GCM Grosvenor

PRIVATE EQUITY

In Brief

Private Equity Co-Investing

August 2019

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, sourcing risk, investment selection, portfolio diversification, management risk, execution of value creation plan, risks related to reliance on third parties, and risks related to the sale of investments.*

GCM GROSVENOR HAS COMMITTED

$3.4 BN

of capital across approximately 150 buyout co-investments in the last 15 years.[2]

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Unlocking Alpha in a Maturing Private Equity Co-Investment Market

The private equity co-investment marketplace is growing and maturing, following trends in private equity overall, with more participants from both the capital supply (limited partner) and demand (sponsor) sides. Given the increasing size and evolution of this market, limited partners (LPs) have more ways to participate directly in transactions. With the right sourcing capabilities, LPs now have a wider range of choices for specific transactions and more access to sponsors to partner with on these deals.

We believe the maturing private equity co-investment marketplace is a good thing, on balance. Here, we offer our perspective on the changing opportunity set and investigate the benefits the maturing market offers us as co-investors. In an environment with more choice, selectivity arguably plays more of a role than in a market at a more nascent stage. And as we will discuss, *manager* research and selectivity is just as critical a part of this process as *deal* diligence.

GROWTH OF THE CO-INVESTMENT LANDSCAPE

The private equity co-investment landscape, much like the overall private equity ecosystem, is indisputably growing. In earlier days, co-investing was a one-off decision to bridge sponsor capital limits in specific circumstances. Now, sponsors have come to embrace co-investment capital as another financing source that they can tap when necessary. The arrangement is beneficial to all participants – to the private equity sponsors looking to secure additional equity financing for deals while furthering their relationship with LPs, and to the co-investors who benefit from strong investment opportunities at favorable economics.

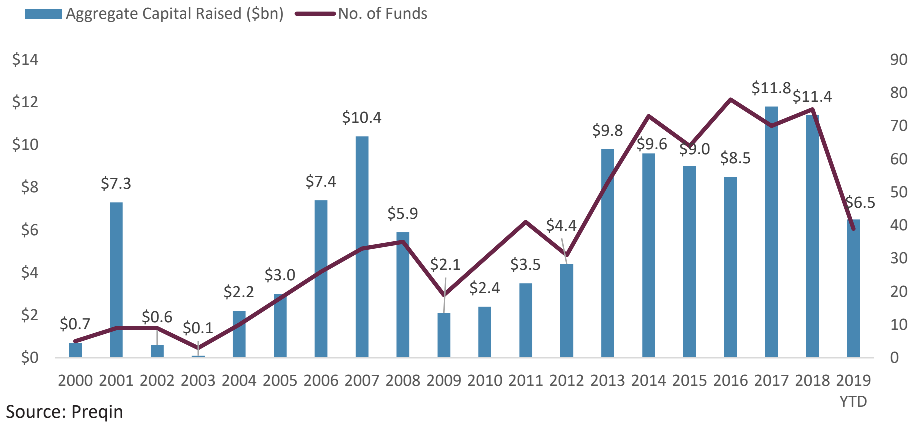
Indeed, assets in completed co-investment deals have grown steadily. At the end of 2017, capital invested in co-investments was estimated at $60 billion and comprised about 20% of the private equity market, according to Cambridge Associates.[1] At GCM Grosvenor, we have committed $3.4 billion of capital across approximately 150 buyout co-investments in the last 15 years.[2]

Fundraising volumes in recent years also demonstrate the growth of private equity co-investing, as the chart below shows. Along the way, the marketplace is also segmenting. Today there are niche co-investment pools for deal size, industry and growth stage.

1 “Ready, Steady, Co-Invest,” Cambridge Associates, 2019.

2 As of March 31, 2019.

Co-Investment & Co-Investment Multi-Manager Historical Fundraising



Source: Preqin
2019 data as of July 25.

Co-investing allows LPs to commit more capital alongside preferred sponsors and create targeted direct deal exposures for their portfolios.

The supply of capital is clearly one key driver of the increased activity. Institutional investors, on the whole, are aiming to allocate more to private equity as an asset class. Co-investing allows LPs to commit more capital alongside preferred sponsors and create targeted direct deal exposures for their portfolios. Additionally, the more appealing fee structure of co-investments, which often have no management fee or carried interest, is fueling demand from institutional investors.

THREE BENEFITS OF A MATURING PRIVATE EQUITY CO-INVESTMENT MARKET

By using co-investment in deals, sponsors benefit from the ability to retain control of a transaction, both pre- and post-closing. The wave of club deals in the years leading up to the 2009 financial crisis illustrated some of the difficulties that sponsors encountered when investing together in the same asset. Co-investors also benefit from a maturing co-investment market in a number of ways, including the following:

1. Strong deal flow enables selectivity. A smaller marketplace for deals may offer a higher illiquidity premium, but a deeper market enables selectivity. Capital allocators invariably face pressure to put money to work. A more robust opportunity set allows co-investors to be more selective. This is a point that institutions may not see explicitly but that we, in the day-to-day process of sourcing and choosing opportunities, vastly prefer.

2. More tools to mitigate adverse selection. We enjoy the benefit of accruing sponsor track records from our robust primary fund practice to guide our analysis of co-investments. As we see a sponsor's lengthening history, we can see what kinds of deals are typical or characteristic of their style and how they've performed. In this respect, it's easier to recognize deals that are out of place in some way – outside of an industry niche or with a different value-creation thesis than the sponsor has previously executed – which could signal adverse selection. In 2018, as an example, we evaluated deals from over 200 unique sponsors, relying on historical data points as critical inputs in our selection process.

3. Wider acceptance and more established process. Sponsors have come to accept and embrace the utility of tapping LPs for co-investment capital, enabling them to pursue larger transactions than their current funds allow. The relationship between LPs and sponsors has also improved the ease of co-investment execution. LPs have come to benefit from a more established set of customary minority protections (e.g., information rights, preemptive rights, tag-along and piggyback rights, etc.) to ensure appropriate alignment with sponsors. Understanding each other's respective process and timeline needs have allowed the co-investment market to continue growing.

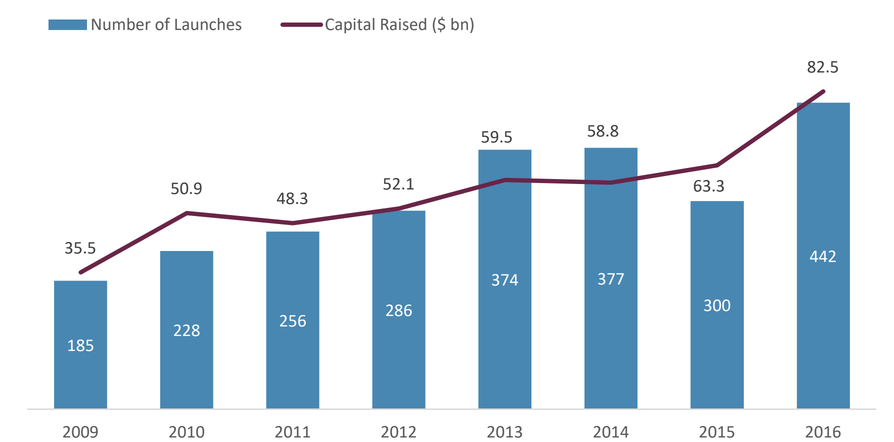
THE IMPORTANCE OF PARTNERING WITH THE RIGHT SPONSORS

We believe co-investing with the right sponsors offers the same alpha potential as picking the right funds, from the LP's perspective. For the past 20 years of private equity investing, upper-quartile managers have outperformed median managers by 820 basis points, according to Burgiss, thus illustrating the critical role manager selection can play in co-investing as well.

As the private equity co-investment market matures, it also offers more continuity. Today, our existing relationships with traditional sponsors (i.e., private equity managers who have a primary fund in which we are an LP) are the biggest source of co-investment opportunities and completed deals. In these relationships, we have the benefit of prior due diligence and a track record to the relationship, which allow us to keep our assessment of the sponsor – of their judgment, management style, and success – up-to-date and accurate. The sponsor also benefits from this continuity, as they can trust that co-investment partners have an established and transparent process for deal decisions, driving shared expectations.

But to source as broad a funnel of deals as possible and try to capture the most alpha, we have to be open to executing co-investments not just with traditional sponsors, but with emerging managers and fundless sponsors as well. As the chart below illustrates, emerging managers are a growing share of the private equity market over the last decade.

Private Equity Emerging Manager Fund Launches



Source: Preqin
Data as of June 30, 2018. Excludes vintage years post-2016.

"In an environment with more choice, selectivity arguably plays more of a role than in a market at a more nascent stage."

Co-investing depends on trust, by design; co-investors have less control over portfolio companies than a traditional private equity investor would have. They tend to be minority investors, for instance, and they're often the "taker" of deal terms. Manager research is therefore imperative. In our view, investors must be able to accurately assess the skill of their partners based on prior track records, deal experience, or whatever else they know of the manager's judgment and access to promising opportunities.

HOW MANAGER RESEARCH AND DEAL DILIGENCE ARE INTERTWINED

Manager research and deal diligence are related endeavors, but the nature of the interaction depends on the manager type:

- **Traditional sponsors:** These relationships have the most straightforward process for manager research. Our assessments of sponsors help us prioritize deal opportunities, since we have to be thoughtful about how we allocate our own attention and resources to seek to optimize returns.

- **Emerging managers:** Without an established fund track record, we rely more heavily on the prior experience of the individual partners at younger firms. In some cases, we may monitor a an emerging manager over a number of years before the right opportunity arises to join them as co-investors in a deal, giving us more time to gain confidence in the firm.

- **Fundless sponsors:** Deals presented by fundless sponsors tend to be smaller, but may offer compelling upside. The investment structure may also allow for more operational control in the portfolio company than in a typical private equity co-investment with a traditional sponsor. We have to carefully evaluate the fundless sponsor's personal financial stability and investment experience alongside the deal structure to ensure appropriate alignment and additional protections.

POSITIONED FOR CONTINUED SUCCESS

The maturing private equity co-investment market alters the dynamics of deals in some ways, but overall, these changes represent improvements for both sponsors and LPs. There are more ways for sponsors to utilize co-investors to get deals done, and more opportunities for LPs to participate in single-deal transactions to complement their primary fund investment strategies.

To operate successfully amid growing competition, we believe co-investors must have broad access to deals, and selection is a matter of both manager quality and individual deal potential. Diligence on both fronts is imperative. This philosophy positions private equity co-investors for continued success even in a more competitive environment.

ABOUT GCM GROSVENOR

GCM Grosvenor is a global alternative asset management firm with over $55 billion in assets under management in hedge fund strategies, private equity, infrastructure, real estate and multi-asset class solutions. It is one of the largest, most diversified independent alternative asset management firms worldwide.

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, serving a global client base of institutional and high net worth investors.

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