Co-Investments: Dispelling the Myth of Adverse Selection

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KEY TAKEAWAYS

- Intuitively, lead GPs are significantly motivated to cultivate strong, long-tenured relationships with LPs; providing co-investment opportunities with less favorable prospects would be directly at odds with this primary objective
- Adams Street's experience co-investing across multiple economic cycles demonstrates no evidence of adverse selection when comparing the performance of deals with co-investment opportunities to all deals completed by a lead GP
- The potential to deliver consistent outperformance requires more than high quality, unbiased deal flow. Co-investment managers with the perspective to assess alignment and transaction fit with the lead GP, and the ability to select only the most attractive investments, are likely best placed to outperform

A core attribute of private equity co-investments is that the lead general partner (GP) in a deal is not typically directly compensated for the portion of a transaction financed through co-investment.

While this cost efficiency is a plus for co-investors, the absence of additional economics also leads some limited partners (LP) to wonder whether lead GPs have an incentive to share co-investment opportunities only on transactions with weaker financial prospects (as compared to transactions completed without the support of co-investment) – a phenomenon known as adverse selection.

During more than 50 years investing exclusively in private markets, Adams Street has tracked and collected data on tens of thousands of privately owned companies and transactions, putting us in a unique position to address the question head on. Fortunately, expanding the discussion beyond pure deal-level economic incentives brings GP/LP alignment back into balance, which is confirmed through Adams Street's lived experience.

Co-investment opportunities typically arise when a lead GP pursues an investment that requires more equity capital than they have available to invest in a single company. Consequently, most co-investment opportunities that Adams Street evaluates are ultimately among the largest single-company investments the GP makes.[1] The coupling of co-investment opportunities to some of the larger single-company investments a lead GP makes helps to promote appropriate risk/return calibration for all participants and to ensure a strong alignment of incentives between co-investors and the lead GP.

In addition, GPs typically engage their LPs as the first source of co-investment capital. LP relationships are long tenured (often nurtured over decades) and therefore represent repeated opportunities for investment collaboration, where GPs are typically hesitant to "poison the well" by offering less attractive opportunities. When put in this context, overall alignment between GPs and LPs is very strong (notwithstanding incentives in a single co-investment). Private equity is an asset class with long-term investment horizons, where long-term alignment across a variety of situations holds considerable influence. Importantly, Adams Street's experience confirms this inference.

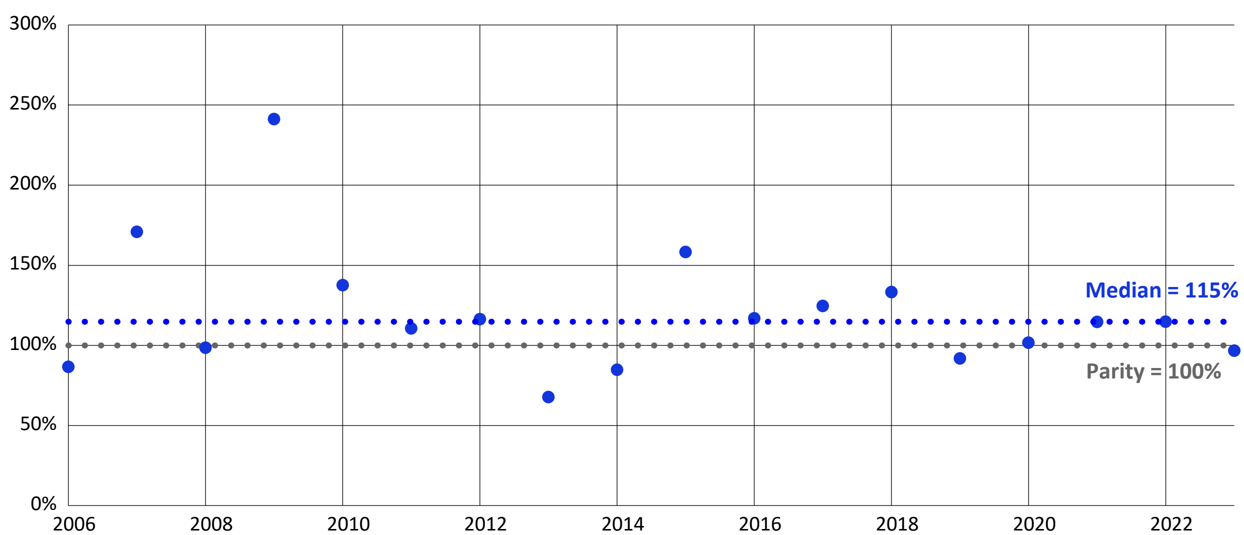
Running the Numbers

Adams Street tracks deal level performance of the lead GPs the firm supports. Since 2006, performance of deals where Adams Street received a co-investment from a GP (defined as "Adams Street Co-Investment Opportunities") has demonstrated no correlation (better or worse) with the performance of all deals completed by those GPs.

The measure of return assessed was Total Value to Paid in Capital (TVPI), and Figure 1 plots the distribution of the relative performance of the aggregate of Adams Street Co-Investment Opportunities in a given vintage year (year the investment was made). Note: a ratio of 100% would indicate that Adams Street Co-Investment Opportunities performed exactly in line with the same vintage cohort of deals completed by these GPs.

As expected, there is a random distribution of outperformance and underperformance depending on the vintage year. In some vintages, deals with a co-investment opportunity outperformed the broader universe of deals in the portfolio, while in other years, they underperformed. The median outperformance of Adams Street Co-Investment Opportunities across all vintage years was about 10%, which doesn't provide empirical evidence of adverse selection.

Figure 1: Relative Performance of Adams Street Co-Investment Opportunities vs. All GP Deals by Vintage Year

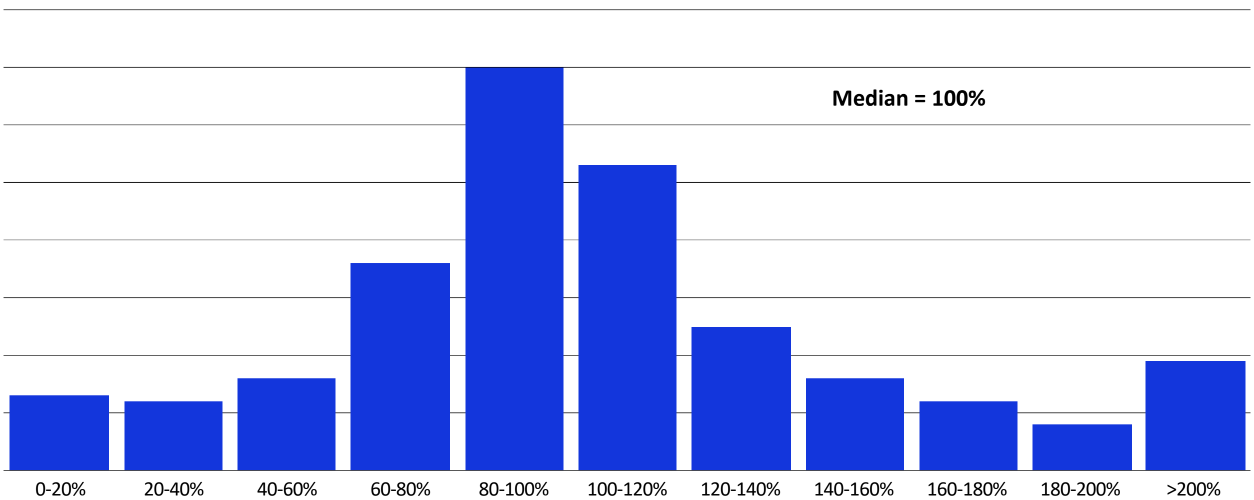


While portfolio level support against adverse selection is constructive, focusing more granularly within the context of individual funds is even more assuring.

Of the more than 270 funds that have shown Adams Street a co-investment since 2006, deal level outcomes are normally distributed when compared to other deal outcomes from the same fund (i.e., including deals where Adams Street was not shown a co-investment opportunity).

Similar to the analysis in Figure 1, a ratio of 100% indicates that the deals where Adams Street was shown a co-investment by a GP performed exactly in line with the median performance of all deals in that same GP's fund. Figure 2 illustrates the distribution of relative performance of co-investments across the universe of Adams Street GPs. Again, as expected, the data show no evidence of adverse selection. These analyses confirm the intuition that adverse selection is not in a GP's interest in co-investments.

Figure 2: Relative Performance of Adams Street Co-Investment Opportunities vs. All Deals Done by GP



High Quality Deal Flow is Only One Piece of the Puzzle

Our decades of experience as both a primary fund investor and strategic co-investor give us high confidence in the absence of adverse selection. However, it is also our belief that co-investors should not rely on a lack of adverse selection alone to consistently generate strong investment outcomes.

In our view, experienced co-investors that can effectively assess the degree of alignment and transaction fit with a lead GP and perform detailed due diligence on the company in question – usually under a tight transaction timeline – have a significant advantage.

Particularly in times of uncertainty, we believe the co-investment managers best placed to outperform are those that combine access to deal flow from a high-quality GP universe with a disciplined and selective focus on only the most attractive investments.

Co-Investment Primer[2]

A co-investment, within the context relevant to this paper, is a passive, minority equity investment alongside a lead GP (or sponsor) into a privately held company.

Co-investment opportunities result when a transaction requires more equity capital than the lead GP has available to invest. Oftentimes, the GP will invest as much as they can from the fund they are managing (fund agreements generally have a concentration limit for any individual company investment), and look to their LPs that provided initial fund capital to invest (in the form of co-investment) the incremental capital needed to complete the transaction.

Importantly, the portion of the transaction financed through co-investment will typically pay no management fee or carried interest to the lead GP.

Co-investments are mutually beneficial – LPs have the opportunity to invest more capital alongside fund managers with little incremental cost, and GPs can pursue a broader range of company sizes where their skillset and investment strategy are relevant. ■

1. 60% of co-investments reviewed are in the top 25% largest investments of the lead general partner's fund.
2. The below description is for illustrative and educational purposes only as a broad summary of the asset class and there can be no guarantee that any particular deal will be structured in a manner described herein or that any of the advantages described herein—whether related to fees, risk, diversification, or otherwise—will necessarily materialize.

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