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Private Equity Performance 2015

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'Perverse Incentives' of Co-investment

Co-investment—every LP wants to do it, every GP needs to offer it, and everybody seems to be worried about it.

Our latest thought-leadership video panel session with private equity performance experts (upon which this report is based) had a big focus on co-investment and how it fits into the institutional portfolio. Cambridge Associates' Andrea Auerbach showed up to the panel discussion with a new, in-depth report that shone much- needed light on how co-investment has performed.

One of the worries about co-investment is that it can lead to perverse incentives on the parts of the GPs to, shall we say, share under-optimized deal opportunities with their investors. Among the findings is evidence that adverse selection may indeed be taking place.

Another revealing finding—discussed in detail by our experts—is not-very-surprising evidence that co-investments targeting strategies that are outside the "strike zone" of GPs tend to underperform compared to those within the strike zone.

In this report you'll also find discussions about the consequences of the distributions boom, and about the relatively underwhelming performance of infrastructure funds to-date.

Enjoy the report,

David Snow
CEO & Co-founder,
Privcap Media
@SnowsNotes

In This Report

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The Risk of Adverse Selection in Co-investing

Co-investments are increasingly popular, and experts from Cambridge Associates, Coller Capital, and Guardian Life explain how they are performing and how to be aware of adverse selection

Andrea Auerbach
Managing Director,
Cambridge Associates

Maurice Gordon
Managing Director,
Guardian Life

Luca Salvato
Partner,
Coller Capital

Privcap: Andrea, you recently did a study on co-investment performance. Why was the study necessary?

Andrea Auerbach, Cambridge Associates: It's interesting because co-investing as an activity has been around since the very first private equity fund, right? It's definitely having a moment in the sun right now, and there are a couple of industry dynamics that are speaking to that. Co-investments—selected and invested properly—are definitely a way to boost returns.

There's been a rise in the availability of co-invest. We all remember the global financial crisis and some of the activities that precipitated that. I'm not saying they caused it, but there was a lot of consortium investing, and there were a lot of GPs buddying up to do a deal. LPs were left wondering, "Why wasn't I asked? I've got capital. I'm capable of being an equity partner with you." GPs are learning that they would rather have a stronger LP relationship than give away some of the deal to another GP.

There are risks to co-investing and one of the risks is adverse selection. What does that mean?

Luca Salvato, Coller Capital: There is a systemic demand now amongst the

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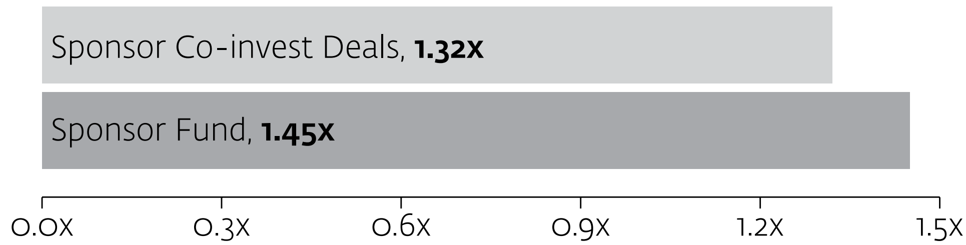
Is Adverse Selection Real?
Co-investment performance (top) versus sponsor GP's fund performance multiple of invested capital

Source: Cambridge Associates



LPs that are really driving a desire to see an increased amount of co-investment. At the very large end, you may even see some LPs that almost dictated the condition of their investment.

You're seeing GPs raise smaller funds but wishing to stay in the same investments that they were doing in terms of size or equity checks. What that means is that they can't do it out of their fund, so they need to bring in co-investors, and LPs like that. But the reality is that the adverse-selection point is in a market, and certainly in frothy markets you see the volume of co-investments go up. If you look at the returns, that is, ironically, probably the worst time to be in co-investments.

Any time you see a GP either doing deals where they're stretching from an investment-size perspective to what their norms and past experiences are, or even strategy shifts in areas that they haven't invested before, that's where you probably have to tread with a little bit of caution.

Andrea, you compared LPs who just went with the fund itself versus those that also invest with the same GPs off to the side as co-investors. What did you discover when comparing those two groups?

Auerbach: We took a number of funds that spawned co-investments. The overall result of just simply doing the fund investment alone was about a 1.5x net. However, we then went and took a look at the co-investment deals that came out of those funds. Overall, those co-investments delivered a 1.3x gross.

It will be even lower on a net basis. If I just did every co-investment that came along, that would have been my net result gross. If I had the ability to pick only the winners and do better, that was slightly less than half the time—and slightly less than half the time, did the investments actually outperform the sponsor fund? For those co-investing, this analysis pointed out to us that trying to out-invest the investor is a "proceed with caution" moment—especially if you don't have the right resources or policies in place to know what you're looking at.

Maurice Gordon, Guardian Life: There is adverse selection, but part of the nuance of that is you don't get it on purpose. I don't think a GP is saying, "I'm giving you a bad deal."

But they can tell you when they know if they're giving you a really risky deal. I've been on the phone before, and they said, "This is a good deal, but it may be outside of your risk zone," because it was a little bit outside of their risk zone. It gets back to your strategy on which co-investments you want to do. ■

"There is a systemic demand now amongst the LPs that is really driving a desire to see an increased amount of co-investment."

–Luca Salvato, Coller Capital

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Where is All the LP Dry Powder?

Experts explain the so-called "shadow overhang," or LP dry powder earmarked for co-investments that's not necessarily listed in PE fundraising data

Privcap: Is some of the deployment of capital not being captured because it is being earmarked for co-investment, and that is the new format for investing going forward?

Andrea Auerbach, Cambridge Associates: The shadow overhang—it's sort of that unspoken asterisk in all of the fundraising information that we all see out there. We all know of those large institutional investors that have a hunting license that doesn't necessarily have an expiration date on it, right? So is it possible that the amount of capital facing the market today is as high as we saw it in 2007, just disguised a little differently? Probably.

Luca Salvato, Coller Capital: The reality is that the GPs that are raising capital are the well-performing, good GPs that have generally gone through cycles. So what you're seeing is investors generally downsizing the number of relationships they have when they're looking at investing their capital. [The LPs'] equity check sizes are stepping up, but the number of GPs that they're backing is reducing. Ultimately, you had an enormous growth and explosion of the number of GPs in the '07, '08 period. If it hasn't happened already, I imagine that will drop in terms of the number of GPs that will actually be able to raise subsequent funds just because they're not going to have the track record or generate that interest from the LPs.

Auerbach: The first-time fund and spin-off fund fundraising business is very much alive and well. For a lot of the larger fund families that may be unable to raise successive capital, they're easily spawning one, if not two, spin-off funds that could be considered re-energized teams. [They're] more crystallized and wanting to do lower-middle-market deals for those that are of that size. We are seeing a wonderful bumper crop of talent finally coming loose from large platforms, and fresh capital for a fresh start. Is that a trend that the partner in the corner office is not always aware that there could be a future for the firm, but it might not be a firm with his name on it?

Auerbach: We are a 30-something-year-old institutional asset class. If they're not willing to concede ownership, direction, or governance, a lot of the founders of these firms are going to face their apprentices— now turned master carpenters—leaving to start their own [firms]. It absolutely behooves those managing partners in the corner offices to think carefully about the legacy that they want to leave. ■

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Dissecting the Distributions Boom

The period through January 2015 showed the highest-ever level of distributions to limited partners. Our experts discuss what's behind the rise.

Privcap: Andrea, we are looking at Cambridge data on distributions coming back to LPs. And I see that the period ending in 2015 has the biggest number. What's going on right now by way of distributions?

Andrea Auerbach, Cambridge Associates: So the chart shows distributions to LPs from 2006 to 2015. And it's definitely not lost on anyone at this table that distributions through January of 2015 are the highest they've ever been at about $147B. That is the fourth year in a row of year-over-year increases. A lot of that money is getting plowed right back into the space because fundraising is also on the rise year-over-year, as well, across the exact same time frame.

If you go back to the previous boom time in private equity, 2007, the distributions now are essentially double. Maurice, as someone overseeing a major private equity program, are you benefiting from this gusher of distributions?

Maurice Gordon, Guardian Life: Absolutely. I would like to thank all of the GPs and sponsors for doing the

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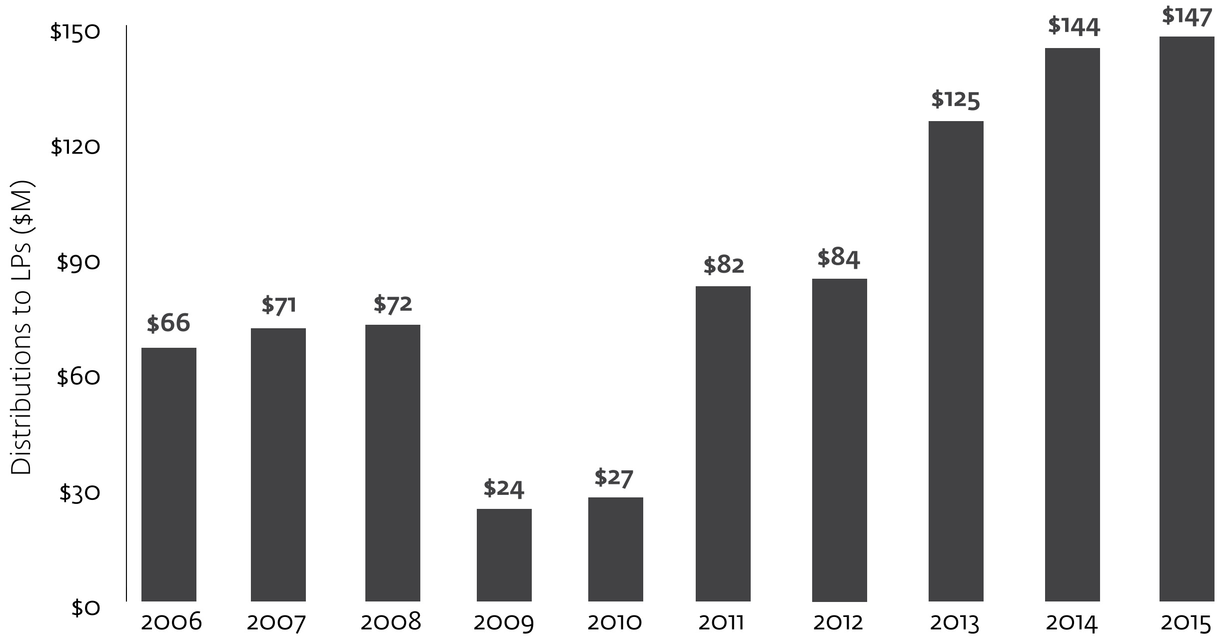
U.S. Private Equity Distributions
The amount of distributions
to LPs as of March 31, 2015.

Source: Cambridge Associates



hard work, and learning from the mistakes in the past. So many people held on all the way up and then rode it all the way down and never sold. So a lot of people have learned that lesson. And when you're getting paid very well to exit, you should really do that. Being in a mutual insurance company, we need a distribution to actually generate income to pay a dividend. So it's very much appreciated that people are taking advantage of this good market.

And what are you observing at Coller, Luca?

Luca Salvato, Coller Capital: From our portfolio it's probably the healthiest distribution that we've seen in a long time. But there is an interesting dynamic when you look at the market, certainly if you go back over the last 10 years and compare invested capital against distributions. What you're seeing currently is a flip in terms of that trend where you're having distributions outpace invested capital.

Prior to that, in the build-up to the previous peak in '07, '08, it was the inverse. So what that ultimately meant is that a constant amount of capital was building that was invested in the ground that was increasing rather than decreasing.

But there's still a long way to go. If you look at the vintage years of '05 to '08, and you look at the net asset value that is still captured within those funds, it's enormous—probably $800B or thereabouts. Now those funds are reaching, or coming towards the end of their natural lives. And it's hard to see that they're going to be able to release all of that through just naturaldistributions and selling of companies.

So what does it mean that LPs aren't plowing money into the market at a fast enough rate to match the distributions they're getting? Are they being cautious?

Auerbach: A lot of managers are simply unable to raise the capital that they want to raise in a formal, traditional fund. And so they may be seeking it through co-investment in other ways.

Do I think LP commitments are on the rise? Yes, for several reasons. A significant one is simply that private equity, as a return-generating strategy, is one of the best ever of all investment strategies. And it continues to attract capital. So I do think LP commitments are going to start to go up. ■

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Mindsets Shift on Co-investment Fees

In an effort to attract LPs to co-investments, GPs are offering more options than ever—and that extends to fees. And fee structures are more varied than ever before.

As more and more LPs are looking at co-investments as a way to increase returns by essentially lowering management fees, many GPs are becoming more creative in order to attract investors.

"There is significantly more variation in fee structures today than there's ever been," says Andrea Auerbach, managing director and head of U.S. private equity research at Cambridge Associates. Auerbach says PE firms are simply asking institutional investors what types of fees they're interested in paying—for instance, a 1 percent management fee and 30 percent carried interest, or a 2 percent management fee and 20 percent carried interest.

"In five to 10 years, fees overall will settle into a new paradigm," she says.

Part of that new paradigm is happening today. The range of options in fees for co-investments is broader than ever before, and down the road there could be much more of a "half and half" strategy, as Auerbach calls it, with half traditional funds and half fee-free or carry-free co-investments.

The question for general partners is becoming whether to eliminate co-investments altogether and simply lower fees.

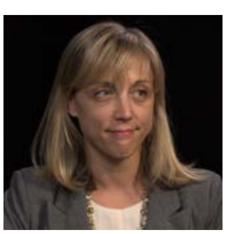
But Luca Salvato, a partner at Coller Capital, says adjusting fees lower isn't always as simple as it sounds. "If I can raise $500M at 2 and 20, that doesn't necessarily mean I can raise $1B at 1 and 10. It just doesn't work that way."

He also says investors shouldn't just look at a fee structure based on the gross and net profits from the fund; they should take into account all of the incremental costs that are associated with being an institutional investor. "The LP has to hire a team to work with the firms, they have to pay for monitoring, and if you have to work out of the investments that don't perform as they should, then all of that becomes incremental costs."

Maurice Gordon, managing director at Guardian Life, thinks PE firms should just lower fees outright. "Instead of calling the sidecar fund a co-investment fund, just call it a lower-the-fees fund," he says. "I mean, that's all it is. If you're doing every deal, every [deal has] checked the box. It's not a co-investment fund, even though they call it that." ■

"In five to 10 years, fees overall will settle into a new paradigm,"

– Andrea Auerbach, Cambridge Associates



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Why GPs Should Pick a Lane in Co-investing

Amid the increasingly popularity of co-investing, GPs need more capital for “outside the strike zone” deals. Experts from Cambridge Associates, Coller Capital, and Guardian Life explain this phenomenon among GPs, and why LPs need to carefully track whether a co-investment opportunity is within the strike zone of a GP.

Privcap: If we look at a chart showing co-investment over the years, 2007 is clearly the biggest year for co-investment. Or the most recent big year for co-investment, and of course, that was the frothiest peak of the market.

Andrea Auerbach, Cambridge Associates: What you see in the analysis that we show is that pro-cyclicality is when the big-ticket co-investments come out to play. A number of analyses that we’ve done at Cambridge [show] that there’s a pretty steady volume of, let’s call it mid-cap/lower mid-cap co-invest that is available.

It’s not “I need $600M to complete the largest acquisition ever made,” which might be a 2007 co-invest opportunity. It might be, “I need an extra $15M to complete this acquisition of a widget factory that I plan to add onto over several years.” And the pro-cyclicality is really related to large ticket co-invest, which can have its own risks and rewards.

Luca Salvato, Coller Capital: One point that we touched on is this element of the GP and LP relationship. A huge part of having a successful co-investment program is developing that relationship and having a dynamic that both suits your needs and meets your needs—more importantly—but also making sure that relationship is being mined correctly.

Sometimes we have interactions with LPs that desire co-investment, but ultimately when you offer it to them, because of the dynamics around a co-investment, they just don’t have the ability to execute. Understanding the constraints that people have, and the processes that they have to go through, is very important.

Maurice Gordon, Guardian Life: It’s so important to have a team that’s done co-investing a long time. [For] some of the people we’ve hired into the team, part of the hiring

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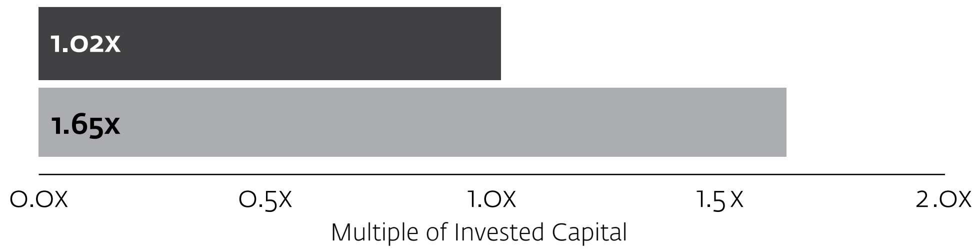
The Strike Zone Matters
Did a co-investment follow the sponsor's typical investment profile?

Source: Cambridge Associates



process was "Show me your co-invest track record." Verify it, instead of thinking you can just hire somebody off the street and train him in three months.

Let's go back to the challenge for the LP of having gotten an opportunity to co-invest. How do you assess whether that opportunity is in the strike zone, versus an outlier that happens to need more capital and might not be a winner?

Salvato: You have to think about how you define the strike zone and what the strike zone is for the GP. And then you need to drill down into the justification—at the least the GP, or the conviction the GP has—for that particular investment.

The main one that everyone obviously focuses on that is the biggest driver of co-investment flow is just stepping out of your deal size comfort zone. If you have a GP that steps out of a size threshold and a sector threshold, those generally don't perform that well, certainly versus the performance of their particular fund. I would see them as not necessarily being a red flag. But they're at least an amber flag, which requires a little bit more investigation for you as an LP to get more comfort around the dynamics.

Andrea, we are looking at a chart from your study showing deals that were in the strike zone versus those that weren't. Can you walk us through this finding?

Auerbach: So what we did is we took hundreds of investments, and knowing the managers as we do, we were able to make a determination. We used our skills as an investment house to make that call. We asked whether these investments were within the stated strategy, scope, and wheelhouse of the manager. If they were, they went into the strike zone. And the results and the performance of the deals in that strike zone were basically a 1.7x gross. And 23 of those deals delivered above a 2x gross.

For investments that were considered outside the strike zone, the overall result was that they got you back cost. If you're sourcing co-investments from GPs within your own program, you know those managers. If they're outside your program, you need to take the time to really dig in and get to know those managers well.

So would you say the number one thing that LPs are trying to determine, is less "they're trying to be an expert on the underlying business and the market it's in" and more "is this a top-performing GP and is this deal I'm being shown in that GP's strike zone"?

Auerbach: There are two strike zones. There's the strike zone of the investor themselves. If you're actually going to edge out into co-investment land—which may be one click past the fund experience that you have—you need to have a good sense of whatever committee and oversight is being brought to that program.

And then they're sourcing from GPs that we all believe have their own strike zones. There has to be harmonic convergence of those two strike zones to really make it work. If you feel the pressure to invest, and your deal flow may be less sufficient, you could end up doing something that's inappropriate. So you need patience.

Salvato: One of the studies we put out is one where we go to a number of LPs—not our own, but LPs globally and of various sizes and specialities. When you ask them to forecast what percentage of their program allocated to private equity will be through co-investments, it's moving dramatically up. And the average mood is people having less than 10 percent of their private equity in co-investments to up to or below 25 percent, so almost a doubling in terms of the amount of dollars that are going into co-investments. And that's a huge shift. ■

From the Archives

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