KEYNOTE INTERVIEW

What co-investment funds bring to the table

Superior sourcing, diligence and execution capabilities are all reasons why investors should consider working with a co-investment manager, say Erik Wong and Matt Cashion, partners in Pantheon's global co-investment team

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Q Why should investors consider a co-investment fund strategy rather than investing directly alongside their GPs?

Erik Wong: Many investors see co-investments as a compelling and cost-efficient way to scale up their private equity allocation. However, co-investment execution is resource intensive, and co-investments could introduce concentration risks on single-asset and GP exposures in an existing private equity portfolio.

By investing via a co-investment fund, investors have the opportunity to expand the universe of GPs and the types of deals to which they have exposure. A good example here is small and mid-market buyout deals, which we focus on at Pantheon, and which are often access-constrained given the size of the equity ticket and the number of potential co-investors being approached by the deal sponsors.

Ultimately, a co-investment fund can allow investors to more efficiently scale up deployment to the asset class, while at the same time increasing diversification in terms of the range of deals, managers, sectors and geographies they invest in, compared to building an in-house co-invest programme.

Matt Cashion: To do co-investment yourself, first you need to see the deal – which isn't as easy as it sounds. We are constantly in touch with our network of GPs as a fund investor; we have relationships with more than 140 managers and sit on more than 480 private equity fund advisory boards. We are in the information flow, which helps a lot with gaining visibility on the opportunities that are out there.

Next, you need to be able to diligence the deal. Co-investment

managers like us have large primary and secondaries programmes that are complementary to our co-investment capabilities, which means we have several different vectors through which to analyse deals that an in-house co-investor would not necessarily have. Then, of course, there is the execution expertise required to meet the strict timelines that GPs have when trying to complete a transaction.

Finally, you need resources to monitor the portfolio post-acquisition. You need to have a relationship where you can pick up the phone when there is an issue with a company and get to the bottom of the matter. In-house co-investors may be able to handle the workload required for a few deals per year but, as Erik says, that could land you with a concentration issue.

Q Why do you choose to focus on the mid-market in particular?

MC: The mid-market is generally a less trafficked area in the co-investment space, and there is a wider range of potential deal opportunities. Specifically, there are more founder- and entrepreneur-led businesses that offer GPs with operational expertise the ability to add value. In contrast, the large- and mega-cap segment tends to offer less opportunity to 'move the needle', given the scale of existing operations.

We have a vast primary portfolio focused on this huge opportunity set, and we are therefore often able to find off-market deals done by GPs that have not been through formal sales processes. These are the types of investments that have the potential to generate really attractive returns.

EW: We have also seen a lot of evolution in the mid-market over the past decade, particularly regarding the emergence of sector specialists. These managers live and breathe the sourcing, diligence and executing of deals in their respective industries, which gives us confidence in their ability to add value as they cross-pollinate playbooks from other companies in the same space. In addition, while many allocators are able to access co-investment with brand-name, mega-market funds, simply because of the scale of co-investment available, it can be much harder for them to access mid-market opportunities. This makes for an area where a co-investment fund can really add value.

Q For investors that do choose to go down the co-investment fund route, what should they be looking for in a manager?

Erik Wong: First, investors need to consider the platform through which the co-investment dealflow is generated, both in terms of quality and volume. The more global the origination platform and the deeper the relationship with the GPs locally, the more deals the co-investment fund manager will see. The quality of those GPs and the performance of their underlying funds offer return assurance on the deals the platform will execute. Additionally, the investors should evaluate how the type of deals and GPs pursued by the co-investment fund can complement and enhance the diversification of their existing PE allocation.

Matt Cashion: Investors also need to consider the depth of the co-investment manager track record in terms of number of years of experience and number of GPs with which they have worked. It is also important to look at the persistency of the co-investment fund manager's track record over time and geographies. Additionally, investors should look at the tenure of the team. Co-investment is a very relationship-orientated business, so those that have been in the market for a long time are going to be best placed to source deals and determine which of the many available opportunities should ultimately deliver for their investors.

Q Are there sectors where you are spending more time as a co-investor right now?

MC: As a firm, we have convictions in a number of key macro and sector themes, and we typically see the best opportunities from the GPs in our primary portfolio – many of which, as Erik says, are themselves sector specialists. Recently, we have seen significant

dealflow in the consumer staples space, while healthcare and financial services, as well as critical technology subsectors, also remain important themes.

EW: Our sponsors typically favour businesses with a differentiated offering that supports sustainable growth, markets that are less correlated with macroeconomic volatility, and critical services that drive recurring revenue streams and margin levels. To this end, our GPs have been focusing on sectors such as healthcare, software, cybersecurity and financial services segments such as insurance brokerage and wealth management.

Q How is the supply of co-investment being influenced by the current macroeconomic environment?

MC: Fundraising has generally been slower. Most of our GPs are hitting their targets, but it is often taking longer than it might have in the past. As a result, we are seeing a greater utilisation of co-investment to support new deal activity and incentivise primary fund commitments during a fundraise. We have also seen GPs stretch out remaining fund capacity and use co-investment capital to bridge the gap in deal financing until their next fundraise.

Of course, GPs are also continuing to use co-investment to try and strengthen relationships with key LPs. The other benefit, from the sponsor's perspective, is they don't have to team up with another private equity firm – instead of bringing in a competitor, they can keep it in the family. At the same time, many other co-investors have either left the market or pressed pause, often due to allocation or liquidity issues that have led to overexposure.

All of this is creating opportunities for groups such as us that have dedicated capital and dedicated teams focused on co-investment. GPs are often running at breakneck speed trying to get deals done, and they need co-investors that can reach the finishing line alongside them.

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MATT CASHION

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ERIK WONG

EW: I would add that the rebound in private equity activity due to improved market sentiment has the potential to propel co-investment dealflow. There are GPs that have been holding onto portfolio companies for quite some time, so there is a real desire to generate liquidity for LPs. There is also a desire to bring in new companies to portfolios, albeit in a way that doesn't stretch the equity cheque made by the fund. This is taking place against a backdrop of moderating interest rate pressures, while debt markets, including private credit, have remained relatively open in the small- and mid-market.

Q Do you believe that the lines between co-investment and GP-led secondaries have been blurred?

EW: GP-leds involve the continued ownership of proven assets, managed by the same deal sponsor and management teams. With co-investments, a key feature is that the GP is investing from its core fund alongside you. That means the return on the deal will impact the GP's next fundraise, bringing significant alignment with deal sponsors. Additionally, co-investments are generally offered on a no-fee, no-carry basis, resulting in a lower cost of access to quality deals for the end investor.

MC: There are fundamental similarities between the strategies; both offer exposure to buyouts backed by great GPs. They just come in a different wrapper and serve different purposes. Co-investment helps get a new deal done, with the co-investor effectively coming in at par, while a GP-led is primarily a tool for generating liquidity on an existing deal. At Pantheon, we view them as complementary strategies, and we have room for both in our platform; they offer similar exposure, just through a different lens. ■

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