Co-investments: the jewel in the private equity crown

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ASSET MANAGEMENT

This article reflects the opinions of the authors and should not be taken as financial advice or a recommendation to invest.

As can be surmised from this note's title, we are unabashedly pro private equity co-investments. Before digging into why co-investments are the jewel in the private equity (PE) crown, as we claim, a little background on their emergence and growth is in order.

Co-investments really came to light in the wake of the Global Financial Crisis as private equity managers/General Partners (GPs) found it difficult to raise capital for private equity (PE) funds from investors spooked by the events of the time.[1]

Their solution was to turn to co-investments by inviting especially trusted clients/Limited Partners (LPs) to invest with them directly into individual companies, rather than indirectly into companies via traditional PE funds.[2]

The chance to invest directly in hand-picked deals and companies, differs from traditional private equity (PE) funds where investors commit capital without knowing which companies will be acquired.

For LPs, co-investments represent a more targeted allocation of their capital enabling them to have direct access to privately held companies on which they can gain deeper insights than when investing through funds.

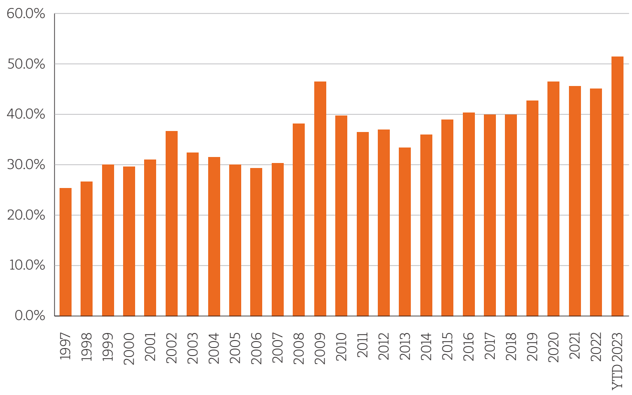
Additionally, co-investments enable LPs to gain a better understanding of a GP's sourcing capability and operational skill, thereby providing valuable intelligence for the future relationship between the parties.

Diversification is a feature of strong co-investment programs with investee companies spanning multiple GPs, countries, and industries.

For GPs, co-investing offers a way of investing in attractive businesses which may be too large for their private equity fund to invest in wholly due to single firm concentration limits. It also allows them to work closely with LPs and build relationships ahead of their next fundraising.

Increasingly, LPs are requiring that GPs offer them co-investments if they are already significant investors in PE funds. With equity contributions for buyout investments at all-time highs in 2023 **(Chart 1)** at over 50% of transaction value (relative to debt), we expect significant co-investment deal flow to continue.

Chart 1: Equity contributions for buyouts at all time-highs
Equity contributions for leveraged buyouts



Source: PitchBook

Minimising the J-curve impact

In our view, co-investments also minimise the J-curve impact – the J-curve being the tendency of PE funds to post negligible returns in their early years and stronger returns in later years as investments mature and value is realised.

Fallow returns in a PE fund's formative years may result from investment costs, management fees, and an investment portfolio dominated by investee companies at the beginning of transformation journeys.

By contrast, co-investments generally accelerate capital deployment and this coupled with typically lower than PE fund fees helps to lessen the J-curve impact.[3]

1 The *advantages of co-investments*, Russ Steenberg, Jeroen Cornel, BlackRock Private Equity Partners, February 2019

2 Ibid

3 *Flattening the J-curve: Private equity strategies to improve investment outcomes*, Darren Spencer, March 14, 2022, **https://russellinvestments.com/us/blog/flattening-j-curve-private-equity-strategies**

Co-investments: the jewel in the private equity crown

June 2024

Our co-investment experience

MLC has been a private equity investor since 1997 and a private equity co-investor since 2007. From the get-go, ours has been a global investment program recognising that the opportunity set beyond Australia was immensely greater than one focused solely on the local market.

Since then, we have built enduring relationships with what we regard as some of the most renowned PE managers, many of whom have shut their doors to new investors, so successful have they been. We are privileged to still be able to invest with this manager suite, and they enjoy working with us.

Relationships and access are key to success in private equity investing because there are large differences between long-term returns delivered by strong-performing PE managers, compared to their lower-performing industry peers. In other words, manager selection is pivotal in private equity.

Indeed, return differences between managers in the top compared to bottom quartiles of performance expanded through the COVID period **(Chart 2, on the next page)**.

For the decade to the end of 2019, there was an 18% net internal rate of return (IRR) difference between the top and bottom quartile PE managers: top quartile returns averaged 30% IRR; the bottom quartile averaged 12% IRR **(Chart 2, on the next page)**.

In 2020, the top versus bottom quartile IRR performance difference blew out to 22%: the top quartile averaged 29% IRR; the bottom quartile averaged 7% IRR **(Chart 2, on the next page)**.

The performance gap was even more stark in 2021 with the top quartile credited with 21% IRR, while the bottom quartile sunk to -9% IRR, a 30% difference **(Chart 2, on the next page)**.

We believe the net IRR performance gap between the top and bottom-quartile private equity managers widened during the COVID impacted years as top-drawer managers sold as many assets as possible capitalising on low interest rates and high valuations, a large buyer universe, and strong deal activity.

We also observed top-drawer managers reacting quickly during the COVID crisis improving portfolio company outcomes with active management.

The inflationary outbreak and rising interest rates put an end to the post-COVID dealmaking surge setting up the more challenging period that followed. Impressive and resilient as the post-COVID private equity rally proved to be, it was ultimately no match for central banks' rate hiking cycle.

As it was, as **Chart 2, on the next page** makes plain, the rally was far from evenly shared. In our view, less well-positioned private equity managers were left with highly leveraged consumer or healthcare focused assets, which struggled with changing consumer preferences or were hobbled by well-publicised supply chain problems and labour cost inflation, stranding them with businesses that needed to be held for longer.

In our view, there are other takeaways from this, foremost being that manager selection is pivotal in private equity.

Just as not all companies are equally good, neither are all private equity managers equally skilled. Another way of unpacking the dispersion issue is to delve into the return dispersion of managers of share market investments versus private equity managers.

While there is a large return gulf between strong-performing and less well-performing performing private equity managers, there is a much smaller return gap between strong-performing and less well-performing performing public equity managers **(Chart 3, on page 4)**.

Co-investments: the jewel in the private equity crown
June 2024

We think this underscores the significance of relationships between investors and a select group of outstanding private equity managers.

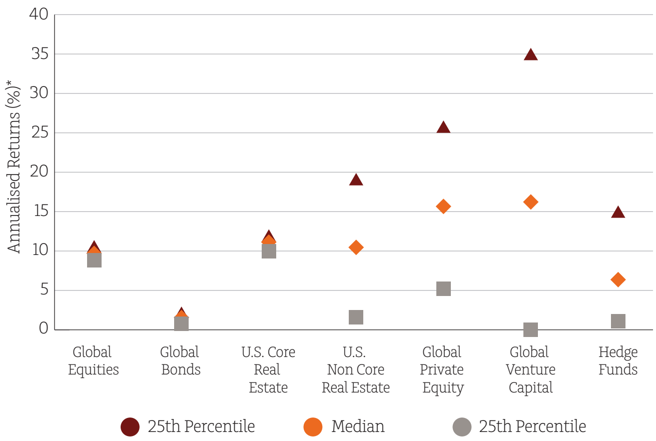
Chart 2: Return differences between top and bottom quartile PE managers widened during COVID period
Internal rate of return (IRR) by year/vintage

	Pooled IRRs			IRR quartiles						
Vintage year	Pooled IRR	Equal-weighted pooled IRR	Number of funds	Top decile	Top quartile	Median IRR	Bottom quartile	Bottom decile	Standard deviation	Number of funds
1998	6.42%	5.47%	41	21.80%	15.57%	9.36%	2.38%	-7.97%	19.80%	93
1999	10.95%	10.81%	38	25.36%	17.90%	12.00%	4.85%	-2.31%	12.17%	89
2000	15.25%	12.71%	50	31.08%	23.54%	13.70%	7.02%	-3.26%	13.00%	109
2001	27.06%	22.26%	28	42.36%	32.17%	19.30%	9.36%	2.42%	19.33%	67
2002	20.44%	17.40%	29	39.20%	27.25%	17.02%	6.15%	-1.27%	21.53%	58
2003	16.74%	14.08%	29	42.60%	29.55%	17.71%	8.36%	2.87%	34.14%	71
2004	10.37%	10.91%	43	39.54%	24.00%	12.45%	3.70%	-0.91%	19.34%	73
2005	9.87%	9.39%	70	21.96%	14.25%	9.40%	3.90%	-1.93%	13.84%	115
2006	8.37%	8.26%	99	19.62%	13.36%	9.08%	4.58%	-1.31%	10.26%	160
2007	8.92%	9.25%	109	22.55%	15.45%	8.95%	4.32%	-2.45%	12.85%	176
2008	13.19%	11.07%	102	23.20%	17.60%	10.73%	5.60%	-5.00%	17.12%	141
2009	12.41%	13.51%	37	25.75%	20.46%	11.61%	7.28%	0.54%	15.81%	54
2010	10.91%	11.32%	46	28.78%	24.75%	12.59%	4.76%	-0.58%	13.28%	68
2011	15.69%	16.00%	73	34.49%	23.28%	15.45%	8.00%	2.25%	17.47%	96
2012	15.00%	14.44%	90	30.50%	22.27%	14.25%	8.32%	1.55%	13.65%	108
2013	14.75%	15.11%	86	29.43%	21.34%	14.96%	9.00%	4.34%	10.63%	99
2014	19.37%	18.71%	84	32.69%	26.74%	19.11%	12.14%	6.24%	12.52%	94
2015	19.71%	19.25%	101	32.47%	25.85%	19.10%	12.86%	7.83%	13.75%	114
2016	20.21%	20.92%	101	33.70%	26.44%	20.89%	14.58%	8.80%	12.99%	131
2017	22.92%	21.03%	105	39.41%	30.28%	21.57%	15.23%	8.20%	15.38%	114
2018	21.79%	22.43%	120	42.42%	32.15%	21.11%	15.15%	8.56%	16.40%	148
2019	22.67%	20.41%	139	41.34%	30.42%	18.83%	9.40%	4.12%	16.67%	165
2020	19.71%	21.44%	107	47.67%	28.99%	17.17%	7.05%	-0.74%	33.75%	134
2021	7.21%	15.62%	134	50.57%	21.11%	6.88%	-8.50%	-18.87%	31.46%	154

As of 31 December 2023
Geography: Global
Source: PitchBook

Chart 3: Larger performance gap between strong-performing and less well-performing private equity managers vs listed equity managers

Comparison of dispersion of manager returns: public equity, private equity, and other asset classes (based on returns over a 10-year window*)



Sources: Lipper, NCREIF, Cambridge Associates, HFRI, J.P. Morgan Asset Management, as of 31 August 2022. For illustrative purposes only. Global Equities (large cap) and Global Bonds dispersion are based on the world large stock and world bond categories, respectively.

*Manager dispersion is based on the annual returns for Global Equities, Global Bonds, and US Core Real Estate over a 10-year period ending 2Q 2022. US Non-Core Real Estate, US Private Equity and US Venture Capital are represented by the 10-year horizon internal rate of return (IRR) ending Q1 2022.

Relationships built over many years and through shared experiences in multiple, successful programs bind strong performing private equity managers and their preferred investors and drives long-term investment success. That's certainly been our experience.

Staying committed through thick and thin, and backing great people

One of the reasons for the strength of these relationships is that we have stood by our investment program and general partners through thick and thin.

We have been an all-seasons investor, rather than a fair-weather one, exemplified by the continuation of our program through the Global Financial Crisis, and COVID. Furthermore, in contrast with investors who may have pulled back from private equity because of over-allocations to the asset class or were deterred by rising interest rates, which have a downward impact on asset values, we have continued with our PE commitments.

PE managers appreciate that we are a source of patient capital willing and able to invest through varying market cycles.

Our co-investments share the same characteristics as PE funds we invest into.

We prefer partnering with industry sector specialists, for example, in financial technology, healthcare or business-to-business software as, according to analysis by Bain Capital in their Global Private Equity Report 2022,[4] increasing use of specialists drives successful deals.

While most of our manager relationships are long-standing, we are prepared to selectively back new managers, especially those who come out of well-known firms with strong track records, who we generally already know.

From our perspective, leaving a recognised PE manager to set up a new shop shows drive and ambition.

Those qualities coupled with principals who risk their capital by ploughing their money into newly founded PE firms, impress us. Said differently, we like managers with 'skin in the game.'

To be clear, we do not commit our clients' funds simply on managers' drive, ambition and alignment on risks and incentives. As always, we carry out intensive due diligence on any opportunity that comes to market that could potentially be of interest to us, whether from a new or established manager.

That said, we steer clear of managers who are unprepared to have 'skin in the game.'

We are broadly agnostic about the industries we invest in and scour the opportunity set on a case-by-case basis.

Nevertheless, both our PE fund program and co-investments do show an overweighting to three intriguing structural themes:

- Healthcare
- Consumer-related industries, and
- Technology, especially financial technology, and business-to-business software

We believe these thematics will benefit from long-term structural trends which will play out over time, matching the multi-year investment horizons associated with private equity whether via PE funds or co-investments.

In these industries, we generally back co-investments provided by specialist healthcare, consumer or technology private equity managers who 'know what good looks like', given their deep industry expertise and sector knowledge.

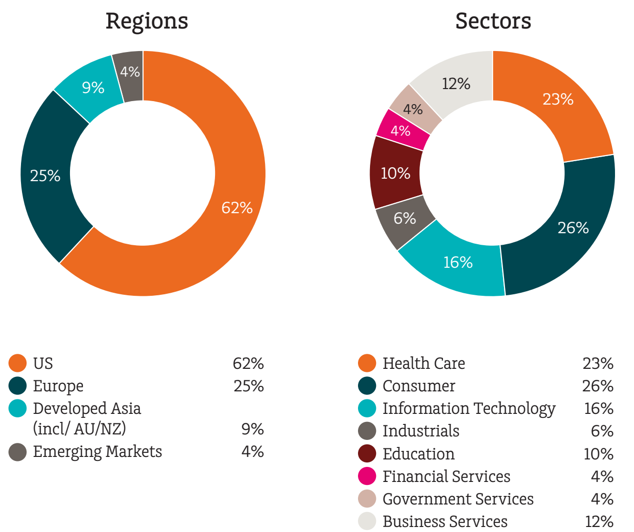
We like the specialist private equity model in healthcare, consumer and technology as we often see specialist PE funds winning deals over generalist funds, impressing founders with their rolodex of industry experts, track records of delivering

4 *The 2022 Global Private Equity Report: Market Overview.* https://www.bain.com/insights/the-2022-global-private-equity-report-market-overview-podcast/

successful returns in similar businesses, and ability to implement proven playbooks of tried and tested value creation initiatives.

Diversification is a feature of our program too as our clients' capital is spread across high-conviction managers, multiple vintages, companies, industries, sectors, and regions **(Chart 4)**.

Chart 4: Regional and sector diversification is apparent
MLC Private Equity Co-Investment Fund III portfolio composition*



* Region and sector based on original cost of investment
* Figures shown are subject to rounding.
As of 31 December 2023
Source: MLC Private Equity

While we are relatively sector agnostic and invest globally, we avoid investments in commodity-related businesses, resource extraction, and property, as well as investments in high-risk geographies such as Africa and the Middle East, Latin America, and the former Soviet Union.

In listed equity terms, we are 'benchmark agnostic.' We do not feel compelled to invest in any industries, companies, countries, or regions just because doing so may be in step with an industry benchmark.

The upshot is that our co-investments have offered clients access to rarity, that is, benefits that accrue from relationships with some of the world's most capable PE managers who have chosen to partner with us to invest directly in hand-picked individual companies.

The mid-size company opportunity

Our one area of preference is company size: the co-investments we invest lean towards are mid-size companies. In our view, there are more operational efficiencies to be achieved in the mid-size company arena over a 3-7 year holding period, than among larger companies where transformation can take longer to realise, or where operations are already highly efficient and growth prospects may be limited.

Because of these inefficiencies, it is possible to have a greater impact on companies towards the smaller end of the spectrum through transformation and growth programs.

From our experience, transformed mid-size companies often become so attractive to bigger companies or other PE managers that they get bought at attractive prices, giving investors an ideal way of realising value.

Digging deeper and being more specific – one of the attractions of the mid-size company realm is the valuations they offer compared to their larger counterparts.

The global median purchase price multiples in the mid-size market are 8.8x versus 9.3x in the large-cap space, creating greater opportunities for valuation growth at exit with 10x for the large cap segment and 10.7x for the mid-market.[5]

The mid-market segment offers potentially greater revenue growth too with Earnings Before Interest, Tax, Depreciation and Amortisation (EBITDA) and Compound Annual Growth Rate (CAGR) being 8% and 10% respectively, while in the large cap space the figures are lower at 5% and 7%.[6]

Mid-cap advocates would argue that these firms provide more room for growth with accretive bolt-on acquisitions, and more value creation opportunities. Lower mid-market companies also tend to have less debt on the balance sheet and as a result are nimbler and better positioned to adapt to market disruptions.[7]

The mid-market also benefits from an abundance of potential targets compared to listed markets. As an example, in the US market "with around 200,000 companies that comprise roughly a third of private sector GDP in the United States, the mid-market provides a target-rich investable universe."[8]

We would argue that there are often more value-creation levers available to private equity investors in smaller companies. Think of the ability to drive margin improvement through operational management, supply chain management, IT implementation, data science, better enterprise reporting and acquisitions integration.[9]

5 *The march of the US mid-market*, Andy Carroll, 5 September 2023, https://www.privateequityinternational.com/the-march-of-the-us-mid-market//

6 Ibid

7 Ibid

8 Ibid

9 Ibid

By the time firms have reached large company status, they are closer to the ceiling in all arenas, in our view. They have reached levels of maturity where revenue growth is slower. There is less low hanging fruit to target.

This means there is greater reliance on the final value-creation lever available to private equity firms – capital markets. Mega firms tend to rely much more on financial engineering and higher levels of debt, which has become more challenging in today's macroeconomic environment[10] with higher interest rates. All up, we believe the mid-market segment represents a source of potentially strong long-term returns.

A one-team approach so we benefit from a breadth of insights

We think the combination of our team structure and culture is a source of competitive advantage.

MLC is a decisive 'yes' or 'no' co-investment decision maker. Indecision and prevarication are anathema in co-investing. Execution speed is valued and private equity managers appreciate our capacity to arrive at thought-through conclusions in a timely fashion.

Our nine-person team of PE investment professionals, divided between the United States and Australia, has, on balance, more senior PE investment professionals compared to those in the earlier stages of their private equity careers. We utilise the decades of experience of our senior team members in assessing and critiquing co-investment opportunities.

A number of our team come from direct private equity investing backgrounds (that is, they have been private equity managers themselves) and therefore are attuned to the nuances of what can make or break a private equity deal, including the importance of good governance, workplace leadership and culture in driving value.

'Workplace diversity' is a much-used term these days. We are proud to be able to say that every member of our private equity team is valued and nurtured.

One third of our most senior team members are female.

Ours is a group drawn from many cultural and national backgrounds, heritages, ages, and life experiences. We know that we are better investors because we are able to channel this richness towards the common goal of delivering financial wellbeing for our clients.

Intensive focus on risk-management

Investment success comes not just from owning good assets. Risk-management is equally important.

Without intensive and constant focus on downside management, a co-investment program could be undone by failures in one part of the program overwhelming positive returns elsewhere.

As is often said when it comes to investing: if you lose half your money, you need to double your return just to get back to where you were.

That is why, as part of our investment process, we model investee companies against severe 'what if' downside scenarios.

What if interest rates rise, stay high or go even higher? What if inflation persists? What if there is a recession? What if the company's most material contract isn't renewed? What if the worst-case scenario the private equity manager contemplates occurs? What if even worse eventuates?

We make sure all our investments have a margin of safety so they can be resilient should the operating environment sour.

Cash flow is particularly important in this regard. In its absence, companies cannot survive, let alone fulfil basic obligations like paying lenders, suppliers, and employees on time.

That is why we analyse prospective investee companies for their cash flow durability. We do not co-invest in venture capital businesses which are loss making. We co-invest in cashflow positive private equity opportunities which we feel can be resilient in a downturn but retain significant upside if managed as well as the private equity firm intends.

A note on illiquidity

As PE and PE co-investment enthusiasts, we are more than happy to speak about what we regard as the good things associated with the asset class all day long. That said, PE and PE co-investments have distinctive risks that investors should bear in mind, the foremost being illiquidity.

Private equity co-investments can lock in investors' capital for 5-10 years, and over this period investors are unable to access their capital. Moreover, given the absence of a vast active market for the underlying investments (in contrast with share markets), it is difficult to estimate when investments may be realised and at what valuations.

Given this illiquidity and uncertainty, investors demand higher long-term returns from the asset class than those generally associated with listed shares, by way of comparison.

[10] Ibid

However, as discussed earlier in this paper, not all PE investments meet higher performance expectations, and as such, it is important to partner with high-performing PE managers who have demonstrated track records of acting in investors' best interests. PE is a sophisticated asset class and it is more likely to be rewarding to invest alongside managers who have a long history in the sector and with evidence of long-term, sustainable value creation.

Co-investment track record

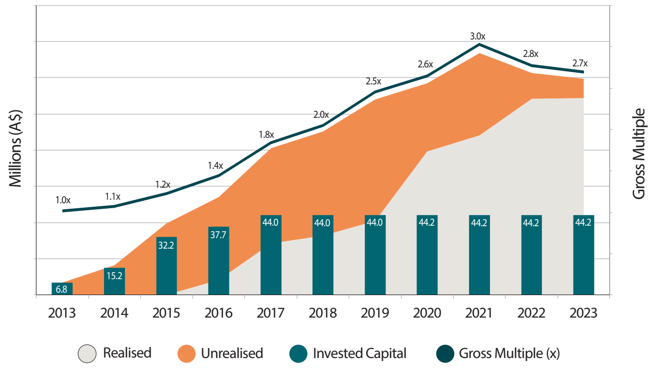
We launched the first of our three co-investment funds in 2013, with the most recent co-investment fund launched in 2020.

MLC Private Equity Co-investment Fund 1 (Fund 1), launched on 15 November 2013, has a since inception to 31 December 2023 IRR of 18.6%, with a gross Multiple of Invested Capital (MOIC) of 2.7x over the same period **(Chart 5)**.

As of 31 December 2023, Fund 1 was invested in 14 companies and realised investments in 12 other companies while being diversified across regions and sectors.[11]

Chart 5: MLC Private Equity Co-investment Fund 1

Long-term track record



As at 31 December 2023
Source: MLC Asset Management

We believe all of this helps to place us in a desirable position to continue sourcing more quality co-investments, including for MLC's Private Equity Co-Investment Fund IV, which will be launching later in 2024.

11 Source: MLC Private Equity

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