Buyouts

Cover story

Sweeter deals: Why LPs are warming to co-investing

Demand for co-investment is soaring as GPs seek to preserve capital and cultivate strong LP relationships in a challenging fundraising environment, writes Amy Carroll

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Despite a muted M&A market, co-investment opportunities are holding strong. Credit constraints and the need to preserve capital in volatile times mean GPs are increasingly looking to their investor base for support on transactions.

Critically, co-investment is also being used to keep LPs sweet in an undeniably tough fundraising environment.

"In almost every economic cycle over the past three decades, we have seen that the more challenging the macro backdrop, the greater the demand for co-investment from GPs," says David Smith, senior managing director at Capital Dynamics.

"That is because in periods of market disruption, GPs prioritize the preservation of capital in order to protect portfolio companies. They are also more sensitive to the timing of fundraising and how long the fundraising process may take. As a result, GPs may seek to dilute the remaining capital in their existing fund, making it go further with co-investment."

"The broader M&A market is down 37 percent globally," says Seth Palmer, managing director at HarbourVest. "But co-investment, by contrast, has remained robust. GPs recognize that capital to support new fundraisings is scarce and one way to capture those scarce dollars is to deepen relationships with strategic partners by offering fee-free, carry-free co-investment.

"GPs are also using co-investment to manage check sizes and concentration levels in individual investments, recognizing the importance of portfolio construction in this more volatile market."

Meanwhile, although co-investment remains extremely popular with LPs, the denominator effect coupled with enhanced volatility mean that more opportunistic co-investors are pressing pause.

"Co-investment is a highly compelling way to invest with lower fees and

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HarbourVest

lower carried interest and when times are tough, people look for value," says Smith. "However, transient co-investors tend to withdraw from the market in more challenging conditions."

Bart Osman, partner at Lexington Partners, agrees. "From a demand perspective, capital constraints and overallocation to private equity have driven many LPs to tap the brakes on new co-investments. On the supply side, we see two key drivers. First, the challenging fundraising environment has hindered many GPs' ability to raise larger private equity funds, resulting in less capital available to complete deals. Second, some GPs are over-equitizing transactions as leverage has become more expensive and harder to come by. This combination creates a greater need for co-investor equity."

Indeed, shifting supply/demand dynamics are creating an opportunity for those co-investors that do have committed capital to improve their competitive position, in particular, by enabling them to take a larger slice of the co-invest on offer.

"While the denominator effect is abating slightly as public markets rebound, it has nonetheless impacted the availability of co-investment as tourist co-investors take a step back," says Palmer. "Those investors are turning off co-invest as a way to manage their ongoing capital allocation challenges, which is creating opportunities for more reliable sources of capital to take wallet share. We are approving fewer deals by number today, but taking a bigger stake in those deals where we have the greatest enthusiasm."

David Brett, partner and head of co-investments at Adams Street Partners, also sees opportunities to take advantage of shifting supply/demand dynamics to increase co-investment allocations. "Given the fundraising environment, GPs are offering more co-investment and, at the same time, some co-investors are taking a step back. That is creating opportunities for groups like us with dedicated funds and teams to access more co-investment than we normally would."

The combination of increasing demand and reduced supply is also creating opportunities for those with committed, discretionary co-investment capital to negotiate better terms. Swain says that if co-investors are paying any economics – while the market standard today is no fees, no carry, some co-investments do carry charges at one and 10 or similar – then now is the time to push for a reduction.

Smith, meanwhile, says it is possible to negotiate structural preferences. "We saw that with the global financial crisis, and we saw it with covid. It is possible to negotiate a better position in the capital structure of the business."

Palmer adds: "Supply/demand dynamics play out most acutely in terms of allowing co-investors to access the best opportunities at scale. The biggest trend is the ability to commit larger dollars to those transactions where you have greatest conviction.

"But we have also seen a modest shift towards the co-investor when it comes to terms, particularly in earlier-stage companies. Previously, we had seen investors in later rounds receive pro rata rights vis-à-vis earlier investors. It is now more common to see the reemergence of preference structures, allowing newer investors to benefit from preferred returns and greater downside protection in order to support valuation uplift or minimize discounts on previous rounds. Those preference structures are a response to the financial trajectory of the businesses involved and the power dynamic that exists between co-investors and their partners today."

Discerning tastes

Despite continued appetite for co-investment, market participants are clearly being highly discerning about the opportunities that they choose to pursue.

"In this more challenging economic environment," says Smith, "we want to be backing companies that enjoy profound recession resistance, which means market leaders with strong pricing power and demonstrable operating experience in a downturn.

"We also always prioritize conservative leverage and that is more important than ever in a period of high interest rates. The last thing you want when

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governments are trying to dampen inflation with monetary policy is highly leveraged companies."

In terms of sector, Capital Dynamics is actively pursuing healthcare, due to its resilience through the cycle. The firm also targets IT and software, consumer staples and the energy transition. "In each of those sectors we are focused on mid-market businesses where there are more buttons to press and levers to pull when it comes to value creation," Smith says. "It's the difference between tacking a yacht and steering a tanker."

Brett agrees that healthcare remains an attractive space, adding that he is also starting to see a comeback in profitable tech. "Industrial investments that address the themes of labor shortages and supply-chain challenges are also presenting interesting opportunities and we have backed some high conviction GPs in those sectors as well."

"In a strained economic environment," says Osman, "the popular sectors typically are the ones that historically have been most resilient in a downturn such as food and beverage, business services, and distribution, in addition to sectors that typically have secular growth trends, like healthcare, technology and financial services, which represent a large part of GDP and have solid tailwinds to support growth."

Francesco Aldorisio, partner and head of investments, private equity, at Unigestion, meanwhile, says the firm's co-investment strategy is predicated on pre-determined investment themes: climate transition, resource efficiency, sustainable cities, service efficiency, future of work, personal wellbeing and re-engineered healthcare. "Situationally, we prefer companies that we have tracked for some time, providing good visibility, which now require capital to accelerate their organic or inorganic growth plans."

Co-investors are also noting

Broken deal expenses

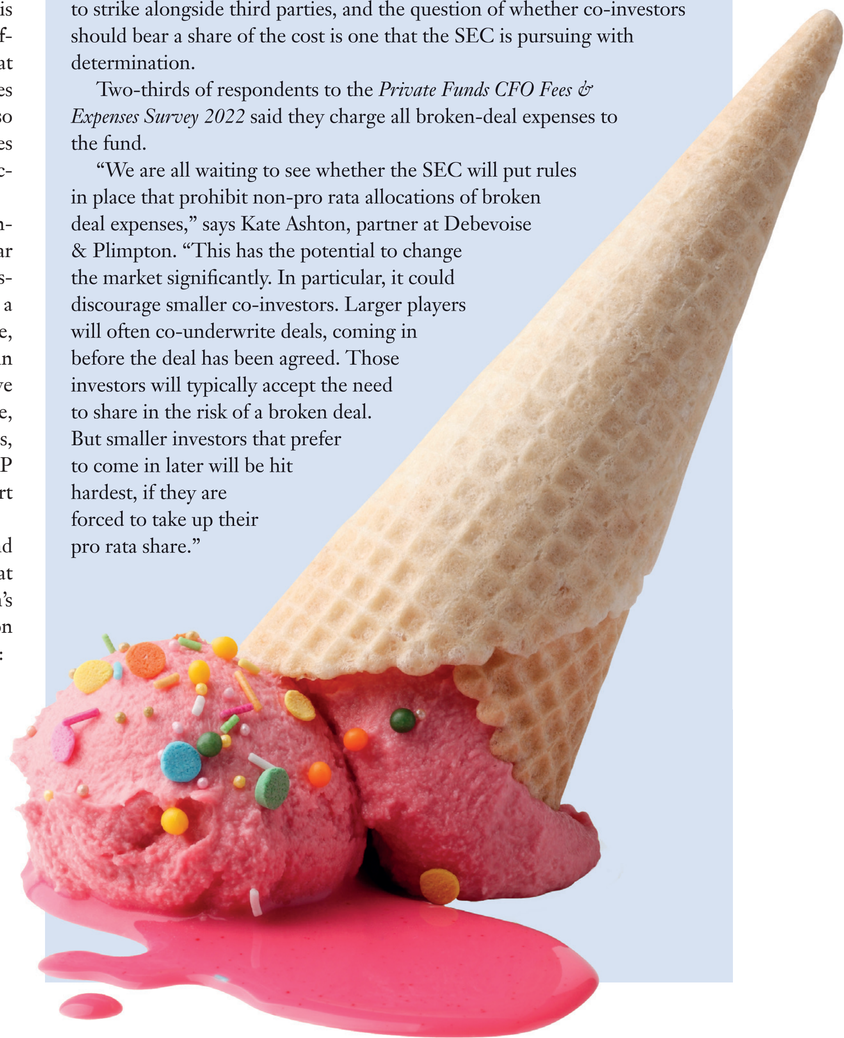
The question of who should pay broken deal expenses remains a contentious issue in the world of co-investment

Broken deal expenses were one of the first anomalies to pique the interest of the SEC when the regulator set its sights on private markets almost a decade ago. KKR was charged with misallocating more than $17 million in broken deals expenses to its funds back in 2015. And while that first-of-its-kind case led to the tightening up of LPAs around the treatment of broken deal fees, it remains to be seen whether the SEC will enforce a change to the rules, which could impact the appeal of co-investment.

Because while LPAs typically now explicitly state the division of broken deal costs between the management company and the fund, allocation issues persist when it comes to deals that a manager intended to strike alongside third parties, and the question of whether co-investors should bear a share of the cost is one that the SEC is pursuing with determination.

Two-thirds of respondents to the *Private Funds CFO Fees & Expenses Survey 2022* said they charge all broken-deal expenses to the fund.

"We are all waiting to see whether the SEC will put rules in place that prohibit non-pro rata allocations of broken deal expenses," says Kate Ashton, partner at Debevoise & Plimpton. "This has the potential to change the market significantly. In particular, it could discourage smaller co-investors. Larger players will often co-underwrite deals, coming in before the deal has been agreed. Those investors will typically accept the need to share in the risk of a broken deal. But smaller investors that prefer to come in later will be hit hardest, if they are forced to take up their pro rata share."



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trends in the types of deals that are transacting.

Palmer has witnessed a significant uptick in take-private opportunities, for example, given volatility in the public markets. Historically, HarbourVest has seen an average of 70 take-privates annually. In 2022, the firm saw over 175, and H1 pacing for 2023 is at the same level, or even higher.

"I think that activity is likely to abate as public markets reset, but it has certainly been a busy 18 months," says Palmer. "Another theme that we are increasingly observing involves GPs looking to fish in their own pond. They are looking for ways to re-invest in assets they understand well because they are invested in them today. That is playing out in the single-asset secondaries market where GPs are finding ways to extend their hold period and remain invested in companies they really believe in. We are also seeing an uptick in minority equity recaps as well as cross-fund transactions given the challenging exit environment.

"Co-investors have an important price-setting role to play in those situations, helping to structure and validate those transactions. We see interesting opportunities to generate attractive risk-adjusted returns with GPs who know assets well and where there is no transfer of ownership risk. There can be some modest misalignment to navigate, which may not exist in traditional co-investment. But, on the other hand, you do tend to get exposure to the best assets in a GP's portfolio."

However, while GPs' desire to optimize the risk/reward profile of their investments in uncertain times is creating interesting co-investment opportunities, the proliferation of continuation vehicles is also creating some tensions.

"You could make the analogy between a continuation vehicle and the IPO of a private equity-backed business. They are valuation events rather than exit events," says Smith. "However, if an asset is moved from a flagship fund into a continuation vehicle, it should be treated as a true exit, with all the drag-along and tag-along rights that go into legal documentation to protect the co-investor, rather than simply a transfer to an affiliate of the fund.

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Capital Dynamics

"As such, the co-investor should have the right to exit if desired. That is uncontroversial. But something that is being increasingly negotiated is the right to roll into the continuation vehicle on the same terms the co-investor enjoyed in the original transaction. We have seen some managers suggesting that when a co-investor rolls, they do so on conventional primary fund market terms. That is aggressive behavior and should be strongly resisted."

When the price is right

Whatever the nature of the transaction, careful underwriting of valuations is of course critical, particularly given the enhanced level of uncertainty around the future of the economy. "You need to be hugely disciplined on entry multiples. It is so important not to overpay," says Smith, who adds that some downward adjustment is taking place naturally as debt multiples reduce in a high interest rate environment.

However, Brett says that valuations are remaining high because asset quality is strong. "Underwriting valuations is always important but has become even more of a priority in this high interest rate environment."

"We have all been waiting for purchase prices to adjust, but what has happened is that it is only the highest-quality assets that are trading, and valuations for those businesses are sticky. It is vital therefore to pressure-test assumptions around multiple contraction on exit and interest rate movements to ensure that the capital structure is appropriate. Discipline in diligence is key." ■

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