RPM—46 | Inside the private equity co-investment market with Geoffrey Dolan

Anna Marcus (AM): Welcome to RPM, the podcast where we explore the world of private markets. I'm your host, Anna Marcus, and today we're talking about the private equity co-investment market landscape.

Since we issued our last report on co-investments a decade ago, economic conditions and deal dynamics have changed a lot. For example, leverage is more expensive, fundraising is slower, and pre-signing opportunities are becoming more common. For those reasons, GPs are increasingly looking to invite LPs to invest alongside them.

Now, even though we've seen a lot of change over the last several years, the reasons to co-invest remain the same. Co-investments still deliver better risk adjusted returns than their parent funds. They also help LPs gain critical insights that can enhance their primary investment programs.

And with both supply and demand for co-investments on the rise, GPs are looking for LPs to be decisive and efficient when it comes to deal execution. But the sheer speed of some deal processes can actually make it difficult for some LPs to make fully informed decisions in the GP's desired timeline. So, despite all of the attractive reasons to co-invest in today's market, LPs may still question whether co-investments are worth it for them. The simple answer is that we think they are.

Joining me today to address this question and break down the market's competitive dynamics is Geoffrey Dolan, a partner on our private equity research team based in New York. This podcast follows our recent white paper Doubling Down on Private Equity Co-investments. Geoff, welcome to RPM.

Geoffrey Dolan (GD): Hey, Anna. Thanks for having me on.

AM: Happy to have you. I'd like to begin with some level setting. The white paper I just mentioned draws heavily from a co-investment survey. Can you take us behind the scenes and tell us a little bit about the data that lies at the heart of some of our insights in this market?

GD: Sure. Look, now more than ever, Stepstone, I think, is differentiated by its scale and the data associated with that scale.

Our private equity platform is investing and committing about $35 billion annually and growing. And that's across primaries, secondaries and co-invest. That really makes Stepstone a critical player in the private equity ecosystem.

So, over the years, we've increasingly become viewed, I think, as a strategic partner to GPs, and that might be as a source of LP capital. It might be a secondary partner, a co underwriting co-investment partner. Oftentimes it extends across asset classes. Whatever the angle, the GPs are more than happy to expand that relationship with Stepstone.

So, when it comes to the survey, we recognize that filling out a survey like this, it takes a lot of time and effort from the GP. And so, we want to make it impactful when we do it and get all the data that we can. And importantly, GPs are willing to take that time and effort because of the relationships that we have with them. And ultimately, there are about 140 GPs that responded, and they provided data from over 400 funds, 1700 individual Co-investments.

So, we think this data is not only useful to the broader LP universe, but I think it was also a good learning exercise for the GPs getting their own insights, managing how they're tracking their co-invest and the relationships they have with LPs. So, all of that said, we're mindful of structuring the survey to cover both quantitative and qualitative data, and we were able to draw some good conclusions by comparing that data with just the everyday information that we get from our normal course of reporting. That's done through the SPI database. So, the diligence on hundreds of funds that we do each year, the hundreds of co-invest opportunities we see every year, we can draw plenty of insights into the co-investment market from that. And it was a great way to enhance that data with this GP survey.

AM: Thanks for that. So, we've been covering the co-investment market for more than a decade now, and it's been about ten years since we wrote our last paper on the subject. What would you say is the biggest change since then?

GD: Yeah. You know, Stepstone's team and Stepstone's co-invest roots really go back well before the financial crisis. And certainly, a lot has changed over that time, and not just for Co-investing, but really the private equity industry as a whole. Both have grown meaningfully, especially since the financial crisis.

I think a key change we've seen over the last ten, 15 years has really been a shift in how GPs think about Co-invest and as a result, how it's offered. So, if you go back before the financial crisis, um, something like 90% of the co-invest market was syndicated allocation.

So, a GP has a deal signed up or more likely closed, and then they go out to their LPs with a syndicated offering. Coming out of the financial crisis, LPs started pushing back against club

deals. The bank and hedge fund capital dried up. Deals required more equity in the capital structure, so those factors all drove GPs to increasingly turn to their LP base as co underwriting and pre-signing partners. And so now the amount of co-invest offered only through syndication has gone from that 90% number down to below 40% today. And so, this shift in where allocation sits, I think it's critical to be able to execute pre-signing if you want to see enough deal flow to maintain a steady, diversified opportunity set and really do a secure allocation. The syndication part of the market is very competitive. And frankly, aside from that, we tend to prefer the pre-signing side of the market. And it's where we invest about three quarters of our co-invest capital today. We think in pre-signing co-underwriting situations, we're often getting better access to information. We have a better ability to leverage our own proprietary information advantages, and we can be a more strategic partner to GPs.

AM: Really interesting insights. Thanks for that. So, while we tend to find Co-investments attractive in almost any market environment, we think that now is particularly attractive. Jeff, what are some factors driving co-investment market opportunity both on the supply and the demand side?

GD: Yeah, I think what we're seeing in the Co-invest market is that volumes have persisted across the M&A cycle. So, you go back to 2020, 2021, co-invest spiked with everything else but co-invest has continued to be strong even in the last few years, when M&A volume overall has slowed down. The LP demand is there for consistent reasons lowering fees, ability to outperform, create stronger relationships with GPs.

And on the GP side, the motivation is a bit different today than 2020, 2021. In those couple of years, it was just the sheer volume of deal activity that that kind of led GP's out to their LP base for more co-invest. And now, the need I think, is being driven a bit more by things like higher debt costs leading to more equitized deals and GPs are mindful of the fundraising environment. They're using co-invest to put 1 or 2 more deals into a fund, better pace out their investments.

AM: Sure, thanks. So, co-investment deal volume has been trending upward over the past decade or so, as we've discussed.

And while this is generally a positive sign, I'd say there are probably some lingering doubts about co-investments' value add. So, Jeff, here's the million-dollar question do Co-investments actually add value for LPs?

GD: I'm guessing a simple yes is not just what you're looking for. So maybe to expand on that a little bit. You asked earlier about things having changed in co-investing over the last 10-15 years. I think the answer here is one that has not changed. The white paper ten years

ago and the current survey and research paper we did recently, I think both demonstrate a number of ways in which co-invest adds value for LPs. There's the more intuitive points which kind of already mentioned, but reducing overall program fees, a tool for portfolio construction, whether that's diversification or managing pacing, helps strengthen alignment and relationships with GPs.

The more data driven answer is that in aggregate, Co-investments outperform parent funds on both a net return basis and a loss ratio basis. Actually, significantly outperformed parent funds on loss ratio. And again, this is something we found consistent from the survey ten years ago and the more recent one. If you move past just the aggregated data, I think what we see in our own track record is that partnering with good managers and the right asset selection alongside of those good managers, you can not only outperform the parent funds, but you can also outperform the private equity index.

AM: And going deeper, where in the market can co-investment be found? In other words, where are you seeing the most action right now?

GD: Yeah. Again, I'll go back to one of the previous questions. Just reference where StepStone sits in the private equity ecosystem. Our advisory business, we've always been focused there on helping our clients build customized portfolios, and that is driving the breadth and depth of our GP coverage. And that's leading our team to taking something like 3000 meetings per year with GPs. And we use those opportunities really as a sourcing engine. So, an incredibly active sourcing channel through that, GPs are happy to show us co-invest. And then I think our execution capabilities and really being a thoughtful partner creates situations where those GPs keep coming to us, particularly as we invest more and see more in the co-underwriting and pre-signing situations.

And so, to answer your question, we see co-invest from all corners of private equity and as a result our deal flow. Ultimately the portfolios end up being diversified by size, geography, industry, GP and that's something we've always been focused on in portfolio construction.

And with all that being said, I think for an average LP looking for co-invest that just by the number of opportunities, so the number of Co-invests that are shown, are generally spread pretty evenly across small mid and large markets. But if you go to allocation and the actual dollars available, 60% of that sits in the large market. Maybe not surprisingly, another 30% is in the mid-market. And then really less than 10% of Co-invest allocation is in the small market. So, if you're a scaled private equity portfolio, if you want to add meaningful amounts of co-invest, you really need to be getting that exposure from the mid and large ends of the market. Data from the survey showed that it's really 1 in 5 deals, you know, 20, 25% of deals in a fund where any co-invest at all is being offered by a GP. And that's true up and down the market by size. So, you put all of that together, and if you want to have a selective co-

invest program, you really need to have a long list of GP relationships that are showing you deal flow. And I think that really highlights the advantage that StepStone has just going back to the breadth of the GP relationships through the advisory business.

AM: Yeah, definitely. So, let's stick with the demand side for a moment longer. In our survey, we found that about half of LPs want to be co-investors, but only a quarter are actually participating in the market right now. While it's clear that there are a lot of positives, I know Co-investments also may come with some challenges. What are some of the things that you think might inhibit LPs from participating, and what are some workarounds?

GD: For the most part, it really comes down to time and resources for LPs. I mean, many of them are staffed to sufficiently cover the managers in their portfolio, maybe spend some time year to year on upgrading some of those names, but there's probably not a whole lot of spare time in there. So, for a Co-invest program, LP is likely needing to go out and build incremental staffing, and those team members need company underwriting experience, not just fund underwriting experience. So otherwise, those LPs really need to look to an external partner or advisor. Maybe, another limiting factor might be process. So, depending on an LPs approval process, Co-invest just might move too quickly for the LP to, to realistically participate.

And you know, at this point in time, just adding on top of those things, we find ourselves in a pretty severe drought of distributions in private equity. And so, uh, cash that might have been available for co-invest, uh, maybe not there at the moment.

AM: Sure. So now shifting gears a bit and pivoting to the GP side, GPs are clearly keen to invite LPs to invest alongside them. As you mentioned before, more expensive leverage might be a key reason for that. However, not every LP that wants to co-invest can. But as competition intensifies, we expect the market to become more efficient. So, we had some interesting takeaways from our survey on this topic. What are some ways that LPs can stand out according to GPs?

GD: Yeah, speed and execution I think are at a premium. Syndicated co-invest processes, GPs are really just looking for a quick yes or no. So, on the LP side, ability to efficiently turn an NDA, what's required for their approval. Anything that adds more time to the process might just be, you know, that's more than a GP might be willing to deal with. And then on the co-underwriting pre-signing processes where Stepstone plays, execution is key on top of the speed. So, uh you know co-underwriting that's a critical point in time in the deal process. The GP is stretched for time. So, you need to be efficient. You need to really work alongside them and be able to digest information quickly. Speak with conviction if you want to be a preferred partner there.

AM: Sure, thanks for sharing that. So, I'd like to take a step back and end on a broader note. Overall, what is important in building a successful co-investment portfolio?

GD: Yeah, we tend to view that there's really three critical components for a successful co-invest portfolio. And you need the broad GP reach that we talked about if you want to generate the right deal flow and stay selective in the co-invest you're making. And we talked about the resources that you need, whether that's incremental internal resources, external partnership. And in either of those cases, you need resources that have the right underwriting capabilities to make the right investment decisions. So, you aren't going to outperform as a co-investor unless you have good asset selection alongside the right managers.

AM: Geoff, thanks for coming on this podcast. We appreciate your time and insights, and I hope to talk to you again soon.

GD: Sure. Thanks again, Anna.

AM: And thank you for listening. For more color on today's conversation, head to stepstonegroup.com where you can download our paper on Private Equity Co-investments along with the rest of our Thought Leadership library. Listen to RPM wherever you listen to your podcasts.