DEVELOPING A SUCCESSFUL CO-INVESTMENT PROGRAM

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Background

Preqin, an alternative assets analytics firm, recently published research indicating that 77% of private equity investors pursue direct investments into companies alongside general partners (co-investments) on an active or opportunistic basis. Further, a Cambridge Associates study indicates that co-investments account for roughly 5% of overall private equity investment activity. Co-investment activity has increased and is expected to continue for the reasons below.

- There is an increased amount of capital directed towards alternative assets driven by higher institutional asset levels and increased allocations;
- The required equity contribution by a single sponsor is increasing as sponsors look to limit the number of other managers with whom they partner; and
- LPs are seeking to manage their portfolios more proactively.

Among the benefits of establishing a co-investment program are:

- Greater control over capital deployment: Co-investments generally have shorter deal cycles with capital drawn at once rather than over time, allowing the LP to accelerate capital deployment in order to increase the private equity allocation.
- Flexibility in investment selection: Co-investments may be selected on an individual basis, providing flexibility for investors to capitalize on current market conditions and diversify their portfolios through targeting attractive strategies, sectors or geographies.
- Lower overall fees: Co-investments often come with low or no management fees or carried interest to the manager, thereby enhancing net returns for the LPs.
- Deeper relationships with core managers: Investors may leverage existing manager relationships for deal flow. Participation in co-investments may deepen relationships with the manager and improve the LP's understanding of the manager's investment process.
- Satisfy LP-specific objectives: Co-investing provides investors greater flexibility and control to avoid certain sectors or gain more exposure in attractive sectors than blind pool commingled funds.

While there are benefits to LPs, there are also a number of factors that should be considered as investors evaluate their approach to co-investments:

- There needs to be an appropriate match between the skill set of the team and depth of resources to source and evaluate opportunities. This is critical as the skills required to evaluate an individual investment are significantly different than those required to evaluate a fund.
- The approval process must be structured to support more rapid timelines and manage potential issues around confidentiality that result from investing directly into a company versus a commingled fund. Co-investments typically require a much shorter timeframe from initial screening to close compared to fund investments and it is sometimes difficult to anticipate when exactly they will move forward. Further, the requirements of certain LPs with regard to transparency and disclosure (i.e., presenting at a public meeting, distributing materials to a board) can present issues when making company investments.
- Investing directly into businesses increases headline risk relative to fund investments and successes/disappointments tend to be apparent earlier in the investment cycle relative to fund level commitments. Unlike commitments to funds, LPs are associated more closely with the activities of a company because they are investing directly into the business rather than through a fund. Further, co-investments draw capital at closing and have a three- to five-year life, during which valuation changes occur more quickly than a fund commitment.
- Leveraging the existing manager relationships within the investor's "core portfolio" of alternative investments is critical to the sourcing and screening process. Understanding the managers' strengths and weaknesses with respect to their investment process, approach and historical track record across different investment

types ensures that LPs focus on the right investment partners. This analysis, along with developing a portfolio management approach to a co-investment program, will enhance deal flow and help LPs avoid "adverse selection" -- one of the key risks in building a program.

In summary, co-investing can provide substantial benefits to LPs but the process and approach must be structured appropriately to increase the chances of success.

Possible Approaches

There are a number of approaches that LPs can employ to implement a co-investment program. The most sophisticated investors with deep internal resources have the ability to build direct and co-investment programs using existing staff. Outside of these groups, the most common approaches involve: a) using internal staff along with a third-party advisor; b) creating a customized, separate account vehicle with a dedicated co-investment manager; or c) committing capital to a commingled co-investment fund manager. The first two of these approaches (a and b) offer a lower cost structure than the commingled fund structure.

Below, we examine the benefits and considerations of each approach. Our firm, LP Capital Advisors, has assisted clients with each approach.

A. Internally managed with assistance of an advisor

In this approach, the LP uses the assistance of an advisor with capabilities to source, screen, evaluate and monitor/report on co-investments. This approach is usually undertaken by mid- to larger-sized investors with deeper resources.

Benefits

There is some flexibility to structure this relationship to complement the capacity and skill set of the existing staff. For example, the LP could engage the advisor to provide due diligence on a fee-per-project basis while the staff manages the sourcing and screening of opportunities. In this approach, the staff would expect to exercise the same level of discretion and follow the same decision-making process as is currently in place for commingled fund investments and fees would be shown as separate expenses. As a result, this is the lowest-cost approach from a fee perspective.

Considerations

- There may be difficulty adapting the LP's current investment process (e.g. if committee and board approvals are required for each investment) to the more rapid timelines required by the co-investment process.
- Co-investments may have increased sensitivity around confidentiality where fund managers do not want details of their individual investments presented in a public meeting, which could lead to adverse selection.

B. Customized co-investment separate account vehicle

Another approach involves the creation of a customized vehicle to make co-investments alongside managers in the existing private equity program that is then managed by the third-party advisor. The LP would set forth the objectives (capital deployment pace, expected return, risk levels, etc.) and constraints (deal size, permitted geographies, industries, etc.) while the advisor would lead the investment sourcing, screening, execution and monitoring efforts. The advisor would provide monitoring and reporting services on the portfolio and deliver to the LP a full, quarterly update summarizing the activities for the quarter. Given the ability to leverage a third-party advisor, this approach tends to work well for small- and mid-sized investors and also can be an effective option for larger investors.

Benefits

- The LP has greater control over the pace of committed capital and influence over investment decisions and the ability to involve staff relative to using a dedicated co-investment fund. This would allow staff to develop their capabilities to evaluate co-investments alongside the advisor.
- The dedicated resources of the advisor likely would increase the sourcing and screening capacity versus approach A and would provide for more flexibility in meeting required investment timelines and managing confidentiality issues, which could increase the ability to execute on deals that may otherwise be unavailable to the LP.

- The terms of the proposed vehicle would include a management fee based on invested capital, carried interest and preferred return.
- As a variant to this approach, the advisor also may have the ability to create a structure that supplements the LP's core manager relationships with deal flow from the advisor's own relationships.

Considerations

- The LP would approve capital commitments and investment guidelines for the separate account vehicle but would not be involved in the approval of each individual investment.

C. Dedicated commingled co-investment fund

There are numerous managers in the market that have developed co-investment platforms, usually as an extension of their existing fund of funds business. These platforms tend to have fees structures that are in line with traditional fund of funds (management fees plus carried interest) but avoid the additional underlying fees to managers as they are making investments directly into companies versus funds. This approach is usually geared towards smaller investors but better options exist.

Benefits

- This approach effectively outsources the entire co-investment program to a third-party manager with a one-time commitment, thus freeing up staff to focus time and attention on the existing portfolio of fund commitments.

Considerations

- The extent of staff influence (and the LP in general) would depend on whether this approach is structured as a commitment to a commingled fund or a separate account within the manager's broader platform. However, this would generally be less than approaches A and B.
- While fees would be shown as a management fee and generally would be lower than a traditional fund commitment, likely it would be the highest cost of the three approaches.
- Based on our analysis, the overall performance of these vehicles tends to fall below expectations of primary fund commitments thus reducing the benefit, as managers tend to be incented to invest regardless of the valuation environment due to the fee structures and limited investment periods of these vehicles.

Conclusion

Co-investing presents an interesting opportunity for LPs to enhance returns and be more tactical in their capital deployment but the skills and process required to do so successfully are significantly different than those used in a primary fund program. As a result, we recommend clients set clear objectives for their co-investment program, understand the associated risks and consider the structure that best suits their situation.

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Note: *LP Capital Advisors' dedicated co-investment team provides extensive expertise and support to clients. Our clients have been active co-investors for many years and we have assisted them in a variety of areas including sourcing (sharing our deal flow), investment screening, detailed due diligence and specialized areas such as valuation. We focus on implementing a disciplined process to avoid adverse selection and ensure internal staff involvement. Our customized sourcing and screening provides clients with a pipeline of deals that have been vetted against their tailored screening criteria and we provide a cost-effective alternative to third-party managed accounts which allows clients the flexibility to manage investment pace and target specific geographies, strategies and sectors. This approach enables us to provide co-investment services to clients either on an advisory basis or through customized separate account vehicles.*

Post-investment, LP Capital Advisors provides active monitoring and reporting for co-investments. This includes identifying key metrics to monitor, obtaining annual budgets and tracking quarterly performance, comparing performance against original projections, conducting regular calls with the investment manager and portfolio company management to assess progress, and identifying governance rights and deadlines to determine potential decision points.