EXPLORING MOTIVES FOR CO-INVESTMENT

CLAUDIO SINISCALCO
MANAGING DIRECTOR AND GLOBAL CO-HEAD OF CO-INVESTMENTS, DEUTSCHE PRIVATE EQUITY AND PRIVATE MARKETS

The demand for co-investment globally has never been higher. Claudio Siniscalco analyses the key factors driving this growth in co-investment exposure.

When leading business school professors and economists go out on a limb to declare that professional co-investors and fiduciaries not only don't outperform their fund commitments, but in fact, underperform them, you know that as an asset class you have finally reached the mainstream. Just like the Efficient Markets Hypothesis has been largely modified, caveated and debunked with the passing of time, the increasing prevalence of co-investment funds and dedicated co-investment teams suggests that institutional and private investors are also skeptical of the initial academic pronouncements and have voted with their feet to increase their co-investment exposure. Is this due to their innate belief in their investment selection skills, or are there other factors at work? The following is an attempt to explore the definitions and probe the motives of the various co-investment market participants.

The Co-Investors

Ultra high net worth investors and their family offices typically view co-investing as a natural extension of their entrepreneurial activities. Many a family office will say that they have been co-investing for decades, and the source of their wealth may have very likely been as a result of a former business or equity partnership. But should we define this participation in partnerships and investment consortia as "co-investment"? Practically speaking, this form of the phrase distorts the cleanest definition of a co-investment, where you typically have a "lead" investor followed by one or more "co-investors", but such a large and diverse constituency can't and shouldn't be ignored and they will almost certainly continue to define their activities as co-investment.

The motives of this type of investor are quite straightforward: Family offices typically enjoy the flexibility provided by a co-investment strategy (allowing for more customized control over their portfolio), and in many cases participation in direct deals – specifically participation in corporate governance (via board seats or chairmanship etc) - delivers lifestyle and intellectual benefits which go beyond the purely financial. Finally, having felt let down by the industry and its cascade layers of fees over the last cycle, many of these groups simply prefer the transparency provided by direct access to deals.

Institutional investors, typically medium sized pension funds and insurance companies, have practiced perhaps the purest form of co-investment. Having supported the private equity GP community loyally for what has in some cases now encompassed several decades, they are perhaps best suited and most comfortable with the typically more passive role occupied by co-investors in relation to lead investors. Given they have already made blind pool LP commitments lasting upwards of a decade, they have the institutional patience, and implicit confidence in their existing counterparties to continue to manage their capital in a fiduciary manner. Their motives are also very clear: these LPs are trying to improve their net performance (via lower weighted average fees), portfolio control (via selectivity), and information (relative to what is typically provided to Limited Partners in a fund).

Private equity platforms (like our own at Deutsche Asset & Wealth Management) position themselves in a very similar way, given most of their co-investment activities typically began as an allocation, or as a side pocket, to their existing primary or secondary funds. These platforms, however, have now begun to separate out co-investments into their own dedicated co-investment funds or pools. These funds are largely blind pools structured very similarly to a typical GP's PE fund, with the exception that they are priced more attractively. The motives of a platform provider are generally to sustain/augment their product relevance and fee base: in short, co-investment funds allow platforms to mitigate customer churn and fee compression in their other business lines.

When a platform is selling you a "co-investment fund", it's quite ironic that they are actually coming full-circle and selling you a blind-pool limited partnership instead, pretty much the exact opposite of a co-investment. The benefit, however, is that with one commitment you can achieve diversification (geography, industry, manager, size, style, and risk profile) that would be impossible to achieve with a commitment to a single manager.

The largest vertically-integrated limited partners such as sovereign wealth funds and the largest US and Canadian pension plans have made their co-investment appetite and presence acutely felt across the private equity system, primarily in the largest deals with the largest sponsors given the scale of the capital they are entrusted to deploy. In an increasing number of cases, these groups are positioning themselves as "co-lead" or even "lead" investors in order to secure the necessary deal allocations of north of $100m per deal. Their clear motive is to capture as much of the "fee reduction pie" as possible by leveraging their better bargaining and execution power relative to their smaller and under-resourced peers.

The Lead-Investors

Mega funds have perhaps become the fastest and most adept of the GPs to take advantage of the co-investment phenomenon. In many cases these groups have dedicated syndication teams, and in some cases, they have even productized their overflow, raising dedicated co-investment or overflow funds for a select group of their LPs. Most of all, however, they have used co-investment as a type of contingent fee break, where a promised "ratio" of co-investment is theoretically modeled during the fundraising process to get a prospective LP to their desired weighted average fee drag. This might end up at a very different level in practice, given the vagaries of the deal cycle, and the disparate execution skills and appetites of their various LPs.

Mid market funds are perhaps the most in need of co-investment of any GP, given they can not only benefit from the firepower flexibility provided by additional capital, but are often under-resourced in terms of their investor relations teams and therefore will look to any way to maintain close relations with their most active LPs. Given their large numbers, but their relative lack of resources and organization, these have provided a fertile hunting ground for the most sophisticated co-investors.

Growth and VC funds - with their smaller fund sizes and equity tickets - are among the less active providers of co-investment, but have nevertheless begun to take advantage of the trend in their own way. With their portfolio companies often requiring multiple follow-on rounds of financing after an initial investment, they have in many cases found willing partners amongst their limited partners. The advantage of working with one's limited partners is that some of the misalignment that can manifest itself around a board room table can be mitigated. Whether leading a follow-on financing alongside someone you know truly equates to co-investment can be debated, given the different cost-bases and going-in valuations of the different participants. However the most sophisticated LPs are viewing these types of financing rounds through a very similar lens as they do their more traditional buyout co-investments.

Fundless sponsors will offer you a "co-investment opportunity" with a straight face, even as they intend to put little or no equity into the deal in which you are asked to co-invest. Attracting deal-by-deal financing is obviously existential for this group of investors, and they have therefore been quick to attempt to take advantage of the growing appetite for co-investments amongst the limited partner community. Just like their entrepreneurial brethren amongst the family office / UHNW world, their definition of co-investment is a loose one: nevertheless, in terms of volume this is another trend that can't be ignored outright. With appropriately aligned interests, there is nothing preventing a deal stemming from a fundless sponsor from outperforming one executed by a brand name fund. Such deals are not for the faint hearted, but this is certainly a space to watch as institutional investors become increasingly crowded out of the more traditional co-investments in the market.

CLAUDIO SINISCALCO

Claudio will take part in the Extended Session on LPs & Co-Investment on Wednesday, November 19th at 16.20