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Co-investments have seen massive growth over the past decade, but how will these deals fare as we navigate a covid-induced downturn? Toby Mitchenall and Vicky Meek look at how more uncertain times are shaping the co-investments of today – and tomorrow

Long seen by LPs as a way of boosting returns in private equity investment portfolios and forging stronger relationships with fund managers, co-investments have become an increasingly popular form of investment over the past decade.

While it's hard to put precise numbers on co-investment value and volume – many transactions happen off market and between individual parties – Triago puts “shadow capital”, which includes co-investment, separate accounts and direct investments, at \$206 billion in 2019, of which 32 percent, or around \$66 billion, is co-investment capital. Appetite among LPs has certainly been strong. A 2019 survey of LPs carried out by *Private Equity International* found 65 percent of respondents intended to deploy capital through co-investments over the following 12 months.

Yet much of the growth in co-investments occurred during a relatively benign economic period. As 2020 has unfolded and the pandemic and the resultant lockdowns have had an inevitable impact on entire industries, sectors

and individual companies, it's clear some co-investments will be facing difficulty, placing a potential strain on LP-GP relationships. Yet with challenge also comes opportunity – seasoned investors with capital are in a position to support strong GPs in a liquidity-constrained environment, generating good returns as well as goodwill.

Against this backdrop, we caught up with a panel of six co-investment veterans over Zoom in early October to discuss the current and future state of the market and how LP co-investors can ensure strong alignment of interest with GPs.

Indeed, when it comes to weathering storms, alignment sits front and centre for our co-investment panel.

“While, last year, a downturn was not so much on the horizon, 2020 has served to reinforce the lessons we already knew,” says James Pitt, the partner who leads non-US co-investments at Lexington Partners. “The first is that you need to co-invest with the very best GPs, who will be with you through the life of the transaction – for example,

there are some GPs that offered co-investments during the GFC that are no longer around. And the second is that you should be fully aligned with your GP partner on all parameters of the transaction, both economic and other.”

He adds: “In investments where there is no residual value, it's simpler to walk away; the more complex situations arise when there is heavy lifting required to recover value – and it's here that alignment and quality of GPs really matter because, as a co-investor, you have relatively little control and difficult situations can unwind quickly if not managed well. We are now seeing private equity investments where it's clear that co-investors will be losing money.”

Yet alignment is clearly more complex in co-investment situations than for fund investments. So what does good alignment look like for a co-investor? In part, it comes down to what Matthew Shafer, managing director and head of the New York office at Northleaf Capital Partners, calls “franchise alignment”.

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Schroder Adveq

“When we assess co-investments, we put as much effort into looking at whether the investment thesis and GP capability fit squarely with what they are trying to achieve as we do analysing the asset and the deal dynamics”

MERCEDES FERNANDEZ
Morgan Stanley Investment Management

GP’s sweet spot,” he says. “You don’t want to be part of a science experiment. You want to ensure that the GP has built fund capital around the type and sector of deal that you’re involved with so you know the transaction is important to them. You also have to visualise what the situation would be if the deal goes sideways and be clear that the individual partner has their personal track record and carry at risk if it doesn’t go to plan.”

Key to this is really knowing your GPs, says Mercedes Fernandez, executive director at Morgan Stanley Investment Management and partner in its alternative investment partners division. “It’s really critical at this point to understand your GPs’ knowledge and capabilities. When we assess co-investments, we put as much effort into

looking at whether the investment thesis and GP capability fit squarely with what they are trying to achieve as we do analysing the asset and the deal dynamics.”

Economic alignment is also an obvious – but vital – part of the jigsaw puzzle. “It all comes down to incentives,” says Pitt. “You want to invest at the same valuation as the GP and any other co-investors that may be involved. That way you maximise the chance that the decisions the GP takes are the same ones that you would under the same set of circumstances.”

Negotiating asymmetries

Follow-on situations can present even more knotty issues, particularly when the company is facing some degree of stress. Some of the complicating factors here can be situations where the deal is a particularly large investment for a GP – whose interest will clearly be in getting capital back – and where the GP relies on connectivity within the industry or is keen to maintain good relationships with the lenders.

Further, there is often information asymmetry in follow-ons, says Ian Lane, managing director and head of

global co-investments at HarbourVest Partners. “The lead GP is actively monitoring the investment as a board member, is deep in the day-to-day operations, and often overseeing negotiations with lenders,” he says. “By the time financing and structure details are finalised, co-investors may only have a few days to make a follow-on investment decision.”

Maria Claudia Prieto, senior investment director at Schroder Adveq, agrees. “Information asymmetry is the biggest challenge for LPs in these situations because the GP would have naturally followed developments in the company closer and over a longer period of time,” she says.

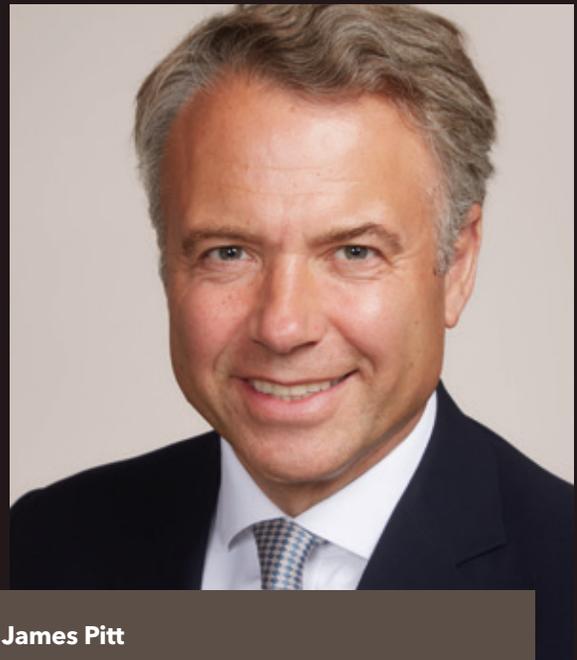
“In that context the most essential element of alignment is a strong relationship through primary fund commitments. LPs also need to have reserves available for follow-on capital injection despite the opportunity cost. Not having follow-on capital can put co-investors in a very bad position.”

Misalignments between co-investors have come to the fore over the past year as some companies have become troubled, says Katherine Ashton, partner and leader of the alternative asset

Katherine Ashton

Partner
Debevoise & Plimpton

Ashton regularly counsels investors on private fund restructurings, recapitalisations and tender offers; listed fund transactions; purchases and sales of portfolios of LP interests; and complex co-investment transactions.



James Pitt

Partner
Lexington Partners

Pitt joined Lexington, one of the world's largest managers of secondaries and co-investment funds, in 2006. Based in London, he co-heads the firm's private equity co-investment business.

Mercedes Fernandez

Partner
Morgan Stanley AIP

Fernandez leads Morgan Stanley AIP's European investment programme. Prior to joining, she was on the investment team at MCH PE and a management consultant at KPMG.





Ian Lane

Managing director and head of global co-investments
HarbourVest Partners

Lane joined HarbourVest in 2003 and focuses on direct co-investments in venture, buyout and mezzanine transactions, and serves as the chair of the firm's direct investment committee.

Maria Claudia Prieto

Senior investment director
Schroder Adveq

Prieto covers Adveq's investment activities in Europe, focusing on co-investments, emerging managers, club funds and turnaround investments. Before joining in 2013, she worked on co-investments and structured finance at Capital Dynamics.



Matthew Shafer

Managing director
Northleaf Capital Partners

Shafer oversees the origination, evaluation and monitoring of Northleaf's private equity investments, and leads the firm's New York office.



and secondary investments group at Debevoise & Plimpton.

“Some areas of conflict we see are around some investors having a bigger stake than others, some going in at different valuations and then there are tax considerations, which can differ

between investors and affect co-investor alignment,” she says.

Co-investments continue to be completed predominantly on a no-fee, no-carry basis – our panellists were clear they resist attempts by GPs to charge primary fund economics for co-investment deals. However, there may be exceptions.

“Most co-investments in the market are still on a no fee, no carry basis and GPs understand that this is an important element of the overall LP-GP relationship,” says Prieto. “Where we have started to see some fee pressure is usually in relation to balance sheet investors who, in some cases, have a lower cost of capital, or investors with smaller teams and resources, who are usually unable to offer other value-add.”

The growth of large firms into different areas, such as consulting, is an emerging area of potential concern when it comes to alignment. “Many of these divisions may play different roles in the company during the life of the investment,” says Ashton. “There is an increasing tendency to do affiliate transactions, for example, and then charge other fees beyond the expected management fees – this is an area our co-investment clients are really focused on because if the GP has an additional cashflow coming in, that may well shape and drive the decisions being made, especially in troubled assets. This also has the potential to weaken expected returns to co-investors as cash is siphoned off through fees.”

A bridge to fundraising

The covid-19 storm may well have concentrated minds on current co-investments, but it is also playing into new opportunities and accelerating some existing trends.

“GPs have been increasingly turning to trusted co-investors to support their investment activities in 2020,” says Lane. “They seek responsive LPs who can act with speed, have the skill

Deal mechanics

One trend that looks to have been accelerated by covid-19 is the increased prevalence of deals being co-underwritten by co-investors rather than being syndicated by GPs.

“In general, I would say that we have seen relatively less of the straightforward, post-close syndication opportunities in these uncertain times,” says Lexington Partners’ Pitt.

“There’s clearly room for both syndication and co-underwriting, but the current environment is playing more to the advantages of the latter – where LPs can write bigger cheques, have an earlier look at the deal and receive the allocation they are looking for, while offering certainty of close to GPs, who may be concerned about portfolio concentration risk in a more challenging environment for fundraising, if a co-investment were not to be fully syndicated.

“We have seen some GPs being left holding syndication bridges and we are still getting co-invest calls about deals completed months ago. The downside to co-underwriting, of course, is that you don’t always win the deal and then co-investors can be liable for broken-deal fees.”

And while some of this trend is underpinned by greater capability and experience among LPs to co-underwrite, it is also being driven by regulatory concerns.

“There has been a lot more scrutiny by regulators – most notably the SEC – around the risk a GP takes in instances where, for example, a GP might over-commit and syndicate later,” says Ashton of Debevoise & Plimpton. “They are also looking closely at how investments are allocated among LPs. This is playing a role in the move towards co-underwriting, but has particular relevance as we stand in a pandemic environment where GPs want to reduce execution risk early on by going to large co-investors with opportunities.”

And, on the topic of broken-deal fees, Ashton says it’s vital to ensure these costs are fairly shared and allocated, especially in a more challenging environment when failed deals will be more commonplace. She points in particular to reverse transaction fees, which penalise buyers if they walk away and can amount to between 5 percent and 8 percent of the equity value.

“We may see more failed deals,” she says. “And as a co-investor, you may well be liable for a share of broken deal fees, even though you may have less say than the GP about whether a deal goes ahead.”

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KATHERINE ASHTON
Debevoise & Plimpton

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JAMES PITT
Lexington Partners

sets to understand complex deal attributes and who can reliably support transactions by committing capital and sharing risk.”

In the early days of the pandemic, this translated into GPs tapping co-investors for funding to help companies respond to the crisis – to shore up balance sheets, repay debt maturities and finance M&A transactions using more equity at a time when debt markets stalled, for example. Now, the focus has moved towards transactions that were put on hold or on to new opportunities.

And co-investors are increasingly being called to support deals being done by strong GPs that have fallen prey to a more difficult fundraising environment. “We are seeing some GPs delay fundraising,” says Fernandez. “They are looking for solutions that

help them do deals and seed funds. We’ve also seen an increase – and this has been true for a number of years – in the number of independent sponsors that operate through deal by deal or who invest without a fund in place.”

Fernandez also points to the existing trend of buy-and-builds as an opportunity for co-investors. “It’s a theme we continue to see in the market as GPs seek to accelerate their value creation plans in the current environment,” she says.

One area of the secondaries market that has seen significant attention over the past few years has been GP-led secondaries transactions. Yet related types of investment, involving the recapitalisation of a single asset that rolls over into a continuation vehicle, have attracted co-investors, leading some to

talk about blurring lines between secondaries and co-investments.

“These can present challenges for co-investors, but also strong opportunities,” says Shafer. “This can play into firms that have both co-investment and secondary programmes. We like these deals as they offer a very different risk profile from a traditional co-investment. You don’t have the transition risk of a new owner coming in and you have continuity that provides a floor on the downside.”

However, they can also have an in-built ceiling on the upside, he adds. “We pay a lot of attention to whether there is a catalyst. You don’t want to be in a deal where the sponsor will continue to manage the asset on a business-as-usual basis – there has to be a clear value-creation proposition and there has to be a shorter path to exit than in a brand new buyout.

“But you also have to look at how the deal affects the economics for the GP. Are they just doing the deal to crystallise carry? Or do they genuinely believe they are the best owner for the next phase of the company’s development? And you have to consider whether management remains aligned. If they are taking liquidity, you need to be comfortable with how that is being done.”

Buyers entering this market will have to be highly selective. Lane points to recent deals where high-quality GPs

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IAN LANE
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MATTHEW SHAFER
Northleaf Capital Partners

pursue a mid-life transaction with the goal of extending the hold period for a high performing asset. “I predict that the scope of mid-life transactions will change over time,” he says. “Instead of being available to only the highest performing, most stable companies, GPs will consider recapitalisation and early liquidity opportunities across their portfolios, creating an increasingly common source of liquidity for private equity funds.”

New opportunities

Caution will be the watchword of the coming 12 months as covid-19 continues to create uncertainty, but with many of the panel seeing record dealflow over the summer, there looks set to be plenty of opportunity to come in

the co-investment space, assuming investment activity holds up.

“We might see more buy-and-build deals,” says Fernandez, “and there might be increased complexity in deals, such as carve-outs and public-to-privates. GPs that are in between fundraisings might look to warehousing solutions to enable deals to go ahead, and a potentially more conservative environment might lead to higher equity ratios – all of these play into the strengths of experienced co-investors.”

“On the fundraising point,” adds Pitt, “there will be a raft of high-quality managers that find their fundraising plans disrupted. They will want capital to complete transactions, while ensuring that at the same time their portfolios are well diversified. Assuming

deals continue to be done, co-investors should be well positioned in terms of dealflow over the next 12 months.”

Prieto and Shafer see further opportunity in single-asset continuation fund deals. “We may even get to a situation where you see a GP doing a continuation fund of a continuation fund for a strong growth asset in the not-so-distant future,” says Prieto. “And while there will be interesting opportunities for co-investments in the GP-led space, it will also be important that good companies are put back into the market.”

Shafer predicts “the next year will see single asset continuation vehicles make a meaningful dent in the sponsor-to-sponsor M&A deal markets, especially as mainstream investment banks become more familiar with this and start adding this as an option for sponsors at the point of exit”.

And, while there will undoubtedly be some tests along the way, the bridges already built between GPs and their co-investors may well be strengthened. “There will be a flight to quality among GPs,” says Ashton. “They will consolidate and build the relationships with LPs they know and trust as opposed to breaking into new relationships.”

“It took five years for venture capital to work through the aftermath of the 2000 tech bubble,” says Lane. “With a strong response from central banks and government intervention, it took approximately two years for private equity to manage through the GFC. Today, the central bank and fiscal support has been even more rapid. This, combined with significant dry powder and the quick return of credit and equity markets, has resulted in a fast bounce-back in deal activity and record demand for trusted LP co-investors who can support GPs in securing and closing new investments.” ■