Case Study #3: Co-Investment Structures for SWFs

IFSWF Subcommittee II: Investment & Risk Management

Objectives

- Describe the co-investment model for private equity investment, highlighting how the roles of General Partners (GPs) and Limited Partners (LPs) differ from the traditional structures.
- Discuss the benefits and risks of the co-investment model for LPs with a particular focus on the unique implications for SWFs. Consider legal, regulatory, political, and investment implications.
- Evaluate the track record of the co-investment model and identify the specific capabilities that SWFs must develop to be successful.
- Describe how a private equity co-investment consortium could work and the prospective benefits it could bring to its members.
- Draw conclusions that apply to the broadest possible set of SWFs, while recognizing that all SWFs have unique objectives, circumstances, and constraints, and that no single solution will apply for all SWFs.

Questions to be addressed

- What is the performance track record of private equity co-investment compared to traditional structures? How does co-investing impact the private equity “J-Curve”?
- What qualities might make an SWF attractive as a co-investment partner? What capabilities must an SWF develop in order to succeed in a co-investment structure?
- What terms should an SWF consider negotiating when structuring a co-investment deal?
- What might be the benefits and challenges for SWFs of participating in a co-investment consortium?

The Co-Investment Model

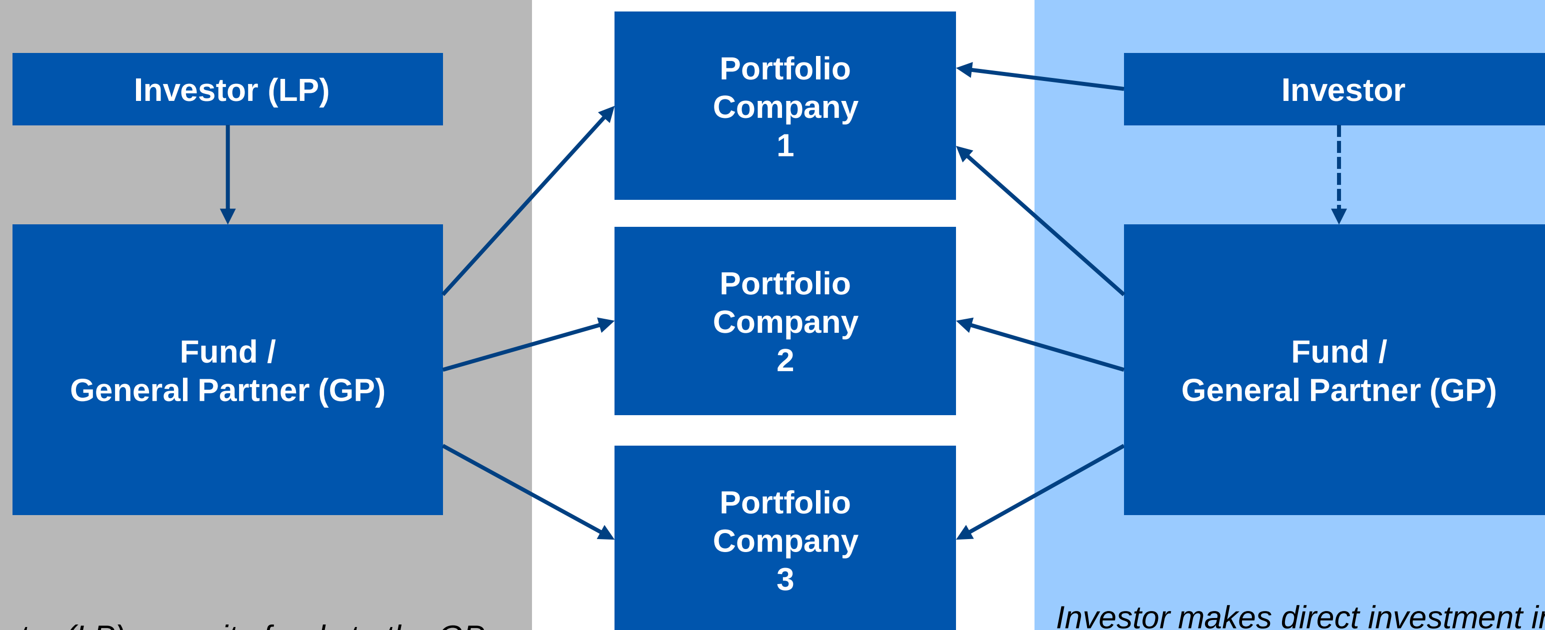
Co-Investing with investment managers and other SWFs

- In this presentation, we focus on co-investment with investment managers, which is a common co-investment model for SWFs
- Co-investing with fellow SWFs can provide another option:
  - Tends to develop from relationships rather than deals
  - SWFs are more likely to be aligned with one another in their horizon, beliefs, risk tolerance, and risk/return expectations
  - No agency risk, is cost-effective, and provides a forum for organic knowledge sharing

Defining the co-investment model

Traditional Model

Co-Investment Model



Investor (LP) commits funds to the GP. The GP then pools capital from multiple LPs and selects end investments.

Investor makes direct investment in portfolio company, typically alongside a another investor or a GP with whom it also invests.

Why co-invest?*

- Potential for greater control than the traditional private equity investment model:
  - Selection and timing of deals
  - Involvement in execution
  - Determination of exit strategy
- Reduced fees provide opportunity for higher net returns throughout the J curve
- Avoid principal-agent problems that may impact the traditional model
- According to Preqin survey data, co-investment is in demand:
  - 43% of investors in private equity funds were seeking co-investment rights
  - An additional 11% of investors were considering doing so

* For details, sources, and more on this topic, see: L. Fang, V. Ivashina, and J. Lerner, "The Disintermediation of Financial Markets: Direct Investing in Private Equity," 2014. SSRN 2159229.

Challenges with co-investment

- Co-investment offers the potential for greater control, but it also requires that the investor dedicate significant time, resources, and talent to exercise this control effectively.

- GPs face conflicting incentives*:
  - Keep the highest quality deals in traditional fund structure (not co-investment) in order to maximize fees
  - Offer high quality co-investment opportunities to LPs in order to preserve their reputation and LP relationships

* See: L. Fang, V. Ivashina, and J. Lerner, "The Disintermediation of Financial Markets: Direct Investing in Private Equity," 2014. SSRN 2159229.

Performance track record

- A recent academic paper* focused on:
  - Seven sophisticated institutions with long-standing direct investment programs
  - University, corporate, and government-affiliated organizations based in North America, Europe, and Asia
  - Several hundred investments over the last 20 years (1991-2011)

- The authors found:
  - Substantial fee discounts for co-investment
  - Evidence that co-investments underperformed traditional fund investments

Conclusion: Co-investment is a relatively new practice for most investors which makes it challenging to draw firm conclusions.

* See: L. Fang, V. Ivashina, and J. Lerner, "The Disintermediation of Financial Markets: Direct Investing in Private Equity," 2014. SSRN 2159229.

The Experience of the Alaska Permanent Fund

The experience of the Alaska Permanent Fund

Background

- Alaska has invested in private equity for nearly a decade
- Always negotiated co-investment rights but did not exercise these rights until the last several years
- Currently holds a combination of traditional private equity investment and co-investment

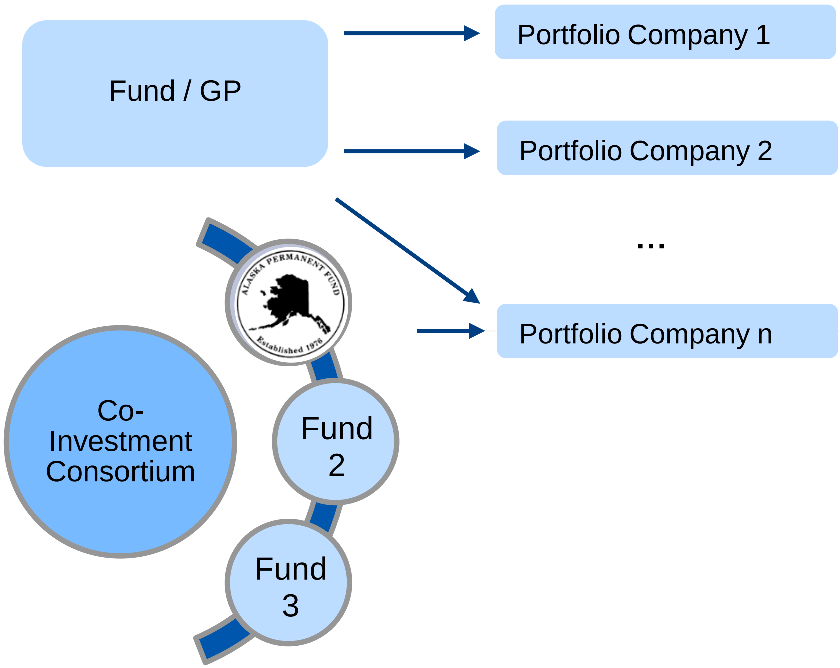
Experience

- Negotiations can be more challenging (terms, deal structure, etc.)
- Recruiting and retaining talent
- Funding / budget issues and governance constraints
- Can be more difficult to access funds (exit / liquidity)

A Co-Investment Consortium

Prospective benefits of a consortium

- A consortium could allow:
  - Greater flexibility in deal size. Members could participate in larger deals OR fund in smaller increments.
  - Knowledge sharing. Improved opportunity to select and participate in deals aligned with local expertise.
  - Market power. The consortium might attract higher quality deals and/or better terms.
  - Potential for a less predatory secondary market. If one member needs to exit, the other members could have "right of first refusal" to buy its share.



Legal, regulatory, political implications

- Would the consortium be a formal organization with a governance structure or an informal collection of members that review and participate in deals with complete independence? In either case, what legal/regulatory constraints exist for members?

- Are there political challenges with cross-border partnerships of this kind? How would the members manage the potential for elevated headline risk?

Alignment between co-investment partners

- Contractual alignment of financial incentives between co-investment partners is important. Alignment of purpose, investment beliefs, and risk tolerance across co-investment partners may be equally important. Recall it is possible to co-invest with fellow SWFs rather than just investment managers.
- For example, co-investment deals between partners with different investment horizons may be less stable than deals where partners have similar investment horizons.
- Successful alignment requires a level of engagement, understanding, and trust between partners prior to engaging in a co-investment opportunity.
- Such engagement can have ancillary benefits, such as the pooling of resources to vet opportunities and the sharing of information, experience, and “best practices” between partners.

Summary

- SWFs with the ability to…..
  - Spend time/effort/resources to source deals
  - Build internal expertise and staff (with appropriate funding/talent/organizational structure)
  - Navigate legislative/political/legal challenges from co-investment
  - Work within a consortium structure (with attendant legislative/political/legal considerations)
  - Select deals where they have specific expertise and alignment

- Could potentially benefit from a co-investment consortium through….
  - Greater flexibility in deal size
  - Lower fees and higher quality deals
  - Increased visibility and enhanced control over investments
  - Knowledge sharing of local or domain expertise
  - A secondary market to enter/exit investments on more advantageous terms

Appendix

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