ROUNDTABLE

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How co-investors are adjusting to an unsettled market

Institutional capital continues to flow into the co-investment market. With inflation high, interest rates on the rise and regulatory change on the horizon, managers need to work hard on returns, writes Carmela Mendoza

When *Private Equity International* gathered participants for its annual co-investment roundtable in London in early September, inflation in the eurozone had just hit another record. Volatile energy prices caused by Russia's invasion of Ukraine, combined with households facing a cost-of-living crisis, was also wreaking havoc on consumers in the US and worldwide.

Within this environment, participants from Ardian, BlackRock, Debevoise & Plimpton, HarbourVest Partners, Lexington Partners and Pantheon deliberated over the most crucial challenges affecting co-investment players.

Appetite for co-investment has been on the rise for years and remains strong, with nearly two-thirds of investors planning to invest directly alongside their GPs over the 12 months following *PEI*'s latest *LP Perspectives Study*. While there is pressure on GPs to deliver co-investment to their investor base, there is also pressure on LPs to execute on the co-investment appetite they have indicated.

Proportion of investors surveyed for *PEI's LP Perspectives Study* who are receptive to co-investing

Looking ahead, the array of challenges for private equity co-investors may prompt an overall slowdown. Raja Hussain, a director at BlackRock, describes the last 12 months as a tale of two halves. "It was a very different sentiment for co-investment [in the second half of last year]… That was driven by the flow of private equity opportunities [and] the level of deal volume, and therefore that ultimately filters down to the amount of co-investments available for LPs. There was a strong

PHOTOGRAPHY: **RICHARD DAWSON**

Craig MacDonald

Managing director, HarbourVest Partners

MacDonald focuses on originating, evaluating and executing direct co-investments in growth equity and buyout transactions, primarily in Europe. He joined the firm in 2005 from Morgan Stanley.

Erik Wong

Partner, Pantheon

Based in London and serving as a partner in Pantheon's global co-investment team, Wong is responsible for sourcing, executing and monitoring co-investments in Europe. He joined the firm from Abu Dhabi Investment Authority. Prior to that, he worked for the UK's IFRS Foundation.

Kate Ashton

Partner, Debevoise & Plimpton

Ashton is a leader of the firm's private funds transactions group. She also regularly counsels investors on private fund restructurings, recapitalisations and tender offers, listed fund transactions, purchases and sales of portfolios of LP interests.

Patrick Kocsi

Head of US co-investment, Ardian

Kocsi co-heads the private equity co-investment practice at Ardian, currently investing from its fifth-generation $2.5 billion fund. Prior to joining the firm, he spent 24 years with General Electric Company and also founded Juna Equity Partners in 2016.

Philip Smelt

Principal, Lexington Partners

Smelt is primarily engaged in the evaluation of non-US equity co-investments. Previously, he was an associate in investment banking at Bank of America Merrill Lynch, and prior to that was an associate in investment banking at NM Rothschild.

Raja Hussain

Director, BlackRock

Hussain is a member of BlackRock's investment team, based in London. He is responsible for co-investment and co-underwrite transactions in EMEA across a range of sectors and deal sizes. Previously, he was a senior associate within Citi's investment banking division.

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>
> **CRAIG MACDONALD**
> **HarbourVest Partners**

appetite for co-investments and a lot of activity in very large transactions. We also had the additional phenomenon of single-asset deals, which can fit in either the secondaries bucket or the co-investment bucket."

That's yet to be seen this year as market participants contend with a somewhat less active deal environment, particularly at the larger end of the deal size, Hussain notes.

"There is a sense that the market is readjusting to the new investment conditions, and perhaps also a concern that the macro outlook could become more difficult before it gets better – particularly in light of further energy price increases," says Philip Smelt, a principal at Lexington Partners. "While deal execution will certainly continue, we expect the pace of deal-doing to remain somewhat constrained over the coming quarters."

In fact, Lexington has heard of several high-quality sponsors discarding their entire deal log pre-summer and saying: "Let's give this two or three months, let's see how things settle down before committing to further investments."

What's different is that the dry powder that's available for co-investment is held by players with greater institutional quality compared with the past decade, Hussain notes. "You have a lot more dedicated teams for co-investment and a lot more sector-focused teams within those co-investment teams. Those institutional LPs are set up to deploy capital on a more regular basis, but it would be a lot more tempered, given the macro environment and the slower dealflow we're likely to see."

Deal landscape

Craig MacDonald, managing director of HarbourVest Partners' co-investment team, says: "What's interesting is that you will see other business sectors that are a bit more favourable to higher interest rates, such as balance sheet financial institution investment opportunities, find renewed popularity, as they have a history of performing better in rising rate environments."

MacDonald also notes that the dominance of the tech sector in last year's dealflow continues to be a feature in 2022. "There was a general hope in late-2021 that in 2022 we might see more industrial or consumer deals. But these haven't materialised due to a combination of factors, such as inflation and [the] impact of the Russia-Ukraine war on energy prices making consumer and industrials a very difficult investment choice."

The participants agree that market complexity will breed opportunities for co-investments. As a potential recession starts taking shape, opportunistic investments could take the form of corporate divestments as companies need to generate cash, says Hussain. It could also be businesses that are running out of cash and need some element of

bridge financing, as well as take-privates, he adds.

"Notwithstanding the reduction in deal volumes, the current higher cost of debt is likely to drive a greater equity component in private equity transactions and an increased need for co-investment from sponsors," says Smelt. "In fact, we have seen this trend recently on various follow-on investments, with sponsors incorporating equity into the financing of add-on investments, when previously they would have been entirely debt funded.

"Furthermore, the ongoing macro uncertainty and crowded fundraising market [are] causing fund sizes, on average, to come in below the levels desired by sponsors, thereby driving a greater need for co-investment capital to execute transactions. So overall, despite the challenges faced by [the] market more generally, we believe there are specific positives for co-investors."

Buoyant capital markets, good debt availability and a generally positive outlook over the last several years have meant co-investment players have run processes and lined them up to maximise price, according to Hussain. "We do a significant amount of stress testing and recession-scenario analysis to examine [the] resiliency of businesses. Now that those things start to become more of a reality, I think the nature of dealflow will start to vary.

"We will start seeing slightly better-priced transactions. But we will also see more complexity coming into those transactions by way of structure, which will bridge that disparity between [the] seller's expectations and buyer's expectations, so that the headline price isn't as major a dynamic or consideration."

Ardian's head of US co-investments, Patrick Kocsi, notes that the firm's selectivity rate for deals – which is already very low – has come down even further. Ardian has also been more focused on the underlying leverage of the company.

"More GPs are now coming to us pre-signing," says Kocsi. "We've always had a very high percentage of our deals where we do pre-signing as opposed to, say, what I'll call the more traditional post-deal syndication. We're happy to do both, but especially in a take-private context where they need co-underwriting, pre-signing is becoming more prevalent. GPs need certainty of execution."

Kocsi makes a distinction between the "structured" co-investment players (themselves and everyone in the room) versus the "episodic" co-investors, who might be traditional LPs and who wear many hats, so may sometimes retreat from the market as their risk profile changes and then come back in.

"We are permanently in the market. We may have lower volumes from time

"Businesses that command a leading or differentiated market position, have a sticky revenue base, and benefit from secular or structural growth will continue to attract strong interest from the investor universe"

ERIK WONG
Pantheon

to time or we may choose to decline certain deals, but we're consistent players investing through any cycle," Kocsi says. "Our GPs know that they can rely on us for that. We're staying in, but we're always selective about the deals we pursue."

More prescriptive regulations

The conversation turns to the US Securities and Exchange Commission's proposed overhaul of private funds regulation. Potential changes published in February will affect how the industry operates, including on clawback provisions, GP-led secondaries, and how fees and expenses are charged.

How are recent proposals affecting thinking around co-investments? On the whole, the SEC is moving toward prescriptive regulation, says Debevoise & Plimpton partner Kate Ashton. "Its usual position was, 'You can do whatever you want in private equity as long as it's disclosed'. For the first time, it's proposing a prescriptive rule that prohibits certain types of contractual arrangements."

Ashton says the most important change for co-investment is the new rule prohibiting non pro rata allocation of costs. "This means that they will require expenses to be evenly done pro rata to the investment among co-investment vehicles and the sponsor's fund going into a deal. The immediate issue I think that that's going to cause is that, in our experience, some co-investors resist broken deal expenses. With this rule, it's expected that co-investors will have to step up for broken deal expenses or other expenses in the same way that the sponsor's main fund goes into it."

She adds: "We don't know what the impact of the final rules is going to be – perhaps co-investors swallow the broken deal costs and don't mind having these allocated to them. But it could conceivably cut some of the co-investment players out, and could well be a differentiator among co-investors."

Erik Wong, a partner at Pantheon, says: "This is essentially a commercial decision, which is a function of the co-investors' assessment of the seller's motivation, attractiveness of the opportunity, the GP's positioning in the process and amount involved, among others."

Kocsi, meanwhile, says Ardian is watching how the rules come into play. "As a French limited partnership, we're already exposed to and comply with various European regulations that in many cases touch upon some of the same factors that the SEC is now discussing. So we can navigate any changes and adapt our business model to be compliant with any regulation, no matter where we do business."

Kocsi adds that if the rules come into play as they are described now,

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> **PATRICK KOCSI**
> **Ardian**

there would likely be middle- and back-office implications to their institutions in terms of adjustments in how they report to LPs. "The cost of business could go up commensurately. We will have to manage that. However, at this point, we don't necessarily see any massive friction in what we do on a day-to-day basis."

Another area of concern: preferential treatment. This would have an impact when the GP has a large anchor co-investor, says Ashton, in which LPs may have a certain amount of leverage and could have negotiated to get preferential information. "The new rules no longer allow investors to have that special treatment," she says.

Ashton also notes that heightened scrutiny worldwide on foreign direct investments, as well as competition and antitrust rules, are coming into play for co-investors. "For a small minority co-investor, that might mean less certainty of execution. If there's going to be an antitrust filing or competition ruling, you're never sure if the deal is actually going to close until those processes are done."

The rise of GP-led secondaries

There is consensus around the table regarding the blurring of lines between secondaries and co-investments.

Private equity sponsors selling assets to themselves – or GPs moving an asset or assets out of an existing fund and into a separate fund, often named a 'continuation vehicle' – has been on the up. Data from Lazard shows this market was worth about $16 billion per year five years ago. In 2021, it hit a record $63 billion, although deal figures for the first half of this year show a slight decline from the prior period.

Kocsi says that between 25 and 40 percent of Ardian's deal pipeline over the last 18 to 24 months has been single-asset deals. "Continuation fund deals have taken market share, and to us, it's somewhat a bull market 2020-21 phenomenon. When we sit with some of the bankers, we do get the sense that their pipeline of these kinds of deals is slowing as well. In fact, we've seen fewer single-asset deals in the first six months of 2022 than we saw a year ago."

There are clear benefits to single-asset GP-led deals and co-investments, depending on the risk/return and duration preferences of investors. Pantheon's Wong notes that a benefit for single-asset GP-leds is self-selection with a positive bias to quality assets, where a sponsor wants to continue to own one of its best assets. "In this case, the sponsor has an extensive knowledge of the asset, strong partnership with [the] management team, and high conviction in the next phase of growth."

He continues: "With co-investments, an investor benefits from full alignment with the GP... The sponsor's sector expertise could potentially

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> **PHILIP SMELT**
> **Lexington Partners**

generate outsized returns, and a well-established co-investment platform with good dealflows could provide the diversification for mitigating return volatility."

Smelt notes that, as a co-investor, it is of the utmost importance to invest in a deal alongside a sponsor's fund.

"In doing so, we align ourselves with both the sponsor's current fund and its most important LPs. This alignment with the most important elements of a sponsor franchise provides protection as a co-investor and is not always there to the same extent on continuation vehicles. In addition, fees and carry are typically charged on continuation vehicles, but generally not on institutional-level co-investments."

For those with the appetite for it, the continuation fund trend will be dependent on the available exit options. HarbourVest's MacDonald says: "The public markets will continue to get smaller in terms of the number of companies trading, as illustrated by the Wilshire 5000. The companies that go public are larger, more mature, and there's a need for the GPs to create an exit ahead of an IPO so they can return capital. I do think that single-asset deals and continuation funds offer this ability, which could be sustained long term."

Kocsi admits he's quite conflicted by continuation funds: "We promise LPs that we're going to build them a portfolio of co-investments on a no-fee, no-carry basis with minor exceptions. We've done a few family-office deals and things of that nature, and we have done a few continuation deals where we pay economics, but, generally speaking, we shy away.

"You need a really good reason to put a single-asset deal in an Ardian co-investment fund. It could be an asset we've been tracking for 10, 15 years – that for whatever reason we haven't gotten access to – or that we just love the company and the company-GP combination. Maybe then we will do it."

In Kocsi's view, the biggest concern is misalignment. Discussions surrounding how much carry a sponsor should roll, how much they can accrue in fees and carry, and what targets they must hit to trigger that carry need to be conducted transparently in order for LPs to feel comfortable around such deals.

Standing out in the crowd

How then do co-investors position themselves amid the competition? Smelt says: "A critical aspect of running an effective co-investment programme is sourcing robust levels of dealflow, and this is, in large part, achieved through maintaining strong and varied relationships with private equity sponsors. Successful co-investors will have developed these relationships over many years, such that when a sponsor requires outside equity on a deal, that co-investor is front of mind.

"Co-investors can also position themselves to see dealflow by acting as a user-friendly and responsive counterparty for the sponsor, with speed becoming increasingly valuable to sponsors as deal time frames have compressed. The ability to provide a strong, early signal – whether that is yes or no – is of real value to the sponsor in these processes."

Hussain says co-investors need to make sure they've got the ability to engage through co-underwriting or via a syndicated process, and, importantly, need to keep the fund open across the different universe of GPs.

"This includes GPs that they may or may not be invested in. It also means leveraging the primary programme and secondary programme relationships. This means co-investors can maintain that selectivity rate and choose what they believe to be the best opportunities."

Building on strengths

In such market conditions, managers and their capital backers need to work hard for their returns, argues Wong. "We are seeing a flight to quality in this current environment on transactions that are completed. Businesses that command a leading or differentiated market position, have a sticky revenue base, and benefit from secular or structural growth will continue to attract strong interest from the investor universe. While valuations may be elevated for those assets, sponsors who have operational know-how and sector expertise should continue to be able to develop their investment angles and generate strong returns."

MacDonald points out: "I think co-invest GPs are benefitting in this current environment by the way that co-investment firms with commingled funds are providing solutions based around their capital and structuring capability... I'm not saying it's the best ever time to be a co-investor, because there are challenges to investing given current market uncertainty. But the last six months underlined why co-investment-focused teams are a permanent feature of the deal landscape."

As Kocsi notes, private equity investors have proven over the last three decades that they can sustain over the longer term. "That's something that LPs value," he says. "If you think about co-investments in the mid-market, LPs like it because they get exposure. And if we do our job well, that's more diversification, a lower fee structure and better net returns. That's a pretty good message in almost any cycle."

"We are cautious in the current market," says Wong. "Equally, we are confident in our GPs' ability to weather the downturn and continue to deliver strong returns, irrespective of market environment." ■

"You have a lot more dedicated teams for co-investment and a lot more sector-focused teams within those co-investment teams"

RAJA HUSSAIN
BlackRock