

CAPITAL DYNAMICS - 10 YEARS OF CO-INVESTING

Coming of age

Co-investing isn't the minority sport it once was. We asked David Smith and Oliver Schumann of Capital Dynamics to explain its evolution over the past decade

Ten years ago David Smith picked up the phone to give feedback on a fund opportunity to a prospective LP. "The head of IR at a firm I had backed for quite some time asked me to have a candid conversation with this investor," Smith recalls. "He wanted some colour on the firm's management team but one of the first questions he asked me was about a co-investment relationship I had with the fund."

It was then that Smith realised co-investment had developed from a niche strategy pursued by few into a much wider industry trend. Or in his words: "The cat was out of the bag."

Co-investments, in which LPs take direct stakes in portfolio companies alongside a fund, was historically only made available to LPs with sufficient negotiating pull. And even then the LP "would have been regarded as the cuckoo in the nest, the strange bird that could only get in the way of completing a deal," recalls Smith. "Today it is a complete sea change. GPs have woken up to the fact co-investments are a way of solidifying relationships with sophisticated investors."

Smith's Capital Dynamics colleague Oliver Schumann agrees: "Some GPs might say, 'I'm not sharing any of my deals with LPs, if they want more access to my portfolio they can go ahead and put more money in the fund and pay the fee'. Over the last decade that mentality has changed dramatically."

OFFERS TO ALL

Capital Dynamics launched its co-investment division in late 2006 after recruiting Smith, Schumann, Andrew Beaton and Luca Giacometti from GE Equity Europe, a subdivision of US conglomerate General Electric, where Beaton and Smith first met in 1990.

"When our team at GE made the move to Capital Dynamics it meant joining a fund

of funds which now has around 800 fund relationships from whom we could cherry-pick direct investments," says Smith, who stresses the importance of quality deal flow in making direct portfolio company investments.

In the mid-2000s co-investments completed the transition from being a contractual right only provided to investors in the know to an opportunity offered to virtually every LP, notes Schumann. "Part of that change had to do with the growing sophistication of private equity investors. Limited partnership agreements began prohibiting special deals for any one LP through most favoured nation (MFN) clauses, which prevent any type of preferential treatment," he explains.

However, an open co-investment offer to all of a fund's LPs resulted in a number of logistical challenges. "It was a cumbersome process for a GP to send every investor a letter offering a pro rata share of a €20 million co-investment in a German plant. Some investors might say they wanted to go beyond their share of the deal should other LPs bow out; others might send back long drawn-out responses that didn't make their intentions clear; and sometimes a minority of LPs wouldn't respond by the offer deadline at all."

The end result for GPs was having to micromanage a "sequential cascading pre-emption process", says Smith. "What happens when 20 percent of LPs reject an offer, forcing a GP to ask the remaining 80 percent if they're willing to take up more of the co-investment to complete the deal? Then, say 60 percent come back agreeing to the increase, leaving the GP to start the whole ordeal all over again. It's burdensome, intricate and complex."

GPs started asking investors to signal a range for commitment amounts but the underlying complexities remained. "Not

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every investor is able to assess the attractiveness of a co-investment in a two- to four-week time frame,” says Schumann. While some LPs enjoyed the thought of being offered direct investments, it didn’t mean they had the necessary consultants or in-house team to review each opportunity in that short time period, he adds. At Capital Dynamics, which took the in-house route, the co-investment team is made up of former GPs with specific industry credentials to assess deal flow quickly.

A MATURED STRATEGY

From 2007 onwards co-investment matured into its current form – a progression that placed co-investment rights firmly in GPs’ control after the hassle of open invitations. “Today, fund managers typically arrange side letters only with those investors who explicitly express an interest in

co-investment opportunities,” says Smith. However, there is no right to co-invest, meaning LPs must position themselves as attractive partners to a transaction.

Overall co-investing has evolved into a more methodical and efficient process compared to 10 years ago, says Schumann. A number of private equity firms are hiring dedicated staff to oversee the process, replacing an older, less disciplined system in which deal teams would have to work out which LPs wanted to co-invest and which didn’t.

Looking forward more and more LPs will look to co-investments as a way of bypassing management fees and increase returns. For GPs the evolution of co-investments as an ingrained feature of private equity means closer ties with institutional investors – clearly an advantage when fundraising is bound to remain difficult. 🌸



Schumann: more efficient processes



Smith: closer ties between GPs and LPs

CO-INVESTMENT PROGRESSION

