KEYNOTE INTERVIEW

Avoiding the pitfalls of co-investment

Understanding both underlying business models and co-investment structures is key, says co-head of infrastructure at Golding Capital Partners Fabian Pötter

Golding Capital Partners began co-investing in infrastructure in earnest in 2015. It did so initially as a way of optimising its portfolio by gaining access to transactions it did not have in its funds, or that were otherwise underweighted. This new approach also served to reduce net fees.

Around 2016, with a growing level of sophistication among investors, the firm saw an opportunity to offer limited partners a dedicated co-investment programme.

Golding launched a dedicated vehicle to allow its LPs to get closer to the investments themselves, without those LPs having to deploy their own resources.

SPONSOR
GOLDING CAPITAL

Q Co-investment is clearly attractive for several reasons, but are there also risks for investors, and are those risks always fully understood?
Co-investing as an access route into infrastructure transactions is becoming more and more popular, which shows co-investments can be a good and complementary addition to infrastructure portfolios.

With all the positive aspects in mind investors will often see the word co-investment and get caught up in the fantasy of being part of real transactions. But while the idea of investing with no fees and no carry is enticing, they forget that when investing in a fund of funds like our flagship product, they gain exposure to 400 or 500 individual transactions.

When you co-invest on a deal, you may end up with five or even up to 10 times the exposure you would otherwise have had on a single asset. Understanding the weighting of individual co-investments and the associated risks for the portfolio is a point that is often missed.

Investors also tend to underestimate how much work co-investment takes. They may choose simply to support a manager they trust and to ride on the coattails of their due diligence. That can work. But in our view, understanding the transaction you are getting into is key.

For that, you need a sizeable and experienced team. In particular, I think it is important to have individuals who have worked on the other side, transacting on individual deals. That gives you a good understanding of risk profiles.

Finally, investors need to understand that there is no incentive for GPs to offer up co-investment, when it is on a no fee, no carry basis. They will only offer it up if it solves a problem for them.

A GP may be looking at larger deals than those they have historically focused on, or at geographies or sectors outside of their investment remit. It is vital, therefore, that that forms part of your due diligence. Is this GP well positioned to make this transaction happen or are you helping someone transact outside of their comfort zone?

Q Should you always co-invest alongside a manager you know well, or can it be a way to diligence a future fund investment?

> *"You may end up with five or even up to 10 times the exposure you would otherwise have had on a single asset"*

Clearly, it is easiest to co-invest alongside a manager you already have a relationship with. That is also true from a fee perspective. If you are not yet invested in a fund, there will probably be a fee or carry component, unless the manager is particularly keen to woo you as a future investor.

Understanding the people involved in a transaction is very important, as well, and obviously it can be an uphill battle to go to your investment committee with a co-investment alongside a manager where there is no relationship and no prospect of forming one.

Nonetheless, there are situations where we may be offered co-investment, in the renewables space, for example, where we do not want to over-allocate and so may choose not to invest in the fund. We may just pick one investment alongside an established GP. As a professional co-investor you need to be prepared to go both routes.

Q What sectors and geographies are producing the most interesting co-investment opportunities?

Opportunities are pretty well spread across the globe. But clearly the most established geographies in infrastructure investing – Europe and North America – dominate in number of opportunities, not least because managers are daring to invest in bigger and bigger transactions and so need more support from their LPs.

The bigger difference we see is between sectors. At the moment, telecoms is clearly the flavour of the month and that is where most co-investment is being offered.

However, telecoms has become an

Q Are co-investments always simultaneous alongside the GP, or does the GP sometimes syndicate post-transaction?

A syndication process is the most attractive form of co-investment – when the deal is fully underwritten by the GP. They give you a timeline. Timelines can be extended.

Basically, you can do all you want before deciding whether to join or not. In most cases, however, the GPs that really need the support from co-investment also need funding security.

They want to be sure they have the co-investment they require, so they will usually ask you to go in alongside them.

That is where the ability to assess whether or not you want to make the investment and allocate the resources to a deal that may or not happen, becomes key. LPs are often better positioned than GPs in that regard.

Experienced and well-connected LPs have multiple relationships with managers across the infrastructure market. They will usually have a good understanding of how well the individual GP is positioned in the transaction and are thus well placed to judge whether the team that made the offer of co-investment will ultimately succeed.

Based on that they will be able to assess whether it makes sense to commit resources to work alongside the GP or not.

especially difficult sector to invest in. The very simple transactions are normally kept within funds.

But when you start looking at data centres or fibre roll-out, that can become challenging from a technical perspective. You have to question whether you are taking real infrastructure risk or if there is a lot of technological disruption risk in there as well.

The telecom sector is also challenging from a valuations perspective. EBITDA multiples have skyrocketed with demand stemming from the covid-19 crisis. Obviously, a good deal is a deal that is fairly priced and, in many cases, telecoms deals are just too expensive.

The other areas where we see co-investment opportunities are mid-stream and transportation. Transportation has obviously become difficult during the pandemic. It can be hard to evaluate these transactions against such prevailing uncertainty. Are we at the low point, or is there more to come?

Q What should investors know when diligencing an infrastructure co-investment?

The first thing is that an investor must have the experience to be able to assess business models. But they also need to understand the co-investment structure itself.

For example, you do not want to be in the scenario where the GP you are working with ends up with a far smaller portion of the investment than the co-investors.

The risk allocation has to be right. You always want the fund to have more at stake, then you know they will fight for the transaction.

Then, there is the whole question of how do I get out of this co-investment? Do I have to exit with the GP? Are there tag along rights? That is the structure we would always favour. Understanding the co-investment structure is as important as understanding the business model of the underlying asset itself.

Q How does a potential co-investor make itself attractive to GPs?

Having formal co-investment rights is obviously the best way to get into a co-investment situation. To get those rights can be quite a challenge as fund sizes in infrastructure have increased significantly and it is often necessary to make fund commitments of upwards of $200 million.

There are some slightly smaller infrastructure funds, and in those cases, we may well be offered co-investment rights. Our fund investments tend to fall between $120 million and $150 million.

But when you look at funds we have worked with on the co-investment side you will find that in most cases having formal rights was not the key to being offered to co-invest.

Many of the largest LPs in those funds – some Middle Eastern investors, for example – just want co-investment rights for the sake of them. Often they do not even take them up or cannot transact fast enough.

We have positioned ourselves as a reliable and responsive co-investor providing fast feedback, which has opened the door to many transactions. We will give an indication of whether we are interested in three to four days and can conduct full due diligence in four to six weeks.

> *"You always want the fund to have more at stake, then you know they will fight for the transaction"*

My advice to anyone wanting to do co-investment, therefore, is to gear up your processes so that you can transact in very short time frames. Terms may change. Structures may change. You need to be able to go back to your investment committee and discuss those changes within hours.

Q What does the future hold for infrastructure co-investment, beyond the immediate covid-19 environment?

We are in a phase where investors are starting to look at infrastructure valuations and realising that the industry's perennial promise of being a stable asset class, through thick and through thin, does actually seem to have materialised.

In reality, this is the first major crisis the infrastructure market has faced. In 2008, the industry was still in its infancy. All the signs are that infrastructure has weathered the storm well.

This realisation will lead to even more demand for investment opportunities and higher valuations in safe harbour transactions, such as public-private partnerships, as well as high-growth sectors like the telecom space. And that again calls for even more rigorous due diligence and strict investment discipline on the part of investors.

Finally, I also think the concept of sustainable investing and the opportunity to make an impact on the environmental, social and governance side will gain importance, especially on the co-investment side.

Understanding the ESG aspects of an investment and working with the GP to improve in that area is something the team here at Golding is very serious about. Infrastructure investing, with all the different access routes, is here to stay and should be an integral part of almost every alternative investment portfolio. ■