

## The seven sins of private equity co-investing

**Co-investing programmes can be important drivers of financial success for limited partners, but they come with myriad risks, including relying too much on the judgment and analysis of the general partner, writes Steve Moseley.**

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Private equity co-investing is a strategy rich in both promise and peril. Promise stems from the opportunity to invest in some of the best private investments led by the best sponsors in their core areas of expertise. And instead of paying a premium for this access, co-investors avoid some of every LPs' adversaries: fat fees, a persistent J-curve and blind-pool risk.

Co-investing's fundamental peril, of course, also exists to varying degrees in all investments: the gut-churning possibility of capital loss.

Only a handful of investors have succeeded consistently in co-investments and they have done so by applying varied resources and customised strategies. Unsuccessful co-investment programmes, on the other hand, are disturbingly common and share a small number of mistakes. With this in mind below is a catalog of some of co-investing's most popular blunders:

**1. Relying on fund investment team and process.** Co-investments and fund commitments are terrifically complementary but fundamentally different. Accordingly, consistent execution requires fundamentally different human capital. Consider the assignment: co-investments normally represent a direct equity interest in an operating company; that company is likely to be a complicated business facing a period of challenge and change. The analytical timeframe will normally be compressed into a few busy weeks and all key research and reference resources need to be ready in advance.



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**2. Relying on GP.** Co-investing does not entail blind pool risk and co-investment programmes do not benefit from blindness. It's certainly important to choose investment partners wisely but you should not substitute their judgment for your own. The better approach to co-investments is typically to piggyback off the data and analysis accumulated by the GP while remembering that their priorities will not match yours. An ability and willingness to apply your own incremental layer of due diligence can also reduce overall portfolio risk.

**3. Forgetting the "L" in LP.** Don't expect to restart the due diligence process or alter deal timing. Don't expect advantaged prices or terms. You should, however, expect customary minority shareholder protections and you should strive towards near-perfect alignment of interests.

**4. Building PE programmes around co-investments.** Co-investments, like chocolate cake, can be wonderful in moderation and harmful in excess. The tremendous synergy between fund investing and co-investing and, similarly, between GPs and LPs, tends to erode when co-investments exceed 10 percent of total commitments. Too much of a good thing is a bad thing.

**5. Waiting for the perfect deal.** First, good things may not come to those who wait. A co-investor should instead identify portfolio objectives, determine the needs of targeted GPs, and hunt for the most suitable deals. Second, perfection is fiction. If a deal seems perfect you are overlooking its flaws (see #6).

**6. Expecting only winners.** You will be disappointed. Worse, unrealistic expectations can be quickly deflated and institutional disappointments are often followed by periods of zero capital deployment. The pace of deployment, however, should not be determined by the quality of your last deal, but by your portfolio requirements and your deal prospects. Empirically speaking, an institutional investment process subject to oscillating commitment tends to deploy investment capital at the wrong times. Without boom time success to offset doom time challenges, long-term performance suffers.

**7. Betting big.** Mark Twain advised his readers to "put all your eggs in one basket and then watch that basket". Yet as it relates to investments and this is especially important to institutional asset managers who want to remain employed history suggests that prudent diversification is the wiser approach. In fact, diversification is the easiest win in the investment business. Co-investors should also anticipate realistically the time required before, during and after capital deployment. Note that even without board seats, a diversified co-investment portfolio requires considerable and unpredictable ongoing effort.

Today, many of the most active private equity co-investors have been sidelined by illiquidity and regulation. At the same time, several factors (including the increasingly apparent limitations of club deals) have increased demand from GPs for capable co-investment partners.

This imbalance, plus a growing recognition of the benefits of a well-executed co-investment programme (reduced fees, greater transparency, demonstrable alpha, etc.), will undoubtedly attract co-investors. Some will flourish and some will fail. And although there are many paths to investment success, it is safe to assume that those who ignore the past are more likely to lose their way going forward.

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