ROUNDTABLE

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When the music stops: Be ready

Co-investment provides access to great assets at reduced economics. However, when this bull run finally ends, co-investors must be ready to get their hands dirty, write Adam Le and Amy Carroll

When the world ground to a screeching halt in March 2020, the internal view at BlackRock was that everyone would need to hunker down and endure a long winter.

"We expected liquidity to dry up and for deal activity to disappear, as investors concentrated on firefighting," Arslan Mian, managing director at BlackRock Private Equity Partners, tells participants at *Private Equity International*'s latest co-investment roundtable. "In reality, that only lasted for a few weeks. Investment pace has come roaring back and leverage is freely available. The biggest surprise for me has been how quickly deal activity has rebounded."

Adams Street Partners head of co-investment David Brett agrees. "We have been impressed by how our GP base has responded to covid, in terms of proactive portfolio analysis," he says. "The response has been even more proactive than what we saw during the GFC. Triage was generally performed quickly. We have been pleasantly surprised by the overall health of the portfolio, which has enabled us to lean into new investment opportunities created by the market dislocation. Our dealflow since August 2020 has been as strong as ever, perhaps stronger."

While co-investment supply is booming, so too is demand. "Clients are competing very hard for co-investment transactions," says Kate Ashton, a partner with law firm Debevoise & Plimpton.

Ian Lane, managing director at HarbourVest Partners, adds: "Private firms have substantial dry powder to invest, while public market companies have high stock prices and large balance sheets they can utilise for M&A. At the same time, high valuations present a compelling opportunity to sell assets. We are seeing all of the historic drivers for deal activity in play in the current environment."

The advantages of co-investment are clear. These deals provide the opportunity to tailor a bespoke portfolio, at reduced economics, and so the return prospects are compelling.

"Most LPs co-invest in order to boost net returns over fund investing, on the basis that co-investment commands little or no fees," says James Pitt, partner at Lexington Partners. "The question, then, is can you create a co-investment portfolio with a similar, or better, risk profile to a buyout fund, which you certainly should be able to assuming you have good access to high-quality dealflow from top-tier GPs."

Some players temporarily withdrew from the market when covid hit only to return when the denominator effect went into reverse in September 2020. Now, with the exception of a small

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> **Debevoise & Plimpton**

number of sovereign wealth funds and state pension funds that have experienced strong demand on their reserves because of covid, these investors are playing catch-up.

"With distributions high, those investors are under huge pressure to put money back into the ground," says Francesco Aldorisio, head of direct investments at Unigestion. "That means demand for co-investment is exceptionally strong. Meanwhile, on the supply side, GPs are using the promise of co-investment to support fundraising, where there has been a pronounced flight to quality."

Lexington raised more than $3 billion for its latest co-investment fund in February. "We only work with a small number of large LPs," says Pitt. "Those LPs on average increased their bite size by over 25 percent and we could probably have raised a multiple of that amount if we had wanted to."

HarbourVest, meanwhile, is in the

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> **JAMES PITT**
> **Lexington Partners**

James Pitt
Partner, Lexington Partners

James Pitt is a partner of Lexington and leads the firm's co-investment business outside the US. Prior to joining Lexington in 2006, he was head of the London office of AXA Private Equity, now Ardian.

Kate Ashton
Partner, Debevoise & Plimpton

Kate Ashton is a leader of Debevoise & Plimpton's alternative assets transactions and liquidity solutions group. She counsels investors on a range of secondaries transactions and co-investments, as well as private fund restructurings, recapitalisations and tender offers.

Francesco Aldorisio
Partner and head of direct investments, Unigestion

Francesco Aldorisio joined Unigestion in 2017 with the integration of Akina into Unigestion's private equity unit. He began his career in 2002 at ABB in the corporate merger and acquisitions team.

Ian Lane
Managing director, HarbourVest Partners

Ian Lane joined HarbourVest in 2003. He focuses on direct co-investments in venture, buyout and mezzanine transactions. He previously worked in investment banking at JPMorgan.

Arslan Mian
Managing director, BlackRock Private Equity Partners

Arslan Mian heads the Americas investment team for BlackRock Private Equity Partners. Prior to joining the firm, he served as a vice-president at UBS Capital Americas in the corporate finance and financial sponsors groups.

David Brett
Partner and head of co-investment, Adams Street Partners

David Brett oversees the sourcing, screening, execution, monitoring and exit of leveraged buyout co-investments at Adams Street Partners. He previously served as a senior partner at PPM America Capital.

middle of raising its sixth commingled fund and continues to see strong demand. "Select LPs are large enough to develop an internal co-investment programme and/or form a separate account relationship with a co-investment GP, but for many investors, the most efficient and cost-effective way to access co-investments is through a commingled fund offering," says Lane. "A dedicated co-investment fund can provide access to a diversified portfolio of investments alongside top performing GPs and at a reduced cost."

What is driving the growth of these multibillion-dollar funds? For BlackRock's Mian it is simple arithmetic. "A decade ago, there were around 3,000 investors," he says. "Today that figure is closer to 10,000. The ballpark allocation used to be 5 percent to 7 percent. Now it is north of 10 percent. If you are an investor that is falling behind and needs to increase your exposure to private equity, co-investment is a great way to put capital to work – and catch up on investment pacing."

The dramatic decline in the number of public companies is also a factor. "These companies aren't disappearing; they are choosing to be funded by private equity instead," Mian says. "If you want to do stock picking in the private world and gain exposure to companies that you may previously have had access to through public markets, co-investment is the way to do it."

Competition creep

Strong demand is attracting more new entrants to the co-investment space, including a spate of US pension plans. That means investors must find ways to ensure they are at the top of GPs' co-investment call lists.

"The ability to perform at speed is important, particularly as transaction timeframes have accelerated," says Pitt. "Pre-emptions, in particular, can be pretty quick. Scale is attractive for GPs, too, because it means going to a smaller number of co-investors, which reduces transaction complexity. It is also important that your fund is fully discretionary. You need to be able to speak for all of the capital you are representing."

Pitt notes that when he started out in co-investments in the mid-1990s, it took about eight weeks from an initial phone call to funding. "Today, we are typically talking about four weeks," he says. "But while timeframes may only have halved over a long period of time, what is critical now is the ability to provide closing certainty. Within 10 days, or less, you need to be able to send a strong signal that you will be coming in or else get out of the way."

The pressure to move quickly on transactions will continue. "Once clients

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> **Adams Street Partners**

become accustomed to tight deadlines, they never go back," says Ashton.

Other important differentiators include a broad private markets platform. "Adams Street works collaboratively with GPs, seeking to provide funding solutions, whether those solutions come through our primary investment, private credit, secondaries or co-investment businesses," says Brett. "We focus on relationship development. A relationship can start in a variety of ways, including with Adams Street providing some private credit. As we develop a relationship with the GP, we may have the opportunity to participate in a co-investment opportunity with that GP. It's about playing the long game. We want to be seen by our GPs as a reliable partner so that we stay top of mind for investment opportunities, with the goal of Adams Street becoming the first call for any capital need."

Another way to differentiate yourself as a co-investor is to be proactive and bring ideas to sponsors. "We bring the best of BlackRock to the private equity partners we work with," says Mian.

"We bring fintech and financial services ideas to our GPs, for example. Another differentiator is the sector specialisation within our co-investment business. This is something we started seven or eight years ago to align ourselves with the way the GP community was evolving. It means that when a GP comes to us with a deal, they don't have to educate us on the basics of the industry. We can have in-depth conversations about the opportunity and the GP's value-creation plan, rather than learning about the industry on the fly."

Successful co-investors must be well resourced and provide a high degree of execution capability. Passive, post-signing syndications are still a meaningful part of the market today, but there is a growing list of LPs competing for those allocations. The more durable opportunity lies with the ability to co-underwrite alongside a lead GP.

"There are fewer participants and higher barriers to entry in the solution-orientated part of the market," says HarbourVest's Lane. "Solution-orientated co-investments require speed, scale, flexibility and risk-sharing. In these situations, co-investors need to deliver value to the lead GP in the due diligence, signing and closing processes."

According to Aldorisio, about 90 percent of what Unigestion does in its mid-market sweet spot involves that form of co-underwriting. "We share in different types of risk and we share workload," he says. "In the size range where we operate, that is the nature of the business."

Reverse termination fee (RTF) liabilities are a particularly contentious issue, however. "While it is very uncommon for reverse transaction fees to be paid, they present a significant potential liability," says Lane. "Most co-investors don't have the underwriting processes required to evaluate that type of risk and instead choose to avoid transactions with possible broken-deal expenses."

Mian adds: "RTFs are a difficult arrangement to be in as a co-investor because typically you will be liable for the GP pulling the deal, but you won't have the right to pull the plug yourself. If you are going to agree to an RTF in that situation, it had better be with a GP you fully trust. Generally, what we see in the industry with RTFs is there is a sharing of success fees."

Another form of added complexity that a sophisticated co-investor may be able to take on involves warehousing – the provision of capital to finance a deal before the GP has raised the necessary funds. "Warehousing can be helpful to GPs that don't want to miss out on an opportunity but that don't have the total capital required for whatever reasons," says Ashton.

Unigestion's Aldorisio cautions that it is important to be selective in this area: "It is one thing providing warehousing for an established GP that has perhaps invested its fund quicker than anticipated, but it is another backing a brand-new team."

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ARSLAN MIAN
BlackRock Private Equity Partners

Mian says: "We sometimes see emerging managers trying to build a pre-fund track record through co-investment. That has been an increasing source of dealflow for us over the past decade. In most cases it will be a team we have already backed inside another institution. It is an interesting part of the market – high-performing individuals who have hit a ceiling in their organisations and require co-investment support for a number of years while they build a track record before launching their first formal fund. I think that is a more dominant trend than warehousing."

Brett says over the past 12 months Adams Street has taken part in three or four deals where assets have been sold between a GP's own funds. "The GP has owned the asset for some time, so already knows where the skeletons might be," he says. "As long as they are demonstrating conviction, for example, by rolling earned carry into the new deal, we like those dynamics. Five or 10 years ago, people might have felt it wasn't worth the headache of getting the different advisory boards to agree on valuations, but the market has now accepted the logic of these deals."

In sickness and in health

Co-investors need to be more than good partners on the way into a deal. They also need to have the capital reserves and human resources to step in if things go wrong later in the investment cycle.

It was the experiences of the global financial crisis that led to a sharp decline in club deals. When trouble hit, the dynamics of having four or five different private equity firms attempting to manage the board of the troubled company became challenging. "Co-investment has been the beneficiary because GPs have surmised that co-underwriting with LPs with whom they are already intrinsically aligned will prove less problematic," notes Mian.

However, that brings with it responsibilities for the co-investor. "Co-investors need to have all the skills of a lead investor, not least because they could potentially have to step up in some cases," says Aldorisio. "We haven't seen it ourselves during this downturn, but we certainly had to take the bull by the horns in a couple of cases in the last recession some 13 years ago."

Ashton adds: "If you are managing a pool of capital on behalf of your clients, you have a responsibility not just to win co-investment opportunities, but also to monitor those investments once they have been completed. You cannot passively rely on the GP. Particularly, if you have a significant equity interest, you may have to make quick decisions around exit, for example, or around whether or not to participate in follow-on funding."

The roundtable participants are sceptical about whether some of the newer entrants to co-investment have all the necessary capabilities in place. "Co-investors must be able to support the companies they invest in," says Lane. "This includes actively monitoring their portfolio and being prepared to participate in follow-on financings as well as liquidity decisions. Many co-investors in today's market have not managed a co-investment portfolio through a recessionary environment and may not have the resources required to make critical, time sensitive decisions."

Brett agrees that it is vital to be a good partner when deals run into trouble and not just when they are going well: "You have to have the resources to be responsive if a GP comes to you and says they have hit a bump in the road."

After all, it is inevitable this unprecedented bull run will end, so co-investors must be ready to face the consequences. "Similar to experienced GPs, co-investors need to have the resources, decision processes, and skill sets to support portfolio companies and make new investment decisions in both high growth environments, as we have seen recently, as well as slower growth and recessionary environments, which are sure to return at some point," says Lane.

"There is a tonne of dry powder out there. A lot of LPs want to increase their exposure to private equity and so the demand fundamentals remain solid," adds Pitt. "Having said that, if there is a market reset, there may be a stand-off for a while as sellers hold out for yesterday's prices and buyers try to negotiate a discount. Anything that impacts the primary deal market will inevitably impact co-investment volumes."

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FRANCESCO ALDORISIO
Unigestion

Aldorisio agrees that the underlying economic cycle cannot continue forever: "All the investments we have completed in the last 18 months have been underwritten on the basis of a slowdown."

For Brett, the key is to remain vigilant around deal selection. "It isn't our job to time the market," he says. "Our strategy is to invest behind growth, dislocation and change and to ensure we are backing resilient businesses which we believe can grow their way out of any downturn."

"We are optimistic that the current pace of investment will continue over the short to medium-term, but more cautious as we move beyond 2022 and into 2023," says Mian. "We have bounced back from the pandemic-driven recession very quickly as people exercise what has been phrased as revenge shopping. The question is how long can this last?" ■