McGuireWoods



Episode 143: What GPs and LPs Owe Each Other in Co-Investment, With Gordon Maner and Kevin Wong

Episode Summary

A decade ago, co-investment was uncommon. Now it takes up one of every three dollars LPs spend on a fund investment. So how much say should LPs have once the deal closes? Gordon Maner, CEO of AMB group of companies and co-founder of healthcare private equity firm Frontline Healthcare Partners, and his LP Kevin Wong, chief investment officer of Lang Partners, tackle that question from both sides of the table with McGuireWoods partner and host Geoff Cockrell. Gordon reveals when sector-savvy LPs can earn a bigger co-invest allocation, and Kevin explains what a GP must prove before he'll double down with a co-investment. Tune in to hear why Gordon never backs a deal that requires co-invest to make it work.

Transcript

Voice Over (00:01):

This is The Corner Series, a McGuireWoods series exploring business and legal issues prevalent in today's private equity industry. Tune in with McGuireWoods partner, Geoff Cockrell, as he and specialists share real world insight to help enhance your knowledge.

Geoff Cockrell (00:20):

Thank you for joining another episode of The Corner Series. I'm your host, Geoff Cockrell, a partner at McGuireWoods. Here at The Corner Series, we strive to bring together deal makers and thought leaders at the intersection of healthcare and private equity. Today, we have two guests, my longtime friend, Gordon Maner, who's the CEO of the AMB Group of Companies, which covers a couple different areas which Gordon will describe, and also the co-founder and partner at Frontline Healthcare Partners, a healthcare-related private equity fund.

(00:47):

Gordon, if you could give a little introduction of yourself and we'll jump into some questions after Kevin, you introduce yourself as well.

Gordon Maner (00:53):

Sounds great. Geoff, thanks for having me. Great to see you again. I will note, I think this may be my fourth time on your podcast, and I think you told me last week the royalty check is in the mail, right? Still coming?

Geoff Cockrell (01:03):

Correct, correct. Fourth and last.

Gordon Maner (01:06):

Okay, great. Okay, well thanks for having us and excited to be talking today. As you mentioned, I am CEO of the AMB Group of Companies. We're a financial advisory firm that covers asset management and wealth management, as well as a healthcare focused investment bank. And I think the primary discussion today is around our work in Frontline Healthcare Partners, which is a private equity firm totally dedicated to investing in the lower middle market of healthcare services, four partners.

(01:29):

We now have six platforms and with luck hopefully closing out our first fund, which will have seven, maybe eight investments here in the very near future. So, delighted to be here again and glad to be joined by my LP and good friend Kevin Wong.

Geoff Cockrell (01:40):

Kevin, if you could give an introduction of yourself and Lang Partners.

Kevin Wong (01:43):

Sure. Happy to, Geoff. Glad to be here. Kevin Wong, chief investment officer of Lang Partners. We're a single family office based in Dallas. We invest broadly across all asset classes, real estate, equities, and credit. And we're also happy investor and supporter of Frontline Healthcare Partners.

Geoff Cockrell (02:01):

So, Kevin, let's start with you. As an LP, the role of the LP in the context of a particular deal can take a number of different shapes. Sometimes, they're not visible at all. Sometimes, they're integrally involved in diligence and discussions with management. Kevin, how do you think about your role in that context and what are some of the variables that might change that role?

Kevin Wong (02:22):

As an allocator, I think my job is picking the right manager and letting them work. We see the portfolio companies from a distance. We read the board decks. We see how clinics are being staffed. We see how the CEO answers hard questions from a board level, but we as allocators have to dedicate our role to allowing the GPs work with the managers and the team to execute the value creation plans.

Geoff Cockrell (02:50):

Gordon, as the GP in a deal, I would imagine that your LP's level of engagement is not always the same on a particular deal or within your LP base. How often do you see very engaged LPs and how would you describe the role of the LP in the context of executing a deal?

Gordon Maner (03:09):

Yeah, it's a good question and it's nuanced, honestly, depending on the LP's level of interest. I mean, I think at Frontline, we have our first view is to be great partners. That's great partners to the management teams and the entrepreneurs we invest in, but equally, if not more importantly, is to be great partners with our LPs. So, we want to strive for a strong level of transparency throughout any process, overly communicate when necessary. And of course it's up to the LP when they want that and when they don't.

(03:34):

We're fortunate enough to have a really strong group of institutional focused LPs, many of which do sit on our LPAC, which is for the audiences, a board that helps give governance and oversight into our fund work. And we want to report to them quarterly and it's very regular that Kevin and I may be on the phone and giving about an update on a company and this or that. And when it comes into a particular deal or an opportunity for co-invest, there's a lot to unpack there.

(04:01):

I think you and certainly Kevin, and I hope the audience appreciates that co-investments really across the industry are now taking up one out of every $3 that an LP is ultimately expected to spend in a fund investment. So, it's becoming more pervasive and very common where 10, 15 years ago, it wasn't common. And that's a function of a whole lot of different reasons, but we want to offer it. We have set out not to be an independent sponsor.

(04:26):

We have set out to be an institutional funds management company and one day take many shapes and sizes to that. But we think the best way in order to have a success in the long run is to have success and transparency in the early innings where we are. And so, we like to have co-investors, especially smart and educated ones that have experience in a sector join us for opportunities. We've talked about this in the past, but the way that Frontline invests, we try to think about a thesis, an industry we want to invest in.

(04:53):

We start with allocating dollars to that thesis, not necessarily dollars into a company. And that just naturally leads to a lot of buy and build opportunities. Platform A has an opportunity to acquire B, C, and D. And with that, it's going to come varying degree of sizes of capital outlay. And that is a great place where co-investors and value added LPs can come to the table, invest alongside of us. So, I honestly don't think it's much different.

(05:17):

There's some fodder around the community that there potentially is an opportunity for conflicts. I think you start with transparency and you end that way and you're going to have a great outcome and great relationships with your LPs.

Geoff Cockrell (05:28):

Kevin, what are some of the variables that drive how much involvement in the context of a deal you're going to have? Is it the size of your allocation to the fund? Is it the size relation to other investors? Is it the degree to which you're participating in a particular co-investment opportunity? Or is it just looking at the GP or the management team and concluding that you bringing some additional internal resources would help? What kind of drives the degree of involvement?

Kevin Wong (05:55):

Geoff, I think size matters. Obviously, if we're contributing a larger amount, we're going to lean in more into investment. But setting aside capital, if we and the GP come together in beginning parts of looking at diligence and we find that we can add value at the board level, we'll lean in a little bit more. One of the perspectives we can bring to the table is that we've invested in over two dozen individual companies over the years.

(06:21):

Now we might not be specialists in any business, but we can add value by bringing in perspective about how different boards have encountered and worked through problems. I think we have done that across all of our portfolio companies, especially the ones that we've invested in with Frontline.

Geoff Cockrell (06:37):

Gordon, when you're having conversations with a target and their management team or the seller, I would imagine that navigating how many voices are present can be a little bit delicate. How do you think about when to bring in some additional voices, Kevin's and others, into that process and how do you regulate the amount of interaction that folks have because that could be overwhelming?

Gordon Maner (07:00):

And it's particularly hard, Geoff, in the lower middle market or the micro cap space that we play into. We're often dealing with first-time sellers non-institutionally backed. And as you know, once you've done this a couple times, the concept of private equity, co-investors bringing in debt, outside capital, follow-on investment, this kind of becomes a regular place, but it is oftentimes pretty tricky to get a first-time entrepreneur selling their company over that hurdle.

(07:28):

I think there's a right place at the right time. The reality is that having outside capital and co-investors isn't really going to affect the playbook all that much. It's going to be an accelerant and enhancement. So, how do you convince a management team that you're partnering with that all that is okay? It really starts with trust. If you can't build a great relationship with a management team, it's going to be really hard to do a lot of exogenous and outside factors to potentially drive the business forward.

(07:55):

And I think you really need to look at that at your underwriting and let that be more of a tail that wags the dog. We talked about this in a podcast as well, finding the right people is so important to partner with. But really after the second or third board meeting, once the cadence is well established and once you're... For us, we do a weekly call with all of our management teams, there is a level of trust.

(08:15):

And when there is an opportunity to acquire a business that's going to need outside capital, because it's just bigger than maybe the 15 million or so that Frontline in this case has potentially been able to allocate to a platform, we will need to go to our value-added co-investors like Kevin. And so, without that trust, it would be a very difficult conversation, but if you can build it early, it makes it relatively simple.

(08:38):

And a perfect example is something that Kevin and I did together last year, our autism platform, which is a great business and it's grown really fast, I think faster than we were even expecting within our value creation plan. We started moving into a third state of North Carolina after starting this business with one clinic three and a half years ago.

(08:58):

We're now in our third state in North Carolina, and a really transformative acquisition to acquire 11 clinics came up and it was going to take more capital than Frontline could responsibly put into just one of our portfolio companies. And it's just a great time. We told our management team really early that this is about the capital that we would have available. There was no surprise. So, it's a very easy discussion. We had already had the opportunity for Kevin, as they do diligence on the funds and GPs.

(09:24):

It's not uncommon for them to talk to our CEOs. And I remember early on, and Kevin, when you were doing your diligence on us, you're speaking to our CEO and gosh, we got to call back. That was a

really thoughtful individual. He'd be super helpful. What would you think about just putting him on the board? And we said, we think there probably is going to be a time for that anyway, but having the right investors and obviously the trust with the management teams, it's super important. And without that, I don't know how you do anything.

Geoff Cockrell (09:49):

Kevin, Gordon alluded to it, but maybe hear your perspective more broadly on the topic of as an LP supporting a fund, maybe making a co-investment. It's one thing to be involved in risk assessment on the diligence side and evaluating whether or not this is something you want to deploy capital to. It's a little bit different of a question to figure out what the role of a co-investor or an LP in a fund is going to be with the company going forward.

(10:16):

How do you think about that and is it need-based, harking back to what you described of areas where you think you could provide value, or is it relegated to instances where you're on the board? How do you think about your role after the deal is closed?

Kevin Wong (10:31):

We think of it as on an as-needed basis. Early on as we were constructing the portfolio, we wanted and needed to be on each board of all of our portfolio companies. But as we've grown, we've now grown more accustomed to getting governance through consent rights and asking our GPs to have board members that are outside directors that bring in different areas of expertise that can help accelerate the value creation plans that Frontline and other GPs are trying to put in place.

(11:03):

We will step in and provide advice when needed, and all that requires an extreme amount of trust between the GP and ourselves. We will have a good sense for the direction of the business, the pace and cadence of change, but it's a delicate balance, Geoff. When you want to be too intrusive, having too many cooks in the kitchen or letting governance go too lax and not trying to make sure that change is running through the organization and we're all getting closer to the goal line.

(11:34):

It is more of the art than the science, and we are always trying to get better at it. We always want to make sure that in the market we're known as an LP that is helpful, but allows our GP room and space to operate and work.

Geoff Cockrell (11:49):

Gordon, when you're constructing the group of co-investors, I could conceive of a couple different things that you're balancing. One is certainty of showing up at closing. One is kind of skills that they

might be bringing to the company either in the diligence or in the operations, but also there might be times when you're wanting someone's capital and then would prefer not to have them be as involved afterwards. How do you think about constructing a co-investor group?

Gordon Maner (12:16):

It's a great question. I think the easy answer is, is that if you're doing what the market perceives as good deals, and we certainly believe we are, is that you're going to have a hundred percent participation on every deal if you show it to everyone. And so, that becomes a challenge in a $20 million deal, maybe there's only $5 million available for co-invest because we do have to get our fund dollars to work.

(12:39):

I think you learn really early on after you do your first call with one of your LPs about the topic, how much they support your fund versus how much they're supporting their own co-investment needs. And that's something Kevin kind of spoke to, didn't say it that way, but that is really important for us to gauge because we can't have everyone come into every opportunity that we have available. So, I think we try to be really clear and let them know upfront that we are through the diligence process, we're trying to understand which LPs have an angle.

(13:09):

It is certainly not thinking about which LPs are going to be more involved and maybe give us a more difficult time. That's furthest thing from the consideration. So, really the only thing that we want to think about is whether they're going to be a constructive party at the board meetings and whether they're going to add value.

(13:24):

And so, there are times where we will over-index the allocation maybe for a Kevin, because in this particular case, Kevin does know the autism sector, he has some experience there, and our management team thought so highly of him in our initial discussions years ago. And so, that's an easy one. And other times we've been looking at some things in the self-insurance world and there's some LPs that have a particular amount of industry knowledge there.

(13:47):

It's up to us to understand our LP base, engage with them, do dinners, understand what they are good at, where they have a particularly keen interest. You're going to get the best value out of everyone when there's a real interest there from your LP base or any investor for that matter. And so, that's something we look towards, but certainly your point is valid. You can't have a deal where everyone is at the table, and I think you just have to be really communicative and transparent.

(14:11):

And that's kind of the key, I think, to this whole business is transparency and communication.

Geoff Cockrell (14:16):

Kevin, when the investment is moving up and to the right, relational dynamics can be easy to navigate. If they're not moving up into the right, it can put pressure on some fault lines and those fault lines might be kind of interpersonal relational with either the management team or the GP. It could be misalignment depending on the structure of the investment, maybe it's a mix of debt and equity.

(14:39):

How do you think about navigating situations where the company is not moving up into the right and where are some of the fault lines that you see emerging?

Kevin Wong (14:48):

Gosh, that's a difficult question, Geoff. Gordon has always spoke about communication and trust from the onset of a deal. When a deal goes sideways or when challenges do occur, that's when you have to rely even more on the trust and have even more enhanced communication. We always have told our GPs, when there's bad news, tell us first, don't message us, and then together, we will help try to craft a solution.

(15:13):

Transparency in difficult situations is probably our number one priority, and we will dedicate the resources and time to see the investment through. But at the end of the day, we are relying on our GPs to work through the situation and we are the best supporters and cheerleaders along the way. It is very challenging, and you have to rely on your relationship with the GP and understand that they're looking out for the best interests of the LPs as we all go through challenges.

(15:43):

And none of our investments always go up and towards the right, all go through their challenges and inflection points. And that's when you see the true test of character on how the GP works through those situations.

Geoff Cockrell (15:56):

Gordon, same question to you.

Gordon Maner (15:57):

I don't have a lot to add to that. I think it was a perfectly said answer. If I have been on message for once in my life, it would be what I've said here, that transparency and communication is super important. I think the bad news is delivered through a phone call almost as soon as you hear it. And I think once you do that a few times, that does build a level of trust. I think you were touching on something on a previous question, which was some of the things that could potentially go wrong that are worth highlighting.

(16:25):

In the case of a good or bad situation on a portfolio company and a co-investment, a co-investor could say, "Hey, look, I want to build this much further where this is a clear success." And the fund is saying, "Hey, this is the right return for the fund." And so, I'll go back to getting the right LP base. I think you would want to weed out as a GP those LPs that were clearly just interested in the co-invest outcome versus the overall fund dynamics and what was right for the long-term of Frontline Healthcare Partners.

(16:56):

And that's something that's very difficult to see in a mutual question and answer session. You have to see it in action. And so, we're really fortunate that we have not seen any of that in our LP base. If we did, I think it'll be a challenge to want to re-up on in future funds. And so, that's an area that we didn't really get into, but I think may have been something that you were prodding at is that the misalignment of incentives can be real. I think you just have to really have the right partners.

(17:21):

At the end of the day, we're working together to make the fund really successful and the co-investment opportunities are great, but ultimately it shouldn't come at the expense of the fund's short- and long-term success.

Geoff Cockrell (17:33):

So, Kevin, when you're looking at making fund investments, as an LP, you probably have a lot of choices in funds that you could consider investing in. What are some of the hallmarks of a fund that you're willing to back? And then secondarily, co-investment opportunities probably present fairly regularly. What are you looking for as the key markers of things that you would want to co-invest in as opposed to just opportunities that present?

Kevin Wong (17:56):

Sure. About seven years ago, we undertook a strategic shift in our portfolio construction, and we started to move away from a portfolio that was tethered to mega cap funds that were just generalist in nature. And over the years, we've tried to invest in GPs that are specialists in the areas that they operate in. For example, Frontline is a specialist in what they deem to be distributed healthcare. So, it was a sector that we had interest in.

(18:24):

We had previously invested in different providers and different modalities, and there was a hole in portfolio that we wanted to fill. And as an allocator, we want to find specialists to look at industrials. We want to find a specialist that targets business services and construct a portfolio of specialists that all in their own unique way collectively fitting into our overall strategy, like unique jigsaw puzzle that we're putting together that takes 15, 20 years to accumulate.

(18:56):

On the co-investment side, where we think that there's alpha in the fund, where we think that we have an overweighting portfolio, that's where we'll want to have a co-investment. Where we think that there's a exceptionally outstanding management team, or there's a problem that the company is solving in a different way that their competitors cannot. And of course, a lot of it depends on our trust level with the GP.

(19:21):

So, obviously before we made the fund investment, we've done a tremendous amount of work on the GP, but in order to upsize our investment, we have to have seen the GP perform and they had done what they say that they were going to do when we first met them. We've had a lot of instances along the way where we found comfort in our GPs after we made the fund investment that allowed us to double down and further invest by investing in a co-investment.

Geoff Cockrell (19:50):

Gordon, when you're looking at having investments that include material co-invest, obviously that lets you kind of expand the size of target that you could look at. It also introduces future funding risk that if you could account for both the initial investment and likely additional investments completely within the fund, you wouldn't exactly have that. How do you navigate kind of balancing future funding risk versus the ability to expand the size of the targets that you're looking at?

Gordon Maner (20:17):

Yes. So, I think it really starts with the value creation process and your ultimate underwriting. I think there needs to be kind of a core principle that the fund's not going to make an investment if it couldn't get it to where we would want it to be to have the appropriate return on a risk-adjusted basis. And so, you know, that's like tenet number one.

(20:33):

Co-invest is there to enhance what we think is available through our own capital, but under no circumstance would we ever go into a potential platform or opportunity believing that we had to have co-invest in order to make it work. That would just be, I think, a pretty unintelligent decision for any fund, and put the fund and the whole team at, you know, pretty great risk. So, it's a really easy one in that regard. So, yeah, I'll pause there.

(20:57):

I could talk about that for a while, but I'll pause. You have to underwrite based on the dollars that you have, simply put.

Geoff Cockrell (21:03):

Last question. Kevin, we'll start with you. Kind of heading into the end of 2026, looking at 2027, do you view '27 upcoming as an investment expanding time or a time where you think you might be pulling back some?

Kevin Wong (21:17):

For us, we are slowing down, not really because of our perspective on 2027 or 2028. It's because our portfolio is getting full. We've been investing in the independent sponsor or the lower middle market using this strategy since the beginning of 2020. Done probably two dozen platform investments now, and we'll probably have another two to four slots remaining in our portfolio.

(21:42):

Now we'll have maturation and exits along the way, but the bar is getting higher for each incremental investment, and that's just due to our portfolio construction rather than a perspective on 2027. But yes, Geoff, it's getting more difficult out there with rates where they are today. It's becoming more difficult to build businesses. It's more challenging time than ever before.

Geoff Cockrell (22:04):

Gordon, how about you? Are you bullish for expanding investment in '27 or does it feel fraught?

Gordon Maner (22:09):

We're very bullish, but that's probably because of our place in the market, in a lower middle market or micro cap. We're not beholden to the cost of capital as much. I think we're able to underwrite in hopefully a shorter period of time and a higher MOIC. And you do that because you take certain risks, of course, investing in a smaller company that's not fully built out. We take the risk to J-curve each investment.

(22:32):

We take the risk to try to perfect the management midway through our investment cycle and then obviously harvest the investment. And so, when you do those three things versus just buy a business and hope to grow sales by 10% a year, you take some risks up front, but ultimately you do so because the market rewards you and is going to continue rewarding you, I think, for building a much bigger, durable business.

(22:51):

And so, our way in, the cost of debt just doesn't weigh on us as much as it might for our middle market competitors. As an example, our highest leverage ratio is about 3x on any of our companies. That is not expected to change going forward. Hopefully we start some point in 2027 with a new fund.

Likely is going to necessitate a little bit bigger and more capital for each company, and we're excited about that. But it's still, I think, on the right side of where you want to be in this market.

(23:16):

I would highlight and double click on everything that Kevin said. There are factors globally, I think, that are causing risks to the system. Yields are causing pressure for companies. I think you'll see some defaults coming into '27 and '28, but I like where we're positioned in the market. I mean, there's a set of statistics that would lead you to believe that specialists generally perform on a DPI basis several hundred basis points higher than your generalist funds.

(23:43):

I think people all know that to be the case. And so, when you look at the type of opportunity and part of the landscape that's really not beholden to the cost of debt, I think investors are going to pick up and say, "Hey, the lower middle market specialist area is able to get outsized returns."

(23:58):

And yeah, potentially they recognize there's some more risk to it, but the good firms like we are building are able to craft great boards of directors, good co-investors, and support those management teams that have to go through a faster amount of build in order to get that hopefully bigger and faster return. So, I love where we're sitting. I think it's got 10 to 20 years of just great opportunity ahead of itself despite all the macroeconomic challenges that are present.

Geoff Cockrell (24:21):

We've covered quite a bit of ground and I think we'll call it a wrap there. Gordon, Kevin, thank you for joining. This has been a real ton of fun.

Gordon Maner (24:28):

Thank you, Geoff.

Kevin Wong (24:29):

Thank you for the opportunity.

Geoff Cockrell (24:30):

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Voice Over (24:49):

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(25:17):

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