KEYNOTE INTERVIEW

Carry on co-investing

Co-investment will continue to play a crucial role in PE despite the present macro environment, says Markus Benzler, head of multi-managers private equity at UBS Asset Management

SPONSOR
UBS ASSET MANAGEMENT

Q What impact has the current macroeconomic environment had on appetite for co-investment?
There is less capital available in the market generally. We are hearing that fundraising is becoming more difficult, even for strong managers. In many cases, investors are keen to preserve those relationships – they just have less money available to do so.

A key contributor to that is the denominator effect. At the same time, there is a degree of uncertainty about how the asset class is going to perform in the short term.

Lastly, investors are shifting allocations into their fixed-income portfolio. In the past, those investors had nowhere to go except equities and alternatives – now there is a third option. For these reasons, fundraising is taking longer and becoming more challenging. It also means there is less capital available for co-investment in the short term.

Having said that, the secular case for co-investment remains the same: co-investment enables investors to reduce their total expense ratio by participating in deals on a reduced or no-fee, no-carry basis. Investors can also tailor the investment approach to their risk appetite and allocation targets, or just boost their returns by selecting suitable co-investment opportunities.

Q What about demand for co-investment from GPs?
In the short to medium term, I think demand for co-investment partners is only going to grow stronger. I anticipate that many fund managers won't reach their targeted fund size in the current market environment; to remain in the same deal segment, these GPs will either need to execute fewer deals or turn to co-investment.

Q What are the risks associated with co-investment? How can they be mitigated?
There are three main categories of risk: portfolio-level risk, GP risk and risk at the level of the underlying asset. Portfolio-level risk can be mitigated

through careful portfolio construction. You don't want to have all your eggs in one basket in terms of industry or geography. You also want diversification of returns drivers – for example, businesses where the value creation plan is predicated on expanding product lines or expanding into new markets.

Another important risk mitigant at the portfolio level is being prepared to do nothing. There are always peaks and troughs in dealflow, and if you don't feel comfortable with the opportunities in front of you, then you must be prepared to wait it out.

In terms of the GP, you want to ensure you are investing alongside a strong manager with the proper resources, skills and experience to drive the deal. Equally, you want to ensure the GP is operating in its deal sweet spot. Co-investment opportunities often arise when a GP is looking at a deal that is larger than those originally intended for the fund – however, if the GP has experience with that kind of asset or the planned value creation route, this isn't necessarily an issue. However, if they are looking to do something they have never done before, that would certainly be a big concern. The further away it is from their sweet spot, the more it is of a concern.

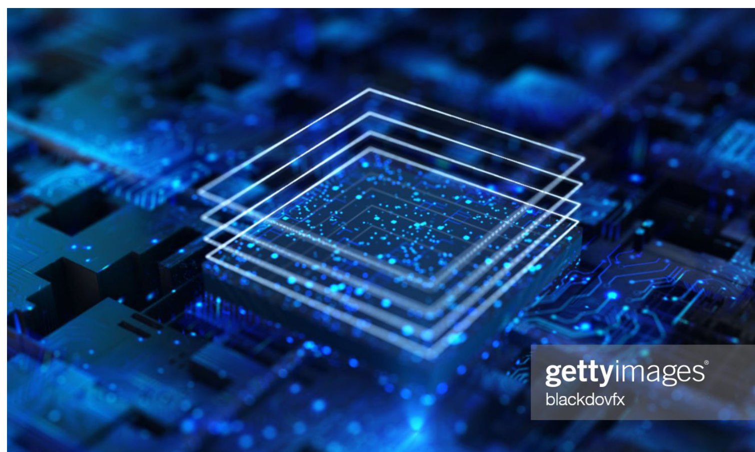
Alignment of interest with the GP is also critical. At UBS Asset Management, we just recently terminated a co-investment deal at the end of the investment selection process because the alignment was too weak, despite everything else looking great. Also, in a fundraising environment like today's, it is important to ensure you are working with a GP where the franchise is not liable to fall apart. If this challenging fundraising environment persists, there will be some GPs that are not able to raise successor funds, and teams will break apart. As co-investors, we don't have the resources or expertise to manage assets on a day-to-day basis, which means we don't want to get stuck with an investment where there is no strong GP to lead the deal.

Q How is technology being used to aid the co-investment model?

We have a process support tool that has been tweaked for co-investment. Obviously, tracking revenue, EBITDA and leverage multiples is crucially important. Having said that, a lot of this information is included in deal review packages or available via data providers, so we don't really see a strong technology advantage in using these software solutions.

We are seeing some interesting start-ups emerge in areas such as the automated generation of special purpose vehicles. But I think it is blockchain technology that has the potential to be most transformative, as the blockchain could hold information in a more accessible format.

We are seeing a number of different approaches being trialled, and there is by no means a definitive standard yet. But ultimately, blockchain could really shake up the asset class, although I think it will take at least five to 10 years before private equity adopts this technology at scale.



Meanwhile, when it comes to the underlying asset, there are a lot of things that we consider including transaction dynamics, valuation, leverage, the market, growth dynamic, profitability, the management team, the value creation plan, ESG aspects, performance outlook under different scenarios and the resilience of the business model. Key risks identified during due diligence are highlighted and discussed during our investment process. By the end, investment committee members have to be comfortable with the key identified risks and their mitigants.

When considering risks, there are also trade-offs to be considered. For example: in some respects, Europe has become less attractive relative to the US, which is further away from the energy crisis and generally is perceived to have lower growth prospects. However, valuation adjustments in Europe mean that, while there may be less growth and more uncertainty, so long as these issues are priced into the asset, deals can still be very attractive.

Q What is your preferred route to co-investment? Do you get involved in deals at the outset or participate in post-transaction syndication?

Typically, we prefer a deal to be fully baked. We usually co-invest with GPs where we are already invested in the fund in order to secure that co-investment on a no-fee, no-carry basis, so we are aware of the transaction early on.

However, to avoid broken deal costs and wasting time on a deal that may not come to fruition, we prefer to become actively involved at a later stage.

There are, of course, exceptions: sometimes we will be approached by our GP because of the value-add we can bring to the investment. For example, the deal may involve a product that we use as an organisation, or we may be a potential buyer of that product. In other cases, GPs may want our brand in the deal to provide comfort to the involved transaction parties. In those circumstances, we may take a seat at the table at an earlier stage.

Q Does the reduced economics of co-investing create a strain on GPs' income streams?

I don't think it does – at least, not in the greater scheme of things. There are two primary forms of co-investment dealflow: there are deals that would be too large for the fund alone where, for diversification reasons, the GP doesn't want to put too much of the fund's equity into the transaction, and so turns to co-investors for additional money. Given that the deal is too large anyway, this type of co-investment doesn't really impact the GP's fee stream.

The other type of co-investment that we often see today involves less-established GPs that offer co-investment in exchange for a fund commitment. In many cases, offering this fringe benefit is the only way they can close the fund around the target. So, again, that isn't a case of co-investment damaging the fee stream – in fact, I would argue that co-investment creates very little pressure on the fee stream, or even none at all.

Q Is there a risk that co-investment could fall out of favour?

The only reason I can see that co-investment would fall out of favour would be if GPs started to charge fees and carry for the deals in which we are already an LP fund investor. That would certainly result in less appetite. But currently, if anything, we are seeing the opposite happen. In Australia, for example, it has historically been the market norm to charge a 1 percent management fee and 10 percent carry on co-investment, but this is now adjusting to the global standard. I therefore believe that the secular trend of using co-investment to reduce fee load and optimise the total expense ratio is here to stay.

"The only reason… that co-investment would fall out of favour would be if GPs started to charge fees and carry"

Q Following recent musings from the SEC, is regulatory intervention in any way a concern for co-investors?

From what we see now, regulators tend to focus on ensuring transparency around how investment capacity is allocated and what investors are paying for their investments. Co-investment, of course, is a means of reducing fees – so, if anything, I would expect regulators to be in favour of its continuing practice, as long as there is a fair and transparent allocation.

Co-investment should be able to outperform a fund portfolio, especially on a net-net basis, and therefore offers a compelling risk/return profile. So long as all these elements continue to hold true, I see no reason why regulators should be concerned.

Q How can GPs and LPs differentiate themselves as co-investment partners?

For GPs, co-investment is both a relationship tool supporting fundraising and a mechanism that enables them to do larger deals than their fund would allow. GPs that offer high-quality co-investment opportunities, rigorous due diligence packages and access to senior management are likely to stand out from the crowd.

From the LP perspective, the market is less crowded than it has been previously. Nonetheless, it is important to have an institutional underwriting process and the ability to make decisions quickly. Having a strong brand, as UBS does, is also extremely helpful as a GP will often welcome the credibility that gives them when it comes to closing the deal.

In addition, there are certain sectors, such as fintech, where UBS can provide a unique and expert view. These are the main factors that I believe GPs value the most. ■