THOUGHT LEADERSHIP
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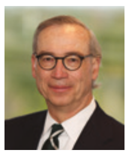
BLACKROCK PRIVATE EQUITY PARTNERS

The Advantages of Co-Investments



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What are co-investments?
Minority investments directly in companies alongside lead sponsors

BlackRock Private Equity Partners has invested over $6.5 billion in 177 direct co-investments since its inception in 1999[1]

Summary

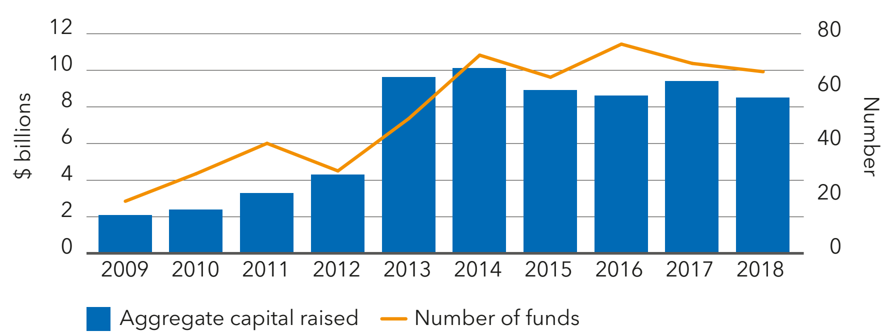
Private equity co-investing is on the rise. Co-investing offers sophisticated institutional and high net-worth investors the opportunity to gain greater exposure to attractive assets but at lower fees—thus squeezing out fatter returns.

Since 2000, over $104 billion has been raised in co-investment funds across a total of 662 funds—with a remarkable increase in the past six years, as shown in Figure 1.

The trend isn't stopping anytime soon: Co-investments were offered by 64% of fund managers in 2017, an increase of seven percentage points over 2016 and 12 over 2015[2], indicating General Partners are responding to Limited Partner demand for co-investments.

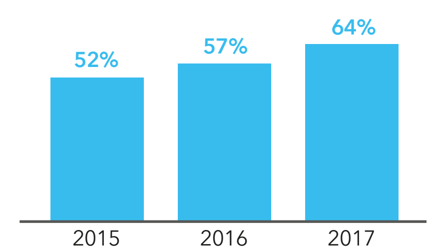
Figure 1: The development of the co-investment market:

Aggregate capital raised and number of funds by year



Source: Preqin – Historical Private Equity Fundraising Statistics (co-investment and co-investment multi-manager) derived on 29 January 2019.

Fund managers offering co-investments



Source: Preqin – 2018 Global Private Equity & Venture Capital Report, derived on 29 January 2019.

1 As of 30 June 2018.
2 Preqin – 2018 Global Private Equity & Venture Capital Report derived on 29 January 2019.

Like any trend, it's worth asking: Are the returns worth the hype? And what are the best practices to take full advantage of co-investments? Key takeaways:

- Institutional LPs looking to co-invest are better off outsourcing this capability to co-investment managers. Such managers are staffed with experienced investment and legal professionals—and have access to diversified deal flow.
- A recent study based on a bigger sample of the co-investment universe found that they outperform traditional direct funds, debunking other surveys suggesting adverse selection.
- Our work shows that incorporating co-investments in a diversified private equity program yields significant fee savings compared with a program only consisting of direct funds.
- Successful co-investors focus on companies with good fundamentals and don't attempt to time. Scoping out the potential for creating fundamental value is key to achieving the returns that make private equity attractive.
- BlackRock PEP currently has conviction in the following sectors: corporate roll-ups, healthcare, disruptive technologies and e-commerce models as well as corporate carve-outs.

Benefits and challenges of co-investing

The post-crisis evolution of the private equity industry has seen demand for co-investment capital gain major momentum.

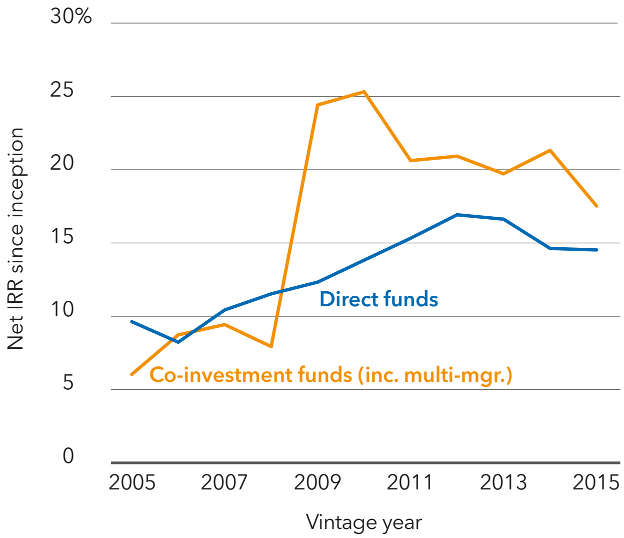
GPs were hard-pressed to meet fundraising goals during the financial crisis. As a result, co-investment rights were used as a go-to fundraising tactic to attract LPs. At the same time, GPs were increasingly looking to "friendly" LP capital in the form of co-investment rather than "clubbing" deals with other GPs. Many club deals resulted in poor outcomes as GPs faced big challenges working together while navigating distressed mega deals through the troubled waters of the crisis.

The potential for higher returns and fee savings (more ahead) drove the popularity of co-investments over the past decade. Co-investing also offers the ability to deploy capital at a faster rate while potentially mitigating the J-curve. Based on internal simulations, BlackRock estimates a co-investment allocation of 20-30% can reduce the J-curve by 12-18 months. From a more qualitative perspective, co-investing provides LPs a "peek behind the curtain," allowing a better understanding of a GP's sourcing capability and operational skill—thereby providing enhanced primary fund intelligence. In an industry where transparency is scarce, LPs capable of transacting in co-investments enjoy this superior access into a GP's inner workings together with the opportunity to generate future deal flow.

Still, co-investing requires a broad skillset and, if done correctly, deep resources. Investment opportunities are often presented with tight timeframes, sometimes just weeks before a final decision. As such, the ability to ramp up diligence quickly and thoroughly is even more critical in today's market. Once a decision is made to invest, an experienced legal team is essential for reviewing and negotiating the terms of the transaction. LPs need to be as aligned as possible with GPs in order to protect their stakes from potential complications. Upon closing, time needs to be devoted to regularly engaging with the lead GP and attending board meetings.

The resources and expertise required to execute co-investments are typically too costly and time-consuming for most institutional LPs, thus making proper in-house co-investing difficult for most. A more cost-efficient solution is to outsource the co-investment portion of a program to a co-investment manager with deep expertise and access. BlackRock Private Equity Partners has been an active co-investor since its inception in 1999, managing co-investments on behalf of institutional clients through commingled and separate account programs. Co-investment managers such as BlackRock not only have the aforementioned resources to properly diligence and swiftly execute deals, but may offer LPs a co-investment portfolio with more diversification and lower risk than a traditional direct private equity fund.

Figure 2: Private equity median net IRRs by vintage year: Co-investment vs. direct funds*



* Direct funds include buyout, venture capital, growth, turnaround, balanced and direct secondaries. Source: Preqin, derived on 29 January 2019.

Do co-investments pay off?: A look at outperformance

Based on Preqin's performance data, co-investment funds have outperformed direct private equity funds based on median net IRR since 2009.

While some studies tout the benefits of the practice[4], others claim that co-investments underperform compared with fund counterparts due to deliberate adverse selection by the GP. This doesn't quite add up: GPs often use co-investments to strengthen relationships with LPs. It thus seems unlikely that a GP would explicitly select investments which would perform poorly.

Such critical studies appear to be based on small and unrepresentative samples. However, a study with a more robust methodology presented at the 2015 Oxford private equity risk symposium finds that co-investments substantially outperform traditional private equity funds.

Figure 3 below tabulates performance of private equity deals by co-investments and non-co-investments. The study shows the Kaplan-Schoar PME ratio, a metric that compares private equity returns to that of public equity. Outperformance is indicated when this ratio is greater than 1.00.

Both the equally weighted mean and median are slightly higher for the co-investment universe, indicating higher outperformance. This trend persists when capital weighting this performance as shown in the far right column. Lastly, the standard deviation for co-investments is smaller compared to that of non-co-investments despite having a significantly smaller sample set. Our verdict is that the gross returns of co-investments are at par with deals that are not offered for co-investing.

Figure 3: Gross KS-PME ratio for co-investments and non-co-investments (Deals not offered for co-investing)

		Gross KS-PME ratio (unweighted)			Gross PME (weighted)
	Observations	Mean	Median	SD	Mean
All deals	5,764	1.70	1.14	2.15	1.60
Co-investments	365	1.76	1.16	2.10	1.76
Non-co-investments	5,399	1.70	1.13	2.15	1.59

Source: Braun, R.; Jenkinson, T., Schemmerl, C. Adverse selection and the performance of private equity co-investments. Working paper presented at Oxford private equity risk symposium 2015. The Kaplan Schoar-PME is calculated by discounting private equity fund cash flows by the public market index value. The discounted distributions plus the current remaining value are divided by the discounted contributions to obtain the ratio. Private equity outperformance is indicated if the ratio is greater than 1.00.

4 Cambridge Associates, Making Waves: The Cresting Co-investment Opportunity 2015. Past performance is not indicative of future results.

Do co-investments pay off?: The impact of fees

Investors are increasingly enticed by co-investments' potential for higher expected returns, which is largely a function of lower fees. A crucial difference between co-investment funds and traditional private equity funds is the economics behind the two transaction types.

Typically the economics of a traditional fund include a 2.0% management fee and 20% sharing of profit, known as carried interest.

Providers offer co-investment funds at significantly lower fees—for example, a 0.75%-1.50% management fee and 10%-15% carried interest. Providers not only charge lower management fees and carried interest but also offer risk management benefits, such as active portfolio construction and diversification.

Figure 4 shows the hypothetical capital distribution breakdown of a traditional fund versus a co-investment fund. The left column shows the economics of a typical fund with gross underlying deal performance of 2.0x. A third of the profits go to the GP via the management fee and/or carried interest. The right column shows the costs for a co-investment fund are substantially lower—in fact, less than half.

Looking more closely, the management fee reduces by two-thirds and the carried interest halves compared to investing in a traditional fund.

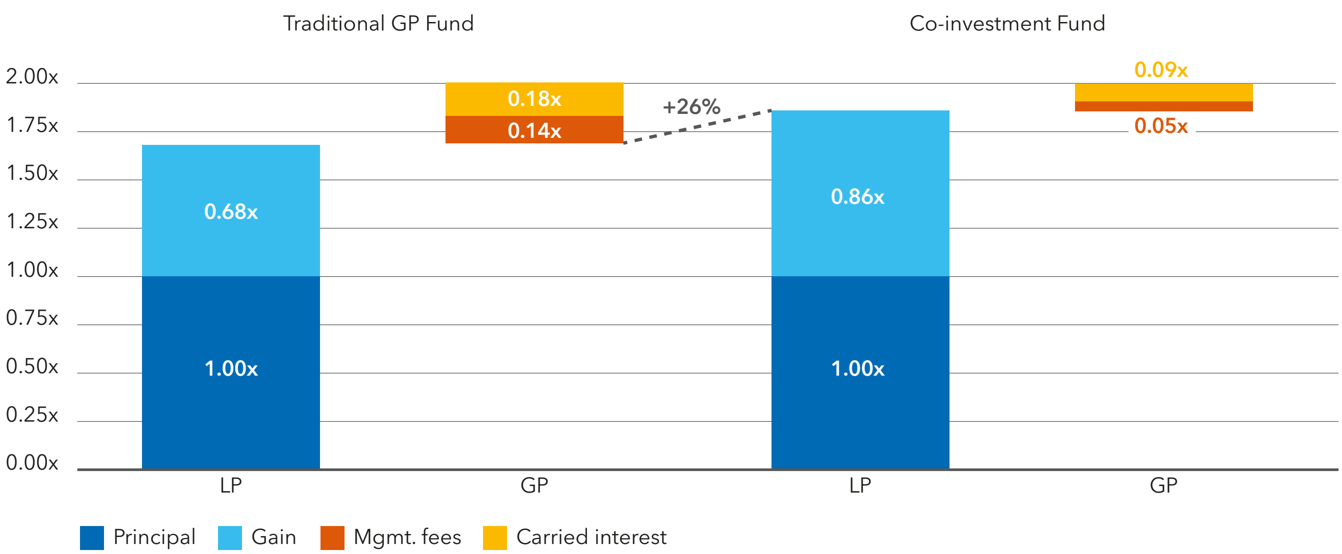
Assuming the same gross deal performance, these reduced costs result in higher net performance for the LP. In this case the gain to the investor increases by 26%.

Creating a diversified private equity program is essential for any institutional investor trying to mitigate risk. Figure 5 on the next page shows the fee savings by gradually replacing traditional private equity funds with co-investment funds.

For a moderate co-investment allocation of 20%, we find savings of $3.6 million in management fees and carried interest over the life of a diversified private equity program. For a program with 50% co-investments, potential savings are estimated to be $9.1 million—a substantial figure for a $100 million commitment.

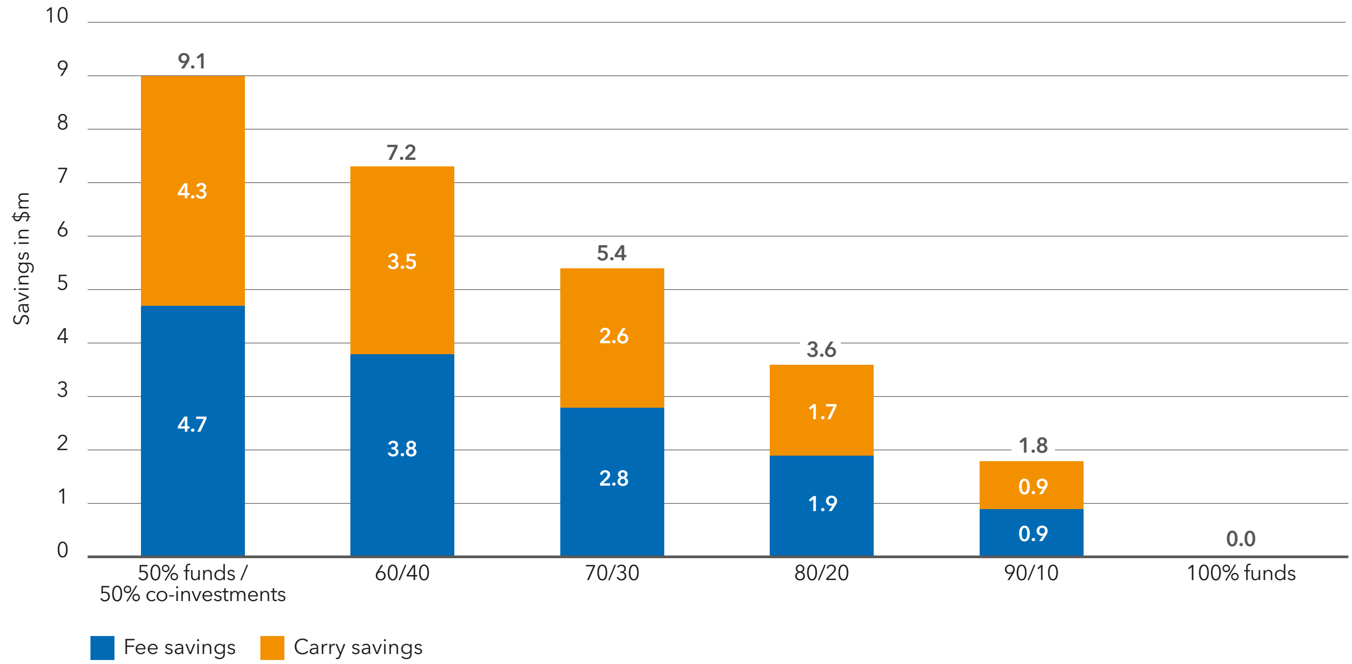
These differentiating economics combined with the same gross deal returns, as shown in Figure 3—undoubtedly form the main reason for the increasing appetite in co-investments.

Figure 4: Distribution of capital comparing a traditional GP fund and co-investment fund based on a 2.0x total return



Source: BlackRock Private Equity Partners. Gross deal level returns = 2.0x. Fund terms: 2% fee, 20% carry deal-by-deal, 8% hurdle. Co-investments terms: 0.75% fee, 10% carry European, 8% hurdle. Calculations based on $100m program and represent life-time estimates. For illustrative purposes only. Does not represent an actual product. It cannot be guaranteed that similar savings will be achieved in the future.

Figure 5: Simulating cost savings ranging from 100% funds to a balanced program ($100m commitment)



Source: BlackRock Private Equity Partners. Gross deal level returns = 2.0x. Fund terms: 2% fee, 20% carry deal-by-deal, 8% hurdle. Co-investments terms: 0.75% fee, 10% carry European, 8% hurdle. Calculations based on $100m program and represent life-time estimates. Does not represent an actual product. It cannot be guaranteed that similar savings will be achieved in the future.

Why "timing" doesn't work

We believe that good and bad investment opportunities exist in all markets. Yet all too often we hear of investors attempting to "time" the private equity market. This concept is difficult to execute in any asset class, let alone private equity, given the long lead-times for deploying capital and the long holding period for most investments.

When investors place undue emphasis on timing, they deviate from a programmatic investment approach—creating a bigger risk of missing out on opportunities or generating poor results. Successful co-investors focus not on timing, but rather on a rigorous and independent approach to assessing asset fundamentals—with an eye toward the potential for value creation. Implementing such a strategy means working with GPs who have expertise in specific industries and a strong track record of execution through previous market cycles.

That's not to say that market conditions aren't an important investment factor. Proper discipline at all points in the private equity investment cycle is critical. A co-investor who pays too much for a company with good fundamentals is no better off than an investor who tried to time the market.

Attractive themes and sectors

Although high market valuations remain the status quo, we believe there are markets and sectors that can deliver significant value in the current environment. Below, we indicate four promising sectors where we have strong conviction due to market conditions and macroeconomic factors:

Corporate roll-ups: Corporate roll-ups typically involve acquiring smaller players at discounted multiples, which ultimately seek to reduce operating costs by leveraging economies of scale. These opportunities often materialize during economic downturns or when a market or sector reaches maturity. The most successful corporate roll-up deals occur in fragmented industries lacking a dominant player. We recently invested in a leading provider of testing, inspection and certification (TIC) services mainly focused on consumer goods. Acquisition and consolidation has been an ongoing trend in global TIC over the past two decades to achieve greater scale and efficiency. The company will seek to fund both smaller bolt-on and large transformational acquisitions in the future.

Healthcare: Healthcare remains an exciting sector due to a demand for cost-reducing innovations from across the market, including drug-makers, medical devices and service providers. Particularly in the US, there is an increased need for value-based services and lower-cost alternatives as healthcare spending continues to rise but increasingly fall on the shoulders of consumers rather than employers. Healthcare offers a wealth of growth opportunities to address market inefficiencies, whether specialty pharmaceuticals addressing drug pricing pressures or healthcare IT creating mobile technologies for health professionals. Our own portfolio reflects these ongoing themes. This includes investments in a provider of payment accuracy solutions for the healthcare space and a provider of market-leading prescription and consumer healthcare products.

Disruptive technologies and e-commerce business models: With the ongoing global shift to e-commerce, companies that rely on disruptive technologies and e-commerce business models hold immense growth potential for the foreseeable future. New technologies provide a significant opportunity to claim market share through first-mover advantages. An example of this is a recent co-investment we made in a highly scalable, next-gen data storage and management solution. Furthermore, we have two co-investments in leading e-commerce players in South Korea and China. Each demonstrates how e-commerce platforms are significant opportunities across sectors and markets.

Corporate carve-outs: Carve-outs have historically been an attractive private equity play, presenting an opportunity for PE owners to drive value creation in what were previously non-strategic assets. Since these types of investments can often be acquired for smaller multiples, carve-outs are particularly attractive in the current high valuation market. Once independent, the business unit can implement the necessary changes to maximize value. An example from our portfolio is a global consumer intelligence and data analytics company which divested from its parent company. As an independent unit, the company is better positioned as a technology-focused big data firm.

Caution and discipline remain essential

In any deals, the key is to stick to an investment discipline and exercise caution on price and leverage—especially in this environment. We believe those who can scope out the potential to create fundamental value in a variety of strategies and sectors are more likely to achieve the types of returns that make private equity attractive. Investing with GPs who have expertise in specific industries and a track record of executing well through market cycles can potentially increase the chance for success.

The above case studies represent the most recent direct co-investments executed by PEP in each respective category as of 30 June 2018. The information above is not a prediction of future performance or any assurance that comparable investment opportunities will be available to the manager at the time of investment.

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