Private Equity Co-investing

Investment characteristics and considerations

October 2020

IN BRIEF

- **Co-investments are becoming an increasingly important component of private equity programs as investors are seeking higher returns from private investments to enhance their broader portfolio returns.**
- **There can be diverse and significant benefits of co-investment from both a General Partner and Limited Partner perspective.**
- **By their nature, co-investments have inherent risks requiring unique skills and relationships to be properly executed.**
- **We believe carefully implemented co-investment portfolios can supplement well-diversified private equity portfolios, increasing the potential to achieve attractive risk-adjusted returns and overall portfolio return enhancement.**

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Investors are increasingly looking to co-investments as an important component of their private equity programs

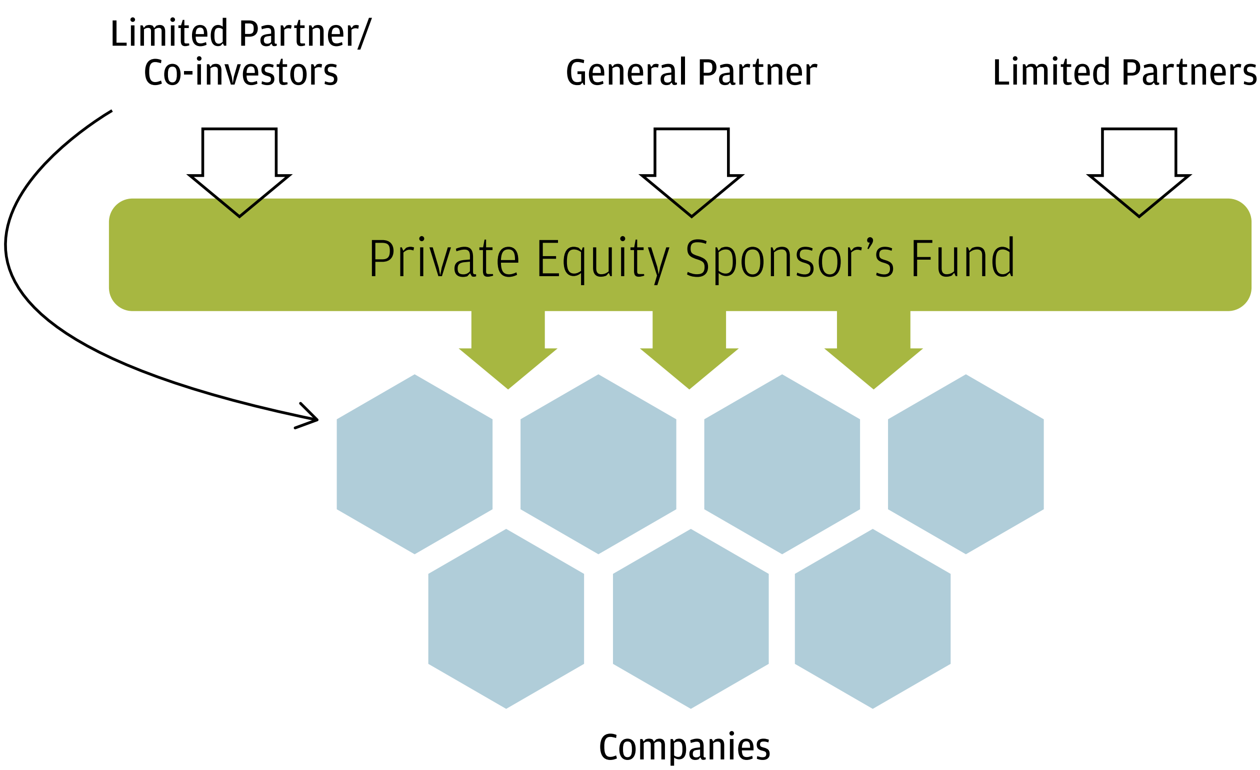
Over the past few years, interest in co-investments has expanded significantly as investors of all types seek higher returns from private investments to enhance their broader portfolio returns. While co-investing has been a part of the private equity industry for some time, it is new for many investors and the landscape continues to evolve. At the start of 2020, nearly 60%[1] of Limited Partners (LPs) were planning to invest in co-investment opportunities, up from an estimated 24%[2] of LPs that were actively co-investing back in 2012. In fact, Cambridge Associates estimates global private equity co-investment capital to be ~$60bn or ~20% of the overall Private Equity (PE) market[3]. Co-investments can be a source of high returns at reduced costs, but the inherent risks and implementation considerations should be carefully weighed in order for investors to realize the full benefit of an allocation to co-investments within their private equity portfolios.

[1] PEI Perspectives 2020; December 2019/January 2020.
[2] Preqin Special Report: LP Appetite for Private Equity Co-Investments 2012.
[3] Ready, Set, Co-Invest, Andrea Auerbach, March 2019.

Private equity co-investments defined

Private equity (PE) investing is defined by equity investments made in operating companies that are not publicly listed and traded on a stock exchange. Generally, private equity investments are made either through a fund or directly into an operating company. Private equity funds are vehicles managed by a General Partner (GP) that consist of a number of underlying private companies, and investors can access these vehicles either by investing into the fund on a primary basis or purchasing an interest in the fund on the secondary market sold by an existing LP. Investors can invest directly into an individual private operating company either on their own or as a co-investment, made alongside a GP that leads the due diligence and executes the deal. In this case, the co-investor receives an allocation to the company outside of the GP's fund, which consists of a broader group of portfolio companies. Often, though not always the case, the LP who co-invests alongside the GP is also invested through the fund vehicle.

EXHIBIT 1: PRIVATE EQUITY CO-INVESTMENT



The GP perspective: Potential benefits of PE co-investments

Though it may seem counterintuitive that a GP would offer LPs the ability to co-invest in a deal when they can draw upon committed capital from their fund, there are a number of reasons why a GP may offer direct access to LPs.

PORTFOLIO CONSTRUCTION

The GP may have guideline limitations or restrictions – for example, with respect to geography, strategy or industry – within their fund vehicles that limit the size of a particular investment. To adhere to these portfolio construction guidelines or concentration limits, the GP will allocate the appropriate amount for its fund and then allow for the remainder to be co-invested by one or more LPs.

CAPITAL AVAILABILITY

GPs may find themselves in a situation where they do not have sufficient capital to close a transaction. For example, if a transaction requires equity in excess of the maximum investment the GP can make out of its fund or if the GP is between funds and has limited or no third-party committed capital to invest, the GP may seek LP co-investors to help finance the transaction and provide surety of closing to the seller.

STRATEGIC BENEFITS

For certain companies, there may be a strategic reason for a GP to invite a specific co-investor who has unique value-add characteristics or capabilities that may help the GP and the investee company to achieve their goals. In this case, the LP is somehow aligned with the company from a marketing or competitive dynamic and its co-investment provides strategic benefit in addition to the capital investment.

INVESTOR DEMAND

Ultimately many GPs offer co-investments simply because their investors want them. In the case of large and sophisticated investors especially, keeping LPs happy makes their capital stickier and, together with proven performance, all but ensures a GP will have a more successful fundraise in the future.

The LP perspective: Potential benefits of PE co-investments

Co-investments can be used as a supplement to fund investing in building out and managing private equity portfolios, widening the breadth of holdings and increasing the potential for enhanced returns to the broader portfolio of investments. The distinct characteristics and potential benefits to investors of private equity co-investments include:

Potential return enhancement

The primary objective of a private equity portfolio is to provide return enhancement over relevant public market benchmarks. Co-investing, as a type of private equity investing, is certainly no different — investors are seeking high rates of return. Research has shown that co-investment net returns to investors enhance overall private equity returns on average, but have a higher dispersion of returns with a larger skew — meaning that a smaller number of deals outperform and a greater number of deals underperform[4]. Given this dispersion of returns, careful investment selection of the best co-investments can provide return enhancement relative to a broader portfolio of assets.

Attractive economics

Co-investments have historically been offered to LPs on a no fee, no carry basis. More recently, certain GPs have structured co-investment deals with some economics, generally in the form of a management or monitoring fee and/or carried interest above a preferred return hurdle where the GP would participate in the upside when a deal performs. Either way, co-investments are certainly available at a reduced fee basis relative to typical fund investments, with an estimated cost differential of 289 basis points[5]. This reduction in fees is important, as studies[6] have found that it is likely to be the primary driver of return enhancement across co-investments made historically. Furthermore, these attractive economics have the potential to mitigate the overall "J-curve" effect — early negative returns resulting from fees and expenses prior to the later realization of higher returns — that is more typical of fund investing.

The J-curve is a well-known concept among private equity investors, describing the general pattern of returns for a primary market private equity investment: moderate negative returns in the early years (when fees and expenses are high relative to invested capital), increasing returns as earnings and valuations grow (with meaningful distributions beginning around year three and cash flows turning positive usually around year seven), followed by the harvesting stage in which asset sales and distributions continue until the end of the investment term (typically 12 years).

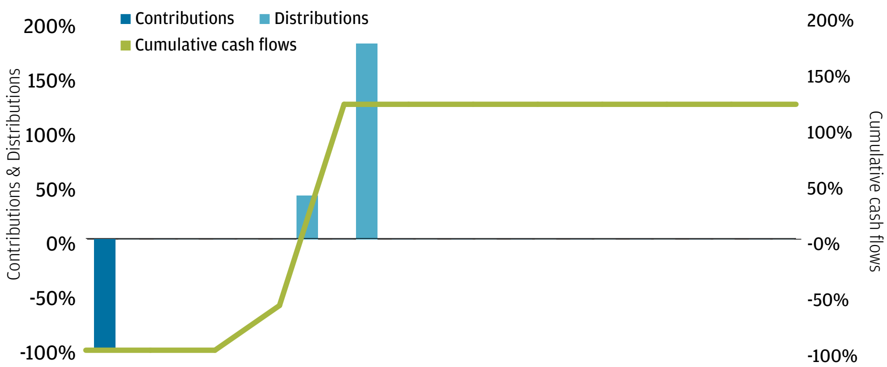
Increased visibility and flexibility in portfolio construction

Private equity fund investments are typically made on a blind pool basis. This means that an investor often makes a commitment to a fund before the GP has identified or made any investments in the underlying companies. Though investors will generally have some insight into the fund's expected composition by geography and sector based on the GP's past experience, the ultimate portfolio allocations are unknown. Co-investing allows investors to have more flexibility in portfolio construction as the decision whether or not to participate in a co-investment allows them control in identifying certain characteristics prior to making an investment.

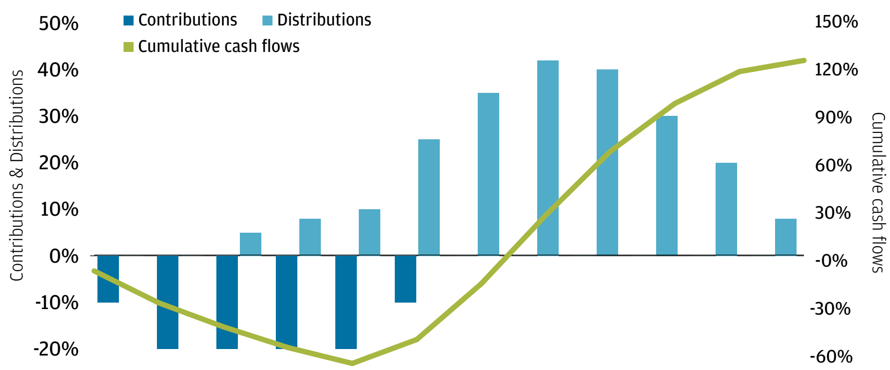
[4] Adverse Selection and the Performance of Private Equity Co-Investments, Reiner Braun, Tim Jenkinson, Christoph Schemmerl, December 2018.
[5] McKinsey & Company, A new decade for private markets, McKinsey Global Private Markets Review 2020.
[6] Adverse Selection and the Performance of Private Equity Co-Investments, Reiner Braun, Tim Jenkinson, Christoph Schemmerl, December 2018.

EXHIBIT 2: CO-INVESTMENT CASH FLOW PATTERNS

Direct



Fund



	Distinguishing features	Year of first distribution	Cash flow positive year
Direct	Large up-front purchase price; distributions may be lumpy, occurring around years ~4-5; cash flow positive earlier than typical partnerships	3	4
Fund	Typical partnerships draw capital for ~5-6 years and turn cash flow positive around years ~6-7	3	8

Hypothetical for illustrative purposes only. Past performance is no guarantee of future results. The manager seeks to achieve the stated objectives. There can be no guarantee those objectives will be met.

The role of co-investments in a diversified private equity portfolio

Co-investments have distinct cash flow patterns relative to fund investing, and the implications of adding co-investments to a diversified private equity portfolio can be significant.

Relative to fund investing in which capital is called gradually over a multi-year investment period, co-investments are funded much more quickly. Co-investments typically involve a high upfront cash payment to fund the company when the deal closes, and may involve smaller follow-on investments depending on the company needs or the deal strategy.

Additionally, each individual company investment typically targets a 4-5 year holding period. A private equity fund, which is comprised of a number of portfolio company investments made over multiple years, could have an extended harvesting period for a typical fund life of 10-12 years. Co-investing in individual companies would therefore potentially allow for a quicker deployment as well as return of capital, shortening the overall duration of the private equity portfolio and returning capital for future investment into new private equity opportunities.

As a result of these cash flow patterns, adding an allocation to co-investments can allow an investor to more quickly ramp the build of an overall private equity portfolio, investing capital in the ground earlier and reducing the time to achieve allocation milestones and overall objectives. Importantly, an allocation to co-investments can result in a combination of reduced fees and return enhancement from investment selection, limiting the returns.

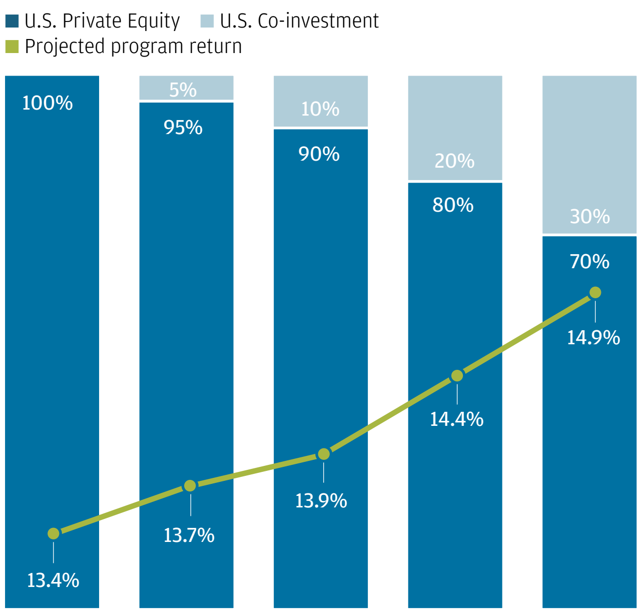
Key considerations for investors in private equity co-investments

Though there are clear benefits to co-investments, implementing a successful program requires unique skills and relationships to be properly executed. The expertise required to perform due diligence and execute co-investments is different than that required for fund selection. Co-investments by their nature are concentrated investments that have inherent risks, increasing the importance of investment decisions in driving returns. The key considerations for an investor considering co-investments are as follows:

Relationships and reputation

Meaningful relationships within the private equity market and a solid network of GPs are essential to drive attractive deal flow of co-investment opportunities. Though GPs may offer co-investments to certain preferred LPs or to all LPs, the LP's size and quality of relationship with the GP as well as the LP's reputation for being a reliable co-investor with speed and ability to provide solutions are critical to accessing opportunities.

EXHIBIT 3: PRIVATE EQUITY PORTFOLIO RETURNS WITH CO-INVESTMENT ALLOCATION[7]



Source: Cambridge Associates LLC Private Investments Benchmartk Index. Data as of 9/30/18. For illustrative purposes only.

Skill and experience

In addition to having relationships with a diverse array of high-quality private equity fund managers, an astute, disciplined approach to due diligence, strong underwriting standards and a forward-looking evaluation of co-investment opportunities are essential. Importantly, the resources and ability to rapidly process information and perform an additional layer of screening on top of the GP's due diligence can aid in avoiding some potential pitfalls of co-investing, such as companies that are outside of the GP's typical investment capabilities or are potentially riskier with greater downside, which could lead to adverse selection. Institutional investors must also be nimble, as often the co-investment decision timeframe is limited to a matter of days. This means having the capital and liquidity, legal resources, flexible investment guidelines, streamlined decision-making process and transaction capabilities to act quickly and decisively when attractive co-investments are identified. Lastly, investors need skill and resources dedicated to monitoring co-investments throughout their life.

Scale to build a diversified portfolio

As mentioned previously, private equity investments in general and co-investments in particular exhibit a wide return distribution. Additionally, research has shown that co-investment returns are heavily skewed, with median return of co-investments significantly underperforming the average return of co-investments[8]. Given this skewed distribution, investing in single co-investments will, on average, produce lower returns than the average private equity fund. Investors therefore will benefit most from co-investments if they are able to pick the best deals and also if they pursue a diversification strategy of a portfolio of co-investments. These elements of success require the LP to have access to – either through their own network or with the help of an advisor – a variety of co-investment opportunities from which to choose and the skill to construct a co-investment portfolio that is additive to the investor's private equity program.

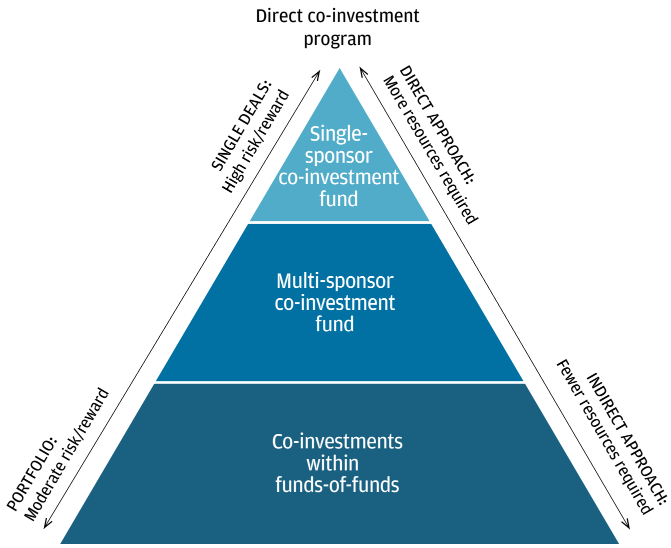
Implementation of a private equity co-investment program

While market dynamics may suggest the continued availability of attractive private equity co-investment opportunities over the near term, the market is likely to remain competitive. Institutional investors may choose to access co-investments

[7] Cambridge: Ready, Set, Co-invest, March 2019.

[8] Adverse Selection and the Performance of Private Equity Co-Investments, December 2018.

EXHIBIT 4: A SPECTRUM OF CO-INVESTMENT IMPLEMENTATION OPTIONS



For illustrative purposes only.

on their own, through GP-specific co-investment funds (if available), through a multi-sponsor fund or account or through a fund-of-funds with a specific co-investment allocation.

The implementation methodologies are shown in Exhibit 4 on a spectrum of risk/reward and required resources for implementation.

Direct co-investment program: Investors can develop an in-house program using internal resources only to source, diligence and execute co-investment opportunities. Though this approach allows for the most control, it requires significant internal team resources and is characterized by the highest risk.

Single sponsor co-investment fund: Some GPs offer co-investment funds that operate alongside their main fund. The co-investment vehicle will aggregate any outsized deal activity relative to its main fund that otherwise would have been offered as a co-investment. These funds often have management and performance fees associated with them, but are generally lower economic arrangements than the GP's main fund. Utilizing this option, to the extent a GP offers such a fund, LPs can pick which GP to co-invest alongside, but have no control over the underlying co-investments and often have to make a firm commitment to a co-investment fund that may not be fully deployed and could tie up capital that could be productively deployed elsewhere.

Multi-sponsor co-investment fund: In this implementation option, an asset manager or advisor manages a fund of co-investment opportunities made alongside a variety of GP sponsors with whom they have a relationship. Similar to single-sponsor funds, these vehicles typically have fees associated with them that are below typical standalone private equity fund fees. The success of these funds depends on the advisor's relationships, reputation and most importantly experience in executing co-investments. As with the above option, investors do not have control over the underlying co-investments, but this implementation option may generate a more diversified portfolio of high-quality co-investments across GPs if the advisor has the access and skill to pick the best opportunities.

Co-investments with a diversified fund-of-funds: Certain fund-of-fund vehicles have a dedicated allocation to co-investments. Fund-of-funds generally charge management and performance fees, which may vary by investment type. In these funds, co-investments are one portfolio component, along with primary and secondary fund investments, providing J-curve mitigation and potential return enhancement to a widely diversified private equity portfolio.

Whatever the chosen route, generating attractive returns ultimately requires relationships and reputation, skill and experience, and access to a variety of opportunities to successfully implement a co-investment program capable of enhancing overall portfolio returns.

Conclusion

Institutional investors looking to expand and/or diversify their private equity holdings are increasingly widening their search to include private equity co-investments given their attractive economics, ability to deploy capital quicker and mitigate the J-curve, as well as their potential to enhance overall portfolio returns. The growth of co-investment interest and the evolution of opportunities have shown no signs of slowing down. As with any private equity investment, implementation is key — the return dispersion of private equity, and co-investments in particular, is high and the average investment may not always outperform the public markets. Investors need to carefully weigh the risks and determine the best path for implementation, should they wish to allocate to co-investments and attempt to achieve the return enhancement they may be able to deliver. A carefully implemented co-investment portfolio can supplement a well-diversified private equity portfolio, providing an increased potential to achieve attractive risk-adjusted returns and overall portfolio return enhancement to meet an investor's needs and objectives.

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