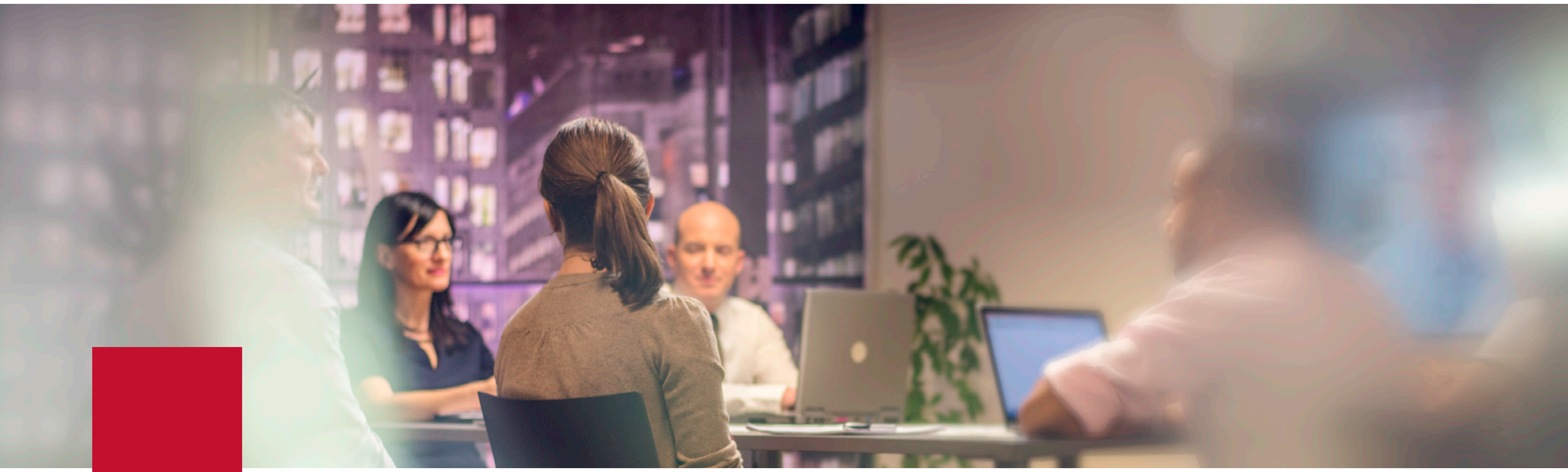

PRIVATE MARKETS INSIGHTS: CO-INVESTMENT SERIES

THE MECHANICS OF CO-INVESTING

This is the second paper in our series on co-investing, which investors have been drawn to for its potential to generate outperformance at reduced costs, as well as the opportunity it brings to be more actively engaged in managing their portfolios. Part I highlighted the key benefits and risks of co-investing, and Part II picks up where we left off by examining the different stages of a deal, and the highly specialized skills required to successfully navigate each phase. Throughout the series, HarbourVest's global co-investment team—which has invested more than $6 billion of co-investment capital since 1989—will share its collective insights and experiences to help make you a more informed co-investor.

Co-investing is attracting attention from more investors for a number of reasons, most notably the potential it offers to generate attractive returns by providing access to private equity deals at reduced costs. Lower fees alone, however, do not result in outperformance; the investments themselves drive performance with lower fees serving as an enhancer. Accordingly, the challenge for an aspiring co-investor is finding, and ultimately selecting, the best deals possible.

While there is no magic formula that guarantees success, it is critical for you to understand the key aspects involved in each step of the co-investment process.

As a starting point, let's focus on the four foundational components that comprise any co-investment transaction: 1) sourcing, 2) evaluating, 3) closing, and 4) monitoring and exiting. Each stage *(Chart 1)* is distinct from the others and demands specialized knowledge and skills for successful, timely execution.

Importantly, the co-investor's level of engagement and participation will vary depending on the type of deal they are offered, as well as their own specific approach to the process. Generally, active co-investors participate across all four of these stages, provided that they have the necessary skills and expertise to navigate each. For passive co-investors, involvement is typically limited to the closing phase.

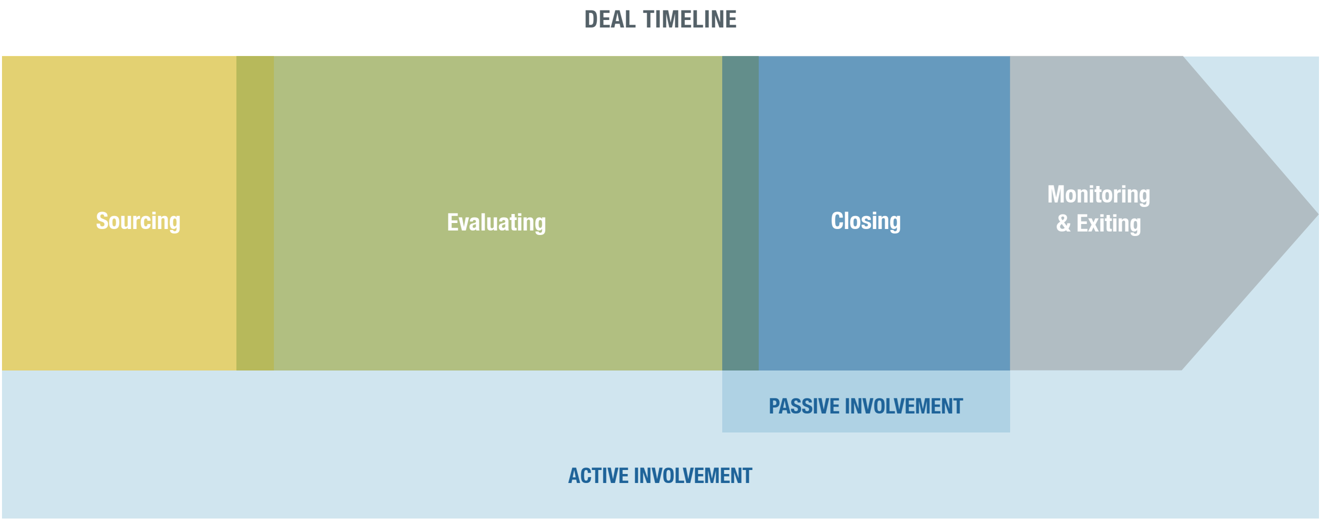

Chart 1: Transaction Stages

STEP ONE: SOURCING

Sourcing transactions is one of the most important aspects in executing a co-investment strategy. A robust sourcing engine allows a co-investor to evaluate and choose from a wide variety of transactions. It also allows for increased selectivity and patience, and provides confidence to pass on transactions that may not meet all of your criteria.

Further, a wider deal flow funnel can provide enhanced diversification within your own co-investment portfolio, which in turn can help mitigate the effects of underperforming investments, improve the likely range of returns, and decrease exposure to exogenous risks.

Sourcing requires a wide range of relationships across the private equity landscape, particularly with top-tier general partners (GPs), who serve as lead managers. These relationships must be cultivated and maintained in order to generate a wide pipeline of deals that can create the basis for selectively investing in the best opportunities.

The most common way to access co-investment deal flow is through your own GP relationships. Being a limited partner (LP) in a GP's fund is a key factor in securing deal flow. Another alternative is to position yourself as a preferred source of capital who can bring specific value to a deal process. Either way, it is important to note that a GP may have many LPs who are interested in co-investing, and opportunities may not be as plentiful when demand is high.

With this in mind, it's important to look for ways to initiate and grow relationships beyond your core GP network. The less common and sometimes most lucrative way to access co-investments is to proactively source opportunities outside of these core GP relationships. Proactive sourcing typically involves holding meetings, attending conferences and industry events, developing domain expertise, tracking specific companies as potential investment opportunities and, where possible, introducing GPs to these companies.

Finally, it is important to differentiate yourself as a co-investor, particularly as the competition for co-investment capital increases. Building expertise, either via an internal team or by working with an experienced third party, can provide a valuable edge when securing a co-investment opportunity.

As mentioned earlier, co-investors can further differentiate themselves with their understanding of private equity, relevant investment and diligence experience, industry relationships, and specific sector expertise. Importantly, proving to a GP that you're able to effectively and efficiently process co-investment opportunities will make them more comfortable sharing future deal flow with you. While there is no guarantee that these efforts or factors will result in an increased level of shared deal flow, they will help keep you top of mind when opportunities arise.

STEP TWO: EVALUATING

After sourcing, the next step is to evaluate the opportunities available. Here, the level of diligence performed is entirely up to the co-investor: Some may choose to co-invest passively, trusting the lead manager and approving all co-investments that are offered to them, while others may re-underwrite (or even help to co-underwrite) the transaction, adding another level of diligence to the process. For this work, co-investors generally lean on experienced investment professionals —either in-house or attached to a third party—to analyze each deal and provide insights and recommendations.

An important distinction between fund diligence and co-investing is that while part of a deal's evaluation process involves performing diligence on the GP leading the deal, investors also need to vet the investment itself, and should be able to evaluate the company's:

> Products and services
> Markets in which it operates
> Competitive positioning
> Management team
> Past and projected financial performance
> Exit opportunities
> Expected returns

Studying these metrics often requires an extensive review of the GP's diligence materials; calls with management teams and consultants; independent modeling of return scenarios; reference calls with customers, suppliers, investors, and other GPs and contacts; an in-depth knowledge and understanding of the relevant market conditions and dynamics; and an analysis of how the investment fits within the broader portfolio and its current and future construction.

Additionally, it is helpful to build financial models that incorporate comparable company data and return sensitivities in order to create a detailed breakdown of the sources of return for an investment. It is also important to understand the business model, the credibility of operating projections, and the validity of the investment thesis. And lastly, one must evaluate the specific terms of a deal, paying particular attention to structures that limit risk yet offer the potential for sizable returns.

In terms of performing diligence on the lead manager, it is important to assess their overall track record, track record in their target sector, and the track record of the individual partner(s) of the GP who are responsible for the applicable deal. The investment thesis of the particular transaction should also be consistent with the GP's expertise.

This analysis, in addition to the diligence performed by the GP, should provide you with a thorough understanding of the merits and risks of a particular company, executive team, and deal structure, which will in turn allow for sound investment decision-making.

Investors will also want to have a flexible, efficient evaluation process in place, including an approval mechanism that can facilitate rapid decision-making. Deals often take place under very compressed timelines, sometimes as short as one week from initial review to verbal commitment. Thus, speed and reliability are paramount in the eyes of the offering GP.

Chart 2: Closing Time

STEP THREE: CLOSING

The closing process begins after the evaluation has been completed and a decision has been made to move forward on the opportunity. The key elements involved in this stage are: 1) negotiating terms, 2) reviewing the tax structure, 3) determining corporate governance, and 4) reviewing the relevant legal documents *(Chart 2)*. Each of these components demands a specific level of expertise, including having a capable staff of attorneys and tax advisors on hand to perform the necessary functions.

Having an in-house legal team can help to expedite investment execution and ensure a swift closing process. This team can also assist in negotiating and securing minority rights and protections, particularly to ensure that you participate at the same terms as the GP and thus maintain alignment of interests between all participants.

As a company is preparing to be sold, co-investors are required to understand the terms of the transaction and how it may affect their returns.

STEP FOUR: MONITORING AND EXITING

Upon closing an investment, the focus turns to monitoring it through to an ultimate exit. A co-investor's level of involvement during this stage will be dictated by the governance and terms that were established at the onset of the process.

In minority positions where there is no involvement in governance, responsibilities may be limited to:

- Reviewing quarterly board presentations and financial statements
- Performing quarterly valuations
- Responding to shareholder consents
- Completing appropriate tax filings
- Anticipating future capital needs for follow-on investments

Conversely, investors in active governance roles may be required to attend board meetings and serve on committees, an undertaking that involves a significant amount of time and expertise. On the plus side, this level of involvement can help guide management strategy, value creation initiatives, and exit options.

While all stakeholders obviously hope the investment performs well, the reality is that there will be instances when things do not go according to plan. Additional diligence and approvals may be required in order to help fund necessary capital injections through follow-on investments. In such instances, a co-investor may add value by making introductions to potential sources of equity or debt capital. Such investments may also require closer monitoring and more frequent interactions with management and the lead GP. Follow-on capital may also be necessary to support M&A activity or to help further develop the investment strategy. In such cases, co-investors must be willing and ready to both evaluate and fund this additional capital need.

Finally, as a company is preparing to be sold, co-investors are required to understand the terms of the transaction and how it may affect their returns. This includes having a clear understanding of the structure, any escrow liabilities, the tax effect on returns, and the timing of any potential proceeds. Armed with this information, you will be able to make a better hold/sell decision. In some cases, co-investors may be in a position to add value by working with senior management to establish an optimal strategy for shareholder liquidity. This may include assistance with initial public offering discussions, outright sale discussions, and/or recapitalization plans. If an exit does move forward, the co-investor needs to have the necessary back-office infrastructure in place to accept wire transfers and process the accounting and tax implications of the exit.

Part III in our co-investment series will focus on the three models investors typically deploy to access opportunities.

COMMON CO-INVESTING MISPERCEPTIONS

For more than 25 years, our global co-investment team has worked with clients of all types to execute their programs. Here are the five most common misperceptions we've observed.

1. **I have experience selecting and investing in GP-led funds, so co-investment should be fairly easy.**

   Actually, the two disciplines are very different and require unique skill sets. Co-investing is more complex than investing directly into a GP-led fund. One example: Evaluating a deal involves performing diligence on both the offering GP and the target investment company.

2. **I don't have the technical skills to do this on my own, but I can purchase the required capabilities on the market.**

   True in some instances, but strong due diligence skills alone will not ensure success. Investors need to have real-world investing experience in order to recognize market cycles and effectively evaluate deals.

3. **Lots of GPs are offering deals, so access and putting my capital to work shouldn't be an issue.**

   While many GPs are offering deals, the key to long-term success is consistently showing top managers that you have the skills and experience necessary to be a reliable, efficient co-investment partner. Also, access could tighten in periods where demand is high and co-investment capital is limited.

4. **With commingled funds, my capital is locked up for 10 years or more—it will be shorter with co-investment deals.**

   The time horizons on different deals may vary, but co-investing itself is a long-term strategy. Investors need patient, committed capital in order to construct diverse portfolios and build relationships with GPs.

5. **Lower fees are the biggest draw to me and should drive my decision to implement a program.**

   The ability to access a large number of co-investment opportunities alongside top-tier managers is the most important driver of returns. Only after this should you focus on the incremental benefit of lower fees and higher net returns.

KEY TAKEAWAYS

Co-investing is an efficient way to access the world's best private market opportunities, and can help expand and diversify existing private equity programs. That said, successful management requires the ability to evaluate, execute, and monitor co-investment opportunities—and these activities must be complemented with extensive back-office support.

Understanding the requirements within each stage of a deal is a key step toward determining your co-investment readiness, as well as your desired level of involvement.

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