ROUNDTABLE

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The future of co-investment

Co-investment remains a compelling proposition for investors. However, continuation vehicles could soon become a competitive force, write Amy Carroll and Carmela Mendoza

Global private equity deal value was down 51 percent year-on-year in the first six months of 2023, according to data from S&P. The volume of deals, meanwhile, dropped 39 percent. The industry's co-investment community, however, is not going short.

The combination of 'tourist' co-investors withdrawing from the market amid liquidity challenges and a significant increase in demand for co-investment from GPs looking to preserve committed capital – thereby making up the shortfall left by a decline in the availability of debt – means co-investments are as attractive as they have ever been. It's a dynamic that was discussed in depth at *Private Equity International*'s annual co-investment roundtable, which took place in August.

"GPs are reaching out to longstanding co-investors with dedicated platforms – co-investors that aren't going to pull back from the market when things get tough," says Patrick Kocsi, head of co-investment for North America at Ardian. "GPs value relationships and certainty of execution above all else in this kind of environment."

Bart Osman, a partner at Lexington Partners, points to the large US pension funds that have stepped back from co-investment due to allocation issues. "Putting the brakes on co-investment is one of the fastest and easiest levers to pull in that scenario," he says.

"At the same time, we have seen some Middle Eastern LPs step up their efforts, writing some pretty large cheques, and that is filling the gap left by the US pension funds to some degree. But with fundraising schedules extending and the equity account on deals getting larger because less debt is available, GPs are in need of co-investment more than ever."

Jason Strife, senior managing director and head of junior capital and private equity solutions at Churchill, a Nuveen company, agrees: "In the mid-market, where we focus on businesses with EBITDA of $15 million to $75 million, the competitive dynamic is more attractive than it has been at any point in the past decade.

"Everyone knows it is extremely challenging to raise the average mid-market private equity fund right now, and that is likely to remain the case for several years. If you have room for two more deals but could stretch to three with co-investment, that is the option you are going to take right now.

"Three or four years ago, you would have blown right through those final

two deals and gone straight back out to the market."

Continued competition

Meanwhile, co-investment is facing competition from an unlikely source: the secondaries industry. Or, more specifically, the recent explosion in continuation vehicles.

Jochen Mende, head of secondaries at UBS Asset Management, who has also been charged with rolling out the firm's co-investment capabilities, says his group does not currently have a dedicated co-investment pool of capital, which means he and his colleagues are comparing robust and high-quality dealflow in the co-investment space with attractive opportunities in other areas, including single-asset continuation funds.

"Those deals are looking very competitive with the co-investment dealflow we have been evaluating from a risk/return perspective. I would argue

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PATRICK KOCSI
Ardian

"It is clear that co-investment provides the potential for extremely attractive risk-adjusted returns. It is a great sleep-at-night strategy"

BART OSMAN
Lexington Partners

Jason Strife
Senior managing director and head of junior capital and private equity solutions
Nuveen

Jason Strife leads the private equity and junior capital platform at Churchill, a Nuveen company, including capital raising, deal sourcing and portfolio construction for six mandates that provide debt and equity capital to the US mid-market. Prior to joining Churchill, Strife was principal at Bison Capital. He was previously an associate at Weston Presidio and also worked in the M&A group of Wachovia, executing private equity transactions.

Bart Osman
Partner
Lexington Partners

Bart Osman is a partner at Lexington Partners, primarily engaged in the origination, evaluation and management of equity co-investments. Before joining Lexington in 1998, Osman was a director of acquisitions and investments at Reuters America. Prior to that, he was an analyst in investment banking at Merrill Lynch.

Patrick Kocsi
Head of co-investment for North America
Ardian

Before joining Ardian as head of co-investment for North America, Patrick Kocsi spent 24 years with General Electric Company in roles of increasing responsibility. In his last role, Kocsi led GE Equity, the $2.5 billion co-investment private equity arm of GE Capital, before the business was sold to Ardian in 2015. Kocsi has more than 27 years' experience in private equity.

Geoffrey Burgess
Partner
Debevoise & Plimpton

Geoffrey Burgess is a corporate partner at Debevoise & Plimpton with a broad practice in Europe, Africa and India. His particular focus is in the private equity, TMT, healthcare and aviation industries. Burgess is also a member of the firm's ESG and special situations teams.

Jochen Mende
Executive director and head of secondaries
UBS Asset Management

Jochen Mende heads the multi-managers private equity secondaries team, a business that forms part of the real estate and private markets unit within UBS Asset Management, and has also been charged with building out the firm's co-investment activities. Mende joined UBS in 2018 after 12 years with another Swiss private asset management firm.

that, given the sponsor has already been managing an asset for three to five years and knows it well, in addition to the alignment of interest which is arguably greater in a continuation vehicle than in a traditional co-investment because the GP is putting its own money at risk, those deals are going to do well overall. But we will have to wait until the first wave of continuation vehicles start to exit at scale."

The increased prevalence of continuation vehicles has led to some existential discussions around the definition of co-investment and its boundaries with secondaries. "The distinction between co-investment and secondaries is an important question we have been asking ourselves as we have built out our co-investment activities," says Mende. "Our approach is that if an asset is new to the GP and there is no pre-existing exposure, we view it as a co-investment and otherwise as secondaries.

"When it comes to the underwriting process, however, I think the two are very similar. You have to understand single-asset risk; you need to evaluate the fit with the GP, the alignment of interest, the value creation plan, and so on. Given the challenging exit environment at the moment and the desire from LPs to receive more liquidity from their portfolios, I think the continuation vehicle phenomenon is here to stay and will grow meaningfully."

Osman agrees that continuation vehicles are likely to be a permanent fixture. "In general, I see this as a positive trend. Firms are sitting on a great deal of NAV, and this is just another avenue for exit in addition to M&A and IPOs. For us, the main point of differentiation between co-investment and secondaries is the economics. Continuation vehicles come with fees and carry, but co-investment does not. That is how we define our buckets."

Strife, whose definition also centres on what is fee-paying and what is not, believes continuation vehicles could potentially deliver compelling

comparative returns regardless of the associated economics. "Most businesses involved in continuation vehicles have graduated out of the traditional mid-market space. They have grown up and become winners, and that does arguably represent competition to the no-fee-no-carry co-investment in that larger part of the market.

"It remains to be seen how that will impact investors' willingness to entrust co-investment specialists to manage their capital and the extent to which the two deal types will blend over time. A lot of the continuation vehicle deals that have taken place do seem to represent really attractive return opportunities. Whether those net returns will match or exceed no-fee-no-carry co-investment is still to play out."

Kocsi adds: "Based on some third-party research we analysed, at the end of the global financial crisis, there was around half a trillion dollars in unrealised value locked up in private equity deals held by GPs. Today, there is almost $3 trillion. And although we have seen double-digit growth in single-asset continuation vehicles, they still only represent around 5 percent of exits.

"A few years ago, my view was that continuation vehicles were a bull market phenomenon, and that appetite would wane once things stabilised. But I think these deals are here to stay because they have become an avenue for liquidity, an alternative form of exit for both GPs and LPs."

"Timelines are proving prohibitive for most… Few LPs are organised to react as quickly as these situations require. It is not as easy as it looks"

JOCHEN MENDE
UBS Asset Management

Resilient valuations

Although co-investment dealflow appears robust, valuations remain stubbornly high.

"We have not seen a huge shift in valuations outside of tech, particularly in the US, despite average entry multiples coming down," says Kocsi. "But that is because our selectivity is even higher than it has been in the past. We've adjusted to the market dynamics by doing only the very best deals presented by the very best GPs, and in those situations, we are comfortable paying the required multiple." He adds that there has been slightly more movement in Europe due to uncertainty around debt and geopolitical tensions.

"We have seen perhaps a turn to a turn and a half coming off what was a very fully valued vintage," says Strife. "It feels like lower quantums of leverage and higher priced preferreds and junior capital have led to a little more margin discipline, but I would agree that we are seeing some very aggressive valuations for certain types of business."

According to Strife, the businesses that are commanding the fullest prices are those with a durable revenue model and a longstanding and uninterrupted top-line growth story through periods of complexity and crisis – preferably with some kind of tech enablement and strong evidence of successful pricing power. "If you have all that, then you have a highly sought-after asset."

Osman adds that investors remain somewhat skittish around tech, but that healthcare is a sector that is commanding consistently high valuations due to its resilience through cycles. "Seemingly mundane sectors including

Playing by the rules

What do the SEC's new fees and transparency regulations mean for co-investment?

Late in August, the US Securities and Exchange Commission finally imposed the sweeping regulatory reforms targeting private markets asset classes that were first proposed back in February 2022. Although the proposals – largely designed to improve transparency and fairness – have been meaningfully watered down in their finished form, the rule changes may have significant implications for the future of co-investment.

"The SEC has been responding to a perceived lack of transparency in the private equity arena, and part of that involves mandatory reporting requirements around co-investment," explains Debevoise & Plimpton's Burgess. "The other significant change in the co-investing landscape relates to pro rata allocations of deal expenses, including broken deal costs. The original SEC proposal prohibited such practices, but in response to industry input, non-pro rata allocation of deal expenses is now possible. But only if it is 'fair and reasonable', and there is adequate general and specific disclosure."

Churchill's Strife agrees, adding that the sharing of broken deal fees and expenses may impact the competitive dynamic in the market. "Firms that run co-investment as a business do stand to benefit from that, because there's a lot of fair-weather or tourist kind of co-invest money that comes in and out of the market that is not structured to actually understand what that means.

"There are channels of capital that are not equipped to stomach that risk or underwrite it or even evaluate it. So there's fallout there to be had for sure."

Burgess says: "Commentators on the original proposal questioned whether an outright prohibition would have a chilling effect on co-investment activity, because the majority of co-investment is offered with less expenses than is charged to the main fund in exchange for equity being made available. It remains to be seen whether, under the new rules, co-investments tail off in any material respect or become more expensive for co-investors.

"We may see that blind pool co-investment structures are largely unaffected, since they are more likely to bear some portion of broken deal costs. For other structures, surely sponsors will update their disclosure generally, and co-investors may prefer to look at deals later in the process, when deal certainty becomes less of a risk. Parties may also think more about corporate structures or other deal types that are outside the scope of the new rules."

asset management and insurance brokerage are also proving popular," he says. "Even food and distribution is commanding top dollar. Again, these are consistent and durable industries and where the quality of the company is also high. Those prices have not come down significantly, if at all. You get what you pay for."

There has also been an uptick in demand for infrastructure co-investment, driven by investors who are drawn to the inflation correlation and downside protection that the asset class offers. "Again, there has not been much of an adjustment in valuation multiples in those sectors for the best companies," says Kocsi, who points to digital infrastructure, in particular, given hype around AI and exponential increases in data consumption.

Competition for energy transition assets is also fierce, according to Geoffrey Burgess, a partner at Debevoise & Plimpton. "So much money has been raised by climate-focused funds, and so there is a lot of capital chasing those deals."

Follow on capital

In addition to prudent underwriting of valuations in a volatile environment, particular care must also be taken by co-investors considering the provision of follow-on capital or equity to support bolt-ons.

Kocsi says Ardian is increasingly receiving calls from GPs looking to bring in co-investors on add-ons. "As long as there is not an insurmountable mismatch in alignment, we are open to those opportunities. But truth be told, these deals are often hard because of the mismatch in basis or projected exit timing."

According to Osman, it is important to discern whether the capital being sought is a lifeline for a struggling company. "Is the play offensive or defensive? Of course, any co-investor will always conduct thorough due diligence,

but these opportunities raise particular issues around alignment. The capital structure can also appear a little upside down."

Burgess, meanwhile, has executed a number of deals involving follow-on investments in distressed assets in a legal advisory capacity. "I agree they raise questions around entry price misalignment. Co-investors need to consider whether their exit requirements match up with sponsors who may have entered at a lower valuation. We have seen situations where co-investors have asked for structured instruments to provide some downside protection as a result."

Burgess says that he has even seen co-investors saying they would consider paying a bit of carry to ensure the manager is really motivated to perform against the co-investor's entry valuation, as opposed to the original price. "Generally speaking, in these situations, the diligence process tends to take longer. There are also negotiations around deal expenses. A lot of sponsors are trying to push broken deal expenses onto prospective co-investors, and that is worthy of consideration."

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GEOFFREY BURGESS
Debevoise & Plimpton

Other risks include the US Securities and Exchange Commission's recent changes to fees and transparency, which could have significant implications for co-investing and foreign direct investment. "In the context of FDI, regulators want to know about smaller passive investment in those situations in a way they haven't before," says Burgess. "That could potentially increase reporting requirements for co-investors, although I suspect it will be the strategics that are first to feel the bite."

Fact-check tech

Due diligence is, of course, the first line of defence when it comes to risk mitigation. This is an area where technology increasingly has a role to play, says Osman. "We use technology to mine data for pattern recognition. Data can reveal that it is rare to lose money in insurance brokerage, for example. But technology is not a replacement for good old fashioned due diligence and relationships."

Meanwhile, according to Kocsi, the best way to mitigate risk in co-investment is simply by building a diversified portfolio. "By that, I mean diversified by GP, by geography, by industry and by deal size. You need to create that proverbial bell curve."

Osman agrees. "Part of what co-investment offers is reduced cost, but also risk mitigation through diversification. We max out any one sector at 25 percent. That has been challenging over the past decade when tech funds were producing off the charts returns, and we have stayed true to our exposure limits. But now, of course, in the current environment, investors have really come to appreciate diversification."

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> **JASON STRIFE**
> **Nuveen**

Indeed, LPs are increasingly looking for co-investment partners that can provide that risk mitigation through careful portfolio construction. "We have around 150 assets in our latest co-investment portfolio, more than 10 times what you would expect in an average mid-market fund," says Osman.

"Our secondaries funds, meanwhile, have exposure to thousands of companies. But when you look at the returns on offer, it is clear that co-investment provides the potential for extremely attractive risk-adjusted returns. It is a great sleep-at-night strategy."

Kocsi adds that while those considering investing with a co-investment manager will, of course, look at returns, the question then becomes whether the manager is actually delivering alpha. "Ardian only closes around five, plus or minus, out of 100 deals that emerge from our GP relationships. Selectivity is key. Investors want to know that the deals a manager is selecting are outperforming those that they are not."

And while some pension funds, for example, have sought to manage their co-investment in house, given the clear benefits in terms of cost savings, there is also the potential to make costly mistakes in terms of poor timing and concentration issues. Such are the benefits in terms of tamped-down fees that the challenges associated with executing on co-investments are often downplayed.

Kocsi points to an emerging trend that has seen a significant uptick in LPs looking to co-invest alongside Ardian's own co-investments.

Mende, however, says appetite is not always matched by ability. "Our client base is looking to us to provide exposure to co-investments, and their appetite to co-invest alongside us in that is strong. In theory, we are bringing them a fully baked deal with no fees and no carry, which is of course highly desirable. But in reality, the timelines are proving prohibitive for most, particularly where the deals are more complex – for example, when a GP is looking to finance an add-on in order to preserve their committed capacity.

"Few LPs are organised to react as quickly as these situations require. It is not as easy as it looks." ■