Adams Street

Disciplined Selection is Key to Co-Investments Amid Higher Interest Rates

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KEY TAKEAWAYS

- In a higher interest rate environment, we believe median returns produced by the private equity industry are likely to be more challenged. This places even more importance on General Partner selection, since the divergence in performance between top and bottom quartile managers is likely to widen.
- We believe it is crucial for co-investment managers to invest alongside the highest-quality sector specialist managers with deep domain expertise and a proven ability to drive true value creation through organic and inorganic growth initiatives.
- Higher rates mean co-investment managers can no longer rely on beta – higher leverage, multiple appreciation, and financial engineering tools – to drive returns. We believe managers should favor market leaders in large, resilient markets with pricing power, good revenue visibility, above-average margins and healthy cash conversion metrics.
- Co-investment managers should remain highly selective. Prudence and a focus on adequate diversification are key ingredients in a portfolio seeking to successfully navigate an elevated interest rate environment.
- In an uncertain macro environment, thorough underwriting should stress test risk-return profiles under various interest rate and recessionary scenarios.

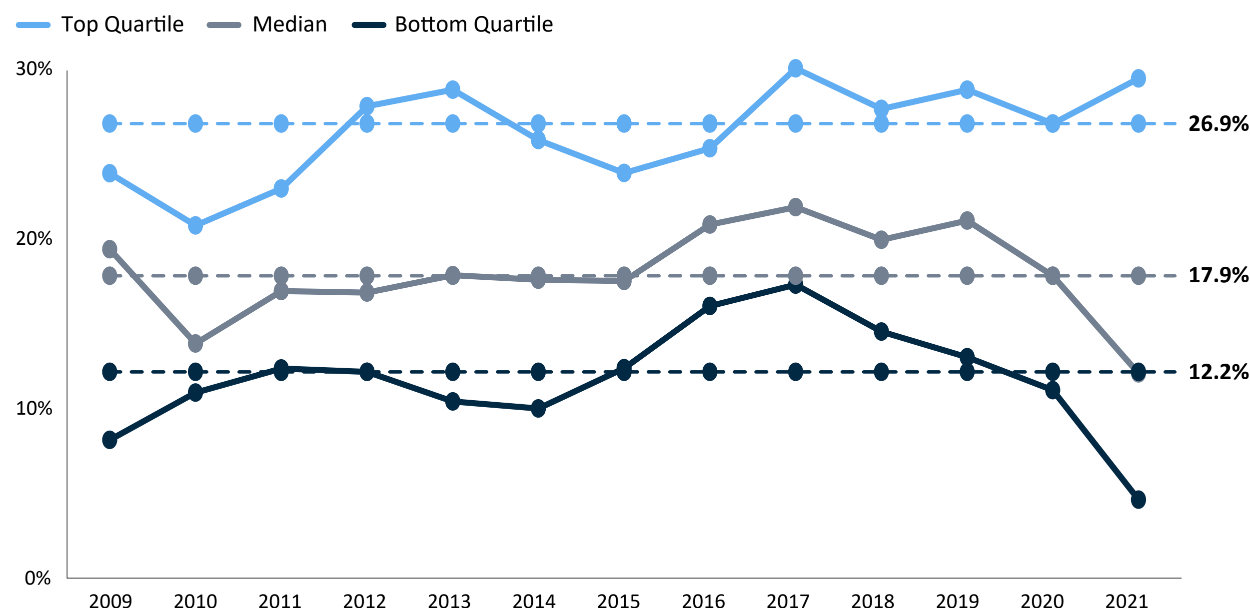
In April 2023 we **wrote** that a rising tide lifts all boats, about a year after citing Warren Buffett's famous **quip** that "you only find out who is swimming without a bathing suit when the tide goes out."

The decade or more of near-zero interest rates that followed the Global Financial Crisis helped to boost median returns for leveraged buyouts, as a lower cost of capital supported higher debt levels and valuation multiple expansion.

But now that the beta tailwinds created by the era of ultra-loose monetary policy are over, we believe that the median returns produced by the private equity industry over the past decade will be more challenging to sustain.

This places even greater importance on General Partner (GP) selection, since the divergence in performance between top and bottom quartile managers, as shown in Figure 1, is likely to be even more stark in a tougher macro environment.

Figure 1: US Buyout Performance by Vintage[1]



The Levered Beta Trade is Over

In a lower beta world, we believe it is even more critical for co-investment managers to invest alongside top-tier sector specialist managers with deep domain expertise and a proven ability to drive true value creation through organic and inorganic growth initiatives.

Co-investment managers with a wide and deep network of relationships with leading GPs are able to amass performance data on thousands of private companies through multiple market cycles. They can leverage this information to back the managers and companies they deem most likely to outperform while ensuring portfolios are adequately diversified.

To adjust for the "noise" of beta tailwinds – higher leverage, impact of multiple appreciation, and financial engineering tools such as dividend recaps – the manager selection process requires a thorough analysis of the drivers of a GP's historical returns. For example, in a typical late cycle phenomenon, we witnessed generalist firms encroaching in sectors such as technology and healthcare over the 2016-2021 period, because they were in vogue. While they sometimes enjoyed early success, this was often largely attributable to the rising tide of multiple uplift.

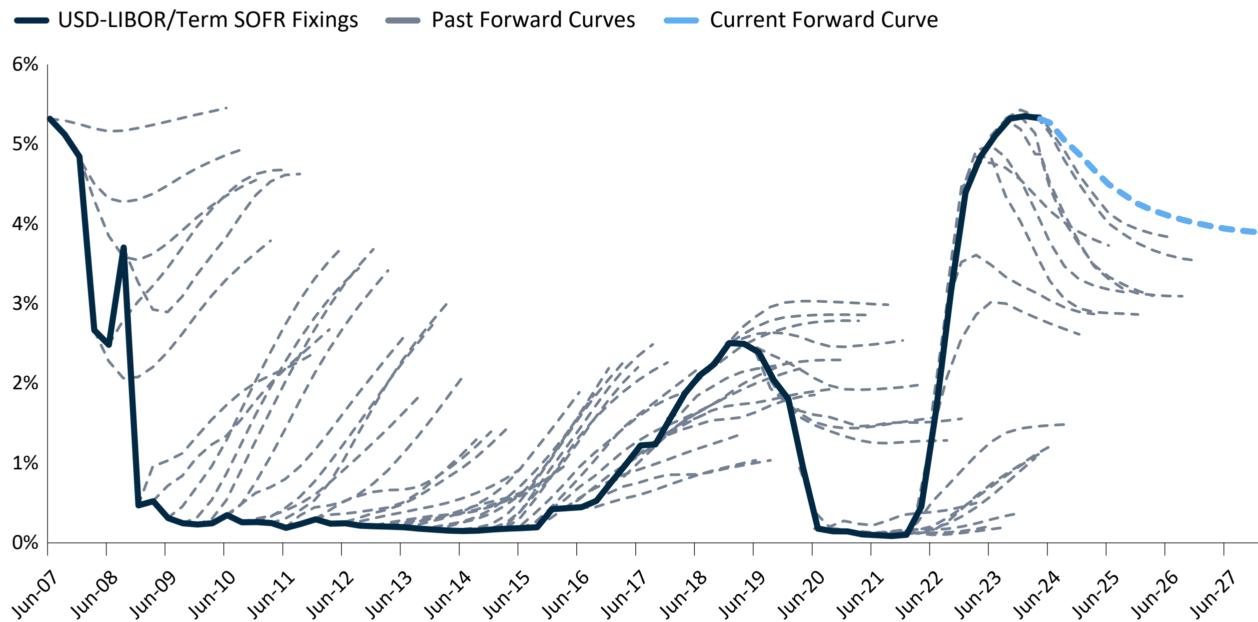
At Adams Street, our preference is to partner with best-in-class sector specialists with strong operating resources and well-aligned management teams who invest in private equity-owned businesses in industries experiencing growth, dislocation and change. We believe high-quality businesses in these sectors are best positioned to create value over the medium and long term, irrespective of the interest rate environment.

Stress Testing Outweighs Predictions

In December 2023, the US Federal Reserve indicated that it was near – if not at – the end of its cycle of interest rates hikes, as inflation continued on a persistent downward trend. However, expectations of rate cuts diminished in early 2024 as inflation proved to be stubborn, leading to the prospect that borrowing costs will remain "higher for longer."

The forward curve projects the Secured Overnight Financing Rate (SOFR) declining to around 4% by the end of 2026.[2] But as Figure 2 shows, macroeconomists and analysts historically have a poor record of calling future rates. An uncertain geopolitical landscape provides potential for additional inflationary shocks through energy and supply chain challenges, further complicating the business of prediction.

Figure 2: 1-month USD LIBOR/Term SOFR vs. Historical Forward Curve[3]



Given this uncertainty, we think co-investment managers should focus on the highest quality assets, typically favoring market leaders in large, resilient markets where the business has demonstrable pricing power, good revenue visibility, above-average margins and healthy cash conversion metrics. We also prefer companies operating in fragmented markets where the opportunity for market share gain and inorganic consolidation accelerates in a weaker economic environment.

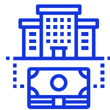
From a capital structure perspective, we believe it is critical for investors to stress test cash flow, liquidity and (where relevant) covenant cushions under various scenarios of both company operating performance and forward interest rate assumptions.

While markets appear to be confident that we can avoid a recession in the immediate future, our underwriting continues to pressure test performance for a mild and severe economic correction. And while rates are expected to descend on a steady glide path, investors should target companies with the necessary growth and cash flow characteristics to withstand higher rates for longer.

Highly Selective

Co-investment managers with access to high deal flow volumes should continue to remain highly selective. A business that exhibits compelling characteristics such as market leadership, strong growth, and high margins should still be excluded from consideration if a high debt stack or cash flow profile leaves little room for error. Prudence and a focus on adequate diversification are key ingredients in a co-investments portfolio seeking to successfully navigate an elevated interest rate environment.

Despite about 500 basis points of rate hikes since early 2022, valuations of the highest quality businesses in private (and public) markets remain robust. In private markets, the biggest impact of rate hikes has been felt in lower sponsor-backed M&A volumes, relative to the peak of 2021. We believe that only the best businesses have been able to attract favorable financing terms and buyers who are willing to meet seller valuation expectations.



A key attraction of a co-investment program is that it offers access to a well-diversified basket of high-quality private companies with a typically lower all-in-cost

Should rates decline as forecast over the medium term, while there is an argument for a positive impact on equity valuations, we are highly cognizant that valuations remain elevated compared with long-term averages. It's therefore necessary to factor in multiple contraction from entry to exit in almost every investment underwritten. For co-investors to be successful when faced with such macroeconomic hurdles, they typically need access to sufficient deal flow volume from a high-quality, specialist GP base, and experienced resources to comprehensively underwrite transactions – oftentimes under tight deal timelines.

Fee Advantage

In our experience, the best managers tend to outperform in periods of economic dislocation. And since attempting to time the market is at best challenging (and at worst well-nigh impossible), our preferred approach is to be a consistent investor through every investment cycle.

However, our expectation that median returns across this cycle are likely to be more challenged warrants greater investor focus on the cost of accessing the asset class. A key attraction of a co-investment program is that it offers access to a well-diversified basket of high-quality private companies with a typically lower all-in-cost.

Adams Street's analysis suggests that the structural fee advantage of a typical co-investment program is a boost to the net Internal Rate of Return of between 200 and 300 basis points.[4] Given the fixed nature of management fees, this figure carries greater significance as the assumed returns of the underlying portfolio decline.

Continued Opportunity

Over the long run, we believe private markets will continue to outperform their public market counterparts. And while median private equity returns are likely to moderate, periods of dislocation typically provide attractive opportunities for astute and experienced GPs. In our view, the current environment should benefit investors seeking lower cost access to differentiated private equity exposure via co-investments. In the absence of strong beta generated by cheap debt capital, investors looking at co-investments should prioritize managers with access to high-quality deal flow and a demonstrated ability to generate alpha through disciplined underwriting and strong investment selection. ■

1. Source: Burgiss.
2. As of April 15, 2024
3. Source: Chatham Financial (April 2024)
4. Estimated structural fee advantage (i) for traditional private equity funds, assumes (A) a fee scheduled of 2% management fee and 20% carried interest that is typical within the private equity industry and (B) a hypothetical net target return of 1.8x MOIC which in turn implies a net target return of 14.5% IRR (based on Adams Street historical data and estimated forward assumptions for buyout funds and assuming a fund life of 13 years, which represents the average expected life of buyout funds in Adams Street Partners' database), vs. (ii) for co-investment funds, assumes (A) a fee schedule of 1% management fee and 12.5% carried interest that was used for a recent Adams Street Co-investment commingled fund, (B) a hypothetical net target return of 1.9x MOIC which in turn implies a net target return of 17.5% IRR (based on Adams Street historical data and estimated forwards assumptions for co-investments assuming a fund life of 12 years, which represents the expected life of Adams Street's most recent commingled co-investment vehicle) and (C) without an additional layer of management fees or carried interest from a co-investment opportunity's sponsoring general partner. These assumptions are made for illustrative purposes only; the fees and returns described herein do not necessarily represent the returns achieved, or fees paid, by any Adams Street Partners fund or any investor in such fund. Targeted net returns (after Adams Street's fees, expenses, and carried interest) are only targets and aspirational in nature. There is no guarantee that Adams Street or any investment vehicle advised thereby will achieve returns in the targeted range. Additional detail on the assumptions used and methodology incorporated is available upon request

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