PRIVATE ASSETS

Co-investments: the great private equity diversifier

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Mid-cap private equity deals offer potential for rapid repositioning of companies and shorter J-curves.

Highlights

- Co-investments provide opportunities to gain faster and greater exposure to attractive assets, often at better terms than for other private equity investments.
- Because co-investment portfolios may provide exposure to a large number of General Partners (GPs), they can be highly diversified, which decreases portfolio risk and potentially improves risk-adjusted returns. Value can often be created faster in the mid-cap space, because the companies are smaller and can be repositioned faster.
- Flexstone’s deal flow is supported by the firm’s primary investment capabilities, which give it access to a wide range of GPs globally. Deal flow is further enhanced by Flexstone’s global capabilities – its deals range across the US, Europe, and Asia.

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Deal flow is strong in the mid-market

Despite geopolitical concerns, the Covid crisis and a sharp rise in interest rates, deal flow in the mid-market has remained robust.

“It is a very deep, rich market,” says David Arcauz, managing partner in the Geneva office of Flexstone Partners, an affiliate of Natixis Investment Managers. The mid-cap market is less impacted by the rising cost of capital because most deals are less than $1 billion enterprise value and many are less than $500m. And because expected returns from mid-caps are higher, investor allocations have held up well, from both debt and equity investors.

Going forward, the macro environment appears positive. Arcauz says: “Interest rates appear to have passed their peak and uncertainty overall has decreased, so the macro environment is more favourable.”

For Flexstone specifically, deal flow is supported by the firm’s primary investment capabilities, which give it access to a wide range of GPs globally. It has completed more than 475 primary deals, and more than 140 co-investment deals across the US, Europe and Asia since Flexstone started its co-investment program in 2008.

“Access to mid-cap deals is particularly strong for Flexstone, given our broad network of GP relationships globally and across numerous sectors,” says Nitin Gupta, managing partner in Flexstone’s New York office.

“Good relationships and access to deal flow are primarily down to the predictability of capital, transparency and speed,” Arcauz adds. “We get our due diligence done at the same time as the lead GP, so we are quick to say yes or no. That is attractive to the GPs we work with as it mitigates the syndication risk.”

A global approach adds value

Deal flow is further enhanced by Flexstone’s global capabilities – its deals range across the US and Europe, and also include significant exposure to Asia. “A global focus on smaller companies is our niche,” says Kit Jong Tan, managing director of Flexstone’s Singapore office. “There are not many others who can operate globally in the mid-cap space.”

Flexstone’s co-investments are typically in the $10-$25m range, with the larger end mostly reserved for European deals given greater inefficiencies in the European market.

Deal opportunities are also increasingly available in Asia. “As elsewhere in the world, technology valuations in Asia are expensive, but there is fantastic value in some service-related companies and regional players,” says Tan.

An example is KFC Korea, which Flexstone invested in at an Ebitda multiple between 5x and 10x. The lead sponsor negotiated a master-franchise agreement, which allowed for

sub-franchising and much faster growth with less capital expenditure than KFC Korea could have achieved by continuing to open its own storefronts.

Why co-investments?

There is a raft of drivers for the growth in and demand for co-investment transactions. Co-investments, for instance, provide opportunities to gain faster and greater exposure to attractive assets, often at better terms than other private equity investments.

And because co-investment portfolios are often invested across a larger number of companies than primary funds and provide exposure to a large number of GPs, they are highly diversified, which decreases overall portfolio risk and potentially improves risk-adjusted returns.

Gupta says: “Co-investment funds also offer an additional level of due diligence, active portfolio construction and broad diversification across asset types.”

Finally, co-investment funds allow investors to access sought-after sponsors, which are otherwise closed to investment or have limited investment windows.

“Co-investment managers can give institutional investors exposure to a wide array of transactions that would be difficult for an individual investor to access,” says Gupta. Flexstone focuses on deals in the small and mid-cap space across three major geographic areas, where entry multiples and leverage are lower, on average, and risk-adjusted returns are therefore higher with an opportunity to capture the higher alpha through proper investment selection.

Flexstone’s three key value creation concepts

Wherever its investments are located, Flexstone’s approach to value creation is consistent and based on three key ideas.

The first is to grow the top line through buy and build strategies, typically by buying competitors. Many investee companies are family-owned and the buy and build approach sometimes require new management. Funecap, a co-investment done with Latour Capital, falls in this category, where the value creation plan was based on further network densification in France and a planned expansion in neighbouring countries, including Italy.

The second is to target companies that provide products in the value chain at relatively low cost, creating strong pricing power and therefore resilience to both inflation and downturns. Non-cyclical sectors are preferred to cyclical industries. “Our preference is for resilient business models with the capability to withstand various and challenging market conditions,” says Arcauz. Both Shur-Co, the largest manufacturer of quality tarp

and containment systems for freight train and trucks in North America, a co-investment made with US GP Behrman Capital, or Guala Closures, a leader in the production of specialty closures for the beverage industry, done with Italian GP InvestIndustrial, are examples of companies producing low cost mission critical components catering to larger industries.

The third is targeting "old-economy" businesses, which can benefit from digitalization to gain market share and reduce operating costs, like Seaga, a leading manufacturer of automated vending machines, inventory control and secure access products in the US. High-tech companies, typically with high valuations, are mainly avoided.

The approach requires low levels of leverage and none at the portfolio level. "Leverage is certainly not one of our main value creators," says Arcauz. "If you are highly leveraged, you will hit trouble when macro turns against you."

Value can often be created faster in the mid-cap space, because companies are smaller and can be repositioned faster. This has the effect of shortening the J-curve. Ways to reposition companies include professionalization of management, scale, operational improvements and refocused sales and marketing.

Lastly, value crystallisation in mid caps does not depend on IPOs as it often does in the larger buyout market. With IPOs becoming rarer, there is considerable advantage in relying more on trade sales and secondary private equity sales.

Long-term levers

Unlike in public markets, GPs have far longer time horizons to optimise value, meaning they can methodically apply value-adding techniques honed over years and cycles. "Many of these firms have been doing what they do for decades," says Gupta. "They have a plan and a toolbox and can adjust to each phase of the cycle, including planning their exits well in advance."

In particular, Flexstone looks for deals that are in the "sweet spot" of the lead investor. That is, the deal is in a sector and geography in which the GP has completed a number of previously successful deals and has the capabilities in place to repeat this. Flexstone estimates that its sweet spot analysis and rigorous due diligence are key to its low portfolio loss ratio under 5%.

ESG is another long-term lever. Flexstone has three main planks to its ESG approach. The first is pre-deal assessment and screening, such as applying exclusions and controversies strategies. It scores each deal and also considers the contribution of each deal to the UN's Social Development Goals (SDGs).

Second, it performs ESG due diligence of the GP, evaluating the maturity of the GP's sustainability philosophy, governance and investment process.

Third, it creates side letters to formalise contractual clauses identified during the ESG due diligence, and monitors the issues in the clauses for the duration of the deal.

Staying true to the strategy

Mid-cap co-investments can thrive in most macro environments. "Smaller companies with great products will always need capital for growth," says Gupta. The key for investors, he says, is to "stick to your knitting" and not get derailed by macro trends, or get over-excited by trending sectors.

Gupta adds: "There are always challenges, but we know that if we don't stray from our strategy, we can invest successfully through cycles, as we have done in the past."

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