ALTERNATIVES RESEARCH

Co-Investments: The Road to Outperformance?

Originally appeared in the Wilshire Private Markets Quarterly Newsletter March 2019 Björn Waltmans, Managing Director

Over the last decade, there has been an enormous growth in the availability and participation of investors in private equity co-investments. Private equity co-investments are investments made by Limited Partners (LPs), alongside General Partners (GPs) and are regarded as a means to improve investment returns and lower overall fees. As a result of the potential to generate outperformance through co-investing, the value of co-investment deal volume has more than doubled since 2012. Furthermore, more than 35% of investors plan to co-invest alongside fund managers in the near future. However, co-investing is not without its risks and challenges and requires extensive resources and expertise to build a sustainable co-investment program. Wilshire has been an active co-investor for over a decade and in this article we will examine in more detail the benefits of co-investing, its risks and the different co-investment models available to investors to seek outperformance.

Why Co-Invest?

The main reasons for LPs to co-invest alongside GPs is to enhance investment returns through exercising better control over direct investments in minority positions and to lower the overall blended fee load of private equity investments (Exhibit 1). Other reasons include better control over investments in terms of portfolio construction, strategy and pace, strengthening the GP relationship, improved fund intelligence, and/or to gain industry knowledge. GPs offer co-investments to build stronger relationships with their (prospective) clients, to gain access to additional capital for deals and improve the chance of a successful fund raising (Exhibit 2).

Exhibit 1 – LP Reasons for Co-Investing

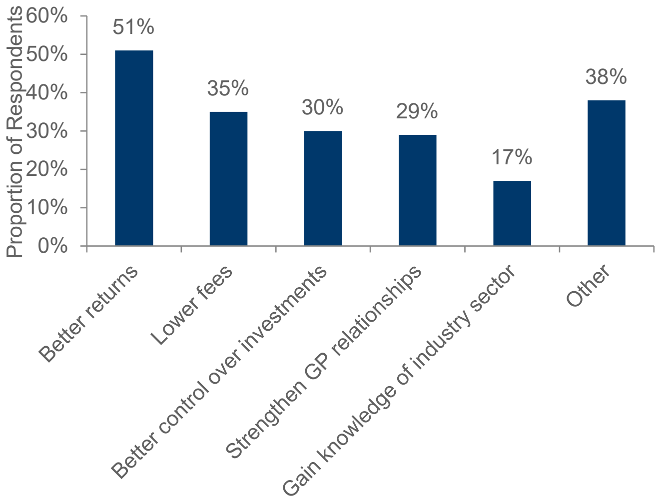
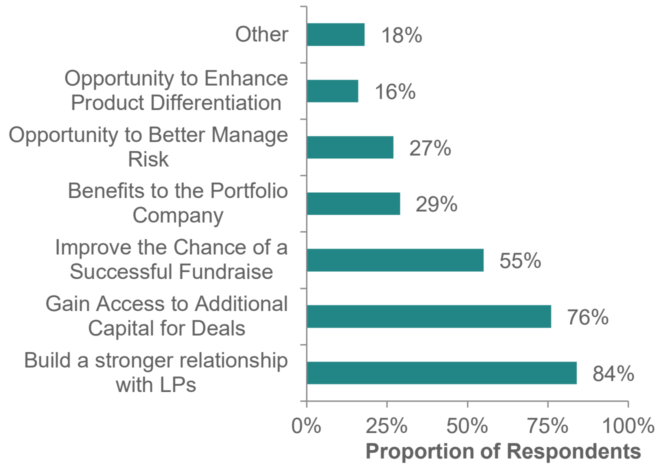


Exhibit 2 – GP Reasons to Offer Co-Investments



Source: Preqin Special Report: Private Equity Co-Investment Outlook.

The potential for outperformance through co-investments is mainly driven by i) having access to top-tier GPs, ii) the ability to originate sufficient and diversified co-investment deal flow, and iii) having the in-house expertise to evaluate and execute co-investment opportunities within a short period of time. Taking into account that co-investments have a less expensive fee structure compared to traditional private equity funds, the overall net return to LPs can improve. Furthermore, co-investments provide LPs with the ability to put capital to work quicker in specific regions and/or industries alongside favored GPs. As co-investing requires an intensive collaboration with GPs it fosters deeper relationships and a better understanding of the investment strategies and processes of GPs.

Exhibit 3 – Number of Co-Investments 2000 – 2016

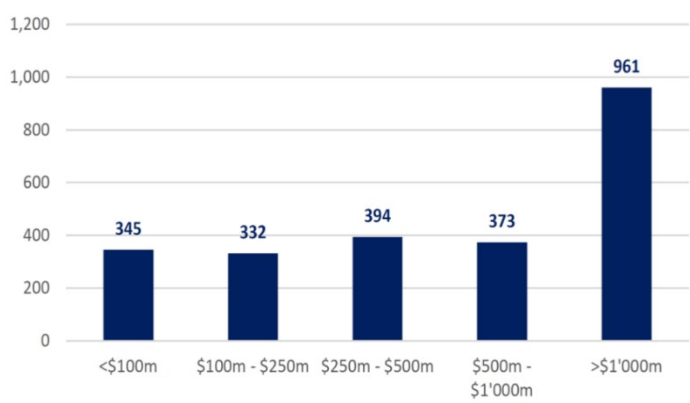
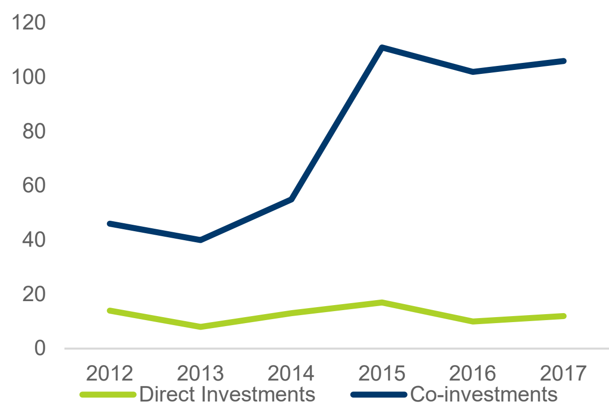


Exhibit 4 – Historical LP Co-Investment Deal Value (US$ billion)



Sources: Cepres and McKinsey

Co-Investing Risks

Although the benefits of co-investing may be clear, it does come with its own challenges and risks. GPs looking to raise bigger funds have the incentive to "prove" they can execute on ever increasing deal sizes that fall outside their original investment scope. This in combination with the increasing amounts of dry powder looking for deals and the abundance of low interest rate debt may create a recipe for future disappointment. Hence, in a bullish market environment where valuations and leverage have surged to levels not experienced since before last decade's global financial crisis, it has become increasingly important to understand and mitigate the risks of co-investment deals that are generally complex and resource intensive.

Exhibit 5 – Average Purchase Price Multiple of Pro Forma Trailing EBITDA

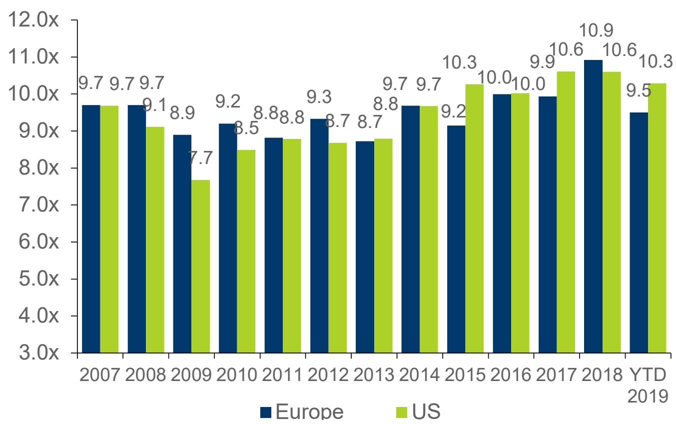
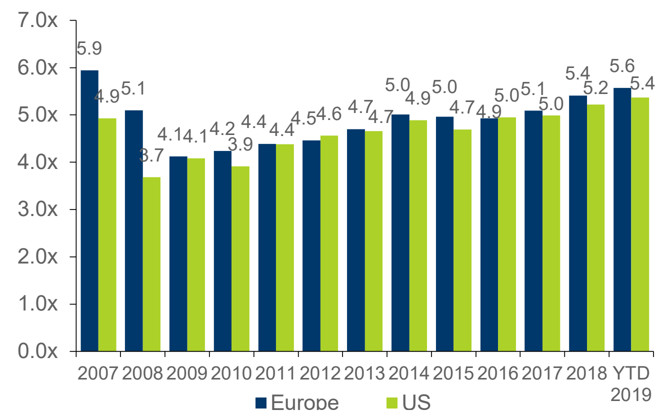


Exhibit 6 – Average Pro Forma Credit Statistics: Total Debt/EBITDA



Source: S&P LCD Data as of Q1 2019.

The main risks and challenges associated with private equity co-investments that can be distinguished are i) adverse selection, ii) large deal bias, iii) concentration risk, iv) challenging execution, and v) GP relationship risk. Co-investments provide the opportunity to overweight particular deals, but generally, LPs are unable to co-invest in every deal of a fund, leading to selection biases, which have the potential to produce idiosyncratic exposures such as sector or geographic tilts. Furthermore, co-investments are commonly offered on the largest deals of the fund, which could overweight the LP's portfolio to larger cap opportunities, which are not necessarily the higher quality deals. The adverse selection, large deal bias and concentration risks can be mitigated by originating sufficient deal flow and building a well-diversified co-investment portfolio. This in itself poses a major challenge from a resource perspective especially for smaller investors without dedicated co-investment professionals. If the execution is poorly managed by the LP it may even deteriorate its relationship with the GP that is dependent on the co-investing LP to syndicate capital and meet the required funding needs to complete a transaction. Examples of poor execution include an inefficient due diligence process, communicating interest in a deal and then passing on the opportunity, and adding complexity or risk to the closing or management processes.

Co-Investment Models

The question investors looking to build a sustainable co-investment program are facing is what co-investment model to use to tap into the promising world of co-investments? The spectrum of different models ranging from doing it all in-house to fully outsourced solutions comes with its own benefits and disadvantages. The in-house model is most suited to large(r) institutional investors that have a well-diversified base of existing GP relationships that are actively investing their funds and have the ambition to build a longer-term co-investment practice. The benefits from a cost perspective are clear but a steep learning curve is required. A fully outsourced solution is particularly suited for smaller institutional investors that lack scale and dedicated resources. The co-investment platform is a hybrid version of the in-house and fully outsourced model where investors retain a discretionary veto and take the ultimate investment decision themselves. This, however, requires a general understanding of the practice of doing co-investments but does not require a fully dedicated team and scale, and is less expensive compared to the fully outsourced model. As such this model typically plays into the needs of (smaller) family offices that may or may not have a direct private equity business.

Exhibit 7 – Co-investment Models

	In-House	Co-Investment Fund	Co-Investment Platform
Benefits	• Full discretion • Direct GP relationships • Increased monitoring insights • Lower burden fee	• Dedicated, experienced resources • Typically proven track record • Accessible for small and large investors	• Discretionary veto • Benefit from GP co-investment research • Free option as fees are paid on invested capital
Disadvantages/ Issues	• Significant investment required to set up own team and infrastructure • Need for scale and long term commitment • No organizational track record	• No discretion • More expensive • GP risk	• No direct GP relationship • Required ability to make co-investment decisions • Lower costs compared to a fully outsourced solution but higher than in-house

Conclusions

Putting it all together, it is evident there has been a surge in demand for co-investment opportunities driven by the enhanced return potential co-investments offer to an investment manager's portfolio. However, co-investing is not without risk and different models are better suited for one investor than the other. Wilshire has been a long-standing private equity co-investor on behalf of its clients offering fully outsourced solutions as well as a more hybrid model tailored to the needs of its individual clients. In the long term, a program based on consistent application of investment principles executed by the right people will be supported by outstanding performance.

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