Q&A

CO-INVESTING

Compelling, complementary – and increasingly competitive

Accessing high-quality deal flow and maintaining portfolio discipline are the keys to success, says Pantheon's Erik Wong.

LPs investing directly into portfolio companies alongside GPs has been a growing trend. Cambridge Associates estimated that global co-investment deal flow amounted to **$60bn** in 2017, while Triago put the global co-investment capital pool at **$55bn** in 2018.

We spoke to Erik Wong, Partner in Pantheon's co-investment team, to understand what has driven the popularity of co-investments – and how this evolving market is coping with a combination of increased competition, an elevated valuation environment and recent market volatility to continue to deliver for investors.

Q Why do you think more LPs are looking at co-investments?

At one level this is about lowering the cost of access to private equity, which in turn may improve potential returns. Co-investments are generally offered by GPs on a no-fee, no-carry basis, which is compelling to investors.

Beyond this headline benefit, co-investing allows investors to gain a greater insight into the investments they are making and greater control over the shape of their portfolio. They're getting additional exposure to preferred GPs they have already underwritten and that they trust. For a fund-of-funds investor co-investments also potentially lower the J-curve through more efficient capital deployment, and reduce the "blind pool" element as commitments are fully funded at the time of investment.

Taken together, the positive deal economics, return potential and cashflow profile mean that a well-designed co-investment program may be complementary to an LP's private equity program, alongside primary and secondary fund investments.

Q And what about the risks?

Co-investments are concentrated exposures in individual assets in an illiquid asset class. Without a considered investment strategy, the performance volatility at the individual asset level can potentially erode the headline "no-fee, no-carry" economic benefits.

The other risk is related to the quality of the GP sponsor. Most co-investors invest on a passive basis and rely on the deal sponsor to manage the underlying companies and create value. They therefore need to know and trust the GP, ideally through a long-standing relationship and deep knowledge of the GP's investment philosophy and track record.

Q How have you responded to the current valuation environment?

At the deal level, valuation in the context of the investment thesis is an important part of our diligence and is one of the main reasons we decline opportunities, especially in the current market.

At a higher level, robust asset prices and more recent volatility in public markets highlight the importance of partnering with managers with whom we have a long-standing history, and who have deep sector expertise and a track record of delivering strong performance through cycles.

We have also tilted our portfolio to sectors that are less correlated to macro trends and more defensive or growth oriented, such as selected segments in the healthcare and IT sectors.

Q What is your approach to co-investing?

There are a few key themes. First, we primarily focus on co-investing alongside managers we know well and with whom we invest on a primary basis. Over the past nearly 40 years, our primary team has identified and invested in quality GPs that have consistently delivered strong returns, irrespective of economic cycles. That platform provides some level of assurance on the quality of co-investment opportunities we are offered.

We also have a disciplined portfolio construction approach that includes pre-defined diversification targets covering geographic, investment vintage and sector exposures, as well as range of bite size and number of companies in our programs. We pace capital deployment based on those targets to optimise diversification and minimize return volatility across the portfolio.

A cornerstone of our investment strategy is to target small- and mid-sized buyouts, and growth opportunities. We believe that there are more levers to create value at these companies, including expanding geographically or into new products, strengthening the management team, or buy-and-build initiatives.

Q How do you get access to the right deals?

We see the ability to access sizable and quality deal flow from a wide range of deal sponsors as being key to building a high quality, diversified co-investment portfolio.

We leverage our fund investment platform and source transactions from over 130 GPs. We're an advisory board member for most of the funds to which we have committed, which means we have close and ongoing dialogue on potential co-investment opportunities.

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After that it's about being an attractive prospective partner for GPs. For us that means providing to our GPs a flexible and sizeable capital pool and working closely alongside the sponsor at all stages of the deal process. Having a dedicated, global co-investment team and an investment committee with direct investment experience that can respond outside of the regular approval cycle where needed are also positives for our GPs, as they value quick and candid feedback on proposed transactions.

Q What are GPs looking for from co-investors?

In addition to cementing LP relationships, GPs use co-investments to support their deal processes and portfolio company growth, and to avoid concentration in individual deals. Sponsors now increasingly bring to their LPs co-investments that are still in exclusivity periods or at the bidding stage. They are looking for partners who can move alongside their process and provide speed and certainty in addition to capital to get deals done.

Last year we completed a number of co-underwritten and warehousing deals – where we funded a sizable co-investment that was later partially syndicated – to support efficient deal execution and fund raising for our GPs.

Another situation might be where a GP has been invested in a company for 6-12 months and is constrained from investing in an otherwise interesting follow-on opportunity. In those cases, bringing in a co-investor that can provide further capital is critical to help that company reach its full potential.

Covid-19: Pantheon perspective

This article was written before the scale of the disruption related to the Covid-19 pandemic had become clear. Over the past three months, that disruption has deepened and broadened across economies globally. Almost all industry sectors are affected, but the biggest impact is being felt by businesses with:

- **Sales into highly affected end markets (e.g. airlines)**
- **Physical store presence (e.g. restaurants)**
- **Provision of on-site services (e.g. clinic-based healthcare services)**

Private equity managers have initially been focused on identifying existing portfolio companies experiencing the most material effects and taking actions where necessary, such as enhancing liquidity, managing costs and discussing covenants with lenders. One consequence will be a slowdown in exit activity as both buyers and sellers re-calibrate and the credit markets become more selective.

At the same time, however, there may be a positive impact in terms of new investment opportunities in the months ahead, especially as deals become available that utilise more interesting deal structures and at more attractive valuations than have been common in recent years.

This article first appeared on the the Informa Connect SuperReturn International conference content hub. Please click here.

Biography

Erik Wong, Partner

Erik is a member of Pantheon's Global Co-Investment Committee and is responsible for sourcing, executing and monitoring co-investments in Europe. Erik joined Pantheon from Abu Dhabi Investment Authority. Prior to that he worked for IFRS Foundation in the UK and before that, he worked on direct investments with Quilvest Asia in Hong Kong. Erik was trained as an accountant with PwC in Hong Kong and is a CA and CPA. In addition to his accountancy degree, Erik holds an MSc in Finance from University of London and an MBA from University of Cambridge. He is fluent in English, Cantonese and Mandarin. Erik is based in London.

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