CO-INVESTMENT

Hand in hand

Competition is on the rise for co-investments, prompting issues with their investor base for some fund managers. But if navigated carefully, such deals can lead to better net returns for investors – and provide a lifeline for GPs during constrained credit markets, says SL Capital's Graeme Gunn

***Gunn:** more selective than ever*

Edinburgh- and Boston-based SL Capital Partners is a funds of funds with a long track record in co-investing. It allocates 30 percent of its capital toward these direct deals alongside general partners and has completed more than 44 co-investments since 1998.

But it doesn't make fund commitments predicated on access to future co-investment.

"We're not trying to contractually bind the GPs to provide us with co-investment opportunities," says Graeme Gunn, partner at SL Capital. "The way that we approach it is to build long term relationships, then market our strengths and ability to deliver. Then we analyse where their best deals come from within their portfolio and target those. We are also flexible in the quantum of capital and whether we are in at closing or acquire the equity on a syndication basis."

If a GP has a particular strength in certain sectors, such as healthcare or energy, within a generalist strategy, we will focus specifically on co-investing in those transactions. The one rule SL Capital follows is that it only co-invests alongside GPs where it has an existing fund investment. This does not mean, however, that the firm will write a cheque whenever one of its roster of GPs needs additional capital.

"Some groups will say, 'We'll definitely give you one deal out of this fund, but we'll tell you which one it is,' which for us is uncomfortable because we want to see two or three and select the one we feel will perform best and meets our own strategic objectives. Obviously we need to manage those we decline quickly and efficiently," says Gunn. "When you're only investing in one or two of the companies in a manager's portfolio you have to be sure that you focus on your own due diligence process to make sure you have confidence in the transaction."

The firm also never makes a co-investment without engaging with the management team of the portfolio company.

"I think everybody's being a little bit more selective and cautious these days," Gunn says. "The deal that Managers offer co-investment on is maybe not always the most important for them, but obviously it's hugely important for us, because we're doubling up our exposure on that company."

A GREAT DIVIDE

While SL Capital's philosophy around making co-investments has remained consistent since creating a standalone business within Standard Life Investments in 1998, and through the partial spin out to form SL Capital in 2007, the market has evolved, particularly in the last few years.

"We've seen the rise of the larger investors – the bigger US and Canadian pension plans and the global sovereign wealth funds – who want to co-invest at scale alongside the GP's at completion," says Gunn. "It makes a lot of sense for them, [as] you can deploy capital outside the normal fee structure. That's always been an advantage in our model. We accept that we pay 1.5 percent in fees and 20 percent carry on a fund, but having up to 30 percent co-investment in our fund of funds means better net returns for our clients."

The introduction of larger investors into the co-investment world has meant new competition for deals, but the dynamic in SL Capital's target market has not been adversely impacted. While the firm has, and will continue to invest alongside larger funds including Advent International and CVC, the bulk of its co-investment activity historically has been with mid-market groups and even smaller managers in Europe and the US.

"Whereas we might write a cheque up to €50 million, a lot of these bigger groups are looking invest up to €500 million."

Interestingly, new entrants in the upper end of the co-investment market have presented challenges for GPs, according to Gunn.

"They've got 30 LPs who want to co-invest, so every time there's maybe €20 million or €50 million available to come up they have to go out to all of them," he says. "It's actually causing the GPs themselves quite a headache in how they manage that process, how to keep all investors onside and how to manage the resource issues within their own team. There's quite a lot of concern about the whole co-investment situation, especially when it ends up with only 5 of the 30 investors able to complete."

For larger funds, however, the ability to satisfy LPs looking for co-investment opportunities is less of a concern.

"If you're working with a fund at the larger end of the market, typically the quantum of equity is significant, therefore they can usually keep everybody happy," Gunn says. "I think it's in the mid-market and the lower mid-market where we see the challenges, however, this is where there can be some really attractive opportunities."

Still, having a large group of co-investors comes with its own set of potential complications.

"You find when there's big co-investment groups in a deal that your ability to influence the direction of the business when there is an operational issue is harder. In those situations we use our link as an LP to put pressure on the GP to work as hard as they can to sort the issue out," says Gunn. "There have been situations where we've had bad experiences with a co-investment where we've been with the GP for a while. That has in some cases caused us not to invest in the next fund. So there is some risk for GP's in bringing in LP's to a deal if they do not have a deep involvement and commitment to a portfolio company. That's why we prefer to co-invest with those groups who have a high operational focus."

GROWING SLOWLY

Despite potential conflicts and some issues, co-investment continues to serve as an advantageous tool for both GPs and LPs, says Gunn. It allows GPs to manage risk through portfolio construction and also acts as a crucial lifeline in times of constrained capital markets.

"Recently the lack of debt availability in deals has meant more equity is required from the fund, and co-invest is a way to manage this and potentially allows GPs to make their equity go further," Gunn says. "The smart ones have realised that they need to keep their investors close and therefore have continued to offer co-invest. It can assist in the next fundraising and it's easier than going to another private equity fund to share a deal."

> ***The co-investment market is becoming more competitive***

SL Capital is increasingly working more with managers in the lower end of the mid-market, where it can act as the only co-investor in a deal or one of a limited group. Though the firm has raised €6.5 billion through 16 funds of funds for primary funds, secondary investing and co-investment, the current climate of uncertainty has given even the most experienced investors reason to be more cautious than ever.

"We continue our historic pace of co-investment activity, but I would say we are being even more selective than normal," Gunn says. "Buyout deal flow is steady at the moment for us, but the second half of 2012 has been slower. The reality is that co-investments are sporadic and you have to be ready and have the resources to respond quickly to an opportunity."

So will SL Capital be still find attractive co-investment opportunities in Europe and the US during the next few years?

"We would expect the markets to grow slowly over the next three to four years. However, within that macro outlook the private equity funds will continue to see opportunities, and we will continue to deploy capital alongside them. It's a long term strategy that consistently delivers attractive returns." ■