The State of Co-Investments

Jessica Duong explores the attraction of co-investment opportunities and presents the results of Preqin’s recent survey of LPs and GPs relating to their attitudes and activities within the co-investment space.

Many fund managers offer co-investment opportunities (investments made in portfolio companies alongside a GP) to their limited partners whereby the private equity firm involved will typically exercise control and perform monitoring functions. Such opportunities are usually at the discretion of the GP rather than a matter of entitlement for the LP, but in recent years, there has been a rise in appetite for such investments in the industry. Generally speaking, co-investments are offered primarily to the larger LPs in the fund, and/or to those which were cornerstone investors in the first close, but now investors of all sizes seem to be showing increasing levels of interest in participating in co-investments with their GPs.

A Win-Win

Co-investments are passive, non-controlling investments, a provision of separate equity that is often not subject to fees. Though they carry a greater level of risk and complexity, co-investments bring a myriad of benefits to both the investor and fund manager. This can include better returns, diversification of portfolio, better alignment of interests between partners and increased efficiency. Specific pulls for the investor could include lower management fees and reduced carried interest, exposure to quality private equity assets, an ability to evaluate the risk-return profile, which is not necessarily available in traditional fund investments, better transparency and mitigation of the J-curve effect as capital is deployed faster. Furthermore, experience in deal-making gained through co-investing alongside GPs gives LPs the opportunity to expand their internal capabilities, acquire valuable experience in direct investments, and gain direct exposure to industries they may not have access to otherwise.

Increasing Prominence

In February 2014, Preqin conducted a survey of 140 private equity LPs based around the globe in an effort to ascertain their current attitudes towards co-investments and their activities within the space.

Results revealed that the vast majority (73%) of investors surveyed have co-invested alongside a GP in a deal in the past. Fig. 1 shows the breakdown of LPs’ current plans for co-investments, with 40% actively seeking co-investment opportunities at present and 37% doing so on an opportunistic basis.

Preqin was interested to test the hypothesis that co-investments are mainly the domain of larger LPs with more assets under management, which many in the industry have assumed. Fig. 2 shows the typical proportion co-investments account for in an LP’s portfolio by current allocation to private equity. It shows that there is no real trend to support the assumption that larger LPs typically allocate a greater proportion of their portfolio to co-investment opportunities. For instance, 31% of investors surveyed with less than $250mn allocated to the private equity asset class have less than 2% of their portfolio made up of co-investments; 11% of investors with $501mn to $1bn allocated to private equity asset class have less than 2% of their portfolio made up of co-investments; 11% of investors with $501mn to $1bn allocated to private equity and 43% of investors with more than $5bn allocated fall in the same category of low co-investment activity.

Fig. 1: LPs’ Current Level of Co-Investment Activity

Source: Preqin LP Co-Investment Survey, February 2014

Fig. 2: Proportion of LPs’ Total Private Equity Portfolio Made Up of Co-Investments by Current Allocation to Private Equity

Source: Preqin LP Co-Investment Survey, February 2014

Fig. 3: GPs’ Views on the Benefits of Offering Co-Investment Rights to LPs

Source: Preqin GP Co-Investment Survey, February 2014
Institutional investors across the board are increasingly seeking new ways to extract value from their private equity portfolios and a growing number are setting aside capital specifically for private equity co-investments. Several different motivations are behind this trend, as shown in Preqin’s survey results. A significant 70% of LPs surveyed specified the reduced costs associated with co-investments as a top pull factor and 75% cited the real potential for higher returns. Forty-six percent of respondents acknowledged the fact that co-investments also allow LPs to strengthen their GP relationships. A favourable relationship with a GP will increase the likelihood that the LP is at the top of the list when a good investment opportunity arises.

GPs are becoming more willing to offer co-investment rights, acknowledging the substantial investor appetite apparent in the industry and perhaps also using it as a strategy to navigate through the difficulties of the current private equity fundraising environment. Since 2008, fundraising levels have failed to recover completely, and parallel to the multitude of benefits co-investments can bring, consideration must be given to the number of existing obstacles that can hold co-investment activities back, ranging from micro to macro factors. A lack of human resources will limit a firm’s capability to take advantage of any co-investment opportunities, as will a lack of available capital. Legal constraints and regulatory changes affecting the private equity industry such as Basel III and the Solvency II Directive in Europe, which limit the amount of capital certain LPs can have held in the asset class, are further possible roadblocks.

In addition to the 140 LPs, Preqin also surveyed 80 fund managers around the world to understand their reasons for offering co-investment rights. Fig. 3 shows the most prominent reason why GPs offer co-investment rights is to build stronger relationships with LPs, which was cited by 76% of respondents. Over half (51%) of GPs view co-investments as a valuable method for gaining access to additional capital for deals. The use of co-investor capital in deals alongside their funds allows for investment into larger transactions, which GPs may not be able to access with fund capital alone.

Hindrances and Downsides

Parallel to the multitude of benefits co-investments can bring, downsides to co-investments from the specific viewpoint of GPs can also be numerous. Preqin’s survey of 80 GPs showed that the greatest proportion (58%) of fund managers see co-investments as a delay to the deals process, as they can slow down the process. Other disadvantages include the additional costs incurred, such as the cost of reporting to co-investors or managing AIV/SPVs, and the negative impact on relationships with those LPs that are not offered co-investment rights, as shown in Fig. 4.

Promising Potential

In spite of the various hurdles that LPs face in their chase for co-investments, Fig. 5 shows that almost half (47%) of all respondents have 6% or more of their private equity portfolios attributable to co-investments. According to Preqin’s Investor Intelligence database, those LPs that have expressed an interest in co-investments have an aggregate $34tn of assets under management.
This number suggests there is some notable potential for investors to partake in private equity co-investments, with substantial amounts of capital allocated to this commitment type.

The current level of LP appetite for co-investments is apparent to GPs when negotiating agreements for their latest vehicles. Fig. 6 shows that 64% of GP survey respondents stated that up to 25% of their LPs pushed for co-investment rights during their most recent fundraise; 27% had 26-50% of their investors do so; 7% had 51-75% of LPs request co-investment rights and 2% had more than 75% do so.

Selective or Passive Followers?

Fig. 7 depicts the breakdown of the LPs surveyed by Preqin by their approach to co-investments. Fifty-five percent stated that they were selective followers, meaning they conduct significant due diligence on deals, but later in the process, and decisions are made on a deal-by-deal basis whether or not to invest in each deal. Conversely, 23% of investors are passive followers; their due diligence is limited, taking up the co-investment opportunity with the intention of generally following the GP’s lead. Other approaches include the LP playing a co-lead role in the deal origin and leading the deal (7%) and the LP being a co-sponsor, whereby the investor undertakes significant due diligence at an early stage in the process.

The Question of Performance

With regard to performance of co-investments, Preqin’s study notes a contrasting picture to the one presented in Lily Fang, Victoria Ivanshina and Josh Lerner’s report titled ‘The Disintermediation of Financial Markets: Direct Investing in Private Equity’, which was published in January 2014. The paper states that co-investments underperform traditional fund investments, attributing poor performance to fund managers’ selective offering of deals at market peaks as co-investments. While Fang, Ivanshina & Lerner’s analysis uses a proprietary dataset of direct investments undertaken in a time period of 20 years by seven large institutional investors, Preqin’s statistics on co-investments have been drawn from direct, first-hand responses from 140 LPs surveyed last month.

All participants of Preqin’s LP survey indicated that they expect some level of outperformance from their co-investments compared to their private equity fund investments. Preqin’s survey results show that less than a quarter (23%) of respondent LPs expect to their private equity fund investments. Preqin's survey results show that some level of outperformance from their co-investments compared to their fund investments. All participants of Preqin’s LP survey indicated that they expect outperformance by +2.6% to +5%, and the remaining 28% look for over +5.1% relative to fund investments. The levels of satisfaction among investors with their realized co-investments are illustrated in Fig. 8, which shows a largely positive picture. Indeed, not a single LP in Preqin’s survey indicated that their co-investments had generated lower returns than their fund investments and of those that were able to provide comment on their returns, 85% stated that their co-investments had given better returns, while 15% said the returns were similar. While our findings are unequivocal and point to the outperformance by co-investments, the divergence of results between the Preqin study and the Fang, Ivanshina and Lerner study is troubling. The safest conclusion may be to say that the jury is still out and further work is needed to fully understand the potential risks and rewards for investors making co-investments.

Outlook

Preqin questioned LPs and GPs about their plans for co-investment activity in the year ahead. The results shown in Fig. 9 and Fig. 10 suggest that 2014 will see an increase in co-investment activity, with 52% of LPs intending to ramp up their operations in this sector and 31% of GPs planning to offer more co-investment opportunities than previous years. However, 35% of LPs are uncertain about their co-investment plans for the year ahead.
they did in the previous year. The responses across both surveys convey the widely positive outlook the private equity industry has for co-investments at present, with strong recognition of the benefits such investments can bring to both LPs and GPs.

However, there seems to be some contradiction between the attitudes towards and the actual co-investment activity occurring. Relatively few LPs are being offered co-investment rights by GPs in the Limited Partnership Agreement, as shown in Fig. 11. In addition, the proportions of LPs taking up such offers in reality according to the 140 LPs and 80 GPs surveyed by Preqin are not as high as one would expect given the enthusiasm expressed for the investment type, as shown in Fig. 12.

It is possible that the hindrances and downsides that relate to private equity co-investments could be holding back both investors and fund managers from following through with co-investments, regardless of the level of desire they have to participate. The high expense of co-investments and also rife competition in the landscape are likely deterrents to those who express an initial interest but fall back further down the line when such issues become more apparent to them.

In any case, the appetite for co-investment is not only evident, but is a strong feature among the plans of many GPs and LPs for the year ahead. As the private equity industry matures and the development of a more sophisticated investor community progresses, 2014 could see an increase in co-investment activity, with benefits for both fund managers and limited partners.

**Fig. 10:** GPs’ Future Plans for Co-Investment Offerings

![Chart showing GPs' future plans for co-investment offerings.]

**Source:** Preqin GP Co-Investment Survey, February 2014

**Fig. 11:** Number of LPs in Latest Fund with Co-Investment Rights Included in Limited Partner Agreement

![Chart showing the number of LPs in latest funds with co-investment rights.]

**Source:** Preqin GP Co-Investment Survey, February 2014

**Fig. 12:** Proportion of LPs that Accepted Co-Investment Opportunities Offered by GPs in 2013

![Chart showing the proportion of LPs accepting co-investment opportunities.]

**Source:** Preqin GP Co-Investment Survey, February 2014

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**Subscriber Quicklink:**

Subscribers to Preqin’s Investor Intelligence can click here to view detailed profiles of 1,136 LPs that consider co-investment opportunities.

The Co-Investor Search feature can be used to find LPs that are interested in co-investing by LP type and location, geographic and industry preferences, requirements when co-investing, future co-investment plans and more.

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