An enduring taste for co-investments

LPs look to double up with familiar managers as forging new relationships proves tough, writes Amy Carroll

Limited partner appetite for co-investment opportunities continues unabated. According to *Buyouts' LP Perspectives 2021 Study*, 71 percent of LPs plan to participate directly in deals alongside managers over the next 12 months. The reasons for co-investment's popularity are clear – LPs can achieve substantial fee savings, as well as doubling up on their favored sectors, geographies or managers. California State Teachers' Retirement System chief investment officer Christopher Ailman, for example, revealed in July this year that the $246 billion pension's plans to build up a co-investment team remain critical, and would continue despite covid-19.

"LP appetite for co-investments continues to be strong," says Andrew Beaton, senior managing director on the co-investment team at Capital Dynamics. "Some private equity investors paused their programs to evaluate the impact of covid-19 on their portfolios. As many management teams in private equity portfolio companies have been able to successfully re-engineer their businesses to take account of the pandemic – and as it became clear there were good opportunities out there – we have seen many investors quickly resume their co-investment programs."

But co-investment can fall into the category of easier said than done. The most commonly cited inhibitors to co-investment include a lack of available opportunities, insufficient staffing and challenges in reaching the required transaction speed. "Competition for the best opportunities and the ability to execute in a reasonable timeframe continue to be the major obstacles," says Beaton. "Some investors also lack the investment experience and expertise to tackle co-investment."

Meanwhile, co-investment can also lead to potentially troublesome concentration issues. "Co-investments are, by nature, concentrated bets into single companies," says Mikael Huldt, head of alternative investments at AFA Insurance. "The advantages are obvious if you can get access to the right deals, but you need to bear in mind your total portfolio exposures and risks so that you don't end up with unwanted overweights in certain areas. Also, as an LP, you need to be comfortable that you have the resources and processes, as well as the additional capital available for additional support, to effectively deal with any such opportunities."

37%

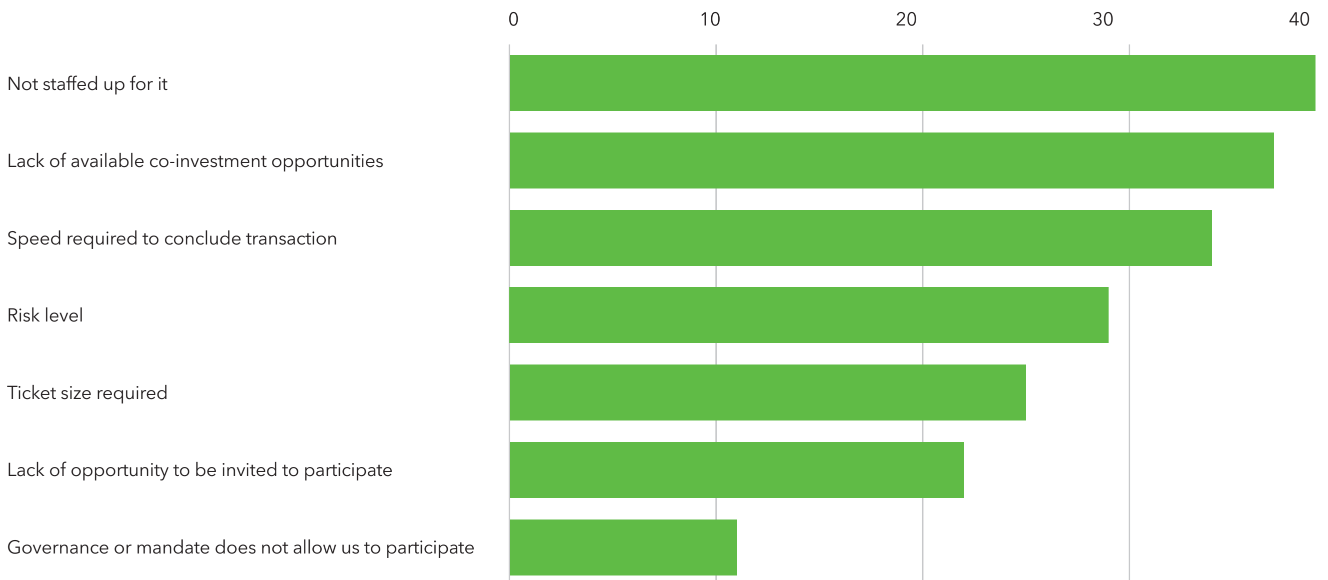
Percentage who cite lack of available opportunities as a hurdle to co-investing

Concentration crisis?

There were initial concerns that reduced diversification as a result of co-investment programs could have hurt some LPs when covid-19 struck. "The last few years have seen record highs when it comes to LP enthusiasm for co-investment," says Gabrielle Joseph, head of due diligence and client development at Rede Partners.

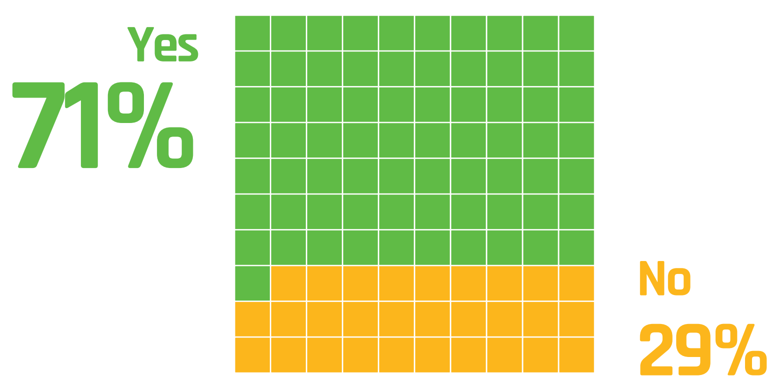
"Because of the reduced diversification that co-investment means for the portfolio, LPs can end up exposed to large swathes of individual companies – potentially individual companies negatively affected by covid. We were initially concerned that could lead to some LPs performing so poorly that they would substantially scale down their co-investment programs. Thankfully, we haven't seen that to the extent that we feared. Indeed, we are continuing to see a lot of enthusiasm."

Which factors hinder your participation in co-investing opportunities? (Multiple responses allowed, %)



> *"The impact of covid and government restrictions has given rise to a significant increase in GPs' focus on gaining co-investors"*
>
> **JAMES COLEMAN**
> **Quest Fund Placement**

Do you plan to participate in co-investment opportunities in private equity over the next 12 months?



Source: Buyouts' LP Perspectives 2021 Study

Furthermore, James Coleman, founder of Quest Fund Placement, believes GPs will increasingly be looking for LPs to co-invest alongside them in the months ahead. "The impact of covid and government restrictions has given rise to a significant increase in GPs' focus on gaining co-investors – due to delays in fundraising or the need to build or strengthen a broader base of relationships," he says.

Beaton agrees that one of the consequences of covid-19 will potentially be an elongating of the fundraising process, as it remains tough to meet investors face to face. "This has meant some firms husbanding their capital and offering a higher proportion of deals as co-investments if only to avoid running out of capital in a somewhat more precarious fundraising environment. Meanwhile, it has also led to some LPs focusing on existing managers, avoiding new relationships."

Indeed, the opportunity to co-invest is likely to exacerbate a flight to quality – or at least a flight to familiarity – that tends to result from nearly all negative structural shocks. "The vast majority of LPs will continue to focus on supporting their existing GP relationships with co-investment, leading to a further barrier to entry for less well-established firms," says Coleman.

"The pandemic has made it harder, if not impossible, to meet new managers in person," adds Beaton. "This has meant that many private equity investors are looking at existing managers, including looking at new products from these existing managers. Given that co-investment opportunities typically come from existing managers, we are seeing increased demand." ■