PE Hub

By: Michael Schoeck
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Cambridge Associates: Co-investing with LPs can help GPs buy and build

Co-investments are on the rise in many sectors, including software, infrastructure and financial services.

Co-investments between limited partners and general partners have grown in recent years. In 2022, private equity co-investment activity totaled about $50 billion, according to Cambridge Associates. The Boston investment, advisory and research firm recently published a white paper called Six Things to Know About Co-investments, written by Scott Martin, Nick Warmingham and Jacquelyn Klehm.

For GPs, there are three primary reasons to offer co-investments, according to the white paper. "First, using LP co-investment capital enables GPs to better manage concentration risk and control the pace of deployment of their fund. Second, LP co-investment may also allow a GP to acquire larger assets. This is particularly helpful to GPs that employ a buy-and-build strategy. In these situations, a portion of a co-investor's commitment is drawn at the outset to acquire the 'platform' and the remainder is reserved for future add-on opportunities. Finally, LPs are asking for co-investment and GPs want to keep them happy or risk losing a future LP fund commitment."

For LPs, the primary benefits are lower fees, more involvement in portfolio management and better understanding of the GP's sourcing and due diligence process.

PE Hub spoke with Martin, who serves as managing director, to learn more.

Scott Martin, Cambridge Associates

Why are co-investments on the rise?

Co-investments can be episodic. The last time they were used was pre-great financial crisis. People have now started to lean into them in both thoughtful and programmatic ways. In terms of how GPs are using them, they're using them because of the slowdown in M&A activity. It's more costly to do deals and it's beneficial to the LP with co-investing more likely to re-up between fund managers.

You have LPs that want co-investments and, with the market being more saturated with debt fueling transactions, it's more expensive overall. Secondly, co-investments facilitate buy and build strategy deals. A GP will go to the LP and say, "we need more capital now, and some reserved for later." We're seeing continued momentum in this regard.

Which sectors are seeing a lot of co-investments?

We are seeing strong deal activity in software, all types, because of high cashflow and lots of recurring capital returns. We're seeing it in infrastructure as well, like road maintenance, wastewater treatment transactions. We've seen financial services transactions, like insurance. And there have also been co-investments in education, training nurses in key areas, as well as advertising and marketing services – not just a technology looking for clicks, but looking for buying decisions, something that directs people online to a mutual fund or credit card, for instance, that has tangible ROIs.

What about deal size?

We're seeing activity take place within growth equity and middle market co-investments from $100 million to about $1 billion.

PE investors with large investment portfolios (greater than $1 billion of net asset value) will likely have a sufficient number of GP relationships that are more likely to have significant LPs in funds such that GPs will oblige when they start asking to see co-investments. For smaller investors with portfolios below $200 million of NAV, sourcing sufficient co-investment dealflow can be more difficult.

For co-investments, Cambridge recommends setting a target range for tactical flexibility since transaction are opportunistic in nature.

For more on co-investing from the LP perspective, see affiliate title Buyouts' recent story.

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