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CAPITAL MANAGEMENT

Co-investments: A Useful Tool for the Insitutional LP

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Co-investments: A Useful Tool for the Institutional LP

Private equity has grown from a niche strategy scarcely targeted by investors to a staple in many institutional investors' portfolios. According to Thomson Reuters, the asset class raised $496 billion in commitments worldwide in 2018, up from $61 billion in 1996. Within private equity, co-investments have garnered particular attention in recent years.

Historically, general partners often sought out other general partners when additional capital was needed to make an investment. General partners are now increasingly turning to their limited partners as a source of additional capital through co-investments. Co-investments are investments made by a limited partner directly in a company alongside a general partner's fund. Offers to co-invest are usually free of the annual management fees and carried interest typically associated with a primary fund commitment, which can be as much as or more than 2% and 20%, respectively. As such, limited partners already having an indirect interest in the company through their primary commitment to the general partner's fund have the opportunity to increase their exposure to the company on attractive economic terms. The attractive economics of co-investments are the primary drivers behind limited partners' strong and growing interest in co-investments. The potential savings from the absence of management fees and carried interest in strong-performing co-investments can lower the overall expenses associated with investing in the private equity asset class, which in turn can generate additional gains for an institutional investor's private equity portfolio. According to a recent Preqin survey, 35% of private market investors plan to co-invest alongside managers in the near future.[1]

There are two main reasons why general partners offer co-investments to their limited partners instead of to other general partners. First, partnering with their limited partners allows the general partner to have increased control of the business compared with bringing in another active general partner who could have different strategic views for the business or different time horizons for its investment. Second, co-investments create greater alignment between general partners and limited partners due to the limited partner's additional capital investment, which helps the general partner complete the transaction. General partners are often seeking ways to generate closer ties with their limited partners (many of whom are reducing their number of general partner relationships), which can be beneficial in future primary fundraising processes.

Benefits of Co-investing

Fees & Returns

As mentioned, the primary benefit associated with making co-investments is the potential for limited partners to reduce expenses associated with the asset class. Private equity has historically generated strong returns: over the past 20 years, private equity funds have generated a net internal rate of return of 12.3%, according to Burgiss,[2] whereas the S&P 500 generated a gross annualized return of 6.0%.[3]

1. Preqin Investor Outlook: Alternative Assets H1 2019, Feburary 2019.

2. Based on Burgiss Private iQ U.S. pooled 20-year IRR, as of March 31, 2019, in the strategy categories of buyouts, energy, expansion capital, generalist, and venture capital, as produced using Burgiss data available as of September 4, 2019.

3. As of March 31, 2019.

Despite strong net returns, expenses for accessing the private equity asset class can be substantial: general partners typically charge an annual management fee and take a percentage of the investment profits, which is known as carried interest. Co-investments typically have no annual management fee or carried interest, which can result in significant savings over a primary partnership commitment, as presented in table 1. As shown, based on $100 million in commitments and a gross return multiple of 2.0 times invested capital, investing in co-investments results in $27.1 million in savings for limited partners compared with investing in a primary fund.

Further Insight into the General Partners

Investors who participate in co-investment processes with general partners gain more insight into the general partner's investment diligence and decision-making processes than they would when participating only in a general partner's primary fundraising diligence process. During a primary fundraising, limited partners are usually relegated to conducting diligence on a general partner during the general partner's narrow fundraising window, and diligence materials are often less detailed and can be less meaningful without context. As part of the co-investment process, however, many general partners provide a detailed analysis of the co-investment opportunity, including investment committee papers, financial models, and consultant reports, thus allowing the limited partner to have a deeper understanding of the general partner's diligence.

Additionally, co-investment processes often include multiple meetings or conversations with the general partner's deal team and with the company's management team and may include meetings or conversations with consultants. These interactions provide important context, not just for the evaluation of the co-investment, but also for gaining a deeper understanding of how the general partner conducts diligence, evaluates risks, underwrites potential returns, and completes the decision-making process. Limited partners can benefit from such insights when considering the general partner's next primary fundraising.

Other Benefits

In private equity, access to general partners can be constrained. Several firms that have top-producing funds often find their new offerings oversubscribed and thus are unable to provide access to all investors seeking to be a part of their fund. A key part of gaining access to these highly sought-after managers are the relationships these managers maintain with their limited partners. Participating in co-investments provides an opportunity for limited partners to establish and strengthen their general partner relationships and also indicates to the general partner that the limited partner can be a reliable source of capital. Such opportunities can help solidify and further enhance the relationship in the eyes

Table 1. Incremental Portfolio Gains from Co-investments Compared with Partnerships
Based on $100 million in Commitments

Portfolio Gross Return	1.5x	2.0x	2.5x	3.0x
Estimated Management Fee Savings ($MM)	$8.9	$8.9	$8.9	$8.9
Estimated Carried Interest Savings ($MM)	$8.2	$18.2	$28.2	$38.2
Incremental Portfolio Gains from Co-investments ($MM)	**$17.1**	**$27.1**	**$37.1**	**$47.1**

Source: Pathway Capital Management, LP.

Notes: Represents the estimated incremental gains generated over the life of an investment by contributing to a portfolio of direct co-investments, with no fee and no carried interest charged, as opposed to investing with a private equity limited partnership charging 1.25% annual management fee and 20% carried interest.

This table is for illustrative purposes only. No representation is being made that an investor in co-investments will achieve the incremental gains presented in this table.

of the general partner, which can be beneficial to the limited partner when the general partner begins raising a new fund.

Co-investments can also allow limited partners to better control the pace of capital deployment and to emphasize a particular segment of the market, such as a specific industry or region. Co-investments are typically funded in full at the time of closing, whereas primary fund commitments are typically drawn over an investment period of five years at the discretion of the general partner. Limited partners can benefit from the additional control over timing and over selection of market segment.

Potential Risks

Co-investments can be a valuable addition to a private equity portfolio; however, they also carry significant risks, including the following:

Adverse Selection

Adverse selection, as it applies to co-investments, is the theory that general partners offer the least attractive deals for co-investments, preferring to keep the more-successful, carry-generating investments solely within their funds because they will generate carried interest and maximize the general partner's personal financial gain in the short term. However, doing this would only serve to alienate existing limited partners. The contrasting theory is that general partners do offer attractive deals because doing so could contribute to the general partner's long-term success. Although research on the topic has been mixed, it is clear that the more a limited partner's interests are aligned with the general partner's long-term success, the less likely it is for adverse selection to exist.[4] One additional way to mitigate adverse selection is to build a portfolio diversified by co-investments.

Deal Flow

A limited partner's ability to gain access to co-investments is dependent on the general partner of the fund. Limited partners need to develop relationships with general partners to gain access to deal flow.

Market Timing & Overconcentration

Because of the long-term and illiquid nature of the asset class, it is important to have a long-term approach when investing in co-investments. Selectively co-investing in different time periods may result in exposure to only suboptimal periods of the market cycle. By maintaining a consistent investment pace, a portfolio of co-investments can be constructed over full market cycles and be less likely to be over- or underexposed to any one time period. Additionally, concentrating capital in any particular co-investment opportunity can expose a private equity portfolio to excessive company-specific risk. Steadily deploying capital throughout the market cycle and building a portfolio diversified by, among other things, time, general partner, industry, region, and deal size can reduce these risks.

Considerations for Starting a Co-investment Program

There are several factors to consider when starting a co-investment program, the most significant of which is deciding on a strategic approach. Limited partners need to determine (i) if the co-investment program will be developed and managed by their existing investment staff or by a newly hired staff, (ii) if the program will be outsourced to a specialist firm or consultant, or

4. Lily Fang, Victoria Ivashina, and Josh Lerner, "The Disintermediation of Financial Markets: Direct Investing in Private Equity," (2015); Reiner Braun, Tim Jenkinson, and Christoph Schemmerl, "Adverse Selection and the Performance of Private Equity Co-Investments," (2017).

(iii) if there is optimal middle ground. Part of this consideration incorporates the limited partners' desired approach to the market; that is, whether limited partners select co-investment deals based solely on their merit, select opportunities solely on the quality of the general partner offering the co-investment, or some combination of the two. Limited partners must consider where on each continuum they should focus (see figure 1).

Limited partners who choose to manage at least part of their co-investment program in-house must also develop a process to meet the strict deadlines associated with executing co-investments. Some areas that should be considered for that process include how to

- source and manage deal flow,
- execute confidentiality agreements to access diligence,
- develop diligence and investment decision-making processes,
- negotiate the various legal structures used for co-investments,
- monitor completed co-investments appropriately.

Figure 1. Strategic Approach Consideration

Conclusion

Similar to the trajectory of the private equity asset class as a whole, co-investments are in-creasingly becoming more common as part of an institutional investor's portfolio. The potential benefits of co-investments are compelling; however, the risks need to be navigated appropri-ately. Ultimately, limited partners who elect to complete co-investments should ensure that they have a well-thought-out strategic approach and sound processes in place. Co-investments, if managed prudently, can be a useful tool for institutional investors to reduce the overall ex-penses associated with the private equity asset class.

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