# Alternative Private Equity Strategies: Co-Investing and Secondary Investing

Winter/Spring 2020 Independent Study by Daniel Tanaka

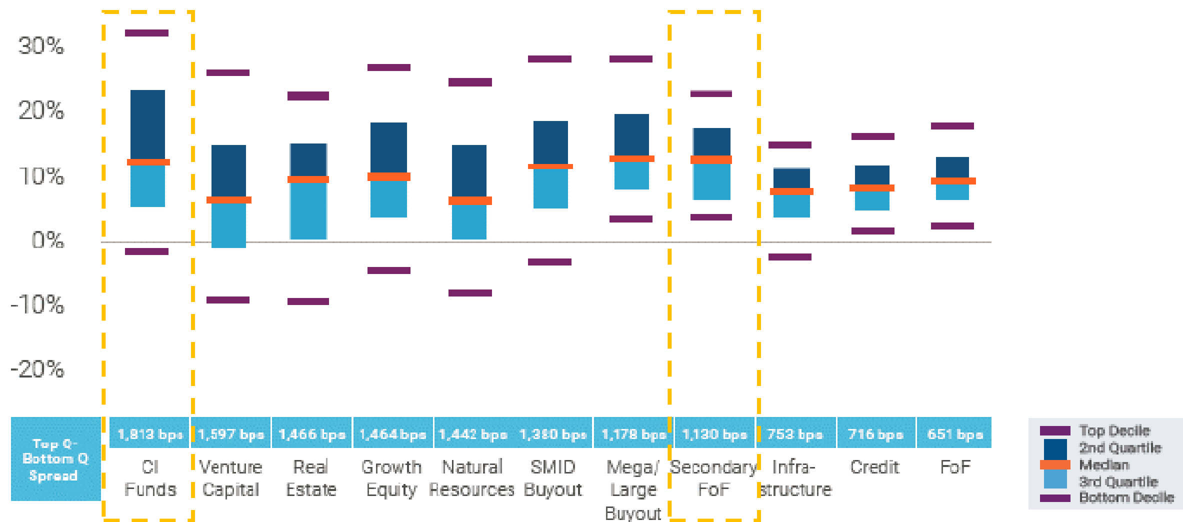
## Introduction

Private equity investing has seen tremendous growth over the last decade. In the last ten years, the number of active private equity firms has more than doubled, and the number of US sponsor-backed companies has grown by 60%. By comparison, the number of US publicly traded companies has remained roughly flat over the same time period. Investment allocations to private equity are on the rise with 2019 setting a new fundraising record for the asset class, with almost $250 billion raised for North America-focused funds.

This rapid growth has brought innovation to the private equity marketplace and expanded the investable products available to limited partners ("LPs"). This note highlights two private equity products and strategies that have risen in prominence in recent years: co-investing and secondary investing.

There are several reasons to highlight these two strategies alongside each other. First, as illustrated in Exhibit 1 below, these strategies have had similarly strong median return performance, with IRRs of ~12%. Where they differ is in dispersion and return metric orientation – co-investing tends to generate higher MOIC while secondaries provide high early-life IRRs that normalize over time. Second, these strategies are often implemented by the same managers as part of a diversified alternative investment platform. Third, both strategies tend to rely on strong general partner ("GP") relationships, albeit to differing degrees. Lastly, both strategies should benefit from continued growth and innovation in coming years, supported by growing allocations to private markets and evolving LP needs.

<u>Exhibit 1 Returns and Dispersion by Alternative Strategies (1979 – 2015)</u>

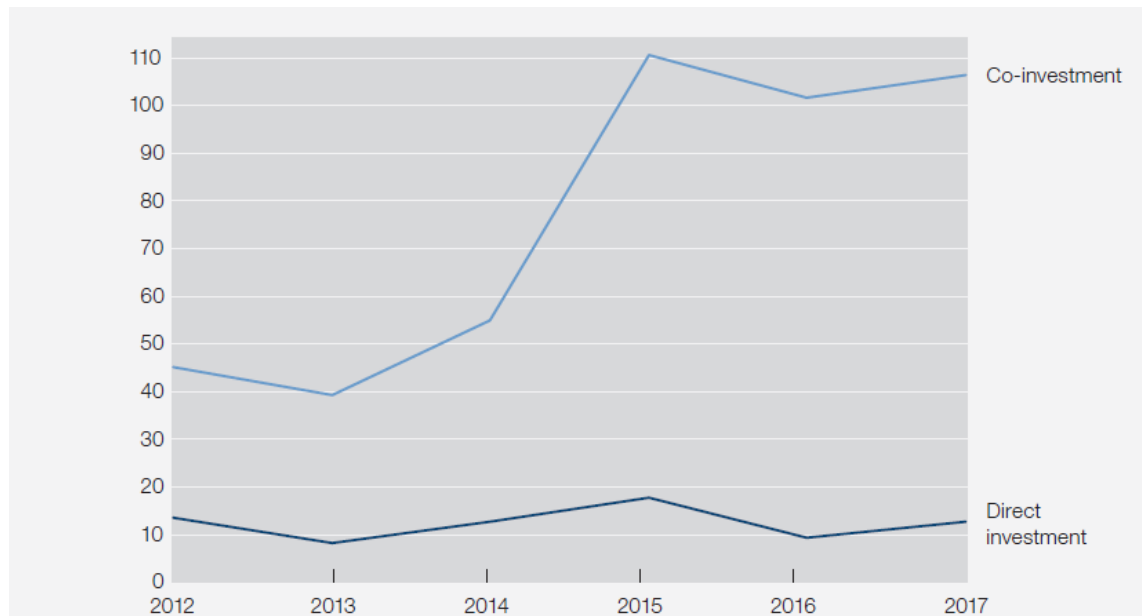



*Source: Hamilton Lane via Cobalt (February 2019)*

## Co-Investing – Strategy Background

Private equity co-investing, which involves investing alongside a GP as a minority equity holder, has grown significantly over the last decade. While it is difficult to get a complete picture of all co-investment activity given much of it is private, McKinsey estimates the aggregate value of co-investment deals has more than doubled from 2012 to 2017, to $104 billion.

Exhibit 2 Limited Partner Co-Investment Deal Value[1] ($bn)




*1. Defined as deals involving at least 1 LP and 1 GP*
*Source: McKinsey Global Private Markets Review (2018)*

Demand for co-investing remains strong – Private Equity International's 2019 survey of LPs revealed that 65% of LPs plan to invest in co-investment opportunities in the next year. Much of the interest in co-investment stems from the strategy's fee savings and potential to enhance net returns, as most co-investments are made on a no fee, no carry basis. GPs tend to offer co-investments to fund LPs first, though outside investors may also participate in a deal if there is not enough interest or capacity within a GP's existing LP base.

Before diving in further, it is worth mentioning the topic of adverse selection, which often arises when discussing co-investments. Adverse selection refers to the concept that, for any given GP, the performance of deals offered for co-investment may be inferior to that of deals not offered for co-investment. The reasoning is that GPs want to maximize fund exposure to their best deals and reduce fund exposure to less attractive deals. If true, co-investments run the risk of being lower in quality than deals not shown for co-investment.

The main research support for adverse selection comes from a 2015 study[1] which analyzed 103 co-investments using data from seven LPs. More recently, a 2019 study[2] which analyzed 1,016 co-investments by 458 LPs found no evidence of adverse selection in co-investments. In conversations with practitioners, adverse selection appears to be a dwindling investor concern. Since co-investors are typically also LPs in the GP's fund, GPs are incentivized to offer high quality co-investment opportunities. Co-investment outcomes can strengthen or strain relationships, which can directly impact the success of the GP's next fundraising effort.

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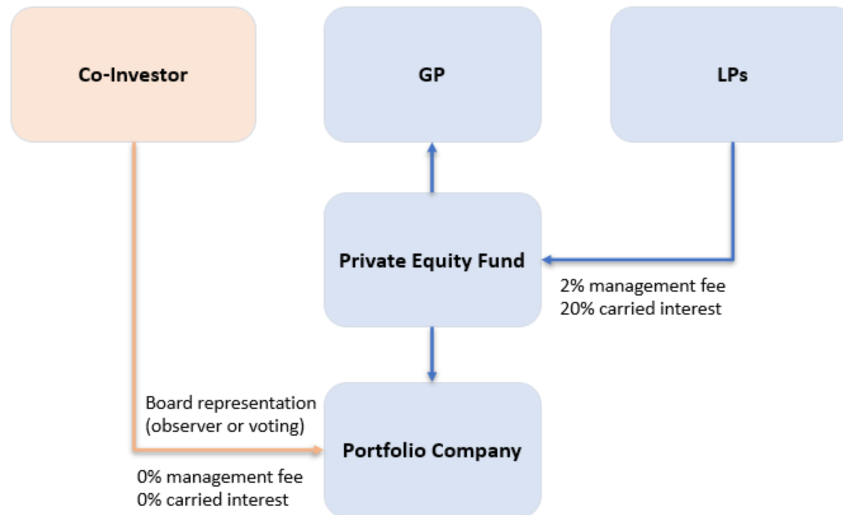
[1] Fang, L., Ivashina, V., Lerner, J., 2015. The disintermediation of financial markets: direct investing in private equity. J. Financ. Econ. 116

[2] Braun, R., Jenkinson, T., Schemmerl, C., 2019. Adverse selection and the performance of private equity co-investments. J. Financ. Econ. 136

**Co-Investing Mechanics**

Private equity co-investors seek to partner with GPs to invest directly in individual companies as minority equity holders. Investors are typically passive investors, with GPs dictating most of the strategic, value-creation, and exit decisions. Co-investors remain engaged with portfolio companies after investment, to varying degrees, by serving as board observers or voting board members. The exhibit below illustrates the fee free nature of co-investments, which contrasts to fund investments, which typically charge a 2% management fee and 20% carried interest.

Exhibit 3 Mechanics of a Typical Co-Investment Transaction




Participants in the co-investment market include sovereign wealth funds, pension funds, insurance companies, and alternative asset managers. Investors seeking exposure to co-investments have two primary ways of accessing the strategy: (i) directly by building in-house capabilities or (ii) indirectly by partnering with an external manager.

Exhibit 4 Co-Investor Archetypes

**Internal Managers**
(managing own capital)

**External Managers**
(managing third-party capital)

| Sovereign Wealth Funds | Pension Funds | Insurance Companies | Alternative Asset Managers |
|---|---|---|---|
| • Alaska Permanent Fund Corporation<br>• GIC<br>• Temasek | • CalPERS<br>• CPPIB<br>• NY State Common Retirement Fund<br>• Texas TRS | • Barings (MassMutual)<br>• GoldPoint (NY Life)<br>• Manulife<br>• MetLife<br>• Northwestern Mutual<br>• Nuveen (TIAA) | • Adams Street Partners<br>• AlpInvest<br>• Ardian<br>• BlackRock<br>• Hamilton Lane<br>• HarbourVest<br>• Lexington Partners<br>• Neuberger Berman<br>• StepStone |

**Direct Co-Investing (Internally Managed)**

Direct co-investing is the most operationally intensive option, as it requires having in-house personnel capable of screening and underwriting deals, often under relatively short timelines. It also requires proactive management of existing and new GP relationships to source co-investment opportunities. In return, LPs benefit from the greatest potential fee savings with no management fees or carried interest on co-investment dollars deployed. Given the meaningful costs involved with building the necessary in-house infrastructure, LPs pursuing this approach are often larger institutional investors who have enough scale to justify the investment.

**Indirect Co-Investing (Externally Managed)**

Indirect co-investing outsources co-investing activities to an external manager, who has the expertise and relationships to execute a direct co-investment strategy. This provides LPs with access to co-investments without having to build in-house capabilities. The trade-off is that fee savings will not be as great as deploying a direct co-investment strategy, given there is an added layer of fees for the external manager. However, co-investment funds typically have a "1 and 10" fee structure, which still offers significant fee savings when compared to the "2 and 20" fee structure typically charged when investing directly in a fund. The table below provides a few examples of recently raised dedicated co-investment vehicles.

| Final Close | Fund Name | Fund Size ($bn) |
|---|---|---|
| 2019 | HarbourVest Partners Co-investment Fund V | 3.0 |
| 2019 | Hamilton Lane Co-Investment Fund IV | 1.7 |
| 2019 | Ardian Co-Investment Fund V | 2.5 |
| 2019 | (LGT Capital) Crown Co-Investment Opportunities II | 1.3 |

*Source: Preqin*

In addition to dedicated co-investment vehicles, LPs may gain access to co-investments through commitments to fund-of-fund vehicles, which may have a set allocation to co-investments and secondaries (e.g. 70% primary investments, 15% co-investments, 15% secondaries). LPs may also have separate account relationships that allow for a customized mix of co-investments as part of their private equity portfolio.

**Importance of GP Relationships**

One of the keys to executing a successful co-investment strategy is having a strong network of GP relationships. The most common way to build and cultivate those relationships is through a primary fund investment program. Most co-investors have primary programs and leverage those GP relationships to source co-investment opportunities. This underscores the importance of manager selection in a firm's primary program as most co-investment opportunities will likely come from funds the firm is already committed to.

With ample demand for co-investments and limited supply, GPs can strategically choose who they partner with for co-investments. Large, established LPs with significant allocations to private equity can be attractive partners, as they are able to support a GP's next flagship fund with meaningful commitments. GPs are motivated to strengthen relationships with their LP base, and part of the relationship building effort may involve providing ample, quality opportunities for co-investments.

**Dynamics of the Co-Investment Market**

Rising interest in co-investments from LPs has been primarily driven by the opportunity to improve net private equity returns through lower costs. However, LPs are also attracted by the strategic benefits a co-investment program can provide.

One of these benefits is the opportunity for more tactical deployment of capital. LPs with a broad GP relationship network and strong co-investment deal flow have the potential to generate excess return through deal selection. This may mean executing on thematic or sector views, or simply adhering to strong underwriting criteria. LPs can also use co-investments as a lever to better pace the deployment of their private equity programs.

Additionally, co-investments allow LPs to explore relationships with new GPs. LPs may use individual co-investments as a way to establish a relationship and gain insights into a GP with whom they are not currently invested with. These insights can help guide LPs on future primary commitment decisions and facilitate access to the GP's future funds.

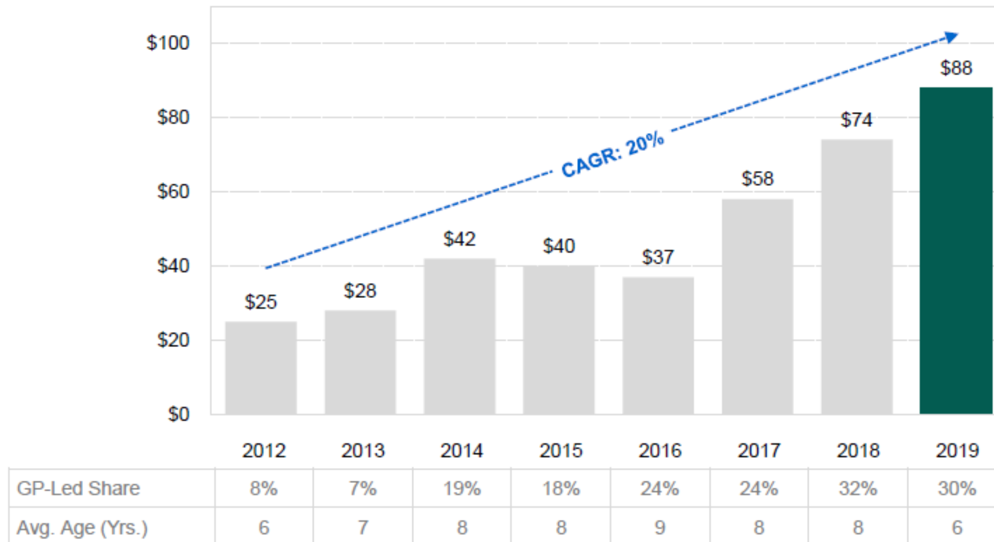
It is worth noting that these strategic benefits are mainly applicable to direct co-investors who have discretion over their private equity programs.

| LP Motivations | GP Motivations |
|---|---|
| • Improve net returns through lower costs<br>• Tactical deployment of capital<br>• Strengthen core GP relationships<br>• Explore new GP relationships | • Expand investable universe<br>• Preference for passive partners<br>• Strengthen core LP relationships<br>• Source new LP relationships |

**Secondary Investing – Strategy Background**

Secondary investing has seen tremendous growth and innovation in the last two decades. Secondary transactions, which traditionally involve the purchase of an LP's stake in a private equity fund, have grown at a 20% CAGR from 2012 through 2019. This rapid growth has been partly fueled by the development of new types of secondary transactions initiated by GPs ("GP-led transactions").

<u>Exhibit 5 Historical Secondary Volume ($bn)</u>




| | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 | 2019 |
|---|---|---|---|---|---|---|---|---|
| GP-Led Share | 8% | 7% | 19% | 18% | 24% | 24% | 32% | 30% |
| Avg. Age (Yrs.) | 6 | 7 | 8 | 8 | 9 | 8 | 8 | 6 |

*Source: Greenhill Global Secondary Market Trends & Outlook (2020)*

Secondary sales have become an increasingly common and accepted practice. However, through much of the 2000s, secondary transactions were often stigmatized. LPs were hesitant to participate in the market, concerned that secondary sales would hurt their reputations as good partners to GPs. This in turn could harm an LP's ability to access top performing funds, which were often oversubscribed. GPs were also concerned about their reputation and hesitant to restructure funds via the secondaries market. Following the financial crisis, fund restructurings were primarily associated with underperforming managers that were unsuccessful in raising follow-on funds.

Today, however, secondaries have evolved into a sizeable market used by LPs for a variety of purposes. The most common driver of LP sales tends to be active portfolio management. Selling may help an LP implement a new asset allocation plan (e.g. set by a new CIO) or it may be part of portfolio rebalancing to comply with an existing asset allocation plan. LPs may also choose to sell due to liquidity issues, which can arise from current cash needs as well as concerns about the ability fulfill future capital calls.

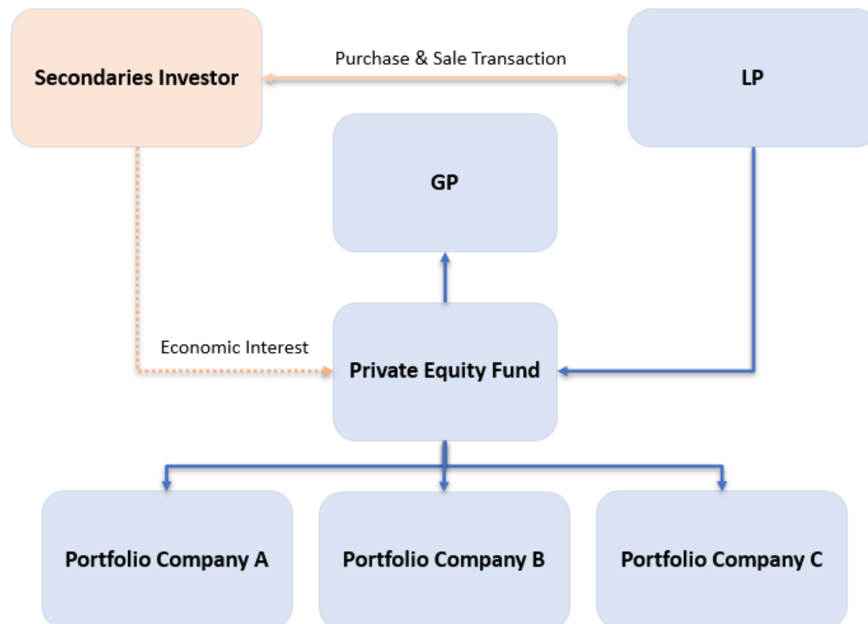
Much of the innovation in secondaries has come from the GP-led part of the market. GPs are increasingly using the secondaries market to address various strategic and tactical objectives. Most of these transactions fulfill a GP objective (e.g. longer fund life, fundraising) while providing LPs with an opportunity for early liquidity, typically funded by a secondaries investor.

**Strategy Mechanics**

While the secondary market has evolved to include a variety of transactions, sales of LP fund stakes remain the most prevalent transaction type, accounting for 70% of transaction volumes in 2019. In an LP fund stake sale, a secondary investor purchases an LP's interest in a fund or a portfolio of funds. Secondary transactions are typically priced at a discount to the fund's net asset value ("NAV") – as an example, an LP fund stake might trade for 95% of the fund's NAV.

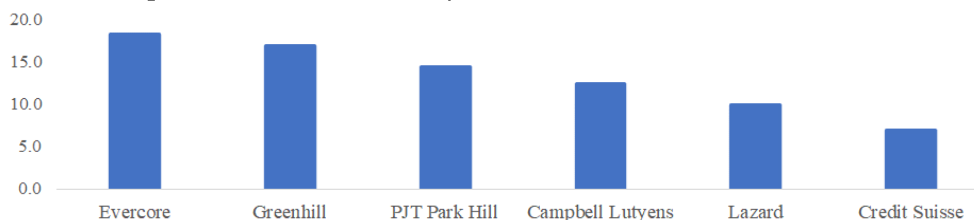
Secondaries investors typically are purchasing stakes in "seasoned" funds, or funds that are several years into their investment period and that have already called a substantial amount of capital from investors (typically over 50%). In addition to gaining an economic interest in the private equity fund and the underlying portfolio companies, the secondaries investor takes on the obligation for any future capital calls from the private equity fund.

Exhibit 6 Mechanics of a Traditional Secondary Transaction




Bidding on LP fund stakes can be competitive as these deals are typically intermediated by investment banks. Evercore, Greenhill, and PJT Park Hill are a few of the investment banks that have developed sizeable secondaries advisory practices. These three advisors worked on over half of the deal volume completed in 2019.

Exhibit 7 Top Secondaries Advisors by 2019 Transaction Value ($bn)




*Source: Secondaries Investor Advisory Survey*

## Competitive Landscape

The secondaries investor base is predominantly made of up of institutional investors investing on behalf of LPs, typically through commingled fund vehicles. While there are a handful of pension funds, family offices, and other institutions that have built in-house secondaries capabilities, they make up a small part of the total market.

It is difficult to cleanly segment the institutional investor market for secondaries. While some managers focus on particular strategies and transaction sizes, many managers operate across a wider spectrum. The clearest demarcation across managers is reflected in fund sizes, which have grown dramatically over the last decade. Most secondaries managers have seen significant size step-ups with each fund raised. This is partially reflected in the chart below – larger funds tend to be associated with more seasoned fund programs.

Exhibit 8 Largest Secondaries Funds Raised in 2015 – 2020, Per Manager

| | **Fund Manager** | **Last Fund Size** ($bn) | **Fund Series** | **Vintage** |
|---|---|---|---|---|
| **> $10B** | Lexington Partners | 14.0 | IX | 2019 |
| | Blackstone Strategic Partners | 11.1 | VIII | 2019 |
| | Ardian | 10.8 | VII | 2015 |
| **$5B - $10B** | Coller Capital | 7.2 | VII | 2015 |
| | Landmark Partners | 7.0 | XVI | 2018 |
| | AlpInvest | 6.5 | VI | 2017 |
| | Goldman Sachs Asset Management | 5.9 | VII | 2016 |
| **< $5B** | HarbourVest | 4.8 | IX | 2016 |
| | Partners Group | 2.8 | VI | 2015 |
| | LGT Capital Partners | 2.8 | IV | 2017 |
| | Glendower Capital | 2.7 | IV | 2018 |
| | Neuberger Berman | 2.5 | IV | 2016 |
| | ICG | 2.4 | III | 2019 |
| | StepStone | 2.1 | IV | 2020 |
| | Whitehorse Liquidity Partners | 2.0 | III | 2019 |
| | Hamilton Lane | 1.9 | IV | 2016 |
| | Pomona Capital | 1.8 | IX | 2017 |
| | Portfolio Advisors | 1.5 | III | 2016 |

*Source: Preqin*

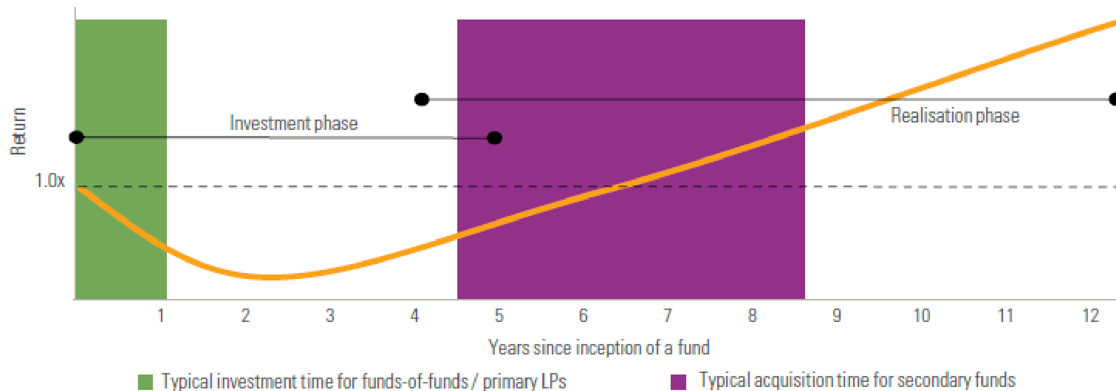
While the managers above account for the bulk of secondaries capital raised in the last five years, there are dozens of other managers focused on deploying smaller funds. Based on Preqin data, more than 45 managers raised funds sized between $100 million and $1 billion in the last five years. This compares to 22 managers who raised funds over $1 billion, most of which focused on funds under the $5 billion mark.

## LP Motivations

One of the selling points of secondaries for LPs is the strategy's ability to mitigate the traditional J-curve associated with private equity. When investing directly in an individual private equity fund, an LP is faced with negative returns and cash flows in the early years of its investment (due to fees and capital calls), which are offset by positive returns and cash flows in the mid to later years of its investment. This timing mismatch creates the "J-curve" return dynamic.

Secondaries provide J-curve mitigation by investing later in a fund's lifecycle, typically in years 5 - 8 of a fund's life. This is often in the realization phase of the fund, which means secondaries have the potential to generate cash distributions soon after making an investment. Secondaries' earlier cash distribution profile also limits the capital intensity of the strategy. Early distributions in a secondaries fund's life may be re-cycled into new investments, which can reduce LPs' capital call obligations to the secondaries fund.

Exhibit 9 The Private Equity J-Curve




*Source: Coller Capital – The Private Equity Secondary Market*

Another reason investors are drawn to secondaries is the strategy's favorable risk-return profile. Historically, secondaries have delivered median net IRRs of ~12%, with relatively low dispersion compared to other alternative strategies, and very low loss ratios (< 2%). This may be partially due to the reduction of "blind pool" risk, as secondaries investors are able to review and underwrite a significant portion of a fund's total investments. Secondary investments in seasoned funds may also benefit from a lower risk, more stable portfolio of companies. Companies with several years of private equity ownership may no longer be at "full leverage" and may have already executed on value-creation plans. With that said, secondaries returns can quickly evaporate if a manager misprices an investment.

One additional benefit offered by secondaries is rapid diversification. Secondaries can offer diversification across geographies, strategies, managers, and vintages. Vintage diversification is a unique feature of secondaries, that may be especially attractive for LPs starting new private equity programs.

| **LP Motivations for Investing in Secondaries** |
| --- |
| • J-curve mitigation<br>• Lower capital intensity (compared to primary investing and co-investing)<br>• Attractive risk-return profile<br>• Significant diversification including vintage diversification<br>• Relatively efficient fee structure (1% and 12.5%) |

**GP Relationship Dynamics in Secondaries**

GP relationships play a role in secondaries, but they are not as critical to sourcing as they are to other alternative strategies like co-investing. Traditional LP-led secondaries, the largest part of the market, are typically intermediated by investment banks and marketed through competitive

auction processes. With that said, GPs do have ultimate approval rights on secondary sales, so maintaining a reputation as a good LP partner can help with access to transactions in the market.

With GP-led transactions, relationships can play a greater role in sourcing as the GP has discretion on who to approach regarding potential transactions. However, initial discussions do not guarantee exclusivity. As transactions increase in complexity, they often require an independent third-party advisor, who may bring in additional bidders if necessary to ensure the transaction is fairly valued.

What may be most valuable for secondaries investors is the breadth of its GP relationships and the access to underlying fund data. Secondaries managers with primary fund of fund platforms are invested in hundreds of funds and have access to a wealth of performance and valuation data. Managers with this access may have an edge in terms of execution speed and market intelligence that may allow them to price and underwrite transactions more quickly than competitors.

**GP-led Transactions**

GP-led transactions have become a meaningful segment of the secondary market, growing from 10% of the market in 2013 to 30% in 2019. GP-led deals encompass a wide range of transactions that vary in complexity. Most transactions provide existing fund LPs with a liquidity option financed by the secondaries investor. A few examples of GP-led transactions are highlighted below.

| Transaction | Description |
|---|---|
| Tender Offer | • Offer to purchase a certain amount of fund interests from existing LPs<br>• Existing LPs can choose to accept the offer or remain in the fund |
| Fund Restructuring | • Sale of asset(s) from an older fund to a new special purpose vehicle ("SPV")<br>• Existing LPs can choose to sell their stakes or roll stakes into new SPV<br>• SPV has new fund terms and economics |
| Stapled Secondary | • GP takes a liquidity event (e.g. tender offer, fund restructuring) and "staples" a commitment to a future fund vehicle<br>• Secondary buyer makes two investments: a secondaries investment in the liquidity transaction and a primary investment in the GP's next fund |
| Preferred Equity | • GP issues a preferred equity security in the fund to a secondaries buyer<br>• Use of proceeds is flexible – can be used to provide liquidity to LPs<br>• Secondary buyer receives priority claim on future fund distributions, up to a preferred return |

GP-led transactions can require extensive negotiations given the often-conflicting interests of the various stakeholder groups involved. In a fund restructuring, these groups include liquidating LPs, rolling LPs, secondaries investors, and the GP. Price will always be a key negotiation point for liquidating LPs in these transactions, but some of the more interesting dynamics of fund restructurings are the opportunities to align go-forward interests across the remaining stakeholders. This tends to be done by setting new terms and economics for the continuation SPV. As an example, one of the ways GPs demonstrate their conviction for these transactions is by rolling their carried interest from the original fund to the new SPV – creating strong alignment with rolling LPs and new secondary investors.

**Deal Vignettes – Co-Invest & Secondaries**

**Omega Pharma (2012)**

**Deal Type:** Co-Investment for Take Private
**General Partner(s):** Waterland Private Equity
**Transaction Size:** €848 million
**Co-Investor(s):** HarbourVest Partners

**Description:** Take private transaction of a Belgian pharmaceutical company. HarbourVest's co-investment team identified the need for a tax efficient structure and leveraged its European investment team to establish trust with the Belgian portfolio company and the Dutch private equity firm. Waterland and HarbourVest exited the investment via a sale to a strategic (Perrigo) in 2015.

**Staples (2017)**

**Deal Type:** Co-Investment for Take Private
**General Partner(s):** Sycamore Partners
**Transaction Size:** $6.9 billion
**Co-Investor(s):** Neuberger Berman

**Description:** Take private transaction of the world's largest office products company. Neuberger Berman has been an LP with Sycamore Partners since its inception and co-underwrote the transaction with the firm, who specializes in consumer/retail investments. To date, Sycamore and Neuberger Berman have recovered 80% of their initial equity investment, primarily through a 2019 dividend recapitalization transaction which paid a $1 billion dividend to equity holders.

**Norinchukin Bank portfolio (2019)**

**Deal Type:** Large LP Stakes Portfolio
**General Partner(s):** Various
**Transaction Size:** $5 billion
**Secondary Investor(s):** Ardian

**Description:** Large LP stakes transaction encompassing interests in 92 funds, including funds managed by Blackstone, Carlyle, KKR, and Apollo. The transaction also included direct equity stakes in seven companies.

**PAI Europe V (2019)**

**Deal Type:** GP-Led Fund Restructuring
**General Partner(s):** PAI Partners
**Transaction Size:** €2 billion
**Secondary Investor(s):** Consortium

**Description:** Highly concentrated GP-led restructuring of PAI Europe V, a 2008 vintage fund. The fund had two remaining assets, with the bulk of the NAV coming from one asset, Froneri, the third-largest ice cream manufacturer in the world. The restructuring provided PAI with additional time to grow Froneri. In December 2019, Froneri acquired Nestle USA's ice cream business, which made the company the second-largest ice cream manufacturer in the world. The size of the transaction required a consortium of investors, which was led by HarbourVest, AlpInvest, and Goldman Sachs Asset Management. Each lead investor committed €300 million to the deal.

## Sources & Suggested Further Reading

Primary Research

- This note was informed by interviews with more than 20 investors and industry participants.

Reports / Whitepapers (links included for publicly available resources)


### Industry Data

- Bain & Company | Global Private Equity Report 2020
- Coller Capital | Global Private Equity Barometer 2019
- KKR Global Institute | Global Macro Trends 2019
- McKinsey & Company | Global Private Markets Review 2020
- PEI | Fundraising Report 2019
- PEI | LP Perspectives Survey 2020
- PitchBook | Private Fund Strategies Report 2019
- Preqin | Alternatives in 2020

### Co-Invest

- Cambridge Associates | Making Waves: The Cresting Co-Investment Opportunity
- Cambridge Associates | Ready, Steady, Co-Invest
- GCM Grosvenor | Unlocking Alpha in a Maturing Private Equity Co-Investment Market
- Hamilton Lane | Co-Investing: The Struggle is Real
- HarbourVest | Co-Investing 101: Benefits and Risks
- PEI | Co-Invest Roundtable – November 2018
- PEI | Co-Invest Roundtable – September 2019

### Secondaries

- BlackRock | The Case for Secondary Allocations
- Blackstone Strategic Partners | A Primer for Today's Secondary Private Equity Market
- Cambridge Associates | When Secondaries Should Come First
- Coller Capital | The Private Equity Secondary Market
- Evercore | Secondary Market Survey 2019
- Greenhill | Global Secondary Market Trends & Outlook
- HarbourVest | Secondaries: Risk Reduction With Attractive Returns
- Morgan Stanley | Secondaries v2.0: The Era of Transformation
- Palico | Secondary Pricing Report – Q4 2019
- PEI | New Strategies for Risk Management in Private Equity
- PEI | Secondaries Roundtable – May 2019
- PitchBook | Extended Holding Periods in PE
- S&P | Transparency is Key to Avoiding Failed GP-led Secondaries
- The Journal of Private Equity | The Private Equity Secondaries Market During the Financial Crisis and the "Valuation Gap"