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ACTIVE CO-INVESTING: WIDENING THE DEAL FUNNEL IN RESPONSE TO A HIGHER VALUATION ENVIRONMENT

By Andrew Bernstein and Andrew Beaton *June 2019*

Co-investments by limited partners ("LPs") in transactions led by private equity sponsors or general partners ("GPs" or "sponsors") has become a hot topic in the private equity community over the last decade.

Prior to the global financial crisis ("GFC"), there were only a limited number of LPs that were active co-investors. Consequently, when a sponsor needed additional equity capital to execute a transaction, that sponsor would typically bring in other GPs and form a consortium. These situations became known as "club deals".

Following the GFC, these club deals fell out of favor for a number of reasons:

- LPs found themselves unintentionally overexposed to certain companies because they were invested with multiple GPs;
- LPs found it difficult to ascertain deal attribution when evaluating sponsor groups;
- When club deals went wrong or needed further capital, these multiple sponsors did not necessarily agree on the solution, exacerbating the problems and sometimes leading to bankruptcy.

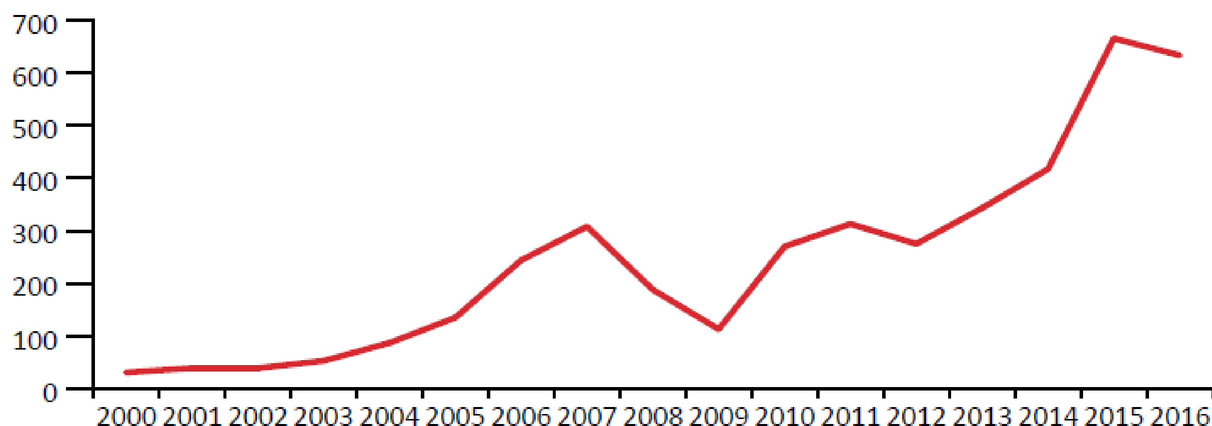
At about the same time, the LP community began to look to GPs to lower their fund fees. As equity returns have fallen in a lower inflationary, lower growth world, private equity fees stand out as significantly higher than other asset classes. In response, GPs increasingly embraced LP co-investment, on a no-fee, no carry basis, in the larger transactions that they were sponsoring. These GPs realized extending co-investment rights could solve two problems:

1. Offer their LPs lower fees on a blended basis, taking account of the co-investment and
2. Raise the additional equity for those opportunities where it was needed, while maintaining control.

Consequently, LPs are increasingly making co-investments in GP-sponsored transactions as illustrated in **figure 1**.

"LP CO-INVESTMENTS IN GP-LED TRANSACTIONS HAVE GROWN SIGNIFICANTLY OVER THE LAST DECADE AS INVESTORS LOOK TO MANAGERS TO LOWER THEIR FUND FEES."

FIGURE 1: GLOBAL CO-INVESTMENT TRANSACTIONS PER YEAR (COUNT)



Source: CEPRES database. November 2018.

The influx of new entrants to the LP co-investment market has also given rise to a wide divergence in how co-investors approach due diligence and investment selection.

In many cases, LP co-investors today (especially those with investment staff responsible for both fund and co-investments) make co-investment decisions based principally on an assessment of the sponsor rather than the deal itself. Such investors typically have less rigorous investment processes, with no desire for additional analysis beyond what the GP provides, and no need to meet the management team in person or negotiate legal documentation in detail. They treat these co-investments in a similar way as they do a commitment to the sponsors' next fund. There is recent academic research that this approach has its shortcomings and may lead to lower returns[1].

By contrast, certain other LP co-investors take a more hands-on approach and do significant incremental work. The prevalence of LPs who take a less rigorous approach, which can be construed by GPs as being more user friendly, presents issues for LPs that want to go deeper.

Many GPs appreciate the value of having a more experienced set of hands as a co-investment partner, especially when it comes to their ability and willingness to provide follow-on capital for an acquisition or when things do not go according to plan.

Others, of course prefer the path of least resistance and favor LP co-investors who ask few questions and do not insist on meeting management teams. **Figure 2** summarizes different co-investment styles.

At Capital Dynamics, the co-investment team is an experienced group of former GPs who believe that co-investment requires discipline and rigor. The team has sector specialization as well as a wide geographic footprint to be able to adopt a global strategy but undertake due diligence locally. Some GPs prefer our approach as it can help validate their own underwriting.

As we seek to balance risk and reward in a high valuation environment, and in an effort to lessen competition from less sophisticated co-investors we have begun to widen the universe of GPs with whom we are willing to co-invest. This broader group includes emerging managers, and in some cases, even independent or "fund-less" sponsors. Such GPs typically invest in smaller deals where valuations tend to be more reasonable. However, fund-less sponsors, unlike more established GPs, typically seek carried interest on this co-investment as they do not have a dedicated fund and must find co-investment for almost all of the required capital.

[1] "Investing outside the box: Evidence from alternative vehicles in private capital", Josh Lerner, Jason Mao, Antoinette Schoar and Nan R. Zhang, August 2018

FIGURE 2: CONTRASTING CO-INVESTMENT STYLES

	Passive	Active
Staff	Make fund investments and co-investments	Dedicated to co-investments only
Deal flow	Existing fund investment GPs	Both fund investment and fund-less GPs
Due diligence	Less rigorous	Substantial own due diligence
Deal economics and terms	Accepted as offered	Negotiation
Post-investment	No-involvement	Influencing lead-GP when needed

Historically, we have had a difficult time investing in deals sponsored by independent managers because of our resistance to paying economics, particularly carried interest, on co-investments. One objective of our co-investment practice is to lower the gross-to-net spread so prevalent in the high fee environment of private equity.

Over the past three-to-four years, as valuations across the private equity landscape have skyrocketed, we have noticed that opportunities shown to us by less traditional sponsors often seem to be more reasonably priced and have greater upside potential than deals we typically see from more established managers.

A key reason for this dynamic is that sellers who are willing to engage with managers that do not have committed capital tend to be relatively unsophisticated and if there is an intermediary involved, it tends to be more of a deal broker then an investment bank. In such instances, where base case returns pencil out well above what is typically seen in private equity, we have seen independent sponsors become willing to accept high hurdle rates before any carried interest becomes payable to them.

In select instances, this has enabled Capital Dynamics to bridge the bid/ask spread on economics with independent sponsors that had historically been a gating issue. But for those managers who have strong conviction in the upside potential of their deals, they can make more money if things go well by sacrificing economics in a scenario where returns are more pedestrian.

At Capital Dynamics, we get to expand our deal funnel to include these smaller deals with lower valuations and higher upside in a structure that ensures our net returns from co-investment meet or, more likely, exceed our target level before any economics get shared with the independent sponsor. In most cases, the amount of capital that we deploy in these situations is lower, but the expected returns are typically higher.

It should be noted that investing with independent sponsors is not for everyone. It necessarily requires a hands-on approach in due diligence as well as significantly more involvement during the life of an investment in comparison to a traditional co-investment. Investors in such deals will typically want to take a Board seat and also need to be prepared to take leadership of the transaction in a downside scenario or if the independent sponsor moves on to another opportunity.

LPs who choose to invest in these deals should ensure they have the proper resources to handle what can be a significantly more rigorous workload. However, if they do, there is an opportunity to build a co-investment portfolio consisting of larger transactions from established GPs interspersed with smaller, but higher returning, opportunities from independent sponsors.

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[2]As of March 31, 2019.

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