PRIVATE EQUITY & VENTURE CAPITAL
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Co-Investments Aren't Paying Off for Limited Partners

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Abstract—
Limited partners from sea to shining sea have been ramping up co-investment programs, lured by visions of fee-free profits.

Full Article Text—
Limited partners from sea to shining sea have been ramping up co-investment programs, lured by visions of fee-free profits.

But a new paper out from researchers at INSEAD and Harvard Business School indicates that while the returns from co-investments may outpace the performance of the public markets, they aren't necessarily outperforming fund investments.

"Despite the substantial fee discounts, we find little evidence of attractive relative performance by direct investments," wrote the authors, Harvard Professors Josh Lerner and Victoria Ivashina and INSEAD Professor Lily Fang. "In particular, co-investments underperform traditional fund investments."

The authors analyzed data spanning two decades from seven limited partners that invested a combined $23 billion in 391 direct investments. More than 60% of that capital, $14 billion, was directed to co-investments.

Presenting the team's findings at an event Wednesday in New York, Mr. Lerner summed up the issues plaguing co-investments as "bad timing, big deals and bad deals."

"Private equity has this slightly unappealing feature," said Mr. Lerner. "Too much money invested during hot markets."

Co-investments tended to be clustered at those exact wrong moments, he said.

Additionally, co-investments have often been offered in larger deals, which aren't always notorious for knocking it out of the park.

As for direct investments, when a limited partner decided to fly solo versus tag-teaming with a general partner, the research team found that deals with some kind of "home field" advantage were the best performers.

Some solo investments outperformed fund investments, but "the performance of both co-investments and solo investments deteriorates sharply in the 2000s, suggesting that any information advantage may have disappeared as the private equity industry became more competitive," according to the authors.

Returns for direct investments also diminished for limited partners as deals got more complicated or the economy got "messy" as in recent years, Mr. Lerner said.

"This is a first look at this issue," he said. "This is an area where there's enormous interest, but very little evidence surrounding what's going on here."

However, the data set included large institutions with the capabilities to execute on such strategies.

"These were all large institutions," Mr. Lerner said. "If you don't see outperformance here, then this is a touch arena in which to be playing."

FORTUNE
TERM SHEET by Dan Primack

"Random Ramblings"

14 February 2014
Dan Primack

Article Text—
Any time I wonder how a buyout firm can afford to cut a particularly large equity check, the same reply appears: "We've got some LPs interested in co-investment."

This trend seems to have really picked up steam in recent years, particularly as "club deals" have fallen out of favor. But some recent academic research suggests "co-investments underperform traditional fund investments." This is surprising, given that LPs often flock to these deals because of the inherent fee savings.

The study was conducted by Lily Fang (INSEAD), Victoria Ivashina (HBS) and Josh Lerner (HBS). It examined the past 20 years of direct investment by a sample of seven "large institutional investors." From the paper:

"This result also holds when we compare the performance of co-investments to the corresponding fund alongside which the investment takes place. We provide evidence that this underperformance appears to be driven by selection (a "lemons problem"): institutional investors can only co-invest in deals that are available to them. In particular, these transactions appear to be concentrated at times when ex post performance is relatively poor. We find that co-investments deals are also substantially larger than an average sponsor's deal."

It also is worth noting that this underperformance also extends to LP direct investment more broadly. Researchers suggest that such deals once did have superior returns, but that it flipped in the 2000's as many informational advantages disappeared. The draft paper was updated last month, and is available here.