Preqin Special Report: LP Appetite for Private Equity Co-Investments

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Preqin, the alternative assets industry's leading source of data and intelligence, welcomes you to this **Preqin Special Report: LP Appetite for Private Equity Co-Investments**, a unique look at investors in private equity that have an appetite for co-investing alongside fund managers in portfolio companies, their current opinions of the co-investment market, and the outlook for co-investments going forward.

This report is based on information taken from Preqin's **Investor Intelligence** database, the most comprehensive and accurate source of information on investors in private equity funds available today, which profiles over 4,800 investors in private equity funds. Included among those investors are 600 LPs actively looking to co-invest alongside private equity fund managers in portfolio companies, and a further 130 that are considering such opportunities. More details on the information available in the Investor Intelligence database on LPs' co-investment preferences can be found on page 8 of this report.

This report also draws on the results of detailed interviews conducted with over 100 institutional investors from around the world that have an appetite for co-investments. All of the LPs interviewed are profiled on Investor Intelligence, and interviews were carried out between December 2011 and March 2012.

We hope that you find the information included within this report useful and interesting and, as always, we welcome any feedback and suggestions you may have.

Contents:

The Co-Investor Universe	3
LP Appetite for Co-Investing	4
LPs' Reasons for Co-Investing	5
LPs' Methods of Accessing Co-Investment Opportunities	6
LP Requirements for Co-Investing, and Outlook for Co-Investments	7
Preqin: Investor Intelligence	8
About Preqin	9

The Co-Investor Universe

Institutional investors are increasingly seeking new ways to extract value from their private equity portfolios and a growing number are setting aside capital for private equity co-investments. As well as reducing the costs associated with investing in private equity funds and offering the potential for higher returns, co-investments also allow LPs to strengthen their GP relationships and build up their knowledge of the deals process, making them an attractive choice for many investors.

Of the LPs tracked on Investor Intelligence, 43% are actively seeking co-investment rights when committing to funds, and a further 11% are considering such opportunities.

Fund of funds managers account for the largest proportion of the co-investor universe (23%), as Fig. 1 illustrates. Public pension funds make up 10%, while asset managers, private sector pension funds, insurance companies, and banks and investment banks each represent 7% of LPs with an appetite for co-investing. The remainder of the co-investor universe is made up of other LP types including family offices, foundations, endowment plans and superannuation schemes, amongst others.

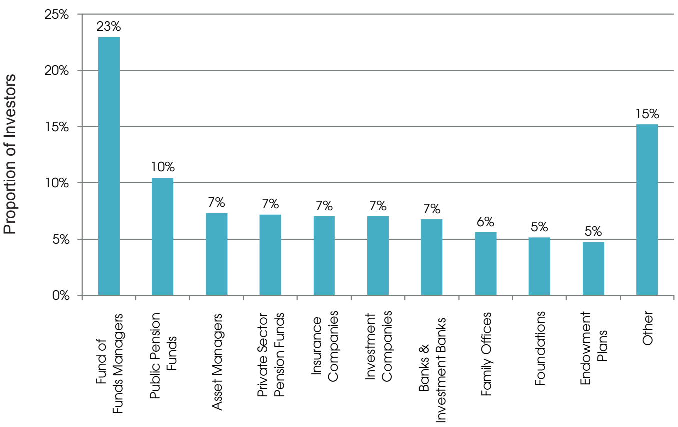
"Sixty-six percent of LPs with an interest in co-investments have over $250mn allocated to the asset class"

In terms of location, 44% of LPs with an appetite for co-investments are based in North America, 31% in Europe and the remaining 25% in Asia and Rest of World.

As illustrated in Fig. 2, LPs with an appetite for co-investments tend to have sizeable allocations to private equity. Sixty-six percent of LPs with such an interest have over $250mn allocated to the asset class, and a significant 13% have a private equity allocation in excess of $5bn. Canada-based CDP Capital – Private Equity Group, for example, has C$15.7bn currently allocated to private equity and dedicates 50% of its portfolio to direct and co-investments.

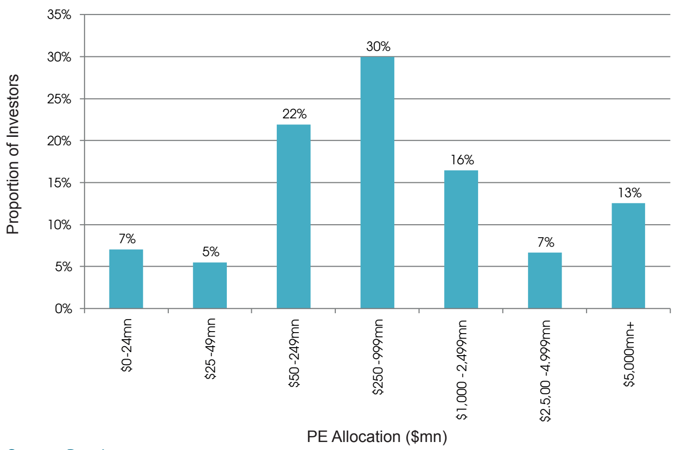
It is interesting to note that 12% of LPs that look to pursue co-investment opportunities have less than $50mn allocated to private equity. One Portuguese foundation we spoke to has just €18mn allocated to private equity and looks to co-invest opportunistically, typically investing up to €5mn in one co-investment on an annual basis.

Fig. 1: Make-up of LPs with an Appetite for Co-Investments by LP Type



Source: Preqin

Fig. 2: Make-Up of LPs with an Appetite for Co-Investments by Size of Private Equity Allocation



Source: Preqin

LP Appetite for Co-Investing

As the private equity industry evolves, many LPs are looking for new ways to access the market; in recent months we have seen an increasing number of investors showing an appetite for co-investing alongside fund managers in deals, willing to take on the greater risks associated with such investments in return for reduced fees and potentially higher returns.

Preqin interviewed 118 investors with an interest in co-investments in order to establish motivations behind such investments, how co-investments fit in with their current private equity strategies, and their intentions for co-investments going forward.

A significant 61% of LPs we spoke to told us that their allocation to co-investments is at the expense of their private equity fund allocation, while the remaining 39% have a separate allocation to co-investments, suggesting that many LPs with an appetite for the strategy are willing to reduce their exposure to private equity funds in order to get closer to private equity deals.

The majority of investors (63%) co-invest alongside GPs on an opportunistic basis and would make such an investment should they be presented with an appealing opportunity (see Fig. 3).

Almost a quarter (24%) of respondents are active co-investors, including one Belgian bank which has so far co-invested in 20 deals, and another Brazilian pension fund which has been co-investing for the past 15 years. Thirteen percent have not previously co-invested but are considering co-investing in the future.

A significant 65% of investors expect to increase their allocations to co-investments in the future and another 26% expect to maintain their existing level of exposure, as Fig. 4 illustrates. One Swiss LP that expects to step up its co-investment activity commented: “People have become disillusioned about fund investments as fund sizes are getting smaller. We want to make as many co-investments as we can with existing managers.”

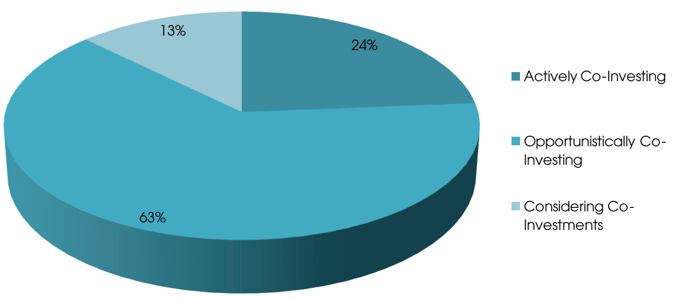
Among the LPs that plan to maintain their current level of co-investment activity is one Finnish insurance company, which commented: “We cannot increase our allocation to co-investments because we do not really have the resources do so.”

“Sixty-one percent of LPs told us that their allocation to co-investments is at the expense of their private equity fund allocation”

Just 9% of LPs that currently have an appetite for co-investing expect to reduce their exposure to co-investments going forward. Some investors noted external influences on their investment portfolios were behind reducing their exposure, including one German bank which commented: “We cannot co-invest as much due to bank regulations [in the European Union],” and a Saudi Arabian asset manager which indicated “legal constraints” as a reason for moving away from private equity co-investments.

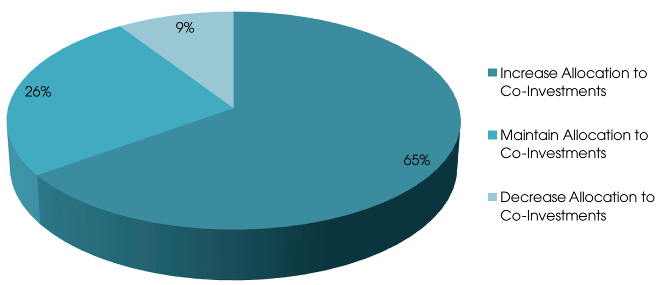
Other reasons given by LPs expecting to reduce their co-investment activity going forward include a lack of human resources, a lack of capital available for co-investments and a difficult market.

Fig. 3: LPs with an Interest in Co-Investing: Current Attitudes Towards Co-Investments



Source: Preqin

Fig. 4: LPs’ Intentions for Their Co-Investment Allocations



Source: Preqin

LPs' Reasons for Co-Investing

There are many reasons why LPs are attracted to co-investments. Although the risk is greater, so are the potential returns; additionally co-investments often offer other incentives to LPs including reduced fees, better transparency, and more control over their investments. We asked LPs about their motivations behind seeking exposure to co-investments.

Fifty-one percent of respondents named better returns as a key reason for co-investing, as Fig. 5 illustrates. Over a third (35%) of LPs we spoke to consider lower fees an appealing factor when pursuing co-investment opportunities, including one Israel-based insurance company which told us it finds co-investments appealing due to "the exposure to quality assets with reduced fees and the ability to evaluate the risk-return profile."

Exposure to deal-making when 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. Thirty percent of respondents told us they co-invest as it provides them with better control over their investments, while 29% feel it helps to strengthen GP relationships. Seventeen percent of respondents seek co-investment opportunities in specific industry sectors in order to deepen their knowledge in particular areas.

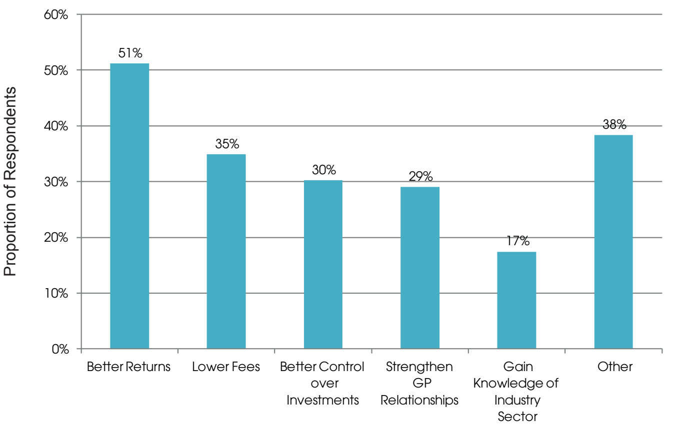
Thirty-eight percent of investors we spoke to named other reasons for co-investing, including further diversification of their portfolio, better transparency, better alignment of interests with GPs, and attractive opportunities in the co-investment space. One US asset manager also commented that "by actively co-investing, an LP can deploy capital with a GP faster, which reduces the J-curve effect associated with private equity investing."

We asked LPs how the returns from their private equity co-investment portfolios compared to the returns from their private equity fund portfolios, and the results can be seen in Fig. 6. Two-thirds of investors noted better returns from their co-investments compared to their fund portfolios, including 13% that told us the returns from their co-investments were significantly better than the returns generated by their fund portfolios.

"Fifty-one percent of respondents named better returns as a key reason for co-investing"

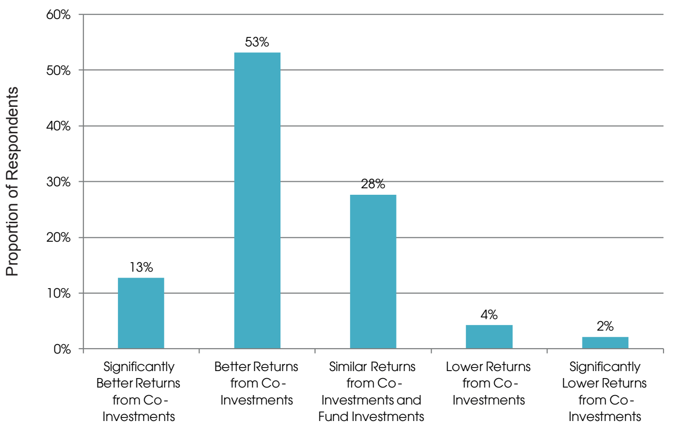
Twenty-eight percent of respondents did not record any variation between the performance of their co-investment and private equity fund portfolios, and just 6% of investors noted lower (4%) or significantly lower (2%) returns from their co-investments compared to their fund holdings.

Fig. 5: LPs' Reasons for Co-Investing



Source: Preqin

Fig. 6: Past Performance of Co-Investments in Comparison to Fund Investments



Source: Preqin

LPs' Methods of Accessing Co-Investment Opportunities

We asked investors how they are gaining access to co-investments – are LPs asking fund managers for co-investment rights? We also asked LPs their attitudes towards co-investing alongside managers that they have not previously worked with.

Three-quarters of LPs we spoke to are asking GPs for co-investment rights when making new fund commitments, as Fig. 7 shows. According to those LPs, when they do ask for co-investment rights they usually receive them. A Saudi Arabia-based investment company commented: "Private equity changed recently and GPs are more willing to offer LPs co-investment rights," and one German government agency noted that "those who commit to a fund before the first close can get more favourable co-investment terms," suggesting that more GPs are willing to offer co-investment rights to investors in order to secure early commitments in this difficult market.

Furthermore, a Belgian investor told us that being offered co-investment rights "is a first hurdle when making a fund commitment," indicating that it would only commit to a private equity fund if it was also given the opportunity to co-invest in deals alongside it.

A quarter (25%) of LPs we spoke to do not ask for co-investment rights in the new funds they are investing in and instead prefer GPs to approach them with such opportunities.

Strong relationships with fund managers are important for many investors when co-investing alongside funds, and 38% of respondents would not consider co-investing alongside a fund manager unless they had an existing relationship. However, 62% of LPs told us that they would consider co-investing alongside fund managers that they had not previously worked with, as Fig. 8 demonstrates.

Many of the LPs that would consider working with new managers when making co-investments noted particular caveats to forming such relationships. An Israel-based investment company would consider co-investing alongside GPs with whom it has no prior relationship provided the GP is a "local partner with well-developed projects."

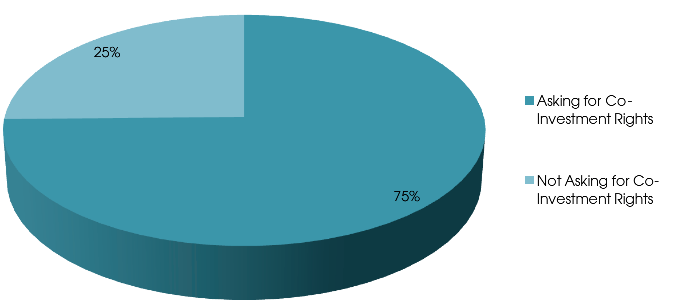
Does Size Matter?

Some investors we spoke to indicated that smaller LPs are likely to face greater obstacles when seeking co-investment opportunities, as a Swiss bank commented: "Smaller LPs will not have as much access to co-investments in the future as GPs tend to offer them to those already showing interest."

Other investors we spoke to emphasized strong relationships with existing GPs and an existing co-investment program as the key to securing co-investment opportunities, rather than LP size. One Saudi Arabian investment company told us: "GPs give [us] feedback and they like when the decision-making process is short. So they prefer to come to smaller LPs like us that have a co-investment program in place and can be more efficient."

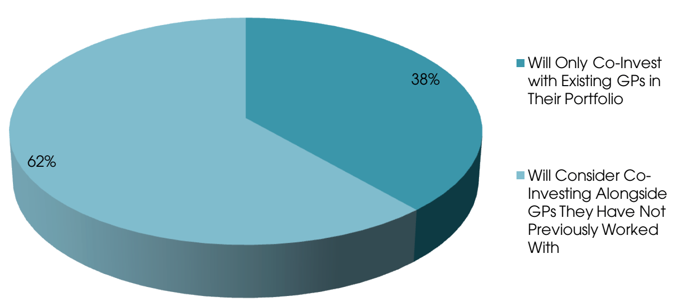
Many LPs we spoke to stressed the importance of good relationships with fund managers when looking for opportunities to co-invest, as one US asset manager pointed out: "We want to have a good relationship with existing GPs so when an opportunity arises we are at the top of the list."

Fig. 7: Proportion of LPs Asking GPs for Co-Investment Rights when Committing to New Funds



Source: Preqin

Fig. 8: LPs' Attitudes Towards Forming New GP Relationships when Co-Investing



Source: Preqin

LP Requirements for Co-Investing and Outlook for Co-Investments

Forty-one percent of the LPs we spoke to noted particular requirements they expect a GP to meet before committing to a co-investment in a portfolio company. We asked investors what particular conditions GPs should meet in order to secure a co-investment from them.

As Fig. 9 illustrates, 23% of LPs we contacted require board representation if they are to make a co-investment alongside a fund in a portfolio company. Sixteen percent of LPs expect special fees, including several which expect no management fees or carry charges. One large Canadian pension fund we spoke to typically expects “the same terms as GPs have,” while a UK bank stated that “special fees are critical given the risk-return ratio.”

Eighteen percent of LPs named other requirements for co-investing including observations rights, a seat on the LP committee and only co-investing with GPs that meet certain size requirements.

However, the largest proportion of co-investors (59%) we spoke to have no special requirements when seeking co-investments alongside GPs and instead prefer to approach each opportunity on a case-by-case basis.

All of the LPs that told us they had received special terms when co-investing in the past stated that they expect to receive similar terms for future co-investments.

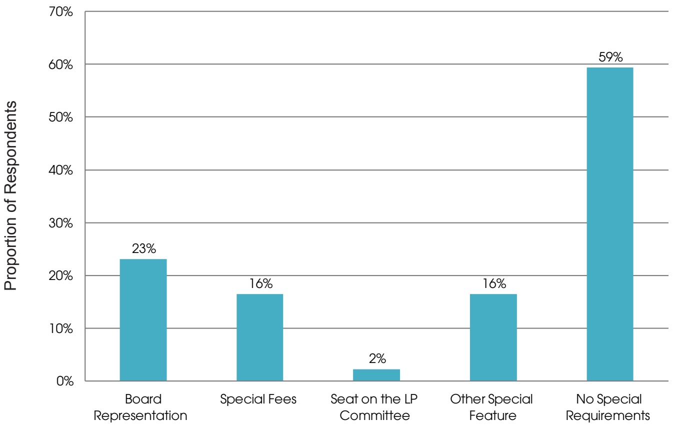
Outlook for Co-Investments

Co-investments are appealing to an increasing number of investors that are willing to take on the additional risk in return for potentially higher returns, better transparency and better control over their investments. Additionally, by co-investing alongside funds LPs are able to negotiate better terms with their managers and reduce the costs of investing in the asset class.

LP appetite for co-investments is coupled with a more flexible GP base, as many GPs are willing to allow investors access to co-investment opportunities in order to secure commitments to their funds. Using co-investor capital in deals alongside their funds also allows GPs to invest in larger deals, which they may not be able to access with fund capital alone.

As LPs continue to look for new ways to invest their capital and co-investor deals become more widely reported, it is likely that we will continue to see investors setting up co-investment programs and looking for more exposure to direct private equity deals.

Fig. 8: LP Requirements when Making Co-Investments



Source: Preqin

Investor Intelligence tracks over 4,800 investors in private equity funds. Premium subscribers can now access information on over 730 LPs with an appetite for co-investments, and filter those LPs using our new Co-Investor Search.

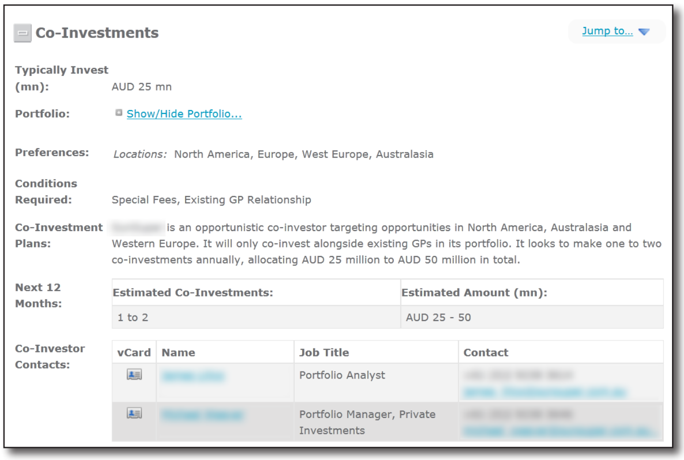
Preqin: Investor Intelligence

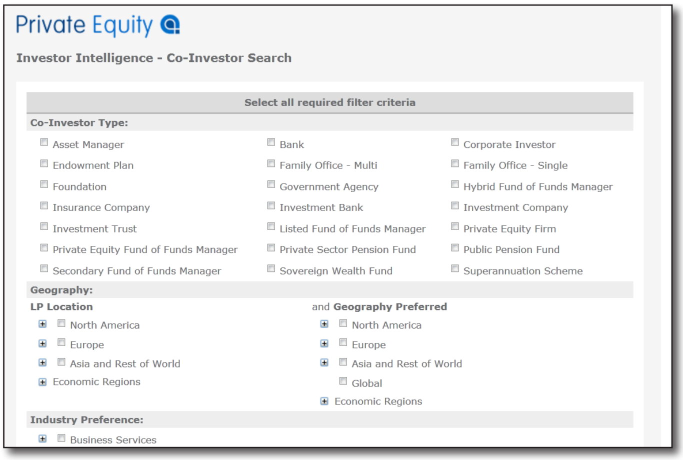
Investor Intelligence is the industry's leading source of information on institutional investors in private equity funds. More than 4,800 institutions of all types worldwide are profiled. Constantly updated through direct communication with our large team of multi-lingual analysts, it represents the most comprehensive and accurate source of investor intelligence today, with global coverage and exclusive information not available anywhere else.

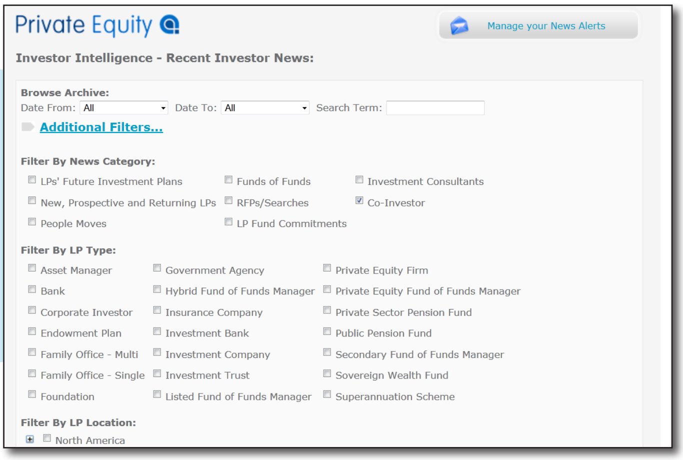
Detailed information on investors' co-investment preferences is also available exclusively to premium subscribers to Investor Intelligence.

LPs' co-investment profiles contain the following information:

- Co-investment preferences by geography, investment type and industry
- An overview of each LP's co-investment strategy, plus a summary of their plans for co-investing in the next 12 months
- Any special conditions required for co-investing
- Direct contact information for key co-investor contacts
- Any known co-investments







Premium subscribers can also:

- Access the *Co-Investor Search* to filter LPs with an appetite for co-investments by LP type, location and co-investment preferences and plans.
- Filter *Recent LP News* to view all Preqin co-investor news posts for individual LPs. Users can also sign up to receive co-investor *News Alerts*.

Investor Intelligence is available by annual subscription from only
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For more information and to arrange a walkthrough of the database please visit:
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