***From left**: Katherine Ashton, Corentin du Roy, Richard Hope, Erik Wong, James Pitt and David Smith*

How to be a good co-investor

In such a competitive market, even the most experienced co-investor cannot rest on their laurels. What should limited partners do to make themselves stand out, ask **Toby Mitchenall** and **Victoria Robson**

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The appetite for co-investment shows no sign of abating. The value of co-investment deals reached $104 billion last year, according to McKinsey. More than 70 percent of limited partners surveyed by the firm intended to boost their co-investment and direct investment capabilities. A record $96 billion was collected in the first half of 2018 destined for a combination of direct, co-investment and separate accounts, according to placement agent Triago, which speculated the figure could double by year-end.

With all this money to put to work and the number of would-be co-investors rising, LPs need to demonstrate their credentials. How does a co-investor prove they are the best source of capital?

First, think about your general partner as you would your customer, says Corentin du Roy, managing director at HarbourVest. "We have a GP-centric mindset. They don't owe us co-investment. We try to earn the right to be their partners and we do that through reliability and flexibility – we can cover all possible cheque sizes anywhere between $5 million and $400 million."

> ***Some of the legal documents, particularly in the mid-market, are simply not fit for purpose***
>
> **David Smith**

Then be inventive. "We think about the problems GPs face when looking for co-investment capital and how we can solve them," he says. "One solution that has been really successful is the warehousing concept that we first put forward about 18 months ago. We offer to be a single, exclusive co-underwriting partner to GPs. Post-signing, they can syndicate a portion of the transaction to other LPs who may not be equipped to co-underwrite with them. It's about coming up with something different, otherwise you are [only] bringing capital, and there's plenty of capital."

Take the partnership approach, says Pantheon principal Erik Wong. "The ability to engage at different points in the deal process is important to GPs, whether the co-investment commitments are from co-underwriting deals when GPs are submitting bids, or prior to GPs signing the deals, or post signing syndications, or in a rare case before GPs have a fund in place where co-investors warehouse transactions. Flexibility in bite size and flexibility to meet the GP's timetable are also important when PE firms look for co-investors."

DARE TO BE DIFFERENT

The keys to differentiating yourself are which GPs you choose to partner, as well as scale, efficiency and market insight, says Richard Hope, managing director at Hamilton Lane. "Efficiency means looking at deals and responding in a way that allows the GP to know where they stand. If you are going to say no, say it quickly. The big thing for GPs is certainty of capital. They want to know that you are there with money and can fund the deal."

After that, he says, behave in a way that does not compromise a transaction. "You get very privileged access to the GP and we all have to remember that. When your team is sitting alongside the GP, the questions you

ask and the role you play in the diligence are important."

How co-investors interact with the target business is a source of huge sensitivity for GPs, he adds. "The way you behave earns you the right to see the deal and then the next deal. GPs need capital and help from co-investors but they don't want a third party losing the deal on their behalf.

The quality of the primary capital you are offering counts, notes James Pitt, partner at Lexington Partners, which manages a $6.5 billion pool of co-investment capital for 11 large institutional investors, including US state pension funds. "These are large, sophisticated institutions that have been investing in private equity for some time and that's a draw for GPs."

LPs seeking co-investment must stay visible and remind GPs that they are relevant, he says. "GPs can forget quite quickly. You cannot presume they will always think of you first. We are constantly meeting GPs, working the annual meeting circuit, »

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>
> **Corentin du Roy**

Q Co-investors complain about lack of provisions in the documentation for follow-on capital. Is this justified?

"Some of the legal documents, particularly in the mid-market, are simply not fit for purpose," says David Smith, a senior managing director at Capital Dynamics. "Take a follow-on in a difficult situation. There will always be an emergency refinancing provision that allows the lead GPs to subscribe the equity to keep things on an even keel – and there should be." However, documentation is often missing an undilution right that would protect co-investors that cannot subscribe immediately, he adds.

"We've had a number of situations where that's not been in the document on first review. We always push here. And we've not done deals if we haven't had that right because it's simply not reasonable," Smith says.

Documents provide for follow-on capital but not in detail, agrees Debevoise & Plimpton partner Katherine Ashton. From the co-investor side, "it's still going to be at their discretion in many cases whether to put money into a distressed situation."

Overall, GPs take "very different approaches" to documentation, she says. "The mega buyout firms have tried to systematise their co-investment programmes and the documentation, partly to make it efficient and partly to increase their negotiating power. They say, 'this is our standard form and if you want to co-invest you have to sign up to these partnership documents that are exactly the same as our last one and we've redlined against changes and you've got a few days to agree to it'."

On the other end of the spectrum and in specific regions, "certain GPs are doing more complex transactions and bringing in one or two co-investors and doing increasingly bespoke documentation. There is much more negotiation around the tax structuring, some co-investors are asking for different requirements in terms of corporate governance, so the documents are more heavily negotiated," Ashton says.

» holding GP marketing events and attending conferences."

Highlight what's unusual about you. Capital Dynamics' co-investment team's legacy of direct investing in the 1990s before it turned to co-investing means it focuses on five sectors and "we're known for that in the market," says David Smith, a senior managing director at the firm. "Often we are approached as a result of that specialist approach."

The firm also leverages its global offices to assist in transactions, as well as its reputation for being "agile, (some might say) a bit unique," Smith says. "We'll do a take-private, for example, in a place like Poland, which not many co-investors will do. And we'll often come in 18-24 months after the original investment, when the GP is knocking up against its 15 percent single risk exposure threshold, and provide that much-needed follow-on capital to facilitate acquisitions or similar."

"Pace seems to matter increasingly," says Debevoise & Plimpton partner Katherine Ashton. "From a legal point of view, deals are often much, much faster, and my impression is that there is proportionately less post-close syndication of co-investment deals and more upfront funding at the beginning, which puts much more time pressure on negotiating the documentation, because it has to be done for the underlying target's acquisition schedule. And not everyone can do that."

HarbourVest has been increasing the size of its team "so we can do the upfront work rapidly", says du Roy. "As soon as an opportunity comes in you have to do a deep dive and decide within a couple of days how much conviction you have."

In the current environment, Lexington undertakes "relatively few truly post-close syndication deals", notes Pitt. Even GPs that can fully underwrite a deal, "want to know that they can syndicate down to their target hold. They don't want to be left with 20 percent of their fund in one deal."

> **Active portfolio management and discipline in maintaining portfolio diversification and limits are very important**
> Erik Wong

This GP approach to risk management is one legacy of the global financial crisis. As the market continues to heat up, the spectre of a turn in the cycle has started to hover over co-investment capital. Demand for co-investment can be more cyclical than the underlying GP direct investment market, says Pitt. "It is capital sitting on the sidelines and can be shut off if deal volumes drop during a downturn. A GP's first priority is to deploy its own fund capital. Even the committed capital co-investment programmes are typically discretionary. They don't have to be drawn."

Co-investing is much more widespread than it was pre-GFC. If another downturn happens, co-investors could have to make some "tough decisions" about providing additional capital to a struggling business. "Is the GP going to be faced with a scenario where they have to find new investors at a time when they don't want to be doing that?"

Having sufficient capital available to support portfolio businesses is one of the

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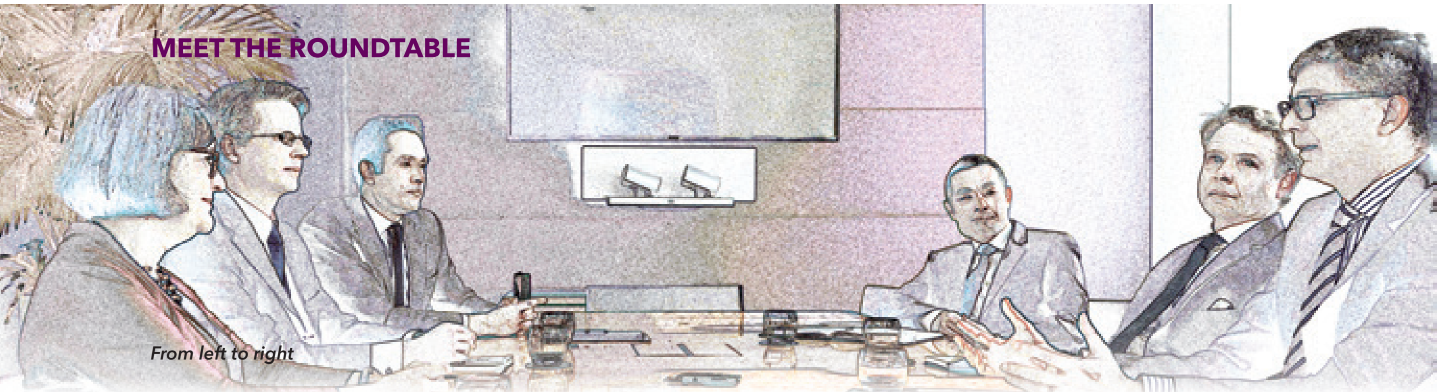
James Pitt

MEET THE ROUNDTABLE



From left to right

Katherine Ashton, partner, **Debevoise & Plimpton**
Ashton is a partner in Debevoise & Plimpton's corporate team. She is qualified to practice in England and the US and advises a broad spectrum of international private equity clients on corporate and securities matters, including direct investments, secondary acquisitions, fund recapitalisations and European listings.

Corentin du Roy, managing director, **HarbourVest**
A 15-year veteran of HarbourVest, London-based du Roy focuses on direct co-investments in buyout, growth equity and mezzanine transactions globally. He joined HarbourVest from Axa Investment Managers, where he was a research analyst.

Richard Hope, managing director, **Hamilton Lane**
In 2016, Hope was promoted to managing director in Hamilton Lane's investment team. He leads its European transaction team which combines secondary fund investment and co-investment activities. Before joining the firm in 2011, he helped establish Alliance Trust Equity Partners' private equity fund investment business.

Erik Wong, principal, **Pantheon**
Wong is a member of Pantheon's Global Co-investment Committee. Before joining Pantheon, Wong worked at the Abu Dhabi Investment Authority, where he was a co-investment manager. His previous roles include working at the IFRS Foundation in the UK, and Quilvest and PwC in Hong Kong.

James Pitt, partner, **Lexington Partners**
London-based Pitt oversees Lexington Partners' co-investment programme outside the US. Before joining the firm 13 years ago, he was head of the London office of Axa Private Equity (now Ardian). He started working in the private equity industry in 2000, prior to which he was investment banker at Morgan Stanley and a strategy consultant at Arthur D Little

David Smith, senior managing director, **Capital Dynamics**
Smith is a senior managing director on the co-investments team. He has over 30 years of experience in private equity and infrastructure financing. He previously worked with GE Capital in the UK and US, as well as with GE's European private equity businesses.

biggest lessons learned from the previous crisis, says Hope. "If it doesn't go right, can you continue to be there on the journey with the GP? If you don't have money or the tap gets turned off, that can spell trouble."

"That's the crux of the question," agrees du Roy. "In a downturn, if there is a financing need at a company in trouble, it's going to be a pay-to-play. You either participate or get crammed down completely or partially. I wonder if some of the more recent entrants into the co-investment market anticipate that correctly. They may think that a GP considers them as a client and wouldn't want to do that. But the reality is they will have to."

The presence of inexperienced co-investors in the market poses a risk, says du Roy. While LPs may be equipped to make an initial investment decision, they may not have the legal or monitoring resources to address issues at portfolio company level, he notes. "They may discover that it is a more complex business than they thought. The follow-up decisions are always the hardest ones. Do you want to support this investment or let it go? Are you putting good money after bad? That's where the problem lies."

The lack of clear visibility over other co-investors' programmes could be an issue, Pitt adds. "We all think hard about GP risk and try to co-invest alongside the best GPs, but we can't legislate for a concentrated co-investor which, for whatever reason, is no longer able to take decisions or provide follow-on capital for

> **You get very privileged access to the GP and we all have to remember that**
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> Richard Hope

CO-INVESTMENT VERSUS DIRECT SECONDARIES

Most co-investors plan to enter and exit a deal in step with other investors, notes Hope. However, "misaligned deals" where co-investors participate at a different point in the investment cycle and at a different price, are increasingly prevalent, he says.

"We know many GPs that have run competitive co-investment processes but [in reality] it's a deal sell-down for their own fund management reasons. [Such transactions] veer into direct secondaries. [As a co-investor] you've got to think pretty carefully about what you are doing at that point," he warns.

"However, GPs are typically sensitive and sensible about potential mis-alignment," says Wong. "They appreciate they are asking people to invest at a different point in time relative to their initial investment. They are typically sympathetic to the structure that a co-investor may require in order to minimise mis-alignment issues, such as putting in place a preferred structure or still participating in the deal albeit with a smaller bite."

"Ultimately," Wong notes, "the decision to co-invest years after the GP requires conviction that the GP can continue to create value in the next phase of the investment, and that the 'new deal' will provide an attractive return for our investors."

a transaction. These [investors] can hold quite large stakes in a transaction. GPs can syndicate as much as 50 percent of the equity to co-investors with potentially some quite concentrated cheques within the co-investment pool."

The reputational cost of not being prepared for difficulties can be significant. "Private equity is a world where reputation and reliability matters enormously," says Ashton. "You are co-investing as a partner for the long term, in down as well as up times."

The mega buyout firms have tried to systematise their co-investment programmes and the documentation, partly to make it efficient and partly to increase their negotiating power

Katherine Ashton

RISKY BUSINESS

However, co-investors do have tools at hand to counter the impact of a negative turn in the market. One way for them to protect themselves is to pick their partners well in the first place, says Wong.

"The primary investments in our platform are made with managers that have strong sector expertise and track records through economic cycles. So this provides us with some assurance of the quality of deals coming through our door, and also the capability of the sponsors to create value in challenging times. It doesn't guarantee that all deals will come out well, but the quality of portfolio of PE firms with whom we work gives our co-investment programme some built-in features to defend and mitigate the impacts of downturns."

Closer to home, portfolio construction has a key role to play. "Active portfolio management and discipline in maintaining portfolio diversification and limits are very important," says Wong. "For example, we tilt our sector exposures in favour of those whose relative valuations are attractive compared with others. In terms of pacing, this is also something that is within co-investors' control. We have made a conscious decision for certain programmes to put them on "diet" or dial down bite sizes despite the high level of dealflow. There are other diversification metrics that we set out and track for our programs such as number of investments, geography, type/stage of deals, etc."

Of all the ways to diversify a portfolio, the most powerful is vintage year, says Smith. "If you don't pace your investments properly and get that vintage year diversification right in your co-investment portfolio, you can get in a tough situation with so-called pro-cyclicality. The second most powerful is manager diversification. Sector diversification and geographical dispersion come third and fourth."

Now, when the market is flourishing, is the moment for co-investors to be discerning and disciplined, Smith cautions. "Markets experience good and bad times. Having the composure to make decisions in a balanced way is important. If the lead GP knows you are that kind of co-investor, that's helpful."

In the end, Smith says, "it comes back to reliability and how you differentiate yourself". ■