GroveStreet

# Crafting a Winning Co-Investment Program

The foundation of successful co-investing

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**The Clamor for Co-investments**

Limited Partners (LPs) have flocked to co-investments over the last decade. Many factors have given rise to this trend. One powerful driver behind the movement is the view that co-investments effectively reduce overall fees and carry on a portfolio basis. Some LPs are drawn to the increased visibility into their holdings and underlying market trends that co-investing affords. The heightened understanding of specific holdings provides LPs with more in-depth knowledge of their portfolio and the ability to make more refined tactical adjustments to their exposures. Of course, the pursuit of higher returns is likely the dominating force driving LPs to consider incorporating co-investments into their investing activities. Whatever the reason for the growing interest, GPs have responded with an ample supply of co-investment opportunities and LPs have pursued them in various ways, ranging from a do-it-yourself approach to working with external advisors.

**Figure 1 – The pronounced rise in co-investments over the past two decades**

Co-Investment vehicles by vintage year as a proxy for overall co-investment activity

Source: Pitchbook

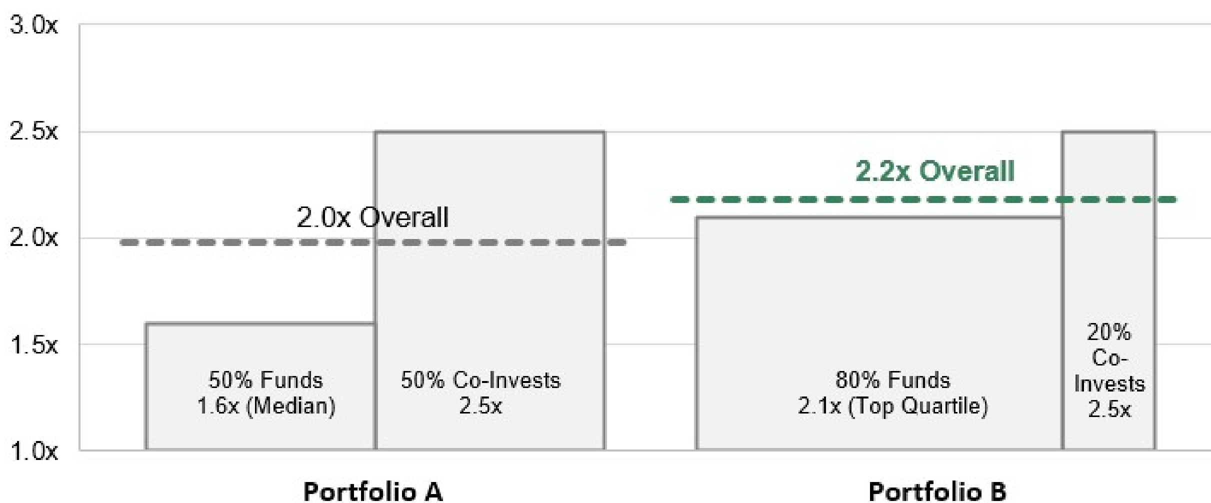
**Revisiting the Math of Adding Co-investments to a PE portfolio**

When it comes to evaluating the success of a co-investment program, the most common measuring stick is to compare the results of the co-investments to those of the fund investments. This comparison is surely useful, but it is hardly sufficient. Clearly, limited partners really care about and thus should focus on the overall performance of the PE portfolio more than the relative performance between the co-investments and fund investments. A simple illustration bears out this fundamental, important reality for LPs.

Below are two illustrative portfolios, each comprising a mix of funds and co-investments. Portfolio A is composed of an even mix of funds and co-investments. In this scenario the fund investments are assumed to generate returns that approximate the median performance of global buyout funds and IRRs of the co-investments exceed the fund investments by 10% (an assumption worth examining and addressed later). Portfolio B has a much lower weighting to co-investments at 20%. Importantly, in this scenario Portfolio B's fund investments generate top quartile returns and the co-investments still outperform the IRR of the funds, but by a somewhat narrower, yet still meaningful margin of 5%. This equates to roughly a 2.5x TVPI, in line with the assumed return for the co-investments in Portfolio A.

**Figure 2 – The return differential between top quartile and median funds dominates total portfolio returns even with meaningful co-investment allocations**

Performance comparison of two portfolios with differing levels of fund and co-investments




Source: State Street Benchmarks, GroveStreet Analysis

As seen in Figure 2, Portfolio B significantly outperforms Portfolio A even with a *much lower* allocation to co-investments that exhibit strong returns. Indeed, the performance differential would be even more

pronounced had the generous assumptions not been made (i) of such a heavy weighting to co-invests (~50% for Portfolio A) and (ii) that the co-investments would perform so much better than their sponsoring funds.[1] This illustration above is a powerful reminder of the touchstone principle of PE investing that *manager selection really matters.* The differential in returns across the GP universe presents both a challenge and an opportunity to LPs. Allocators considering co-investments should be as, if not more, assiduous in their fund selection process as they are in their fervor for co-investment opportunities.

Beyond the performance differential presented in Figure 2, the relative risk of the two portfolios deserves consideration. Assuming a consistent approach to deal selection and sizing across the two scenarios, a portfolio with 50% in co-investments is incurring a variety of meaningful risks. Clearly, there are idiosyncratic risks associated with single asset investments. There are also the heightened challenges associated with selecting individual direct investments from among an array of co-investment opportunities. Moreover, the fundamental exercise of manager selection is taxed because of the increased deal flow from the co-investment activities. Finally, if, as is assumed for Portfolio A, co-investments are modeled to meaningfully outperform their sponsoring funds, it would not be surprising to see considerably more risk taking.

**What the Studies Tell Us about Co-investments**

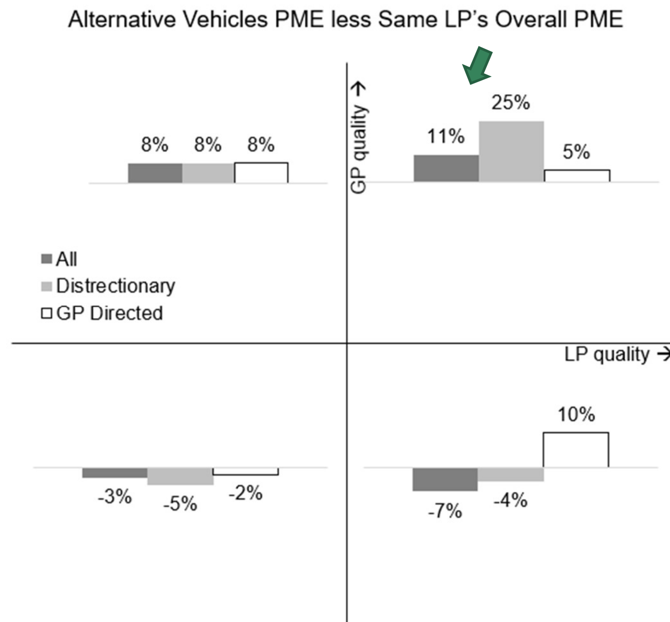
In his recent paper, "Investing outside the box: Evidence from alternative vehicles in private equity", HBS Professor and Senior Advisor to GroveStreet Josh Lerner shares some interesting findings. Using previously unexplored PE data from custodians, Josh's team examined alternative investment vehicles (AVs) in private equity funds over the last four decades. AVs are a good proxy for the universe of co-investment opportunities. The study found that the average AV performance matched the overall PE market, which includes both funds that have sponsored the AVs and those that have not. Interestingly, when the AVs are compared specifically to the main funds that sponsor them, the AVs *underperformed* the main funds. Furthermore, the study observed that LPs with stronger past performance from their fund investing activities experienced better than average performance from their AV investing activity. That "LPs with better past performance invest in alternative vehicles that have above-average market performance" appears to be driven largely by preferential access of top LPs to top AVs. In Figure 3 below we present a graphic adaption of the results from the paper in a two by two matrix. LPs are presented on the X-axis as "bad" or "good" based on their past performance, and GPs on the Y-axis, again as "bad" or "good" based on their past performance. Figure 3 compares AV performance by LP-GP pairing to the

[1] The assumption that there would be strong outperformance of the co-investments in Portfolio A is especially optimistic, likely unrealistic, given that those co-investments would be sourced from *median performing managers*.

performance of the *LPs' overall portfolio*. By examining the chart, we see that the first (and arguably the most important) factor for successful co-investing is to pick from "good", or high-performing GPs, as indicated by overall outperformance in the upper half of the chart. A closer comparison of the chart's northwest and northeast corners shows that LP quality – approximated by prior fund investment performance – also plays an important role in outcomes. While a "bad" LP may still enjoy some outperformance from co-investing with high performing GPs, the "good" LP is clearly the bigger winner. The difference would be even more pronounced if one considers the benchmark being used. "Good" LPs compare themselves to a much faster rabbit than that being used by "bad" LPs - outperforming mediocre performance is not as hard as outperforming already strong performance! The lower half of the chart serves as an equally powerful reminder than fund selection matters. Avoiding "bad" GPs into your portfolio can be as impactful as chasing better returns. The data in the chart reminds us that even "good" LPs will find it hard picking better deals from "bad" GPs. However fundamental it may seem, this observation is especially important for LPs to internalize as the fervor for co-investments swells, a trend that can tempt investors into partnering with weaker GPs just to access co-investment deal flow.

According to the paper, this trend holds true when comparing co-investment performance either to a corresponding main fund of a GP or to the LP's overall portfolio as shown below.

**Figure 3 –Co-investment (AV) Performance by GP & LP Quality vs Overall Pool Performance**




Source: Lerner, Mao, Schoar, Zhang – "Investing outside the box: Evidence from alternative vehicles in private equity"

To seasoned investors, these findings are not surprising. Experience teaches us that investments in companies led by strong GPs whose interests are aligned with LPs tend to produce better and more consistent outcomes. Selecting deals from GPs whose track records have exhibited a tight range of positive outcomes tends to be less risky and more rewarding than selecting co-investments from teams with a high degree of dispersion in their investments. *The fundamental lesson is clear and largely intuitive – LPs should focus on building co-investment portfolios from a basis of strong fund investments.* The odds of successful outcomes are better, and the risks better controlled. Lerner's paper clearly shows that selecting and accessing top-performing funds tracks closely with stronger co-investment performance. The goal of co-investing is not to beat mediocre funds. The goal is enhanced overall returns at the portfolio level. Our simplified portfolio illustration combined with Lerner's research provide a valuable reminder that partnering with top-tier funds is critical to better outcomes in co-investing.

**A Coda on Co-investing**

Experienced investors consistently focus on incentives yet few research papers delve into the topic. Regardless of the stated objectives, incentives meaningfully impact investment outcomes. This axiom holds true in co-investing. If an investment team is rewarded for their co-investment performance separately from their fund investing performance, overall portfolio returns may be compromised. As detailed above, successful co-investing emanates from effective fund investing, so aligning incentives across these activities is essential. At GroveStreet, we pool the performance of our fund and co-investment activities and rely on a single team to execute on these highly interrelated investment activities.

**Tying it All Together**

Lerner's research provides academic grounding for the intuitions of experienced practitioners. The formula for success is to co-invest alongside the best GPs one can find and access. Additionally, LPs tend to do better when they maintain investment discretion over co-investing activities rather than participating in GP controlled co-investment pools. While so many LPs find themselves in a fervor for co-investments, patient, discerning fund selection remains at the core of long-term success.

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