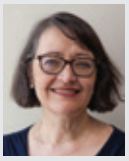
MEET THE ROUNDTABLE



KATHERINE ASHTON
Partner
Debevoise & Plimpton
Ashton has extensive experience in European and US private equity transactions and regularly counsels private equity and other investment funds on corporate and securities matters including investments, secondary acquisitions and fund recapitalisations.

RICHARD DAMMING
Senior investment director
Schroder Adveq
Damming covers European investment activity for Schroder Adveq, a specialist private equity business with more than $8 billion of client assets under management. He previously worked at Zurich-based fund of funds Capvent and PwC.

FLORIAN KREITMEIER
Managing partner
& co-chief executive
SwanCap
Kreitmeier co-founded SwanCap in 2013 by spinning out UniCredit's private equity business. He previously headed the unit, having joined UniCredit in 2011 from Apax. SwanCap manages €3bn in private equity primaries, direct co-investments and secondaries.

CORENTIN DU ROY
Managing director
HarbourVest
Du Roy, a 14 year veteran at HarbourVest, focuses on direct co-investments in buyout, growth equity and mezzanine transactions in Europe and globally. He joined from AXA Investment Managers, where he was an equity and high-yield debt research analyst.

JOANA ROCHA SCAFF
Managing director
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Scaff serves as head of Europe private equity and a member of the co-investment and private investment portfolios investment committees. She previously worked in the investment banking division of Lehman Brothers and has advised on corporate transactions including M&A, financial restructurings and debt offerings.

ALISTAIR WATSON
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Long-term partners

Co-investing is now less about the specific deal and more about the LP-GP relationship.
By Toby Mitchenall and Victoria Robson

PHOTOGRAPHY BY JAMES CLARKE

The fundraising market is on a tear. This year GPs collected capital in volumes last seen in 2007 when GPs raised a staggering $481 billion over the course of a year.

The fear that an exuberant fundraising market would lead to an equally exuberant dealmaking environment has, however, not materialised. In the first three quarters of this year around 1,600 transactions have closed with a combined value of $494 billion, whereas more than double that closed in the same period a decade ago. In 2007, GPs put almost $800 billion to work, according to data provider Dealogic.

Amid tricky investment decisions, managers appear to be staying disciplined.

In these circumstances, it seems remarkable that LP co-investment is on the rise. With GPs having to work hard to source good opportunities, how are they being persuaded to give up a slice (often at the expense of fees and carry)?

At our roundtable of co-investment experts, there is a clear sense that GPs are making co-investment available mostly to keep limited partners happy.

"I don't think you're seeing GPs taking smaller tickets than they would normally to make room for co-investment necessarily, but it's pretty clear that co-investment has become a key part of the partnership model," says Alistair Watson, senior investment manager private equity, Aberdeen Standard Investments. "If you ask any LP whether they are interested in co-investment they will almost all say yes. The large LPs are asking for co-investment at the outset and it's an accepted part of the [fundraising] equation."

Major LPs, including a growing number of European sovereign wealth funds, are demanding co-investment, says Kate Ashton, partner at Debevoise & Plimpton. "LPs are increasingly using their weight to request allocations. They may not want to go into every deal, but they'll look at each opportunity as it comes in."

> ***The market is still a place where people are going to run into each other over and over again, so it's in the interest of most LPs to find an amicable solution to any dispute***
>
> **Kate Ashton**

The range of LPs pursing co-investment has also broadened significantly, says Richard Damming, senior investment director at Schroder Adveq. It now encompasses LPs such as pension funds that are "seeking co-investment to reduce their overall fee load". A second group is chasing enhanced returns and "overall performance good enough for a standalone co-investment product offering". And there is a third camp, which is growing in size, "where the co-investor almost goes direct and becomes a competitor to the GP".

The other driver of co-investment activity is supply. GPs are becoming more conscious of risk management, portfolio

> ***As a co-investor you have to be flexible around the needs of the GP and accept different situations as they come***
>
> **Corentin du Roy**

construction, long-term performance and protecting their LPs, says HarbourVest managing director Corentin de Roy. "That's the main dynamic [for increasing levels of co-investment]."

SYNDICATION GAME

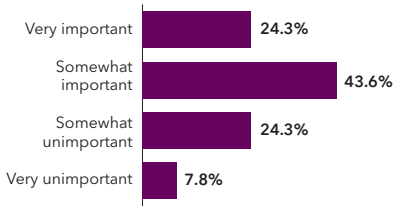
Whereas the pre-crisis private equity market was characterised by GPs clubbing together to execute larger transactions, GPs are now more likely to partner with an LP on transactions. The two organisations will conduct due diligence alongside each other and co-underwrite a deal. This is, however, still limited to a few participating LPs, says Joana Rocha Scaff, head of European private equity at Neuberger Berman. Co-sponsoring requires additional resources and skills, she says. "Generally, LPs who can be co-underwriters can play into the co-investment syndication market, but the broad syndication players can't co-underwrite."

Scaff highlights transparency and access to the same information as the GP as advantages of co-sponsoring, in contrast to more competitive syndications where information is often "prescriptive" and the memorandums are "pre-packaged".

Co-underwriting usually means a bigger fund allocation for the LP, and greater insight into the transaction and mindset »

SOMEWHERE A PLACE FOR IT

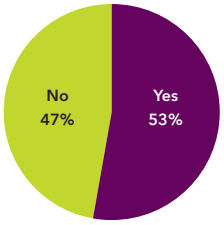
Most LPs consider co-investment 'somewhat important'



Source: Intralinks/Global Fund Media

A SHADOWY FIGURE

LPs on whether they are moving away from the standard PE model



Source: Palico

ON THE FENCE

Do you believe a significant number of large US private pension funds will embark in direct private equity investment programmes over the next five years?

Source: Palico

> ***A big risk LPs underestimate is not setting aside sufficient capital for add-on investments and having their stake diluted***
>
> **Richard Damming**

» of the sponsor, says du Roy. "You can influence the process more. You can feed in your questions and comments and try to instil some discipline."

"The downside is you can work really hard and put a lot of resources into a deal and end up with just a broken-deal expense bill," he adds.

Co-investing is demanding and only a few LPs have the ability to access and select the best deals.

"Many LPs raise their hands when asked if they are interested in co-investment, but the number of LPs ultimately participating is comparatively low," says Florian Kreitmeier, SwanCap Partners managing partner. Within that group there are even fewer who have the expertise and capabilities to co-underwrite a transaction, he adds.

"We observe that not all co-investment programmes are successful in the sense of delivering enhanced returns. Given the spectrum of possible co-investment types, from syndicated deals to co-sponsoring, a co-investor needs in-house expertise, a dedicated team, resources and structured processes to develop a diversified programme and get access to the high-quality co-investments that everyone is looking for."

Co-investors should not "purely rely on the information on the table and enter very passively into selected investments," he adds.

When pursuing co-sponsorship deals, LPs need to be nimble and committed, says

BREAK UP, MAKE UP

Who pays for what when a co-sponsored deal fails to go ahead?

While responsibility for broken deal expenses has been a grey area for co-underwriters in the past, Watson describes the situation as "clarifying".

"GPs have various approaches; it is something that will evolve. If you are proceeding with a transaction, co-investors need to give a clear indication to the GP of their criteria and what they think the key risks are and then go on the hook for deal costs at the right time. You should have that built into your process."

And if co-investors are going to share those costs, they also want to see the benefits, says du Roy. "If there's a success fee for closing the deal, we want our pro rata of that, so it's a symmetrical situation."

The treatment of due diligence costs in co-underwriting is another area where terms can vary. At the larger end, "for every transaction we sign, we pay our pro rata share of the due diligence costs", says Scaff. "It's standard in this market."

But for smaller funds, how due diligence costs are split with co-underwriters is not uniform, says Damming. The European Investment Fund, for example, is encouraging co-investors to pay their pro rata amount. "The EIF has started to push this as an LPA term in funds in which they are invested."

Ashton, but they also need to be thorough. "It's very important for the co-investor not to cut corners on issues that are important to them and make sure they are happy with the documentation and parameters of the transaction, no matter how oversubscribed it is."

Alignment of interests is vital, and Scaff adds co-investors need to ensure they have core protections in place, including anti-dilution safeguards and the right to exit at the same time as the lead sponsor.

GPs should approach their LP base first before looking elsewhere for co-investors, she says. "If a GP has acknowledged LP interest in co-investment it would be disappointing to then see them bypass their clients."

The alignment of interest extends to other LP co-investors, says Watson. "It's important to make sure it's people you can trust and work with on a difficult day as well. As the co-investment community widens that is going to come more to the fore," he says.

DAMMING INDICTMENT

Damming goes even further, highlighting the importance of an alignment of interest between the co-investor and the management team. "We like to see that management has skin in the game and are fully aligned should something go wrong."

As managers focus on buy and build, another "big risk LPs underestimate is not setting aside sufficient capital for add-on investments and having their stake diluted", Damming says. "There is an opportunity cost to reserving capital so you have to make sure you have the most accurate information on your portfolio and have reserved the right amount and adjust it as necessary. That has burnt LPs on a number of deals."

Damming also flags the danger that not all LPs have the same co-investment rights. In the current market where there are a number of first-time fundraises, managers are bestowing special terms on cornerstone investors, including co-investments, he says. "It's clearly a way for GPs to raise money, but it also introduces a poison pill, where LPs joining the fund later won't be able to get the same rights."

Conflicts between GPs and co-investors are rare, says Ashton, although she adds that may change if businesses begin to struggle in a downturn.

"The market is still a place where people are going to run into each other over and over again, so it's in the interest of most LPs to find an amicable solution to any dispute. On the other hand there are situations where investors chalk it up and decline to work with that counterparty again. »

> ***Many LPs raise their hands when asked if they are interested in co-investment, but the number of LPs ultimately participating is comparatively low***
>
> **Florian Kreitmeier**

> ***It's pretty clear that co-investment has become a key part of the partnership model***
>
> **Alistair Watson**

» Fundamentally the best solution for any conflict situation is disclosure."

One market development that may reduce the potential for conflict is more and better documentation. "Over the past five years, major GPs have moved toward standardising terms when offering co-investments," says Ashton. "They are not always successful and may be negotiated against by some LPs, but standardisation was relatively uncommon a few years ago."

However, at the smaller end of the market, where GPs are new to co-investment or do not do it regularly, the documentation is "still very much a case by case," says du Roy. "As a co-investor you have to

CYCLE AHEAD

While no one knows when a downturn may hit, co-investors can begin to prepare for it

"There were lots of co-investors that were burned quite badly in the last crisis," says Watson. And like co-investors at the peak of the market in 2007-08, "LPs co-investing now in a high valuation environment need to be careful."

Scaff says her firm's appetite for cyclical plays has diminished compared with 2010-11 and the team is seeking covenant-lite terms in almost every co-investment. "Keeping the keys of the business during the cycle is crucial," she says.

She also advocates "idiosyncratic investment theses" and businesses that are less dependent on external factors like commodity prices. "And partner with GPs that are well resourced, experienced and have seen a cycle. Memories can be short."

Trying to time the market is a mistake, agree Kreitmeier and du Roy. "We all felt in 2013 that pricing was starting to be elevated," says du Roy. "Who knew that we would still be saying this in 2017? And we might still be saying it in three years. 2013 is going to be a great vintage for most people. Our philosophy is to be even-paced in our investment approach."

The cycle is going to end at some point, says Kreitmeier. "In this environment it is even more important to really understand the GP's value creation plan for a specific company, its skill-set and expertise in the relevant industry and the GP´s ability and track record to execute on the envisaged strategy."

Co-investors could be caught out by changes they could not foresee, warns Watson. "We are very focused on technology disruption. Technological change is moving much quicker than pre-crisis. We see that as an opportunity, but if we do think there is a risk of a sector or sub-sector being challenged by technology in the next few years then we're pretty careful."

Understanding potential exit routes and who might buy an asset is "absolutely vital," Watson adds. "There is the pass-the-parcel mentality right now and lots of secondary and tertiary deals. In a few years time, in a different market environment where there might not be strong exit options, that could be pretty challenging for some deals."

be flexible around the needs of the GP and accept different situations as they come."

This includes on fees. "There is room for creativity in the lower end of the market in the deal-by-deal structures," says Damming. For larger funds with an established franchise, his perception is that they offer no fee, no carry to existing LPs.

While in most cases there is wording that outlines the framework and process for allocating co-investment in a limited partnership agreement, it tends to come down to the GP's discretion, says Kreitmeier. "It is not simply a case of them selecting the biggest ticket LPs – although that is taken into consideration for sure – but seeking the best possible partner on a co-investment."

This includes, among other criteria, assessing whether "the co-investor is beneficial to the overall deal, has the necessary expertise and operational resources to deliver on time, is flexible on cheque size, and will be ultimately a trusted partner," he says.

SELECTION BIAS

The issue of trust cuts both ways. In the early days of co-investment, LPs questioned whether they were being offered the most attractive deals, says du Roy. "There was a lot of scepticism from LPs as to why a GP would give access to their best deals for free. Now we're past that hurdle. The track record is long and established. Co-investment is accepted as a strategy and part of the allocation."

To get access to the best deals, co-investors "can take it a notch further and try to identify deals that will be of interest to a GP and do some matchmaking", du Roy says.

Kreitmeier agrees. "Given the discretion of the GP, it's about proactive sourcing from an LP perspective and it has a lot to do with long-term relationships, trust, your co-investment history, whether you are close enough to the execution team and have been a reliable partner in the past."

> ***If your mindset is, 'Where can I help the GP creatively?' on a deal, that is definitely a plus***
>
> **Joana Rocha Scaff**

Success depends on having access to a "broad set of high quality potential co-investments to choose from, across different tranche sizes, regions, strategies and GPs. [The co-investor needs] to be the one that is sufficiently close to the GPs, market and companies to source transactions."

"If your mindset is, 'Where can I help [the GP] creatively?' on a deal, that is definitely a plus," says Scaff. "And frankly having the capital that solves the equity need – if you [the co-investor] have critical mass to solve the problem, that's important in many cases. If you're a significant investor or have the potential to be one, that's enticing to GPs." ■