KEYNOTE INTERVIEW

Co-investment advantages boost investor interest



Co-investments can add incremental, tactical private equity exposure for a typically lower all-in cost, say Adams Street's David Brett, Michael Taylor and Craig Waslin

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Q How would you describe the current environment for co-investments and how do you see it evolving over the next 18 months?

David Brett: Co-investments continue to be a very important part of many investors' private equity strategies. The opportunity to invest directly in deals alongside your highest conviction managers, typically with all-in lower fees, while at the same time being able to proactively build a more tactical and diversified portfolio, can be extremely compelling, and so appetite continues to increase. At the same time, many GPs have responded to this increased interest by incorporating co-investments as a core component of their activities, which has further established co-investments as an important source of capital in the market.

Meanwhile, the future growth of co-investments is not only supported by the core long-term benefits that it can afford investors, but also by the specific market conditions that we are experiencing right now. Tighter availability of credit and a tougher fundraising environment have led to an increased need for co-investment capital on the part of many GPs.

We have seen this in our recent dealflow, which is slightly up over the past 18 months despite headline figures showing that M&A and private equity activity overall is down significantly over that same period. This combination of short-term need and the long-term benefits that have been increasingly recognized over the years – by investors, GPs and portfolio companies – suggest that co-investments will only become a more important part of the market over time.

Q How has the LP community evolved in the co-investment space in recent years?

Craig Waslin: We have certainly seen more interest in the advantages that co-investments can offer, whether that is the typically lower all-in fee profile or the incremental tactical private equity exposure that it brings. As a result, many co-investment partners are increasingly dedicating more resources to co-investments and are shifting some of their strategy, internal review and/or approval processes to accommodate co-investment transaction timelines, which have become more condensed over time.

GPs really value a transparent and efficient process from their co-investment partners, as well as flexibility around sizing and structure. The ability for interested parties, such as Adams Street, to meet those GP expectations is important if they are to be successful in closing on co-investment opportunities.

So, too, is the ability to provide additional capital solutions. Adams Street, for example, can also provide both secondaries and private credit solutions, which strengthens the relationship with the GP. When an LP selects a private equity manager and invests in a fund they are, by definition, entering into a long-term partnership. When we enter into that partnership, we do so as a true solutions provider in an effort to support our GPs' overall success.

Q When does it make sense for an LP to invest in a specialist co-investment fund to gain access to the benefits of co-investments and when does it make sense to go it alone?

DB: LPs considering co-investing in-house would have to invest significantly in specialist resources because co-investments require a different set of skills to fund investment. It is also vital that the investor can act quickly, reaching the finish line in a predetermined time period so that the GP is able to transact.

Q For an LP that is looking to invest in a co-investment fund, what key drivers for success should they consider?

DB: Whether an investor is looking to co-invest in-house or planning to invest in a co-investment fund, we firmly believe that success is predicated on two things: access and selectivity. Access means having a large, generally expanding funnel of opportunities alongside high quality GPs. In our view, that is critical for driving outperformance from a co-investment perspective. We think a vital component of a successful co-investment program is having a dedicated primary investment team that has been committing capital to funds and creating longstanding institutional relationships with managers for decades that will help foster access to co-investment deal flow.

Selectivity, meanwhile, comes down to having a dedicated team of experienced investment professionals focused on identifying the very best opportunities and building the strongest possible co-investment portfolios.

A team with decades of experience and complementary skill sets transacting on co-investments is also key and we have greatly benefited from the insights we have on the thousands of portfolio company investments that our buyout GPs have made over our history in that regard. We believe those

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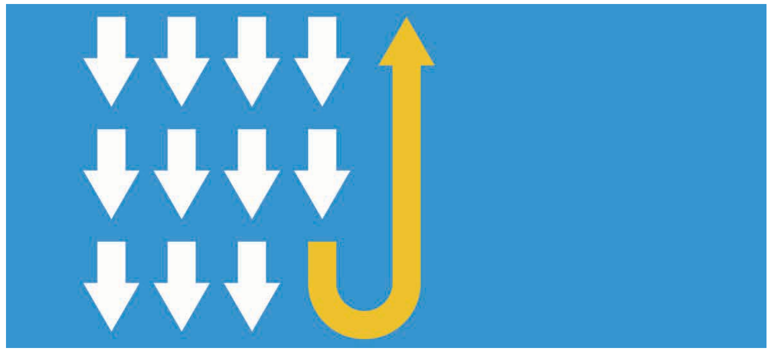

Q What sectors do you see as the most promising for co-investment right now?

CW: We believe that private equity is particularly well positioned to support sectors that are undergoing structural growth, change and/or dislocation. Our firm seeks to invest in best-in-class managers that we believe are able to take advantage of those broad themes. For example, we have historically been overweight in technology and healthcare co-investments. Those are two sectors where we dedicate a lot of time and have been particularly active investors. Technology and healthcare focused companies benefit from favorable secular trends and generally have a high degree of revenue visibility.

Meanwhile, in addition to technology and healthcare, we also like selected themes within industrials, financial services and consumer where changing consumer preferences are generating exciting investment opportunities.

insights have been invaluable. In short, we think the key to co-investments success is first, having access to strong opportunities and, second, having the skills to identify the very best opportunities.

Q How do you think about your capital base in the context of access and selectivity?

Michael Taylor: Ensuring that you match your capital base to the opportunity set is something that we talk about a lot internally. It is important that we are raising funds that we can responsibly invest over a reasonable time period while still being selective. We don't want to raise a fund that is so large that it causes us to do something unnatural from a selection standpoint. Discipline is fundamental when aligning your capital base with the opportunity set in front of you.

Q What is your broader approach to portfolio construction?

MT: Given our long history at Adams Street, both managing private equity portfolios ourselves and observing all the various fund investments that we have made over the years, we have clearly observed the power that diversification brings to our clients. When you are putting together a fund, it is critical to establish strong diversification over time through exposure to multiple vintage years. This ensures you are not overly concentrated in one part of the cycle.

It is also important to have diversification by industry. While there are certain sectors where we have more exposure because we believe they are areas where private equity is best suited to driving value, as Craig explained, and others where we have less exposure, we still have a high level of diversification overall. In addition, you need to be diversified by geography, manager and, importantly, size of company. All these elements of diversification contribute to the overall success of a portfolio. To be diversified, you need to be seeing enough quality deal flow in the first place, which goes back to David's point on access and selectivity.

What is interesting about co-investments specifically is that it is possible to achieve that level of diversification without sacrificing specialty management. That is because we are partnering with GPs that have particular expertise relevant to the company that we are partnering with them on. When we co-invest on healthcare deals, for example, we are doing so alongside healthcare experts, and when we invest in a German technology company, we are doing so with German technology specialists. So we get all the benefits of diversification without losing the sharpness of deep sector knowledge and experience.

Our job at Adams Street is then both to evaluate the risk-return profile of each individual opportunity on a standalone basis and to evaluate how these opportunities complement each other and fit together in an overall portfolio. Those are two separate gates that any prospective co-investment has to clear for us to participate.

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Q How are the macroeconomic and geopolitical uncertainties that we are facing today likely to impact co-investments, and private equity more broadly?

DB: There has undoubtedly been a great deal of uncertainty around the globe recently, both from an economic and geopolitical standpoint. That can be somewhat paralyzing. But we are not market timers. We are firm believers that, over the long term, private equity can deliver strong, relatively consistent investment returns relative to public market benchmarks across market cycles and, in particular, we believe that private equity is better positioned than other forms of ownership to take advantage of market dislocation and change.

Indeed, we have seen that many of our GPs are continuing to find opportunities to invest in companies with resilient business models, sticky revenues and strong margins – companies that should be well positioned to take advantage of these more volatile times.

Overall, I would say we are cautiously optimistic over a three-to-four-year horizon. We believe we are building some really interesting portfolios and that we will look back at this time period and view it as a strong vintage for private equity. ■

David Brett is partner and head of co-investments at Adams Street Partners, and Michael Taylor and Craig Waslin are both partners on the co-investments team