Hamilton Lane Research

CO-INVESTING: THE STRUGGLE IS REAL

By Jeff Armbrister, Managing Director, Co-Investment Team

Co-investing. It's an area about which we continue to be asked most frequently and in which investor interest doesn't seem to be abating. As with many topics that end up in the center of public attention and discourse, there are plenty of ardent proponents of the practice, as well as some vehement skeptics. One thing that seems certain, though, is that co-investment is an ingrained and fundamentally important part of the private markets landscape and a subject that commands ongoing discussion and debate across all parts of the market.

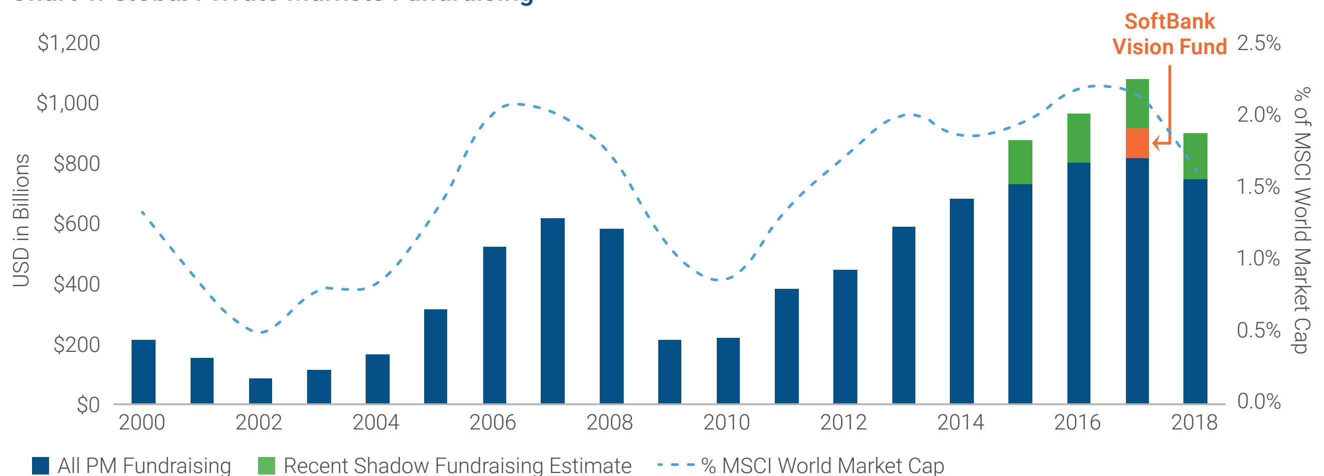
Indeed, the co-investing topic seems to have firmly established a perch within the private markets media, the industry conference circuit and even the hallowed walls of Hamilton Lane's own research department. And yet, through our experience operating in this space over the last 23 years, coupled with our proprietary survey data, we've observed a more nuanced dynamic at play: Despite the high (and growing) level of interest from LPs in CI, the ability for them to effectively execute a co-investment program is less apparent. In fact, the prospect of doing so can result in a frustrating – and often fruitless – exercise for both LPs and GPs alike.

Here, we'll explore the issues and challenges contributing to that frustration, against the backdrop of the current state of the co-investment market and the various dynamics at play.

Private Markets & Co-Investment Activity

Private markets fundraising continues to be strong, despite currently being off peak levels reached in 2017 (Chart 1). Riding that same wave is capital allocated to co-investment. We estimate that for every dollar raised by a GP, an additional twenty cents is allocated to deploy in global co-investment opportunities.[1]

Chart 1: Global Private Markets Fundraising



Source: Bison Data via Cobalt, Preqin, Bain, Hamilton Lane Estimates (February 2019)

[1] Hamilton Lane Estimates, Global Private Equity Report 2017, Bain & Company, Inc.

Indeed, the appetite for co-investment seems quite strong, fueled by motivations and incentives for LPs and GPs alike that are both rational and compelling. For LPs, co-investing provides an opportunity to improve returns through lower overall costs, create faster and more targeted deployment of capital and prioritize and consolidate overall relationships. For GPs, co-investing enables them to manage fund exposures, expand the size of their target investment universe and avoid partnering with other GPs, which can be difficult situations to manage.

Evidence of these compelling motives shows up in the data: According to McKinsey, since 2012 the value of co-investment deals has more than doubled, reaching $104 billion in 2017[2]. Growth has become so apparent, that it appears more and more LPs are asking for co-investment opportunities and negotiating co-investment rights as part of their fund LPAs. So, LPs seem to be ramping-up co-investment activity.

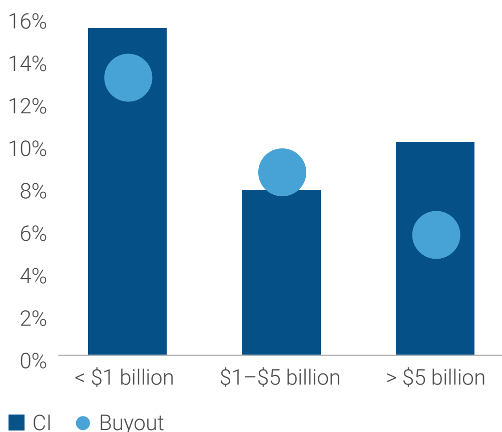
Additionally, the co-investment community has largely gotten over one of its detractors' most favorite critiques – adverse selection. For the uninitiated, adverse selection, in this case, refers to the fear among investors that GPs would only show their bad deals. This fear was exacerbated further when the investment period relates to co-investments made at the top of the cycle, i.e. 2006 through 2008. In truth, we don't tend to hear this question anymore and for good reason, as the performance data below illustrates, but it's still important to ask "why are we seeing this deal vs other LPs and co-investors". The historical concern has been focused on deal quality, but the "pecking order" can also bring other advantages to certain co-investors in regards to the amount of deal flow and investment allocation.

Co-Investment Performance

As you can see in chart 2 below, 2006 – 2008 co-investment deals outperformed all buyout deals during the same period for companies with enterprise values less than $1 billion and greater than $5 billion.

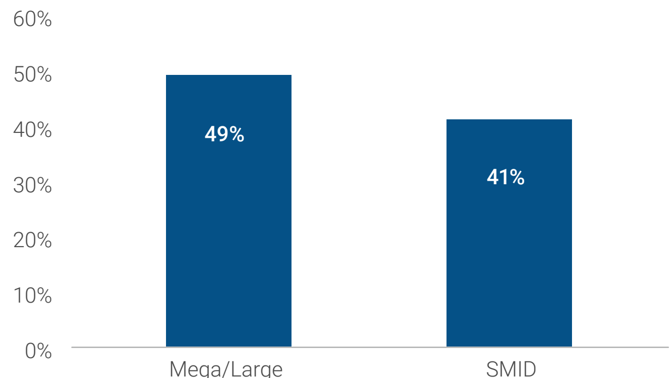
Conversely, less than 50% of Mega/Large co-investment deals and SMID co-investment deals outperformed their associated buyout fund (chart 3). But as responsible investors in this asset class, we can't look at returns without analyzing associated risk.

Chart 2: Gross IRR by Deal Size
2006–2008, By Enterprise Value



Source: Hamilton Lane Data (July 2018)

Chart 3: Percent of Co-Investments Outperforming Associated Buyout Fund
2006–2008

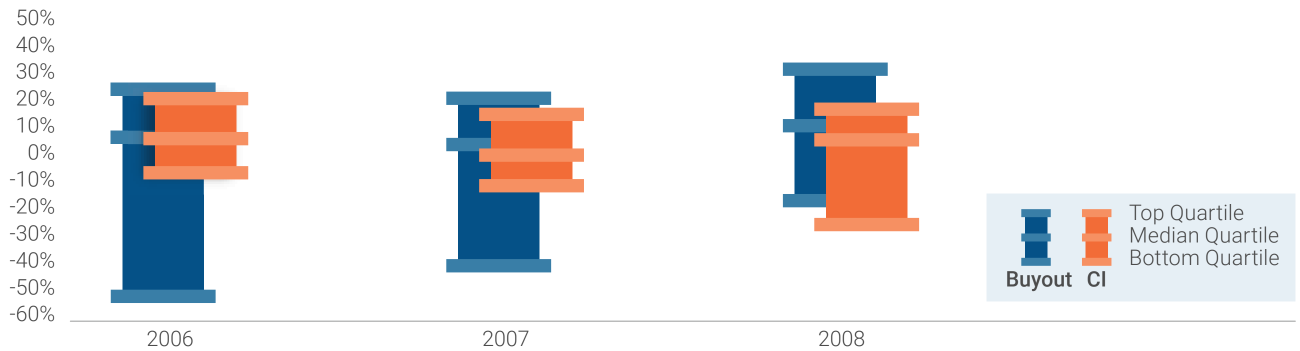


Source: Hamilton Lane Data (July 2018)

[2] https://www.mckinsey.com/~/media/mckinsey/industries/private%20equity%20and%20principal%20investors/our%20insights/the%20rise%20and%20rise%20of%20private%20equity/the-rise-and-rise-of-private-markets-mckinsey-global-private-markets-review-2018.ashx

The chart below shows that compared to all buyout deals during the same period, the downside risk associated with co-investments appears to be much less, demonstrating the potential for a favorable risk-reward profile for a diversified co-investment portfolio.

Chart 4: Co-Investments vs. Buyout Gross Deal IRRs
2006–2008



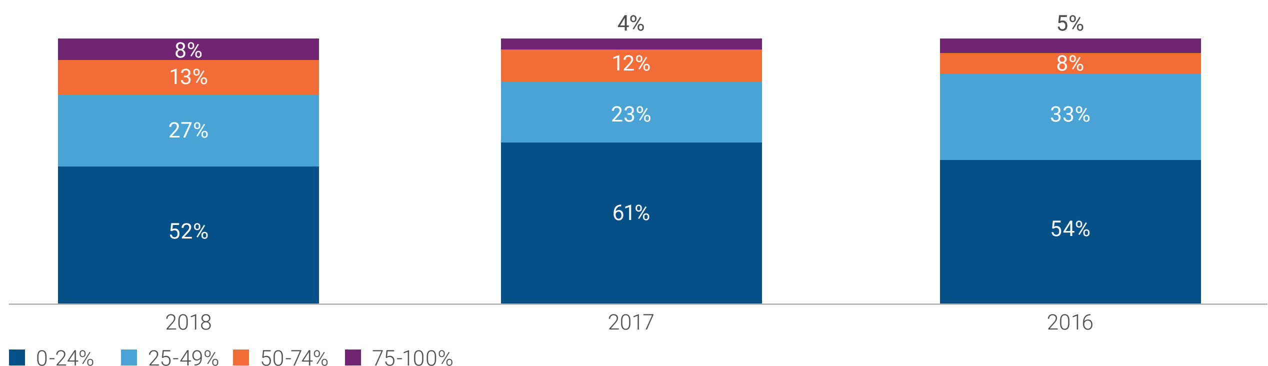
Source: Hamilton Lane Data (July 2018)

Where's the Disconnect?

Let's recap: With co-investment demand evident; actual investment volume up as a result; and one of the industry's most serious criticisms put to bed, you would expect to find many LPs running successful co-investment platforms. In reality? Not quite!

According to the GPs we surveyed in our 2018/2019 GP Dashboard, despite LPs requesting co-investment opportunities, few are actually executing. This is a bit of a complicated chart, but worth pondering over for a moment. Even with the trends slightly more positive in 2018 vs prior years, the results still show that over half of the GPs surveyed say that less than 24% of their LPs who have asked for co-investment opportunities are transacting.

Chart 5: What Percent of LPs Who Have Asked to See Co-Investment Opportunties Have Participated in at Least One Transaction?



See what we mean?

There are certainly some LPs that are making good on their goals, but this is the exception and not the rule. We see more examples of LPs acting on one or two co-investments here or there versus building a truly dynamic and structured program that can generate the necessary deal flow to yield a diversified portfolio.

Why? Well, there are several forces at play, but, to put it bluntly, co-investing is hard! So what's accounting for the increased activity and co-investment volume? We believe that dedicated co-investment funds run by institutional managers are generally driving this growth, as their capabilities and resources allow them to be

better aligned with the supply side (i.e., the GPs) and deliver on the terms and expectations required by the fund managers offering co-investment opportunities.

Got it, you say, but back to the whole LPs aren't really doing much CI idea – what precisely are the issues? Let's take that one from the GP angle: Again, going back to our GP Dashboard, GPs say that the most important factors for them when offering co-investment to their LPs are as follows (and in this order):

1. Speed and certainty;

2. The GP's relationship with the LP; and

3. The reputation of the LP.

This makes sense: As a fund manager, the last thing I would want to do is to risk losing a deal that my firm has worked on for months if not years to originate, structure and sign-up to then lose it because my co-investment partner can't meet the closing timeline. In a competitive investment environment, credibility is an extremely important differentiating factor when dealing with the target's stakeholders, management teams and advisors. A GP can quickly suffer reputational damage by failing to deliver on the timeline to which they had committed.

The issue around speed and certainty is exacerbated further by GPs wanting to bring in co-investors earlier in the process. Co-investment syndication post-closing used to be much more prevalent. Now, for a variety of reasons, GPs want co-investors to come into the deal pre-closing. That favors groups with relationships, resources and an ability to move quickly ('speed and certainty'; check and check). LPs looking to do it themselves need to consider whether they have the resources and process to meet GP's expectations.

But Wait, There's More! Portfolio Construction Considerations

As LPs look into co-investing, it's important not to forget about portfolio construction. It's often underappreciated that when making an investment decision, you are adding a very specific exposure at a specific point in time and that the importance of vintage year and sector performance is crucial at the deal level. Ok, but what does this really mean for co-investors? In short, exercise caution. Because different sectors and vintage years generate varying returns over time, LPs must understand that they are taking on a significant responsibility when co-investing. Again, what does this mean? What is this responsibility? The answer is that co-investing is the same as taking on deal risk, which has a wider returns dispersion than fund investing. LPs may subject themselves to more risk because they don't invest in enough co-investment opportunities to build a diversified portfolio and narrow this dispersion.

Chart 6 illustrates that there is a wide dispersion of returns by investment strategy as well as geography. We feel that there is no need to be overly concentrated in these areas and accept this unnecessary variability, but some LPs may unintentionally be forced into this situation by only co-investing with a few GPs.

Chart 6: Dispersion of Returns by Strategy & Geography

Vintage Years 1979–2015, Ordered by Spread of Returns

Source: Hamilton Lane Data via Cobalt (February 2019)

Here's another way to look at the dispersion risk issue. An obvious and crucial question when building a portfolio is "What are our goals?" Most investors would instinctively cite being in the top quartile. Well, if you are committed to the same strategy year after year, then you have to accept that in some years that may not happen (Chart7). Taking a look at the performance of "All Deals" in the same chart, we can see that it has generated more consistent and attractive results. You've certainly heard this from us before, but we believe diversification is key, and that a properly-constructed, diversified portfolio can provide meaningful downside protection without sacrificing performance. LPs should take this into consideration when co-investing in individual deals. Unfortunately, the reality is that some do not have the access to enough high-quality deal flow to build a large diversified portfolio.

Chart 7: Buyout Deal Median Gross IRR by Deal Year

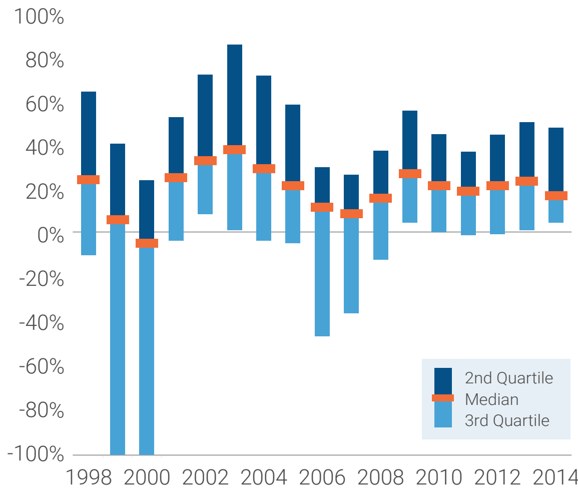
2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015
Consumer Staples 42.1%	Telecom 19.8%	Healthcare 17.1%	Consumer Staples 29.0%	Materials 47.0%	Telecom 34.0%	Materials 31.8%	Healthcare 34.2%	Healthcare 42.4%	Telecom 28.3%	Consumer Staples 33.7%
Materials 41.5%	Consumer Staples 19.4%	Consumer Staples 13.7%	Materials 22.6%	Telecom 43.7%	Materials 31.2%	IT 30.5%	Materials 30.7%	IT 35.2%	Healthcare 23.6%	Materials 33.6%
Industrials 34.4%	Healthcare 17.2%	IT 9.9%	Healthcare 20.5%	Consumer Staples 40.7%	IT 26.9%	Healthcare 22.7%	Telecom 29.4%	Consumer Staples 32.4%	Consumer Staples 23.3%	IT 23.7%
IT 22.7%	Materials 12.8%	All Deals 7.9%	IT 16.3%	IT 37.3%	Healthcare 21.3%	Consumer Staples 21.2%	Consumer Staples 25.5%	Materials 31.1%	IT 21.0%	Industrials 22.3%
All Deals 19.7%	IT 12.0%	Materials 7.9%	Consumer Discretionary 16.1%	Industrials 27.6%	All Deals 20.9%	Consumer Discretionary 19.9%	IT 23.0%	All Deals 21.6%	Materials 20.8%	Healthcare 20.1%
Healthcare 18.8%	All Deals 10.3%	Consumer Discretionary 5.5%	All Deals 13.2%	All Deals 26.6%	Consumer Staples 19.9%	All Deals 18.2%	Industrials 20.9%	Industrials 17.9%	All Deals 16.3%	All Deals 19.0%
Financials 18.6%	Financials 9.4%	Industrials 3.7%	Financials 11.9%	Consumer Discretionary 24.8%	Industrials 19.7%	Industrials 14.2%	All Deals 20.6%	Financials 17.2%	Industrials 14.2%	Consumer Discretionary 14.6%
Energy & Utilities 12.6%	Industrials 8.5%	Financials 3.0%	Industrials 8.9%	Financials 23.0%	Financials 17.3%	Financials 11.5%	Consumer Discretionary 14.0%	Consumer Discretionary 16.1%	Financials 18.6%	Financials 14.5%
Consumer Discretionary 12.3%	Consumer Discretionary 5.2%	Energy & Utilities -9.1%	Telecom 1.3%	Healthcare 22.3%	Energy & Utilities 14.3%	Telecom 9.9%	Energy & Utilities 12.3%	Energy & Utilities 11.8%	Consumer Discretionary 13.9%	Energy & Utilities 12.6%
Telecom 10.4%	Energy & Utilities 3.3%	Telecom -15.3%	Energy & Utilities -2.4%	Energy & Utilities 3.0%	Consumer Discretionary 14.2%	Energy & Utilities 4.5%	Financials 10.8%	Telecom 8.1%	Energy & Utilities 9.4%	Telecom 11.1%

Source: Hamilton Lane Data (July 2018)

What about timing and the economic cycle? As we mentioned before, portfolio allocation decisions are important, especially before a recession, which tends to magnify downside risk. Chart 8 shows the increased impact on IRRs for deals completed just before the past two recessions, which is meaningfully larger than the other years.

Chart 8: Gross Buyout Deal IRR Quartiles

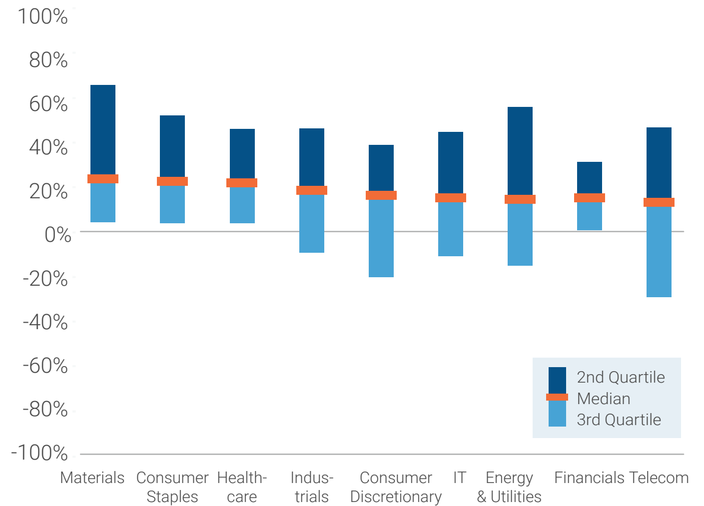
By Deal Year



Source: Hamilton Lane Data (July 2018)

Chart 9: Gross Buyout Deal IRR Quartiles

By Sector, Sorted by Median Return

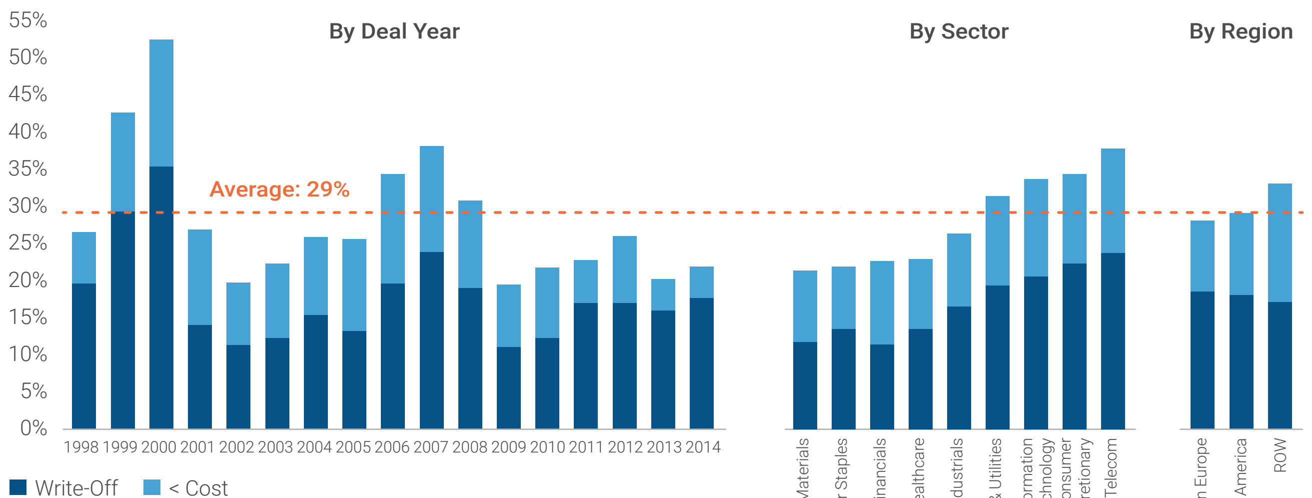


Source: Hamilton Lane Data (July 2018)

But even without including the risk of a recession in the near term, it's also important to note that the risk of loss of each deal is typically around 30% - which is not immaterial! Most people we talk to are shocked that the risk can be that high (Chart10).

Chart 10: Loss Ratios of Realized Buyout Deals

% of Deal Count



Source: Hamilton Lane Data (July 2018)

Again, deal risk can manifest itself in many ways – by GP, strategy, sector, geography, timing etc. – so it's important to try and mitigate these risks through constructing a diversified portfolio.

Final Thoughts

The allure of co-investing is real – and understandable. As stated previously, it can offer LPs a unique opportunity to improve returns through lower overall costs, creates faster and more targeted deployment of capital and helps to prioritize and consolidate relationships. Yet, co-investing – more specifically, co-investing effectively – requires an investment in time and resources that some may not be able to afford. In order to maximize the benefits of co-investing, it's not enough to participate on an ad hoc basis. Instead, building a successful co-investment platform that generates strong returns requires, access to meaningful deal flow and a structured and efficient investment process that produces sound investment decisions within the GP's time frame. LPs have the choice to build out their own, in-house platform; invest in a large, institutional manager – whose scale can help give them advantages to address the aforementioned requirements necessary to be successful; or a combination of the two. Regardless of what path LPs choose, we believe that interest in co-investing will continue to grow and we look forward to continuing to be an active participant in the market.

Strategy Definitions

All Private Markets – Hamilton Lane's definition of "All Private Markets" includes all private commingled funds excluding fund-of-funds, and secondary fund-of-funds.

CI Funds – Any fund that either invests capital in deals alongside a single lead general partner or alongside multiple general partners.

Co/Direct Investment Funds – Any PE fund that primarily invests in deals alongside another financial sponsor that is leading the deal.

Corporate Finance/Buyout – Any PE fund that generally takes a control position by buying a company.

Credit – This strategy focuses on providing debt capital.

Distressed Debt – Includes any PE fund that primarily invests in the debt of distressed companies.

EU Buyout – Any buyout fund primarily investing in the European Union.

Fund-of-Funds (FoF) – A fund that manages a portfolio of investments in other private equity funds.

Growth Equity – Any PE fund that focuses on providing growth capital through an equity investment.

Infrastructure – An investment strategy that invests in physical systems involved in the distribution of people, goods, and resources.

Late Stage VC – A venture capital strategy that provides funding to developed startups.

Mega/Large Buyout – Any buyout fund larger than a certain fund size that depends on the vintage year.

Mezzanine – Includes any PE fund that primarily invests in the mezzanine debt of private companies.

Multi-Management CI – A fund that invests capital in deals alongside a lead general partner. Each deal may have a different lead general partner.

Multi-Stage VC – A venture capital strategy that provides funding to start-ups across many investment stages.

Natural Resources – An investment strategy that invests in companies involved in the extraction, refinement, or distribution of natural resources.

Origination – Includes any PE fund that focuses primarily on providing debt capital directly to private companies, often using the company's assets as collateral.

Private Equity – A broad term used to describe any fund that offers equity capital to private companies.

Real Assets – Real Assets includes any PE fund with a strategy of either Infrastructure or Natural Resources. Real Estate funds are not included.

Real Estate – Any closed-end fund that primarily invests in non-core real estate, excluding separate accounts and joint ventures.

Real Estate Fund-of-Funds – Any fund that primarily invests in other real estate private equity funds.

ROW – Any fund with a geographic focus outside of North America and Western Europe.

ROW Equity – Includes all buyout, growth, and venture capital-focused funds, with a geographic focus outside of North America and Western Europe.

Secondary FoF – A fund that purchases existing stakes in private equity funds on the secondary market.

Seed/Early VC – A venture capital strategy that provides funding to early-stage startups.

Single Manager CI – A fund that invests capital in deals alongside a single lead general partner.

SMID Buyout – Any buyout fund smaller than a certain fund size, dependent on vintage year.

U.S. Mega/Large – Any buyout fund larger than a certain fund size that depends on the vintage year that is primarily investing in the United States.

U.S. SMID – Any buyout fund smaller than a certain fund size, dependent on vintage year that is primarily investing in the United States.

VC/Growth – Includes all funds with a strategy of venture capital or growth equity.

Venture Capital – Venture capital includes any All Private Markets funds focused on any stages of venture capital investing, including seed, early-stage, mid-stage, and late-stage investments.

Venture Debt – A venture capital strategy that provides debt financing to companies, rather than equity.

Index Definitions

Barclays U.S. Corporate Aggregate Index – Tracks the performance of U.S. fixed rate corporate debt rated as investment grade.

BofAML High-Yield Index – The BofAML High Yield Index tracks the performance of below investment grade U.S. dollar-denominated corporate bonds publicly issued in the U.S. domestic market.

Credit Suisse High Yield Index – The Credit Suisse High Yield index tracks the performance of U.S. sub-investment grade bonds.

Credit Suisse Leveraged Loan Index – The CS Leveraged Loan Index represents tradable, senior-secured, U.S. dollar-denominated non-investment-grade loans.

FTSE/NAREIT Equity REIT Index – The FTSE/NAREIT All Equity REIT Index tracks the performance of U.S. equity REITs.

HFRI Composite Index – The HFRI Composite Index reflects hedge fund industry performance.

MSCI Emerging Markets Index – The MSCI Emerging Markets Index is a free float-adjusted market capitalization index that is designed to measure equity market performance of emerging markets.

MSCI World Energy Sector Index – The MSCI world Energy Sector Index measures the performance of securities classified in the GICS Energy sector.

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MSCI World ex U.S. Index – The MSCI World ex U.S. Index tracks large and mid-cap equity performance in developed market countries, excluding the U.S.

MSCI World Index – The MSCI World Index tracks large and mid-cap equity performance in developed market countries.

Russell 3000 Index – The Russell 3000 Index is composed of 3000 large U.S. companies, as determined by market capitalization.

Russell 3000 Net Total Return Index – The Russell 3000 Index is composed of 3000 large U.S. companies, as determined by market capitalization with net dividends reinvested.

S&P 500 Index – The S&P 500 Index tracks the 500 largest companies based on market cap of companies listed on NYSE or NASDAQ.

S&P 500 Information Technology – The S&P 500 Information Technology comprises those companies included in the S&P 500 that are classified as members of the GICS information technology sector.

VIX – The Volatility Index is an index created by the Chicago Board Options Exchange (CBOE) which shows the market's expectation of 30-day volatility.

Other

Desmoothing – A mathematical process to remove serial autocorrelation in the return stream of assets that experience infrequent appraisal pricing, such as private equity. Desmoothed returns may more accurately capture volatility than reported returns. The formula used here for desmoothing is:

> where: rD(t) = the desmoothed return for period t r(t) = the return for period t ρ = the autocorrelation
> $r_D(t) = (r(t) - r(t-1) * \rho) / (1 - \rho)$

PME (Public Market Equivalent) – Calculated by taking the fund cash flows and investing them in a relevant index. The fund cash flows are pooled such that capital calls are simulated as index share purchases and distributions as index share sales. Contributions are scaled by a factor such that the ending portfolio balance is equal to the private equity net asset value (equal ending exposures for both portfolios). This seeks to prevent shorting of the public market equivalent portfolio. Distributions are not scaled by this factor. The IRR is calculated based off of these adjusted cash flows.

Sharpe Ratio – The Sharpe Ratio is the average return earned in excess of the risk-free rate per unity of volatility or total risk.

Time-weighted return – Time weighted Return is a measure of compound rate of growth in a portfolio.

Total Exposure – Total Exposure is equal to NAV + Unfunded Commitment.

Volatility – Volatility is a statistical measure of dispersion of return, specifically standard deviation.

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