THE MECHANISMS OF CO-INVESTMENT

In private equity, “co-investment” refers to a transaction structure in which a general partner or GP syndicates part of its investment to third-party investors, who thus take a minority position in the deal. Most of the time, these third parties are institutional investors wishing to invest alongside a private equity fund in which they already invest as limited partners or LPs.

Co-investment offers a number of benefits to an LP:[1] potential outperformance, optimisation of the cost of deploying capital, enhancing relations with its network of GPs, or an opportunity to strategically balance its portfolio. Modern PE portfolios almost always include co-investments, and it is therefore important to understand the mechanics in play at the different stages of the process, in order to ensure that an investment programme is a success.

In this publication, we therefore describe the four stages of the co-investment process: origination, selection, execution and monitoring. We will set out the key success factors at each stage and examine the implications for the resources and processes that a co-investor requires.

For more details, see our publication “Co-investment: benefits and potential pitfalls”.

THE FOUR STAGES OF CO-INVESTMENT

Co-investment generally unfolds in four stages, each requiring different resources and skills:

- **Origination**, i.e. the work required to feed the deal flow at GPs
- **Selection**, meaning the internal due diligence phase that makes sure only the best opportunities are selected
- **Execution**, i.e. the transformation of the investment decision into a legal reality
- **Monitoring**, for the purposes of reporting, oversight and ultimately exiting the investment

These stages, which demand resources and skills in a variety of fields such as finance, strategy, law and compliance, are not fundamentally different to the stages of any other investment. At each one, however, the mechanics in play, the risks and the key areas for attention are specific to co-investing.

Co-investment – Key success factors by investment stage:

Co-investment stages	Origination	Selection	Execution	Monitoring
Main actions	• Enhancing relations with the network of GPs • M&A Intelligence	• Financial, strategic and legal analyses • Discussions with the GP and the management	• Negotiation and signing of the legal documentation • Cash management and transfer of funds • Compliance analysis	• Discussions with the GP and the management • Reporting • Negotiation of exit terms and conditions
Key success factors	• Close long-term relationships with GPs • Responsiveness	• Substantial experience in direct investment • Highly flexible staff	• Experience of legal and compliance teams	• Process efficiency

1. Origination of co-investment opportunities

The origination phase is critical, as it determines the volume and quality of the deal flow.

First of all, potential co-investors must bear in mind that syndication processes can vary significantly not only between GPs, but also between transactions.

For large cap deals, in which the syndicated amounts can be up to several hundred million euros, GPs tend to approach a large number of potential co-investors, typically for a highly structured co-investment. This usually involves setting up a data room with access to due diligence documents, as well as question-and-answer sessions with the different parties involved, who may be very numerous (e.g. advisors, lawyers, management). The whole process may extend over several weeks or months. Syndication normally takes place after the GP has signed or indeed closed the deal, as the GP takes the decision to "carry" the equity temporarily on the co-investors' behalf. In such a case, it is vital that co-investors comply with the deadlines set by the GP, who will not hesitate to exclude potential laggards. An ability to react fast is therefore crucial – sometimes all the more so as GPs may allot co-investments on a first-come, first-served basis. In fact, it is not unusual to see certain large investors snapping up the bulk of a co-investment allocation early on.

For smaller deals, there are other strategies a GP can choose. It may still approach a large number of potential co-investors after securing the deal (post-signing or post-closing), more or less in the way described above. Most of the time, however, GPs tend to syndicate the investment ahead of signing, either to limit the syndication risk (failing to find co-investors would jeopardise a deal) or to demonstrate the soundness of the bid to the vendor or the target company's management. Syndication in these cases is generally limited to a small number of co-investors, who will be offered a relatively large minority stake (up to 30-40% of the total). Although responsiveness remains crucial, the criteria for selecting co-investors will equally be linked to the value they can add to the transaction, in the form of industry expertise, potential synergy with another investment, etc.

Two main criteria thus exist for the successful origination of co-investment opportunities:

- **responsiveness** : if you can't react fast, you have no hope of a long-term presence in the co-investment market
- **close long-term links with GPs**, building tight relationships that facilitate your inclusion in syndication processes.

2. Selection of opportunities

The opportunity selection stage is crucial, since co-investment deals are every bit as varied as private equity in general.
Co-investors therefore need to ensure that they only select the most attractive opportunities. This requires:

a) Direct Investment Skills

Substantial experience in direct investment is essential, because selecting co-investment opportunities 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.

At Omnes Capital, we achieve this through a holistic analysis of the opportunity and the associated risks. Historically, Omnes Capital mainly analysed risks according to seven distinct criteria: market, competitive environment, customer types, competitive positioning, supply chain, financial aspects and deal structure.

The Covid-19 crisis, and the resulting acceleration of certain existing trends such as digitisation and limitations on assets and personnel, has prompted us to add five further criteria to our analysis grid that reflect the target's ability to adapt to these trends: its level of digitisation, the risk level of its product offering, the degree of control over its supply chain, its ability to control relations with end customers, and its financial resilience. We thus prefer a granular, case-by-case approach to opportunity selection, based on an analysis of a company's intrinsic qualities, to a generic selection process, such as one based purely on sector (e.g. healthcare, software).

b) Highly flexible staff and efficient decision-making processes

As noted above, responsiveness is vital in co-investment. 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.

At Omnes Capital, the co-investment team is 100% dedicated to co-investment, ensuring maximum flexibility in time allocation. When a GP offers up an opportunity, we can generally devote two or three weeks to the issue in order to make a firm bid.

This responsiveness is the product in particular of the experience we have built up and the efficient processes we have put in place since this activity began in 2007. Some of this has to do with methodologies and analysis matrices, but it also relates to the tools that we use for potentially time-sapping tasks such as researching information, analysing a development plan or estimating the value of a business. At Omnes, for instance, our other investment activities (growth, buyout, 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. Decision-making processes must also be designed to reach decisions fast, without compromising quality.

Key actions and timing for selecting an opportunity :

Week 1
Preliminary analysis of opportunity

- Preliminary analysis of the company's relevance to the investment strategy and portfolio construction
- Detailed understanding of the company's business
- Understanding of the components of the investment thesis
- Preliminary analysis of the associated risks and identification of the topics to be explored
- Confirmation of the interest for the opportunity to the GP

Week 2
Challenge of investment thesis

- High-level review of legal terms
- Analysis of the sensitivity of the deal's performance to key assumptions
- Challenge of key assumptions via extensive research (e.g., market reports, broker reports)
- Validation / invalidation of structuring assumptions via interviews with market experts
- Request of additional information from the deal team

Week 3
Definition of the "Omnes" investment thesis

- Refinement of investment assumptions and creation of a return scenario
- Validation of the adequacy of the "Omnes" scenario and the fund strategy in terms of risk / return ratio
- Internal validation of the investment opportunity
- Binding commitment to the GP (generally under suspensive conditions on the legal documentation)

3. Deal execution

Where the analysis phase ends with a firm commitment to a GP (generally subject to agreement on the legal documentation), deal execution follows the three steps below, each of which requires a very different skillset:

- Negotiation and signing of the legal documentation
- Compliance (e.g. anti-money laundering)
- Transfer of funds

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.

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.

Every situation is unique, and the negotiation phase therefore demands an excellent sense of what terms can be demanded, negotiated or considered acceptable.

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.

The transfer of funds presents no particular difficulties, although it does require fluid order execution. Co-investors must be sufficiently responsive to meet GPs’ deadlines for drawdowns, which are usually set at ten working days.

4. Investment monitoring and exits

How an investment is monitored is 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. Firstly, 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.

Conclusion

Running a co-investment programme involves four main steps: origination, selection, deal execution and the monitoring of investees. Each of these steps plays a vital role in the overall performance of the programme. Mastering each one is therefore essential – which can prove complex, due to the multiplicity of skills required.

Co-investors must have access to a wide range of suitable skills – in investing, legal, compliance etc. – to ensure a maximum level of responsiveness and flexibility. They must also put a number of processes and routines in place – managing a network of GPs, matrices for analysing opportunities – in order to maximise the fluidity of the process.

At Omnes Capital, our organisation is designed to give us holistic control of the co-investment process. That enables us to run our programmes efficiently and profitably, while staying true to the value proposition we offer our LPs: designing bespoke co-investment solutions tailored to our clients' needs.