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CO-INVESTMENTS: *the* fourth pillar *of* incentives

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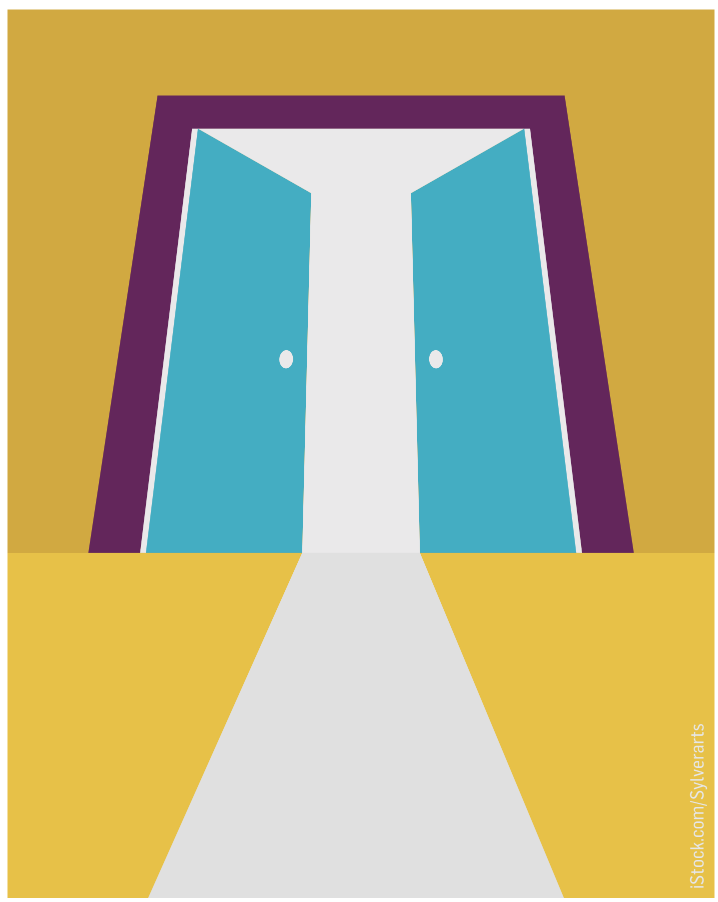
Expanding *the* co-investment OPPORTUNITY

General partners or GPs typically invest 2% alongside the LP as co-investment, with the management team — typically executive and senior-level employees — either required or invited to participate in order to have 'skin in the game.' Amid efforts to better retain talent post-Covid, the conversation has changed to firms considering expanding co-investment eligibility. NAREIM spoke with **Lucy Bertsch,** *Director, Compensation Consulting at* **Ferguson Partners** *about key co-investment trends among real estate investment management firms, including opening up the opportunity, loans and downside risks.*



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The co-investment opportunity is under discussion within real estate investment management, with co-investment being seen as a fourth pillar of compensation. Is eligibility being expanded, and, if so, to whom?

There is an accredited investor or ‘knowledgeable employee’ requirement given the inherent risk of investing in the private market. To date, the opportunity to co-invest hasn’t been opened up to a broad-based group of employees. But we’re seeing that changing slightly, specifically with respect to mid-level employees such as VPs or Directors who might be first- or second-time participants receiving points in the deal or fund.

“ The biggest challenge to expanding eligibilty has been the administrative burden associated with co-investment. ”

The biggest challenge to expanding eligibilty has been the administrative burden associated with co-investment. As a company offers co-investment opportunities to a broader group of employees, they will need to be able to handle the required filings and put in place termination provisions.

Where are changes occurring?

To date, a lot of companies have offered co-investment sporadically; there hasn’t been a framework in place around the amount, eligibility and which products are included. We are getting many questions around formalizing co-investment programs.

In what ways?

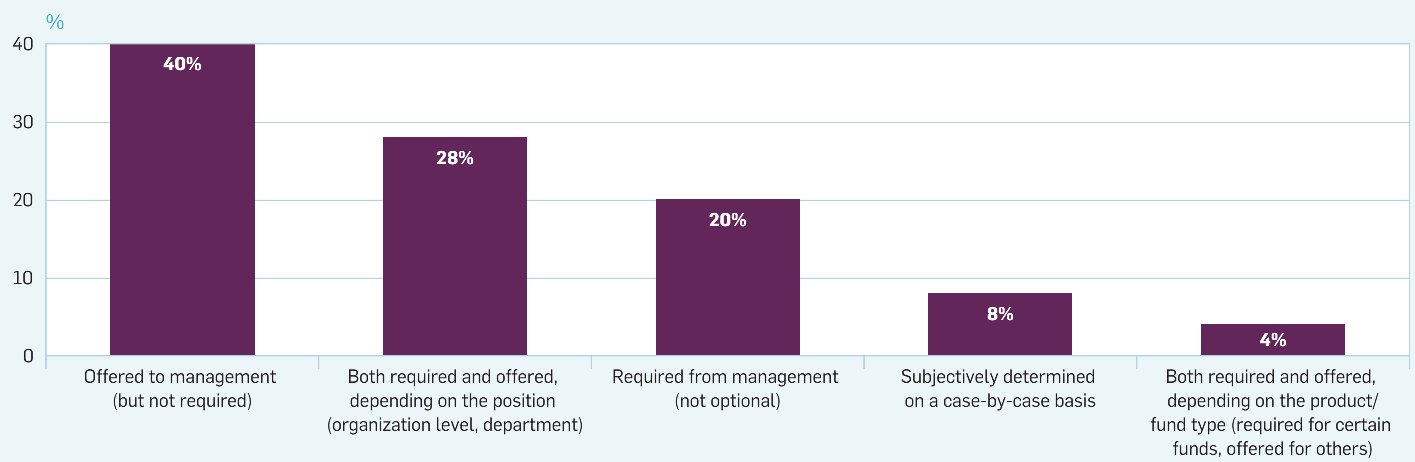
When it comes to formalizing co-investment programs, this typically includes definitions around contributions and eligibility.

On the topic of contributions, we typically see three main approaches in the industry. Firms will use a percentage of total cash compensation, to, say, an average of your base and bonus over the past three years; or a fixed dollar amount by level; or, for those companies that are directly granting promote, it’s very common to link promote and co-investment in the form of a ratio. A 3:1 ratio would indicate for every 3% of promote awarded, the employee would be required to co-invest 1% of the GP’s total co-investment.

Talk us through co-investment loans, as only a third of firms use a loan program, while more than half don't.

Co-investment can either be required by investors, or firms can offer the opportunity for select members of management to co-invest as a total rewards benefit.

Exhibit 1: Your company’s co-investment plan for management

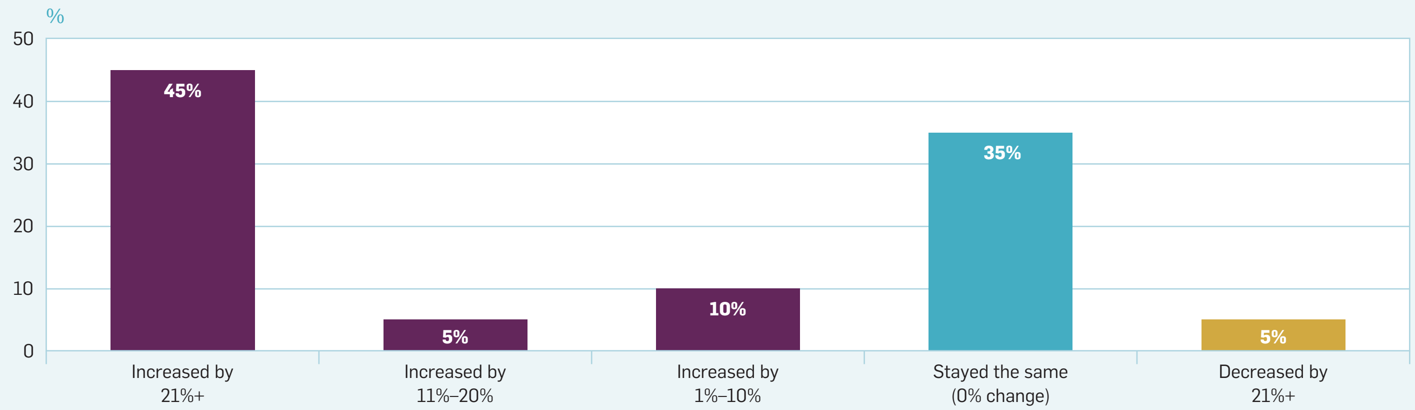


Source: NAREIM Compensation Survey 2022.

Exhibit 2: Total co-investment (across all funds) by the company in 2021 contributed by management ($m)

	25th percentile	Median	75th percentile	Average
Total co-investment in 2021	$4	$6	$24	$15
Amount contributed by management in 2021	$1	$3	$9	$6

Exhibit 3: Co-investment amount contributed by management, 2021 vs. 2020



Source: NAREIM Compensation Survey 2022.

When co-investment is required, it is more common for loans to be provided either off the company's balance sheet or through a third party with negotiated favorable rates. When co-investment is offered as an opportunity (versus required), there isn't the same sentiment that companies have to offer a loan program.

Many investment managers provide loans to help facilitate the inherent benefit of co-investment, but it's not seen as a must-have per se. Typically co-investment loans can make up around 50% to 80% of an individual's co-investment contribution.

If you're a first-time co-investment participant, we oftentimes see that companies might waive or lessen the requirement or offer a more meaningful co-investment loan. I think that's an interesting piece, especially as you think about offering this up to more mid-level employees.

Are you seeing more innovation in terms of co-investment programs?

We've seen some innovation with select clients who have deferred compensation plans, whether a deferred portion of an annual bonus award or a cash-based long-term incentive. For example, the deferred portion of the award is invested on the employee's behalf in the fund or deal. Upon realization, the employee would essentially receive the deferred portion of the award as well as the returns on the invested capital.

But there are downsides to co-investments, of course.

In general, most investment managers think about co-investment in a very positive light. We receive feedback from clients that it is an incredible opportunity for wealth creation, alignment of interests with investors, and a very strong motivator when you have skin in the game.

As we are entering a downturn environment, it is especially important to remember that co-investment is inherently not diversified, and there's a good amount of risk associated with investing in the private market. Further, the capital you've invested isn't liquid; co-investment can be held up in the fund for five to eight years — or more in some cases — so employees need to be comfortable with that fact for personal financial planning. ◆

The 5 CO-INVESTMENT Qs to ask

Co-investment is a key tool for aligning interests with investors and employees. Yet it's something only 52% of real estate investment managers provide.

The reason? The challenges of delivering co-investment programs are significant. Regulation and tax are the two greatest challenges cited, and those alone can make co-investment programs feel daunting to execute upon.

However, as recruitment, retention and culture strategies continue to be top of mind for firm leadership, co-investment is increasingly being looked at as the fourth pillar of incentive programs. But what questions should managers ask themselves as they look to introduce, or improve on their, co-investment programs?

1. What are your objectives?
What is your key objective in relation to co-investment? Is this primarily about alignment with investors, or are you also looking to co-investment programs as an employee incentive tool, to assist your recruitment and retention strategies? All managers providing co-investment attest to the same challenge: It's complex and not for the faint-hearted. The amount raised from employees may be small for the work involved. But it's powerful. For investors, co-investment is a critical, if not essential, means of demonstrating skin in the game; for employees, it's access to a means of wealth generation.

2. Who is eligible?
This very much depends on the country where your employees work, and also the country where the fund is registered, with each country having different minimum requirements around investment eligibility. Legal counsel will be your best friend when it comes to co-investment programs, managers admitted, as there are plenty of gray areas to debate. "There is no one playbook out there," said the CEO of a $100bn AUM investment management firm.

In the US, the SEC sets guidelines around who can invest. Employees must be a qualified purchaser or an accredited investor, and must be able to meet certain financial and sophistication criteria. However, there is no perfect definition of what the SEC means by 'knowledgeable' person — a factor that can result in significant internal discussions as to who (or which functions) are 'knowledgeable,' and which are not. Typically, the closer to the fund, the fund's management and the deals, the safer the assumption surrounding 'knowledgeable.' For more back office roles, potentially HR and IT, the definition can become more problematic.

3. What about the UX, the user experience?
This is imperative for anyone doing co-investment, all managers agree. Hear the lessons learned from one CEO who said the first co-investment fund his firm provided required him (and other senior employees) to file taxes in every US state the fund invested in. It was a painful lesson learned.

But it's not just about taxes and filings, it's also about ensuring ease of investment, communication around fund performance, and the ability to re-up or exit as needed. Make it too complex and employee participation will be low.

4. Who pays the fees?
Employee feeder funds are critical to all co-investment programs, but the costs rise exponentially once a firm expands co-investment beyond domestic employees. That's why understanding your objective to co-investment is vital.

Firms should also think about asset management and performance fees, and whether employees should be required to pay those fees just as LPs do. One organization said they did not charge fees on employee co-investment after investors revealed they were not sensitive to the issue. It was also a move that helped that organization increase co-investment participation tenfold, the manager said.

However, it also raises questions on taxable benefits. Just like legal counsel, tax specialists will be your friend, as you consider co-investment programs for employees.

5. Do you provide employee loans?
Just over one-third of managers provide employee loans for co-investment programs, according to the 2022 NAREIM Compensation Survey. Of the 38% of managers providing loans, half cap financing to 33% to 50% of the co-investment amount, while the other half provide financing greater than 75%.

Loans can be a valuable tool to help expand participation. But for one manager, it was a "step too far," as it diluted the value of the employee co-invest and skin in the game, in the eyes of LPs. Again, fully understanding your objective with co-investment is important here. Is co-investment primarily for LPs or is this a dual-purpose strategy to align with investors and employees?