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CO-INVESTING

Hand in hand

LPs are increasing their appetite for co-investment, but with growing competition they will need to focus on the value they can bring to a partnership with a GP, say Pantheon partners Dennis McCrary and Jeff Miller

As co-investment grows in popularity among limited partners and competition for deals increases, it is more important than ever that LPs are able to differentiate themselves as a worthwhile partner for fund managers, say Pantheon partners Dennis McCrary and Jeff Miller.

Q How has the co-investment market evolved over the last decade?

Jeff Miller: While LP demand for co-investment has certainly increased, we believe there has been a greater supply of co-investment opportunities available in the market. More GPs are aware of the relationship benefits with LPs of offering co-investment and are doing less partnering with other PE firms on deals than they may have done 10 or 15 years ago. GPs have also become increasingly comfortable and confident that they can syndicate co-investments successfully with their LP base. They might not have had that same confidence 10 or 15 years ago. We believe the net effect of both of these factors has driven greater co-investment supply.

Q Has the perception of risk around co-investment changed?

Dennis McCrary: In the past, investors were saying 'co-investments – aren't they really risky?' Well, they're the same underlying operating companies you are exposed to if you are an LP in a direct private equity fund or a fund of funds. However, you have more control with regard to deal selection, allowing you to optimise portfolio construction, and you are paying a lower fee. People have become more comfortable with co-investments as returns have proven to be quite solid over the last 10 years and it's become easier to see multi-year track records. Co-investing can, of course, be riskier if concentrated in just a few deals.

Working together: LPs must view co-investment as a 'partnership', say McCrary (right) and Miller

Q How do GPs manage the competition for co-investment among their LP base?

JM: Most GPs are managing co-investment syndication in a thoughtful way to enhance their LP relationships and not disappoint LPs. However, there are varying approaches that can be driven by the nature and capability of the LP base and the dynamics of the transaction. Some GPs will look to syndicate deals more broadly across their LP base. They may effectively rotate the deals around, so each LP may not see every deal but they'll get their fair share. Or they may syndicate each deal more broadly and LPs may get a lower allocation than desired as a result. Occasionally, the nature or speed of the transaction necessitates the GP to go to the LPs they have the most confidence in, because ultimately they need to get their deal done and not disrupt their own deal process.

Q Besides reduced fees, what are some of the benefits of co-investment for LPs?

JM: Benefits include more investor control over the deployment and pacing of their capital as well as where and how that capital is invested. Other advantages include being able to build out diversified portfolios to help fill in certain sectors, geographies or vintages to which they may want more exposure. From a portfolio construction point of view, this would be the one area that an LP has more control over how its capital is invested and when. That's certainly attractive to LPs.

DM: LPs can also concentrate their capital with their preferred private equity GPs. They will likely have a fund investment, but then they can deploy additional capital »

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» with that particular GP. This is increasingly relevant today as many LPs are looking to concentrate their GP relationships and reduce the number of managers in their fund portfolio.

Q Can an LP to have too much co-investment in its portfolio?

DM: I don't think in theory you can have too much co-investment. The idea is to build a portfolio with the best PE managers you can find and access, and in whom you have great confidence; where you have the geographic, sector and vintage diversification and exposure that you think builds a good portfolio. Whether you do that through co-investment or through a direct fund investment, the ultimate portfolio of underlying operating companies is most important. I should note that not all PE firms offer co-investment, or offer very little. So to obtain exposure to certain excellent managers will generally require investing in their fund directly or through a fund of funds or managed account.

JM: Some LPs would say there's a natural minimum they want to have because co-investing requires different resourcing, so they want to make that meaningful within their portfolio. Then there's probably a natural ceiling on how much co-investment you can have, because you need to still maintain meaningful fund relationships and investments in funds to be able to drive the co-investment flow.

Q What level of due diligence do you need to do and what capabilities does an LP need to have?

JM: Co-investors will get access to a fair amount of diligence. GPs typically provide their investment memo, third-party consultant reports, industry research, comparables valuations and their base model that you can sensitise.

There are other things co-investors can do to help augment information provided by the GP. One is to look at the track record of deals in their own portfolio, whether it's through primaries, co-investments or secondaries, and understand how that sector has traded historically, prices buyers have paid and returns these buyers have generated investing in the sector. Co-investors also may be able to talk to other GPs they have relationships with that have experience in the space. Also, it is quite important to analyse the deal and the fit with the manager. Is this a type of investment where the manager can deliver and has in the past delivered differentiated value?

Q Does the desire to be a good co-investment partner hamper an LP when it comes to negotiating terms on a primary fund?

DM: It's a delicate balance. You need to make sure upfront that the fund investment is properly structured and then from that will hopefully come a good relationship. Even if you're negotiating hard, you do it in a way that the GP still finds it attractive to work with you in a co-investment context. As it relates specifically to co-investments, there is always a balance between rigorous due diligence, which is of course required, and being a good partner, being user friendly. Leveraging off the GP's diligence, and supplementing that with our own has worked well.

Q Is adverse selection – the GP offering their LPs the less attractive deals as co-investment opportunities – an issue?

JM: Intuitively we've felt there's less risk of adverse selection for a couple of reasons. First, these LP relationships are very important to the GP in terms of raising their next fund, so we can't see a GP potentially disadvantaging their LPs by showing them a co-investment that might be less attractive than what they would normally do. And this assumes they know upfront the relative performance of the deal, which is unlikely.

And second, these deals are going into the GP's fund and they're going to be important drivers of performance, because co-investments tend to be larger than the average deal in the fund, which is part of the reason they need the co-investment. These larger deals will be very big drivers of performance but also will be scrutinised by LPs in future fund diligence, whether they did the co-invest or not, because they represent a meaningful part of the fund.

Q Do you tend to see more co-investment at the beginning or the end of a fund's life?

WHAT WILL BE THE BIG TRENDS IN CO-INVESTMENT IN 2018?

DM: LPs need to continue to evolve the value they bring to GPs. The more competitive the market becomes, the more the LPs need to differentiate themselves. The engagement has to be professional, it has to be responsive in terms of time frame, and all those fundamentals, but there are other things like helping to underwrite and bringing diligence insight where it becomes more of a partnership than just, 'hey, can I buy a piece of this deal?' I think you'll see that evolution continue. ■

DM: We see co-investments offered throughout the life of a fund for a variety of reasons. Certain GPs may offer opportunities at the beginning of a fund's life if they are still fundraising and use co-investments to entice LPs to make a primary investment into their fund. Also they don't know how large their fund will be. Let's say a GP wants to raise a $500 million fund, and they've raised $250 million and they're starting to close deals into that fund. Even though at $500 million they might be able to flex up to say a $75 million equity cheque, when they've only raised $250 million they can't take that concentration risk, so they do a smaller equity cheque and then syndicate the remainder.

At the back end of a fund's investment period co-investment may be influenced by investable capital remaining, the number of deals the GP would like to fit into that fund, and the timing of those deals and the next fund raise. For example, if the normal bite-size is $50 million and there is $70 million remaining in the fund for new transactions, the GP may choose to do two more $50 million deals, investing $35 million in each, and invite LPs to fill out the deals with $15 million of co-invest in each deal.

Q Now co-investment has become a more established part of the private equity landscape, are investors becoming more creative in how they approach this strategy?

JM: Traditional LP syndications certainly represent the majority of what we see, but co-investors have been considering broader sets of opportunities and have been more creative in what they'll do.

This can include warehousing deals, where an LP might speak up for a larger cheque size to give the GP deal certainty, and then allow the GP to syndicate a piece of it out to smaller investors later in the process or post-close. The other area warehousing could be applicable is if the GP is raising a new fund and hasn't had a close yet, but they want to do a deal. An LP could underwrite the equity and allow that GP to claw a piece back for the fund once they've had a first close.

There are cases where LPs are effectively co-bidding alongside the sponsor, and because of that they're willing to underwrite a large cheque, get involved earlier, but also underwrite their share of the broken deal expenses if a deal doesn't close.

Q Have you seen fundless sponsors tapping into co-investment capital?

JM: Groups that have spun out of larger firms and want to raise a fund but maybe they're not able to quite yet, and who want to demonstrate some track record working together, may seek equity from the co-investment market, tapping into traditional co-investment sources and family offices.

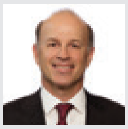
For a co-investor, that could come with additional risk, but they may get access to smaller deals and companies that have the potential to generate outsized returns. An LP may not see those deals through their traditional manager relationships given the smaller size. We occasionally see fundless sponsors where the principals have significant experience working at larger, well established firms and have gained valuable experience that they can now apply to smaller companies and that can be attractive.

DM: It takes a more experienced set of skills and deal professionals to be effective in the fundless sponsor area, and it's a bigger time commitment too, depending on how the deal unfolds, who the sponsor is and what their goal is. We don't do very many of them but we do see a lot, and they can be attractive. The economics tend to be a little different so you've got to make sure you've got a deal that's providing a good return. ■

Pantheon accesses co-investment capital from a variety of investment vehicles which it manages, including commingled funds, separate accounts, the firm's publicly-traded vehicle PIP and its 40 Act fund. The firm's global co-investment committee comprises:

Jeff Miller is a partner in Pantheon's global co-investment team. He was previously a principal at Allied Capital.

Erik Wong is a principal in Pantheon's co-investment team. He joined the firm from Abu Dhabi Investment Authority, where he was a co-investment manager.



Dennis McCrary is a partner, a member of Pantheon's partnership board, and chair of the co-investment committee and the global secondary investment committee.

Francesco di Valmarana is a partner in Pantheon's European investment team. He was previously at Unigestion, where he managed the firm's global secondaries programme.

Jie Gong is a partner in Pantheon's Asia investment team. She joined from Morgan Stanley Alternative Investment Partners' private equity fund-of-funds group.

Helen Steers is a partner and head of Pantheon's European investment team. Previously she was a managing director for Russell Investments, overseeing private equity in Europe.