KEYNOTE INTERVIEW

Standing out from the crowd

Responsiveness and flexibility are increasingly advantageous traits for co-investors seeking access to the best deals in the new covid-19 environment, says Adams Street Partners' David Brett

Co-investment activity has grown in popularity over the past few years as LPs have become more sophisticated in their approach to constructing private equity exposure and GPs have sought to strengthen relationships with current and potential fund investors. This has led to a more competitive market for the best deals, so how can LPs ensure they are getting access to the companies with the strongest potential? And how is the market adapting to the pandemic? We spoke to David Brett, partner and head of co-investment at Adams Street Partners, to explore these issues and discuss how the co-investment market is evolving.

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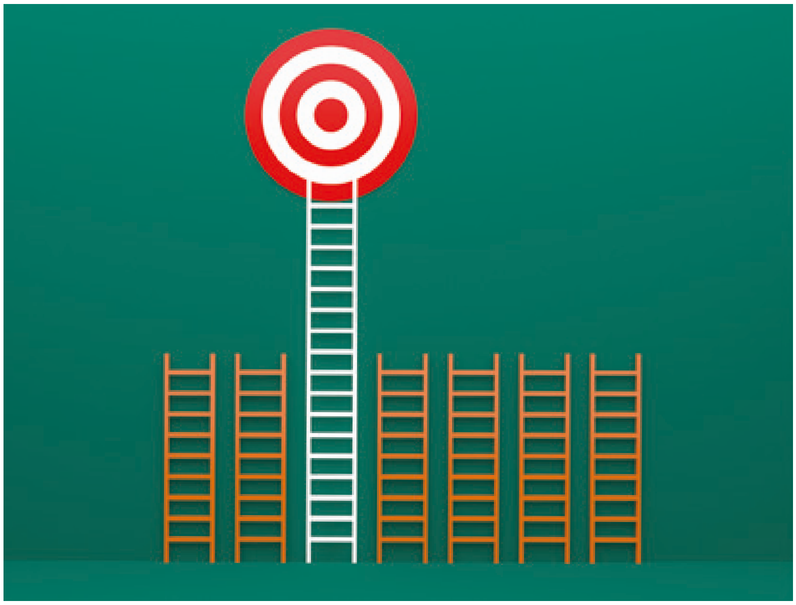
Q How has co-investment activity held up through the pandemic?

While the year started busy, the arrival of covid-19 had a significant impact when in its early stages. Co-investment activity always tracks that of the broader private equity deal market, and from March through May lead GPs were deep in existing investment triage work and were communicating with their co-investors. For us, existing portfolio company evaluation and stabilisation was the primary focus and any new investment decisions were tied to supporting those companies that needed capital to help ensure the right capital structures were in place for what was set to be a challenging period for some businesses.

By June it was clear that people had started to get their arms around the pandemic's effects and the credit markets stabilised. Those without a lot of portfolio issues could start turning their attention to new deals. That meant picking up where they left off with some transactions and working through their pipeline, particularly where GPs had already conducted face-to-face meetings with management. We saw a pick-up in co-investment activity in July and August and there were some interesting opportunities – GPs already knew the businesses from pre-pandemic times, but they had to reassess them through a medium to long-term covid-19 lens, conduct stress tests to get comfortable and cut new deals where necessary. There was caution, but it was clear private equity and co-investment were back in business.



Q How has this shaped up since the summer?

Activity really picked up in September and October, although a clear picture has emerged of haves and have-nots. It has become obvious which businesses have remained resilient through the pandemic, with technology and healthcare among the better performers. Those two sectors in particular have been priority exposures for us given our conviction around their resiliency, and it's nice to see that proving itself out. Given the prevalence of those deals over the past several months in the market overall, we've been keeping very busy.

The past few months have demonstrated the need to be responsive as a co-investor. That has always been the case, but it is particularly important now. If we have had any concerns, for example, about a company's resilience to another wave of covid-19 restrictions, we've quickly decided not to do the deal – we never want to be a drag on GP decision-making.

Q How have you seen GPs respond to restrictions when it comes to deal-making?

We have seen different approaches from GPs as to how they can get the same level of conviction during a pandemic. For some, this has meant finding ways of meeting teams in a covid-secure way. For these GPs, it is so engrained that they have to be face to face to understand the nuances and relationships between management teams, and they see this is providing a marginal advantage when it comes to auction situations. Others are managing to make virtual meetings work.

Ways of achieving this have evolved, however, so that they are not hosting five-hour question and answer sessions. They have found ways of being creative and sophisticated with virtual meetings, ensuring they are more interactive by using break-out rooms and so on. It's probably safe to say the level of on-site diligence required by a lead GP also varies by sector – in some industries, such as industrials, the GP still wants to walk the factory floor while in others, such as software businesses, it just might not be as critical.

"To be effective, you have to be proactive with GPs"

Q Co-investments have increased in popularity among LPs. Is this driven purely by a desire to reduce fee drag?

The ability to lower fees through co-investments has always been a key focus for LPs and this remains important, particularly in this low interest rate environment.

We have been co-investing since 1989 and we have seen the longer-term evolution of the market. For our clients, co-investing is also an important way of getting money in the ground across vintages – investors can be more tactical in co-investments than in fund investments. It helps them build out diversified portfolios and invest capital tactically over a three to four-year period. They can tilt their co-investment portfolio towards particular areas, for example. As a co-investor, we also

Q The co-investment market has become increasingly competitive in recent years. How can co-investors gain access to the best deals?

When we first started co-investing, there were usually up to three co-investors around the table, but it has become a more crowded field over time. Co-investors are often now competing for the allocations they want, so they must find ways of differentiating themselves. Access is one of the most important factors here because you need a big funnel of opportunities to select from. We see most deal flow in co-investments from GPs we have already backed, so there is a high conviction already about the deals we are shown – but you still need to be highly selective. Our hit rate is about 10 percent of the deals we are shown, for example. That means we can build a portfolio that provides the exposure we are seeking on behalf of our clients.

Maintaining a full funnel relies on us having a broad range of strong relationships with GPs through our fund, secondary and credit practices. It is also about being responsive to GPs and offering solutions that help them win deals. We are on a lot of advisory boards, so we hear about deals early on and can approach GPs with ideas and offer flexibility around the size of cheque we can offer. That provides them with certainty at an early stage of the deal.

avoid specific restrictions placed on traditional lead GPs such as sector or geography limitations; we've actually got more flexibility to be tactical.

While the all-in cost of co-investments may be lower, it is worth stressing that there are additional costs involved. You need to be good at it, so you must invest in the right people and systems to make it work successfully.

Q You mention diversification, what does that look like in co-investments?

At a high level, there are three main buckets – vintage year, industry and geography, and I would put them in that order for importance. It is critical investors have a good spread of co-investments across three to five years so that they are not concentrated in particular years. Industry and then geography come in second and third as, while helpful for investors, they are not as crucial as diversification across time.

That said, diversification across industries is less important for some of our clients because they have a diversified portfolio elsewhere and want to target specific areas through co-investment. We are seeing more direction from our clients outside commingled co-investment funds about where they want to invest.

We like to include different value creation strategies within our portfolio. For example, we'd like a portfolio to include deals where follow-on investments in fragmented industries is key, just as adding assets where the GP believes it can provide operational improvements might be a nice diversifier. Most important, of course, is that the value creation strategy fits well with the lead GP.

Q One common concern around co-investments is the risk of adverse selection. How do you avoid this?

I do not deny it could be out there, but it is hard to see what the incentive would be for a GP to show us a lower quality deal. We are alert to the possibility, and we look for red flags. If we are not comfortable, then we will move on. But it all comes down to relationships, the additional due diligence you can carry out, and alignment – all these give us confidence to make an investment.

Q For what types of deal are GPs currently seeking co-investment partners?

One of the most prominent is sector-focused funds where GPs see a wide range of deal sizes. Some of these deals will just be too big for a fund and that is often where they see significant value in bringing in co-investors as it means they do not need to work with other sponsors to get the deal done. We also see a lot of co-investment opportunities in buy and build strategies as this takes the risk out of raising capital over the following years as acquisitions are targeted. Here, GPs are asking for a proportion of capital upfront to fund the platform purchase, with further capital requests down the line. This helps GPs plan for and meet their capital needs.

Finally, we see continuation fund deals, in which a GP seeks co-investment from select LPs to offer liquidity options to investors while holding on to a portfolio company with further upside potential. I expect these will be increasingly popular over the coming period as GPs choose to hold investments in which they know the management team, company, risks, and opportunities. They are good for our clients because funds are not suited to long holds and it is hard to find good assets and teams, so it does not always make sense to sell after just five years when there is still value to be had.

Q How do you see the co-investment market developing over the coming period?

I see a slow evolution. The market will continue to be crowded. To be effective, you have to be proactive with GPs, find ways of being helpful to them and be a reliable partner so that you are high up the list of calls they make when seeking co-investors.

Some co-investors and GPs may be firefighting currently, but we are focused on the recovery market – and here, we believe we will see some very attractive opportunities. ■