KEYNOTE INTERVIEW

A mid-market partnership approach

Opportunities for co-investors to support portfolio companies will proliferate, says Matt Shafer, managing director and global head of direct private equity at Northleaf

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Q What are the key drivers behind investor appetite for co-investment?

Co-investment provides investors with fee-efficient access to private equity deals. It also allows them to mitigate the J-curve by putting money to work immediately, and therefore acts as a great complement to a primary investment program, where capital is drawn down over time.

Co-investment also allows investors to tilt their exposure from an industry and geography perspective. It is difficult to time the market, but we do monitor our overall exposure to particular sectors or regions on a look-through basis. Co-investment is an excellent tool for ensuring you have the right balance or helping you lean into investment themes that you believe will prove most profitable. It also provides the opportunity to increase exposure to top performing GPs on a fee-efficient basis, since it traditionally involves no management fee or carry.

Q Do you think appetite will be impacted by the current macro environment?

We expect appetite for co-investment to remain high. This is certainly a challenging macroeconomic environment and LPs can become more hesitant in periods of volatility. But a good investor with a dedicated co-investment program will continue to deploy capital throughout the cycle, looking for opportunities that the particular market environment presents.

After pretty subdued activity in Q2, we are starting to see better value. Private equity goes through adjustment periods, but sellers are now recognizing that there needs to be some allowance made for current uncertainty. Our pipeline is picking up as a result.

Q How do you think supply may be affected?

Volume of deals is by far the biggest force that impacts co-investment supply. But there are some mitigating

factors. The debt markets will likely be more constrained for a period of time, which will increase the size of the equity check required to get deals done. There may also be more situations where funds don't hit their target fund size, or may take longer to get there. For example, that means a $100 million equity check, which would have been comfortable for a $1 billion fund, might now be too large for a fund that only reaches $800 million, and therefore requires co-investment.

Q Is the downturn creating new opportunities?

If an investor only thinks about co-investment in terms of what is tied to their primary commitments and only react to what managers offer up, they are going to be highly indexed to overall market volume. But there are some steps you can take to increase your share of the addressable market.

It is important to be a good partner. If you are not able to do a deal for reasons that are specific to you, then say no quickly. Wasting the manager's time will result in less flow. In addition, there are opportunities for well-resourced co-investment teams to build market share by creating solutions for GPs when it comes to their existing portfolio companies.

Co-investment is not only about passive syndication when new deals are completed. Sponsors may be looking for capital to help grow portfolio companies at times when the fund is constrained due to size, concentration limits or if the fund is later in or past its investment period.

We are increasingly seeing opportunities to bring equity capital into existing platforms mid-life. That will become more important in a constrained exit environment and in a market less supportive of high leverage.

Q Where are you seeing attractive opportunities?

We believe the mid-market provides greater scope for differentiation and opportunities for positive returns. Generally, mid-market deal activity is less tied to the availability of leverage because value creation is more important than financial engineering. Exit opportunities are also broader because large private equity firms are potential buyers for companies that, in a sense, graduate from the mid-market. This means mid-market deals are less reliant on the IPO market or where the stock may be trading for a small set of strategic buyers.

The historical statistics will show that there is a higher dispersion of returns in the mid-market. Which means as a co-investor there is more opportunity for outperformance, but also potentially more risk. We believe that with good manager selection and disciplined underwriting, an investor can achieve premium performance by focusing on co-investments in smaller and mid-sized companies. It's important to have strong underwriting capabilities and access to the best, proven managers.

Q And which sectors are you favoring or avoiding?

Our approach is to build balanced portfolios that are broadly reflective of mid-market private equity and of the economy as a whole. We don't look to time the market or disproportionately weight any sector. But we are aware of the economic context. The bar is certainly going to be higher for consumer deals in an environment where we are facing inflationary pressure on spending and potentially a recession. That is not to say that we won't do those deals, but those uncertainties need to be reflected in the valuation, the deal structure and the capabilities of the manager. We also tend to avoid energy and other commodity-exposed categories, where there are strong macro forces that are outside the control of the GP.

Q Are there areas that you are diligencing more?

We are highly aware that, as a co-investor, we are primarily making investment decisions based on the talents of the GPs that we are partnering with. Our number-one priority is pattern matching the GP's capabilities and strengths with the deals that they are doing. We tend to avoid situations where the manager is buying a company outside of their industry expertise. We look for deals in the traditional sweet spot of the manager where they have proven ability to create value and drive returns.

Another area of concern would be a mid-market manager stretching for larger deals outside of their historic comfort zone. But it is important to consider company size, not deal size. We believe the skills required to succeed with a $200 million EBITDA business are different from what's required for a $20 million EBITDA business. Having said that, purchase price multiples have increased such that we do see good mid-market managers effectively becoming priced out of buying the same size companies they would have been able to buy five years ago. A manager that wouldn't have needed co-investors to buy that $20 million EBITDA company five years ago might want or need them today, and that's a good opportunity set for us.

The traditional criticism of co-investment is adverse selection – the idea that a fund will only show you deals where there is less conviction. There is nothing in our experience or in the data to suggest that this is an industry-wide issue, but it is certainly something we scrutinize very carefully.

Q What will it take to succeed as a co-investor in the coming months?

Having a flexible and proactive approach is going to become increasingly important. Co-investors who wait for the market to come to them will continue to see dealflow and get good outcomes for investors. The real opportunity is for those that have the resources, expertise and creativity to work with their GP partners to create solutions for existing portfolio companies. ■