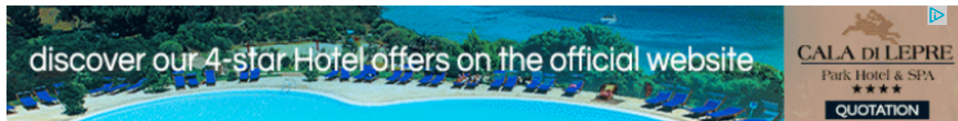

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Private Equity On The Cheap

By Harry Brumpton

Private equity funds are notorious for their generous fee structures — typically 2% of the assets under management and 20% of all profits, the so-called "carried interest" — but as the wider public gets increasingly worked up about the firms' swelling fortunes, Wall Street has, as always, adapted.

The process is known as "co-investing." Traditional investors in private equity limited partnership funds– endowments, pensions, fund-of-funds and insurance companies—may be invited to up the ante by also injecting money directly into companies alongside buyout shops.

Don't be put off by the milquetoast name. Co-investing is also known as "shadow capital" because the exact amount is not disclosed.

Whatever you choose to call it, the seemingly win-win buyout method is attracting enthusiasts. Last year private equity advisor Triago estimated shadow funds at an "unprecedented" $161 billion, or 26% of the year's capital raised, noting they "have been rising at a faster clip than classic fundraising."

The method has much to recommend it. "The most strictly defined co-investment is a fee-free, carry-free opportunity to participate in a deal that's not available to others – the only other way to participate is via the lead (general partner's) two-and-20 fund, so it's an unbelievable discount on a scarce commodity," says Claudio Siniscalco, Global Head of Co-Investments at Deutsche Asset and Wealth Management, a co-investing outfit within the bank.

Moreover, co-investment gives institutional investors more latitude, letting them in the tent with the buyout whizzes who did the legwork –without actually *doing* all the legwork.

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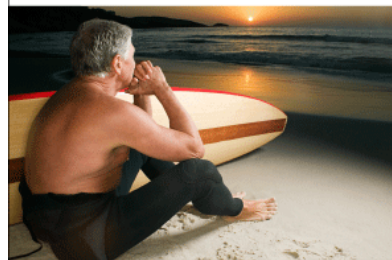
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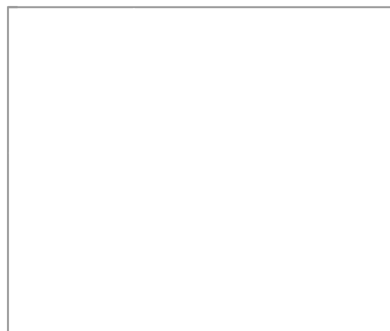
"There's an element of human nature in this, to the extent that people generally trust themselves more than they trust a fiduciary or a third party, no matter how reputable they are," Siniscalco adds.



And benefits run the other way, too.

For private equity firms, the strategy can sweeten the relationship with deep-pocketed players.

It can also open up a whole new universe of acquisition prospects by letting the manager tackle larger targets without committing too big a chunk of its portfolio to one play.

None of this is a new thing. New York-based Twin Bridge Capital has been participating in co-investment deals for "more than two decades" partner Debbie Ackerman told a roomful of people on a panel at this month's iGlobal Forum Co-Investment Summit in New York.

But many others at the summit – the organization's first — were newcomers to the concept, ranging from state pensions dabbling in tiny trial-balloon allocations, to hedge funds sniffing out new avenues for alpha.

Still, the performance has been mixed at best. Co-investment returns look far uglier than the industry's results at large, according to academics from Harvard as well as separate research by private equity advisory firm Altius Associates. (Although practitioners argue the studies' average risk-adjusted returns are unduly dragged down by too-large of an average investment size as well as the financial crisis.)

Another hurdle is that investors new to the game may feel pressure to move quickly on the deals they are offered. A common timeframe between getting the invite and deciding to ride shotgun seems to be just a few weeks or less, according to a number of co-investors.

Joseph A. Smith, a partner at Schulte Roth & Zabel representing private equity fund sponsors and institutional investors, notes it's one thing for investors to run diligence on the talent and integrity of a fund manager and quite another to play detective in the data room of a buyout target to see if it has accounting problems, environmental issues or weak growth prospects.

"Which LPs are expressing interest in side-letter provisions and receiving co-investment opportunities? The answer is a great many that do not have the resources to do this effectively," Smith says.

Private equity giant Bain Capital also noted "some real concerns" about coinvesting in its Global Private Equity Report 2016. It echoed worries flagged last year by the SEC over fairness and transparency.

Still, despite all these clouds, ever more private equity firms and their limited partners see rays of light. "There are lots of win-win synergies and there are a lot of opportunities to fumble," Smith says.

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