ROUNDTABLE

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How to be the perfect partner

A well-thought-out co-investment strategy can put you first in line as the partner of choice for your favourite GPs, write Amy Carroll and Adam Le

Co-investing has become the darling of private equity, offering a tantalising combination of financial and strategic advantages over traditional fund deployment. "At the simplest level, there are three key benefits to co-investment: returns, diversification and economics," says Patrick Kocsi, co-head of co-investment at Ardian, speaking on *Private Equity International*'s annual co-investment roundtable.

Co-investment also offers participants greater control over their exposures when compared with blind-pool offerings.

"Co-investment can be a way of tilting your portfolio in a certain direction," says Lutz Fuhrmann, a partner at Lexington Partners. "You can also control your own deployment speed, ramping up or putting the brakes on as necessary. Finally, co-investments allow you to deepen relationships with GPs, doubling down on exposure to your favourite managers."

Churchill Asset Management's co-investment programme, for example, focuses exclusively on the US mid-market. "We find that resonates well with investors around the world who want that access but do not necessarily have the infrastructure to go out and establish those relationships first-hand," says Churchill senior managing director Derek Fricke. "They essentially outsource that task to us and pay half the economics that they would if they were picking individual managers."

"We like the fact that as co-investors, we are essentially private company stock pickers," adds Andrew Bernstein, senior managing director and head of private equity at Capital Dynamics. "We can leverage our platform to identify the very best mid-market businesses owned by the best mid-market GPs and then build a diversified portfolio that is available on better economics than any portfolio investors could build for themselves."

Meanwhile, Debevoise & Plimpton partner Gavin Anderson says co-investment can also be an effective way for institutions to move up the direct investment knowledge curve, learning more about the nuts and bolts of what is required, should the sponsors be willing to share that information. "Given the preferential economics, I would also assume that co-investment should outperform primary fund investment, all things being equal."

Kocsi agrees, noting that a proactively selective approach to co-investment does indeed result in superior returns. "We track data on deals we have completed and those that we have declined. The data demonstrates that we do generate alpha. It shows that selectivity matters."

Capital Dynamics also runs analysis of deals completed versus deals passed on. "The deals we do perform better, but more importantly, there is also far less volatility," says Bernstein. "We are

Lutz Fuhrmann

Partner, Lexington Partners

Lutz Fuhrmann is responsible for the evaluation and management of non-US equity co-investments at Lexington Partners. Prior to joining the firm in 2012, he was an investment director at CVC Capital Partners and an associate at Deutsche Bank.

Gavin Anderson

Partner, Debevoise & Plimpton

Gavin Anderson is a member of Debevoise & Plimpton's private fund transactions, and investment funds and investment management groups. He has broad experience in advising sponsors and investors on fund formation, co-investment, fund restructurings and carried interest arrangements.

Patrick Kocsi

Co-head of co-investment, Ardian

Before joining Ardian, Patrick Kocsi spent 24 years with General Electric Company, most recently leading GE Equity, the private equity arm of GE Capital, before the business was sold to Ardian in 2015. He also founded Juna Equity Partners. He has 27 years' experience of private equity investing.

Andrew Bernstein

Senior managing director and head of private equity, Capital Dynamics

Andrew Bernstein has over 25 years of experience in private equity and investment management. Prior to joining Capital Dynamics, he worked at TCW/Crescent Mezzanine and at Canterbury Capital Partners. Earlier in his career, he worked at Goldman Sachs.

Derek Fricke

Senior managing director of junior capital and private equity solutions, Churchill Asset Management

Derek Fricke is responsible for sourcing and executing investments in junior capital, equity co-investments and private equity funds, and serves on the investment committee. Before joining Churchill in 2013, he worked at Chrysalis Ventures and BIA Digital Partners.

not looking to back home runs necessarily, but we are definitely looking to avoid losses. Our investors are looking for consistency, and that is what we deliver."

Access all areas

Of course, in order to display active selection and deliver those consistent and superior returns, co-investors first need access to dealflow. That means differentiating themselves as a partner of choice for GPs.

For Kocsi, it all starts with being primary investors in GPs' funds. "That capital piece is crucially important," he says. "At Ardian, we have more than 600 GP relationships worldwide and sit on more than 360 LPACs. We source deals from these relationships. It is no surprise that there is a high correlation there with where the firm's primary dollars are deployed."

An ability to play across the capital stack can also prove helpful. "We often get early calls from GPs because of our senior direct lending business," says Fricke. "Sponsors want senior lenders on every new LBO, so we are often contacted for a debt read, as well as co-investment and potentially junior capital as well."

Anderson, meanwhile, points out that a willingness to actively seek out emerging managers rather than simply going with the big, well-known names can be an interesting strategy when it comes to gaining access to co-investment. "There is a lot of value in finding diamonds in the rough and getting there before those managers have built enormous funds and co-investment programmes," he explains.

"Diversification is our friend. We are not on the front lines. We are one step removed, and so our influence is limited. Having a diversified portfolio that can be resilient through market cycles is key"

DEREK FRICKE
Churchill Asset Management

Whatever the strategy, communication and trust are paramount. "It is all about being a reliable partner," says Fuhrmann. "Many GPs are looking to reduce uncertainty around their deployment. As co-investors, we therefore need to be very clear about what we like and don't like, even during the initial call, so the process can be as efficient as possible."

Bernstein, meanwhile, believes it is important to bring differentiated value. "In order to stand out from the crowd, you need to be more than just a capital provider. We are involved at a board level in around a third of the deals that we do, either as a director or observer, and even where we are not, we find ways to support our GPs. For example, we often invest in global companies backed by managers based in a single country. We are able to leverage our global footprint to make introductions and open up new avenues of growth for those businesses."

While the ability to add value in the ownership phase is important, positioning yourself as a good partner begins in the due diligence phase. "GPs don't want to be pestered with irrelevant questions throughout the due diligence process," says Fricke. "That means you need an experienced team that understands the cadence of an auction and can be self-sufficient [while] digesting information."

"There is definitely such a thing as a silly question in due diligence," agrees Kocsi. "A deal partner's priority is getting the deal done. We ask the right questions at the right time and are always clear where we stand on any given deal. You are expected to do your own digging and come to a swift conclusion."

Of course, there have also been attempts to secure preferential co-investment access through LPAs and side letters, but with limited success. "LPs often ask for language around co-investment in side letters, but GPs are typically reluctant to agree," says Anderson. "If an investor is writing an enormous cheque or has a cross-platform relationship, they may sometimes be able to secure preferential access, but generally allocations tend to be discretionary, which means it all comes back to relationships and a co-investor's ability to be a good partner."

"GPs have many different ways of allocating co-investment," adds Bernstein. "What we find works best is to be proactive. You can't just sit back and wait for the phone to ring. You have to constantly be out there talking to GPs about what they are working on."

Pre-signing vs post-deal

Proactivity has become particularly important in recent years, given the shift towards pre-signing co-investment and away from post-deal syndication. "We like that because instead of competing for allocations with everyone in the market, GPs are choosing to approach just one or two co-investors they trust ahead of securing the asset," says Kocsi. "As a result, we see GPs asking us to increase the amount that we initially indicated we would be interested in. If our diligence bears out taking a larger piece, we will."

"Prior to 2022, demand for co-investment consistently outstripped supply, which meant allocations were often scaled back," says Fuhrmann. "That dynamic then changed completely and we were regularly being offered allocations at the top of our range or even more.

"That situation is now correcting itself to a degree. In many instances, there is still slightly more supply than demand in the market – which is great for dedicated co-investment programmes, but I would say we are closer to an equilibrium than we have been for some time."

Supply and demand of co-investment are both fundamentally a function of the fundraising environment. "In the mid-market in particular, fundraising has been challenging, and so GPs

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> **ANDREW BERNSTEIN**
> **Capital Dynamics**

have been more reliant on co-investors in order to get deals done," explains Bernstein. "It has also been harder to warehouse deals and do post-closing syndications, so we are seeing more pre-signing opportunities.

"Meanwhile, on the demand side, those LPs that have been less active investing in funds have also not been investing in co-investment deals. The confluence of those two factors has resulted in an explosion of dealflow over the past two years."

The CV phenomenon

Another pronounced trend with implications for co-investment involves the meteoric rise of the single-asset continuation vehicle.

There are striking similarities between the two strategies, along with some important differences. "We primarily differentiate based on whether fees and carry are charged," says Fuhrmann. "If there are no fees and carry, then it is co-investment. If carry has been reset and economics realigned, we would typically treat it as a single-asset continuation vehicle."

"The underlying companies themselves are the same, but the GP is in a very different position," adds Bernstein. "With a co-investment, we are underwriting assets simultaneously with the sponsor, while in a continuation vehicle, the GP already knows the asset very well. In these cases, the GP is in sell mode and is trying to convince secondaries investors to come into a new [special purpose vehicle] so that it can continue to own a trophy asset."

Regardless of how firms choose to differentiate between co-investment and continuation vehicles, it is clear that the continuation vehicle market is here to stay. Churchill has even built a business around the phenomenon.

"We actively hired an experienced head of secondaries two years ago, largely because we were seeing a significant number of single-asset continuation vehicles coming to fruition out of our primary portfolio and our

Finding success

Our roundtable participants were asked what it takes to be a successful co-investor in just one word

Access

"First and foremost, you need access to high-quality co-investment dealflow," says Lexington's Lutz Fuhrmann. "You need to see the best possible opportunities in order to then apply both human experience and the vast amount of data that we have accumulated, in order to be selective. We are very focused on pattern recognition at Lexington, mining data in order to help our investment decision-making."

Alignment

"Co-investors are inevitably back-seat drivers," says Gavin Anderson of Debevoise. "They don't have the ability to control terms to the same degree as the sponsor and so they will always be reliant on the GP to a degree. It is important to recognise that and to ensure all parties are fully aligned."

Curiosity

"We see many hundreds of transactions every year, which means everything can become a blur," says Ardian's Patrick Kocsi. "If you don't continue to remain curious, you won't be able to pick out the best combinations of GP and asset. Certainly, when we are hiring young people onto our teams, that fundamental curiosity about what makes a business work and why we should work with a certain GP is what we look for."

Relationships

"Co-investment is primarily offered to existing LPs in funds, and so it is vital to have those trusted relationships and the resulting understanding of whether this particular sponsor should own this particular asset," says Derek Fricke of Churchill. "Without those relationships and that knowledge, it is impossible to proactively select the best co-investment opportunities and therefore to deliver outsized returns relative to the broader market."

Reliability

"GPs need to be able to trust that their co-investment partners are able to get deals done in an efficient manner, particularly where they are working in concert with the sponsor, as opposed to a post-deal syndication," says Capital Dynamics' Andrew Bernstein. "There are a lot of LPs that will raise their hands when asked if they want to do co-investment, but there are not nearly as many that can deliver, executing on the same timeline as the GP."

co-investment book," says Fricke. "While we did roll our position in some circumstances if the terms remained the same and opportunity warranted it, by and large we found we were taking liquidity and moving on. But we recognised that these deals represented great opportunities and have since stood up a programme to play offence in these, and other, secondaries opportunities.

"I would argue that the hardest thing a GP has to do is originate transactions. The second-hardest thing is finding the right management team and executing on the value creation strategy. With a continuation vehicle, the GP is a few years into the holding period; they know the asset and have helped to improve and create value for the company over time. In many respects, it is a de-risked co-investment, but with enhanced economic alignment. We're incentivising sponsors, but also requiring they are putting their money where their mouth is."

However, the rise of the continuation vehicle has caused some controversy around existing co-investments, says Bernstein. "Issues have arisen as a result of co-investment in assets that have gone on to be put into co-investment vehicles, which is why we now ensure language goes into documents on the way into a co-investment that provides us with tag rights but not the requirement to be dragged."

Anderson notes, "There is definitely a lot of discussion at the moment regarding what investors want and what sponsors think is reasonable in these situations."

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GAVIN ANDERSON
Debevoise & Plimpton

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PATRICK KOCSI
Ardian

Co-investment pitfalls

Ensuring co-investment scenarios are catered for in legal documents is just one of the ways in which co-investors need to prepare for potential pitfalls.

"Co-investment often comes with a great deal of time pressure," says Anderson, "so co-investors need to think carefully about what questions to ask. Potential areas of risk include tax. FDI filings have also become more of an issue over the past few years, particularly for large institutions that may need to cross aggregate holdings, with that analysis potentially needing to be carried out at short notice. It is important to be prepared."

Says Bernstein: "There are standard protections that you need as minority investors in terms of tag-along rights, pre-emptive rights and registration rights. Those are basic provisions, but it is amazing how often we get the initial draft of the legal documentation from the GP and there are issues with those terms, which undermines our ability to be in lockstep with the sponsor."

For Fuhrmann, however, the best way to avoid pitfalls is to stay disciplined. "Most people say they are not trying to time the market. Having said that, private equity tends to be cyclical. Most deals get done when valuations are highest, and so that is when most co-investment capital is deployed as well. You need to hold back when things are overheating and make sure you have the capital to keep deploying consistently when the correction comes."

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LUTZ FUHRMANN
Lexington Partners

Fricke, meanwhile, believes diversification is the best risk mitigant. "Diversification is our friend. We are not on the front lines. We are one step removed, and so our influence is limited. Having a diversified portfolio that can be resilient through market cycles is key."

Market outlook

With that disciplined and diversified approach in mind, the outlook for co-investment deployment looks positive. "We believe dealflow will increase in the coming quarters, with M&A contributing more meaningfully," says Fricke, citing bankers with a backlog of engagements, sellers looking for liquidity or a partner, LPs desperate for distributions, and direct lenders with money to put to work.

"Then, of course, there are the sponsors," he adds. "GPs need to return capital to their LPs so they can look ahead and raise their next vintage."

Kocsi says: "We feel that private equity dealflow is bound to come back almost regardless of the economic and political situation – barring any major calamity, of course. That uptick will be positive for us in terms of dealflow. I also think this vintage will be good in terms of the quality of companies, deals and GPs coming to market. The potential challenge will be that there will be more demand for co-investment allocations, as well."

Fuhrmann says Lexington has already seen a pick-up in PE deal volumes in 2024. "With higher equity components to finance transactions compared with the last decade, co-investment dealflow remains very strong as sponsors more carefully navigate their fund deployment. We expect this trend to continue over the next 12 months."

Bernstein agrees: "Many GPs have now recognised how important co-investment is to their LP base and so they are making co-investment a permanent part of their business models. As a result, I expect the co-investment market will continue to grow." ■