DIRECT CO-INVESTING: MYTH VS. REALITY

OR: WHY OUTSOURCING MANAGEMENT MAXIMIZES THE VALUE OF CO-INVESTMENTS

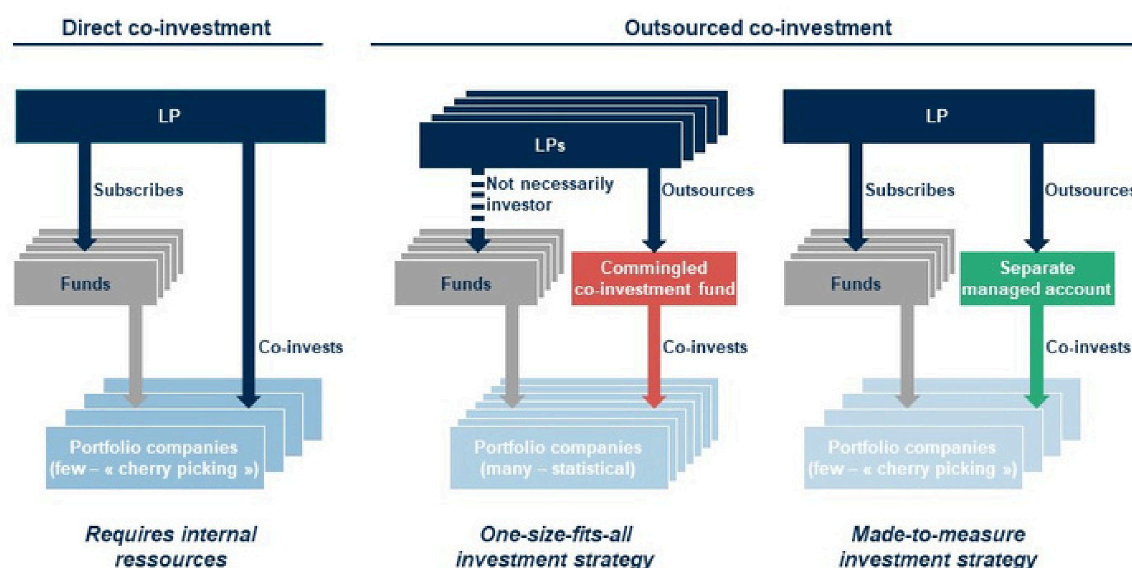
Co-investment offers a number of benefits to an LP: potential outperformance, optimisation of the cost of deploying capital, enhanced relations with its network of GPs, or an opportunity to strategically balance its portfolio.

While co-investment itself may be unavoidable in a private equity portfolio, putting the right structure in place is crucial to the success of a programme. It may be tempting for LPs to co-invest « directly », rather than signing up to a multi-subscriber co-investment fund or handing a mandate to a discretionary manager.

Putting that choice into practice, however, is an especially complex affair that hampers value creation more often than not, particularly for LPs with limited resources. This is because the skills and know-how that this market demands are often underestimated or misunderstood.

In this publication, we will shine a light on the disconnection between the preconceived ideas – the myths – that people form of each stage in the co-investment process (origination, selection, execution and monitoring) and the reality of the market, which is often much more complex. We will then look at how that complexity can be reduced by employing a management firm.

Different Structures of a Co-Investment Program



Possible Structures for a Co-Investment Program

LPs have a number of options when it comes to structuring their co-investments. One is to invest directly in the target company alongside the GP's fund, keeping close control not only of the execution, but also of the deal selection process, investment monitoring, etc. Later on, we will look at how this solution requires resources and skillsets that are difficult to acquire in-house.

The second, more common, option involves subscribing for shares in a co-investment fund, i.e. an investment vehicle accommodating several LPs and managed by a third-party management firm, which takes charge of deal origination, selection and execution. In this case, the LP is exposed to a portfolio shared between all the shareholders in the fund, while lacking ability to determine its choices.

A third option is to hire a management firm, giving the manager a discretionary mandate to devise a bespoke co-investment strategy and handle origination, selection and execution on the LP's behalf.

The reality of the Co-Investment Process

1. Origination of Co-Investment Opportunities

« To find co-investment opportunities, all you need to do is wait for invitations from GPs »

Myth

« Origination is long-term, pro-active work, especially in a growing and increasingly competitive market »

Reality

a) The reality of the market

The co-investment market has rapidly expanded in recent years. LPs know the inherent benefits of co-investing, and are showing an increasing appetite for this strategy.

At the same time, GPs have taken this desire on board and are syndicating more and more transactions, but in practice demand is outstripping supply and the majority of deals are “oversubscribed” by investors. GPs can adopt a variety of strategies in response to this increased demand, but it is clear that offering every investor the chance to take part is no longer necessarily the norm. Instead, managers first approach investors who pro-actively and regularly express their wish to participate in co-investments. To put it another way, you may well have signalled your interest in co-investment in a side letter, but that’s no longer enough.

As a consequence, “passive” investors will see far fewer opportunities coming their way than investors who regularly approach their GPs, and the ones they do see may well be the less attractive ones for which there is the least demand. If you want to be well placed to enjoy the best opportunities, sounding out your GP network on a regular basis is therefore an essential tactic.

b) The benefits of outsourcing

Two key aspects explain the added value that a management firm can provide (either as the manager of a multi-investor fund, or as a discretionary manager).

First of all, **a management firm is generally much more effective at tapping the GP network than the staff of an LP**, because it can devote specific resources to this activity. It can therefore devote regular time to maintaining relations with different GPs, ensuring it is kept informed and invited to take part in syndication processes. It will also keep an eye on the market as a whole, and stay up to date with current or upcoming deals through an informal network of contacts.

The second aspect concerns that fact that **GPs have more to gain from approaching a specialist co-investment team than a single investor.**

To grasp this, you need to understand what syndication means to a GP : beyond keeping investors happy, it is primarily about amassing the capital required to bring about a deal. Responsiveness and the ability to execute are therefore crucial when it comes to selecting a co-investor. Firms are thus naturally inclined to approach investors with a genuine track record of bringing deals to execution, so as not to jeopardise a transaction.

Moreover, a co-investment team can represent the interests of multiple investors. That makes it a natural focal point for the GP, which can maximise its potential reach through a single interaction (bear in mind that syndication is time-consuming for a team, which will consequently try to optimise its interactions with potential co-investors). By using a management firm, LPs can therefore receive co-investment opportunities from GPs outside their own contact network.

2. Selection of opportunities

« Selecting the best co-investment opportunities is easy and requires no specific skills »

Myth

« Performance can vary substantially from one co-investment to another. Selecting the best opportunities in very short timeframes takes real expertise »

Reality

a) The reality of the market

The opportunity selection stage is crucial, since co-investment deals are every bit as varied as private equity in general. While a slim cost structure will certainly improve the return on any one co-investment, co-investments as a whole vary in performance just as much as the rest of the private equity market.

Selecting co-investment opportunities thus demands a different skillset to that required when assembling a fund-of-funds portfolio. Managers doing the latter will be inclined, for instance, to select the GPs with the best track records. This criterion is less decisive when choosing a co-investment. Assessing a co-investment opportunity requires well-defined, rigorous analysis procedures designed to prevent selection bias (caused by, for instance, favouring the GPs with the best track records as above), but it also requires a detailed understanding of the deal itself.

Co-investors must be able to do all of the following in a very short timeframe :

- Obtain a detailed understanding of the target, the fundamentals of its market and its competitive position
- Validate the key features of the deal (e.g. valuation, leverage, exit strategies)
- Challenge the GP’s investment case
- Examine the sensitivity of deal performance to the GP’s key assumptions
- Validate the details of the legal and tax structure of the deal
- Understand the GP’s reasons for carrying out the transaction

This last point is especially important, as it is often underestimated.

For one thing, PE firms, for one reason or another, sometimes carry out deals outside their core specialism. The target, for instance, may be much bigger than the GP's usual targets or operate outside its preferred geographical region, or the investment case may not be founded on the GP's favourite sources of value creation (e.g. when a GP takes on a restructuring scenario when its normal preference is buy & build). If this happens, you need to be able to spot it.

For another thing, while it is generally supposed that the interests of a GP and its co-investors are automatically perfectly aligned, that is not always the case. Some situations can give rise to slight conflicts of interest, for example in the case of continuation funds (especially with regard to valuation) or reinvestments, where existing investors may face the threat of potential dilution.

It is therefore vital to form your own independent, documented opinion – and that requires substantial experience in direct investing.

b) The benefits of outsourcing

The number one benefit of a specialist team is responsiveness, which as we noted above is fundamental – if you cannot react quickly, you have no chance of being a co-investor. Co-investors are generally given four weeks – sometimes less – to take a stance on an opportunity. Staff therefore need the flexibility to devote time to these opportunities, and they need to have efficient analysis and decision-making processes in place.

The second distinctive factor is **expertise in direct investment**. By its very nature, a management firm will have much more extensive experience and know-how in selecting the best opportunities. This means it will be skilled in:

- estimating the value of the target
- assessing the quality of the target in the light of previous investments
- casting a critical eye over the make-up of the target's business plan
- examining the inherent risks of the deal
- examining the relevance of the deal for the GP.

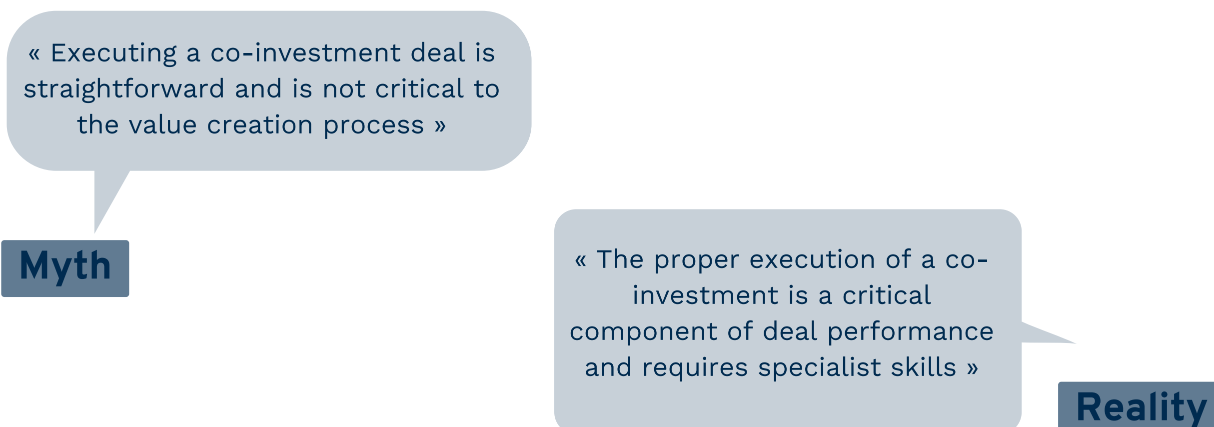
Moreover, it will be able to call on outside resources (e.g. expert advisors, databases) to support its own analyses. At Omnes Capital, for instance, the other investment activities (venture capital, infrastructure) have enabled us to create a pool of 250 experts who can help us get up to speed quickly on the topics we research.

Lastly, it is important to mention **alignment with the LP's interests and independence from the GP**. A co-investment team will have an interest in deal performance, generally in the form of outperformance fees (generally around 10% of the gain, vs. 20% for a "normal" private equity fund), which reduces the risk of an unfavourable selection. The team will also be totally independent of the GP, meaning that the stance it takes on an opportunity will not be influenced by oral commitments or financial considerations linked to the LP's subscription to the primary fund.

These three factors explain why management firms that specialise in co-investment outperform the market when it comes to deal selection.

At Omnes Capital, our co-investment team draws upon our know-how in direct investing to ensure that only the best opportunities are selected. We are highly selective, turning down around 80% of potential deals, and we pay particular attention to the long-term fundamentals of the businesses we analyse. Since we began this activity in 2007, this has enabled us to outperform the market by around 10% in IRR terms.

3. Deal execution



a) The reality of the market

Once the decision is taken to invest, the execution phase begins. This stage generally covers the finalisation of the legal documentation, compliance processes and the transfer of funds. That means deploying a variety of specialist skillsets in a very short timeframe.

In the legal negotiations, co-investors will strive to maximise the safeguards they obtain, according to the bargaining power conferred by their stake in the overall arrangement. Co-investors making substantial investments (e.g. an equity stake of 15% or above) may be able to negotiate a seat on the supervisory board. By contrast, those taking very small equity interests will attach more importance to ensuring that the terms they obtain are at least in line with market practice. Since no two situations are alike, the negotiation phase thus demands an excellent knowledge of market practices, so that investors can tell what deal terms they may be able to insist on (e.g. tag along, right of first offer), negotiate (e.g. A seat on the board) or accept (e.g. drag-along). This negotiation phase is crucial to maximising the return on investment, whether the investment itself performs well or badly.

Compliance, which can be particularly time-consuming, involves ensuring that the deal is made in complete accord with all applicable regulations. Co-investors need to stay constantly aware of new regulatory changes and have a precise understanding of the subtleties. This is especially critical when it comes to the constantly changing standards that govern the prevention of money-laundering, terrorist financing and tax evasion. The DAC6 Directive, which aims to control transactions involving “aggressive” cross-border tax arrangements and to which investment managers have been subject since the start of 2021, is a good example.

b) The benefits of outsourcing

As well as the resources required to analyse an investment case, it is thus clear that executing a co-investment deal under tight time constraints also demands specialist personnel in a variety of fields and a robust, responsive back office. For an LP, ready access to specialist resources is thus one major benefit of outsourcing the management of its co-investments.

An **experienced team** is once again a key factor, given the need for a good understanding of market practices.

4. Investment monitoring and exits

« Once the deal is done, you just sit back and wait until the GP decides to sell up »

Myth

« To maximise value creation, you need to monitor your co-investment closely »

Reality

a) The reality of the market

How an investment is monitored can be mutable, depending on the percentage of -the co-investor's holding. Co-investors with smaller holdings will mainly be spectators. They will base their investment monitoring on reporting supplied for that purpose by the GP. When negotiating the legal documentation, it is therefore important for them to ensure that this reporting matches their needs. Co-investors with a significant equity holding may take a more substantial role in the governance of the investee, potentially with a seat on the supervisory board.

Whatever the situation, two things are fundamentally important when monitoring a co-investment. First, close relations must be maintained with the GP, whose closeness to operations makes it the preferred source for up-to-date news about the investee. This will include regular reporting on a number of predefined KPIs. However, since reporting only covers the past and often only appears after several months' delay, it is important to keep in touch "in real time" with developments at the investee, in order to maintain visibility over all major upcoming decisions. Maintaining relations with GPs can be time-consuming, especially if you have a large portfolio.

Second, prior experience in direct investing is a must, so that you can form a detailed understanding of the investee's position and be able to take the right decisions on matters (such as reinvestment) that arise during the investment period. No matter what the holding is, it is not unusual to see one or more critical situations arise, on which decisions that materially affect performance must be taken.

In such situations, substantial analysis work usually has to be carried out to update the convictions that were formed when the initial investment was made. This second point is also linked to the first one, since the quality of decision-making will depend on the quality of the information you obtain and your understanding of the investee.

b) The benefits of outsourcing

A dedicated team is indispensable, because monitoring investments is time-consuming whether the co-investor is closely involved in the deal or not. This is true not only of oversight per se (e.g. GP presentation meetings, monitoring performance, attending meetings if you have a seat on the board), but also of the process of drawing up the ensuing reports. As a result, it can be more efficient for an LP to employ a specialist management team to write customised reports on its behalf.

Expertise in direct investing is also crucial throughout the holding period. It's not unusual to have to take key structural decisions in short order. When that happens, you need strong convictions, based on a sound knowledge of the investee and the additional analyses that will have to be carried out. That may prove complicated, especially if your interests do not line up with those of the underlying GP – a possible situation that is all too often underestimated (e.g. when a reinvestment is based on a valuation set by the GP or affects the proportions of investors' holdings).

Lastly, a specialist co-investment management firm plays a potent role in **maximising value creation**. With its expertise, its network and its experience of previous investments, it can work with the GP to share best practices and market knowledge, facilitate contacts etc. Co-investors are thus more than mere spectators: they also use every source of value creation in the private equity playbook. Tapping into these sources is not so easy for an LP's in-house team.

Conclusion

When it comes to co-investing, some myths die hard. Whether a deal is in the origination, selection, execution or monitoring stage, it is tempting to picture the co-investor as a passive onlooker with little involvement in value creation.

The reality is quite different. Maximising the performance of a co-investment programme actually requires a large number of skills and resources, which it makes sense to outsource to specialist management firms. Sufficient staff availability, direct investing skills and an understanding of market practices are all things that LPs will struggle to create efficiently and cost-effectively in-house.

In conversations with investors, we also find that managing co-investments in-house often leads to unhappy compromises on speed of deployment and investment performance.