unquote analysis

co-investment focus

in association with Capital Dynamics

Navigating the complex world of co-investment

Co-investments are more popular than ever among limited partners, but require careful thinking – from devising the initial strategy to managing the post-investment process. Capital Dynamics' David Smith shares his expertise with *unquote"*

A quick glance at any private equity conference agenda speaks volumes about the current popularity of co-investment strategies: these often feature prominently on one if not several panels, when a few years back the topic would have barely deserved a passing mention. Private equity co-investment has certainly come of age.

A less anecdotal way of charting this meteoric rise is to look at general partners' growing propensity to include co-investment pledges from limited partners in their fundraising figures. In fact, market estimates put the contribution of this so-called "shadow capital" to global fundraising tallies somewhere in the region of 20-25%, against less than 15% in the boom years.

Canada's institutional pension funds may have blazed the trail in the early days of the industry, followed by early corporate adopters such as GE Capital a few years later, but today the theme of co-investment in its various guises is one that preoccupies all LPs – from small family offices to large institutional investors. "It is now front and centre and considered a natural adjunct to any private equity strategy of any scale," says David Smith, managing director and co-head of co-investment at Capital Dynamics.

The appeal of co-investment for LPs is well documented; what is perhaps less evident is why GPs are aggressively showcasing their willingness to share deals with their investors at a time when the best funds are oversubscribed and the pressure is mounting to deploy capital in increasingly expensive deals before investment periods end.

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But Smith points out the ball is still firmly in the LPs' camp: "To say GPs are keen to seek out co-investors is perhaps a bit too generous. What they have realised is that they have to tolerate it. As they've matured, LPs have become increasingly mindful of the '2 and 20' model that still prevails in the mid-market, and there is relentless price pressure as a result. Since that fee and carry model has so far proven very much immovable, GPs understand that the only way to offer a better deal

to LPs is to offer co-investment. They know that if they don't deliver, LPs are unlikely to come to the successor fund."

All parties broadly agree that co-investment is now an integral part of the pact, then. But given how rapidly this specific subset of private equity has matured, the approach to co-investing has arguably become more complex, from mapping out the initial strategy to managing the transactions and the inevitable pitfalls that can arise.

Plotting the course

The seemingly most straightforward way for an investor to build up a co-investment strategy would be to go the self-managed route. After all, the most sophisticated LPs often have a time-honoured understanding of the private equity industry, having built a network of successful GP relationships and tracked the fortunes of countless underlying investments over the years. While offering the greatest level of control, setting up a bespoke co-investment team can pose significant governance and risk management challenges. And more importantly, the time-consuming nature and complexity of co-investing means that building the right team and integrating it in the business usually requires significant time and resources.

"The first thing to recognise is that co-investing is actually direct investing: you are investing in an underlying portfolio company, very much at the coalface of private equity activity," says Smith. "That's quite different from being a fund investor, and having a manager between you and that underlying business. The former is about manager selection, and co-investment is about portfolio company management selection, much like a direct investment (almost the same word but there's a gulf between the two).

"It is much more intensive, and the cadence and rhythm of it are entirely different. You are working in lock-step with the sponsor when documenting and executing the transaction, so you need a team that's able to go and meet management at three-days' notice, potentially on the other side of the globe. Being familiar with due diligence processes, the vagaries of different jurisdictions and being able to go through all the reports, is also crucial."

This complexity has been a key factor in the development of other routes into co-investing in recent years, namely via external managers that will manage either co-mingled funds or, for the very largest investors, single-client programmes. While this goes some way towards alleviating the burden for LPs, not all outsourced co-investment managers are created equal when it comes to dealing with the challenges of running a successful co-investment strategy.

Making the right choice

Capital Dynamics, for instance, has to navigate a particularly rich dealflow, which fully warrants the fact its co-investment programme is executed by a dedicated business with a bespoke team. "The driver of our co-investment strategy is the underlying network of fund relationships that have been cultivated over the years as part of the primary fund business. These 950 funds, spread across 460 managers, are the bedrock of our programme," says Smith. "We tend to find that, three to four times over the lifetime of a fund, a manager will put forward co-investment opportunities to LPs."

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As a result of this network, Capital Dynamics will see in the region of two qualified deals a week and ultimately does three or four a year – highlighting the significant amount of work that goes into assessing the merits of specific investments and transaction execution itself. Even if the relationship with the sponsor is important, the skills involved at this stage can be significantly different to investing as an LP in private equity funds, says Smith: "We take the view that the management of the underlying company is in many ways more important than the lead sponsor. Who is going to make us money? Ultimately it is the management team heading the business, more than the sponsor."

The work does not stop there, as Smith points out. If Capital Dynamics secures an equity stake above around 15% in a business, it generally becomes a board observer or sometimes a full voting board member. That means quarterly if not monthly meetings, and ongoing dialogue with management.

Avoiding the pitfalls

This is where the potential for significant hurdles can catch ill-prepared co-investment managers unaware. Even though co-investment specialists will usually work alongside sponsors they know and trust, collaborating on a deal through thick and thin can test the most harmonious of relationships.

Smith says Capital Dynamics has indeed had occasional disagreements with sponsors in the past and highlights the skills needed to manage tricky situations successfully: "It is a minority of cases, but it does happen. A crucial aspect of this is to never, ever let the portfolio company's chairman or CEO see that division between two parts of the shareholder base. If they do, it is likely they will exploit this and use it to their advantage. My advice would be to deal with it professionally and properly, but behind closed doors. Come to a consensus privately and deliver this outcome to management in a board meeting."

Interacting with sponsors is only part of the equation though, and the relationship with other co-investors can add another layer of complexity to the work of the LP or its external co-investment manager. LPs with significant clout in any given fund are usually entitled to certain co-investment priority or privilege, which can create some degree of friction between them and other co-investors.

On the other end of that argument, GPs usually want to retain some flexibility and discretion in the way they allocate co-investment opportunities, perhaps offering preferential status to an LP bringing in a proprietary deal or with demonstrable sector insight. With each party looking to maximise the benefits of the co-investment pact, the potential for conflict is worth bearing in mind.

Smith believes the key to handling these situations sensibly is transparency: "The main concern is that co-investments can be viewed as the proverbial free lunch of the private equity world. It is important that this free lunch is distributed fairly and that the manner of distribution is disclosed to all. This extends to early-bird deals, which are less common these days but can still be controversial. As long as that's disclosed from the beginning of fundraising, I don't see that it's problematic. It is the investor's choice whether or not they want to come in as part of that early stage of fundraising."

Regulatory concerns

Transparency – be it on the sponsor or co-investor side – is therefore a key element to successful co-investing ventures. While established organisations with a proven track record of co-investment will have incorporated this in their strategy already, others might soon have no choice but to follow suit. Indeed, financial regulators on both sides of the Atlantic have understandably put co-investing under greater scrutiny in recent months as such programmes have become a vital part of the private equity landscape.

In Europe, the Alternative Investment Fund Managers Directive (AIFMD) is particularly specific as to how co-investments should be initiated, requiring a much more proactive stance from LPs – making a well thought-out, formalised strategy all the more important. “Under AIFMD, one has to be careful about whether the GP can properly and actively solicit co-investment from an LP,” says Smith. “In many cases, it can’t do that unless the LP has expressed the desire to be approached or is proactive in seeking out co-investment opportunities, most likely to negate the problems of mis-selling and undue preference as much as possible.”

Meanwhile in the US, the Securities and Exchange Commission (SEC) is also getting increasingly concerned about the way that co-investments can be used as a covert marketing tool by GPs at the expense of other LPs in a fund. The regulator’s Office of Compliance Inspections and Examinations has therefore increased its focus on private equity co-investing in its investigations from 2012 onwards, which means that LPs and co-investment managers should be mindful of this increased drive to level the playing field and prevent conflicts of interest.

Smith argues this shouldn’t have a negative impact on the popularity of the strategy in the long run: “The SEC has been pretty open about the fact it is worried about investors at the time of fundraising not being told about ‘sweetheart’ deals made with other LPs. It is both right and understandable that the SEC has taken this approach, but it isn’t a worry for an organisation that conducts its co-investment programme properly and transparently,” he says. “Our view is that if there is proper, full and fair disclosure of co-investment arrangements and their implementation to all LPs so that they know what everyone has been offered and why, then it shouldn’t be an issue.”

Co-investment therefore remains a complex and changing world to navigate and requires patience, skills and resources to execute properly. With LPs and their co-investment managers refining their programmes at a rapid pace, and given the attractive return profile of successful co-investment strategies, this attractive discipline should remain a vital component of the private equity landscape for the foreseeable future. ■