Industry Insider

An interview with David Smith, Capital Dynamics

Welcome back to our Industry Insider series, during which we will be speaking to a number of key private capital industry participants from across the globe and across asset classes, including fund sponsors and investors, investment professionals and operational experts, established managers and first-timers; each providing an unrivalled insight into the industry.

In this edition **Ted Craig**, Head of Private Funds UK at Dentons, and **David Smith**, Senior Managing Director of the Co-investment team at Capital Dynamics, explore the continued – and increasing – rise in popularity of co-investments along with the impact of COVID-19 on this part of the private equity market. They also draw comparisons between the current and previous crises and discuss some of the short-, medium- and long-term effects.

Ted Craig
Head of Private Funds UK
Dentons

David Smith
Senior Managing Director
of the Co-investment team
at Capital Dynamics

Introduction to Capital Dynamics and its Co-investment Platform

Ted: For starters, it would be great to get a bit of background on three elements: (i) Capital Dynamics, (ii) Capital Dynamics' co-investment platform, and (iii) your own background and investment experience.

David: Capital Dynamics is an independently owned and managed private asset manager. We look after about US$17 billion in assets, which primarily fall into three asset classes: private equity, private credit and clean energy infrastructure. The genesis of Capital Dynamics was a private equity business but we have grown into other related private asset classes over time.

In relation to private equity, I describe our business there as a three-legged stool comprising (i) primaries, (ii) secondaries, and (iii) directs. For us, "directs" means co-investment.

Capital Dynamics' co-investment business, one of the three legs of the private equity stool, was established in late 2006 as a result of the growing portfolio of primary fund investments made by the firm's funds of funds business. As the primaries business grew, at which time Capital Dynamics was about half the size it is now, occasionally fund managers, whose funds we backed through Limited Partner equity commitments, would come to us and say "We have a co-investment opportunity, would you like to it take it up?". Quite properly at the time, pre-2006, management at Capital Dynamics said "no" as co-investment seemed like a very different discipline. However, it got to the point where the volume of these offers increased in tandem with the primary fund relationships and management believed we were missing a trick. As a result, in late 2006/ early 2007, Capital Dynamics launched a business unit focused on moving into co-investment and I was a founding member of that team.

Personally, my background in private equity dates back to the late 1980s when I was working at BP Ventures, the venture capital business of BP. In those days the phrase "private equity" didn't really exist, and what we now refer to as private equity was then known as venture capital. Following BP Ventures, I moved to GE Capital where I formed the European co-investment team. That team then span out of GE and we formed our own business in 2005, somewhat unimaginatively called European Co-investment Partners. After a period of time, we, at European Co-investment Partners, were looking for an organisation, like Capital Dynamics, which had a portfolio of active fund relationships. We had realised, a bit like margarine going stale on a shelf, if you're a co-investment group and you don't enjoy constantly renewed fund commitments, your access to deal flow becomes stale. So, in late 2006, we were looking for a partner with fund relationships just at the time Capital Dynamics was looking for a co-investment team. By early 2007 we had become the exclusive team providing co-investment advisory services to Capital Dynamics.

We had raised three programmes of co-investment capital prior to joining Capital Dynamics. Upon joining, we raised four further programmes. We are now investing our sixth and seventh co-investment programmes as a team.

The Co-investment Market

Ted: Your co-investment programmes sit outside the primary fund of funds in terms of vehicles and LP base. There is a lot of interaction between the two but it isn't the same pot of capital that is making primary investments that is then also making the co-investments. That is right, isn't it?

"the discipline of co-investment is different from fund investing"

David: Yes, it is broadly separate; it is discrete. There are two good reasons for that:

Firstly, the discipline of co-investment is different from fund investing; secondly, and somewhat selfishly on our part, we want to ensure that there is only one group of people at Capital Dynamics which does all the co-investing. Much more importantly, this segregation is also designed to ensure that our investors seeking co-investment exposure see all our firm's co-investment deal flow, so avoiding allocation conflicts.

However, what I would say is that some of our investors, UK local government pension schemes and their equivalents in continental Europe and elsewhere, in particular seek fund-of-funds exposure in tandem with co-investment. So, in those cases we have provided hybrid fund programmes tailored to investors' needs such that these programmes will be perhaps 70 to 80% LP equity investment in funds with the balance split between secondary investment and co-investment. The important thing about these hybrid programmes is that the co-investments are done on a carry- and fee-free basis at the level of the hybrid such that they "look-through" to our discrete co-investment funds. If investors want co-investment exposure in a hybrid programme, as some of our investors do, we provide it in that way. Fundamentally, in those hybrid programmes, our co-investment fund provides the co-investment exposure sought by the limited partner.

Ted: The benefit there being that, for investors who want to invest in both pockets, they are not necessarily co-investing alongside the funds that they are investing in on a primary basis. They could be doing a co-investment deal alongside a fund which they are not already invested in.

"An important facet of diversification – we use that "D" word a lot when we are speaking to investors – is that it's incredibly important in minimising risk."

David: If the investor happens to be invested in a manager that offers us a co-investment, then yes, it will have gained incremental exposure to an underlying asset. But one of the great benefits of co-investment is manager diversification. We can bring in third party fund managers, in which the limited partner may not be invested other than through us, which increases diversification.

An important facet of diversification – we use that "D" word a lot when we are speaking to investors – is that it's incredibly important in minimising risk. Let me explain.

Firstly, Capital Dynamics as a house is a mid-market firm, most of our 350+ general partner relationships that we maintain globally are in the mid-market. Yes, we know the KKRs and the TPGs and we know the key venture capital firms on the west coast of the US, and we maintain strong and healthy relationships with them through our funds business. But, the vast majority of our commitments as a funds house and, therefore, as a co-investment house, are with mid-market funds. We in our co-investment business define mid-market in terms of the enterprise value of the underlying company: at the lower end of the scale, EUR 50 million to EUR 250 million in enterprise value, and EUR 250 million to EUR 1 billion at the upper end. Lower mid-market and upper mid-market, respectively. This is a deliberately broad spectrum.

Within this mid-market spectrum, we do four things in terms of diversification:

1. We diversify by manager. For our co-investment funds, we strive to build a portfolio of 25 or so holdings, each with a different manager – the mathematics and actuarial simulations behind this show it is a quite a smart thing to do in terms of risk mitigation;
2. We diversify by sector;
3. We diversify by country. We tend to build

what we call "40:40:20" portfolios with a 40% allocation to North America, 40% to Europe and 20% to Asia and the Rest of the World. Again there is sound actuarial mathematics behind this; and

4. We diversify by vintage or year of investment.

As you can see, diversification for us is really important. We call this "intelligent portfolio construction".

Because of our global reach and large network of manager relationships, we enjoy the kind of co-investment deal flow that allows us to pick and choose the transactions we work on. Firstly, based on the underlying merits of the individual transaction and secondly on the basis of the degree of fit with our intelligent portfolio construction approach.

The Impact of COVID-19

Ted: Turning, perhaps inevitably, to the COVID-19 crisis. Firstly, for some context, could you give us an idea of your sector focus as a co-investment team, if any?

David: As a co-investor, you are, in a way, privileged, you are a generalist. In terms of incoming deal flow, we divide it into four or five sectors and each senior team member assumes responsibility for one of them. Our sector division is derived from our time at a former employer when we operated in these practice groups or so-called "verticals". In no particular order, we have clean energy and industrial manufacturing, financial services and healthcare (the link between these two being insurance), consumer and leisure and finally technology and software (where most of our investments are in software companies). That division into four *versus* five is dependent on whether you see healthcare as part of financial services. I tend to see it as five discrete sectors, notwithstanding the insurance link between these two.

Ted: From your breadth of experience, what is your view of the impact of the current crisis on the co-investment market?

"The COVID-19 environment has increased the attractiveness of co-investment very significantly."

David: The COVID-19 environment has increased the attractiveness of co-investment very significantly. Fundamentally, what has happened is a combination of three things, which has created the almost perfect storm for co-investors – which is why we have been so busy over the last three months or so!

Firstly, whenever there is a crisis transient players disappear from the market. Transient players tend to regard co-investment as a discretionary activity. Unlike us, they don't see it as a continuing activity, come rain or shine. We sometimes describe ourselves as an "all-weather" co-investor. What we have seen is a large number of people who use co-investment when times are good and leave the market when times are bad – these are the transient players. If you have committed capital, as we do, you are a fortunate player, you are not a transient player. You can deploy and track investment. The exit of the transient players is behind the waning of capital available for co-investment.

Secondly, the waning is happening at the time when the demand for co-investment capital has increased. If you're a general partner looking to preserve liquidity to protect your existing portfolio, and you want to make two to five more investments to fill out your fund, and you still want to tell your investors that you are sticking to the middle of the fairway – that you are focussing on businesses with the same enterprise value to avoid so-called "style drift"- you're going to have less equity capital to deploy in those new investments. So, what we are seeing is many managers diluting or "leaning out" their remaining capital as they fill out their portfolios. Therefore, at a time when the supply of co-investment capital is waning, the demand for such capital from our network of general partners is increasing. We have an exceptionally high volume of deal flow, where really good managers are turning to us saying "we need help filling out our equity book". The impact of this supply-demand dynamic is perhaps predictable.

Thirdly, of course, when this happens the terms on which you are able to provide that much-needed co-investment capital become much more favourable to the co-investor. For example, right now we are

transacting an opportunity with a pharmaceuticals business (a clear beneficiary of COVID-19) where the entry multiple starts with a five – I haven't seen pricing like that in an awfully long time!

So, you have much more attractive pricing due to the supply-demand dynamics and, in co-investing, if a general partner wants to do a transaction and really needs that co-investment capital to complete the equity book, then you have a profound impact on pricing and structure, far more influence.

"I'm old enough to have lived through several crises and even though this one is unlike any other, every time a crisis occurs, a number of familiar patterns reappear."

Ted: And what about the impact on deal structures?

David: In relation to attractive investment terms and structure, we are seeing a reversion to preference structures, which we have seen in prior crises. I'm old enough to have lived through several crises and even though this one is unlike any other, every time a crisis occurs, a number of familiar patterns reappear. We see an inability to price, as people worry about the performance of businesses, and the liquidity and the number of transactions declines which in turn enhances the difficulty in understanding pricing. The whole process of price discovery is much harder in an illiquid market. In these more illiquid markets, such as the one seen after the Lehman crisis, we put in place preference structures.

So, rather than just focussing on the ordinary shares or the common equity with the lead investor, what we say is, if the transaction needs, for example, EUR 150 million of equity to complete the equity book, the lead investor will provide EUR 110 million in ordinary shares and we will offer EUR 40 million in preference shares with detachable warrants. So, we get the benefit of downside protection coupled with a lot of good common equity beneath us and nice warrant upside. If you think of how investors respond, the attractiveness of such a structure is high. This shows the importance of agility in adapting to the COVID-19 environment.

Ted: And the impact on sectors?

David: There has been a profound polarisation between sectors which are COVID-19 beneficiaries and those that are really struggling. For example, aviation and transportation are tricky places to be right now. But technology and healthcare – for example, the very attractive pharmaceuticals opportunity I mentioned earlier – are both really interesting. This is again being agile in terms of directing capital to sectors which are beneficiaries of COVID-19 and with respect to how you structure your investment as a co-investor.

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Comparing Crises

Ted: You touched on comparisons with previous crises, is this different or very similar? Obviously, the circumstances are very different but are the outcomes similar?

"COVID-19 is a crisis of demand destruction, not a crisis of liquidity"

David: I have lived through three previous crises. My first baptism was the Drexel Crisis, in the late '80s/'early 90s. The second was LTCM, the third was Lehman and, now, the fourth is COVID-19. I would characterise the first three as, ultimately, crises of liquidity. In the first you had a crisis of liquidity starvation in the junk bond market, in the second you had starvation of liquidity in a key emerging market which rippled through others and in the third liquidity starvation in the senior debt market as the banking industry went into a tailspin.

So, of course, liquidity affects the cost of capital and, therefore, affects prices in the way that we saw in each of those earlier crises. Many features of those crises are the same. However, the really tricky thing about COVID-19 is it is not about banks starting to struggle, at least not yet. COVID-19 is a crisis of demand destruction, not a crisis of liquidity in the senior debt market or emerging or other debt markets. These crises could happen if we see banks start to struggle and write off debts. But, at the moment, we have seen strong government and central bank responses since February and April, dependent on where you are based in the world (on that point, geographical diversification is really important in avoiding hotspots, enabling co-investment in places more insulated from the pandemic).

We are seeing demand or revenues falling off, and then coming back quite quickly once countries have come out of lockdown. It is a very different crisis to the earlier crises affecting pricing and demand in the financial markets. The COVID-19 crisis has its roots in the "goods market", as an economist might say.

Types of Co-investment

Ted: Going back to co-investments and GPs requiring more capital, in terms of the deals you're looking at, are these new transactions or are GPs coming to you to provide capital for existing investments?

David: In the overwhelming majority of cases where we are currently transacting, the co-investment is made as a new investment in a portfolio company when the lead investor also makes a new investment. It is very rare for us to make an investment in a portfolio company at a different time and with a different valuation to the lead investor's. Co-investment thrives on economic alignment. So, we generally want to invest at the same time and in the same security as the lead investor unless we have particular reason to want to be more senior in the capital structure, which leads to the preference structure we discussed earlier.

Again, this is very rare: I can only remember two instances where we have co-invested at a later time and at a different entry price to that of the lead investor. If you invest at a higher valuation and at a later date, it distorts economic alignment. The only way to solve that is through preference structures.

Ted: Are you seeing other sources of capital in the market for existing portfolios rather than co-investment?

David: Capital from secondaries funds is one example. Of course, there is quite a large grey area between a co-investment and direct secondary or a continuation fund. We have seen continuation funds being put in place to allow existing portfolio companies, with existing managers, to continue to grow when only limited capital is available in the legacy fund envelope. So, co-investment is not the only solution to the need for capital, but it's probably the easiest one. The expenses of fund formation for an annex or continuation fund are large. Their use can be time-consuming and costly for the investor. That route probably only makes senses for the largest opportunities, not the mid-market opportunities where we are active as a firm.

Ted: With other co-investors, transient co-investors as you described them, leaving the market, are you currently typically investing as part of a group of co-investors or on your own or a mixture of the two?

David: I think the best way to answer the question is to give examples we've had over the last three to four months. We had a very busy summer and early autumn: we closed or committed to four transactions. This is unusually busy if you consider that we normally commit to four to six transactions in an entire year, not over a three- to four-month period. In one of those transactions, an Asian pharmaceuticals business (which had been ongoing for over a year), COVID-19 presented the right opportunity to complete and we invested in preference shares and detachable warrants, this structure being driven by our view of an ideal opportunity in the right part of the capital structure. We are the sole co-investor in these securities. In another, again, we took a preference share with detachable warrant structure as one of two co-investors in addition to the lead investor. The third is a technology business, producing computer equipment which is benefiting from COVID-19. In that situation we are one of two or three co-investors, so a small group. In the fourth, another pharmaceuticals business, we are the sole institutional co-investor. In a fifth, where we are pushing but are not yet done, I expect that we will be one of two or three co-investors. So I would say we have been one of a rarefied group, which is itself becoming much smaller!

Looking to life post-COVID-19

Ted: Now, could you comment on looking forward to a post-COVID-19 world, the future of portfolios and draw the distinction between those who had money in the ground pre-COVID-19 and those looking to make new investments now. Any comments on how life has changed in the private equity direct investing industry?

"The forward perspective is really all about being agile with sectors and countries, specifically in the sectors which are likely to be beneficiaries and in the countries which are better-insulated from COVID-19"

David: The principal changes have been around sector: there are sectors which are toxic right now, aviation services for example, and they will be very

tricky for some time. But, historically, that sector has been a good place to make money – we have done well there over the years. Our former employer had a huge aviation services vertical with a focus on aircraft leasing (better insulated than most given the mobile nature of its assets and the underlying asset backed nature of the sub-sector). Now it's almost untouchable – although there are one or two exceptions – due to the reduction in revenue passenger miles being flown by airlines. Conversely, technology is the huge beneficiary. There are businesses all around the supply chain, one of which we invested in recently in Germany, which are huge beneficiaries of COVID-19.

The forward perspective is really all about being agile with sectors and countries, specifically in the sectors which are likely to be beneficiaries and in the countries which are better-insulated from COVID-19, either because their governments took a robust view about lockdown or because their culture is such that their peoples take compliance guidelines with respect to COVID-19 more seriously. Counter-dependent nations will probably fare worse than the more compliant nations in terms of their adherence to COVID-19 guidelines.

Most importantly, the one thing that will really help with the performance of a co-investment portfolio is diversification. We are not going to get it right every time, but if we sensibly diversify along the four threads or pillars by manager, country, sector and vintage, we will mitigate risk of loss materially. We are really rigorous about how we do that in our firm. As I said earlier, we call that "intelligent portfolio construction", and if you do that well, then the actuarial mathematics shows that you should do well. Be agile, in response to sectors, in particular, be agile in response to countries, too. If you have a global platform where you enjoy deal flow coming from every part of the globe, that's a huge advantage and then, if you are really disciplined and rigorous about the diversification parameters you put in place, you will do well.

I think another appealing factor is the blank canvas aspect for those groups that are fundraising. If you are in the market now with a fund, you have no pre-COVID-19 exposure. Once the fund is raised, every investment you make and will have made from that fund is a post-COVID-19 transaction with everything that that entails. You are not burdened with portfolio company problems, when you perhaps bought at much higher multiples, or with creaking capital structures. You are really just discerning where you can deploy capital very selectively and carefully in the sectors and countries where you can be agile about the impact of COVID-19. Based on those key features and given that you can deploy structures and achieve pricing which haven't been seen in a decade or more, the blank canvas is, I believe, both attractive and compelling.

Future of ESG

Ted: Finally, turning to a topic of particular interest and importance to me – ESG. This was a key theme of ever-increasing importance within private equity. Do you think enthusiasm for ESG will remain? What importance will the private equity industry place on ESG post-COVID-19?

"there is absolutely no doubt in my mind that the impact of COVID-19 will increase the importance of ESG"

David: Firstly, there is absolutely no doubt in my mind that the impact of COVID-19 will increase the importance of ESG. At Capital Dynamics, we prefer to use the phrase "Responsible Investment", which is a slightly broader definition/approach. If you are interested, we have published our own Responsible Investment Policy and report on this important aspect of our business at least annually. I serve on our Responsible Investment Committee, which is one of my various roles within our firm. In a way you're preaching to the choir – it's an incredibly important part of what we do as a business.

We as a firm were a very early signatory to the UNPRI, now called the PRI, and we have adapted that approach over the last 24 months to encompass the UN's sustainable development goals (SDGs). The spectrum of activity is very broad and that is one reason why we use the term Responsible Investment. The 17 SDGs span much more than ESG, which we think is really important.

No doubt it will be more important, if you think about how some have suggested COVID-19 started, in a live animal market in China. I think the backlash against activities of that nature is only just starting.

I think we will see a greater focus on it within asset managers, partly – and really helpfully – driven by the institutional investment community. Our clients are saying to us "How can you help us with our approach to responsible investment matters?". If we listen to them, we learn and, most importantly, if we then act, we are then going to be a survivor because we are meeting our clients' needs. We have put in place policies, procedures and approaches which reflect their concerns and we are already seeing the benefits.

Ted: I agree that your last point about the institutional investor focus on this is tremendously important.

David: If I had gone into a meeting five or seven years ago with an institutional investor talking about one of our co-investment programmes, I might have had a question on ESG, probably environmental, maybe two-thirds into the meeting. If I have a similar meeting now, the Responsible Investment question, not just the ESG question, generally, comes up within the first 10 minutes of the meeting. I believe this shows more than anything how important it is to the institutional investor community.

Ted: Perhaps I was too cynical in the way I framed the question on this topic, perhaps implying that the importance placed on ESG might decline!

David: You are right to be sceptical. Investors are naturally sceptical and we were sceptical 10 or 15 years ago. Personally, one of the benefits of my time at a former employer, in its glory days, was the environmental debate; it was a huge one there. The US had a host of really tough environmental so-called "Superfund" legislation, then known as CERCLA/SARA, that was drilled into us at boot-camp. The focus on environmental matters, which we are now seeing with increasing prominence, was a huge part of what we did in the early '90s and Responsible Investment more generally is a natural extension of that. We really do welcome this as responsible investors.

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Dentons' global Asset Management & Investment Funds group is a team of more than 200 asset management-focused lawyers led from key management jurisdictions within the world's largest law firm, whose dominant focus is investment funds work, both transactional and advisory. Through our unrivalled global coverage, clients can be sure that wherever they have assets, make investments, do business or see opportunity, we can assist.

Capital Dynamics is an independent global asset management firm focusing on private assets including private equity, private credit, and clean energy infrastructure. Capital Dynamics offers a diversified range of tailored offerings and customized solutions for a broad, global client base, including corporations, family offices, foundations and endowments, high net worth individuals, pension funds and others. The firm oversees more than USD 17 billion in assets under management and advisement[1].

Capital Dynamics' roots go back to 1988, the year our predecessor (Westport Private Equity) was founded in the UK. Our headquarters were established in Zug, Switzerland in 1999. The firm employs approximately 160 professionals globally and maintains offices in New York, London, Tokyo, Hong Kong, San Francisco, Munich, Milan, Birmingham, Dubai and Seoul.

In 2020, Capital Dynamics was awarded the highest rating (A+) from the UN-supported Principles for Responsible Investment for (i) Strategy & Corporate Governance, (ii) private equity strategy, and (iii) clean energy infrastructure strategy. For more information, please visit: www.capdyn.com

[1]As of June 30, 2020

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