unquote" analysis

co-investment focus

in association with Capital Dynamics

Co-investments in clover

Co-investing has undoubtedly become a key element within the private equity universe. But, as the strategy gains in popularity and LPs strengthen their hunt for value, it is becoming clear only a handful of investors are able to successfully carry out these deals

ON THE surface, co-investing may appear to be straightforward and suitable for all LPs, but as more and more investors pile into the space, it is becoming apparent the strategy requires a great deal of resources, expertise and a highly-disciplined approach.

Rise of co-investing

While co-investing can trace its beginnings back to the early 90s, it was then seen as a strange and niche market. However, over the past five years, the strategy has been embraced by LPs as the benefits have become more widely recognised. According to David Smith, a managing director at Capital Dynamics: "The co-investment market has seen a rapid growth during the last five years."

Indeed, every investor and manager alike operating in the asset class today is discussing the strategy; managers know that it needs to be offered and LPs are demanding it. Clear evidence of the strategy's rise is the increased number of dedicated co-investment team members in private equity houses: "This underscores the importance of having a dedicated, experienced team to work with on these deals," says Smith.

Drivers

An obvious driver behind the rise of co-investing is LPs' search for value. Co-investment is a lower-cost strategy, says Smith: "The gross-to-net yield erosion is reduced when co-investing. For example, say typical gross-to-net yield erosion is 8-10% post fees and carry when simply investing in a fund, for co-investments the erosion is around 4-5%." Indeed, direct exposure to an asset removes a decent chunk of costs for the co-investing LP.

Another key reason for the rise of co-investments is the J-curve. "Because of the lower fees, the J-curve is shallower and shorter," explains Smith. And, with pockets of the LP community more sensitive to the J-curve, notably Asian and sovereign wealth funds, the co-investment J-curve can be closer to that of secondary investing.

Co-investing also offers LPs an additional layer of diversification. While investors can typically manage their risk profile through three main diversification elements: sector, geography and year of investment, co-investment provides an additional layer of diversification through the manager with which the LP is investing alongside. "We tend to do only one co-investment per manager per co-investment fund, which creates further diversification," says Smith.

A further attraction to co-investing is super selection, or rather, the reverse of adverse selection. As co-investing has been a feature of the market for several decades it may have been the case in the past that less attractive deals were offered up for co-investment. But, for investors with an established primary investment platform, such as Capital Dynamics, which has around 400 manager relationships, it is in the best interest of the manager to only offer the most exciting deals to potential co-investment partners. "In our experience, co-investments generally outperform the underlying fund," reveals Smith. "We operate solely in the mid-market, which typically offers better returns when compared to the small or large-cap market. Furthermore, the bulk of our co-investment dealflow comes through our manager relationships, which are hand-picked and nurtured. This means we are targeting top-quartile managers, aiming for the best of the best."

Challenges

Super selection, or the ability to identify high-quality deals, hints at some of the growing challenges involved with co-investing, and begs the question: are all LPs able to properly discriminate between good and bad deals?

As LPs rush into the co-investment market, the growing number of players means more people fighting for the same deals. While increased competition makes deploying cash through this strategy more challenging, the Darwinian nature of competition also means that those LPs with the required resources and expertise are more clearly defined as the adaptable survivors. "More players in the market means you need to present yourself as a preferred co-investor; one that GPs will want to offer deals to; someone who can present some sort of specialisation or other form of added value."

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David Smith, managing director, Capital Dynamics

Furthermore, increased competition is not exclusive to co-investment; the entire private equity market is feeling the heat as the recovery gathers pace and asset valuations are soaring. One of the fundamental rules of private equity investing is buying well, and in today's market this is becoming extremely challenging. "At the moment, pricing often seems absurd and difficult to justify. But this is a challenge felt by both GPs and co-investors," says Smith.

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Discipline

Smith believes the solution to tackling co-investment is discipline. Capital Dynamics operates on six key assessment criteria.

The first is working to the GP's strength. "We use our understanding of the manager when partnering on deals," says Smith. Through a primary investment platform, the investor is able to analyse the GP's track record by sector and other domains, and co-invest accordingly.

Second is competitive advantage. You have to select co-investments where the asset presents barriers to entry, alongside attractive growth trends within the particular sector. "We target co-investments where the asset is a market leader – a business with a moat around it," says Smith.

Third is entry valuation, which is of particular prominence in today's market. "This is where we need to be really disciplined, and have the guts to stay out of the market if necessary," says Smith. Given the current excitement of the co-investment market, coupled with the increased competition, it is likely that some deals will be overpriced; however, co-investors must maintain conviction when it comes to valuations.

Fourth is the target's management team; after all, it is this group at the coalface driving the growth of the company: "It is management's strength that makes the deal work," says Smith. An experienced and driven management team ensures proper alignment of interests through robust incentive structures.

The fifth discipline is growth opportunities. "In a low growth environment like that currently experienced in much of Europe, we need to ensure that a good portion of the company's revenues are derived from other parts of the world," explains Smith. This strategy can be referred to as "old world governance and new world growth".

The final requirement is exit opportunities – of equal importance to buying well is ensuring assets are sold well. "You must always have an eye on the exit," says Smith. Indeed, it is all well and good to find the perfect asset operating in the perfect sector run by the perfect management team but without clear and accessible routes to divestment there are no returns.

Overcoming competition

Once the right co-investment has been selected it will undoubtedly have attracted a plethora of investors wanting a slice of the action. So, in order to win the deal and ensure the right terms, co-investors must present themselves as the preferred partner. "It's about bringing something more to the table than just cash. GPs are looking for investors with deep pockets to support further growth, and for a level of sector expertise to help access that growth," explains Smith.

As Capital Dynamic's co-investment team has experience of direct investing, all senior members having worked previously in GP-like roles, it is able to provide expertise and a deeper understanding of transactions. The team has four key sectors in which it has deep expertise, and therefore prefers to co-invest in energy and power; industrial manufacturing and services; financial services and healthcare; and consumer retail. "Having a sector capability is important – if managers know you have a well-developed understanding of a particular area of business or commerce, they know you can get up to speed with the transaction rapidly," says Smith.

What is more, Capital Dynamics has been an active co-investor for several years, which gives the team an excellent competitive advantage.

GP concerns

While it is in the interest of all private equity managers operating in today's market to offer their LPs co-investment opportunities, the strategy also presents challenges for GPs. In an increasingly competitive and frothy market, managers are under extreme pressure to cleverly transact and this often requires moving at a fast pace. "GPs want certainty," says Smith. "They want to know that the co-investor will work in the required timeframe."

According to Smith, this often means that a quick "no" is crucial. "We may turn down opportunities for a number of reasons, often on the basis of fund portfolio diversification. But it is important to be prompt and transparent about why we're not doing a deal so that we can work together more efficiently in the future," explains Smith.

Active management

Clearly a huge amount of effort is required simply to make a co-investment but, the deal does not end when the cash has been deployed. Far from it, the bulk of a co-investor's work takes place post-investment. "It's about being an active owner; working with the GP and management after the initial investment, perhaps by making follow-on investments to finance growth by acquisition," says Smith.

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Indeed, over the holding period, companies grow and change, which often requires more cash and certainly a great deal of support and guidance.

As previously mentioned, exiting a deal is just as important as investing, and this presents another area in which co-investors need to be skilled. "Co-investing is also about exit readiness and facilitation – this could be done by working with management to ensure that the company is structured to appeal to the intended buyer

universe and by introducing the company to others in the sector," says Smith.

Working in lock-step

Perhaps one of the less discussed subtleties of co-investing is ensuring that the deep alignment so dearly cherished by the asset class is maintained. Private equity works because of its economic alignment and its strong governance. While co-investing becomes ever more popular, it is vital that maintaining alignment is at the heart of these transactions. However, in practice this can be challenging to achieve.

Capital Dynamics approaches alignment by ensuring that all parties are striving for the same goal. "Actually doing this is more subtle than one might assume," says Smith. "All need to be invested in the same securities, at the same price, on the same day, on the same terms and with the same exit horizon."

But, as the hallmark of late-stage private equity investing – the purchase of a controlling stake – is affected by co-investing, co-investors need to be careful alignment is maintained. "As a co-investor is typically taking a 10-20% equity stake in a deal, legally it's a minority investor. This often means the co-investment stake needs to be pooled with the lead investor's stake so you enjoy the majority shareholders' rights," explains Smith.

Other facets of a co-investor's minority position include board representation and working out clearly defined governance, pre-emption, and tag-and-drag-along rights before the deal goes ahead. "It is crucial to ensure there are appropriate governance mechanisms in place, which feed back to making sure you are working in lock-step with the lead investor," says Smith.

Indeed, the slight disturbance caused by co-investing to the traditional alignment of private equity could be a fatal flaw in the strategy. If a company executive senses any level of discord between GP and co-investor it will undoubtedly be exploited to the executive's benefit. "We need to deal with any differences with the GP privately. Typically this is done through a pooling agreement by which we agree with the GP to vote at the relevant forum in the same way," reveals Smith. "It is crucial to establish a common position outside the boardroom." But, in order to do this successfully, co-investors need experience of direct investing and all the challenges that come with the activity of growing portfolio companies.

Co-investing really must be a co-operative, harmonious process. Private equity's *raison d'être* is its deep alignment and, in order for co-investing to work, it is crucial that this structure is upheld. The strategy is complex and resource-intensive, and one that requires experience of direct investing, deep sector knowledge and a comprehensive understanding of the partnering GP. While the drivers behind co-investing are indeed attractive, which will draw further interest and discussion, investors need to think seriously about how the strategy works in practice and whether it would be prudent to consider partnering with a co-investment specialist such as Capital Dynamics. ■