Adams Street

Co-Investments: Avoiding Adverse Selection and Generating Outperformance

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Adding private equity co-investments to a diversified portfolio has become increasingly prevalent as more investors see the attraction of reduced fees (relative to a traditional private equity fund) and potential for alpha generation.

Adverse Selection

If a co-investor has the ability to be flexible on deal size, sector, and geography, along with the ability to limit how much is invested in any given deal, they can build a balanced and well-diversified portfolio. An experienced and disciplined approach to investment selectivity can further increase the potential to outperform.

However, the question is sometimes posed as to whether there is risk that a General Partner ("GP") may offer "inferior" opportunities to co-investors, and retain as much equity as possible in its "best" deals. This is referred to as "adverse selection", the risk that a GP offers a co-investment (therefore reducing its own equity exposure) in deals it considers below average, while electing to hold a larger investment amount of the deals it considers to be superior. A deal may be considered inferior due to various factors, but from our perspective inferior refers to deals with a lower return expectation relative to the amount of risk being taken.

In our experience, there are several reasons to believe that a GP would not select inferior deals for co-investment:

1. Any GP incentivized to perform well would not seek to commit to a deal that it thinks will ultimately be a sub-par investment
2. It is very difficult for a GP to know, at the time of closing, which investments will perform better than others
3. Co-investors are typically Limited Partners ("LPs") in the GP's fund and, as such, the GP would not want to be offering them increased exposure to poor investments. The GP ultimately wants to build relationships to ensure existing investors continue to invest in its funds or, where the investor isn't a current LP, make the investor more likely to consider investing in future funds.

For co-investors who are still concerned about adverse selection, we believe it is possible to further mitigate this risk through high-quality co-investment deal flow and ensuring strong alignment with the lead equity sponsor. A lower quality or inexperienced GP not focused on longer-term performance and reputation could, in theory, use a co-investor as a mechanism to selectively reduce risk exposure. As such, we believe that a co-investor with reputable, high-quality GP commitments that ultimately serve as an important source of co-investment deal flow is critically important.

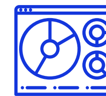
In addition to high-quality deal flow, it is important to understand the alignment with the GP. Among the key considerations when performing due diligence on an investment, a co-investor should consider the GP's experience and track record of

i) making investments in the same sector and/or geography and

ii) executing on similar value creation plans. If the GP intends to hold an equity investment below its typical level for comparable deals, the co-investor should carefully consider whether this is reasonable.

In all cases, the quality and motivation of the lead GP, along with deal alignment for co-investors, is very important to consider.

Finally, with regards to adverse selection, our internal analysis also supports the view that there is no fundamental adverse selection bias in the co-investment deals that Adams Street has been offered historically. This analysis compares the performance of the co-investments offered to Adams Street to the performance of the underlying GP fund which also committed to the investment (where Adams Street is an investor in the GP's fund).



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Investment Selectivity

Co-investment managers may take different approaches to investing in co-investments offered by a GP. In our experience, co-investments typically do not have any management fee or carry, at least in cases where the co-investor is also an LP in the GP's fund. Therefore, one approach taken by co-investment managers may be to invest in all (or the vast majority) of the opportunities offered, to take advantage of these favorable economics. Alternatively, co-investors may attempt to generate alpha by performing their own due diligence and applying specific selection criteria on those opportunities, in effect seeking to outperform the broader pool of co-investments offered to them.

Investment selectivity can be approached in different ways. Co-investment managers, particularly those with dedicated co-investment teams and resources capable of performing independent due diligence, may simply decline an investment opportunity because their own investment analysis forms a different perspective on the relative risk/return profile of the deal relative to the GP. Alternatively, a co-investor may choose to decline certain opportunities due to its specific co-investment mandate and portfolio construction considerations.

The broad investment mandate for a co-investment fund often provides flexibility on company size, sector and geography, allowing the manager to construct a portfolio based on where it sees the most attractive investment opportunities. For example, a mid-market, healthcare-focused buyout GP will likely be required to make mid-market healthcare investments regardless of the relative attractiveness of mid-market healthcare in the current environment. Conversely, a co-investor with a flexible mandate could either choose to invest alongside that healthcare fund, or, if it believes that the outlook for healthcare is less favorable or valuations in the sector are too high, it could choose to decline these opportunities and focus on other investments.

Adams Street's internal analysis and experience has demonstrated that it is possible for a co-investor to selectively invest in a subset of these opportunities and generate outperformance relative to investing in all co-investment opportunities offered to a co-investor. Further information may be available by request to Adams Street.

Conclusion

Based on our analysis, we believe a well-managed co-investment portfolio, investing alongside high-quality GPs, has the potential to provide both advantageous economics and additional alpha for the overall portfolio. We see no evidence, from our analysis, of adverse selection and no incentive for GPs to offer inferior deals to co-investors. While co-investment teams can take advantage of high-quality deal flow generated from top-tier GPs, experienced co-investors can take this further by selectively investing in a subset of these investments to generate outperformance and build a well-diversified, balanced investment portfolio. ■

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