How Co-Investments Round Out PE's Virtuous Cycle

Brendon Parry, January 2018

TIFF has a long history of making "opportunistic" private investments. The label can easily be misunderstood. To some, "opportunistic" may sound short term and risky or imply some sort of exception to an otherwise well-founded, long-term strategy. Sometimes the difference between a single, off-the-beaten-path investment and a less traditional but long-term strategic investment approach may seem blurry, especially to our members, who aren't with us analyzing investments every day. We at TIFF even employ a fund category labeled "opportunistic" for many of our direct co-investments and investments in fund interests acquired on the secondary market. The category is more of a convenience than a statement about ranking assets or strategies. The fact is, thinking of secondaries and co-investments as somehow outside the bounds of a core private investment approach devalues the importance of this form of investing to our PE program.

TIFF began buying secondaries in 2003, and members have since seen how these instruments can be used in different market environments, either to bring greater value to existing TIFF funds when we see buying opportunities or to speed the wrap-up of TIFF funds when we believe selling underlying interests makes sense. We have written extensively about our secondaries approach. In this commentary, we examine co-investing, a strategy that is newer to TIFF and that some might consider – wrongly, we'd argue – as merely "opportunistic" and, thus, outside the realm of a core PE program.

We devoted many years of thought and discussion to co-investments before entering the arena in 2011. A typical co-investment is a minority investment made directly into an operating company alongside a private equity firm, usually with no or dramatically reduced fees and carry. In the years since our first foray into co-investing, the effort has become part of the core competency of our team as well as a rising share of our capital deployed and time allocation. It is far from a tactical dalliance in direct investing and stands as a complementary long-term piece of our strategy.

We employ two broad co-investment strategies – fee-lowering and targeted. In fee-lowering, we invest in all or a significant number of a fund's co-investment deals while at the same time committing capital to the same fund's traditional PE approach. This is done to lower our effective fees when we're able to negotiate special rights with a general partner (GP) and view this as a part of the primary fund commitment. Fee-lowering co-investments help boost the effective net returns of a primary investment, increasing our odds of achieving TIFF's goal for PE: returns of public equities plus 500 basis points.[1] The subject of most of this treatise is targeted co-investments. These are rifle-shot investments in single deals, which we view as stand-alone investments. In addition to often offering reduced fees, targeted co-investments offer an opportunity for outsized returns and may shorten the hold periods of members' PE portfolios.

When properly executed and sized in a PE program, a co-investment strategy can play a powerful return-enhancing role in many ways. It is important at the outset to understand the impact on a portfolio when fees and carry are reduced substantially or even eliminated in a co-investment. Imagine a PE portfolio invested in equal measures over a five-year investment period in deals that each generate a 2.5x multiple. With a five-year hold and a typical "2 and 20" fee structure (2% management fee and 20% carry), the portfolio would yield a 2.0x net multiple and 15% net internal rate of return (IRR). If no fees or carry are charged, the same portfolio would return a 2.5x multiple and 20% IRR. While low or zero fees are clearly no guarantee of success, better economic terms certainly tilt the odds of producing strong returns in investors' favor.

Beyond the fees advantage, co-investments tend to have a shorter effective hold period, with no unfunded liability. When we commit to a standard underlying PE fund with a five-year investment period, we are typically taking on a significant unfunded liability on day one. This slowly trends toward zero by year five as capital is invested into portfolio companies. For example, if a fund's GP invests in Le TIFF BBQ Café in year five of the fund's investment period, we pay five years of fees on committed capital leading up to that investment. We also incurred an obligation to fund the deal and had that obligation open for five years. Now, we're expecting to hold the investment for another five years. A co-investment in the same BBQ Café would result in no unfunded liability, we would likely pay no fees, and the expected hold period would remain about five years.

This is in no way an argument against taking on the illiquidity of a typical PE fund. We still believe in the PE fund model and its ability, via superior managers, to generate a significant premium over public equities. Instead, we are highlighting the structural advantage of a portfolio of co-investments that can help leaven a set of standard underlying PE funds. In essence, co-investments operate as synthetic direct PE funds with no or low fees and carry.

Finally, co-investing allows us to directly access deals that, when deemed attractive, can be overweighted to produce outsized returns for the portfolio. We're well aware of the history of adverse selection in PE co-investments, where some GPs might use co-investing with limited partners (LPs) to pursue large deals outside of their strategies or to sell down stakes in companies considered unworthy of overweighting in their own funds. In our view, GP-LP dynamics have changed since the global financial crisis. While we're still wary of adverse selection, we believe GPs are more frequently offering co-investments to key LPs as a tool to develop closer relationships and increase the odds that LPs will invest in future funds. For some emerging managers whose early funds were constrained by limited capital, the GP may tap co-investments more regularly, sometimes on every deal. High-quality "pre-fund" managers (PE firms that acquire companies deal by deal rather than through a traditional fund structure) raise capital from LPs on every single investment. These managers are highly motivated to invest only in deals with attractive return profiles, as they invest a significant amount of personal capital and aspire to raise their own first fund at some point. They can't afford to damage their reputations, or their finances, by investing in lemons. TIFF is able to sift through deals brought to us by existing managers – typically ones we know and trust – and select the investments that we believe offer the most attractive return profiles.

One overriding goal drives our co-investments effort: to find deals with the best liquidity-adjusted risk/return profiles on behalf of our members. At the same time, we have found that this co-investment effort makes us smarter investors by serving as a powerful complement to the investment process we undertake when evaluating primary funds and secondaries. In turn, the investment process for primary funds and secondaries benefits our co-investing.

In the direct private equity world, a massive amount of time and effort is sunk into finding, evaluating, winning, and closing deals. Proprietary deals are extremely hard to find but have a higher chance of closing, while intermediated deals are easier to find but harder to win at reasonable prices. Great effort can be expended on investments that turn out not to be actionable. In some cases, this can cause GPs to begin relying primarily on auctions and stretching on valuations to put capital to work. As a co-investor, TIFF sees highly catered deal flow. Deals are vetted by GPs on whom we've performed extensive fund-level underwriting and have a higher probability of closing, as the GP typically has the deal under exclusivity when the team brings it to us. Our primary fund due diligence is helping TIFF create what we view as an exceptionally high-quality deal funnel.

The deal evaluation stage is where co-investing benefits our primary fund due diligence. Once one of our GPs brings us a deal, we perform a significant amount of research on the market and the company. As important, we also evaluate the GP's own due diligence process, investment thesis, and risk assessment. The extensive work that goes into a single co-investment has directly benefited both our deal selection and our manager selection. During our own evaluation, we learn a great deal about the quality of the GP teams as well as their sourcing and due diligence processes. Instead of hearing a polished story from a manager about an investment after it's been completed, we're looking at the deal alongside the manager and (we hope) seeing the good, bad, and ugly. Luck is always a factor in investing; whether the deal ultimately goes well or poorly, we can better assess whether the GP's process was sound, not just whether the outcome was positive.

TIFF's work on co-investments with pre-fund sponsors has the explicit goals not only of improving the quality of our co-investment program but also enhancing the consistency of our returns from managers raising their first fund ("Fund I"). TIFF has a long history of backing GPs in their first institutional funds, but we're always thinking about ways to reduce the dispersion of outcomes. Increasingly, we've seen Fund I managers that consummated several deals prior to raising a fund. We spend significant time researching these earlier investments when evaluating a team and examining its track record. We have asked ourselves: wouldn't it be more effective if we looked at some of those deals live, with the sponsor, rather than discussing them after the fact? Isn't it less risky to perform due diligence on a firm and drip-feed small amounts of capital deal by deal while building a closer relationship rather than making a single large commitment to a blind pool, i.e. a Fund I yet to invest in a single portfolio company? Our work in pre-fund investments is relatively new, but thus far it has been an interesting source of deal flow for co-investments and future primary fund investments. The complementary nature of the work should pay dividends across our strategies.

Of course, co-investing doesn't come without risks. Co-investments increase concentration, potentially leading to greater volatility. Adverse selection, as discussed, is still a real risk, especially with larger, more mature managers. If GPs become nervous about raising a new fund and then manufacture co-investments to curry favor with LPs, the process only distorts incentives and alignment. The work flow on co-investments can be intense, unpredictable, deadline-oriented labor that doesn't lend itself to leisurely deliberation. Co-investment deal flow, like that of secondaries, is hard to predict.

Co-investing isn't easy. It takes the right team, a smart implementation strategy, and sound structure. Even with those pillars in place, the odds of success have only been improved, not guaranteed. We view our co-investment program as a key piece of our PE portfolio, not an "opportunistic" side project. And so far, we are encouraged. While TIFF's targeted co-investment program is largely unrealized, we believe it is off to a strong start, generating a 29% IRR across 16 investments as of June 30, 2017. [2] Performance of co-investments and fund investments should have a high correlation – the co-investments are the underlying deals in a fund investment. When we incorporate secondaries, which are composed of the same assets as a fund investment but can be acquired at significant discounts to intrinsic value, we have a complete arsenal of PE strategies that can perform well across cycles. We believe that being active in all three strategies – primaries, co-investments, and secondaries – creates a virtuous cycle that continually improves TIFF's PE program. While primary fund investments will continue to be the central pillar of the program, secondaries and co-investments are important pieces of TIFF's long-term private equity strategy.

Footnote: [1] There can be no assurance that this goal will be achieved or that substantial losses will be avoided.

[2] Performance data represent past performance; past performance does not guarantee future results.

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