OMNES

CO-INVESTMENT

ADVANTAGES AND POTENTIAL PITFALLS

The co-investment market has experienced strong growth in recent years. In fact, more and more Limited Partners are attracted by several characteristics of this asset class, notably the potential for outperformance and the flattening of the "J-curve" that is specific to private equity. While co-investment appears to be a true must-have in a portfolio, it is nevertheless important to keep in mind certain pitfalls that are specific to this market in order to choose the most suitable strategy.

In this publication, after succinctly explaining the nature of co-investment and the different forms that it can take, we will present the key advantages as well as the potential traps to avoid for a successful investment strategy.

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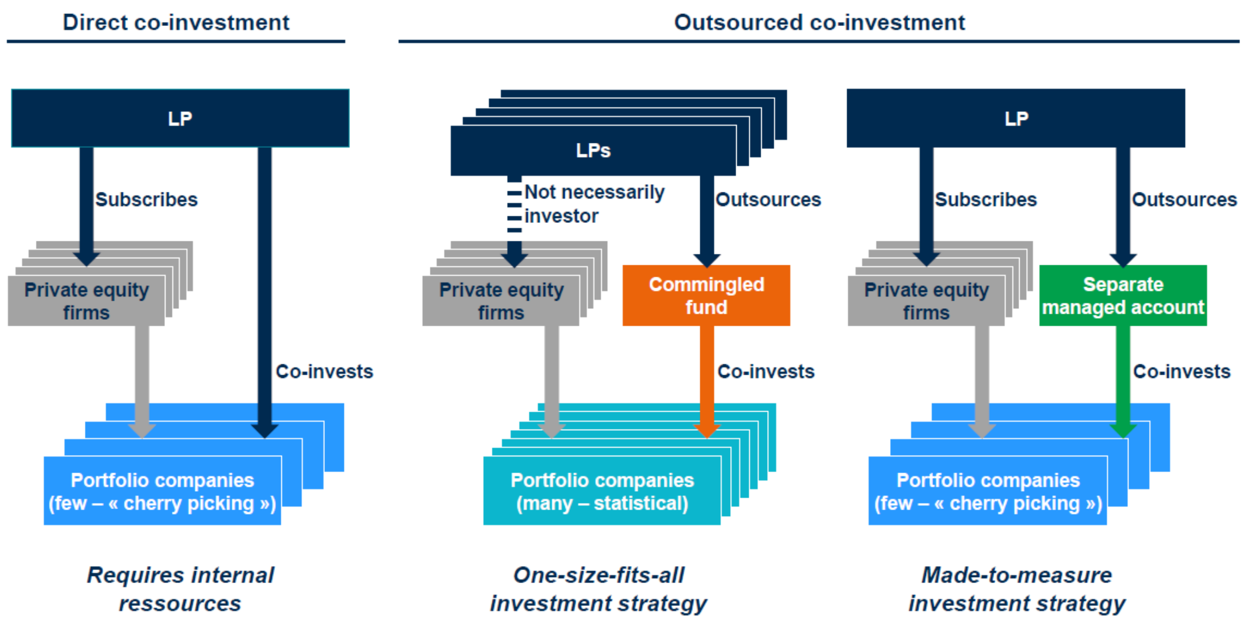
What is co-investment ?

In private equity co-investment refers to a transaction structure in which a private equity company (or General Partner, GP) syndicates a portion of its investment alongside third-party investors who thus take minority positions in the operation. These third-party investors are most often institutional investors who wish to invest alongside a private equity firm in which they already have a stake as a Limited Partner or LP.
Private equity companies can have several reasons to offer co-investment opportunities: to increase the size of their investment tickets to target higher value companies, to de-risk a transaction by sharing the investment or even, as is increasingly the case – to respond to client wishes.

In practice, there are several possible models for LPs to participate in co-investments.

The first consists of investing directly into the portfolio company alongside the General Partner's fund, while retaining the execution tasks of the transaction – and also the selection of opportunities, monitoring shareholdings, etc. – within internal teams. The second, which is also the most common, is based on the subscription to co-investment fund shares, that is to say an investment vehicle hosting several LPs and managed by a third-party private equity firm overseeing responsibilities for the origination, selection and execution of transactions. In this case, the LP is exposed to a portfolio shared by all of the subscribers in the vehicle, without the possibility of making its own strategic choices. Finally, a third option consists of entrusting the management of co-investment opportunities, via a management mandate, to a private equity firm that could create a bespoke co-investment strategy and manage the origination, selection and execution of the transactions.

The different types of co-investment structures



The advantages of co-investment

No matter which model is used, co-investment presents several advantages for an LP:

1. A potential for outperformance in its private equity portfolio;
2. Optimisation of its capital deployed,
3. An in-depth knowledge of its network of GPs
4. A strategic arbitrage opportunity in its portfolio.

These four points, which are detailed below in this publication, explain the enthusiasm of LPs for co-investment in recent years, and the subsequent rapid development of this market segment.

Nevertheless, it is also important to highlight that a successful co-investment program requires certain counterparties and presents certain risks that all LPs must be aware of before deciding on their allocation strategy.

Advantage N°1: The potential for outperformance

The key advantage of co-investment for an investor is found in its cost structure that allows for flattening the "J-curve" generally attributed to private equity investments. In effect, whereas "traditional" investment funds typically offer subscription conditions based on a model of 2% per year for management fees on the capital invested and 20% outperformance fees (or carried interest), co-investments general carry a management fee of 1% per year of the capital invested and a outperformance fee of 10% (and sometimes - for direct co-investments - no management or performance fees). This combined effect of reduced fees and a different calculation basis has a marked impact on the return profile noted throughout the life cycle of the fund.

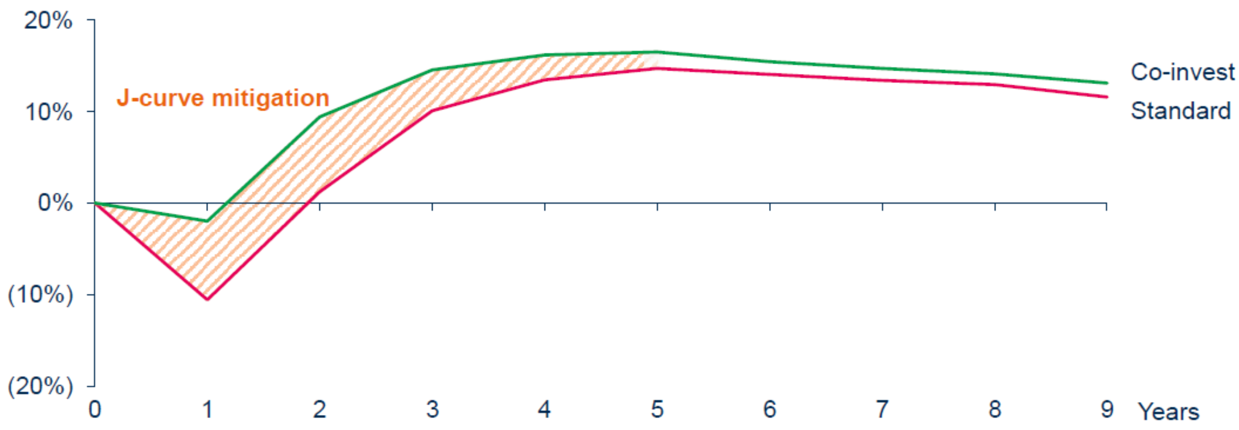
Co-investment outperformance: an impression or a reality?

Both: 71% of LPs believe that co-investment funds perform better than "traditional"[1] funds. This impression was effectively confirmed by recent research[2] that notably highlights the importance of the fee structure.

(1) "Preqin Special Report : Private Equity Co-investment Outlook", November 2015
(2) Reiner Braun, Tim Jenkinson, et Christoph Schemmerl, "Adverse selection and the performance of private equity co-investments", November 2016

Co-investment funds enable to "flatten" the J-curve

Net IRR: Co-investment fund vs. "standard" PE fund



Assumptions for "standard" PE:
- 2% fees on committed capital (on capital drawn down for divestment period)
- 20% carried interest

Assumptions for co-investment:
- 1% fees on drawn down capital (during investment and divestment periods)
- 10% carried interest

Assumptions:
- Total allocation: €100m, evenly invested over 5 years
- Gross multiple: 2x after 5 years

Beyond the structure, the very nature of co-investment opportunities generates high potential for outperformance. On one hand, this is because GPs most often opt to syndicate a portion of their investment for transactions relating to large companies and on upper-mid-cap or large-cap segments, that are more resilient and present a reduced risk profile. On the other hand, taking into account the risk of exposure taken directly by LPs, private equity firms have a tendency to be particularly vigilant on proposed co-investment transactions, and only offer the best deals to their LPs. Moreover, by definition co-investment involves a double selection process - firstly by the private equity firm, then by the co-investor - which tends to lead to the best opportunities.

Finally, in terms of indirect co-investment (via a fund or an investment mandate), co-investment vehicles generally have a faster deployment pace than traditional funds. As co-investment effectively consumes less resources, teams have the capacity to carry out more deals per year. This allows for a deployment duration of approximately 3 years (vs. 5 years for "traditional" funds), and consequently quicker returns on investment.

Implications

Two elements are important to activate co-investment potential:

1 - Capacity for differentiation:
The quality of the co-investment portfolio is highly dependent upon the origination capacity of the investor. Taking into account the marked enthusiasm for this market segment, it is not unknown for GPs to favour, for syndication, co-investors capable of differentiating themselves: either by a specific expertise in the target sector, or by a capacity to efficiently execute co-investment (notably the speed of decisions).Flexibility and the capacity to take a position on a transaction within a tight time frame are competences valued by GPs.

2 – Direct investment experience:
Co-investment transactions are marked by high volatility, just as the private equity market is. The selection of these opportunities requires a different expertise to building a hedge fund portfolio. For example, with hedge fund portfolios the focus would be on selecting GPs with the best track record. This criterion is less important when selecting a co-investment opportunity.In addition to defined and rigorous analysis procedures to safeguard against selection bias (for example, by favouring GPs with the best track record as mentioned), the evaluation of an opportunity requires in-depth understanding of the transaction, which in turn requires know-how of direct investment.

Advantage N°2 : optimisation of capital deployed

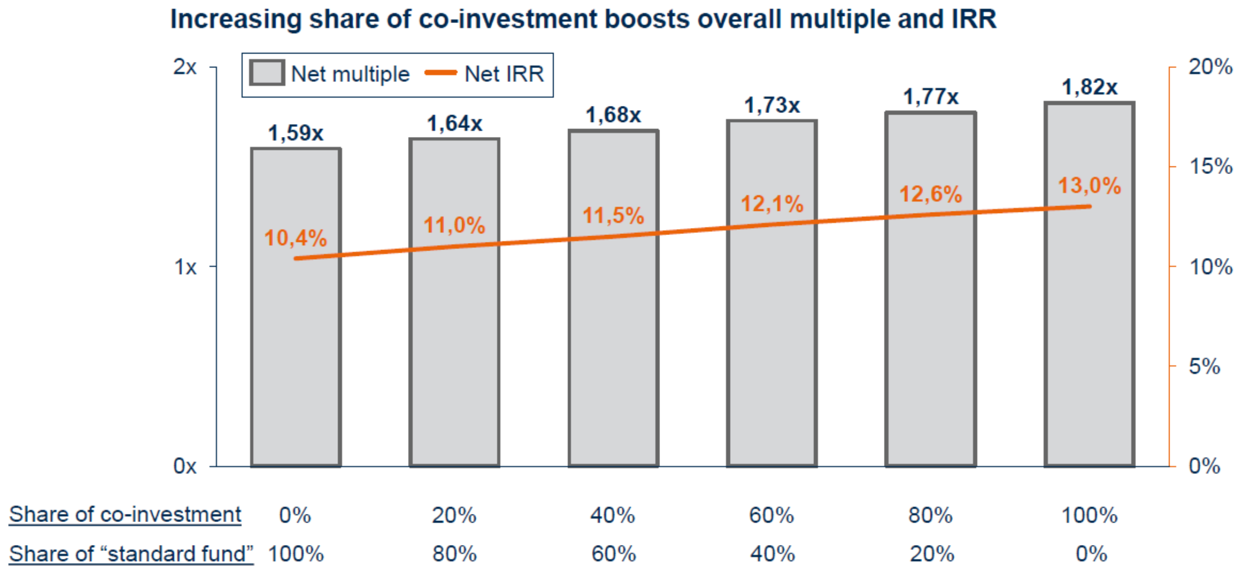
Generally-speaking, co-investment opportunities are offered to LPs alongside investment by the LP in the GP's main fund. A side letter signed at the point of subscription guarantees that the LP will benefit from priority rights to co-invest, as well as attractive conditions of reduced or zero fees. In other words, the co-investment enables LPs to deploy a smaller level of capital at a low cost - an opportunity that, due to a lack of internal resources or availability, is rarely taken up by LPs who do not take advantage of the value of this asset.

The possibility of optimising the capital deployed is strengthened by the fact that co-investment gives access to pre-qualified deals by the GP, which generates a higher selection rate than "traditional" private equity activities.For example, at Omnes Capital, the selection rate is close to 15% for co-investment activities, against a lower rate of 5% for capital growth activities.

Moreover, co-investment allows for increasing the deployment of the private equity segment within a pre-existing network of GPs, without resorting to selecting a new private equity firm which can be time consuming.

To conclude, co-investment enables an LP to increase its capital deployed and to improve the profitability of its assets without increasing resources (in the case of outsourced management). By way of example, by allocating 20% of its capital in co-investment an LP can boost the performance of the private equity segment by 0.05x multiple and 0.5% IRR. This is under the assumption of a dedicated vehicle model including a management mandate, with a brute performance equal to that of funds within the network of GPs.

A share of co-investment in private equity allocation enables to increase returns



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Implications

Outsourcing co-investment management provides an LP with the benefit of maximising its returns without requiring additional resources. However, it is important to highlight that in-house management requires a high-level of availability and flexibility from teams.

On one hand, the origination of co-investment transactions requires strong ties with the network of GPs, a proactive solicitation approach, and the capacity to demonstrate the efficiency of the in-house execution process to the GPs.The selection of opportunities offered also requires teams to be highly flexible, in addition to knowledge of direct investment.

On the other hand, executing the transaction is particularly demanding in terms of resources, because it calls for several additional profiles and competences (legal, compliance, finance and investment teams).

Advantage N°3 : in-depth knowledge of the LP's network of GPs

In the context of syndicating a portion of the equity during a transaction, the GP will solicit all of the subscribers having expressed - usually via a side letter - the desire to study co-investment opportunities. During the process, the GP's teams are therefore required to be in regular contact with the LP teams to present the transaction and the investment rationale etc. This allows the LP to become more familiar with the investment teams and to also have a practical insight into the internal operating and organisation of the private equity firm.

Moreover, the regular contact between the GP and LP teams during a co-investment represents a significant motivation so that private equity companies, who are seeking to form closer ties with their subscribers, syndicate a portion of their transactions.

Implication

However, the closeness of the teams during a co-investment can become detrimental to the relationship between LPs and GPs if they struggle to agree on the terms of the transaction. In the context of a competitive transaction, whereby it is critical for co-investors to be reactive and flexible, the fact that each party looks out for their own interests can have a counter-productive effect and even risk the completion of the transaction.

Advantage N°4 : a strategic arbitrage opportunity in an LP's portfolio

Whether an LP invests directly or via a dedicated management mandate, it has the possibility of closely managing its co-investment program, both in terms of building a portfolio and the pace of the deployment. This would not be the case if it invests in a co-investment fund.

Contrary to "traditional" vehicles for which management fees are annually levied on a percentage of the global undertaking, co-investment vehicles generally offer management fees calculated on the basis of the capital deployed. Consequently, the decreased pace of investment does not have an impact on the net performance of the vehicle over the long term. This characteristic can prove to be particularly valuable in the case of an unfavourable conjuncture at the point of deployment, such as the current health crisis, or even if the LP wants to temporarily hold on to its cash to focus on one of its other class of assets.

Direct co-investment or via a dedicated mandate both offer an LP the possibility of steering the construction of the portfolio, based on a strategy that can greatly vary. For example, aiming for maximum diversification to achieve stability, or even attempting overexposure in certain sectors of activity, certain geographical areas or even certain sizes of companies.

Moreover, co-investment can have a strategic interest for an LP because it enables better monitoring of shareholdings, notably thanks to broader and more frequent reporting than the information generally shared in a fund report; and even possibly due to a position that the co-investor might have negotiated during a management meeting. This accrued level of information is particularly useful for making decisions regarding shareholdings (for example, for a reinvestment), but also to better predict subjacent market trends.

Conclusion

Co-investment appears to be an indispensable allocation strategy for institutional investors. It allows for capitalising upon rights in order to increase the capital deployed, while also offering a high-potential for outperformance and a flattening of the "J-curve". Co-investment represents a strategic interest by allowing for control over the construction of the portfolio and the speed of deployment. Additionally, it guarantees access to privileged information on the performance of the shareholdings as well as on the working methods of the private equity firm.

While the direct management of co-investments (via internal resources) appears attractive, there are several pitfalls to avoid, notably (i) co-investment management consumes significant resources, be it for the origination, the execution or the monitoring of transactions particularly at the point of specific events (reinvestment, recapitalisation etc.) (ii) GPs expect a high level of reactivity from their co-investors, which amplifies the importance of team flexibility (iii) co-investment requires direct investment skills, particularly to ensure the alignment of interests between the different stakeholders.

Outsourced management enables institutional investors to optimise their returns yet without increasing internal resources, by providing solutions to the risks identified.

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La gestion dédiée des co-investissements, vue par Omnes

We have been designing bespoke co-investment solutions for institutional investors since 2007

€500 M	40+	2.3x
Assets under management	Portfolio companies	Gross average multiple on 10+ exits

We believe that co-investment, due to its flexibility and potential for outperformance, is an indispensable allocation strategy for institutional investors.

However, co-investment management consumes significant internal resources. Our role is to support our investors, via dedicated investment mandates, in order to enhance and manage their co-investment rights. We oversee the entire investment life cycle: (i) origination, (ii) selection of the best opportunities, (iii) execution of transactions and (iv) monitoring shareholdings and exit.

We design **bespoke co-investment solutions**, in terms of investment structuring and strategy, based on our clients' needs. Thus, we can work in a variety of classes of assets (e.g.: infrastructure/capital development), no matter what the business sector is, the geographical area or the size of the portfolio company.

Thanks to our historical market presence, we are preferred partners among European and American GPs who recognise our expertise and capacity to efficiency process opportunities. Moreover, Omnes Capital's direct investment experience enables us to select and execute transactions that meet our clients' best interests.

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