HARBOURVEST

CO-INVESTMENT Q&A

WITH BOSTON-BASED MANAGING DIRECTOR PETER LIPSON

How is the current economic environment (e.g., competitive deal market, significant dry powder, and high deal multiples) affecting co-investment?

Over our 25-plus years of co-investing, we have seen interest in co-invest grow and subside with market cycles. Typically, the demand for co-investing is driven by excess liquidity and investor under-allocation to the asset class—both of which are often seen in markets with elevated prices. This does not seem to stop institutions from wanting to co-invest, but it can make for a risky time to start a co-invest program because of the leverage and valuation environment.

What capabilities does a co-investor need to help ensure success?

Firstly, it is important to have a dedicated team that can be responsive to the general partner (GP) community and which has accrued the knowledge base to vet and select what it views as the best co-invest opportunities. Secondly, it is important to have a sourcing platform, or a wide deal funnel, to identify deals where the risk-reward profile appears most compelling. Finally, it is important to be flexible, which entails the ability to get involved early in the process when the chance of closing an investment is low, to underwrite broken deal expenses, to be viewed as a trusted partner alongside the sponsor GP, and to have the capability to adjust investment size and structure when necessary.

A widely cited study[1] found that large investors tend to do better investing directly than co-investing, and that this appears to be related to an adverse selection risk that investors face. Do you see this as a problem in practice?

We do not see adverse selection as a problem. If GPs knew the good deals from the bad, then they would never choose the bad ones, especially if they are inviting their Limited Partners (LPs) to co-invest. As a good check, we constantly analyze our track record compared to the broader set of opportunities we are shown. What is clear is that avoiding bad deals is critical to achieving outperformance.

Large equity investments have the potential to underperform, but there are plenty of examples of successful large investments. The key to co-investing is to see sufficient deal flow to be able to calibrate what we believe are the good deals from the bad ones, which is difficult to do unless you have an experienced team, a long history of investment execution, and a large deal funnel.

How does HarbourVest distinguish itself from other groups offering co-investment products and services?

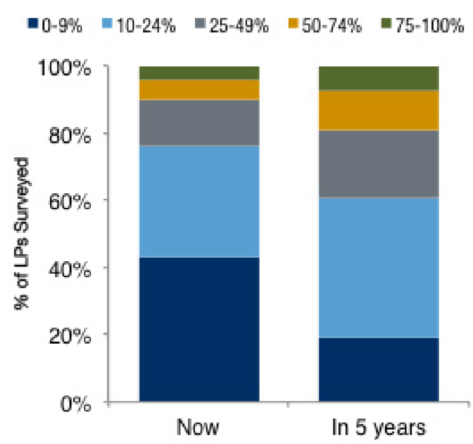
We distinguish ourselves in three important ways. Number one is our large and tenured team. HarbourVest's co-investment team is one of the largest in the world and has been working together for over 15 years. The long tenure of the team promotes continuity of relationships with GPs and allows us to be incredibly responsive. Number two relates to investment size and structure. HarbourVest has the capability, for example, to invest in late-stage growth rounds—in both equity as well as senior and mezzanine debt—at sizes ranging from $5 million to $150 million. Finally, we stand out for being able to provide a broad variety of co-invest offerings. For over 25 years, HarbourVest has been working with its LPs to offer global co-invest fund offerings customized to specific geographies, investment stages, and sectors. This enables our investors to construct portfolios that better match their risk and reward needs.

Finally, what have been a few of the big changes you have seen in private equity co-investing over the last 10 to 20 years?

Co-invest has become not only accepted, but a highly sought after sub-strategy within Alternatives *(see chart below)*. Believe it or not, it wasn't long ago when more than a few LPs thought co-invest was a fad and would go away. Another important change is that some LPs are willing to match or exceed their primary commitment with co-investment. And finally, GPs are incorporating co-investment offerings into their internal investment process, which validates the demand for co-invest that can be seen in the market today.

LPS EXPECT CO-INVESTING TO PLAY A BIGGER ROLE IN THEIR PORTFOLIOS OVER THE NEXT FIVE YEARS

Proportion of LPs' private equity exposure that is or will be through co-investment or direct investments.



Data Source: Bain & Company Global Private Equity Report 2015

[1] Lily H. Fang, Victoria Ivashina, Josh Lerner, "The Disintermediation of Financial Markets: Direct Investing in Private Equity," National Bureau of Economic Research, Working Paper, No. w19299, April 2013.