Unique Opportunities for Co-investments

The Current Environment has Offered Increased Opportunities for "Mid-Life" Deals

The co-investment deal flow that HQ Capital has seen so far in 2020 has been consistent in volume to previous years but we have observed a shift towards more "mid-life" transactions (i.e., an investment in a company that the lead sponsor already owns) with the number of "mid-life" deals entering our pipeline having tripled so far this year. This trend is largely a function of the COVID-19 pandemic as General Partners ("GPs") have needed to further capitalize their portfolio companies in order to, (i) manage through the crisis, and (ii) pursue growth opportunities, like accretive add-ons, that may present themselves over the next couple of quarters. This has created an opening for co-investors to provide co-investment capital in these "mid-life" transactions.

While traditional co-investments, like co-underwrites and post-close syndications, continue to comprise the majority of our co-investment program, "mid-life" transactions have offered especially compelling risk-return profiles and below we have listed some of the reasons why.

1 Built-In Knowledge of Asset / Risk Mitigation

In "mid-life" transactions, the co-investor and the financial sponsor(s) with whom they partner have built-in knowledge of the asset including its key strengths, risks and possible levers for future growth. Further, they will have insight into company characteristics such as, (i) the performance of the business relative to the original investment case, (ii) management team capabilities and ability to execute the operational roadmap (e.g., integration of synergistic add-ons) and, given the current market environment, (iii) the impact COVID-19 has had on the business and the market(s) in which it operates. This insight is particularly helpful today, allowing the co-investor to avoid "mid-life" transactions where additional defensive capital is likely to be required.

Case study: In a "mid-life" transaction completed by HQ Capital, a GP that had owned a company for almost two years required additional capital to continue its buy and build strategy. Since the fund that held the investment needed to reserve capital for the other companies in the portfolio, HQ Capital was able to step in and invest alongside a GP that has demonstrated an ability to successfully acquire and integrate add-ons.

2 Ability to Step into Embedded Value / Potential for Immediate Mark-Ups

Many GPs generally hold their investments at cost for the first year of ownership, which sometimes obfuscates the true performance of the investment. In a "mid-life" transaction, the GP has a current and recent mark-to-market, which the co-investor will review as part of the due diligence process and use to create an initial valuation. "Mid-life" transactions allow the co-investor to step into embedded value based on current and expected growth of the company and/or expected synergies from a potential add-on acquisition. Additionally, in some "mid-life" transactions, the co-investor may price or structure the deal in a way that results in an immediate mark-up and strong downside protection. While the objective of co-investing is to achieve strong risk-adjusted returns over the duration of the investment, the ability to mark-to-market sooner is a helpful benefit.

Case study: In a "mid-life" transaction completed by HQ Capital, we stepped into an attractive preferred security that allowed a GP to provide growth capital to a strong performing business that it had owned for three years but in which it was unable to increase its investment due to the company already having the largest exposure in the GP's fund. Based on the current mark-to-market by the GP, HQ Capital was able to enjoy an immediate mark-up and potentially avoid the "J-curve" effect that impacts most single manager direct funds and multi-manager co-investment funds. Additionally, the security that HQ Capital invested in provides strong downside protection.

3 Shorter Duration

Given that GPs have been invested in the underlying asset for one or more years by the time the co-investor reviews a "mid-life" opportunity, the expected time to exit is often shorter than the typical private equity hold period. Accordingly, "mid-life" transactions have the potential to have shorter durations than traditional co-investment transactions while having comparably strong upside potential. With that said, it is important to ensure that the co-investor's and the GP's interests are aligned with regards to exit timing and return.

The current market environment has presented HQ Capital with an attractive set of co-investment opportunities and we will look to continue partnering with top-performing managers in both traditional and "mid-life" deals while crafting portfolios designed to outperform the broader private equity fund market.

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About HQ Capital

HQ Capital is a pioneer in private equity with a track record dating back to 1989. In 2019, HQ Capital was ranked a *Consistent Top Performing Private Equity Fund of Funds Manager* by Preqin for the fifth year in a row based on our Auda Capital U.S. series. As of June 30, 2020, the firm manages $8.0 billion in assets, has invested in 570+ funds and 100+ direct companies alongside 274 GPs, and holds over 90 Advisory Board seats.

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