DIRECT ACCESS TO RETURNS

A GP's View On The Merits Of LP Co-Investment

BILL PRUELLAGE, CO-PRESIDENT OF NEW YORK-BASED PRIVATE EQUITY FIRM CASTLE HARLAN, PROVIDES UNIQUE INSIGHT INTO THE BENEFITS OF CO-INVESTMENT FOR BOTH LIMITED AND GENERAL PARTNERS, AND WHY WE SHOULD EXPECT TO SEE MORE DIRECT INVESTING IN COMING YEARS.

CO-INVESTMENT'S RISE

Just five to ten years ago, it was only the more sophisticated limited partners who would occasionally co-invest alongside general partners, either due to a special need for financing in a certain deal or a strong relationship with their fund sponsor.

Co-investment has since evolved into an established strategy for fund of funds, pension plans, endowments/foundations and many other types of investors to achieve higher returns. An increasing number of institutions are taking up the practice with some even specifically allocating capital and resources to direct investing.

To give a sense for recent co-investment appetite, current and prospective LP co-investment has represented almost 30% of the total equity invested in Castle Harlan's deals over the last three years.

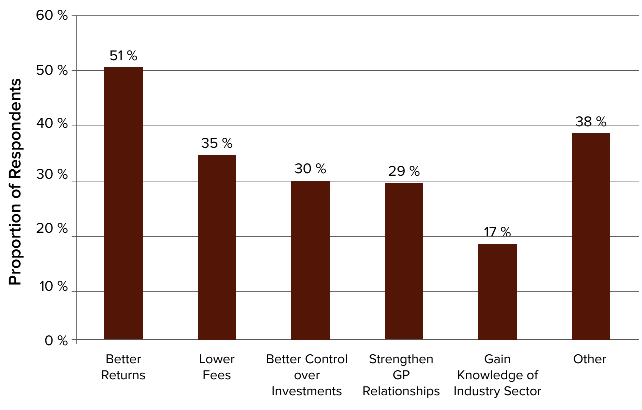
This continually growing interest should be of no surprise to fund managers given co-investment's benefits to LPs, especially in today's competitive environment.

ENHANCED RETURNS

The private equity industry weathered the global recession, outperforming the public markets and other asset classes during the 2008 to 2010 period, but as it has continued to grow, LPs have sought new ways to extract value from their private equity portfolios.

By co-investing alongside fund sponsors in certain deals, LPs are able to "cherry-pick" deals in which they have strong conviction – whether that conviction lies in a specific sector or specific

Exhibit A: LPs Reasons for Co-Investing



Source: Preqin. "Preqin Special Report: LP Appetite for Private Equity Co-Investments". 2012.

characteristics of a deal (e.g., pricing, company profitability). LPs can increase their exposure above their partnership stake and potentially realize greater overall returns, while further optimizing their portfolio across certain sectors or strategies. In fact, John Drake, managing analyst for the State of Wisconsin Investment Board, an institution that actively co-invests, found that their average co-investment has outperformed its related fund 72% of the time and either equaled or exceeded top-quartile fund returns in every case .

By actively seeking out co-investment opportunities, an LP can more quickly deploy capital with any given GP, diminishing the J-curve related to private equity investing. To add, since LPs often pay limited or no management and performance fees on the portion they co-invest, directly investing allows them to leverage the costs they already pay to a fund sponsor. A portfolio manager at a U.S. state investment board estimated that, on a $100 million commitment, an LP can save over $20 million in fees over a five-year period through co-investing[1].

OUTSIDE THE NUMBERS

Stronger returns and the ability to leverage costs are clear motivations for LPs to co-invest but, as Exhibit A demonstrates, LPs recognize other meaningful benefits from direct investing.

As a separate shareholder in a portfolio company, LPs have greater visibility into the ongoing developments with their investments through access to management and board observation rights. If their equity commitment is large enough, LPs can even gain board rights and the corresponding influence over the investment's performance.

As a shareholder alongside fund sponsors, LPs also gain an opportunity to expand their internal capabilities and get to know their existing and prospective fund sponsors even better. At Castle Harlan, for instance, LPs considering co-investing will often evaluate the opportunity alongside our investment team, thereby gaining access to all due diligence materials and valuable experience in deal processes.

It is worth noting that the evaluation process for LPs is an efficient one. GPs generally only approach LPs with deals that are in advanced stages, meaning much of the due diligence has already been completed and the probability of a consummated transaction is high. And in many cases, the LP simply acquires a portion of the GPs stake post-closing. Whether LPs actively or just opportunistically co-invest, the number of evaluated deals that actually close is very high and LPs are not necessarily required to devote substantial time or resources to the effort.

Additionally, the evaluation process and consequent shareholder experience provide LPs with knowledge in specific sectors and investment strategies that they can apply in identifying other investment opportunities in private equity and other asset classes across their broader portfolio.

WIN-WIN

Co-investment allows LPs to extract even more value from their private equity portfolios, but I would be remiss not to highlight its benefit to GPs and fellow LPs.

Additional LP equity represents another financing option for acquisitions, one that provides a fund sponsor with execution flexibility and broadens the field of potential investment opportunities. In deals that would be particularly large or potentially overleveraged, co-investment can allow general partners to optimize the fund equity commitment, thereby mitigating risks and positioning the investment for superior returns.

In specific cases, like a recent Castle Harlan investment, limited partners may possess or have access to valuable resources, such as industry expertise. As a co-investor, an LP can bring these resources to bear and supplement the general partner's efforts to add value to a portfolio company.

It goes without saying that each of these instances, and co-investment in general, represent great opportunities to improve existing GP / LP relationships and build new ones.

LOOKING FORWARD

Co-investment has evolved over recent years from an occasional foray into an established way for limited partners to enhance their private equity portfolios. Given the outperformance and other advantages it creates for co-investors, funds and GPs alike, we can expect LP co-investment, whether done opportunistically or through formal in-house programs, to continue to flourish.

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[1] Barry B. Burr. "Wisconsin Investment Board plans in-house private equity co-investments." Pensions & Investments. June 2013.

BILL PRUELLAGE HAS BEEN CO-PRESIDENT OF CASTLE HARLAN SINCE 2010 WITH PARTNER AND CO-PRESIDENT HOWARD MORGAN, WHO WILL BE A PANELIST IN THE ELECTRONIC POLLING SESSION AT 9.50 ON DAY 2 OF SUPERRETURN INTERNATIONAL, WEDNESDAY 26 FEBRUARY.

What do you think? #SuperReturn14