

Q&A With David Brett: Five Key Questions for Co-Investors as Recession Risk Rises



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KEY TAKEAWAYS

- In times of dislocation, we believe co-investments will remain attractive to those seeking more control over investment selection by providing the opportunity to back high-conviction managers at an all-in lower cost.
- Co-investments generally provide an opportunity to tactically switch focus to industries and companies that historically have been more resilient in recessionary times.
- As the risk of a downturn rises, so does the need to pressure test opportunities to try to ensure that investments have an acceptable margin of error in a tougher macro environment.
- Valuation, capital structure, flexible covenants, revenue visibility, market position and pricing power are all generating heightened attention in underwriting.
- Our co-investment deal flow was relatively stable in 2022 despite the pullback in broader M&A volumes compared with the exceptionally high levels in 2021. We expect our co-investment opportunity funnel in 2023 to continue to be strong, allowing us to remain highly selective and disciplined.

David Brett, Partner and Head of Co-Investments, spoke with Mustafa Salih, Vice President, Co-Investments, about co-investments and how they can help the tactical navigation of dislocations and volatility with the goal of meeting risk-return objectives as economic data signal a heightened risk of recession in 2023.

Mustafa Salih: Thanks for talking with us, David. We saw public equity valuations correcting materially in 2022, and looking into 2023 there's a gloomier economic outlook, so what do you think this means for co-investments?

David Brett (DB): Certainly, there are many economic signs that are flashing yellow – if not red – around the world. So we believe there is a need to be more cautious across most asset classes, including private equity.

That said, being cautious is not the same as timing the market. Over our 50-plus years of experience at Adams Street, we've seen the difficulty in market timing. That's why we don't do it. And we really believe that vintage year diversification is a key component of good portfolio construction.

So when you think about the attractions of private equity co-investments, we think it's likely to remain robust because participants generally have the ability to exercise more control over their investment selection versus the blind pools that are typical of most private market funds. They also enable us to back our highest conviction managers generally at an all-in lower cost, which will always continue to make a lot of sense.

When you think of it from the lead GP perspective, the benefit for a general partner to offering co-investment opportunities is helping them to meet their portfolio construction objectives, while also strengthening partnerships with their LP base. That can be particularly important in times like these, as it could prove to be a tougher capital raising environment. We believe institutional co-investors like Adams Street are well placed as a reliable capital solution partner for GPs.

Over recent months, we have started seeing some signs of other investors dialing down their co-investment pace, which we think is likely a combination of market timing and "denominator effect" issues. But with our dedicated strategy and our experienced team we're going to remain actively investing.



We are increasingly focused on investing in industries and companies that have historically been more resilient in recessionary times, and which demonstrate more predictability of revenues and pricing power.

Q: As you think about the platform and your own co-investments, what characteristics of a typical co-investment portfolio make it suitable as an asset class in times of dislocation like these?

DB: We think now is an even better time to be a stock picker.

Having a platform such as ours, that has had historical access to high-quality opportunities across a range of industries, has served as a big advantage for our co-investment strategy.

We aim to build well-diversified portfolios across sector, company size, geography and vintage, and we continue to think private equity-backed businesses tend to thrive in times of dislocation versus their public comps, which have multiple stakeholders.

Given what we view as some of the ownership and governance advantages of private equity-backed businesses, we believe there will continue to be compelling opportunities in 2023 across sectors.

However, we are increasingly focused on investing in industries and companies that have historically been more resilient in recessionary times, and which demonstrate more predictability of revenues and pricing power.

Examples of recent deals that we've done with our GP base include a couple of pharma services deals, some insurance brokerage businesses and, more recently, a testing, inspection and certification business. What these companies have in common is that we believe they demonstrate a resilient profile, with defensive characteristics that we're looking for in these times.

Q: How do co-investment portfolios tend to perform during a slowdown? Are there examples from a prior recession, such as the GFC era and its aftermath, that provide insights into how portfolio construction and how portfolios perform during times of dislocation and disruption?

DB: This period will likely be different than the GFC but we can still apply some hard-learned lessons from previous downturns.

We have a highly experienced team here, and Adams Street as a firm has been doing co-investments since 1989. We have the benefit of many decades of experience – not just from co-investments but investing in private equity over many decades and many investment cycles – and we aim to apply that knowledge, especially during times of dislocation and change.



It's important to pressure test new deals with assumptions of multiple contraction at exit and level of covenant and cash flow cushions.

We think the operating performance to date of our portfolio has generally been encouraging as we continue to learn and improve our selection and underwriting process.

History tells us that purchasing companies at peak multiples and peak earnings, with high debt leverage and covenants can combine to leave little room for error. Therefore, we think it's important to pressure test new deals with assumptions of multiple contraction at exit and level of covenant and cash flow cushions, to help ensure there is an acceptable margin of error given economic uncertainties.

As a result, we generally have a slight bias towards (i) more resilient, recurring revenue businesses in sectors such as health care and technology and (ii) covenant-light deals with respect to capital structure, which has historically given us added flexibility.

So far, many GPs have been proactive in helping their companies manage through this volatile economic environment. But continued monitoring remains a necessity for good portfolio management.

Q: From a diligence perspective, how is the environment changing how you underwrite deals and look at investment opportunities?

DB: As I said, we've been cautious for a while now, and we're going to stay cautious, at least over the short term.

Even with our historical access to many high-quality opportunities from our strong GP base, we have always been highly selective, and have become even more selective over the past couple of years. For us, having the right sponsorship in the lead GP and a level of comfort in that GP executing on a value creation plan is really key in this environment. We continue to believe that a levered beta strategy likely won't work over the long term.

So our heightened areas of focus around underwriting are around valuation, capital structure, flexibility in covenants, level of revenue visibility, the market position and pricing power. Those are factors that we are pressure testing even more, causing us to be even more selective.



Q: What are your expectations at the top of the funnel for deal flow? Should that inform any changes to deployment pace?

DB: Our 2022 co-investment deal flow was broadly flat as compared to 2021. Now 2021 was an exceptionally strong year generally for M&A volumes, so I would characterize our 2022 deal flow as very robust. We saw many opportunities and our goal is to continue positioning ourselves as a strategic, reliable co-investment partner for our GPs.

The assets that we did see come to market, and a trend we're still seeing now, tended to be higher quality companies, where the buyer-seller valuation expectations were more aligned, and so a deal was able to be struck.

For 2023, a number of factors are expected to be at play – the severity of a possible recession, continued inflation and how different governments are going to be able to get that under control, interest rates, the overall credit market and how open that will be. These are all important factors to us. Because of that, we expect a further pullback in deal volumes and, potentially, valuations, with such effects more likely in the first couple of quarters.

But we're not expecting any major contraction in volume. We're still expecting to see enough volume from our GP base, which should allow us to continue to be highly selective. We plan to remain disciplined and stick to our tight underwriting criteria with the goal of not compromising clients' returns. ■

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