

Hello! I Am a Co-investment Deal

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Not far back in the past, there happened to be a time when I was popular and revered within the private equity (PE) community. I used to be a star among investor groups, for I offered them possibilities of large returns. I always found myself a cozy place outside of the lead sponsor's fund. On top of this, my investors' financial returns never took a hit due to the carried interest paid by funds to sponsors.

If there is any pay-off, it is that investments made outside the fund may expose one to higher absorption of risk than investments in the fund itself, as co-investors have historically been inclined to park their money only in some of the investments made by a fund. There I stood up to help, mitigating this risk by attempting to build their own portfolios, similar to the way a lead sponsor builds a portfolio within each fund.

Gone are those days, as PE is now experiencing a stealthy capital boom. Data collected over the years has consistently shown extremely high appetite for co-investment, suggesting substantial supply from sponsors. Last year alone, c. 58% of all sponsors actively offered co-investment opportunities to their limited partners. In reality, it is not an overlooked fact that some of these new investors move away from well-known sponsors if lucrative co-investment opportunities are not offered as part of the deal package.

While I understand that the co-investment crusade could have significant implications, I would still like to ask my sponsors, "why me?" The flow of substandard deals has increased considerably, impacting my reputation in the market. I also want to warn large institutional investors not to cross the limits and to be careful when conducting deeper diligence. I second your requirement for improved return if you investment in me, but do you have in-house capabilities to conduct deeper due diligence, perform comprehensive valuation and work closely with portfolio companies? If not, then my friend you are taking a big risk by just relying on a general partner's capabilities.

Another scenario that makes me sad is the way in which investors are monitoring my performance. I spare no effort to help you yield attractive returns and mitigate the J curve by deploying capital immediately, but look at the way you are managing your co-investment portfolio internally. Sometimes, I feel completely ignored, as there is no adequate process that builds on quality resources to manage my performance periodically and to advise me how to create greater value for my investors.

The more leisurely speed of deal making and exit activity has done little to deter PE fundraising. A total of USD655bn was raised from FY 2015-17. This is a huge swing and a big opportunity for funds to fulfill investors' desires to focus more on established general partners for better fee structures,

access to co-investment opportunities, and lower costs of diligence.

In FY 2017, the proportion of funds with less than USD100m of committed capital dropped to 26%, well below the 5- to 10-year average of 34%. Although this strategy has its rewards, it is yet to be proved whether it would deliver well to investors. I am afraid the bigger sponsors may fail to deliver top-quartile performance and that limited partners, too, may see diminished returns.

Lastly, I refer co-investors to Acuity Knowledge Partners, where they can obtain help to find good deals, conduct deeper diligence, carry out more meaningful valuation studies, set up effective monitoring processes and access strategic research experts to closely work with their portfolio companies.

About Acuity Knowledge Partners

Acuity Knowledge Partners is a leading provider of high-value research, analytics and business intelligence to the financial services sector. The company supports over 350+ financial institutions and consulting companies through a team of over 3,000+ subject matter experts who work as an extension of the clients' teams based out of various global delivery centres.

We empower our clients to drive revenues higher. We innovate using our proprietary technology and automation solutions. We enable our clients to transform their operating model and cost base.