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CO-INVESTMENT

OUTSOURCING CO-INVESTMENT: THE ADVANTAGES OF A SEPARATE MANAGED ACCOUNT

Introduction

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 in a fund 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 by offering increased flexibility.

Co-investment also offers many advantages for an LP[1]: the potential for outperformance, optimisation of capital deployed, in-depth knowledge of the LP's network of GPs, and even a strategic arbitrage opportunity in an LP's portfolio. While co-investment appears to be a true must-have in a portfolio, it is nevertheless important to reflect on its set up structure in order to choose the most suitable strategy.

In this publication, after presenting the various co-investment structure options, we will explain why it is better for certain institutional investors to outsource their co-investment management. Secondly, we will analyse the advantages of separate managed accounts, and the key areas of focus to implement one.

1. *For more details, see the publication "Co-investment: advantages and potential pitfalls".*

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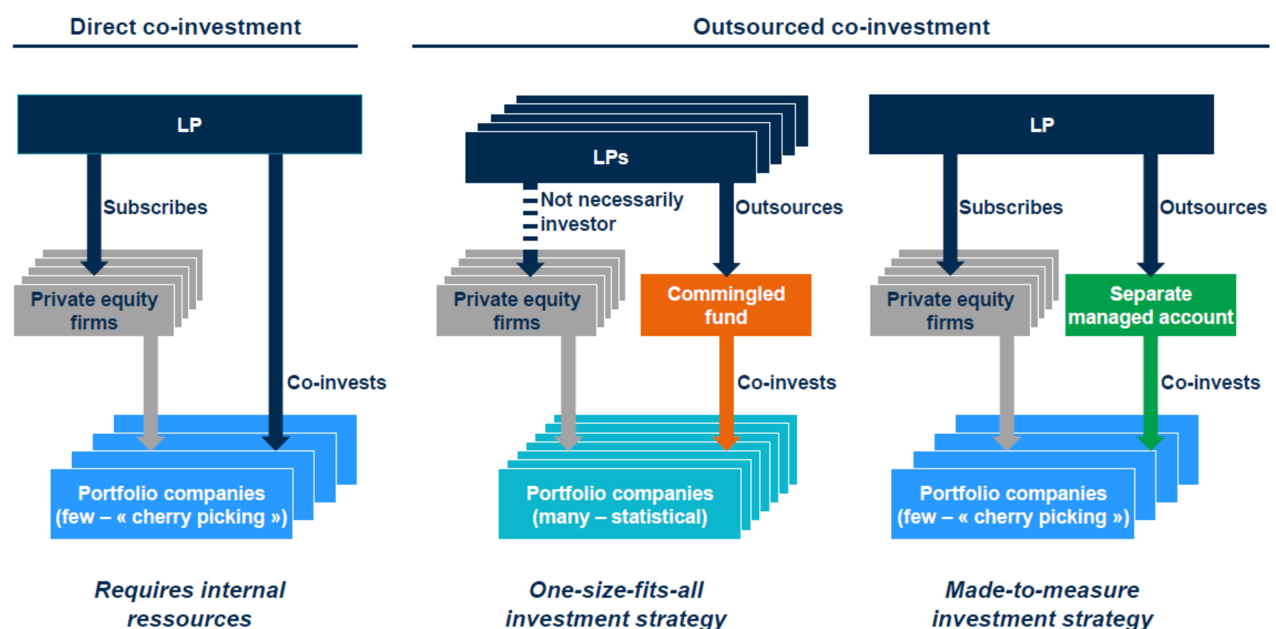
The various co-investment structures

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 in-house, as well as the selection of opportunities, the portfolio monitoring etc. This option requires resources. The second, which is also the most common, is based on the subscription in a commingled co-investment fund, 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 separate managed account, to a private equity firm that creates a bespoke co-investment strategy and manages the origination, selection and execution of the transactions.

The different types of co-investment structures



Why outsource co-investment management?

While the direct management of co-investments appears attractive for an LP (by avoiding an intermediary and their fees), it is important to keep in mind the key characteristics of the structure before implementing a co-investment solution.

A key aspect of the popularity of co-investments is linked to a reduced cost structure, compared to usual fees for private equity fund. Whereas “traditional” investment funds typically offer subscription conditions based on a model of 2% per year for management fees on the capital committed and 20% outperformance fees, co-investments generally carry a management fee of 1% per year of the capital invested (and not committed) and an outperformance fee of 10% (and sometimes - for direct co-investments - no management or performance fees).

These reduced fees will generally be negotiated at the point of subscription to the main fund, along with priority rights to co-investment opportunities, and formalised by a side letter. Accordingly, co-investment equates to the right to reduce average subscription fees, set by private equity firms managing the funds subscribed to by an LP. However, in practice, many LPs give up this right, and therefore do not optimise the cost of their capital deployed.

Two main reasons explain this phenomenon. Firstly, co-investment management consumes significant resources. In a market where reactivity and flexibility are essential, it is necessary to have the appropriate resources to guarantee the best response time to GPs throughout the co-investment process. Over time, GPs have a tendency to offer co-investment opportunities to investors capable of rapid delivery, whether at the point of making a decision about an opportunity, when negotiating legal terms, or also during closing. Not only must resources be available, they must collectively possess a variety of skills: financial, strategic, legal, compliance etc. In practice, few investors have a set up that truly allows for guaranteeing this level of reactivity towards GPs.

“Co-investment is a right, offered to LPs to reduce their average subscription fees. However, in reality few LPs take up this opportunity due to a lack of internal resources.”

Co-investing also requires experience of direct investment. Co-investment transactions can be very varied in nature, just like private equity in general. The selection of these opportunities requires a different expertise to building a fund of funds portfolio. For example, with fund of funds 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.

The advantages of a separate managed account

When investors with few internal resources are obliged to outsource management tasks, two options are available: the co-investment fund or a dedicated management mandate.

These two models have their own specific characteristics, as summed up in the table below:

Vehicle type	**Separate managed account**	**Commingled co-investment fund**
Number of LPs	One	Many
Structuration	Taylor-made	Set up by the GP
Investment strategy	Defined by the LP	Defined by the GP
Investment pace	Typically 3 years ; can be adapted by the LP	Typically 3 to 5 years
Portfolio construction strategy	• Limited (c.12) number of participations – selection of best opportunities • Strategy is adapted to LP's requirements	• High (c.20) number of participations – statistical portfolio construction • Portfolio construction is managed by GP
Deal origination	Mainly from the LP's network of GPs	Done by the GP, through its own network of GPs
Services	Taylor-made – close relationship: • Transaction execution with potential involvement of LP • Frequent and customized reporting • On-demand ad hoc analyses or informal reporting • Cash flow management: drawdown, distributions, cash flow predictions	Identical for all LPs: • Transaction execution – discretionary decisions • Frequent reporting • Cash flow management: drawdown, distributions

While separate managed accounts require an established network of GPs and capital that is already deployed, they offer several advantages for an LP:

1) Bespoke structures

In the context of a separate managed accounts, the LP is by design the only subscriber to the co-investment vehicle. The LP naturally benefits from significant room to manoeuvre to define the characteristics. For example the type of vehicle (e.g. FPCI, SLP - French investment funds reserved for professional investors), geography, size of the global undertaking, duration of the subscription period, etc., can be adapted to suit the LP's specific needs. This is not the case with a commingled co-investment fund that has more than one LP subscribing to it.

2) Control over the pace of investment:

Contrary to "traditional" vehicles for which management fees are annually levied on a percentage of the committment, 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 is 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. The fact of being the sole suscriber once again guarantees optimal flexibility for the LP for the management of their global private equity portfolio, which is not the case for a commingled co-investment fund.

3) Building a bespoke portfolio

Co-investment via a separate managed account offers an LP the possibility of steering the construction of the portfolio, based on a multi-criteria strategy. For example, aiming for maximum diversification, or even attempting overexposure in certain sectors of activity, certain geographical areas or even certain sizes of companies. Once again, the flexibility of the management company is an essential element to adapt the deployment of capital on the basis of its client's needs.

Omnes Capital's co-investment teams are dedicated to finding innovative solutions to respond to LPs' requirements. The aim is to guarantee maximum flexibility in order to offer LPs an additional tool for their private equity deployment strategy. For example, we designed - for an LP that wishes to progressively invest in co-investment - an ad-hoc vehicle to host a single transaction, while retaining maximum flexibility for its future evolution. Designing an investment vehicle divided into sub-funds to hold different asset classes (e.g. LBOs vs infrastructure) is also a good example that demonstrates the capacity of an LP to steer its investment strategy under the framework of a separate managed account.

4) Increased knowledge of its network of GPs and portfolio companies

Moreover, a separate managed account can have a strategic interest for an LP because it enables better monitoring of portfolio companies, notably thanks to broader and more frequent reporting than the information generally shared in a fund report; and even possibly due to a position in the management board that the co-investor might have negotiated.

This accrued level of information is particularly useful for making decisions regarding participations (for example, for a reinvestment), but also to better predict subjacent market trends.

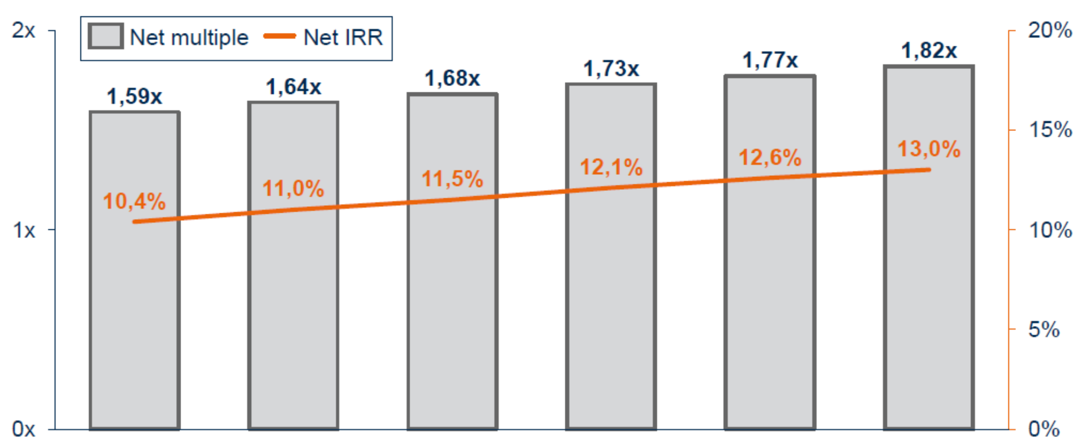
How is a separate managed account set up ?

1) How much to allocate to co-investment ?

The first question that an institutional investor should consider is the volume of the private equity segment to allocate to co-investments.

A key consideration to answer this question is the potential that the co-investment has to boost the performance of the overall private equity allocation. Via the structuring of its management fees, co-investment allows for optimising the return on capital deployed. By way of example, by allocating 20% of its capital in co-investment an LP can boost the overall performance of the private equity segment by 0.05x multiple turn and 0.5% IRR. This is under the assumption of a separate managed account, with a gross performance equal to that of funds within the network of GPs.

Performance d'une allocation de *private equity* en fonction de l'allocation en co-investissement



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

While, in theory, a private equity allocation made up of 100% co-investment allows for achieving significantly higher returns, it appears unlikely in practice to allocate a portion above 20-25% to co-investment. For an LP, one of the key elements of a successful separate managed account is effectively based on the rate of deal flow arising from its network of GPs. Therefore, it is important to have a significant portion of capital invested in subjacent funds. Moreover, certain GPs restrict the total amount of co-investment allocated to a client to the amount subscribed in their vehicle.

2) Which co-investment strategy?

By design, the LP increases its exposure to a transaction during a co-investment, because it is already an indirect shareholder via the intermediary basis of a subscription with the GP that is leading the syndication. Thus, defining a co-investment strategy consists of defining a typology of transactions to which the LP wishes to overexpose itself.

3 main co-investment strategies can be identified:

Stratégie thématique

This approach involves concentrating co-investments in specific market segments. Selection (or exclusion) criteria can focus on:

- Business sectors (i.e. health, software)
- Geographical exposure
- The development phase of the target: Venture Capital / Expansion Capital / LBOs
- The nature of the activity: Infrastructure / Private Equity
- The type of transaction: primary / secondary

This approach allows for steering the private equity envelope risk/rewards ratio, by targeting segments with specific profiles in terms of potential returns, resilience, or even volatility. On the other hand, this strategy requires initial a priori strong convictions about the characteristics of the target market segments. Consequently, this can turn out to be a losing strategy.

Diversification strategy

Contrary to the previous strategy, this option involves reproducing the GP network's "natural" exposure, via a highly diversified co-investment portfolio. With this approach, the gross return on the co-investment portfolio will generally be similar to the gross return on the LP's private equity segment. On the other hand, the net returns will be superior due to the reduced fee co-investment structure.

The advantage of this strategy is its simplicity, since it requires little know-how in terms of analysis and selection of co-investment opportunities. Additionally, it is relatively low risk since it involves replicating the gross performance of the LP's private equity allocation.

On the other hand, it consumes significant resources as it requires a high level of availability and flexibility from teams for the execution and monitoring of the portfolio companies. Moreover, the potential for outperformance is limited to the differential of the fee structures between the subjacent funds and the co-investment funds.

Best-of-breed strategy

This approach consists of being very selective about co-investment opportunities, in order to target transactions offering the most attractive risk/reward ratio. Simple in theory, however this strategy presents several pitfalls.

Firstly, a reduced selection rate implies a longer deployment pace and/or a portfolio with fewer portfolio companies. It is therefore paramount to remain disciplined in the selection of opportunities in order to avoid any temptation to accelerate the deployment by selecting less attractive opportunities. This bias, that can exist for any private equity management firm, can prove to be particularly detrimental in co-investment.

Additionally, this strategy requires significant co-investment experience. Effectively, co-investment transactions have, as per the entire private equity market, very diverse characteristics. The selection of best opportunities requires a different expertise to building a fund of funds portfolio. For example, with fund of funds 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.

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Conclusion

Co-investment offers many advantages for institutional investors and appears to be a true must-have in an asset management strategy. Nevertheless, the choice of structure to set it up requires thought. Even if the direct (i.e. in-house) co-investment option appears to be the most attractive from the point of view of the associated costs, in reality few LPs have the availability and flexibility of internal resources to capitalise on their co-investment rights.

Accordingly, in order to optimise returns on capital deployed, it truly is in an LPs best interest to outsource the management of its co-investment segment, either via a subscription to a co-investment fund or via a separate managed account. This arbitrage will mainly depend on the characteristics of the LP (e.g., the volume of assets under management, the size of their GP network etc.) as well as their allocation strategy.

In the context of a separate managed account, the LP will have the possibility of benefiting from a bespoke service. The aim of this service is to defend its best interests. Effectively, co-investments require an in-depth understanding of the transaction as well as significant experience in order to avoid the potential pitfalls.

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Co-investment by 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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