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Graziella Scassillo: You are listening to RPM, the podcast that explores the world of private markets. I'm your host, Graziella Scassillo, based out of StepStone Rome Office. I am joined today by the co-heads of StepStone's co-investment practice, Lindsay Creedon and Darren Friedman, to discuss the state of the co-investment market. Lindsay and Darren joined StepStone in 2010 and are based out of New York Office. Darren, Lindsay, welcome to RPM.

Darren Friedman: Thank you so much for the invitation.

Lindsay Creedon: Thanks. We're excited to be recording this.

GS: Thank you. My first question is for you. Co-investment are becoming an integral part of the investors' portfolios. Why should an investor consider including co-investments in their portfolio?

DMF: There are several potential benefits that make co-investments attractive to Private Equity market investors. First off, and most importantly, co-investments are typically offered on a no-fee, no-carry basis – so clearly this is a way to invest in the asset class with a reduced fee burden. But there are other benefits for investors – such as the ability to outperform through investment selection. If you are able to continually source a large pool of co-investment opportunities, you can be highly selective, and then target returns greater than a PE primary fund portfolio may yield on its own. Co-investments can also be an effective way to gain exposure in different sectors or geographies based on your current market views – as opposed to a primary fund commitment which is entered into upfront and then invested into that strategy over a several year period. And even beyond that, co-investments offer investors a way to make tactical moves in a portfolio by either scaling up or down its exposure more quickly than through adjustments in their primary portfolios. Finally, there are significant market intelligence benefits. Now, let me break this down into two pieces - the first one being differentiated insights gained into the strengths and weaknesses of a manager that are harder to learn during the primary fund due diligence process alone. Second, being in the co-investment market provides investors with a first-hand view of the PE environment including things like the level of competition, where are valuation multiples, what are the sectors that group are focused on, what are the market return expectations, what is the latest credit market status, etc.

GS: I see, that sounds very interesting. Lindsay, it sounds like co-investments can benefit portfolios, but there's always been discussion around whether there is any adverse selection in co-investments and if LPs are being offered the best opportunities.

LC: Yeah, this is a fairly common question, and one where people have tended to make assumptions around GP incentives when offering co-invest. So, we took a hard look at this issue and we looked at it from two perspectives: a qualitative one and quantitative. So, starting with the qualitative. When seeking co-invest equity, GPs are almost always taking a full investment position in their own funds, so signaling strong conviction in the investment. And if they're not taking a full position themselves, this is something that we always want to understand and discuss with them. In addition, intuitively, it just doesn't make sense that GPs would bring subpar or what they view as riskier opportunities to their most important, most strategic LPs who are institutions that they want to continue having as long-term primary investors. Second, we also just wanted to see what the data says, so we leveraged our proprietary SPI database of nearly a thousand investments to see if there is, in fact any evidence of adverse selection. And we looked at the question quantitatively in a couple of ways. First, we compared investments in a fund that had co-investment as part of the equity and compared their performance to the related overall parent

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fund performance. And we found that on a gross basis, the co-investments outperformed the parent fund about 50 percent of the time and thus underperform 50 percent of the time, so no evidence of adverse selection. And on a net basis, when adjusting for the more favorable fee structure on co-invest, they actually outperformed 60 percent of the time. We also took this large co-invest sample and then bucketed them into vintages to simulate a fund investment period. And when we did this, we found that the simulated co-investment funds were first quartile performers in every vintage year except for one, where it was the second quartile performer. So, based on our analysis and experience and the data, we just don't see that there's any adverse selection going on in the market.

GS: So, Darren, in that case, why did GPs offer co-investment opportunities at all? What's driving the market?

DMF: The primary reason GPs offer co-investments is to allow them to be able to complete a transaction in an efficient way that would otherwise be too large for that group to undertake. GPs rather not partner with another GP, which we call a club deal, but they rather maintain primary control as opposed to shared control over an investment. Now, also, LPs generally do not have a positive view of club deals, which were very popular in the mid 2000s. So, LPs want to avoid club deals, GPs want to avoid club deals, and probably the most vocal group against club deals are management teams. They want to know who their partner is, and that is much easier when you only have one group in control. Now, I want to take a step back because co-investment, it's a very broad term and there are really two types of co-investment. The first are syndications. These are where the GP underwrites an investment backed by the fund, and then it will sell down the exposure to LPs. These posts signing syndications are a good way for GPs to show opportunities to a wide range of their investor partners. Then, there are pre-signing or co underwriting co-investments. These are where the GP work side by side, in partnership, with one or a very small handful of LPs or strategic relationship, and all parties sign at the same time. This way, the GPs fund does not have to take any underwriting risk, and these pre-signing capabilities are highly valued by GPs as it allows them to target opportunities where they may have a very good angle but will need incremental capital, and they could do this without having to partner with another GP. There's a much smaller universe of market participants that are equipped to undertake these co underwriting opportunities, with Stepstone being one of them, and this type of co-investment has been a growing part of the market over the last 10 years. So, let me come back to your question on GP rationale. Co-investments also allow the GP to manage its exposures, either to a single investment or a single industry, that may trigger the fund's diversification limits, either their legal limits or just what they've targeted internally for their own diversification and portfolio construction. So, co-investment then, it allows the GPs the ability to manage its fund size, to be able to target the widest range of opportunities, so they can strategically use co-investment for larger opportunities in their sweet spot, while still being able to take advantage of the smaller or more appropriately sized companies for the overall fund. And then finally from the GP's perspective, there's the relationship aspect. Generally, many LPs are seeking co-investment, and this then allows GPs to deepen relationships with their existing or to build relationships with potentially new investors. And some of these will be more sophisticated partners. And they may bring a unique viewpoint, skill or differentiated network or other resources to an opportunity to complement that of the GP.

GS: Hundred percent clear, thank you Darren. Lindsay, now that we're talking about how co-investments benefit both GPs and LPs, I would like to ask you, how do you create a successful co-investment program? What are the key components that are needed?

LC: Well, there are several key components that I think one needs to build a successful and sustainable co-investment program, and the first is sourcing. Can you generate enough deal flow to build a high quality, properly diversified portfolio, and be highly selective in the deals in which you choose to invest? And this is driven by the scale of one's primary capital deployment in the asset class, the breadth of one's GP network and

relationships and their global reach. To put some numbers around that, just last year we allocated over 20 billion of capital into private equity and in the last three years we've approved over 50 billion of primary capital in over 350 funds. But in addition to sourcing, you also need to have an experienced global team with professionals on the ground in the local markets and regions. It's very hard to perform effective due diligence halfway around the world. You need professionals on the ground who know the local market, the language and have those deep relationships with the GPs. I'd say, third, is really having the ability to leverage technology and information to gain additional insights and incremental diligence angles beyond the lead GP's diligence, which really enables the team to better assess risk/return opportunities and to make decisions efficiently, and at Stepstone we do this through our proprietary SPI database, and the information we're able to access through our broader global platform, but, you know, you also need the ability to create appropriate diversification and experience and portfolio construction. Our experience of managing portfolios through Covid has clearly illustrated the importance of both diversifications, as we've seen different sectors, strategies, geographies be impacted in vastly different ways, and the importance of having access to high quality managers and teams, who've been able to manage so well through this period. And the last one, I'll mention is flexibility, and what I mean by that, is the ability to do more than just the plain vanilla type of deal, so, to be able to do add-ons, or transformative acquisitions for existing portfolio companies, for example, but also flexible in terms of how we work with GPs. So, Darren discussed the syndicated versus the pre-signing and co-underwriting markets, having the flexibility to work alongside GPs during diligence real-time is very valuable. Over 60 percent of what we do is on a pre-signing or co-underwriting basis, where we can perform our diligence really hand in hand with the GP. So, all of this allows you to develop a reputation for being a trusted, reliable partner to GPs and someone they want to partner with on potential transactions really time and again.

GS: Now that Lindsay has just mentioned Covid-19, I have a question for you, Darren, that I'm sure you have already fielded many times. As we move into 2021 what is the outlook for co-investments, and in particular how has Covid-19 impacted the landscape?

DF: Yes, this is a question that we've been answering many times over the past 12 months. So, having personally been a participant in the co-investment market for over 20 years, I've been very fortunate to have first-hand experience seeing the evolution of the market, and obviously over the past 12 months, I spent a lot of time on the impacts of Covid-19 on the investment market. So, just going back, coming out of the financial crisis, we really saw a marked decrease in the willingness of GPs to bridge equity to a large syndication. And that was really due to the potential for market volatility. But we also saw that to start fading a bit, particularly in the 18 months before the onset of Covid-19. So now we believe the increased market volatility from Covid-19, coupled with some of the geopolitical developments in the world, will lead GPs to underwrite less equity syndication risk, due to this potential for continued volatility, and therefore, the need for pre-signing capital will increase. The trend of co-underwriting with LPs/strategic partners, like StepStone, we think will be solidified. Club deals will continue to remain out of favor, and that is probably a permanent change in the marketplace. Couple that with the positive experience that many GPs have had on a pre-signing basis, working with strategic partners, has further cemented this type of co-investment as here to stay and in my view most likely grow. So, overall, proven and credible partners will become even more advantaged, particularly those groups with this capability, and, as Lindsay said, experience, market reputation and reliability, these are all things that will really matter on a go forward basis. Now, we also feel there's going to be certain investors that will pull away from direct co-investments, as they may not have had diversified portfolios and some of their experiences, depending on where they had concentration. So, for example, if they had a lot of concentration in hospitality or energy or certain areas of retail, they might have bad experiences due to Covid-19. So, just to touch on some of the underlying specific deal trends that we're seeing, it's really been around the continued focus on growth industries such as tech, consumer, healthcare and away from more capital-intensive ones. We believe exposure to these industries will be easier for co-investors to gain access to, but not forgetting those with sourcing capabilities that abroad, as Lindsay alluded to, we'll be able to construct a portfolio



that will benefit from the correlation, or really negative correlation of having this diversified portfolio with multiple industries. We saw the first-hand benefits of diversification during Covid-19 and GPs saw this as well, so we would anticipate more companies in each co-investment portfolio, whether it's an SMA or an aggregated vehicle, and GPs and co-investment managers both realize that diversification is critical as various industries have impacts that hopefully correlate differently with one another.

GS: So finally, Lindsay, how does StepStone work with clients to gain exposure to co-investments?

LC: We partner with our clients really in two ways as it relates to investments. First, for clients who have larger allocations to co-invest, we can build a Separately Managed Account or SMA, that can be customized based on various parameters, to meet the specific needs of an institution. Second, for those who either have smaller allocations to co-invest, or ones who might have legal or structural reasons preventing them from creating an SMA, or really just for simplicity, we aggregate those clients into a vehicle that mirrors the same approach of building a diversified portfolio of direct equity investments, alongside high quality managers, and one that has access to all the advantages of the Stepstone platform that we mentioned earlier, the global platform, the powerful sourcing engine, the experienced team, diligence resources, etc. So, you know, those are really the two main ways that we would partner with clients looking to build co-investment exposure.

GS: Thank you both.

That does it for this episode of R.P.M. Stay tuned for new episodes every few weeks.

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