Building a mid-market co-investment portfolio

Guest comment by **David Smith** and **Oliver Schumann**

Intelligent portfolio construction can create outperformance and simultaneously mitigate risk over multiple market cycles

Over the last decade, co-investment funds have continued to develop and professionalise as the early approach to making individual co-investments often led to unsatisfactory returns. Here, we make the case for taking a global, actively managed and well-diversified approach to building a mid-market co-investment portfolio. We show that this approach leads to outperformance while reducing risk over multiple market cycles when compared with conventionally built portfolios. We call this 'intelligent portfolio construction'.

The secret of success

Independent academic research on the topic of co-investment has shown that a key success factor is the presence of a dedicated primaries platform with a broad and deep network of several hundred top-performing private equity fund managers. The scale of co-investment dealflow derived from this network permits the adoption of intelligent portfolio construction.

This expansive network complements the skillset co-investment managers should have to enable proper, comprehensive assessment of the characteristics of target companies and their management teams. The intelligent portfolio construction approach encompasses multiple diversification factors, including geography, sector, pacing/vintage and lead investor.

Empirical analysis of more than 1,000 co-investments among over 13,000 private equity transactions completed in 1981-2011 has shown there is no so-called 'adverse selection' and co-investments generally outperform investments not offered for co-investment by private equity managers. This outperformance is primarily attributable to the lower costs of a co-investment fund versus those of a typical mid-market private equity fund (i.e., approximately half the annual management fee and carried interest). Over this 30-year period, outperformance appears more frequently than underperformance and, on occasion, it can be substantial.

Intelligent portfolio construction also provides far greater downside protection than would be typical of a randomly selected buyout fund constructed by a single fund manager. To explore this, we conducted advanced proprietary simulations on 268 private equity funds with vintage years of 1995-2010 and their 4,739 underlying portfolio companies and found that, by using the spread between the median and lower decile measures of total value to paid-in capital (TVPI) as a measure of risk, a co-investment fund mitigates risk by 67 percent versus that of a randomly-selected buyout fund (i.e., a co-investment fund posts an increase in lower decile TVPI of 67 percent).

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Anticipating change

An experienced co-investment team adds value by capturing trends that take account of market cycles, deliberately over- or under-weighting a portfolio by region, sector, transaction size and/or structure. For example, emerging from the last crisis, there were good opportunities to invest in mid-sized industrial businesses with international expansion potential, particularly in Asia.

Later in the economic cycle (2014-16), the co-investor was offered the opportunity to invest in transactions with high-value creation potential, especially in software and services. More recently (2016 onwards), co-investors have looked for transactions that provide a higher degree of downside protection to safeguard against increased volatility. These examples reflect trends that experienced co-investment managers have followed over the last decade or so.

Academic research and advanced simulation studies confirm that investing in a global, well-diversified and actively managed co-investment fund can be an attractive way of generating outperformance, mitigating risk over multiple market cycles. ■

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