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Private Equity and the New Era:

Co-Investments, Club Deals, & Direct Investments

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Introduction

Private equity firms, from large buyout funds to venture capitalists, are coming to grips with a new reality: investors are increasingly looking for alternatives to the standard private equity fund model. For decades, private equity limited partners have willingly paid the industry standard expenses of two percent management and twenty percent performance fees (and even higher fees to invest in the top quartile funds). In recent years, however, institutional investors have investigated alternatives to the standard private equity investment structure such as direct investments outside of a fund, co-investment rights to invest alongside a private equity fund, and club deals with other institutional investors.

When investors have agreed to commit capital to a private equity fund, it is often only after the General Partner has surrendered significant concessions such as lower management, greater transparency and reporting, co-investment rights, rebates on deal fees, a reduced carry, and the addition of measures that insure better performance like a higher hurdle rate. Led by organizations such as the Institutional Limited Partners Association (ILPA) and prominent capital allocators, limited partners are pushing for better terms, lower fees, and more flexibility in their private equity investments.

Amid this sea change in the private equity industry, investors are also looking at investing directly or taking advantage of co-investment rights to invest alongside a successful private equity fund. This latter change is a significant change in an industry where firms already face the aforementioned pressures on fees and investing terms. Private equity firms that embrace this movement by being more flexible with deal terms will have greater success raising capital and satisfying investors; the firms that resist the change and cling to the standard limited partner model will struggle to retain investors and market their offering to new LPs.

I hope that you enjoy this concise white paper. If you would like to learn more about the Private Equity Investment Group, please visit PrivateEquity.com or join us in New York for our live **Private Equity Investor Insights** conference on December 4th with a great lineup of LP speakers, networking, and discussion on important topics like the subject of this white paper.

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Co-Investments

It is wise to first answer a common question: what is co-investing? Co-investing typically refers to when a limited partner invests directly with a general partner in a company, thereby allocating capital indirectly through the fund to the company but also directly to the company via the co-investment. Co-investment rights may be offered to fund investors as a way to invest additional capital to a specific deal in which the private equity fund is investing. The benefit to the investor is that this co-investment allows for a greater allocation to a specific company, often with minimal fees. In past years, that additional capital investment might have been part of the total capital commitment to the general private equity fund. Institutional investors who have spent years developing their private equity investing expertise are now better positioned to invest confidently in deals that are particularly attractive. If a single family office has an experienced deal team, as many large single family offices do, the team might identify a specific company that makes sense for a co-investment allocation.

Speaking generally, there are two main types of co-investments: direct and indirect. In a direct co-investment, the co-investor will make an allocation directly into the portfolio company, manage that investment from the initiation to the exit, and negotiate terms of the investment with the company itself. Indirect co-investments are more likely to be structured differently, reflecting characteristics of the investor and the company. Indirect co-investment will most often occur under a Special Purpose Vehicle (SPV) where the co-investor allocates capital to the company via the SPV and then the investment is managed under that SPV, although co-investments may be made under different structures such as limited partnerships and LLC's, depending on the tax treatment of the vehicle. Alternately, an indirect co-investment can be made through a fund, which could aggregate multiple co-investments, rather than a singular investment through the SPV. Of course, there are many different features of both indirect and direct co-investment structures and numerous considerations for co-investors, all of which should be evaluated with proper legal or investment counsel (Pepper Hamilton).

It is easy to understand why private equity fund managers have been reluctant to allow co-investments. General partners have resisted the inclusion of co-investment rights for a number of reasons: the co-investment adds a layer of complexity to the fund; the general partner sacrifices capital that would have been invested under the standard fund vehicle and instead receives that capital through the co-investment structure; other limited partners in the fund are more likely to request similar arrangements; and by allowing co-investments, the general partner encourages future co-investments and direct investments by investors.

Investors are demanding co-investment rights for many of the same reasons that private equity fund managers have historically opposed the model; LPs hope to use co-investments to reduce overall fees on private equity investments, manage more investments internally, gain more control

through investments in companies, and gradually establish an in-house private equity platform. Additionally, the costs and added complexity of developing co-investment structures, whether it is a Special Purpose Vehicle for a single co-investment or a co-investment fund, can be burdensome on private equity firms. While some of the costs specific to the co-investment may be shared with the co-investor(s), fund sponsors may be expected to forego management and performance fees on co-investments. This expectation is based on the understanding that the co-investment is piggy-backing the work already done by the private equity firm in sourcing and evaluating the company and therefore the fees same fees should not be charged to co-investors and this concession is often viewed as a reward for investors. The economics of co-investments will vary depending on the GP-LP relationship, the expenses incurred by the fund sponsor, the level of involvement by the LP, the structure of the investment, and many other factors (Pepper Hamilton).

As we will discuss below, investors choosing to invest directly can have a significant effect on the capital raising efforts by private equity funds and most private equity funds have little interest in encouraging alternatives to the traditional LP-GP structure. All this raises the question of why private equity firms would offer co-investment rights, if by doing so they are encouraging institutional investors to develop investing capabilities internally and potentially circumvent the traditional passive private equity investor model.

We recently recorded a webinar on Co-Investing for PrivateEquity.com and the Certified Private Equity Professional (CPEP) training program. Our featured guest Julia D. Corelli, a Partner at law firm Pepper Hamilton LLP, shared her insights on the co-investing trend. As Ms. Corelli explained, co-investments occur for a number of reasons. Co-investors may be brought in after the close for strategic reasons, for relationship reasons, or because the portfolio company needs the investment. For example, when a portfolio company requires additional capital, the private equity fund may approach investors and other partners for an injection of capital in the form of a co-investment.

One reason that private equity firms are starting to embrace co-investing is that it is a "necessary evil" for wooing some investors. In many capital raising campaigns, target investors will use the recent fundraising dry spell as an opportunity to bargain for better terms from private equity firms. Investors who are approached by the investor relations or marketing team might see the chance to secure co-investment rights and set that precedent with the private equity fund. This is an important concession to investors, and GPs are more likely to acquiesce if the investor is likely to make a substantial capital commitment in the fund, as well as the additional co-investment, and if the investor is unlikely to participate in the fund without the co-investment rights. Private equity firms are increasingly forced to "pick their poison" as to whether they will allow the co-investment (or substitute other concessions like lowered fees, greater liquidity, more flexibility, etc.) or risk losing a large capital commitment and even the ending of the relationship with that investor. For those funds

who have established a tremendous performance record of late, the decision is likely less difficult because meeting the fundraising target is a fairly easy task.

For one of the many funds that suffered significant losses during the crisis, co-investment rights can even be encouraged to sway wary investors burned by past allocations to the fund. Indeed, co-investment-focused funds have cropped up more as of late, with well-known private equity firms like Pantheon launching funds that encourage co-investments. In November, Pantheon filed documents with the SEC that showed the firm had raised $400 million from 11 investors in its Pantheon Global Co-Investment Opportunities Fund II (AltAssets). It is a difficult time to raise capital for new funds especially, so we have observed many private equity firms turning to co-investments to establish a unique value proposition for investors in hopes of luring away LPs from larger funds which often have less flexibility and stiffer fees. Our team spoke with one private equity firm CEO who was having trouble raising capital from investors and he noted that creating a co-investment vehicle for investors was an attractive option that his team was pursuing in order to draw in reticent LPs and compete for capital with the larger players who may be less likely to accommodate co-investment demand, especially if the investors making the request are smaller. At a recent Family Office Workshop hosted by our sister company, the Family Offices Group, single and multi-family office executives cited co-investments as a very appealing component of any private equity investment, especially for those larger single family offices with an experienced investment team capable of handling the additional responsibilities.

Those private equity firms that have embraced (and even encouraged) co-investments by LPs have been met with an exceedingly positive response from investors and LPs may take co-investment rights and co-investment platforms into account when deciding between different private equity managers. It will be interesting to monitor the success of private equity funds specializing in offering co-investments and there is certainly investor demand.

Club Deals

The term “club deal” is often used interchangeably with co-investments but the two structures are very different. In some ways, a club deal resembles a co-investment and also a direct investment because club deals share characteristics of both types of investments. The practice of club investing has fallen out of favor in recent years among private equity firms but club deals are gaining some popularity with LPs from ultra-wealthy individuals like Michael Dell to sovereign wealth funds like Singapore’s Temasek Holdings.

As we did with co-investments previously, it is helpful to define a club deal. The definition of a club deal (as it relates to this white paper) is an investment made by multiple investors to buy a private business whole or at least acquire a substantial stake in the company. These investments are made

directly in the company and each of the club "members" will contribute capital to the deal and typically receive a proportional share of the profits or losses on the investment. Investors might make the acquisition for strategic reasons, such as when a corporation collaborates with private investors to acquire a competitor or synergistic business. For other club deals, the transactions are essentially private equity deals where the investors identify an attractive buyout target and pool funds between a small number of other LPs to purchase a company with an eye toward selling it again for a profit after several years of improving or expanding the business.

Similar to co-investments, these deals often require a "lead" investor for the investor syndicate. The lead typically sources the deal and performs the necessary valuation, due diligence, and negotiations to complete the deal. In this case, other investors in the club deal are acting more like limited partners in a private equity fund where their primary role is providing capital and their reward is a share in the profits on the deal with a greater portion going to reward the lead investor, even if the deal is a single transaction outside a fund structure. Family offices, sovereign wealth funds, pensions and endowments, and other institutional investors are exploring club deals as a way to lower investing expenses and assume greater control over deals. Club deals, like direct investments and co-investments, allow investors to allocate a specific amount of capital to an investment in a single company. This is an especially attractive feature for LPs who have been frustrated by a lack of discretion over their exposure to the various companies in a private equity fund's portfolio.

There are a numbers of differences between club deals and co-investments. While the structure often varies for co-investments based on a variety of factors, investors in a club deal generally come into the investment under the same structure. Club deals are more pre-meditated, with parties agreeing on terms and structures for the transactions in advance. A co-investment, on the other hand, is often an added feature on a deal and tends to be structured more opportunistically.

A club deal is often defined in the private equity world as a group of private equity funds and other investors who pool their assets to take down a large acquisition. Club deals are most common outside the middle market, where a single fund cannot buyout a large target company and thus multiple parties are needed to finance a deal. These club deals happen with multi-billion dollar acquisitions where several top buyout firms will bid for a company like Hertz, Freescale Semiconductor, ClearChannel, or Energy Future Holdings—to name a few big private equity club deals. In the years leading up to the financial crisis when billion-dollar buyouts were fairly common and financing was more readily available for these "mega deals," private equity firms routinely teamed up to bid on large companies that would be difficult for any one firm to buy.

Investor-led club deals have two noteworthy effects on private equity. First, private equity funds are increasingly bidding against LPs, whether it is a group of LPs or an LP teaming up with a rival buyout fund. For years, large buyout funds had little competition beyond other investment funds and

strategic buyers. Today, buyout funds are seeing more investors—whether individually or as a group in a club deal—chasing the same deals, driving up the acquisition price and occasionally outbidding private equity firms. Furthermore, the element of competition adds a new layer of complexity to LP-GP relations; many LPs large enough to do these club deals have multiple allocations to different buyout firms. It has been the case that an investor finds itself in direct competition for a deal with a private equity fund that the institutional investor has a history with as a limited partner, an uncomfortable situation if nothing else. The second effect on private equity that we would like to highlight here is the allocation of capital by investors to club deals, instead of to a private equity fund as a traditional limited partner. Private equity firms do not appear to be suffering too much in lost capital from club deals to-date but it is important to consider that if this trend continues and more capital is diverted from private equity fund allocations to club deals and direct investments then buyout funds will begin to feel the bite in their fundraising.

LPs have largely opposed private equity firm club deals because many buyout fund club deals resulted in extremely large deals and increased the fund's exposure to a single large deal (especially when an LP had invested in multiple GPs in the deal), rather than diversifying the portfolio across several moderately sized private equity investments. Ironically, the club deal model has now been embraced by a few investors in pursuit of lower fees, greater returns, and more control over investments.

Of course, when an LP is teaming up with a buyout firm on a club deal, there is an advantage for the private equity firm in having a partner on a deal that is not a direct rival. The trend has allowed several large buyout firms to benefit from limited partners' participation in club deals, such as when the Ontario Teachers' Pension Plan and Chicago-based buyout firm Wind Point teamed up for a buyout of Shearer's Foods in 2012 or the 2006 mega-buyout of Hospital Corporation of America by a group of private equity firms and the Frist family clubbed together for a multi-billion dollar acquisition of the hospital company, resulting in the Frist family acquiring a 12 percent stake in the company (Wall Street Journal).

Club deals are a frequent topic in the conversations our company has with investors in recent years and many LPs are still testing the waters, learning more about how club deals are structured, and evaluating the merits of the model. We expect increased club activity as investors become more familiar with club deals and better understand when a club deal makes investing sense. At this point, the complexities and risks involved with club deals have made this structure less attractive to LPs compared to co-investments and direct investments, although it is important to monitor this trend as investors search for alternatives to traditional private equity allocations.

Direct Investments

After years of letting fees cut into the returns from private equity investments, some institutional investors are increasingly looking to direct investments. Direct investments allow the investor to exercise complete control over the investment and manage all of the deal processes internally while keeping all of the profits. For smaller deals, direct investing is an effective way to buy a stake in a middle market company, purchase real estate properties, and make allocations toward unique opportunities. Of course, a direct investment is not exactly a revolutionary concept; investors have been investing directly for centuries. But the financial crisis and the losses on many private equity investments have led some institutional investors to look for returns outside of private equity funds, rather than surrendering a fifth of the profits to a third party manager.

A direct investment, as opposed to co-investments (which are typically passive), requires substantial work by the investor. All of the functions that would be performed by a private equity GP under a traditional private equity investment must now be done by the investor. The investor is responsible for sourcing the deal, a tremendous challenge for any private equity fund and more so for an institutional investor that lacks the fully developed network and contacts that private equity GPs have spent years cultivating. Our firm is often approached by single and multi-family offices, foundations, and wealth managers who are looking for proprietary deal flow for direct investments. LPs are growing their deal channels but this remains an obstacle for many investors.

Another challenge for investors seeking to invest directly in companies is the amount of due diligence work required to effectively make an investment. The valuation process alone can be exceptionally taxing and requires many weeks of high-level work. For smaller investors, it makes little sense to retain expensive and skilled analysts and financial professionals when their deal expertise might only be needed a few months out of the year. Even at the larger pension funds and endowments the costs of retaining private equity professionals in-house can be too high and that work might be outsourced to expensive consulting firms (undermining the logic behind doing investments internally). The valuation and due diligence work are especially tough to swallow if the process does not ultimately lead to an investment, as is frequently the case when screening potential private equity investments. Once an investment is made, the investor then has to take on the constant burden of monitoring the company, evaluating the investment, and working directly with the company's management team to improve performance and make whatever changes are required to generate returns on the investment.

The Ontario Teachers' Pension Plan is one of the most famous examples of a successful direct investment program, having made its first direct investment in private equity in 1991. But even this oft-heralded private equity investor struck out on its very first deal when the company it invested in, White Rose, went bankrupt and the fund lost its whole investment. This was a harsh blow to a first-

time direct investor and illustrates why many private equity professionals warn against direct investing, even by large institutional investors. Fortunately for the Ontario Teachers' Pension Plan, the pension's board allowed the fund to continue its direct investment program and to learn from its first investment. As Jim Leech, President and CEO of the Ontario Teachers' Pension Plan, told a CFA Institute audience in a speech this year, "Perhaps due to the White Rose lesson, we took our time – more than 10 years – in building the talent and infrastructure to prudently invest directly, first in Canada, then the US and now globally." Now, the pension fund is a shining example of the success and rewards for those who manage to make direct investments effectively. The benefits of this program for the Ontario Teachers' fund have been tremendous. The fund can exercise its own risk controls, manage the investments internally, and importantly, the fund achieves exceptional cost savings on its private equity investments. As Mr. Leech explained in his speech:

> . . . One of the key benefits of "going direct" is lower cost. Think about it, a successful private equity investment via a fund will cost the investor 6% per annum. Our private equity costs are way below that and yet our net returns are in the top quartile.
>
> Assuming that the differential is 5%, that means that our $20 billion Private Capital portfolio will, on average, earn an extra billion dollars per annum compared to investing through the best performing funds – enough to pay over 25,000 pensions each year.
>
> Our Internal rate of return on our Teachers' Private Capital direct investment department, for example, is nearly 20%. Why? Because we have our own internal investment deal teams – we have about 50 investment professionals. This means we don't have to rely on high cost, third party fund managers. (OTPP)

Other private equity investors have followed Mr. Leech and his Ontario team's lead in developing a private equity program but, like in the case of the White Rose deal, it may require accepting some trial and error. If an LP is unwilling to invest the time, energy, and money into developing a competitive direct investment program then the investor is better off focusing on fund manager evaluation and due diligence and securing the best possible terms on its private equity allocations.

Challenges to Investors

When presented with this "new era" scenario where co-investments, club deals, and direct investments are increasingly popular with investors, many private equity executives offer a number of reasons why this trend will not result in major changes to private equity funds. For one, co-investments and direct investments are not simple to execute. Private equity funds are paid exceptionally lucrative fees but those fees pay for very real expenses incurred from managing portfolio companies, structuring deals, compensating lawyers and service providers, paying highly

skilled professionals, and many other costs. Investors may avoid paying some fees to private equity managers, but ultimately those savings will be reduced by the cost of managing that alternative investment. Co-investments are typically less expensive for investors because the private equity fund often sources the deal, performs due diligence on the company, and monitors the investment.

Another immense challenge to investors is simply identifying the deals. An investor may not be invested in funds that offer co-investment rights or may not be interested in committing to a co-investment in the funds that do offer this feature. As any private equity executive will tell you, one of the toughest parts of private equity is finding an attractive deal and a willing seller. Our firm works with a number of family offices and they are consistently searching for qualified deal flow in specific sectors and revenue ranges. In many cases, these family offices do not have a consistent pipeline of deals and they often express frustration at their inability to source deals effectively and consistently. We have spent years developing relationships with investment bankers, business executives, industry professionals, and private equity firms to help family offices better access proprietary deals. Co-investments offer investors some access to deals, but it takes many meetings and extensive research to identify attractive deals in the areas that investors really want to allocate capital. Private equity firms continue to have a strong advantage over many investors who are just now developing in-house deal sourcing operations.

The Effects on Buyout Funds

So, are these trends really affecting buyout firms? If you look at the California Public Employees' Retirement System (CalPERS), one of the largest private equity investors in the world, the answer appears to be a definite "yes." Co-investments and direct investments comprise a growing portion of the capital invested in private equity from the California pension's $278 billion in assets under management. According to minutes from a recent CalPERS Investment Committee meeting, the investment team appears to be focusing more on co-investments. Real Desrochers, the senior investment officer heading up private equity for CalPers, recently received approval from the Investment Committee to increase the size of co-investments made by the pension with private equity funds. Mr. Desrochers can now make co-investments equal to the size of the total commitment that CalPERS makes to a fund. CalPERS has also been encouraging other investors to invest alongside the pension fund in many of its private equity and real estate investments. Another change that shows how much CalPERS has expanded beyond only making allocations to private equity funds is that Mr. Desrochers and the Investment Committee have been active in the secondary market with several reported bids this year already. Meanwhile, the pension giant has also continued to improve its direct investing program that allows it to circumvent comingled private equity funds altogether (Pensions & Investments).

For a buyout fund that has grown reliant on institutional investors like CalPERS to anchor its private equity funds, it is an unsettling evolution to see CalPERS buying up stakes in past funds, seeking co-investment rights, clubbing with other LPs, and investing directly. Still, it would be wrong to suggest that all investors are leaving private equity funds for co-investments and other options. Fundraising has been significantly lower in the years since the financial crisis but the larger, established private equity funds have still been able to raise large pools of capital for new funds. Indeed, many of the top players in private equity and a number of smaller, middle market and sector-specialized buyout shops have had tremendous success raising capital post-financial crisis. For example, Blackstone years raising capital for Blackstone Capital Partners VI LP, its latest "mega fund", with a close of $16 billion in 2012—a remarkable achievement in a difficult fundraising cycle. Blackstone has also had success raising multi-billion dollar funds for energy-focused investments and real estate investments (Business Insider). European rival, Apax Partners LLP, announced in June 2013 that it had raised $7.5 billion for its private equity fund, Apax VIII. Although the Apax fund fell short of its lofty $11 .8 billion target, the capital haul showed that many institutional investors remain faithful to the bigger buyout shops (Apax Partners).

It is difficult to determine the significance of co-investments rights in negotiating these capital commitments, but investors are increasingly pushing for flexibility from buyout firms on this and several other investing terms. The uptick in LP-led direct investment activity and interest in alternatives to private equity fund investments will certainly have a noticeable effect on private equity in the coming years. The challenge will fall to private equity firms to outperform these less experienced investors and reinforce the private equity model's reputation for delivering strong returns above more traditional investments.

Conclusion

After years of mixed performance amid a tough investing climate, private equity funds are now poised for a positive investing window. In 2012 and 2013, the booming stock market and recovering economies in the U.S. and abroad have pushed up valuations and allowed a number of buyout firms to exit investments and distribute profits to investors finally. While the billions of dollars in dry powder held by private equity funds remain a concern, there are signs that private equity is emerging from its financial crisis hangover. There are a number of encouraging trends for private equity including: a number of large buyouts, billion-dollar portfolio company exits, successful initial public offerings by private equity-backed companies, and the renewed interest from investors, especially public pensions looking to recover recession-era losses.

In discussing direct investments with investment bankers and private equity veterans, many of these professionals see a common ground that can benefit both LPs and GPs. As one buyout CEO put it, "We have the expertise doing deals; they have the capital and the interest." Investors often lack confidence in doing deals outside of a fund because there is a fear that they will miss a red flag in the due diligence process, bungle the deal terms, become exposed to unforeseen risks, or run into any number of other problems that buyout firms have spent years learning to avoid. Investment bankers and private equity firms can assist in structuring these deals and help assuage these concerns for LPs.

From a private equity professional's perspective, it makes sense to act as an advisor or partner on a direct investment because private equity firms structure and execute deals all the time. If a buyout fund can develop a positive relationship working with investors on a deal-by-deal basis, there is the potential for future partnerships. Very rarely do we find an LP that exclusively invests directly without any allocations to private equity so firms can get in the door by advising on an LP's direct investments and then there is a better chance the LP will consider the private equity fund in the future or at least advisory work. Furthermore, an LP is more likely to refer deals to these private equity firms. One of the biggest challenges in private equity is sourcing attractive deals and finding those deals before rival buyout firms. Institutional investors are pitched deals constantly and a network of LPs willing to refer these potential investments is a tremendous advantage for any private equity firm.

Ultimately, the threat posed by these trends is not life-threatening for the private equity industry and the effects of co-investments, direct investments and club deals on buyout funds will largely be determined by how these firms react to "the New Era." As we have reported in this white paper, there are numerous examples of private equity GPs embracing the changing landscape whether it is by bringing in an institutional investor on a club deal or offering a co-investment vehicle to accommodate interested investors. The demand for co-investments, direct investment deals, and club deals will continue to grow and private equity firms will learn to live with this new reality. In the end, most investors will continue to allocate capital to the private equity firms that execute complex

deals in multiple industries every year while co-investments, club deals and direct investments will only make up a small portion of the portfolio.

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