



IN SEARCH OF CO-INVESTMENTS: A SIDEBAR ON SIDECARS

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Appetite for co-investment opportunities has never been greater. Limited partners (LPs) are demanding more access to deal opportunities, and on their own terms. At the same time, valuation multiples are at an all-time high. Middle-market sponsors are looking to LPs to co-invest in larger acquisition targets that otherwise may be beyond reach. To capitalize on the trend, players on both sides need to understand the demand and take appropriate measures to avoid common pitfalls.

A “co-investment opportunity” is an option to invest alongside a primary private equity fund in an investment that may otherwise be too large for the fund. A “sidecar” is an investment vehicle organized by the sponsor of the primary fund to participate in one or more co-investment opportunities.

LPs are seeking sidecar investment opportunities for several reasons. First, these opportunities can improve net investment returns to the LPs who participate in the sidecar because the economic terms usually include lower management fees and carried interest allocations. Second, these opportunities present a faster means of deploying capital, since the organization of a sidecar requires less formality than a full-blown fund formation. Finally, sidecar investments require less monitoring than a direct co-investment, and they can provide additional diversification, depending on the asset classes involved.

Sidecars benefit sponsors too. They make a sponsor more nimble in its investment activity. With a sidecar, a sponsor can secure deals despite the concentration limits of its primary fund and without the need for leverage. Sidecars also provide faster access to capital in excess of primary fund commitments because, as noted above, they avoid a traditional fund-raise. Finally, offering sidecar opportunities can help a sponsor attract LPs, or strengthen relationships with existing LPs, if the economic terms are indeed “lower load” than the primary fund.

A sponsor must consider several issues when organizing a sidecar, the most important of which are maintaining alignment of interests and tax matters. Sidecar funds will be most effective when their structure aligns the interests of not only the sponsor and the sidecar LPs, but also the sidecar LPs and the LPs in the primary fund that do not participate in the sidecar.

To maintain alignment, sponsors and sidecar LPs negotiate a number of common protections. The sponsor and sidecar LPs will typically agree that the sidecar will invest alongside the primary fund on a *pari passu* basis, so that the co-investors, the primary fund LPs, and the sponsor will be investing (indirectly) in the same type and combination of securities. Similarly, the parties will agree that the exit from the applicable investment(s) will be *pari passu* as well. In addition, the parties sometimes agree to lower management fees (or no fee) and a lower carry (or no carry), so that the sponsor is not incented to favor the performance of the sidecar over the primary fund; however, some LPs actually prefer that the sponsor receive a carried interest so that the sponsor is properly motivated to make the sidecar successful. The parties also commonly specify how investments are allocated between the vehicles. For example, the investors might agree that opportunities are apportioned to the primary fund and the sidecar pro rata based

on respective commitments, provided that the primary fund will always have the first opportunity and a minimum allocation.

Tax matters may also present special challenges when organizing a sidecar. Frequently one or more LPs investing in the sidecar may have special tax needs (*e.g.*, tax exempts, domestic or foreign pension plans, REITs). Sponsors may be required to resolve additional tax issues for these LPs when structuring the sidecar. Other times LPs may participate in the primary fund and the sidecar simultaneously. Depending on when the sidecar is formed, the investment bifurcation may result in reporting nuances for the LP that the sponsor may want to disclose.

In sum, it appears that investor demand for co-investment opportunities and sidecars is here to stay. The arrangements offer substantial benefits to both sponsors and their LPs, but to maximize the advantages, sponsors should work to align interests and consider structural alternatives very carefully.

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