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EXPERT COMMENTARY **CAPITAL DYNAMICS**

Co-investment: today's economic imperative in private equity asset allocation

By Andrew Beaton and David Smith, Co-heads of co-investment team

In recent years, but particularly after the credit crisis, investors have become more sensitive to pricing questions as well as to trying to find new ways to increase returns. This sensitivity, together with an increasing understanding of the asset class, has raised the interest in co-investments selectively to augment an existing portfolio of fund investments. In the following article we explore what co-investments are, why they are an interesting opportunity, where their main challenges lie and how best to gain access to them.

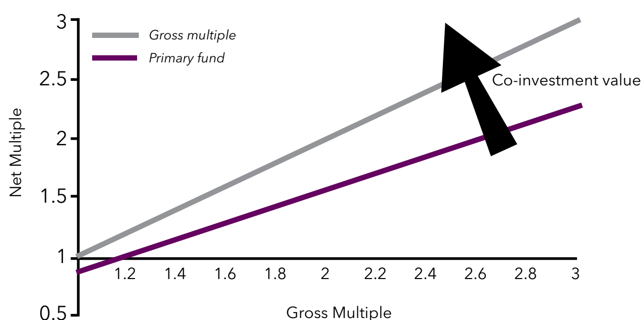
What is co-investment?

Private equity co-investment is the process of simultaneous investment in portfolio companies by a limited partner (LP) alongside funds managed by a general partner (GP). Hence an LP has not only a commitment to the GP's fund but also a direct investment in a portfolio company on the same terms as the GP's fund. Co-investment opportunities usually arise when a GP seeks to structure and invest in a transaction where the equity amount required is more than can be prudently provided by the GP's own fund.

Why is co-investment an interesting opportunity?

Firstly, co-investment is interesting because it allows an LP to invest more capital with quality GPs without increasing the number of GP relationships. Secondly, if the LP can find a way to co-invest in the best opportunities being promoted by the GP, then the LP can build an attractive portfolio of high-return investments. However, perhaps more importantly, co-investments are typically offered to LPs on a no fee and no carry basis. This means that there is no "gross-to-net" yield erosion as exists when investing in a fund. On a typical "two and twenty" fund, the combination of the annual management fee (paid initially on amounts committed) and the carried interest payable to the GP can easily eat up one-third of the total return to the LP.

Hence, a 2.4x gross multiple will become a 1.9x multiple net of fees and carried interest and a 20 percent gross internal rate of return will equate to 14 percent on a net basis. When private equity funds were generating gross returns of 35 to 40 percent, investors were comfortable paying the fees. However, with gross returns in the upper teens, the asset becomes much more marginal and the opportunity to improve the net return through co-investment all the more important. See chart below.



Source: Capital Dynamics analysis; not actual or model Capital Dynamics investments returns

What are the main challenges of co-investment?

Co-investments are direct investments and require different skills from fund selection. Fund investment requires manager selection skills whereas co-investment is rooted in portfolio company management appraisal and assessment. As a co-investor will typically not be leading the transaction, there is always an element of reliance on the lead GP. As a result, co-investment is largely the analysis of a direct investment opportunity paired with a good understanding of the skills and experience of the lead GP.

Sound portfolio construction is a vital element of a co-investment programme. In order to achieve this, the co-investor must have access to co-investment deal flow from a large number of quality GPs in order to select the investments desired. This means that the LP should have a large number of GP relationships or should join forces with other LPs to maximise co-investment deal flow. Often however, deal flow is an issue. An LP seeking co-investment opportunities must market to the underlying GP base to promote its appetite. Even though many GPs keep detailed records of the co-investment objectives of their LPs and sometimes offer co-investment opportunities pro rata to the LPs of the fund, GPs prefer to deal with those LPs which can demonstrate an ability to execute, respond in a timely manner and add value.

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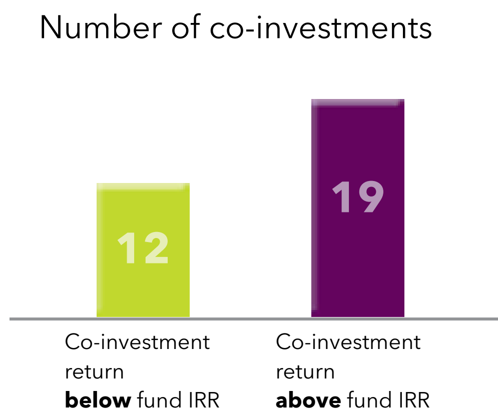
Typically the co-investment decision is based on the due diligence material issued by the lead GP. At this point the co-investor has to decide in principle whether it wishes to make an investment or decline. Here, swift and professional execution is paramount and fears of offending the GP by declining an investment should not interfere. In reality, the GP will prefer to receive rapid feedback and a quick "no" is often better than a positive but drawn-out response where the GP is uncertain as to the co-investor's intentions. One way of seriously damaging a relationship is to promise to invest and to pull out late in the process, causing major embarrassment to the GP who will by then have made commitments to the vendor, bankers, mezzanine providers and others. A good co-investor needs to have the ability to work in "lock-step" with the GP, sharing information and concerns and communicating frequently as the investment process moves towards completion.

Is there adverse selection?

A frequent concern is a possible built-in adverse selection in co-investment (i.e., deals offered to LPs are inherently less attractive as GPs will always keep the best deals for themselves). In fact there is little, if any, industry-wide data to support this somewhat cynical view. However, a co-investor can check this by simply looking at a GP's historical track record, comparing it to the performance of investments where co-investors were brought in and where they were not. Anecdotally, GPs state that they would not deliberately offer less attractive deals, if only to preserve the relationship with the LP and ensure a commitment to the next fund. As one GP stated, "Why would we want to spend the first hour of a fund-raising meeting talking about the co-investment that went wrong?"

The chart below shows 31 co-investments undertaken from 1994 to 2002, 19 of which outperformed the host fund. Given the fee advantage of co-investments, this will have resulted in very strong outperformance over an investment in the funds.

Number of co-investments



Source: Capital Dynamics analysis; not actual or model Capital Dynamics investments returns

How should an institutional investor execute a co-investment strategy?

Although a co-investment programme may be an excellent way to increase net returns to an investor in private equity, it requires specialist resources for proper execution. A large, sophisticated investor probably has the choice of whether to recruit a team and execute in-house or to outsource the work to an external specialist manager. Smaller investors will typically not have this option and should consider co-investment funds to avoid mistakes and deteriorating GP relationships. A decision on whether to recruit an in-house team or an external manager will largely depend on practicalities such as the incentive structures required to recruit and retain the right talent, appropriate decision-making processes as well as the availability of sufficiently large allocations. After deciding to outsource co-investment, the next step is to decide whether to go for a separate account or invest in a co-mingled fund. Larger investors with a substantial fund portfolio that can generate their own co-investment deal flow will be able to negotiate lower fees through a separate account as the manager is providing evaluation and execution services only. For those investors that cannot generate their own deal flow a co-mingled fund is the better choice. This will generally provide access to a greater number of high-quality co-investments with the caveat that it does not allow the investor to decide which GPs to support. Consequently, the decision process should be as follows:

1. **Consider overall approach**
   - Self-managed, separate account or co-mingled

2. **Establish investment parameters**
   - Levels of discretion and risk/exposure limits
   - Investment guidelines and restrictions
   - Geographies and transaction types

3. **Select experienced co-investment team**
   - Co-investment track record and positive selection
   - GP network and geographic footprint

4. **Select GPs with whom to co-invest**
   - Prepare core/target list of GPs approved for co-investment

Where should an investor co-invest?

Given the significant savings represented by co-investment, an investor could consider co-investments across all the private equity strategies that are attractive. However, closer scrutiny suggests caution in certain areas.

Co-investment in larger buyouts is easier as they are typically led by GPs with significant resources, involving the extensive use of outside consultants and professional advisers. Amounts of invested equity are substantial, allowing for more room for co-investment. ➟

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However, easier access to these buyouts does not necessarily mean that they are inherently attractive – as a number of co-investors in large buyouts completed in 2006-2008 have learned. Whilst well-structured larger transactions should certainly provide attractive co-investment opportunities, each still requires detailed scrutiny by dedicated professionals.

Venture co-investment lies at the other end of the private equity spectrum. This can be very challenging. Co-investment opportunities in the early "A" or "B" rounds are scarce and require specialists. Later-stage rounds may yield opportunities with the fundamental problem that the co-investor is usually being asked to invest at a much higher valuation in the "C" or "D" rounds where scope for adverse selection increases. The access-restricted nature of the top venture capital managers does not help and makes good opportunities scarce. Furthermore, many venture investments fail. These features present additional challenges to programme size and diversification objectives.

In contrast, mid-market private equity co-investment offers considerable scope given the large number of GPs. Post crisis, there is less leverage available for the mid-market, which increases the likelihood of needing additional funds to close a deal, simultaneously providing a large number of co-investment opportunities with very attractive return potential. However, access for institutional investors may be more difficult given the need for regional coverage, knowledge of more GPs, necessity to screen larger numbers of deals and, most importantly, the need to stick to the GP's timetable given the absence of underwriters in this market segment.

Conclusion

Co-investment offers the LP an opportunity to build a portfolio of attractive investments with leading GPs without paying fees and carries. Thus, co-investing can allow an investor to select high-quality opportunities in private equity and to increase the return of the overall private equity portfolio, a compelling proposition to any institutional investor in the private equity asset class. However, co-investment is a direct investment discipline and cannot simply be executed as an adjunct to fund investment. A co-investment programme has to be properly structured, carefully planned and well executed. Access to, and established relationships with high-quality managers are paramount. A specialist team or access to a dedicated external co-investment manager is a prerequisite for success and any LP that plans to outsource its co-investment activity needs to decide whether to build a separate account or invest in a co-mingled fund. Irrespective of the approach, a properly structured and well-executed co-investment programme is likely to be accretive to the overall performance of a private equity portfolio. ■

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Capital Dynamics' co-investment business was established in late 2006 as part of an ongoing commitment to the expansion of products and services, benefitting clients and investors alike. The co-investment business comprises highly experienced specialists, the leaders of which have worked together since 1990. The firm's broad network of many hundreds of relationships with the globe's top-tier fund managers provides a consistent volume of high-quality co-investment deal flow. The co-investment strategy is focused on mid-market buyouts but also includes select development capital and special situations, reflecting the extensive experience of Capital Dynamics' dedicated professionals.

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