CO-INVESTING

Cherry-picking

Co-investment is a great way for LPs to boost returns and diversify the portfolio – and it's particularly attractive at this point in the cycle, says Quilvest CEO Michel Abouchalache

***Abouchalache:** time is ripe for co-invests*

For LPs interested in co-investment, this is the time to act. Funds are finding it harder to raise money using the standard manner, and so are looking for injections of cash from elsewhere. There are also a number of investment professionals that have spun out of their old firms – either because there isn't enough work to keep them bust, or because they believe this is the right point in the cycle to go it alone. Often these managers will have the right skill-set and a good pipeline of deals, but they won't have the requisite funds. All of this presents LPs keen to add some co-investment to their portfolio with a window of opportunity.

"This is a beautiful period," says Michel Abouchalache, CEO of Quilvest, global wealth and private equity investor. "It offers an ideal opportunity for folks like us who are co-investors at all times of the cycle."

Abouchalache is a big advocate of co-investing. The primary appeal, he says, is that it allows you to "cherry-pick" great deals. "You are using your relationships with quality GPs and leveraging their platform and their know-how."

They are also a great diversification tool, he adds. "It allows me to deploy globally in multiple geographies without having our teams on the ground." Quilvest did 11 co-invests this year – not only in its core countries (i.e. the US and Western Europe), but also in Peru. He is currently considering one in India and Nigeria. "If you have solid relationships with GPs in those countries, co-investments allow you to diversify globally. I think of co-investment as an opportunity to deploy money with quality GPs globally."

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Co-invests offer diversification in another sense, too. With direct investing, you need your own team and resources, and so your risk is concentrated around one GP: yourself. As such, says Abouchalache: "By definition, co-investments help diversify your portfolio." Another advantage is that co-investments typically come as done (or almost done) deals, so there's less execution risk.

SELECTION ISSUES

So the appeal is clear. But as Abouchalache admits: "It's not all upside".

One common concern is around fees, although the issue is often overstated, he suggests. "One has to be aware of the fees that come with co-investments. Ignoring them is a problem, but so is focusing too much on them. You don't want to pay too many fees, but you certainly shouldn't make the fact that you will pay fees a reason not to do the investment. It's a sensitive and subtle area."

The best approach is to concentrate on absolute net performance, he says. "[And] you can always structure creative fees that kick in only when you have the risk/return that you were shooting for."

If fees are a worry, does it ever make sense to pay for a second round of due

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diligence? Usually, says Abouchalache, Quilvest relies on the GP's due diligence; but also does its own independent due diligence, yet "We don't re-invent the wheel", he says. Even though more people are involved, co-invests are often less complex than direct ones, he suggests – because rather than driving the deal through from A-Z, a trusted partner has already largely done all the legwork.

The bigger issue is adverse selection. "Sourcing good co-investments is challenging. You want to invest in the top five investments out of 15 in a good GP fund. If you are going to pick the median investments, then you lose the whole benefit of the strategy – because you will get the same return with a higher risk and volatility, and in that case you might as well just be invested in the portfolio as a whole. You try to have the top quartile or the top third of the deals from a good GP portfolio."

Which raises the question: why would GPs offer an LP its best deals, rather than keeping these deals for themselves? One possible reason is that the deal might be too big or risky for the GP, and they want to offload some of that risk. It might also be that the GP has reached its fund limit. "It could be that the size of the equity is larger than their maximum allowed by fund regulations," explains Abouchalache. "Or it could be that it's not at the maximum today, but they want to keep reserves so they can follow up with future capital if they need to put more money into the deal."

KNOWING YOUR PLACE

So how do you raise the chances that a co-invest is successful? Working with a good GP is the most important thing, says Abouchalache. "You are pretty much sitting in a plane and relying on the pilot, so the first step in picking a co-investment is to pick your GP. Let's be clear, no good GP will offer you a bad deal."

The best way to ensure that you get offered deals by good GPs is to develop a reputation as a good co-investor, so that people seek you out. That means having the ability to react "quickly and professionally". It also means understanding your role in the deal, whether you're a passive participant or whether you're a 50/50 co-investor, contributing expertise about a particular geography or sector. "There are shades of grey in terms of active/passive, or higher or lower amounts of equity," says Abouchalache. "You need to be an effective, accepted and friendly co-investor. It's about asking good questions. We try to ask a lot of good questions."

Being a good co-investor can also mean accepting a loss of control, at times. "I can think of situations when we were passive co-investors and the GP started working in ways we didn't like," says Abouchalache. "One of the negatives is that you don't control your exit timing, or your destiny. I can think of a few situations where we thought, 'I wish they hadn't done that' – but we didn't have a say."

Nonetheless, he says he doesn't believe in democratic leadership in private equity. "There should be one pilot; there's maybe a co-pilot, but they have to know they are the co-pilot. Then all those decisions – management, when to exit etc. – are in the hands of the GP. That said, if I think about the few co-invests we had that went sour, we probably in the majority of cases wouldn't have done anything differently from the GP. They are smart GPs, and we don't have a magic wand."

Not being able to control when exits happen can be a headache, which is why Abouchalache likes to invest alongside funds with a known life-cycle; timing is more of an issue with fundless GPs who create an SPV for a deal, he says. Has he seen situations where minority co-investors needed cash and want to sell? "Yes, but usually you find a way to get them liquidity. They may take a hit on the valuation, but today we have quite an active secondary market, so the market is quite fluid. It becomes trickier if the company is doing so-so, and the valuation of the company is not obvious."

His final advice for those interested in co-investing? Don't sit back and expect deals to fall into your lap. "Come at co-investment with a top-down approach," he says. "By that I mean that you should be proactive and not reactive. If you believe in certain countries, then you want to plant the seeds so that the right GPs will offer you the right co-investment with the right risk profile." Unlike some good things, quality co-invests don't come to those who wait. ■