

Insights**“MAKING THE POT LAST LONGER” - CO-INVESTMENT AS AN ESSENTIAL FINANCING TOOL FOR PRIVATE EQUITY SPONSORS**

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Over the course of the last six years, the UK has endured a seemingly unremitting series of geo-political and economic difficulties. On 31 January 2020 “Brexit” saw the UK formally withdraw from the EU after being a member for 47 years. This was followed shortly thereafter by the outbreak of the Covid-19 pandemic in March 2020, the related restrictions of which were generally phased out by February 2022. There was no reprieve, however, when later that same month Russia launched its full-scale invasion of Ukraine. Together, these events fundamentally altered the UK landscape both economically and socially, leading to the cost-of-living crisis in 2023, ranked as perhaps the most severe short-term cost-of-living crisis in the 21st century, the damage of which has been further compounded by the United States' imposition of tariffs on international trade in April 2025, and most recently, the start of the 2026 Iran war in February of this year.

The ongoing economic, social and geo-political challenges experienced in the UK, and indeed, globally, have resulted in a backdrop of uncertainty in the private markets, with private equity sponsors finding it more challenging to hit their intended fundraising targets than they may have done in the past. Industry data suggests that aggregate private equity fundraising has declined materially from its 2021-2022 peak, with a significant proportion of funds closing below target. In addition to market uncertainty, private equity sponsors have had to adjust to account for a reduction in exits over the last few years, fuelled in part by higher interest rates which have resulted in a higher cost of debt and a gap in valuation expectations resulting in reduced demand. In an effort to adapt to the current environment while still targeting their capital goals, sponsors have had to seek alternative routes to make up the shortfall in desired capital.

One such approach has been to focus on more narrowly tailored, deal-specific fundraises, often utilising vehicles such as special-purpose vehicles (SPVs) which co-invest alongside an existing fund, or other similar structures designed to operate on a deal-by-deal basis, where the vehicle is putting capital directly into a single portfolio investment. Each of these alternative structures will have slightly different financial dynamics from one another, but they all will have terms that differ from those typical of traditional blind-pool funds, simply due to the inherent deal-specific nature of these vehicles, including pre-identified investments and, generally, shorter hold periods, thereby

allowing a sponsor to access investor capital while decreasing, as much as possible, the investors' risk of uncertainty and capital lock-up. While the preferred alternative structure may vary depending on, among other things, how established the sponsor is, the nature of the target investment, the investor pool, and/or the jurisdiction of the fund and the asset, to the extent a sponsor has an existing active fund in the market, utilising a co-invest vehicle alongside the fund generally offers an additional option for both investors and sponsors.

Co-investments are generally structured as SPVs that invest in a target portfolio investment alongside, but separate from, a sponsor's existing blind-pool fund (the "Main Fund"). Subject to the provisions of the LPA, the GP for the Main Fund will generally have flexibility over which persons, whether new or existing investors, are offered the opportunity to participate in the co-investment. The LPA for the Main Fund may contain certain pre-set terms for any co-investment opportunities, including which existing investors, if any, the opportunity must first be offered to (e.g., it may require offering to all existing pro rata, or offering only to those over a certain value threshold or another formulation), and any such terms hardwired into the Main Fund LPA must be followed with respect to any co-investment offering. In this regard, sponsors should ensure that their allocation policies and conflicts of interest management frameworks adequately address the interplay between the Main Fund and any co-investment vehicle, particularly with respect to deal allocation, expense sharing and the equitable treatment of investors across both vehicles.

As noted above, one of the key components of a co-investment opportunity that makes it an attractive option for LP investors, especially in the current market, is the existence of a targeted, pre-identified deal-specific investment opportunity, which reduces uncertainty, provides targeted exposure to specific industries, and offers LPs more direct control over the allocation of their available capital. However, there are several other factors that make co-investments appealing to investors, including:

- Shorter holding periods reduced (or eliminated) management fees and carried interest as compared to a traditional blind-pool fund (which enables investors to increase deal exposure while simultaneously decreasing the cost of access to the asset class through blended fee rates across their overall portfolio).
- The opportunity to work with trusted sponsors on deal-specific opportunities that have undergone their internal due diligence process.
- The ability to leverage and learn from the infrastructure and operational expertise of established sponsors; and
- The opportunity to build relationships across sponsors and platforms.

From the sponsor's perspective, while the reduced fee and carry structure on the co-investment vehicle may appear to dilute GP economics, the ability to deploy additional capital into high-

conviction opportunities and to strengthen LP relationships often more than compensates for the concession.

The benefit offered by co-invest opportunities is not limited to LPs alone. For sponsors, in a market where private equity investment on the whole is down compared to previous years, co-investments provide:

- An alternative means of accessing available capital from both new LPs and existing LPs.
- A way to raise additional capital in order to consummate an investment opportunity that might have otherwise been limited to or prohibited by concentration limitations in the Main Fund LPA; and
- An opportunity for the GP to market itself by developing relationships with a larger pool of investors.

As is the case with most investment vehicles, co-invests do not come without their own risks and challenges. From an administrative standpoint, co-invest vehicles have substantially similar back-office implications as a traditional blind-pool fund, including requiring:

- Separate performance monitoring.
- Separate bank accounts; and
- Separate tax filings.

Co-invest opportunities also lack the diversification of traditional blind-pool vehicles, and while this is also one of their most attractive aspects, it likewise results in increased risk of loss if the single investment is not a success and could result in potentially adverse and damaging reputational risk in the event that the investment attracts unwanted attention for any one of a number of reasons, or indeed, should it prove to be unsuccessful.

From a legal documentation perspective, the establishment of a co-investment vehicle typically requires a suite of transaction documents broadly analogous to, though generally more streamlined than, those associated with a traditional blind-pool fund. At its core, the documentation suite will generally include:

- A limited partnership agreement (or equivalent constitutional document, depending on the jurisdiction and legal form of the vehicle), which sets out the rights and obligations of the GP and the co-investors, including provisions relating to capital contributions, distributions, allocation of profits and losses, transfer restrictions, and the winding up of the vehicle.
- A subscription agreement (or side letter, as applicable), entered into by each participating investor, pursuant to which the investor commits to subscribe for its interest in the co-

investment vehicle and provides customary representations, warranties and undertakings, including with respect to its status as a qualifying investor under applicable securities laws.

- Where the co-investment is made alongside a Main Fund, an investment participation agreement or co-investment agreement to govern the relationship between the co-investment vehicle and the Main Fund, addressing matters such as the allocation of the investment between the two vehicles, the terms on which the co-investment vehicle participates in the acquisition and any subsequent follow-on investments or disposals, expense allocation, and the coordination of exit mechanics; and
- Depending on the nature of the underlying transaction, additional documentation which may include shareholder or joint venture agreements at the portfolio company level, management or advisory agreements between the GP (or its affiliates) and the co-investment vehicle, and any ancillary side letters negotiated with individual investors granting bespoke rights such as most favored nation protections, reporting obligations or co-investment priority rights in respect of future opportunities.

Co-investment opportunities are not a new phenomenon. While historically, this source of equity finance was episodic and considered opportunistic, the challenges faced by both sponsors and investors given the current state of the market have shone a new light on co-investments, exposing a structure that is uniquely situated to respond to current market conditions as compared to traditional blind-pool funds, and resulting in co-investment strategies being increasingly viewed as an essential financing tool for private equity sponsors. Looking ahead, as the macroeconomic environment continues to evolve and LP appetite for transparency, control and fee efficiency grows, co-investment programmes are likely to become an increasingly formalised and strategic component of sponsors' capital formation strategies, rather than a merely supplemental or ad hoc offering.

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