FOOL’S GOLD?
Over half of limited partners now seek co-investment opportunities from private equity fund managers – both to boost returns and to customise their portfolios. This occurs despite a widely cited paper by Fang, Ivashina and Lerner (featured in issue nine of Private Equity Findings) suggesting that co-investment returns lag behind those of direct investments and fund commitments. However, a new research paper from Braun, Jenkinson and Schemmerl has now directly challenged these earlier findings, suggesting that co-investments in fact outperform fund commitments net of fees. We spoke to two of the authors and three practitioners to lift the lid on co-investment performance. Chaired by Brendan Scott.

The rationale for many LPs pursuing co-investments is that they can ‘average down’ the cost of deals, thereby improving returns. Tim, your findings support this hypothesis. Is that what you expected?

**Tim Jenkinson:** “My prediction was that we wouldn’t find any difference between co-investments and fund performance. Two arguments are often made in this debate. One is, if you’ve got a great deal, you don’t offer it for co-investment, because why give up the economics – the carried interest – on a great deal? If you’re a general partner, why not keep it for yourself? On the other hand, the reputational impact of laying off all your worst deals on your investors is potentially pretty bad for a GP, and investor relations are very important.

“So, we went into it with an open mind, but wanted to rigorously test whether there really was any adverse selection. What we found was a stunning sort of non-result, in the sense that the performance and distribution of gross returns are pretty similar across co-investments and the other investments within a fund.”

**Corentin, what do you make of the adverse selection argument that some have put forward?**

**Corentin du Roy:** “Conceptually, it defies logic for a GP to offer their LPs inferior or less attractive opportunities. First of all, it doesn’t make sense for the GPs to have deals in their fund that are less attractive, but it would be even worse to double up the exposure of what are generally their largest LPs by putting them directly into one of these deals.

“If you’re offering co-investment to attract LPs into your next fund, you’re not going to put them into deals where you think the risk-return profile is poor.

“What I’ve observed over the past 14 years – though I think this situation has eased over time – is some GPs’ fear of showing LPs a deal that, although they think it’s great, doesn’t work out and will stop investors from investing with them in the future.

“Is it ever the case that a GP shows you a deal simply because they want to generate co-investment deal flow for LPs? That may happen, but it’s very rare and these are likely to be GPs that are struggling with their performance and need to create co-investments as an inducement for fundraising. This is a situation we can recognise and avoid very easily.”

**Josh, your earlier paper suggests that, if there is indeed an element of adverse selection at play, it’s the result of LPs participating in larger deals near the top of market cycles, rather than GPs knowingly sharing weaker deals for commercial reasons. Can you explain more?**

**Josh Lerner:** “That’s right. When you look at the data we have, the co-investments are disproportionately concentrated in larger deals around market peaks. When you look at the co-investments made by funds, they tend to be the largest transactions that those GPs do. In general, PE and venture capital are intensely cyclical businesses. An investor performs a lot better investing in troughs than investing at market peaks. And the basic pattern is that the largest deals being done at market peaks are in general less attractive than those done in troughs. So if you have an uptick in size and clustering around peaks, that’s not a recipe for great returns.”
“I think it’s fair to say that governance issues loom large, given the pattern of LPs jumping into co-investments at exactly the wrong time, which leaves one to wonder whether investment committees are trend-chasing.”

I suppose the question then becomes whether the clustering of large co-investments around market peaks is a function of that specific data sample or a broader trend? So should size drift be a concern when considering which co-investments to make or refuse?

Tim Jenkinson: “I worked on a separate paper in which we make the distinction between style drift and size drift. Our research certainly shows that the larger deals tend to be offered for co-investment. As a result, some investors are concerned that GPs may be overreaching. But actually, the performance of larger deals in our sample is pretty good. Some other papers have found that, on average, the larger deals in a fund tend to do worse, but we don’t find that.”

Francesco di Valmarana: “I’d say it depends on the extent of size drift. If you look at a deal that is two or three times the size of a manager’s standard deal, that doesn’t generally take them outside their capability set. When you get into significant multiples, and the number that I’ve heard is four to five times, then you’re looking at a fundamentally different type of transaction, with different structuring, different economics around the debt, different value-adding levers, and so on.

“There’s a sweet spot across our GPs who manage the €500m to €1bn funds and are doing deals in the €50m to €100m region, maybe a little more. In that bracket you can easily see how an opportunity can come along that is twice as big as the GP would typically do but, because it doesn’t change their strategy, they want to seize it.”

Johanna Barr: “I agree that the larger a deal, the more likely it will generate an element of co-investment. So LPs need to think about whether the size of the deal is ultimately something the GP can handle and how it complements their skills and experience in, for example, a specific sector.

“When it comes to size, we try to do what’s best for the deal. Often, given the size and potential complexity of a deal, the best solution is teaming up with another GP who can bring in another large deal team. Yet sometimes there is a strategic reason to include an LP because they can add real value – that might be because we’re investing in a region where we don’t have an office, or it might be additive to have a local pension fund involved to navigate the domestic regulatory landscape. This was the case with Nets, a deal we did in the Danish payments space with Bain Capital. The two of us invited the local pension fund ATP to become a small shareholder in the consortium.”

Johanna Barr
Johanna co-heads Advent International’s limited partner services group, and is primarily focused on fundraising and investor relations activities in Europe and Asia. Previously, Johanna worked in the M&A and corporate broking departments of Deutsche Bank.

Francesco di Valmarana
Francesco is a partner in Pantheon’s European investment team. He was previously with Unigestion, and prior to that co-founded the venture capital firm DN Capital.

Corentin du Roy
Corentin is a managing director of HarbourVest. He focuses on co-investments in buyout, growth equity, and mezzanine transactions around the world. He joined the firm from AXA Investment Managers, where he was an equity and high-yield debt research analyst.
We have similar examples of involving local pension funds in deals in Latin America as well.”

If co-investments largely offer the same gross returns, and the only gain is saving on fees and carry, is that enough to compensate for the increased concentration risk?

Tim Jenkinson: “There’s a lot of idiosyncratic risk on a deal-by-deal basis – you expose yourself to a much greater distribution of outcomes. Broadly speaking, most buyout funds double their money, and yet not all deals double their money by any means – and some return five times their money.

Obviously, co-investment doesn’t give you the same benefits of portfolio diversification that fund investing does, so if you’re going to do it, you have to do it systemically, not the odd co-investment here or there. If you have 10, 20, 30 deals and the economics are good, it is like being invested in a PE fund with no fees. It’s PE for free – although there are some nuances. For example, portfolio company fees don’t get refunded if there are no management fees to refund them against. But it’s much lower cost.

“In an undiversified portfolio, what you tend to find is that the mean and median returns differ quite a lot. But if you do enough co-investments, the returns are worth it in terms of the incremental public market equivalent (PME) return you get as the result of the zero fee, zero carry structures. If you didn’t diversify, if you only did one or two, it wouldn’t be worth it because you’d be exposing yourself to all of that risk for not a huge gain.”

Corentin du Roy: “We’ve conducted a lot of quantitative work on this using our own samples and we’ve found that a portfolio of around 30-40 companies gets you to the point where the risk of capital loss becomes quasi nil – negligible. But the very interesting finding was that you could add more companies; as long as you’re not degrading your selection criteria and have enough quality co-investments to choose from, you don’t detract from your expected return and you’re still improving your diversification. So, clearly, the conclusion was you can have pretty large co-investment portfolios – it’s good from a risk standpoint and it doesn’t lower your returns.”

Francesco di Valmarana: “We build co-investment portfolios of 40 to 50 deals, so there’s no concentration risk at all. In that scenario, the economic benefit of not paying the two-and-20 clearly comes through. If you’ve got fewer than 10 deals, where one deal losing money can have an impact, that is not optimal.

“Interestingly, when we analysed our own data, we found there was more downside risk on the non-co-investments. Very few deals that had been offered to us for co-investment, whether we did them or

Tim Jenkinson
Tim is professor of finance at Said Business School, University of Oxford, as well as director of the Private Equity Institute, Oxford, and one of the founders of the Private Equity Research Consortium.

Josh Lerner
Josh Lerner is the Jacob H. Schiff professor of investment banking at Harvard Business School and author of many research papers on VC, innovation, PE and entrepreneurship. He founded and runs the non-profit Private Capital Research Institute.
not, lost money. Obviously, GPs don’t want to do any deal that’s a lemon and you never know coming into a deal whether it’s going to be a great one. Even at the start of a transaction, GPs certainly know whether it is at the riskier end of the scale, and most good managers will not ask their LPs to invest in those deals.”

**Johanna, do you have a view on that from the other side of the LP-GP fence?**

**Johanna Barr:** “In general, LPs prefer a lower risk profile on deals. Many of them have only just started their co-investment programme, so the worst outcome for them is having a zero in year one of their own track record. I can’t comment on whether GPs across the board are offering less risky deals for co-investment, but our view is that LPs are typically pretty risk averse.

“We did a deal on US payments firm Vantiv in early 2009, not long after the collapse of Lehman Brothers. We bought the payment processor from a bank that was supported by the Troubled Asset Relief Program. It provided vendor financing and was a 49% shareholder in the new deal. When we tabled that for co-investment, many LPs passed on it even though it was fee- and carry-free – they saw it as being towards the higher end of their risk spectrum. Not all, but certainly most, investors tend to prefer the fairway deals in sectors they know and where there is less operational complexity, and which they therefore perceive as lower risk.”

**Josh, going back to the research, do you think the underperformance observed in the earlier paper you co-authored is the result of a comparatively limited data sample? Whose results do you believe?**

**Josh Lerner:** “Neither of these studies is perfect. We sourced data from seven large institutions on all the co-investments they had made. So the concern you can raise is whether these seven institutions are representative of the whole. As hard as we try to control for sample selection, you can tell any number of stories why it might be biased some way or another.

“The other study uses data from Capital IQ and that’s drawn from a variety of sources, one of which is the asset owners themselves, who are likely to publicise successful co-investments that they have participated in. One would not be surprised if there was some degree of bias in terms of which of their co-investments they might choose to highlight. The very largest co-investments get on the radar screens of investment bankers and are likely to find a way into the database, regardless of whether the asset owner chooses to highlight them or not. But for many of the smaller ones, one might fear that there is some degree of selection at work in terms of what gets reported into the database and what remains undisclosed.”

**Imperfections aside, what should LPs draw from the research results?**

**Tim Jenkinson:** “Well if you believe our results, even though some investments are riskier than others, you could take the view that you should simply do every co-investment that you’re offered and completely eschew due diligence because, on average, they’re good deals. If, on average, you achieve a perfectly normal distribution of deals, why wouldn’t you do them all?

“Funnily enough, a very large investor came to me after I made that observation when presenting this paper and said that’s exactly what they do. They said it’s the GP’s job to come up with deals and that they don’t second-guess the GP. They are invested in the fund and don’t make judgements about whether one deal will do better than another.”

**Corentin du Roy:** “I’m not sure I agree with that. If we just went with every co-investment offered to us by a good GP, we’re not adding value. There are two reasons why I think selection makes sense. The first is – obviously – portfolio construction, which should be balanced and diversified; if there is a bias in the market at some point for, say, growth buyouts in the software and healthcare space, you don’t want to end up with a portfolio that is 70% exposed to those deals.

“Secondly, we are quite convinced that, having been in the co-investment business for a very long time, we can filter the more interesting situations from those that may be a little bit less attractive. We track the performance of the deals we select versus those that we decline, and we consistently see a positive differential. So our selection adds alpha to the portfolio.”

**Johanna Barr:** “I look at it in a slightly different way. If you just run the simple maths, I don’t see why doing every deal
your core managers show to you for co-investment wouldn’t outperform, just given the fee and carry savings. Actually, the question I would have is: what costs are LPs building up in putting together their own teams with more direct investment experience to make decisions around potential co-investment opportunities? That seems to be factored into the research pieces, but it’s something that shouldn’t be underestimated. It would be interesting to know how cost-effective building these programmes is in the long term. If those costs go out of hand, that could bring down the outperformance of co-investments.”

And finally, both papers do show evidence of co-investments clustering at market peaks, although the Braun, Jenkinson and Schemmerl study finds this to a lesser extent. Both papers also show underperformance in these deals. This raises a legitimate concern that LPs may be dialling up co-investments at precisely the wrong time. Do you think this merits further investigation?

Josh Lerner: “I am working on something now with Antoinette Schoar of MIT, and State Street, which is a large custodian for PE asset owners. This study will have the advantage of a very large sample, and because there isn’t an opt-in here, the kind of biases that one might associate with earlier studies should be fewer. Our hope is that this third study will be able to address some of the concerns that both of these first two studies pose. We could then say more definitively how well co-investments perform and also answer whether this clustering exists more broadly across the market.”

### THE RESEARCH

**Adverse Selection and the Performance of Private Equity Co-Investments** (by Reiner Braun of the Technical University of Munich; Tim Jenkinson of Said Business School, University of Oxford; and Christoph Schemmerl, also of the Technical University of Munich) re-examined the performance of co-investments compared with other investments in the relevant sponsors’ funds.

The research draws on a broad sample from a commercial database of 1,016 co-investments by 458 LPs. In contrast with earlier findings (see below), the paper found no evidence of co-investment underperformance resulting from adverse selection.

Rather, the gross-return distributions of co-investments and the deals that remain entirely within a fund are similar – there is no significant evidence of selection bias, either positive or negative. Indeed, the similarity of gross returns, across the whole sample, results in higher average net returns to investors in co-investments, once their lower fees and carried interest are accounted for. This outperformance is observed for ‘reasonably sized’ portfolios, which are defined as 10 or more buyout deal co-investments. Further, the higher cost to investors of running a co-investment programme does not reverse this result.

**The Disintermediation of Financial Markets: Direct Investing in Private Equity** (by Lily Fang of INSEAD and Victoria Ivashina and Josh Lerner of Harvard University) is understood to be the first paper to analyse the relative performance of fund-only investments and co-investments.

The academics compiled a dataset of 392 investments obtained by seven major institutional investors, 288 of which were co-investments. These 288 deals underperformed both direct investments and various benchmarks, undershooting the fund investments made by the same GP by an average of 9% per annum.

The research found that the adverse selection associated with such deals (also known as the “lemons problem”) resulted from investors being offered assets that were on average five times larger than was typical for a given private equity sponsor’s fund. This was compounded by the fact that these co-investments tended to be concentrated around market peaks – periods at which it is generally accepted that assets tend to have high prices and high leverage.