea is through fear of failure. If a manager had no fear of failing, then it might well be prone to imprudent risk taking, which could be reined in by requiring material skin in the game.

While there are many examples of a lack of fear of failure, two disparate examples illustrate this phenomenon.

Managers that have evolved from highly entrepreneurial environments such as development firms might be good candidates for co-investment. Such firms a) would have a high tolerance for risk, b) might not have internalized a fiduciary mindset and c) would have little fear of failure because they may have lost substantial investor capital in the past and yet lived to invest another day. This is particularly true for firms with a history of raising capital on a deal-by-deal basis as they could look at a discretionary venture with institutional investors as a free option believing they could return to their previous business model raising capital deal by deal if their venture failed.

Co-investment also would be appropriate for a mature privately held manager with a track record of success whose partners have earned substantial personal wealth. Such a firm might need the discipline of investing its own money for at least two reasons: First, the partners may be financially secure even if the current venture were to be unsuccessful. Second, the firm may have a substantial enough track record that it could absorb one unsuccessful venture. Such a firm might be prone to high-risk behavior on the front-end and, on the back-end, be more likely to lose interest in a fund that is out of the money.

Finally, there are some strategies for which co-investment does increase manager alignment with investors. Some examples include a) strategies that involve acquiring options wherein significant capital is really deployed when the decision is made whether or not to exercise the option, b) ventures with long investment periods, and c) ventures with operators or developers. With strategies such as these, co-investment can help maintain underwriting discipline that might otherwise loosen over time. ❖

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