ROUNDTABLE

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The power of co-investment

A co-investing strategy can boost portfolio performance for investors while allowing GPs to get deals done in a challenging market, write Amy Carroll and Carmela Mendoza

Protracted economic and geopolitical uncertainty mean buyout volumes have remained muted in recent years. Co-investment, by contrast, is booming.

"We've observed the co-investment market experiencing strong levels of dealflow in recent years, despite overall buyout activity being more muted," says Craig Stevenson, a partner at Lexington Partners, speaking on *Private Equity International*'s co-investment roundtable. "There are a number of observable industry dynamics that are constructive for investors. In our view, this year's market presents robust opportunities compared with past cycles seen over my 17 years in the industry."

The data supports this theory: Clodagh Coghlan, managing director at StepStone Group, notes that a 2024 StepStone survey of 145 GPs and 420 co-investments found that co-invest deal volumes have significantly outpaced overall M&A over the past decade. GP demand for the strategy is largely being driven by a tough fundraising environment and higher cost of debt, meaning managers are increasingly having to rely on third-party equity to complete deals.

Furthermore, co-investment is a highly effective marketing tool, according to Thomas Roche Toussaint, head of private equity secondaries and co-investments at UBS Asset Management's Unified Global Alternatives: "Managers want to incentivise LPs to invest in their funds. They want to demonstrate their capabilities, and so they are offering co-investment as a way to kickstart conversations on the primary side, forging and strengthening those LP relationships."

Dominic Blaxill, a partner at Debevoise & Plimpton, adds that while there are clear market drivers for the growth of co-investments, another factor is simply that the market is getting better at them. "Every deal is different, and we're some way off standardisation. But advisers are more practiced at spotting issues before they become problems.

"GPs are rarely starting from scratch in terms of their own process, and LPs are able to move increasingly swiftly. Put that all together and it quickly becomes a more attractive deal type."

The deal appeal

While general partner demand for co-investment is high, so is appetite among investors. The primary draw, of course, is economics. "One of the main reasons that investors like co-investment so much is that the fee savings can be significant," says Stevenson. "Co-investment deals are typically accessed on a reduced- or no-fee basis, which makes it easier for co-investors to achieve an attractive outcome."

Co-investment is also a great way to build relationships with GPs and develop an understanding of how those GPs operate. "It offers an incredible advantage when it comes to underwriting on the primary side," says Coghlan. "For example, you get to see how a firm iterates its thinking as it receives more information. You get to see how the investment committee works. It really helps inform your overall view of a manager."

"A co-investment allocation can complement primary commitments," agrees Stevenson. "It can offer strategic and informational advantages."

What's more, Stevenson adds, co-investment can allow investors to refine their exposures. "When investors commit to blind-pool funds, they don't typically know exactly how that capital is going to be deployed," he says. "Co-investment can be used to adjust those exposures. If a large number of investors start moving into tech, for example, an investor can rebalance by co-investing in other sectors."

Meanwhile, the strategy is also proving popular with newer pools of capital, including private wealth investment. "Private wealth is already playing a very significant role on the primary side. Most of the large-cap players now expect to raise a third of their capital through this channel," says Roche Toussaint. "There is definitely a growth angle for co-investment here as well, given the fee reduction, diversification and consistency that co-investment offers."

The strategy is well suited to evergreen vehicles in particular because capital can be deployed quickly, according to Alexandre Motte, senior managing director and co-head of co-investment at Ardian. "A lot of private wealth investors are also entrepreneurs who like the fact that co-investment enables them to be closer to the assets."

Risks to consider

While the benefits of co-investment may be readily apparent, execution is not always straightforward

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> **DOMINIC BLAXILL**
> **Debevoise & Plimpton**

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> **ALEXANDRE MOTTE**
> **Ardian**

Thomas Roche Toussaint

Head of private equity secondaries and co-investments, UBS Asset Management, Unified Global Alternatives

Thomas Roche Toussaint is responsible for leading the selection, execution and portfolio management of private equity investments in secondaries and co-investment transactions. Prior to joining UBS's Unified Global Alternatives unit, he held various roles at HarbourVest, Deutsche Bank, JPMorgan and Bridgepoint.

Craig Stevenson

Partner, Lexington Partners

Craig Stevenson focuses on the origination, evaluation and execution of equity co-investments. He joined Lexington as an associate in 2008 from JPMorgan, where he was an associate in investment banking.

Benjamin Hur

Managing director, co-head of the direct equity team, Future Standard

Benjamin Hur joined Future Standard in 2010. He was previously an investment banking analyst in the global consumer group at Citigroup, where he worked on financing and M&A transactions.

Dominic Blaxill

Partner, Debevoise & Plimpton

Dominic Blaxill is a partner in Debevoise & Plimpton's M&A and private equity groups, as well as being part of the firm's private fund transactions group. He joined the firm in 2015, having previously worked as an associate in the corporate group of another international law firm.

Alexandre Motte

Senior managing director, co-head of co-investment, Ardian

Before joining Ardian in 2007, Alexandre Motte worked for eight years at Boston Consulting Group, where he was a principal focusing on healthcare and consumer goods. He also worked as an M&A analyst for two years at the Banque Nationale de Paris in New York.

Clodagh Coghlan

Managing director,
StepStone Group

Clodagh Coghlan is a senior member of StepStone's private equity team, primarily responsible for the origination, evaluation, execution and management of equity co-investments. Coghlan, who joined StepStone from Credit Suisse in 2016, has a particular focus on the lower mid-market.

– particularly as the co-investment space becomes more complex and competitive.

"There are a lot of co-investors clamouring for high-quality, recession-proof and tariff-proof assets right now. The price you pay is important, and so discipline is key," says Benjamin Hur, managing director and co-head of the direct equity team at Future Standard.

"We are seeing a lot more auctions. Competition is high," adds Stevenson. "We believe it's important to have a big team so that you are able to source widely, because there is no guarantee you will prevail in every deal you pursue."

Co-investment is also becoming more complex due to an ongoing shift towards co-underwriting. "Around 62 percent of all co-investments now happen prior to the deal being signed, up from 40 percent between 2010 and 2014 and just 12 percent in 2005-09," says Coghlan. "In some cases, a portion of that co-investment may later be syndicated, but a full 30 percent of co-investment today is purely co-underwritten. That is because GPs need certainty of execution. Co-investment is no longer just a carrot to entice LPs to commit to a fund: it is a tool that the GPs use in order to get deals done."

"Co-investment is very appealing, but it isn't easy, particularly given the trend towards co-underwriting," says Motte. "That means groups like ours are gaining market share. We are also helping to grow the market because we are professionalising co-investment, providing a real solution to GPs. We are enabling them to do deals that they couldn't otherwise do. Co-investors without those resources are either leaving the market or are not being picked by GPs as preferred partners."

"In our view," adds Stevenson, "co-investment used to be a syndication market, but we've observed that it is now evolving more into junior capital. The level of professionalisation needed to execute is getting higher and higher."

The perfect partner

So, what does it take to become a preferred co-investment partner? According to StepStone's Coghlan, GPs are looking for speed and certainty, as well as consistency and scalability of capital. "Our report showed that 51 percent of LPs say they want access to co-investment, and yet only 23 percent of those have been able to execute over the past five years. GPs have limited time. They are chasing competitive deals, so they are going to turn to those co-investors that show up time and time again."

"In order to stay on GPs' shortlists," adds Roche Toussaint, "you need experienced co-investment teams that can act quickly and with conviction. Sometimes – with a take-private, for example – you need to be able to perform due diligence on the asset, commit and release capital in a matter of weeks."

Hur agrees that co-investment timelines have become truncated, particularly over the past 18 months. "That means you need a dedicated team that can move quickly. In a highly competitive market like this, where co-investors are clamouring for high-quality assets, speed, consistency and reliability are paramount."

Having the right external advisers to allow you to execute quickly is also critical. "You need someone who knows your processes and the points that you are going to want to see raised with the other side so that you can be really efficient," says Blaxill. "No one wants legals holding up a deal."

In addition to speed, GPs are increasingly looking for a true partner. "Co-investment used to be transactional. Now it is more about forging a partnership with the GP," says Motte. "As co-investors, it is therefore very

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> **CRAIG STEVENSON**
> **Lexington Partners**

important that we can meet GPs' needs. At the same time, GPs are working hard to try and understand what each co-investor wants. Some have even set up teams dedicated to handling co-investment processes."

Coghlan adds that a partnership approach is even more important at the smaller end of the market. "Many of the big global players have entire teams focused on facilitating co-investment. In a smaller firm, there may be just one investor relations professional. These are the firms that need partners," she says. "They need strategic solutions providers who they know will be able to deliver."

Coghlan also emphasises just how much value co-investors can potentially bring to a deal. "We are lucky to be sitting in a part of the private equity ecosystem through which a lot of information passes. GPs only see the subset of deals that they review.

"We underwrite a much larger opportunity set, and that gives us a unique perspective that our GP partners value. Take insurance brokerage, as an example: that has been a hot sector for

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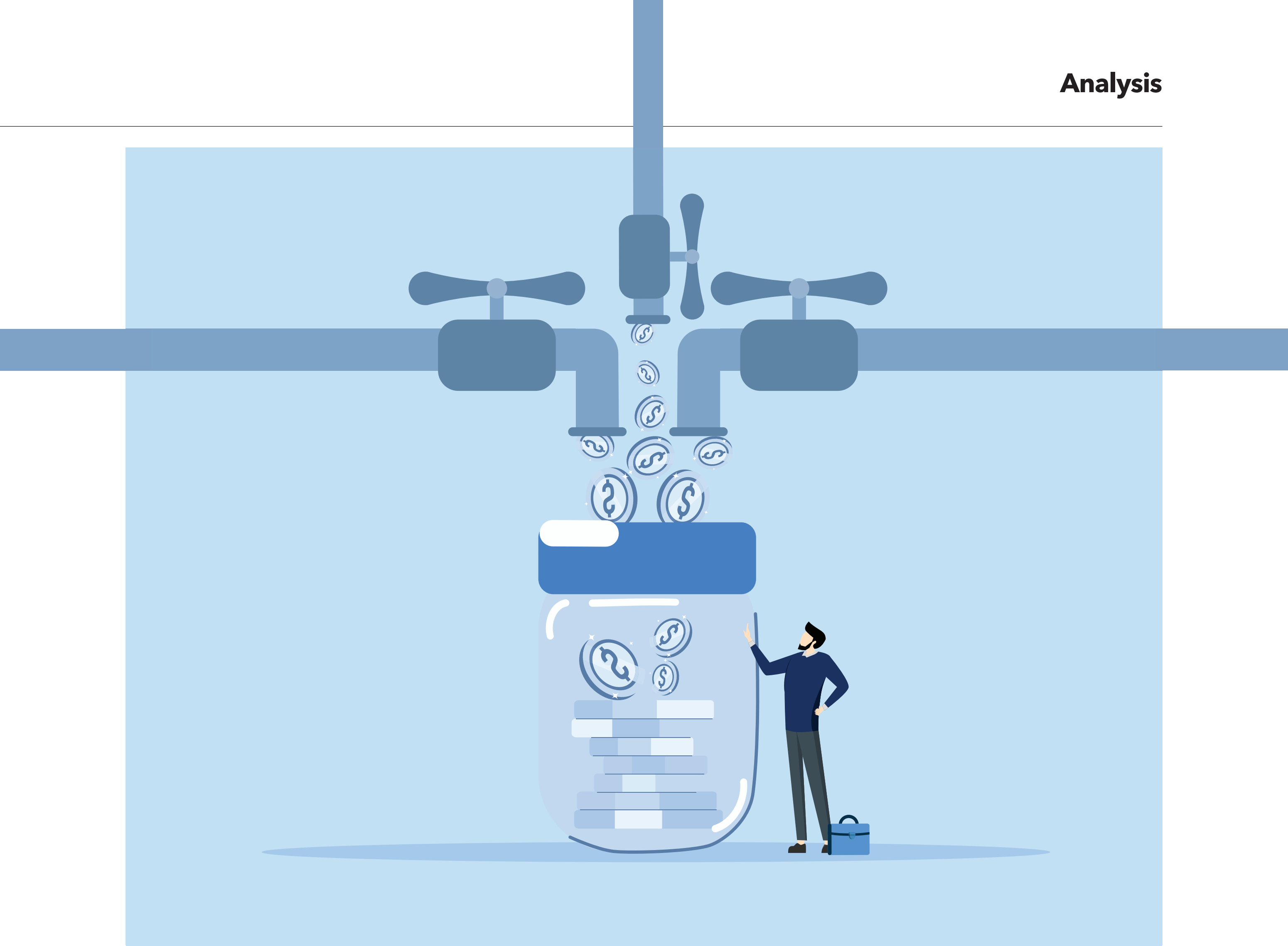

The economics of co-investing

Is 'no fee, no carry' putting too much pressure on GPs' income streams?

While co-investments have traditionally not commanded economics, their growing prevalence in the private equity ecosystem means some GPs are trying to reverse this trend.

StepStone's Clodagh Coghlan is unperturbed: "We have never paid economics, and this is not something that has been an issue with GPs. Particularly when we are playing a co-underwriting role, we are providing a solution to the GP, so both sides are getting something they need.

"Economics could potentially be an issue with first-time funds that don't yet have a consistent management fee stream – but no fee, no carry is still standard. Across our entire deal set, less than 7 percent of transactions had economics proposed."

Lexington's Craig Stevenson agrees: "GPs can use a co-investment strategy to their strategic advantage. Having strong co-investment partners can allow them to lean into deals. This can be especially true for small and mid-cap managers that are going up against upper-mid-market managers. In our experience, sellers often prioritise deal certainty, and so having those co-investment partners allows smaller managers to remain competitive."

Alexandre Motte of Ardian adds that offering free co-investment is a great way for a GP to make their biggest LPs happy. "This is why it is so important for big LPs to get their share. Co-investment is part of the economic deal."

Meanwhile, Benjamin Hur of Future Standard warns that for any successful GP, no fee, no carry co-investment really shouldn't be an issue. "If a GP tells you that they need to charge fees and carry on co-investment in order to keep the lights on, then that would definitely be a concern."

private equity. Each GP might review 30 deals, but we have seen 85-plus in the last few years. That gives us interesting insights into how others are thinking about the space that we can bring to bear in our underwriting."

Avoiding the pitfalls

For co-investors that do not have the appropriate experience or resources, there are some tension points to consider.

One common pitfall that LPs fall into is a lack of consistency in deployment. Stevenson notes: "A lot of LPs will use co-investments to catch up on deployment at the top of the market. We saw that in 2020 and 2021. Those that don't have a highly formulated pacing model end up overexposed to private equity in peak valuation years, then pull back on co-investments at the bottom of the cycle.

"They should instead use co-investments to smooth out deployment and take advantage of market dislocations. Vintage-year concentration is a trap that many LPs fall into."

Motte, meanwhile, says there is danger in straying outside known parameters. "At times when the market is particularly strong – or even more so at times when dealflow is scarce – there can be a tendency to try something that you haven't tried before. But it is important to stay true to your DNA."

"You need to make sure that any deal you do fits your strategy and meets the risk/return profile that you have promised your own LPs," adds Hur. "You have to be highly selective; in an uncertain environment such as this, you have to make sure you are viewing opportunities from all angles. The margin for error was a lot greater when we were in a bull market with low interest rates."

"In an uncertain environment such as this, you have to make sure you are viewing opportunities from all angles. The margin for error [used to be] a lot greater"

BENJAMIN HUR
Future Standard

Careful portfolio construction is also paramount. "One of the biggest risks is to blindly follow the market and become overexposed to the big trends or the flavour of the year," says Roche Toussaint. "You need to be disciplined at a portfolio construction level because it is essential to maintain diversification and remain selective, even when you are being presented with great opportunities."

Coghlan adds that LPs sometimes make the mistake of divorcing the GP from the asset. "They might choose to co-invest simply because they love the GP, or they may proceed with an asset they think is great while knowing very little about the sponsor backing it," she says. "It is important not to over-index GP quality or asset selection, but rather to realise that this is a strategy where you are backing both the jockey and the horse."

Certain types of co-investment are also riskier than others. "We are seeing more mid-fund-life deals at the moment, but these do require careful consideration, as there is the potential for misalignment," says Hur. "We therefore have a higher threshold for these opportunities."

"Traditionally, a lot of the mid-life deals went to existing LPs," adds Roche Toussaint, "but many of those LPs are now overallocated to private equity and cannot commit to these transactions in a significant manner. That means GPs are having to reach out to a broader pool of investors. The bar is high for those deals, but they can give you access to some very interesting transactions nonetheless."

One of the most acute potential tension points within any co-investment, meanwhile, is at exit. Here, preparation is key and alignment is paramount.

"Co-investors need to look at their rights around exit and what the

> *"Dedicated co-investment teams need to react quickly and with conviction. In many of the best deals, diligence, commitment and funding happen in a matter of weeks"*
>
> **THOMAS ROCHE TOUSSAINT**
> **UBS Asset Management**

different exit avenues might be," says Blaxill. "There's a definite temptation to put that into a box of 'problems for tomorrow', or at least be somewhat vague in that part of any agreement, especially when there is an existing strong relationship. But it's important to properly air expectations around exit, document them and be clear about rights on both sides."

The proliferation of continuation vehicles has made this abundantly apparent. "Continuation vehicles are a good example of why it is so important to have alignment of interest between co-investor and GP around exit," Blaxill explains. "They have become a fixture in the landscape, and so this is definitely a topic that gets a lot of airtime at the moment."

Driving returns

Co-investors that are able to avoid these common pitfalls should be able to generate strong returns, particularly given the favourable economics on offer. To suggest that co-investment funds can be directly benchmarked against buyout funds, however, is an oversimplification.

"Co-investment has a unique risk/return profile," says Hur. "A group of buyout funds with eight or 10 companies, with one or two homeruns, can set the top-quartile threshold. Co-investment funds typically have more investments per fund, which allows them to have a tighter return dispersion compared with the buyout benchmark. I don't think it's really an apples-to-apples comparison."

Stevenson adds: "Where a manager has succeeded on the back of one or two deals, it can be hard to evaluate how repeatable that is. A successful co-investment programme predicated on strong sourcing capabilities, asset selection and diversification is generally more sustainable than relying on just one or two outliers."

Co-investors obviously strive to generate alpha through asset selection. "We are invested with some of the best GPs in the world and we are trying to pick their best assets," says Motte. "Because we are also LPs in these funds, we can follow what happens with the assets we don't invest in.

"In our case, the deals we pass on have still done well – averaging 2x gross. This demonstrates that we are already fishing in a good pond. But through our deal selection, we are able to generate alpha, taking us to 2.4x or 2.5x. That's our value-add as a co-investor."

Coghlan, meanwhile, emphasises that while co-investors can add alpha to a portfolio through asset selection, co-investment also can reduce risk through appropriate diversification. "For this reason, it is important to look at loss ratios as well as absolute returns," she says. "We sometimes hear concerns about the risk of adverse selection: are we doing the largest deals in a fund, and does that indicate strategy drift?

"What our survey showed, however, is that 61 percent of co-investments offered by GPs outperformed the parent fund on a net TVPI basis, and 75 percent outperformed on a loss ratio basis. This suggests there is strong alignment of interest in the deals that GPs are showing to co-investors." ■