Institutional Investors Co-Investment

Over the last few years, we have been building up our clients' allocation to private investments. BigSur believes that traditional asset classes (stocks, bonds, cash) will have lower performance going forward and that "non-traditional" and illiquid asset classes offer investors intrinsic value, especially in a QE world, where easy money has significantly inflated prices of liquid assets. In our Thinking Man #22, published in September 2014, we explored this concept and analyzed five of the largest global banks' return expectations on different assets classes. Across the board, we found equity return forecasts over the next 5 years to be between 5-7% per annum and high grade bonds forecasted to return 1-2% per annum. Using this information and a financial model, our Investment Committee estimated that a traditional portfolio with no "non-traditional" exposure would likely return around 4-5% per annum over the next 10 years vs. 6-7% per annum for a portfolio with 15-25% exposure to "non-traditional" assets.

Over the last few years, we have studied "non-traditional" assets and also the strategies, allocations and investments of high quality institutional investors (i.e. sovereign wealth funds, endowments and pensions), who have been investing in these types of assets for decades. In the last few years, co-investments have become an increasingly important part of these large and sophisticated investors' portfolios. On the spectrum of "non-traditional" assets, co-investments offer outsized return potential, making them an interesting asset type to evaluate for our client portfolios. In this month's Thinking Man, we go through a Q&A on co-investing.

What are co-investments?

A co-investment is a minority investment made directly into an operating company, alongside a financial sponsor or other private equity investor in a leveraged buyout, recapitalization or growth capital transaction.

They are essentially direct investments made alongside a private equity or debt fund in one of the fund's underlying investments. These direct investments are typically offered to existing Limited Partners (LP) of the fund, who is invested to participate in the transaction by the General Partner (GP) of the private equity or debt partnership. Effectively, the co-investing LP becomes a small minority investor in the transaction led by the GP.

The Thinking Man's Approach

March 2016 | Series #39
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This month's Thinking Man is a primer on co-investments, as this strategy will both be an added source of value to our client portfolios and a differentiation of BigSur's offering. In the end, we find ourselves getting good access to co-investment deal flow for a simple reason: we are good LPs and the GPs like us. Co-investing in high quality deals is typically reserved for much larger institutional investors. So why do these GPs invite us? Because BigSur is diligent with our follow up, ask questions that show depth and understanding of the opportunity, spend time getting to know the GPs on an on-going basis, and are quick to take action.

For more on how we are positioning our portfolios, please contact your investment advisor or email:

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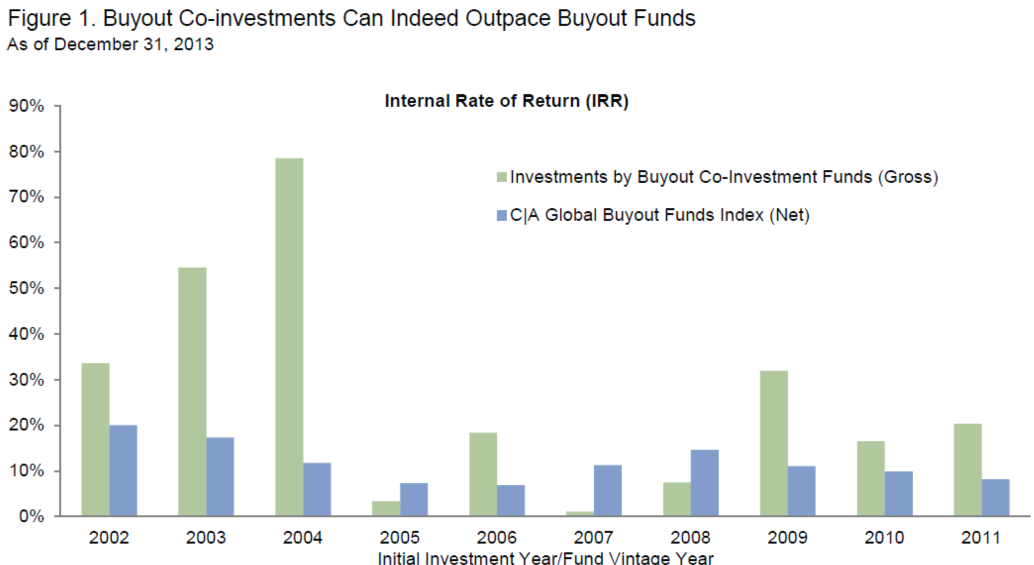
Co-investment opportunities are usually offered by GPs to those significant and experienced LPs or investors that have contributed a significant amount of capital to the fund or prior funds. Not every transaction that the fund makes may have a co-investment opportunity; these typically occur when the private equity fund cannot invest the full amount required in the transaction due to concentration or diversification restrictions. In other cases, the GP may know that LPs have appetite for co-investments, and if they know there is interest in a particular investment from LPs, may plan to size the transaction accordingly.

What are the benefits of co-investments?

Many institutional investors are looking to increase their allocation to co-investments/directs as these investment have shown higher returns than other typical buyout funds. The below chart shows the return profile of co-investments in a study done by Cambridge Associates. The average return spread between dedicated co-investment funds IRRs and general buyout fund IRRs has

Chart 1: Buyout Co-Investments outperform General Buyout Funds



Source: Cambridge Associates

historically been significant, averaging about 24%, with a range from 7% to 67%.[1]

Part of the higher returns of these investments is due to the fact that co-investments lower the aggregate fee burden to investors. LPs typically do not pay a management fee (typically between 75 – 150bps) or a performance fee (typically between 10-15% on an 8% preferred hurdle) on co-investments. Thus far, all of the private equity and debt managers BigSur invests with do not charge their LPs to co-invest. Another benefit to co-investing is that the capital is immediately committed and drawn, which allows for an element of investment timing. This allows investors to take advantages that came up opportunistically – and also better assess if they can take on additional

[1] Andrea Auerbach, Priya Pradhan, Christine Cheong and Rohan Dutt ,"Making Waves: The Cresting Co-Investment Opportunity," Cambridge Associates, 2015.

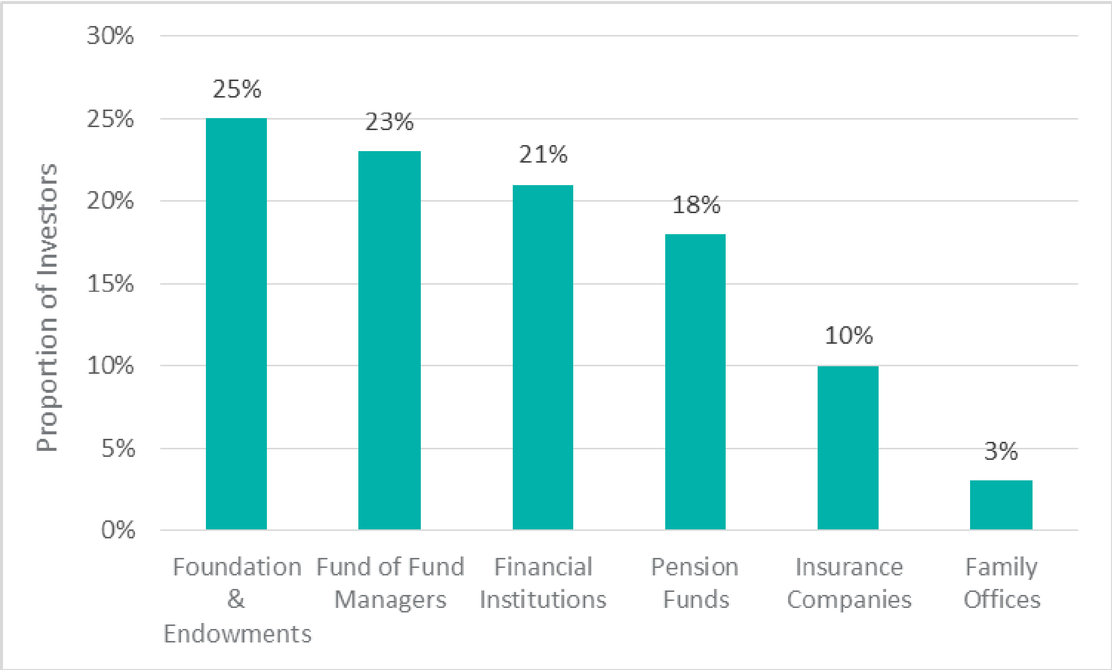
exposure at a certain point in time, or to take on more exposure to a transaction they may have high conviction in.
Co-investing also offers LPs the opportunity to become better investors: through co-investing the investor may gain experience in structuring, monitoring, and exiting private equity or debt transactions. All of these can help to better select private investments in the future.

Another key benefit of co-investing is collaboration. When we co-invest alongside other institutional investors or significant families, we've notice more often than not, we share similar values. There also seems to be a consistent group of top-tiered investors who have a history of co-investing alongside each other, similar to a "Club of Investors". Through some of our existing investments, we've started to join this "Club of Investors" and are sharing best practices with these top-tiered investors. Overtime, through collaboration we can improve the quality of our access to deal flow.

Who is investing in co-investments?

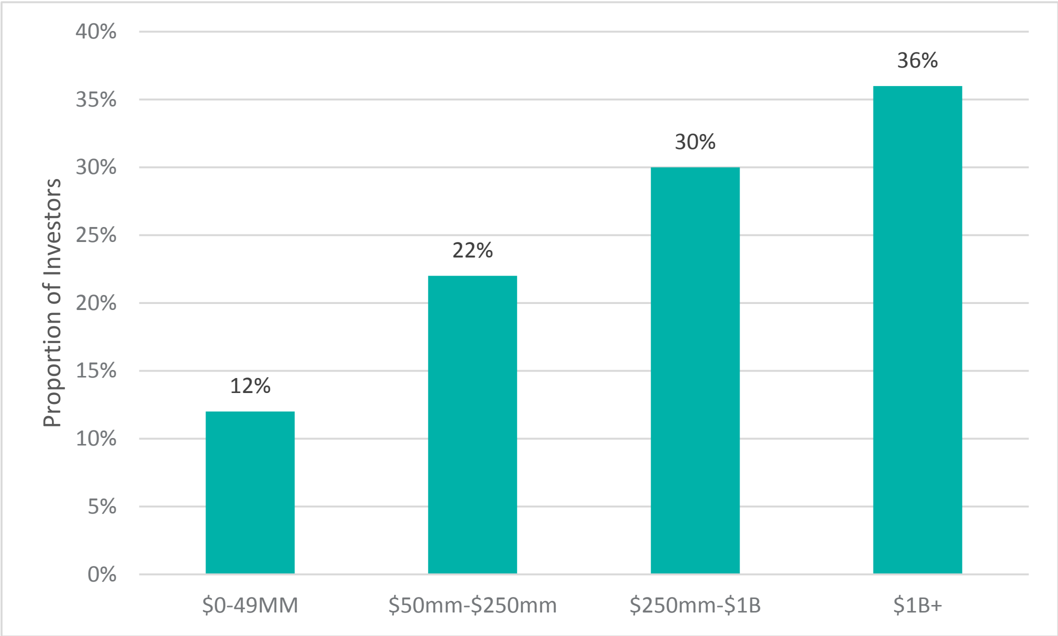
The benefits of co-investing have led many of the most sophisticated and large institutional investors to make co-investments an important part of their strategy. In a special report, "LP Appetite for Private Equity Co-Investments," Preqin, the most extensive private equity data and research provider, put together information on the type and size of the investors who are making co-investments. You can see from Charts 2 below that Family Offices are still very new to co-investing, only representing 3% of the participation. Chart 3 shows that the majority of co-investments have been done by very large entities, which is largely attributed to the fact that the largest LPs often get the most access to deal flow.

Chart 2: Breakdown of LPs with an Appetite for Co-Investments by LP Type



Source: Preqin

Chart 3: Breakdown of LPs with an Appetite for Co-Investments by AUM



Source: Preqin

Risks to Co-Investing

There are of course risks to co-investing. One is the short time horizon that investors have to analyze the deal – most often, the GP shows several LPs the deal, and allocation is somewhat on a first come, first serve basis. This leaves a two week or one month turnaround time for investors to analyze the opportunity. For BigSur, this means that we will only co-invest with LPs that we have an "open book" policy – those that will share all of their own internal and proprietary due diligence materials and memos. We don't have the time or capacity to do this research ourselves; instead we leverage off of the expertise and extensive work that our GPs are doing. They are the specialists in the space and they are often evaluating these deals for months at a time.

The timing of when an investor will be offered co-investments is often unpredictable, which can make building a co-investment strategy difficult. Deal flow can be hot or cold – depending on several micro and macro factors. A great co-investment may come at a time when cash flow is limited or deals may be scarce when there is an abundance of cash. Taking this into consideration, we find it very important that investors use this as an opportunistic strategy – and not a core building block of a portfolio.

Finally, there is concentration risk when making co-investments. Investors are taking exposure to individual deals, so there is lopsided risk on the upside and downside. If a transaction does very well, it can generate outsized returns; if it does poorly, it can have a large negative impact. What becomes very important then, is that the size of the investment is appropriate for the client's portfolio and that the investors feel very comfortable with the particular co-investment they are investing in.

Conclusion: BigSur's Strategy on Co-Investing

Part of our philosophy is to bring our client's to the "cutting edge" of the investment industry, and also to track the best practices of top investors. Given that co-investments have become a more important part of large and sophisticated investor's strategy - and that we are working to get deal flow from institutional quality and top tier GPs that have an "open book" policy with us - we believe this is an opportunistic strategy that can add value to a client's portfolio.

We have already been co-investing with large pension funds on the real estate side, and to date have invested in 11 transactions. We have been evaluating a specific co-investment opportunity sourced by a private debt manager we invest with. This represents our first non-real estate private opportunity. We will likely close this transaction in the next weeks.

We are one of three co-investors in this transaction; the others are two of the largest US insurance companies (each managing hundreds of billions of dollars). We are excited to be offered a co-investment alongside these LPs who are a much larger size and experience in co-investing.

In the end, we find ourselves getting good access to co-investment deal flow for a simple reason: we are good LPs and the GPs like us. These deals are typically reserved for much larger investors. So why do these GPs invite us? Because BigSur is diligent with our follow up, ask questions that show depth and understanding of the opportunity, spend time getting to know the GPs on an on-going basis, and are quick to take action. GPs usually justify our participation because we are often the only private wealth or family office investors in the roster of LPs for that specific manager, and many times, the only institution representing Latin American investors. This is key differentiation of BigSur's offering.

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