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Are you ready to co-invest?

LPs are raising their hands to snatch a piece of the co-investment opportunity, but are they prepared for what follows? By Adam Le and Victoria Robson

There is no doubt the co-investment market is now well established. LPs are clamouring to access the co-investment dealflow valued as high as $60 billion by Cambridge Associates, and accounting for around 20 percent of market activity. We asked our expert panel, given the extraordinary level of appetite, what proportion of LPs are truly equipped to take part?

"It depends on your definition of taking part," says James Pitt, partner at Lexington Partners. "Most LP co-investments are now made into a partnership and, if an LP can close a fund commitment, they can close an LP co-investment. The 'taking part' is fairly easy. However, the considerably more complex task is sourcing a high-quality stream of co-investment opportunities, evaluating them in real time, constructing a well-diversified portfolio and the monitoring it over time. Running a process end-to-end is considerably more difficult."

"We ask our GPs this question every year," says Nick Kavanagh, vice-president at Hamilton Lane. The response is telling. "They say of all those LPs that ask for co-investment, less than a quarter consistently transact. Plenty are dipping their toes in the water and doing the odd transaction but not in the structured way you need to build a diversified portfolio."

When assessing co-investment capability, our panellists agree it depends on the deal. "Over the past 10 years, the market has separated into post-close syndications, which are relatively accessible to most LPs, and the co-underwrite market," says Corentin du Roy, managing director at HarbourVest Partners. "The co-underwrite market has grown in line with the capabilities of LPs and taken greater share as a portion of all co-invest capital deployed, but co-investment co-underwriters are few and far between because the execution, resource and investment requirements for these opportunities are much higher."

Du Roy also points out that determining if an investor is adequately set up to partici-

PHOTOGRAPHY: **JULIAN WINSLOW**

Corentin du Roy
Managing director, HarbourVest Partners

Corentin du Roy joined HarbourVest in 2003 and focuses on direct co-investments in buyout, growth equity and mezzanine transactions around the world. At HarbourVest he has worked on deals including Deliveroo, Eaton Towers, Klarna and Marle. He joined the Firm from AXA Investment Managers, where he was an equity and high-yield debt research analyst focusing on the telecom sector.

Kate Ashton
Partner, Debevoise & Plimpton

Kate Ashton is a corporate partner at Debevoise & Plimpton with a broad international practice, including extensive experience in Europe and the US in private equity transactions, corporate finance, debt and equity offerings and restructurings. She counsels private equity and other investment funds on corporate and securities matters. Ashton is dual-qualified in England and the US.

Raja Hussain
Director, BlackRock Private Equity Partners

Raja Hussain is a member of BlackRock Private Equity Partners' investment team, based in London. He is responsible for co-investment and co-underwrite transactions in EMEA across a range of sectors and deal sizes. Hussain previously worked in the private equity coverage team at Citi. He began his career at Ernst & Young where he was a chartered accountant in the M&A team.

James Pitt
Partner, Lexington Partners

James Pitt is a partner of Lexington Partners responsible for international co-investments. Prior to joining in 2006, Pitt was head of the London office of AXA Private Equity. He was previously a managing director of JH Whitney & Co and a vice-president in investment banking at Morgan Stanley. Pitt has a BSc (Hons) in Management Science from City, University of London, and an MBA from INSEAD, France.

David Morse
Managing director, Neuberger Berman

David Morse is a managing director of Neuberger Berman and the global co-head of private equity co-investments. He is also a member of co-investment, private debt and private investment portfolios investment committees. Morse joined Lehman Brothers in 2003 where he helped raise and invest Lehman Brothers Merchant Banking Partners III. He was also previously a founding partner of Hampshire Equity Partners.

Nick Kavanagh
Vice-president, Hamilton Lane

Nick Kavanagh is a vice-president on Hamilton Lane's global investment team. Based in London, he focuses on co-investment transactions. Prior to joining Hamilton Lane in 2017, he worked on co-investment transactions at Temasek International and at Pantheon Ventures, as well as at Gresham Private Equity. Kavanagh has a BSc from Cardiff University and postgraduate qualifications from Warwick University.

pate in the co-investment market can come down to the health of the broader economy.

"They may be [equipped to take part] in a market that is only going well and with an economy that is supportive. I advise our LPs when they tell me they want to get into co-investment that they need to have the resources to cope with a crisis, and a market in which a number of their companies may struggle," he says, adding the co-investor are likely to be called upon to make tough decisions on whether to provide follow-on capital in situations where they may no longer be fully aligned with the lead investor.

Public to private

"The co-underwriting world has become more exciting and interesting," says Kate Ashton, partner at Debevoise & Plimpton. "Particularly with the larger stakes that some co-investors are taking, LPs can't just put their money in and wait. Even when investments are not in crisis, unexpected events occur, and if you have a significant stake in a company you need to monitor that and pay attention to it. I'm not sure everyone in the co-investment market is equipped for that."

"[Co-investors] need to take the bruises with the rewards. Provided your portfolio is sufficiently diversified and you have that breadth of dealflow, you can potentially take the hit of broken deal costs on a transaction"

RAJA HUSSAIN
BlackRock Private Equity Partners

In co-underwriting situations, more deals fail, Ashton says.

"Particularly with the trend [in Europe] toward public-to-private transactions, which are inherently less predictable and riskier, the deal may collapse. Co-investors need to assess the likelihood of a deal not proceeding and the cost. Some are not set up to do that and won't take that risk. Syndications are less time-pressured – the deals arrive more slowly, are calmer and frankly the co-investor has less negotiating power."

In public-to-private transactions, where the disclosure burden can be heavy for companies in regulated industries and legal costs can soar, "the bar is high and I think for these deals we often don't see other co-investors than the ones around this table or similar organisations participating", says du Roy.

It is surprising how many co-investors are not positioned to participate in public-to-private transactions, notes David Morse, global co-head of private equity co-investments at Neuberger Berman. "Those co-investors who want to play in the co-underwriting space typically need to execute equity commitment letters, as well as

be willing to stand up for dead deal expenses and reverse break-up fees. There are lots of significant co-investors who cannot or will not subject themselves to that."

Raja Hussain, director at BlackRock Private Equity Partners, agrees. "Executing a pre-bid co-underwrite requires a different capability and skill set than a completely signed-up deal with price validation, leverage structure and terms in place. A meaningful percentage of transactions we see are co-underwrite. Then it's a question of what resources the co-investor can bring to the table to help enhance the due diligence process. There are a lot of LPs coming into the market trying to source deals but don't have the capability to co-underwrite and execute."

That said, the syndication market poses its challenges too. "Securing an allocation is getting tougher," says Morse. "LPs don't do the work expecting to get winnowed down. [In contrast] when you co-underwrite, you pretty much get what you ask for."

The biggest difference between co-underwriting and syndication is that "the GP is not trying to sell you into the transaction", says du Roy. "On a co-underwrite they don't know yet if they want to proceed with the deal. Their primary focus is on establishing a valuation. As a co-investor, you have a more transparent relationship with the GP and in return, you need to be flexible. A GP can come to you at the 11th hour and you need to act fast."

Ashton agrees the pace to close a transaction has picked up considerably.

"We are talking days [to assess a deal]. It's really important for our [co-investor] clients to have a large and dedicated team. And as service providers we need one too."

For a co-investor seeking to maintain a good relationship with GPs, it's crucial to be able to turn down an opportunity very quickly to free them up to talk to another potential interested party, adds Ashton.

Picking up the pace

Tighter timeframes are crucial, says Morse.

"You can't say my board meets once a quarter or the next one is at some point in the future. Neuberger Berman Private Equity has two standing investment committee meetings a week. We have our IC wired to be available when they need to be."

In an increasingly mature market, deal structures are also becoming more complex. Du Roy notes that HarbourVest will supply equity to "warehouse" a transaction on behalf of a GP that may be in between fundraises.

Morse says Neuberger Berman will often agree with a GP to syndicate part of its co-underwriting stake post-close. "Just as long as we're guaranteed on a minimum hold, we're generally comfortable doing it. And we better be ready to hold all of the stake if their subsequent syndication is not successful," he adds.

However, Ashton cautions: "These sort of creative strategies are not for everyone. You need to have a team that can do the analysis and the due diligence necessary to take that level of investment."

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> **JAMES PITT**
> **Lexington Partners**

Fees and returns

Should a co-underwrite deal fail, the allocation of broken deal expenses is an issue co-investors grapple with. Panellists say co-investors generally take their pro rata share of monitoring, refinancing and exit fees.

"There's scope to negotiate on those fees particularly if, as a co-investor, your involvement is critical to that deal," Kavanagh says. "If you are an enabler there's likely enough value add from you as a co-investor to try to warrant navigating that cost dynamic."

Hussain takes the view that co-investors "need to take the bruises with the rewards. Provided your portfolio is sufficiently diversified and you have that breadth of dealflow, you can potentially take the hit of broken deal costs on a transaction, which we would consider selectively on a case-by-case basis", he says.

In the broader fee landscape, just like the "two-and-20" regime applied to funds, the no fee/no carry arrangement driving demand for co-investment persists largely unchallenged. "I can think of only one GP that charges carry to their fund LPs on co-investments," says Pitt.

But that might change. "The majority of the market is still no fee/no carry provided you're an LP of the fund," says Hussain, adding that "at the margins certain GPs are testing the market by trying to overlay some element of economics to rein back some of that supply of co-investment capital".

And there are other less obvious costs.

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KATE ASHTON
Debevoise & Plimpton

"Looking at the total drag of economics on a deal, the management incentive plan is usually a meaningful part, and there are certain GP costs and expenses that are implemented onto the portfolio company, like monitoring fees that can result in dilution," he says.

So, given the effort required, does co-investment actually boost returns?

"What's missing from the question is, at what risk?" notes du Roy. "That's the element that is often underestimated. Yes, you can aspire to top decile performance by trying to build a more concentrated portfolio. However, our advice to our clients is to build a well-diversified co-investment portfolio to achieve strong performance that is accretive, but without taking undue risk."

Some co-investment fund managers go a step further and claim they can outperform GPs on plain vanilla co-investments, says Pitt. "I think, really? Desktop research, perhaps not meeting the management team and never really getting properly under the skin of a business and you think you can consistently outperform some of the best GPs out there? You might get lucky occasionally. As long as generally you're able to source quality dealflow from a top tier group of GPs you should do well. But if you're consistently top decile, I'd be very surprised."

Competition

In the quest for co-investment, capital is not everything. Would-be co-investors need to stand out from the crowd. One way to do that, says Pitt, is by "being proactive and highly responsive".

"Repeat business with GPs is hugely helpful. You've not only got to provide fund capital yourself, but also help with things like making capital introductions to new prospective LPs."

Nothing can replicate repeat business, says Kavanagh. When positioning themselves to see dealflow, how early and frequently a co-investor can engage with the sponsor, and specifically who at the manager they talk to, are important, he says. "We are engaging more with GP sector teams

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> **CORENTIN DU ROY**
> **HarbourVest Partners**

Downturn? What downturn?

"The prevailing general wisdom every year for the past five years has been that we've got another 12-18 months before we enter a recession," says Pitt. Lexington's response is to focus on diversification, limiting single investments to 1-2 percent of its portfolio and ensuring "right business, right capital structure and right sponsor – one you clearly think can manage through a downturn.

"You've got to be adequately resourced. It's going to be extremely interesting to see how those more recent co-investor entrants react come a market downturn. Their institutional experience is much shorter."

When Hamilton Lane assesses a deal, it's looking not only at whether the sponsor is the right owner of the business, but how reactive or pre-emptive that sponsor has been historically in preserving value, says Kavanagh.

"With the amount of dollars people are investing, the natural inclination [for a co-investor] might be to roll up your sleeves and see if you can engage with a business yourself, but we believe that it is important to maintain trust in that GP and consider such a potential scenario carefully when choosing to invest. It will be interesting to see how harmonious that co-investor/GP relationship remains going forward."

However, the rise of covenant-lite debt financing and the proliferation of private debt funds means "there's a significant amount of de-risking in the market now, relative to pre-financial crisis", says Hussain. "How these funds will react when a business underperforms and hits covenant levels is yet to be tested, but our view is they will take a different view relative to the banks and be more collaborative with GPs."

Defensive portfolios

Ashton stresses that as a potential downturn approaches, it's important for co-investors to have the resources to continually monitor investments.

"The people who are going to do best are the ones who are willing to commit the time and energy to figuring out what can be done. There may be companies that face temporary periods of distress and can be pulled out of it, but it will take a lot of dedication and effort."

For Morse, defensive portfolio management is key. "We've been building a defensive portfolio for four years now. We seek to avoid cyclicals, heavy capex businesses and heavy working capital businesses," he says. Buying larger businesses can help weather the storm, he adds.

"We would prefer to buy a $150 million EBITDA business over a $15 million EBITDA business if they are going to trade at that same multiple based on our expectation that a larger business would have a deeper management team, better access to capital markets and would be national not regional, international not domestic," Morse says.

Such businesses are typically in industries with more barriers to entry and as such have a reason to exist, he adds.

"We are engaging more with GP sector teams to ensure we're front of mind when they look at situations"

NICK KAVANAGH
Hamilton Lane

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> **DAVID MORSE**
> **Neuberger Berman**

to ensure we're front of mind when they look at situations. For example, if we do a TMT deal with a sponsor and it's a good experience for both sides, going forward we're increasingly getting a call from that deal partner directly."

At the portfolio company level, underlying management teams are curious to get to know the investors and are requesting meetings early in the process.

"We can overlay some diligence into that, so it's mutually beneficial and it's also good courtesy to show management teams who you are."

Mirroring increased GP specialisation, co-investors are becoming more adept in certain sectors, learning the language and keeping an eye on trends.

"Software, financial services, healthcare, anything heavily regulated, we have people who have gravitated to those sectors and it certainly helps," says Morse. However, he adds, "co-investment is an opportunistic business and you don't know if the deal is going to be a retailer one day or a business services company the next. You have to be a generalist at some level".

And then there is the issue of resources. "There's GP overlay and geographical overlay," says Pitt. "The reality is, co-investing is a complex matrix and there are certain sectors where there is sufficient volume to make specialisation worthwhile. But our teams, at the end of the day, are finite." ■