

# In Brief

## Co-Investing Challenges

September 2017

Past performance is not necessarily indicative of future results. No assurance can be given that any investment will achieve its objectives or avoid losses.

Select risks of co-investing include: macroeconomic risk, capital markets risk, credit risk, company risk, and liquidity risk. Additional risks that result in losses may be present.

## Navigating Co-Investments in the Middle Market

After a multi-year cycle of strong performance and record distribution levels, the private equity markets are awash in capital. Purchase price multiples remain elevated compared to prior years. Nevertheless, investors continue to search for illiquidity premiums, which may be unlocked by adding co-investments to their private equity portfolios. Whether new to private equity or a seasoned investor with a full in-house team, investors commonly share the same co-investment objective: the prospect of achieving lower fees and higher returns. In today's environment, many are left wondering if that objective is attainable.

In this edition of "In Brief," we address why we believe (i) co-investments remain a cost-effective way to access private equity, (ii) the middle market represents a differentiated and compelling segment, and (iii) experience matters when entrusting a manager to source, execute and monitor a co-investment program.

### Q WHAT IS SUSTAINING LP APPETITE FOR CO-INVESTMENTS IN THE FACE OF CHALLENGING MARKETS?

Sponsors often offer co-investments to existing investors on a no-fee / no-carry basis. As such, co-investments provide the potential for higher returns at a lower cost than primary fund investments. Eighty percent of investors have experienced outperformance of their co-investments compared to their private equity fund investments.<sup>2</sup> Investors are driven by these preferred economics, and the demand for co-investments is showing no sign of abating.

Investors are drawn to co-investments for a variety of other reasons, including (i) investing alongside GPs that may be difficult to access, (ii) mitigating the J-curve with potential for more rapid capital deployment, and (iii) targeting diversification by sector, strategy, geography and vintage year.

### Q WHERE CAN INVESTORS FIND ALPHA IN THE CURRENT MARKET?

We believe investors would be well-served by focusing on the middle market. The immense size and breadth of this segment allows sponsors to identify companies that tend to be less widely followed and, as such, are often subject to fewer competitive bidding situations. The chart on the next page, which compares purchase price multiples for middle market buyouts ("MMBO") versus large buyouts ("LgBO"), demonstrates the sustained discipline of MMBO pricing.

We believe sponsors in the middle market have greater opportunity to create value by improving operating performance, upgrading key management and scaling the businesses. The result of these efforts can also potentially command a higher multiple upon exit. Because of their unique market segment position, middle

## DID YOU KNOW?

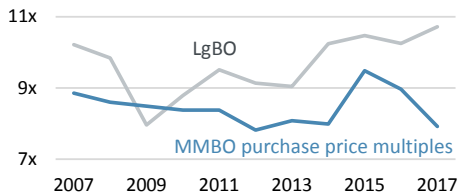
# 72%

of private equity LPs are currently co-investing or will consider doing so in the future<sup>1</sup>

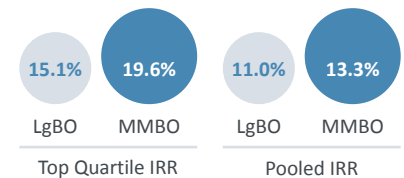
market companies offer a wide variety of exit options for sponsors. The combination of a large addressable market with lower entry multiples, a diverse set of value creation opportunities, and an increased number of exit options results in what we believe to represent a compelling and differentiated market opportunity. These factors have produced returns for MMBO funds that have consistently exceeded those of large buyout funds.

#### Middle market buyout and large buyout

**Purchase price multiples<sup>3</sup>**  
2007 - 2017



**Fund performance<sup>4</sup>**  
1997 - 2016



## Q HOW SHOULD INVESTORS THINK ABOUT CO-INVESTMENTS IN THE CONTEXT OF THEIR OVERALL PRIVATE EQUITY PORTFOLIOS?

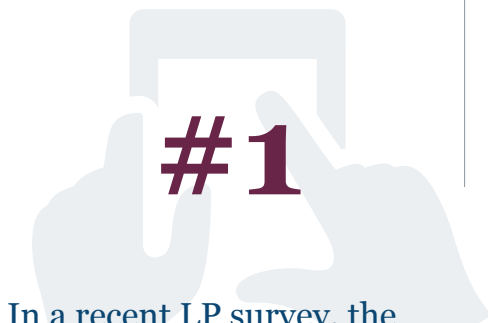
There are a variety of factors that have contributed to the widespread adoption of co-investments within investors' core private equity portfolios. In addition to the prospect of lower fees and higher returns, co-investments can bring valuable diversification benefits to a program otherwise dominated by primary funds.

Unlike blind-pool primary fund investing, co-investments allow LPs to access specific sectors or market segments that are underrepresented in the LP's core private equity program. For example, investors often find their primary fund exposure is skewed toward the larger end of the buyout market. The MMBO universe may be complementary to investors' existing exposures while exhibiting less sensitivity to movements in the broad public markets. Co-investments, in turn, enable investors to have more surgical precision in obtaining very specific exposures with sponsors that may have demonstrated expertise in a particular niche.

## Q WHY CONSIDER A DEDICATED FUND STRUCTURE TO ACCESS CO-INVESTMENTS?

Sponsors sharing co-investment opportunities with potential co-investors seek reliable sources of capital, experienced investors and the ability to execute quickly. While investors may be drawn to the opportunities available through co-investments, they often find they lack the internal processes and breadth of resources necessary to build and operate a successful program. The sourcing, due diligence and monitoring process for co-investments is materially different from that of primary fund investments in which a substantial portion of the focus is on the fund sponsor rather than the underlying companies. Because of this, accessing co-investments through a dedicated fund structure managed by a third party often represents the most practical and cost-effective approach.

Risk, as well as return potential, may be higher in co-investment strategies given the smaller number of investments and concentration of capital. One of the primary advantages of a dedicated fund structure is its single point of entry to co-investment opportunities. A dedicated fund structure can significantly reduce or eliminate much of the operational complexity commonly associated with implementing and monitoring a diversified co-investment program.



In a recent LP survey, the number one reason cited for choosing not to co-invest was lack of resources<sup>5</sup>

## **Q WHAT ARE THE KEY ATTRIBUTES INVESTORS SHOULD SEEK IN IDENTIFYING A TRUSTED CO-INVESTMENT MANAGER?**

Investors who choose to utilize a dedicated fund structure for their co-investment program should focus on identifying and selecting a trusted partner. For many, this represents the single most important decision they can make to maximize the probability of a successful program.

We believe strong sourcing capabilities and an extensive network of sponsor relationships are key to ensuring high-quality and robust co-investment deal flow, particularly in the middle market. Given the wide dispersion of returns that exists across co-investments, access to top-performing sponsors is critical. Developing such a network requires a deep, experienced investment team with significant amounts of capital committed across a wide variety of sponsors' primary funds.

In addition, successful co-investing requires an ability to execute a rigorous investment and operational due diligence process in a timely and efficient manner. Given the compressed timeframe typical of co-investments, managers must have the necessary expertise and resources to provide sponsors with a quick indication of interest. A successful co-investment manager should have a large, focused team that can underwrite multiple deals simultaneously and invest across the capital structure. The complexities of co-investments also require structuring experience to minimize investor-specific tax burdens, which can result in unexpected performance leakage.

Finally, in addition to a robust sourcing and investment due diligence program, operational due diligence represents a critical step in the process and should be conducted by an independent team to mitigate risk of conflicts. Those performing operational due diligence should have extensive accounting or legal backgrounds and typically evaluate the legal structure of the target vehicle as well as the sponsor's internal control environment.

### **SUMMING UP**

We believe that MMBO co-investments will continue to represent a compelling opportunity with differentiated deal flow and pricing discipline compared to the larger end of the market. When a comprehensive diligence process is applied to a robust, selective pipeline of investments, we believe the potential for investors to achieve superior risk-adjusted returns can be real. But co-investing is not easy—the process demands time, energy, expertise and resources. Given the investment and operational complexities required to build, monitor and maintain a successful co-investment program, investors are well-served by partnering with a trusted manager to help navigate toward their goals. ■

## ABOUT GCM GROSVENOR

With approximately \$50 billion in assets under management, GCM Grosvenor is one of the world's largest and most diversified independent alternative asset management firms.

GCM Grosvenor has offered alternative investment solutions since 1971. The firm is headquartered in Chicago, with offices in New York, Los Angeles, London, Tokyo, Hong Kong and Seoul. GCM Grosvenor serves a global client base of institutional and high net worth investors.

Data sources:

- 1 Preqin Special Report: Private Equity Co-Investment Outlook, November 2015, p. 9.
- 2 Ibid. p. 11.
- 3 S&P Leveraged Buyout Review, 2Q 2017. U.S. leveraged buyout transactions – MMBO: TEV \$250mm-\$499mm; LgBO: TEV ≥ \$500mm.
- 4 Ibid. U.S. leveraged buyout transactions – MMBO: <\$50mm of EBITDA; Large BO: ≥\$50mm of EBITDA. Pooled returns represent the net return calculated on the aggregate of all cash flows and market values as reported by individual fund managers in their quarterly and annual audited financial reports. These returns are net of management fees, expenses and performance fees that take the form of carried interest.
- 5 Preqin Special Report: Private Equity Co-Investment Outlook, November 2015, p. 10.

**Investments in alternatives are speculative and involve substantial risk, including strategy risks, manager risks, market risks, and structural/operational risks, and may result in the possible loss of your entire investment. Past performance is not necessarily indicative of future results.** The views expressed are for informational purposes only and are not intended to serve as a forecast, a guarantee of future results, investment recommendations or an offer to buy or sell securities by GCM Grosvenor. All expressions of opinion are subject to change without notice in reaction to shifting market, economic, or political conditions. The investment strategies mentioned are not personalized to your financial circumstances or investment objectives, and differences in account size, the timing of transactions and market conditions prevailing at the time of investment may lead to different results. Certain information included herein may have been provided by parties not affiliated with GCM Grosvenor. GCM Grosvenor has not independently verified such information and makes no representation or warranty as to its accuracy or completeness.

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