Are Co-Investments Here to Stay?

In this extract from the newly-launched Preqin Special Report: Real Estate Co-Investment Outlook, we take a look at fund manager and investor appetite for co-investments.

Recent years have seen an increase in investor appetite for exposure to real estate through alternative routes to market to traditional commingled funds. Co-investments have emerged over recent years due to the many benefits on offer to both investors and fund managers. In order to find out more about this growing area of the asset class, we have surveyed 75 active real estate fund managers to better understand the changing levels of co-investment participation, with this information enhanced by a survey of 100 institutional investors, as well as data taken from the in depth profiles of more than 5,100 institutional investors featured on Preqin's **Real Estate Online**.

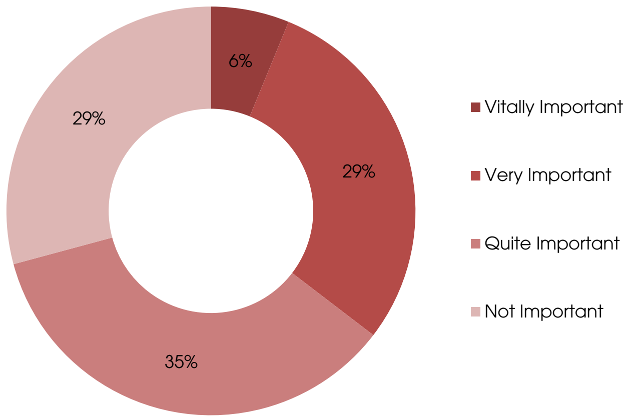
Fund Manager Perception of Co-Investments

Discussions surrounding the disintermediation of real estate are becoming more common, and increasing numbers of institutional investors are exploring alternatives to pooled fund commitments. Reflecting this trend, the majority of real estate fund managers feel that it is important to offer potential investors co-investment rights when seeking new commitments, and that this increases the chances of a successful fundraise (Fig. 1). Given this, it is perhaps unsurprising that 57% of fund managers expect to offer more co-investment opportunities to investors in 2016 than they did in 2015, while just 2% expect to offer fewer.

We asked real estate fund managers what they perceive to be the positives and negatives of offering LPs co-investment rights. Just 6% of respondents stated that there are no benefits in offering LPs co-investment rights (Fig. 2). The survey revealed that the most important benefit for fund managers is that it helps build a stronger relationship with their investors, with co-investments likely to help establish long-term partnerships, while access to additional capital is also an important consideration for a large proportion of firms.

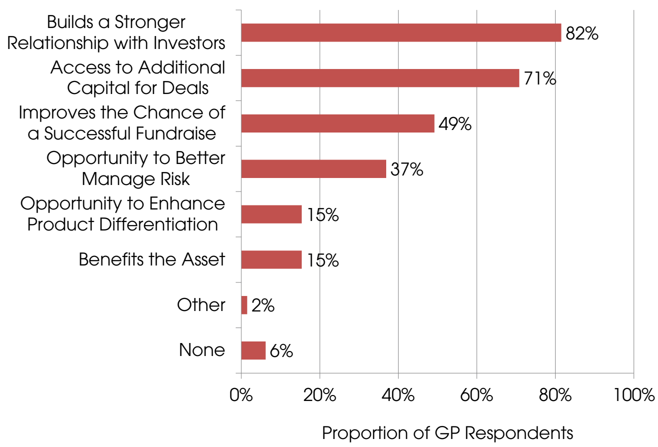
Co-investments do present managers with challenges however, with the additional costs associated with reporting or setting up special purpose vehicles named by 44% of firms as a downside (Fig. 3). The potential for a deal to be delayed, the problems associated with the timing or rights of co-investors and the loss of control of an investment were also named as important considerations.

Fig. 1: Fund Managers' Views on the Importance of Being Open to Offering Co-Investment Rights for a Successful Fundraise



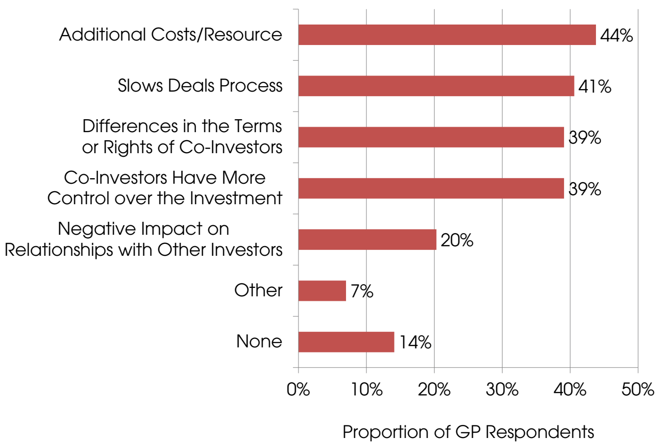
Source: Preqin Fund Manager Survey, H2 2015

Fig. 2: Fund Managers' Perceived Benefits of Offering Investors Co-Investment Rights



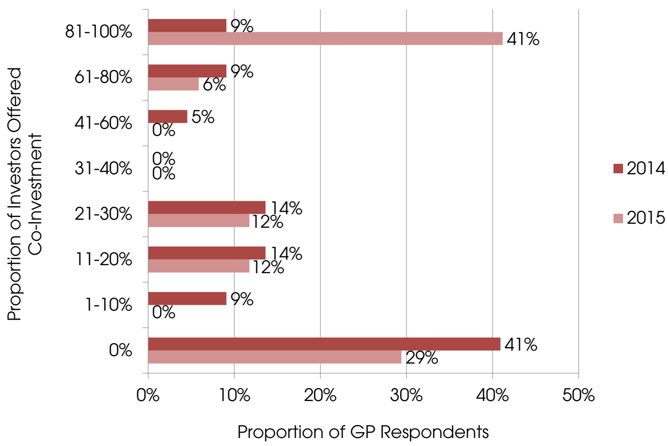
Source: Preqin Fund Manager Survey, H2 2015

Fig. 3: Fund Managers' Perceived Disadvantages of Offering Co-Investment Rights



Source: Preqin Fund Manager Survey, H2 2015

Fig. 4: Proportion of Investors Offered Co-Investment Opportunities by Fund Managers, 2014 vs. 2015



Source: Preqin Fund Manager Survey, H2 2015

Fund Manager Activity

Nearly two-thirds (63%) of real estate fund managers surveyed offer co-investment rights to their investors, and a further 25% are considering doing so in the future. No respondents had previously offered co-investments in the past that do not offer them any longer. Just 12% of firms do not expect to offer co-investments, reflecting how prevalent these structures are within the real estate fund market.

The most common point at which investors are offered co-investment rights is during the fundraising process or during the bid for deals. It is rarer for fund managers to offer them at final close of the fund, with only 3% of respondents doing so.

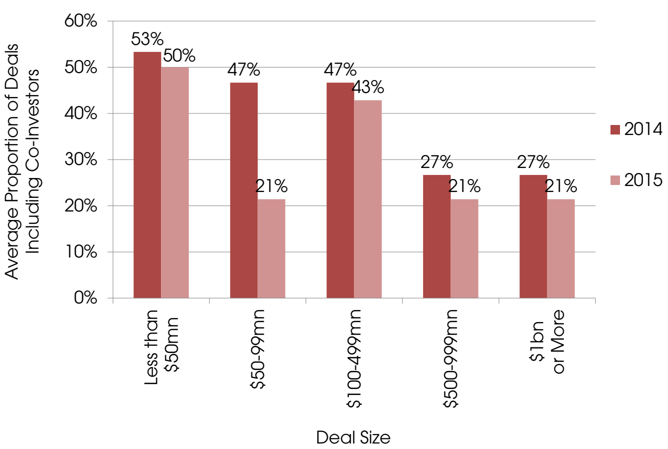
In order to track the changes and developments in the private equity real estate co-investment space, we asked fund managers about their activity in 2015 compared to 2014, with the results clearly illustrating the growth of co-investments in a relatively short period of time. Fig. 4 demonstrates that GPs are generally offering an increasing proportion of their LPs co-investment opportunities; between 2014 and 2015, the proportion of fund managers offering 0-40% of their LPs co-investment opportunities has dropped, and in turn, the proportion offering these opportunities to more than 80% of their investors has risen considerably. In 2014, 9% of real estate firms were offering more than four out of five investors co-investments – this rose to 41% in 2015.

Fig. 5 shows the average proportion of deals completed in 2014 and 2015 that included LP co-investors by deal size. The overall trend is that smaller deals (those less than $500mn in size) are more likely to include an LP co-investor. Our survey results show that there have been slight changes within each size bracket moving from 2014 to 2015, with the most notable shift in the category of deals worth $50-99mn. Of all $50-99mn real estate deals completed by respondents in 2014, 47% of these included LP co-investors, compared with just 21% in 2015.

Investor Relationships

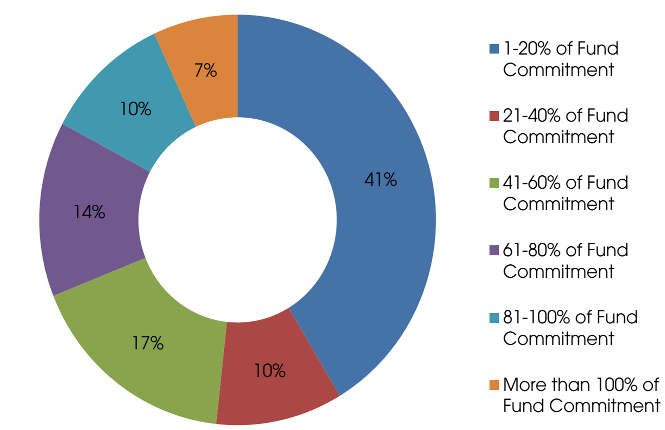
Preqin's survey results highlighted the differing experiences real estate firms have when offering co-investments. For example, the largest proportion (41%) of fund managers stated that the capital co-invested by their investors typically equates to 1-20% of the LP's original fund commitment (Fig. 6). However, for 7% of surveyed fund managers, the co-investment capital equated to more than 100% of their investors' original fund commitments.

Fig. 5: Size of Deals Completed that Included LP Co-Investors, 2014 vs. 2015



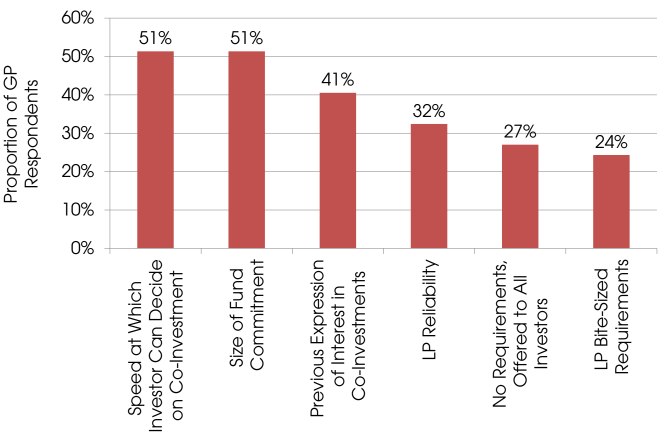
Source: Preqin Fund Manager Survey, H2 2015

Fig. 6: Fund Managers' Observations of Capital Typically Co-Invested Alongside Fund Commitments by Their LPs



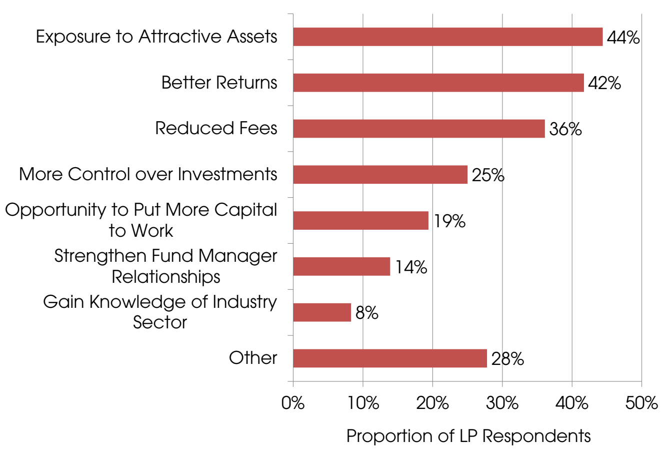
Source: Preqin Fund Manager Survey, H2 2015

Fig. 7: Requirements for Investors to Qualify for Co-Investment Rights



Source: Preqin Fund Manager Survey, H2 2015

Fig. 8: Investors' Perceived Benefits of Co-Investing



Source: Preqin Investor Survey, H2 2015

There can be a number of prerequisites for investors when qualifying for co-investment rights. The largest proportion of fund managers rated both the speed at which the LP can evaluate and agree to co-investment and the size of the fund commitment as high importance, with over half of respondents stating this as a requirement to qualify for co-investment rights (Fig. 7). The competitive bidding process and the fact that several co-investors may be waiting on one another's decisions means that there is some pressure on timing, with fund managers often looking for a verbal commitment from investors within as little as two to three weeks.

Investor Activity

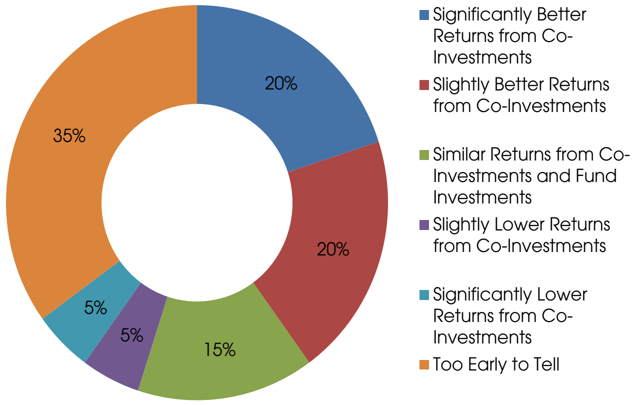
Of more than 100 investors surveyed by Preqin in H2 2015, one-third had some interest in co-investments, perhaps illustrating the barriers to entry to some institutional investors that lack the internal resources to manage capital invested in these structures.

For those that do make co-investments, the key motivation is gaining more exposure to attractive assets, which was mentioned by 44% of respondents (Fig. 8). A large proportion (42%) of surveyed investors also stated better returns as a perceived benefit of co-investing, as well as the opportunity for lower fees than in the traditional commingled fund model.

As shown in Fig. 9, of those real estate investors surveyed, 40% have seen their co-investments outperform their private real estate fund returns, including a fifth that have significantly better returns. While the majority of investors have seen better returns, one in 10 investors has seen their fund investments outperform their co-investments.

The results of our survey indicate that co-investments typically have lower fees than those seen in the usual fund arrangements (Fig. 10). The majority (58%) of fund managers offer co-investment opportunities with a reduced management fee, with an additional 19% offering no management fee. A similar trend is seen for carried interest rates too. A quarter of firms charge no carry, whereas 44% offer a discounted carry structure to the standard fund commitment. More often than not, LPs are seeing reduced and more favourable fee arrangements on their co-investment commitments when compared to their fund commitments.

Fig. 9: Investors' Views on the Performance of Their Co-Investments Compared to Their Fund Investments

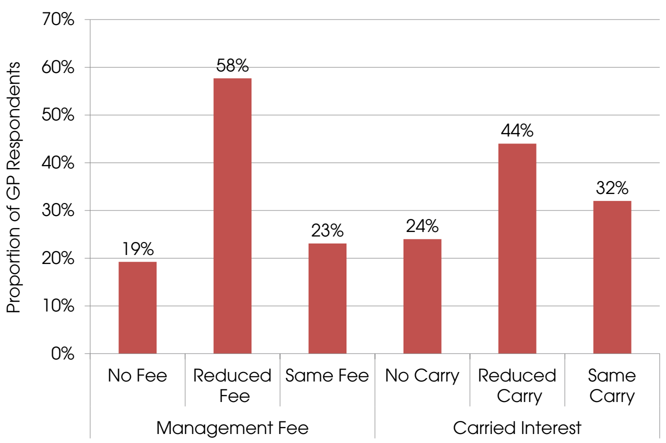


Source: Preqin Investor Survey, H2 2015

Outlook

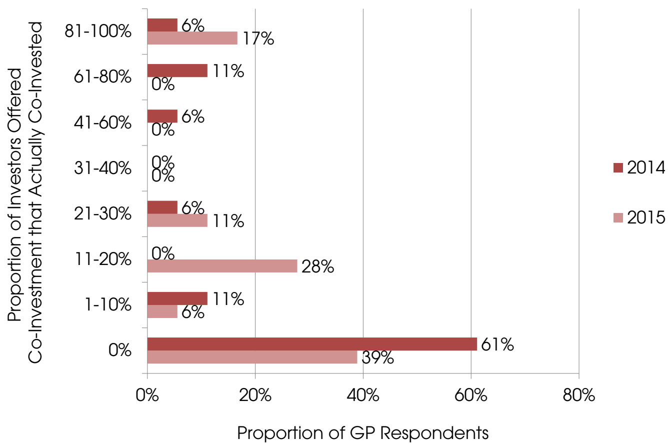
The responses across both surveys convey the widely positive outlook many active in the real estate industry have for co-investments at present, with strong recognition of the benefits such investments can bring to both investors and fund managers. While there is strong interest in these structures, there remain a number of challenges that can prevent institutional investors from being able to participate in co-investments. However, given the prevailing view among fund managers that offering co-investments is important to the fundraising process, and the growing demand for more exposure to attractive assets from investors, it seems GPs and LPs will continue to work to overcome these challenges, and we are likely to see this structure become ever more common in the coming year.

Fig. 10: Discounts Offered to Co-Investing LPs Compared to Usual LP Fund Commitment



Source: Preqin Fund Manager Survey, H2 2015

Fig. 11: Proportion of Investors that Actually Co-Invested with the Fund Manager after Being Offered the Opportunity, 2014 vs. 2015



Source: Preqin Fund Manager Survey, H2 2015