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CO-INVESTMENTS

Co-Investments: Strategies for Capital Deployment

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Over the years, the market for equity co-investments has grown meaningfully alongside the broader private equity industry. Both Limited Partners (“LPs”) and General Partners (“GPs”) alike have come to understand co-investing’s quantitative and qualitative benefits, resulting in the “mainstreaming” of the investment strategy.

According to Cambridge Associates, global private equity co-investment deal value was estimated to be approximately \$60 billion¹, or ~20% of overall private equity capital called from LPs. In this paper, we will explore:

- benefits of co-investing for LPs and GPs
- the typical co-investment process
- strategies for accessing co-investments, and
- certain key considerations in building a successful co-investment program.

Private equity co-investing generally refers to the process whereby an LP (the co-investor) invests alongside a lead financial sponsor (the GP) directly into a company. Typically, a GP will offer co-investment opportunities to LPs invested in the GP’s fund that have expressed an interest and have the ability to execute.

Benefits of Co-Investing for LPs and GPs

LP PERSPECTIVE

From an economic perspective, co-investing has the potential to afford LPs numerous benefits. First, a well-constructed co-investment program provides LPs with a portfolio of companies carefully selected from a larger universe of investment opportunities already handpicked by GPs. Second, co-investments are typically offered to LPs free of management fees and carried interest, which can significantly benefit net returns compared to investing directly in GP funds. Finally, co-investing allows an LP to deploy incremental capital alongside GPs, thus affording the LP an opportunity to both accelerate its investment pace and allocate dollars to specific areas of interest (e.g., industry or geography under/over weights).

In addition to the potential economic benefits, LPs can form closer relationships with GPs by working directly alongside them in a co-investment due diligence process. While the level of interaction between LP and GP varies on any single co-investment, the process should provide an LP with a better understanding of how the GP assesses, structures, and manages its investments. Importantly, these insights can help inform future fund investment decisions as a potential LP in a GP’s funds.



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GP PERSPECTIVE

For GPs offering co-investments, the most obvious potential benefit is that the additional capital may allow the GP to invest in larger deals (at entrance or via follow-ons) without compromising portfolio construction targets or having to cede partial control/governance to another party. The GP may also benefit from strengthening relationships with current LPs through the co-investment process and building new relationships with prospective investors for future fundraising efforts. Finally, experienced co-investors may be able to aid GPs with due diligence or provide useful perspectives throughout the underwriting process, which may lead to improved investment decisions.

Co-Investment Process

While every co-investment is unique, the graphic below details the stages and progression of a typical co-investment process from sourcing to post-closing.

Stages of the Co-Investment Process

1. SOURCING

- Existing GP relationships
- Prospective GP relationships
- Independent GPs
- Intermediaries

2. DUE DILIGENCE

- Review of sell-side advisor's and GP's company and industry research
- Discussions with lead GP
- Management/GP meeting
- Stress test financial model assumptions / sensitivities
- Reference calls

3. LEGAL/CLOSING

- Typically investing at the same time and on the same terms as the lead GP
- Legal determination that there is alignment of interest between the co-investor and the GP
- Engage outside counsel for regulatory, tax and suitability with LP side letter requirements

4. POST-CLOSING

- Receive financial reporting on an ongoing basis
- Board observation rights (potentially)
- Further engagement with GP for future follow-on equity rounds for acquisitions, equity cures, etc.

Implementing a Co-Investment Program

Investors have a variety of options on how to pursue co-investments: (i) develop the capabilities to evaluate co-investment opportunities in-house, (ii) establish a joint venture with an experienced co-investment manager, or (iii) invest in a manager's dedicated co-investment fund.

STRATEGY 1: DEVELOP IN-HOUSE CAPABILITIES

LPs may develop the capabilities to evaluate co-investment opportunities in-house. This strategy will likely afford the LP the greatest degree of control over their co-investment program and potentially strengthen the ties between the LP and its GP relationships. Developing a co-investment program requires a commitment of time and resources to building out a team with relevant co-investing expertise, as investing directly in companies requires a different skillset than investing in private equity funds. Whereas a team evaluating private equity fund investments focuses on manager selection criteria (track record, strategy, team, etc.), co-investment teams focus diligence narrowly on the merits and risks of single asset investments. Additionally, the LP will need to develop the requisite internal processes and infrastructure including, for example, a deal underwriting process and investment committee, an internal or outside legal team to execute transaction documentation, an outbound marketing program to educate the GP community of the LP's co-investment capabilities, and ongoing monitoring of the co-investment portfolio. The timeframe to respond to a co-investment opportunity can be short and unpredictable; LPs evaluating co-investments in-house will need to be responsive and flexible in providing feedback to GPs in order to be a valued co-investment partner.

In the long-term, in-house programs can prove cost-effective relative to paying a co-

investment fund manager. However, the cost of building the program is borne entirely by the LP. Significant human capital, money, and time will be needed to build a successful co-investment program.

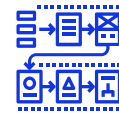
STRATEGY 2: ESTABLISH A JOINT VENTURE

Another potential strategy for LPs to access co-investment opportunities is through a joint venture arrangement with a co-investment fund manager. A joint venture will typically entail a dedicated co-investment fund manager evaluating co-investment opportunities sourced from the LP's existing GP relationships. In these arrangements, the co-investment fund manager may act as the LP's outsourced deal team to evaluate co-investment opportunities that the LP had access to historically but has not had the resources to properly assess. Key to the joint venture strategy is the inherent flexibility regarding terms, including economics, LP rights and discretion, and mandate structure. A joint venture may also allow the LP to capitalize on co-investment deal flow from existing GP relationships without the need to invest in the resources to evaluate co-investments in-house. LPs can also utilize a joint venture strategy while simultaneously developing their in-house capabilities to evaluate co-investments, potentially learning valuable insights from the co-investment fund manager throughout the deal underwriting process.

Due to the flexible nature of joint ventures with established co-investment managers, these programs generally do not have "one size fits all" economic arrangements and the co-investment manager may provide advantageous pricing if the LP is providing the deal flow.

STRATEGY 3: INVEST IN A CO-INVESTMENT FUND

Investing in a dedicated co-investment fund is another strategy for accessing the co-investment class with several benefits. First, established co-investment funds have dedicated investment teams with tailored



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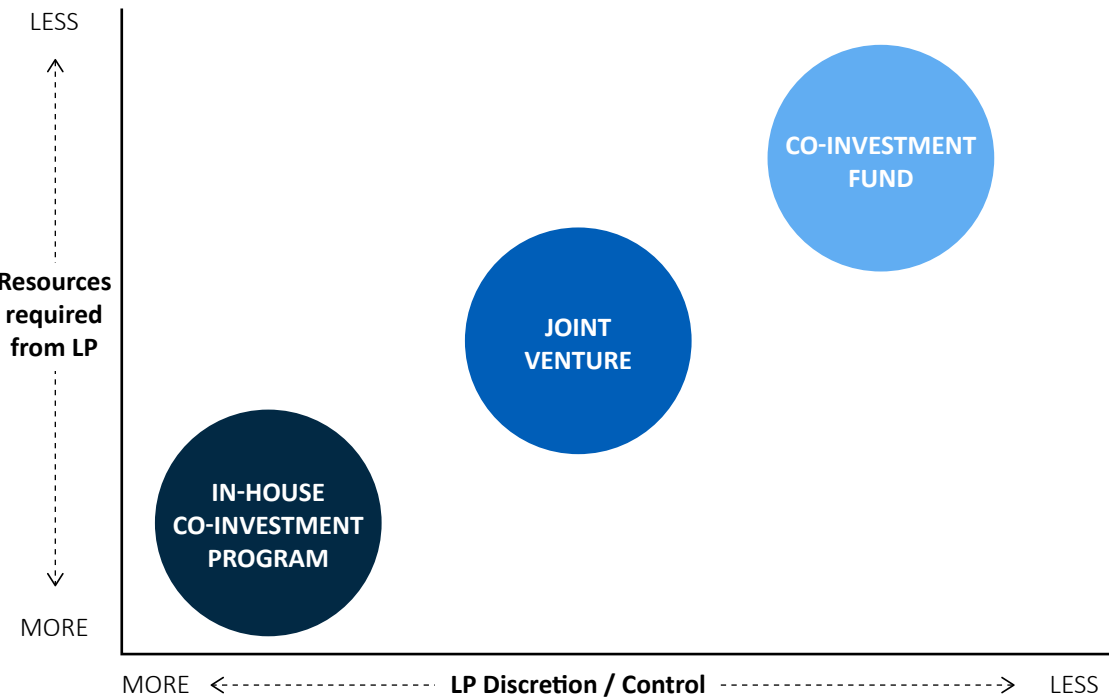
skillsets and a sole focus on co-investing and selecting high-quality investment opportunities. Second, co-investment funds typically have dedicated investment teams with verifiable investment track records, allowing prospective investors to evaluate the team’s historical performance. Third, established co-investment funds and their investment teams typically maintain deep relationships with an extensive roster of lead GPs, potentially providing access to deal flow and a broad universe of investment opportunities. Strong deal flow enables a high degree of investment selectivity due to the numerous opportunities available. Fourth, a dedicated co-investment fund has the potential to provide interested investors with a diversified pool of assets aligned with thoughtful portfolio construction. Lastly, investing in a co-investment fund allows investors to access co-investments without

needing to build out any capabilities in-house, which depending on an investor’s circumstances, may take significant time and resources to develop.

For LPs seeking to invest in a dedicated co-investment fund, one can typically expect to pay some combination of an annual management fee and carried interest (oftentimes with a hurdle rate). In turn, the LP will not need to dedicate time and resources to developing a co-investment program in-house, which can be costly and outside the LP’s core competencies. Investing in a dedicated co-investment fund can provide material cost savings relative to the traditional private equity fund terms, as co-investment funds typically charge less than the industry standard private equity fund pricing (commonly 2% annual management fee and 20% carried interest).



Each Co-Investment Strategy Offers Unique Benefits To LPs



Perhaps most important of all, LPs should be clear and decisive in determining what role co-investments will play in their investment portfolio.



Keys to a Successful Co-Investment Program

Adams Street believes that regardless of how investors choose to access co-investments, they should carefully consider certain keys to success when constructing a co-investment franchise. A first order consideration should be maintaining a consistent alignment of interests with the lead investor, which will ensure that a co-investor's eventual investment outcome parallels that of the lead GP. Co-investors should also prioritize building and maintaining a broad funnel of new pipeline opportunities, as a sizable pipeline allows investors to remain selective in only picking the "best of the best" co-investments. Additionally, prospective co-investors should consider the relative importance to their investment mandate of portfolio construction in the context of diversification by various criteria (e.g., sector, lead GP, geography, company size). Perhaps most important of all, LPs should be clear and decisive in determining what role co-investments will play in their investment portfolio, which will help inform which strategy is most appropriate for accessing co-investments. ■

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1. Auerbach, Andrea (Cambridge Associates). "Ready, Steady, Co-Invest." March 2019.

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