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Avoiding the pitfalls of co-investment

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*By Elizabeth Pfeuti - **Co-investments remain a theme in 2019, as both GPs and LPs increasingly see value in separate partnerships alongside commingled funds.***

Earlier this year, the listed Standard Life Private Equity Trust announced it would allocate up to 20 per cent of its net asset value to these partnerships, kicking off with a stake in Midlands-based Mademoiselle Desserts alongside Europe-focused IK Investment Partners.

Institutional investors, too, such as pension and sovereign wealth funds, are getting in on the act. Some of the largest public pensions in the US, including the Teacher Retirement System of Texas, which announced this year it was raising its co-investment target and staffing level, have been attracted to the method.

Henry Smithers, managing director in the Financial Sponsors Group at Duff & Phelps, says the shift has several drivers: "Firstly, for private equity houses, co-investment with institutional investors is a way to build a closer relationship with a LP, which can be beneficial in a competitive current and future fund-raising environment."

Cost-saving benefits play a part, too, according to Smithers, as co-investment can mitigate paying fees twice where an LP is invested in GPs that transact on the same deals or between each another.

For GPs, it gives the option to deploy and manage more capital where it may not have been able to in the past because of fund life or investment size restrictions.

"Co-investing can also allow the GP to invest in a quality asset which may have otherwise breached restrictions related to fund diversification," says Smithers.

Nail down the rules

So far, so mutually beneficial.

But there are important considerations for both parties to weigh up before signing the co-investment deal.

Unlike investing in a fund, which offers relative flexibility should either side of the investment partnership have a change of heart, a co-investment works differently.

David Arcauz (pictured), managing partner at Flexstone Partners, has been part of many co-investments as an LP and he says it is vital to nail down the rules of the game at the start to avoid problems later.

“A lot of the structuring work is done up front and time is spent to ensure alignment between the partners (GP and co-investors),” explains Arcauz. “We usually target deals where we are on a pari passu basis with the GP to have the right governance in place.”

Arcauz recommends potential LPs work on co-investments with managers with whom they have experience through allocating to their funds or from primary due diligence already completed.

“Through co-investments, investors generally ‘hand over the driving seat’ to the GP,” he continues. “It is important to define all the rules and governance up front that can be maintained throughout the life of the deal.”

For example, there can be issues such as a dilution of funds or when an LP needs to put more money in. What happens in these cases needs to be thought about and dealt with up front to avoid confusion and uncertainty later on.

“The balance of power within a co-investment deal also lies very differently between large LPs and smaller LPs,” cautions Arcauz.

Outside of the traditional fund structure, LPs have other considerations, too, according to Mark Zünd, head of investments at Unigestion Private Equity.

“Because co-investment processes are usually co-underwritings at the lower end of the market, this exposes both parties to the risks of M&A processes,” he says. “For instance, co-investors are exposed as much as the GP to a broken-deal outcome in terms of sunk costs and reputation.”

Have a well defined plan

This means if a co-investor were to pull-out of a process, the relationship with the GP may be at risk, which could affect its reputation in the market, says Zünd.

Proper planning should help prevent much of these potential problems. Zünd advises institutional investors and other prospective LPs to “bring a defined plan to the table”, including their objectives and what they think their portfolio should look like.

“Things to consider include the number of transactions, investment size, sector, currency, industry, geography, cyclicality, lead investor, liquidity profile, type of strategies, target return and risk profile,” he says.

The best-laid plans do sometimes go awry, of course, and a new – or seasoned – LP needs to be prepared.

“There have been some instances where co-investors have initially committed to a follow-on financing on a co-investment deal but could be reluctant to fund it if the company’s trading is deteriorating,” confirms Arcauz.

Secondaries market remains limited

No one wants to throw good money after bad. But it is important to have the matter covered off in the initial agreement.

Additionally, for the moment at least, there is little action in the secondaries market. While funds move companies and assets on to other buyers relatively frequently, moving out of a co-investment before time attracts more attention.

“It can be challenging to pull the plug on a co-investment, as people could be wondering why the seller is doing it,” says Arcauz. “It is not a vote of confidence in the asset.”

As the market gets more used to co-investments, however, it is likely that a secondary market will evolve – but this maturity is likely to bring other less welcome elements, too.

“Co-investment in Europe as a strategy has been going for less than 10 years, so it is not that mature compared to funds, which have been operating for more than 20-30 years,” comments Arcauz. “There has been no real downturn for these deals to have been tested by and we will see fall out when it happens. There is likely to be some souring of relationships between LPs and GPs if LPs want to take their money out before the end of a deal term.”

Arcauz does not see the model itself falling out of favour, but thinks it will be useful for all sides to see how it works under pressure.

“At the moment, while markets are still on the up, people are very keen on deploying capital in co-investments. But you definitely need to have a strategy in place and get all the documentation and governance lined up before you sign the deal,” concludes Arcauz.

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