Co-Investments in Real Estate: A Quick Primer

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Two Types of Co-Investment

As institutions consider their options for real estate investing going forward, many are adding co-investments to the traditional candidate list of funds, separate accounts, and joint ventures. Like any other strategy, co-investments have some unique characteristics as well as pros and cons that need to be weighed. It is also helpful to know that the industry uses the term "co-investment" in two distinct ways:

Definition #1: Investment opportunities created by concentration limitations or other fund restrictions. These are also known as "sidecar" investments. In this context, there are opportunities for investors to contribute capital alongside the "host" fund involving a specific asset or portfolio. Pros and cons for investors and sponsors are summarized in the following matrix:

	Pros	Cons
Investor	• Creates opportunity to "cherry pick" by reviewing individual deals and opting in to those that best fit individual investor criteria. • Investor may be able to achieve better economics (lower fees, better waterfall) than those offered to fund investors.	• Requires thorough and timely due diligence on individual properties or portfolios, which may strain investor resources. • If investor's existing portfolio is primarily fund-oriented, co-investing may add "lumpiness" by introducing concentrated exposures to individual properties. • The sponsor may encounter conflicts of interest while managing both the "host" fund's interest and the co-investors' interest in the same property or portfolio. (For example, differing fees, prefs, and promotes between the two could motivate the sponsor to act differently.)
Sponsor	• Provides a way to invest in assets that would otherwise be prohibited due to concentration limitations or other fund restrictions.	• Spreading investments across more vehicles increases up-front documentation and ongoing administrative and reporting burdens.

In addition to the pros and cons of Definition #1, it is useful to know that co-investment provisions vary widely in partnership documents. For example:

- Sponsors may or may not be required to offer any co-investment opportunities to "host" fund investors.
- Offering co-investments to investors outside the "host" fund may or may not be permitted.
- There may or may not be a protocol for which "host" fund investors are offered co-investment opportunities, what allocations they are offered, and in what order.

- The time frames required for responding to co-investment opportunities may be tight.
- Economic terms (fees, pref, and promote) for co-investments may be required to mirror the "host" fund's terms, or may be different but predetermined, or may be freely negotiated on a deal-by-deal basis.

Definition #2: Sponsor capital committed to a fund, syndicate, or joint venture. In this context, there are opportunities for investors to contribute portions of the sponsor capital for funds, syndicates, or joint ventures in exchange for superior economics. This is typically structured as an "LP position in the GP" (or the LLC equivalent). Pros and cons for investors and sponsors are summarized in the following matrix:

	Pros	Cons
Investor	• Relatively small investors can negotiate better economics (lower fees, better waterfall) for the investor. For example, a $20m investment representing 2/3 of the sponsor capital in a $600m partnership requiring $30m (5%) of sponsor capital will likely have more negotiating strength than a $20m "traditional" investment in a $600m partnership. • Similarly, relatively small investors can achieve more control over and/or visibility into partnership decisions.	• Additional liability such as personal recourse to the investor must be addressed or avoided through careful structuring and documentation.
Sponsor	• Frees up otherwise illiquid sponsor equity for use in other projects, enabling sponsors to diversify their capital across more deals. • Increases the expected IRR & equity multiple on the "true" sponsor capital in the deal.	• May require providing more observation rights, or even higher control levels, to investor. • Presence of third-party sponsor capital should be disclosed, and may inhibit fundraising efforts.

Crucial Steps Toward Implementation

A thoughtful approach to co-investing can enhance a real estate portfolio by providing increased exposure to investments that are particularly well suited for a specific institution. To maximize potential benefits, the following steps are critical:

- Evaluate the existing portfolio's composition to determine which property types, geographies, and/or risk profiles are underweight, both currently and prospectively, relative to the overall strategy. Focus on opportunities that fit those needs, rather than pursuing every co-investment opportunity that arises.
- Perform an honest assessment of in-house capabilities to conduct thorough and timely property-level and deal-level due diligence when opportunities arise. If doing so will strain resources, arrange for help either by reconfiguring internal staff or outsourcing.
- Review partnership documents governing current fund investments to determine existing co-investment rights, if any.
- Communicate with fund managers to help them understand your objectives and due diligence processes, so your agenda is top of mind when they encounter co-investment opportunities.

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