Avoiding the pitfalls

Co-investing is a hugely popular option for LPs looking for a cost-effective way to access an expensive asset class. But there are many other factors to consider if they are to be successful at it. Matthew Goodburn reports

On a typically grey autumnal day in the City of London, six leading co-investment specialists sat down to discuss the pros and cons of a sector that has caught the imagination of GPs and LPs alike in recent years.

Accounting for roughly 10 percent of total private equity assets under management, according to Bain & Company, co-investing has blossomed in the latest cycle. An abundance of dry powder and benign credit markets has led many investors to look beyond the traditional fund structure to deploy capital.

Co-investing appeals to LPs in a number of ways; it gives them a level of discretion over their capital deployment while ideally falling back on the expertise of a general partner. For many, though, the main attraction is the cost savings it brings by allowing them to access the asset class more cheaply than through a traditional fund structure.

Research from PEI Research & Analytics shows that in terms of pure co-investment vehicles alone, as opposed to deal-by-deal co-investment, $10.2 billion has been raised in the year to mid-November, down from a 2013 peak of $15.76 billion, but considerably more than the $5.82 billion raised in 2014, and the second best year on record.

But as the popularity of co-investing grows, so does the potential for things that can go wrong.

GPs cannot offer co-investment opportunities to every LP and on every deal, and some LPs may lack the operational resources and expertise to participate as a co-investee. There may also be issues over due diligence, timing of entry, fees, structure, terms and governance to be taken into account.

While all participants said lower costs was an attractive option for both GPs and LPs, Merrick McKay, SL Capital Partners managing director, private equity, points out that just going through the due diligence process helped investors gain valuable knowledge.

"For our primary investing programme, it is hard to beat the due diligence benefit of really seeing how a GP works on a deal and manages it thereafter. There is such a deep knowledge base you gain about a GP from having gone through the co-investment process, whether that opportunity is eventually executed or not."

Colin Burrow, Aberdeen Private Equity senior investment partner, alternatives division, agrees: "It gives you a better perspective; it is much more about digging down to work out if they are optimistic or pessimists when they underwrite deals, and it gives you so much more insight on them as a sponsor."

The panel agreed that some LPs, who rush into co-investing, may lack the

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operational resources to do so, but Pantheon partner Dennis McCrary said that often they may already have a good working knowledge of the GP in other areas.

"Some co-investors do less independent deal diligence, and consider co-investing an opportunity to deploy more capital efficiently with a sponsor they have already vetted, saying, 'If this is a sponsor we like and on whom we have done significant due diligence, we should trust them and just do the deal."

And while all the participants agreed that cost was a key consideration for LPs, it could also be important for GPs.

Claudio Siniscalco, managing director, global co-head of co-investments, DB Private Equity and Private Markets, says: "The GPs also like offering co-investments as they view them as a form of contingent discount. They can effectively provide their LPs multi-million-dollar fee discounts by offering fee-free co-investments alongside fully priced '2&20' funds."

However, he added: "Only those LPs with the appetite and capability to deliver on particular co-investments are able to take advantage of these discounts."

And capability is an important aspect, if LPs are to avoid making bad investments.

Neil Harper, chief investment officer of Morgan Stanley Alternative Investment Partners PE, believes having that deep knowledge and experience of co-investing is paramount if the chance of adverse selection is to be minimised.

"If you took a pool of all the co-investment deals offered to LPs, and compared it to the funds within which these deals reside, you would probably find the co-investment pool, corrected for fees, underperformed a little, hence careful deal selection and co-investment experience really matters."

He adds: "In many cases, what GPs are offering as co-investment will represent a slight extension of their typical deal, at least in terms of size."

A QUESTION OF SIZE

For McKay, in Europe at least, wrongly-sized funds are less of an issue than in the last cycle, but can still be a risk if GPs move outside their normal deal-size remit.

"In terms of adverse selection risk, in all of the co-investments we've been offered by GPs, we found that (on the whole), they tended to perform at least as well as that manager's deals not involving co-investment."

But he adds: "If the deals are significantly larger than what those GPs would typically do, then you start to see adverse performance."

McCrary points out that Pantheon research going back to 2010 revealed that the performance of a fund versus a co-invest was not materially different – until the deal size was taken into account.

"Our analysis shows that if the co-invest deals are two or three times larger than those GPs typically do in their fund, then you can start to see adverse performance.

"Since the GFC, we see GPs generally right-sizing their funds more sensibly; in part because they have increased confidence in their LPs delivering on co-investment capital for larger deals. For co-investments that are markedly larger than the fund size would indicate, we prefer investing with a GP that has genuine sector expertise. I think this reduces the risk of larger-than-normal deals."

Another factor to consider when looking at potential deal partners, is the level of sophistication of the LP, which McKay says can vary dramatically. He recalls a recent meeting of LPs eyeing a co-invest opportunity.

"One of the participants was asking certain questions of the management team »

If you are thinking, 'I haven't done a deal for a while,' that's completely the wrong attitude

Colin Burrow

The GPs also like offering co-investments as they view them as a form of contingent discount

Claudio Siniscalco

» and I was thinking, 'You're dangerous, I can't believe you're managing someone's money.'

"At the LP level, we've seen a few situations where people appear genuinely clueless in what they are doing. Unfortunately, whether you've done direct investing for 30 years or not at all, everyone has an opinion on the apparent merits of a business opportunity."

For Burrow too, co-investing requires a specific set of skills.

"It's taken us a long time to build a stable team of people we trust to co-invest. It is probably similar to building up a GP but once done, you can incrementally grow it."

Harper says that to be more effective, co-investment practitioners need to draw on their experience across different segments of private equity.

"There is a certain set of skills required to execute a primary deal well, and a slightly different set to diligence and execute a secondary well. All of these skills are critically important in co-investment too, in that assessment of the business and investment thesis goes together with an assessment of lead sponsor skill-set and fit.

"We believe that we blend all of these skill-sets in our approach and find it extremely valuable to have a broad team experienced in primary investment, secondary investment, and co-investments."

For McKay, too many LPs may be making decisions purely based on their knowledge of GPs in primary deals.

"We think a lot of people are subconsciously relying almost exclusively on their view of the manager based on a primary relationship angle, and only playing at doing real due diligence to help them make their own, informed investment decision.

"You have to get the balance right between depending on the lead sponsor's due diligence and investment process, but also doing your own work."

For Capital Dynamics managing director Oliver Schumann, getting it right with the lead sponsor is critical.

"Co-investing is a bit like bus-driving. Your lead investor is in the driver's seat and you rely on him. But I would rather sit in the second row than in the back row as part of a large syndication.

"There are two types of risk in a co-investment. The first question is whether you have the right lead investor for each deal. If not, you often have a problem. The second risk is the quality of the deal itself. Here you need to make up your own mind and live with the consequences of your decision.

"You want one good bus driver who leads investments and takes the required decisions."

Siniscalco sees potential risks for passive co-investors when deals become distressed.

"In a rising tide environment where everything is going well, alignment is generally very good. In a situation where a company breaches a covenant or a cash infusion is required that alignment can fray."

This, he says, can ultimately lead to a 'pay to play' situation, where whoever puts more money in is diluting whoever chooses not to.

"This is where alignment among investors can come apart and individual co-investors, if they are actively involved, will have to make a distressed-debt type analysis given the equity of the company is likely significantly or totally reduced and they may therefore have to invest in a new fulcrum security.

"I've seen co-investors become totally diluted by running for the hills with remaining co-investors benefitting significantly as a result. 'Throwing good money after bad' can be a very complex decision, however, as timeframes become very compressed and the stakes very high."

The panellists agreed that the whole issue could hinge on the lead GP and the fairness with which they operate the process of additional capital going into a company, with some participants ill-equipped to deal with a scenario where decision time might be tight.

McKay says: "In rescue situations, which may involve pay-to-play, the urgency required to make a rapid decision in a fluid situation can really hurt those investors not set up to do so – particularly those more used to participating in large, syndicated processes."

Timing a co-investment is an area that needs careful assessment, especially when original investors may be sitting on far more attractive multiples than investors coming in at a later round of co-investment.

Siniscalco says: "In certain pre-IPO rounds, which some venture capital GPs define as a co-investment, venture backed companies grow into 'unicorns', with original VC investors often sitting on three, five or 10x returns and those coming in at the last, pre-IPO round, will be coming in at a much higher valuation.

"Our job is to ensure there is sufficient alignment with the original VC investors."

While deal risk is the main issue, there are also risks associated with potentially damaging the relationship with GPs and other investors if LPs promise what they can't deliver.

McKay says: "Probably the most challenging aspect of my job, is making a quick decision that I and the GP knows will be deliverable. We see so many people who claim to want co-investment deal-flow from a GP during a fundraise, but the list of ones who can really transact gets whittled down very quickly.

"The minute you damage the process from poor execution, you won't be near the front of the queue in the future."

And when it comes to building relationships with potential GP co-invest partners, timing is again a crucial part of the equation, and clarity of communication is paramount.

"A quick no is often as good as a medium-term yes, in the sense that a three or four-week process that comes to a no decision is not very helpful, especially when a lead sponsor needs certainty on commitment of an additional chunk of capital to complete the deal," says Harper.

Another issue, as Schumann points out, is that if co-investors don't get in, and exit, on the same terms as the lead investor, interests are not aligned and problems can occur.

"If you invest globally and across many industry sectors, you have to rely on the lead investor's knowledge, so going with a lead investor with the best expertise is paramount to a favourable outcome."

He adds: "If you are a co-investor you have to acknowledge that your lead investor has to provide what you don't have. If you have any doubts about that you should not make the investment as this is the part that often goes wrong.

"It is difficult to invest if someone else just made three or four times money."

And once a fund is closed, there may be 10 or 12 who express interest, he says, but that will reduce quickly. Those that progress will be the ones that can give a quick decision.

"Most GPs are not upset if you don't invest, as long as you give quick feedback and don't promise something you can't deliver," adds Schumann.

"Strong GPs don't mind if you question their investment strategy. They have either already thought about it and come to their own conclusion, or they can learn from it."

And what of the types of co-invest opportunity on offer? The panellists saw a significant difference between a syndicate deal and a co-invest deal with one or two partners.

"With underwrites you get much better information and access, but the risk is, you have to qualify them much more »

Most GPs are not upset if you don't invest, as long as you give quick feedback and don't promise something you can't deliver

Oliver Schumann

» carefully to ensure you are investing time in the right opportunities," says Burrow.

The impact of sovereign wealth funds moving into the co-investment space has also been a significant recent development, he adds.

"At the larger end, sovereign wealth funds are coming in much earlier in the process, with \$2 or \$300 million cheques up front but they have a much more limited impact in the mid-market where we are focused."

Burrow says this development has typically replaced many of the club deals from the last cycle.

"In the last cycle it was two, three or maybe four sponsors working together on some of the larger deals but now it is often single sponsors working with co-investors on larger deals."

This can be at odds in terms of the time horizon of different investors.

"Sovereigns can have much longer timescales than other LP co-investors who are more aligned to the fund lifecycle," says Burrow.

Such potential differences emphasise once again the importance of due diligence, according to McCrary.

"You can't make an assumption that the sponsor showing the deal is always in control. You need to understand all the other participants in the equity/ownership and their motivations.

"Of course you want an investor group that is well aligned. If there are multiple co-investors we make sure the decision-making resides with the GP we know and trust."

Burrow points out that sometimes, too many investors can be problematic.

"There is the potential for conflict as one co-investor might want to retain control over certain aspects of the investment but we wouldn't want another investor to be able to veto something relatively straightforward. This makes ensuring the documentation is balanced and the partners you choose are ones you trust completely an important factor."

In terms of attractive current co-invest opportunities, the panellists had a broad spread of focus.

Harper says his team takes a bottom-up, rather forensic approach to sourcing potential co-investment targets.

"In our programme overall, we are looking globally for sub-segments of the PE market with an interesting capital supply/demand imbalance in favour of the investor. Once found, we look for sponsors with a differentiated and sustainable source of competitive advantage versus their competitors, and we seek to invest with them on a primary basis and to co-invest in deals within their sweet spot.

"In developed markets much of what we do is at the small and mid-cap end of the market, across buyouts, growth, venture, and special situations."

McKay points to SL Capital Partners' longstanding focus on Europe and to partnerships forged over a number of years with GPs in the region.

"We have been a major European investor for a long time, so have a long list of managers with which we have a strong relationship."

Siniscalco says a major investment theme for next year is drawing on his firm's expertise in its home market to focus on Germany's vast group of Mittelstand companies. It will also be looking for opportunities in other parts of Europe and in North America.

"Co-investment origination is very time-consuming and utilises the resources and relationships of our entire €12 billion platform; our job is to ensure we are at the front of the queue and to make sure we are seen as a reliable co-investor and partner," he says.

For Burrow, a few close relationships are key to finding the right deals, in the right sectors.

You can't make an assumption that the sponsor showing the deal is always in control

Dennis McCrary

"We work closely with a few key partners globally. Thematically, technology is an important consideration as we see it being a key growth engine in private equity deals as well as a potential risk. Not just in venture or growth, but across the board."

As a minority investor, Schumann says Capital Dynamics is looking for a mix of "old world governance and new world growth".

"We rely on our GP relationships and look for broad exposure to the global mid-market. Our LPs are interested in that type of exposure. Recent deals have included two deals in southern Europe where there is less capital available and two in the US in software and services where we saw growth opportunities."

An area to which some of the panellists have been looking recently is fund-less sponsors.

"We see so many opportunities in that market. In the past, fund-less sponsors may have had a smell about them of people who couldn't raise a fund, but there are good opportunities on an exclusive basis with people we rate very highly," says McKay.

Pantheon's McCrary agrees that the strategy holds some interest for his firm.

"There may be some interesting opportunities with certain fund-less sponsors; for example, solid groups not yet ready or able to raise a fund, or individuals who have left good PE firms and don't want to go through the process of raising another fund but can still access good deals."

However, Burrow views the majority of the fund-less sponsor opportunities as less enticing.

"We approach this area cautiously, focusing mainly on spin-outs from teams we know. A large proportion of the wider fund-less sponsor market we would not currently be comfortable investing with."

Siniscalco agrees: "There is more adverse selection in the fund-less sponsors [area] than elsewhere. You really have to ask yourself a simple question, 'Why does this fund-less sponsor not have a fund and therefore need our money?'"

In many cases, what GPs are offering as co-investment will represent a slight extension of their typical deal, at least in terms of size

Neil Harper

Harper explains that his team has taken a slightly different approach to investing with fund-less sponsors.

"Morgan Stanley AIP PE has gone down an adjacent route by frequently backing spin-outs or emerging managers with a co-investment alongside a primary commitment to the sponsor that helps stimulate the fund-raising process."

The panellists also agreed that deal-by-deal investing was on the rise partly because some LPs had a mistrust of GPs. Siniscalco says: "If you ask the wider universe of alternatives investors, many think of 'co-investments' not as a category of blind-pool funds offered by funds of funds platforms, but instead as being offered deal by deal access instead.

"One of the reasons family offices and UHNWI's like co-investing is because they don't trust fund managers as much as they trust themselves."

The participants unanimously agreed that the growth in co-investing had not materially fuelled sharply rising asset prices.

"Co-investing is just one avenue of investing in a private equity model. Increased co-investing in itself hasn't caused asset prices to rise but it has participated in it. The overall liquidity in the market and the resultant strong interest in PE assets around the world, as well as the robust debt markets, have driven up asset prices. Co-investing is just one route that capital is taking," McCrary says.

"GPs offering co-investments is in part a response to the overall pressure on fees." »

At the LP level, we've seen a few situations where people appear genuinely clueless in what they are doing

Merrick McKay

» Burrow adds: "It is a malleable capital structure: co-investment is replacing capital from other sponsors in club deals and overall, the equity percentage of every deal in this cycle is greater than in the last cycle. GPs recognise the value of satisfying LP demand for co-investment but must balance this with the need to deploy fund capital in a highly competitive market."

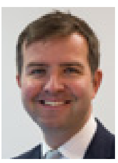
And what are the most important lessons to learn for those considering co-investment?

Harper offers: "The co-investment market ebbs and flows. There are attractive co-investments in every part of the cycle, but the volume does change, and selectivity is key. We have a team focused on looking for the best opportunities you can find across the global private equity universe. It's about organisational and investment discipline – often a scarce commodity in the industry."

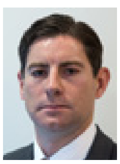
Burrow takes up the point that co-investing is often all about biding your time and waiting for the right opportunity.

He says: "Don't push it. The right investments will come. If you are thinking, 'I haven't done a deal for a while', that's completely the wrong attitude." ■

MEET THE ROUNDTABLE

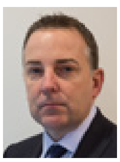


CLAUDIO SINISCALCO
Global co-head of co-investments
DB Private Equity & Private Markets
Siniscalco is responsible for sourcing and executing co-investment opportunities for discretionary and non-discretionary private equity mandates. Previously, he was a principal and head of the London direct investment team at HarbourVest Partners (UK) Limited. He joined the direct investments team in early 2007.

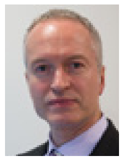


COLIN BURROW
Senior investment manager, alternatives division
Aberdeen Private Equity
Burrow leads the co-investments and secondaries team at Aberdeen Private Equity, which manages over $15 billion of assets. He also sits on the investment committee. Burrow began his career with Andersen Corporate Finance and has also worked at Bridgepoint and Lloyds Banking Group.

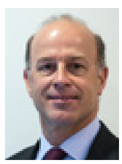
OLIVER SCHUMANN
Managing director
Capital Dynamics
Schumann is managing director on the co-investment team in investment management at Capital Dynamics. He has 21 years of experience in private equity and investment management. Prior to joining Capital Dynamics, he held positions with Arthur Andersen, GE Capital, Sal Oppenheim, and Resurgence Asset Management.



MERRICK McKAY
Managing director, private equity
SL Capital Partners
McKay joined SL Capital in 2014 as a consultant and is based in the Edinburgh office. He is responsible for primary fund investments, secondary fund investments and has a particular focus on co-investments. He is responsible for managing relationships with SL Capital's Australian clients. Prior to joining SL Capital, he was head of European investments and senior partner of Macquarie's Private Markets division.



NEIL HARPER
Managing director
Morgan Stanley Alternative Investment Partners
Harper is CIO for the AIP private equity funds of funds team. Prior to joining AIP, he was a partner at McKinsey operating in Europe, North America and Asia providing consulting services to corporate and private equity clients on strategy, performance improvement, mergers and acquisitions and corporate finance. Previously, he worked for Arthur Andersen providing audit, corporate finance and financial advisory services.



DENNIS McCRARY
Partner
Pantheon
McCrary is chairman of the co-investment committee and the global secondary investment committee and is a member of the US regional investment committee and the international investment committee at Pantheon. He was previously the head of the US partnership team at Adams Street Partners where he was responsible for primary and secondary fund investments, and was a member of the firm's global investment committee.