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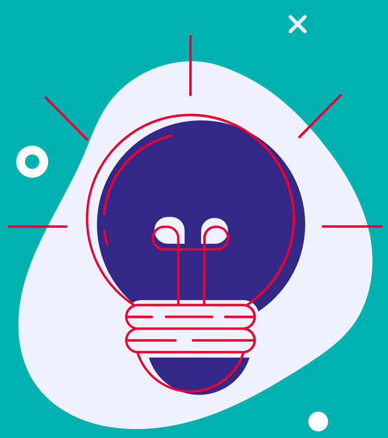
Top tips for Private Equity Co-investing in Europe

Contents



Top tips for securing and evaluating a deal (1/1)

Driven by the opportunity for outsized returns and lower fees, co-investing is the “hidden gem” of the private equity investor community.

Although, in theory, there are a number of ways to access co-investment opportunities –indirectly as an investor in a Fund of Fund (FoF) dedicated to co-investments or by directly co-investing alongside a private equity (PE) fund - in reality, such investments are in limited supply.

FoF investors do not participate directly in co-investments and so are in effect acting as LPs in a typical PE fund with a particular co-investment strategy. Investors may select multiple FoF managers to allocate risk more broadly but may not access the best individual deal opportunities.

Therefore, for those LPs looking for more direct and active participation, direct co-investing is the more sought-after deal type and is typically reserved for the largest LPs in a PE fund by commitment, other LPs that agree co-investment rights in their side letters or other strategic investors on the hunt for co-investing.

Why is co-investing so popular

Co-investments should be "win-win" as they give the PE firm the ability to execute larger deals whilst at the same time giving a co-investor access to direct investing, more particularly as below:

- Outperformance: Co-investing has been shown to deliver better returns outside of the typical 2:20 fee structure.
- Lower fees: Investors are attracted to lower fees (0.5%-1% or even waived fees if a co-investor is also a LP in the main fund) with returns not subject to the same expense exposure and mechanical delays as the main fund.
- Builds relationships: Successful co-investing builds strong relationships for future fundraising by the fund and gives co-investors the ability to experience a new asset class more directly, educating themselves for future deals or even to build out a direct investing platform in the future.
- More direct involvement and control: Even with interests aligned, co-investors achieve more control over their capital than via a fund. Whilst co-investors are backing the PE deal team by co-investing they will have more direct "skin in the game" so can justify more direct oversight over the portfolio company, access to management, add value through a board seat and obtain ongoing insights on the asset.
- Positioning for the future: When it works well, co-investing enhances the collaboration between the PE house and the co-investor, possibly positioning it well as a LP for future fund allocations and deeper co-investment rights. For co-investors, successful execution should enhance market profile alongside the PE house (although sometimes confidentiality limits this) which should increase the ability for the co-investor to raise future client capital of its own.

Co-investments should be "win-win" as they give the PE firm the ability to execute larger deals whilst at the same time giving a co-investor access to direct investing

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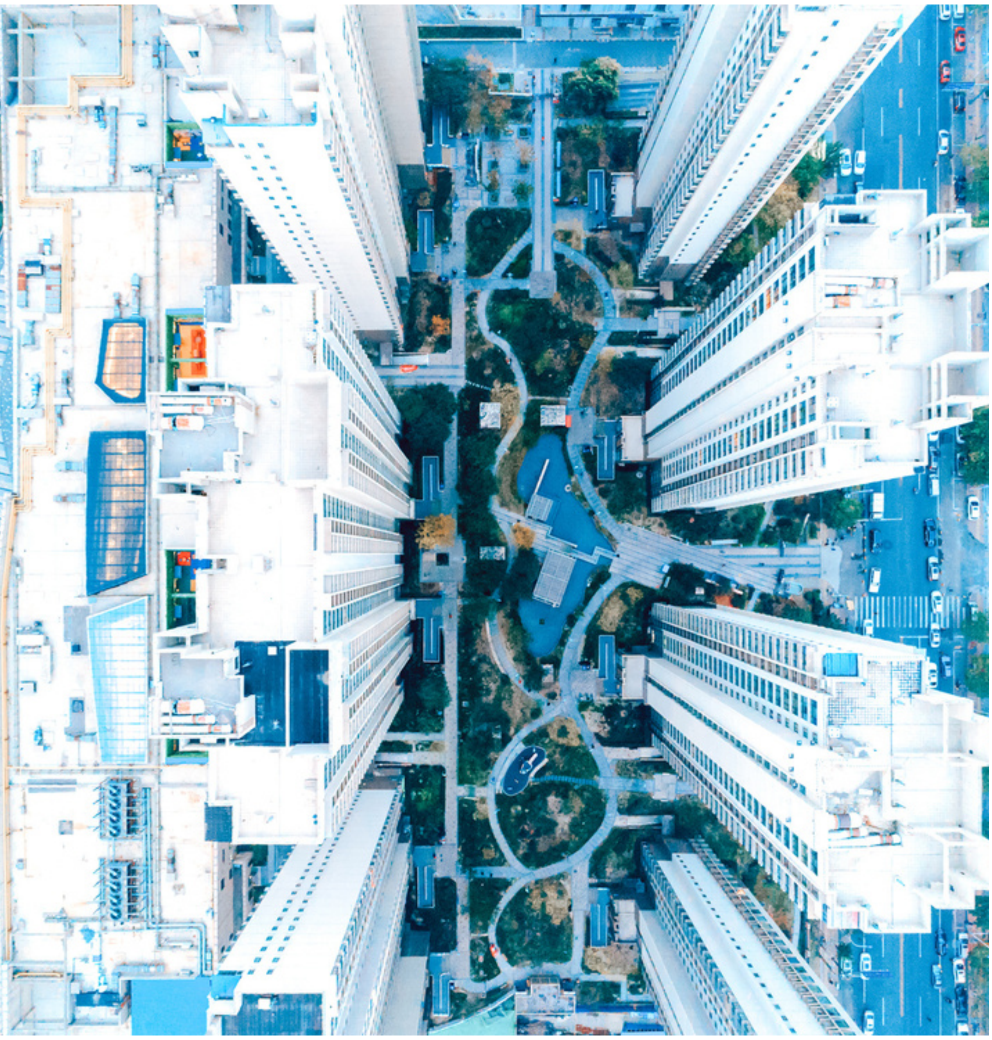
OUR TOP TIPS

FOR CO-INVESTORS

Co-investing starts with the negotiation of your investor commitment so LPs should make their interest in co-investing clear from the outset. LPs can flag their desire for more exposure to larger deals but may limit this to a particular sector or geography. To best position themselves LPs should additionally flag their ability to access additional capital on fairly short notice and demonstrate that they have the internal processes and governance in place to support a co-investment deal.

This approach should secure a strong position for a co-investor when the PE house has a deal with a valuation that exceeds the available commitments in the fund or is in itself too large for the fund based on the aggregate value or sector or country allocation limitations.



A PE fund's first port of call will typically be the existing LPs with co-investor rights but certain funds may be permitted to explore other outside of its existing LPs. Co-investors may wish to take advantage of the following "top tips" when evaluating whether to take up a co-investment opportunity, how to evaluate a deal team, put in place its own team and consideration of the approach to diligence and the deal.

TOP TIP 1

Is it too good to be true? Look out for deals that may be too large for the PE house to handle, even if they are able to access additional capital. Co-investors should evaluate whether the PE house is taking on opportunities outside of its optimal deal characteristics – sector, country, size – and why the PE house is looking to syndicate/de-risk the deal through co investing. Co-investors would be wise to compare performance of the PE fund in their co-investments as against their main funds, evaluate risk versus performance and plan accordingly.

TOP TIP 2

Be aware of the risks and plan accordingly: By making direct co-investments rather than through a fund, the lack of diversification increases the risk profile of a particular investment. Co-investors must be prepared to accept that some co-investments may fail or underperform or even require additional capital in the future, whether in emergency situations or to support the growth of their asset. Therefore, additional attention to detail and effective planning, management and execution will be key. This should also be addressed in the deal documentation.

TOP TIP 3

Avoid majority control: Co-investors typically do not take majority positions but allow the PE house to bear most of risk as well as the upside of success as their incentive to perform. A co-investor should consider the overall exposure to the deal if it is already a LP in the main fund investing in the deal.

TOP TIP 4

No fees. No win: Be careful not to disincentivise the PE house by pushing too hard on a no fee commitment which may ultimately hamper their ability to execute and manage the investment or may even de-prioritise it over others in the portfolio. At the same time, co-investors should watch out for excessive fees and treatment of deal and abort fees so as a co-investor it does not end up paying excessively through the fund.

TOP TIP 5

Prioritise diligence to reduce risk: Co-investors should evaluate the execution and deal management capabilities of the PE team to ensure that there are sufficient internal resources to effectively manage the deal risk and execute the investment strategy through the life cycle of the investment. More particularly, co-investors should get comfortable with the deal team's capabilities and approach to diligence as it will be expensive to assemble an internal team to independently review all aspects of the target asset. However, co-investors should overlay the PE diligence and be able to give strategic input on value add/ key risk items.

OUR TOP TIPS
FOR CO-INVESTORS

TOP TIP 6

Seek reliance on the reports: Co-investors may not get direct reliance on diligence reports but they should ensure that at least the co-investment vehicle gets reliance (not just the instructing PE fund). There may be limits to how the co-investor may exert influence through the vehicle if it ever wished to take action as a result of information in a report but at least it has an economic interest in it.

TOP TIP 7

Focus on the report and take action: There should be specific carve-outs in the NDA for co-investors and their advisers to review documentation as well as a process to feed-back comments to the deal team. Co-investors could instruct their advisers to review the reports and to prepare a red flag issues list to follow up with the PE deal team and track issues into the deal documentation.

TOP TIP 8

Prepare a team to focus on the detail: Co-investors should assemble an experienced team and advisers to review each of the principal underlying deal documentation being negotiated by the PE deal team, starting with the heads of terms. A key aspect to consider is the expected appropriateness of the overall liability package such as the extent of the warranties given by sellers/management, any necessary indemnities for issues identified in diligence and the coverage offered, whether capped by value or in time.

TOP TIP 9

Do your own research: Although the PE deal team is leading, the co-investor deal team should also get a deep understanding of the target market, do their own research on the macro-economics and opportunities/threats impacting the target. Co-investors should not be wholly reliant on the PE house and do their own evaluation of pricing and multiples in the market as well as exit opportunities. If the deal doesn't make sense commercially, it is better to opt out early than later on.

TOP TIP 10

It takes time and effort: Co-investors should allocate time and resource to both structuring their investment into the co-investment vehicle and overseeing the PE deal team diligence and negotiation of the deal documents. As a direct investment it should be expected that this will be more intense than a typical LP investment into a fund.

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Germán Cabrera
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Top tips for effective deal execution (2/2)

In part 1 of this series we considered why co-investing is so popular, how opportunities arise, some top tips for a prospective co-investor in evaluating whether to pursue a deal and how to approach risk and resourcing when doing so.

For this part, we dive straight in, as in typical co-investing deals there is plenty to do and limited time to do it!

As a result, co-investors will be well served to consider the further top tips below, covering points to effectively execute co-investment deals, including structuring the co-investment and equity arrangements and negotiation of co-investment documentation.

OUR TOP TIPS

FOR EFFECTIVE CO-INVESTMENT EXECUTION

TOP TIP 1

Follow up on your promises: Co-investors should be ready to follow up on the promises made in securing the co-investment. They should be reactive to the requests from the PE deal time whilst at the same time be pre-emptive of the deal process. Co-investors should not slow down deals in decision making and may get ahead by setting up internal processes, an effective deal team, fast decision-making capability including investment committee approval and plans for monitoring and performance measurement.

TOP TIP 2

Select experienced advisers: Select external professional advisers who understand co-investing, risk allocation in these types of deals and structures as well as those who know what issues to look out for. Time and fees well spent up front could save extensive re-negotiation of points later on or possibly pulling out of a deal if something fundamental is off market. In the worst-case scenario, a poorly executed deal will usually lead to a drag on performance.

TOP TIP 3

Consider de-risking equity arrangements: There are different structuring options for equity, quasi-equity and quasi-debt in the co-investment structure, such as convertible and/or redeemable preference shares, warrants or similar. These could assist to create a self-liquidating structure and de-risk the co-investment based on certain events.

TOP TIP 4

Protect against equity dilution: Secure pre-emption rights on transfer and issue of new shares. Although a co-investor may not be able to justify a block of a transfer of equity to a third party by the PE house it should secure pre-emption rights and the right to tag along on a sale if it turns down pre-emption rights. Co-investors may wish to negotiate for a tag of all of its shares to "exit" its stake or at proportional tag to dilute its holding. In addition, it is important to protect the co-investor with respect to any drag-along right so that the offered consideration is at least above a certain formula (the higher of a certain IRR or a certain multiple of invested capital) or at the fair market value.

TOP TIP 5

Secure additional minority protections: Although key to a successful co-investment is allowing the PE team the freedom and incentives to execute their strategy, co-investors should seek to secure key minority veto rights over their equity and economic rights, key decisions of the target such as taking on new debt, actions outside of the business plan that require new capital such as bolt-on M&A as well as related party transactions and conflicts.

TOP TIP 6

Board matters: Co-investors typically seek board seats, at least in the co-investment vehicle and occasionally on the target board depending on a number of factors, such as its relative size of commitment and ability to bring industry expertise. If a board seat is not on offer or sought at the target level then at least observer status and rights to the board packs are recommended. Depending on the jurisdiction of the entity co-investors should be mindful of "shadow director" rules.

It is important to protect the co-investor with respect to any drag-along right so that the offered consideration is at least above a certain formula or at the fair market value.

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OUR TOP TIPS

FOR EFFECTIVE CO-INVESTMENT EXECUTION

TOP TIP 7

Additional information rights: Co-investors should secure appropriate information rights to meet their own fiduciary, internal reporting and investment monitoring requirements. A co-investor should not assume that they will get the same information as the PE fund and it should require the same level of information as is given to the fund as well as third party banks/debt providers. It is also good to get to know the portfolio company board and founders in case relationships change or there are exits in the future.

TOP TIP 8

Prepare a team to focus on the detail: Co-investors should assemble an experienced team and advisers to review each of the principal underlying deal documentation being negotiated by the PE deal team, starting with the heads of terms. A key aspect to consider is the expected appropriateness of the overall liability package such as the extent of the warranties given by sellers/management, any necessary indemnities for issues identified in diligence and the coverage offered, whether capped by value or in time or whether overly limited.

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Do your own research: Although the PE deal team is leading, the co-investor deal team should also get a deep understanding of the target market, do their own research on the macro-economics and opportunities/threats impacting the target. Co-investors should not be wholly reliant on the PE house and do they own evaluation of pricing and multiples in the market as well as exit opportunities. If the deal doesn't make sense, it is better to opt out early than later on.

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It takes time and effort: Co-investors should allocate time and resource to both structuring its investment into the co- investment vehicle and overseeing the PE deal team diligence and negotiation of the deal documents at the same time. As a direct investment it should be expected that this will be more intense than a typical LP investment into a fund.

Co-investors should secure appropriate information rights to meet their own fiduciary, internal reporting and investment monitoring requirements.

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