Doubling down on private equity co-investments

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Introduction

Since we issued our last report on co-investments in 2014, economic conditions and co-investment deal dynamics have changed markedly. Leverage is more expensive. Fundraising is slower. GPs are even keener to invite LPs to invest alongside them. Pre-signing opportunities are becoming the norm.

Yet despite these changes, the reasons to co-invest are fundamentally unchanged. Co-investments still deliver better risk-adjusted returns than their parent funds; they also grant LPs critical insights that can enhance their primary investment programs. It's a small wonder that 50% of LPs want to be co-investors.

But with both supply and demand increasing, a new equilibrium has emerged. GPs place a premium on decisiveness and speed of execution, but not every LP is properly equipped. Moreover, the sheer velocity of certain deal processes means that some LPs can't make an informed decision in the GP's desired timeline. Despite a confluence of macroeconomic conditions and GP motivations driving increased co-investment deal flow, LPs may still question whether co-investments are worth it in today's mile-a-minute marketplace.

We think they are.

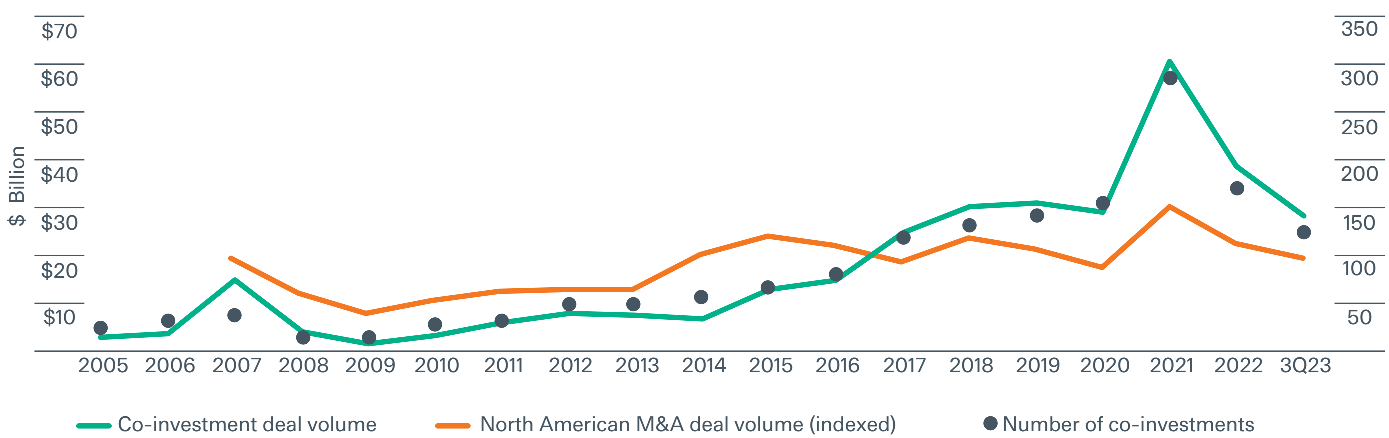
To answer this question and to help LPs understand the market's new competitive dynamics, we analyzed more than 1,700 private equity buyout co-investments (the Sample) completed by more than 145 GPs and 420 funds, which represent over US$340 billion of co-investment deal volume and serve as a proxy for the broader co-investment market.

State of the co-investment market

DEAL VOLUME

Since the early 2000s, co-investment deal volume has increased tenfold. After peaking just prior to the Global Financial Crisis (GFC), it took approximately 10 years for deal volume to recover. From 2017 through 2020, the market stabilized around $30 billion per year. However, it reached a new peak in 2021, when trillions of dollars of fiscal stimulus flooded the global economy, and a prolonged period of zero percent interest rates led to record levels of M&A activity and, correspondingly, co-investment volumes. While the market has partially normalized over the past few years, deal volume remains elevated by historical standards (**Figure 1**).

FIGURE 1: CO-INVESTMENT DEAL VOLUME



Source: StepStone co-investment survey, as of September 30, 2023. Includes buyout co-investments from 2005–2023. 2023 co-investment deal volume is annualized. North American M&A deal volume provided by PitchBook, as of December 31, 2023.

Co-investment drivers

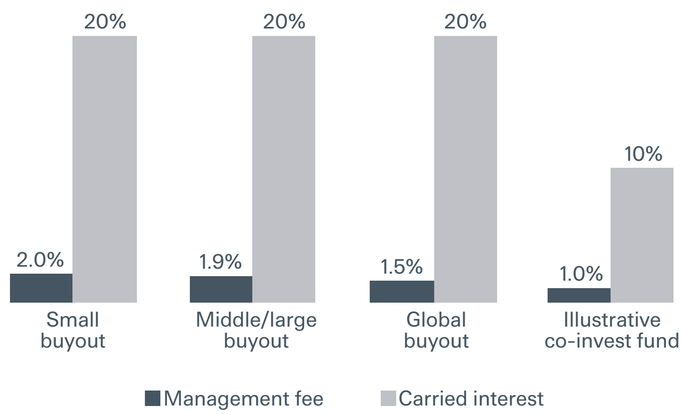
LP APPETITE

Growth within the co-investment market is supported by both LP demand and GP supply. As LPs have grown more sophisticated, they are seeking better economic terms, greater control over portfolio management and deeper relationships with top-tier GPs. Co-investments can help LPs achieve these objectives.

Fee benefits

Direct co-investors often invest pari passu on a "no fee and no carry" basis alongside GPs; co-investments at large benefit from more attractive economics than a typical primary fund (**Figure 2**). As a result, co-investing can help LPs enhance the net-return potential of their broader portfolio while providing a cost-effective way to achieve private equity exposure.

FIGURE 2: CO-INVESTMENT FUND ECONOMICS



Source: StepStone co-investment survey, as of September 30, 2023. Includes buyout co-investments over the past 10 years (2014–2023). Note: The opinions expressed herein reflect the current opinion of StepStone as of the date of appearing in these materials only. There can be no assurance that views and opinions expressed in this document will come to pass.

Enhanced portfolio management

From a portfolio management perspective, co-investments allow LPs to make their primary portfolios more resilient with greater diversification across geographies, sectors and GPs. However, without a broad GP network and a wide sourcing funnel that third-party co-investment consultants and co-investment fund managers often bring to bear, LPs may struggle to round out their portfolios.

However, the ability to utilize this playbook is contingent on allocation and deal flow. LPs can more reliably utilize co-investment as a portfolio management tool when partnering with a co-investment partner who can offer enhanced deal flow, broad GP relationships and diligence expertise. LPs may choose to increase certain exposures they already have access to (e.g., actively overweighting a sector or geography), or choose to increase their overall private equity allocation at a certain point in time (e.g., increasing deployment pace through co-investing).

Deeper GP relationships

Co-investing can also allow LPs to deepen their relationships with GPs. By working closely with GPs during the due diligence process and the holding period, LPs often develop a stronger sense of a GP's strengths, weaknesses and ability to create value in their portfolio companies. Further, by integrating co-investments into their primary investing program, LPs might gain greater access to GPs with the strongest historical performance.

GP MOTIVATIONS

From the GP's perspective, the most obvious advantage to seeking co-investment is the ability to access additional capital to complete larger transactions without sacrificing governance. In addition, GPs see co-investing as a way to build stronger strategic relationships with key investors.

Current market drivers

We believe that current market dynamics point to continued strength in co-investment deal flow due to:

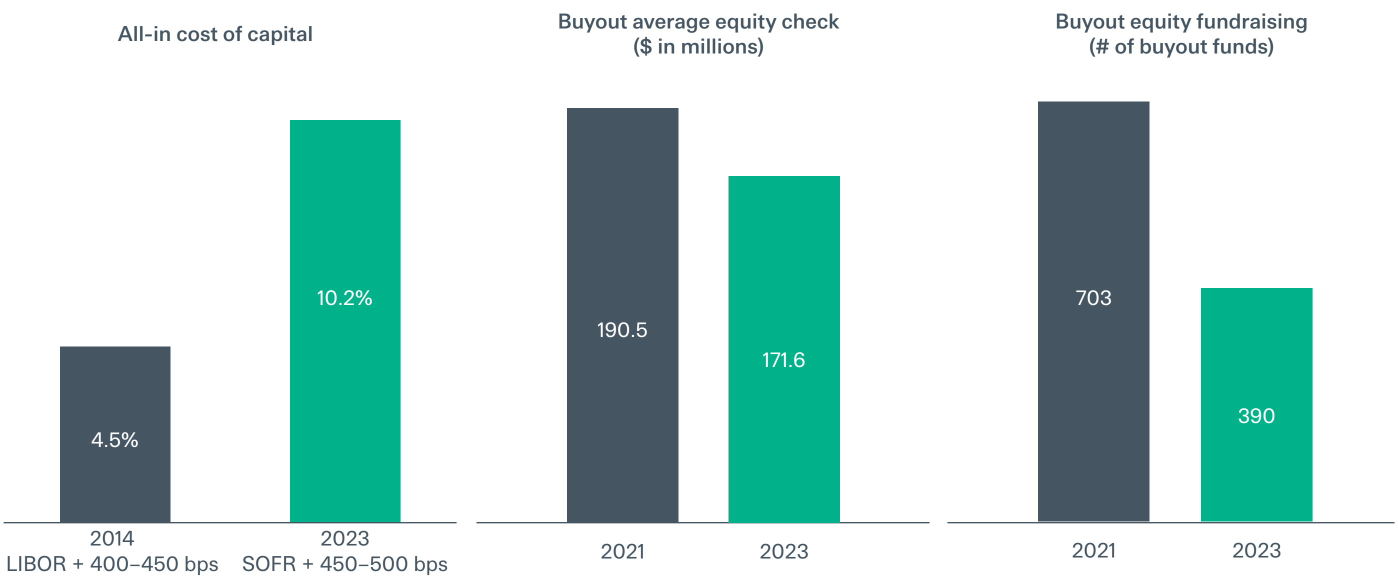
- higher costs of capital;
- slower fundraising markets; and
- pent-up transaction activity.

While spreads for US leveraged buyouts have been about 400–500 basis points over the past 10 years, the US Federal Reserve's spate of interest rate hikes to combat inflation in 2022–2023 has made debt more expensive. On average, the cost of leverage is up more than 100% (SOFR + 450–500 bps).

Because of this, equity contributions increased in 2023, surpassing levels not seen in the post-GFC era. GPs have looked to over-equitize investments in a tightening credit market, with average equity contributions to US leveraged buyouts increasing from 48% in 2021 to 52% in 2023.

Despite increasing equity contributions, the average GP buyout equity check has declined 10% since the peak in 2021. In 2023, 390 buyout funds closed, or just 55% of 2021 levels. As a result, many GPs are looking to extend their return to market. Many are keeping equity contributions flat to down, instead funding additional capital needs with co-investment capital.

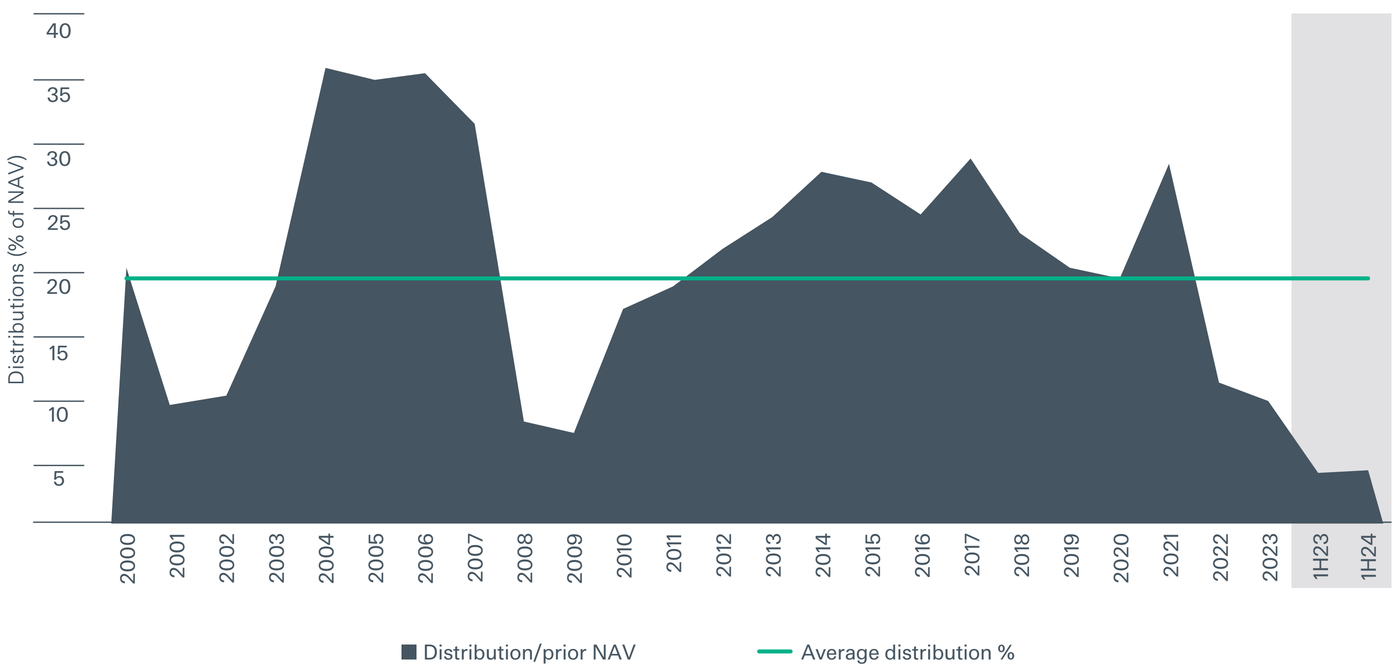
FIGURE 3: MORE EXPENSIVE DEBT IS DRIVING CO-INVESTMENT SUPPLY



Source: Federal Reserve Bank of New York, as of June 2024. SPI by StepStone, as of August 2024.
Note: The opinions expressed herein reflect the current opinion of StepStone as of the data of appearing in this material only. There can be no assurance that views and opinions expressed in this document will come to pass.

Further, North American M&A volume has meaningfully declined between 2022 and 1H24, and distributions during this time period have been well below historical averages. This is creating pressure for GPs to generate liquidity to facilitate future fundraising. As seen in **Figure 4**, historical periods of similarly low distribution environments lasted only two to three years. This implies that M&A activity should rebound in 2025, creating increased opportunity for co-investment.

FIGURE 4: PRIVATE EQUITY DISTRIBUTIONS SINCE 2000



Source: SPI by StepStone, as of June 2024. Full dataset and average annual distributions calculation covers from 4Q99–1Q24. Dataset includes 3,312 global private equity funds.
Note: Distributions % of NAV calculated as annual global private equity distributions as a percentage of total NAV from the prior year. YTD distributions are divided by the NAV at the end of the prior year.

But do co-investments actually add value for LPs?

POTENTIAL CONSIDERATIONS

With the rise of co-investments, skeptics continue to raise concerns about adverse selection, asset concentration risk and the challenge of generating alpha. The confluence of events driving increased co-investment deal flow, including the slowing fundraising environment, tightening credit markets and pent-up transaction activity, may lead LPs to question whether the expected return profile rewards LPs for the risk assumed.

COMPARISON WITH PARENT FUNDS

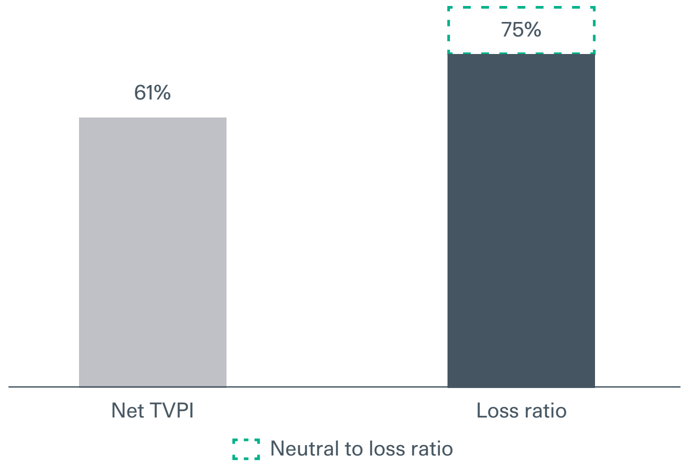
According to our analysis of the Sample, co-investments have attractive risk-adjusted return potential. In fact, more than 60% of deals outperformed the net TVPI of parent funds, and 75% outperformed the loss ratio of parent funds (**Figure 5**).

While co-investments have demonstrated an ability to outperform parent funds, not all co-investment opportunities are equal: Asset selection is a key element of a successful co-investment program.

FUND ALIGNMENT

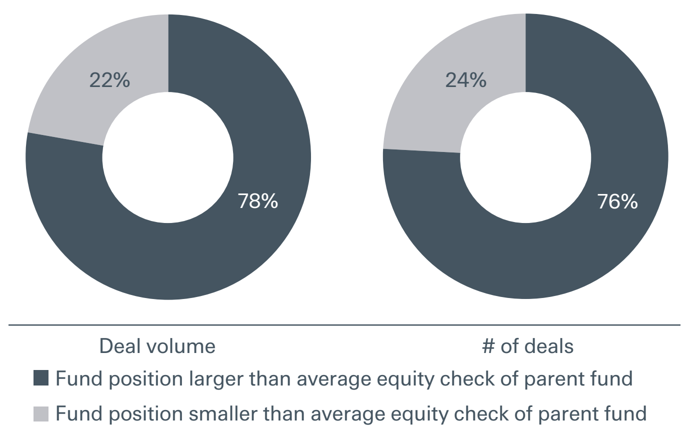
Co-investments are often offered alongside larger fund positions relative to the parent fund's average equity check. This fosters strong alignment between LPs and GPs. Additionally, more than 75% of co-investment deals were completed alongside larger fund positions (**Figure 6**). This suggests that GPs have higher conviction in deals with co-investment offered and are not looking to simply sell down risk.

FIGURE 5: CO-INVESTMENT PERFORMANCE VS PARENT FUND



Source: StepStone co-investment survey, as of September 30, 2023. Includes buyout co-investments from 2010–2021 for which StepStone tracks parent fund performance and excludes co-investments held less than two years as performance is not considered meaningful.

FIGURE 6: MOST CO-INVESTMENTS DEMONSTRATE ALIGNMENT



Source: StepStone co-investment survey, as of September 30, 2023. Includes buyout co-investments over the past 10 years (2014–2023).

Where can co-investment be found?

CO-INVESTMENT BY SECTOR

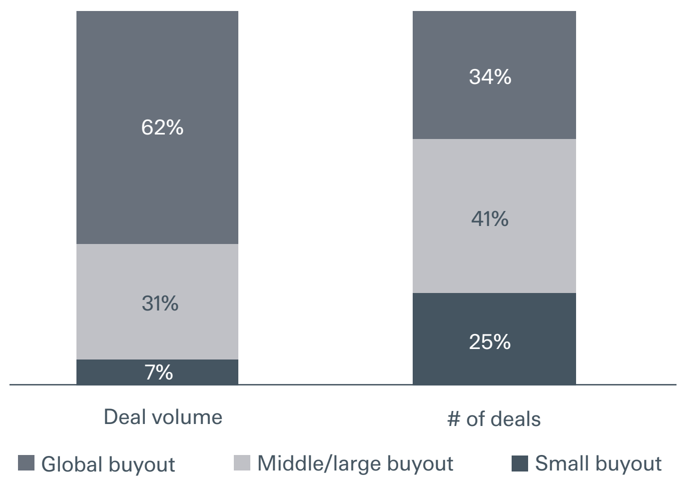
During the past 10 years, global buyout funds have contributed over 60% of total co-investment deal volume, while middle and large buyout funds have accounted for most of the remainder (**Figure 7**).[1]

Interestingly, when broken down relative to fund size, the average ratio of co-investment capital to fund size is consistent at 1:5 (i.e., 20 cents of co-investment for every dollar of fund commitment), according to our Sample, which includes only funds that have offered co-investment (**Figure 8**).

While volumes relative to fund size are consistent across market segments, the average number of co-investment opportunities per fund increases from three to six as funds move up market and portfolios grow. The average co-investment deal size increases 2–3x with each step up market, and the number of LP co-investors rises from five in the lower end to eight in the upper end of the market. Because of these factors, there are more shots on goal in the upper end of the market; the lower end is simply harder to access.

Our co-investment performance analysis shows that small buyout co-investments have the potential to outperform, though deal volume is more limited, and realized deals in this segment show a slightly higher loss ratio compared with larger

FIGURE 7: CO-INVESTMENT DEAL VOLUME BY FUND SIZE



Source: StepStone co-investment survey, as of September 30, 2023. Includes buyout co-investments over the past 10 years (2014–2023). Note: The opinions expressed herein reflect the current opinion of StepStone as of the date of appearing in these materials only. There can be no assurance that views and opinions expressed in this document will come to pass.

FIGURE 8: SUMMARY OF CO-INVESTMENT SUPPLY BY MARKET

	Small buyout	Middle/large buyout	Global buyout
Average fund size	$650 million	$3 billion	$11 billion
Average total LP co-invest per fund	$150 million	$750 million	$2 billion
Average number of co-investments offered per fund*	3 of 11 (~27%)	4 of 15 (~27%)	6 of 29 (~21%)
LP co-invest to fund size ratio	1:5	1:5	1:5

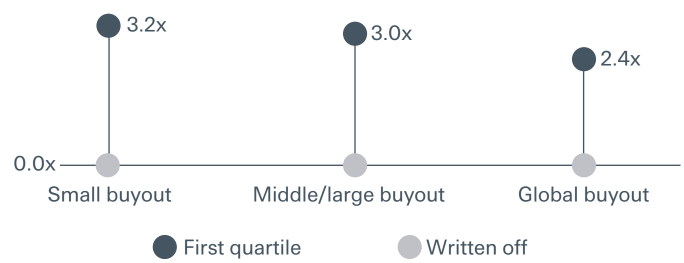
Source: StepStone co-investment survey, as of September 30, 2023. Includes buyout co-investments from 2005–2023 for which StepStone tracks parent fund data.
*Portfolio companies per fund represents the average for each sector, per SPI by StepStone.

[1] Sector is defined by fund size per SPI by StepStone. StepStone defines small-market funds as those raising less than $2 billion; middle-market funds as $2B–7B; large-market funds as $7B–12B; and global funds as greater than $12B.

peers.[2] However, as the data shows, write-offs can occur in every part of the market, underscoring the importance of asset selection across all segments (**Figure 9**).

Though competitive, co-investment opportunities are available across all market segments. However, LPs will need to be strategically positioned and have a broad network of GP relationships to drive significant co-investment deal flow. Additionally, given the variance in availability and band of returns, having a balanced and diversified co-investment portfolio is key.

FIGURE 9: CO-INVESTMENT BAND OF RETURNS



Source: StepStone co-investment survey, as of September 30, 2023. Includes buyout co-investments from 2010 to 2021 and excludes co-investments held less than two years as performance is not considered meaningful.

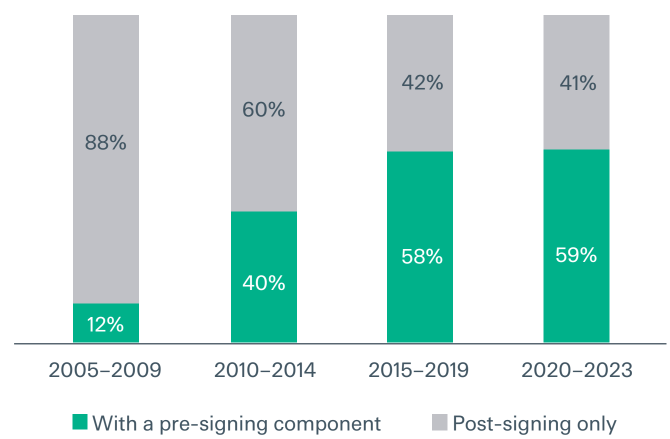
SYNDICATION VS. PRE-SIGNING

While the co-investment market has grown over the past 20 years, there has been outsize growth in opportunities with a pre-signing component. The concept of pre-signing refers to opportunities for co-investors to work alongside a GP to underwrite a deal prior to the signing of a transaction. In this situation, the co-investor may receive information in real time and better access to primary sources of diligence (e.g., management teams and third-party consultants). On average, these "pre-signers" are brought into the fold three weeks earlier than post-signers. Having the necessary resources to pre-sign can be huge.

Pre-signing deals have increasingly become the norm, growing 5x in the past two decades (**Figure 10**).

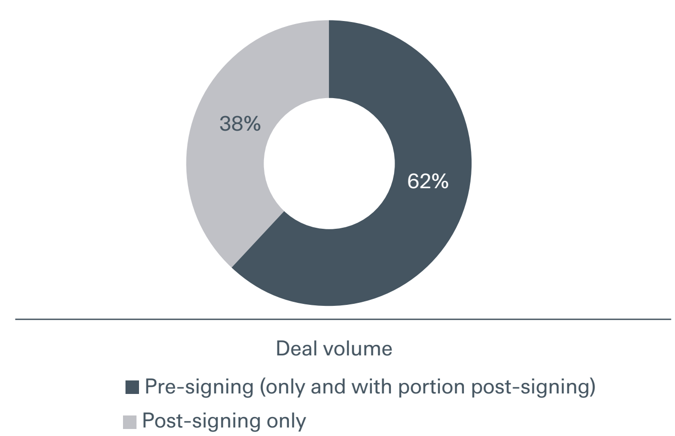
The Sample data indicates that ~30% of co-investment opportunities offered over the past 10 years were on a pre-signing basis only. A further ~20% of co-investment deals are offered on a pre-signing basis, with a portion reserved for syndication. Of the assessed co-investment deal volume, only 38% of co-investment capital was offered through only syndication processes in the past 10 years (**Figure 11**).

FIGURE 10: PRE-SIGNING HAS BECOME THE RULE



Source: StepStone co-investment survey, as of September 30, 2023. Includes buyout co-investments from 2005 to 2023.

FIGURE 11: CO-INVEST BY SIGNING



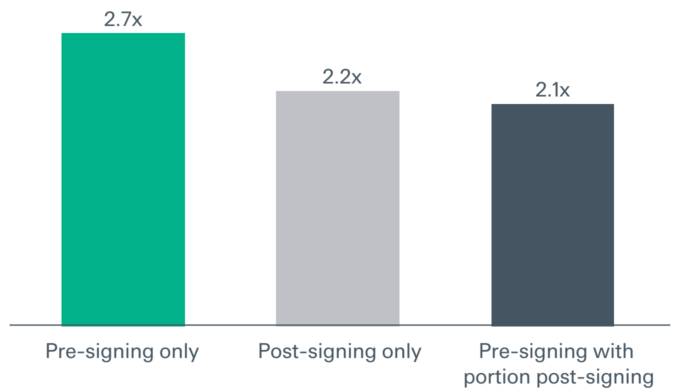
Source: StepStone co-investment survey, as of September 30, 2023. Includes buyout co-investments over the past 10 years (2014–2023).

[2] Represents all fully realized deals in SPI by StepStone from 2010 to 2021.

Because pre-signing deals are less competitive than syndicated deals, we believe that LPs with pre-signing capabilities have a range of advantages. Not only do they often see better deal flow, but they have a leg up in more competitive situations that include pre- and post-signing elements.

Based on our analysis, pre-signing opportunities offer not only allocation, deal flow and due diligence advantages, but also return advantages. Co-investments offered on a pre-signing-only basis have outperformed post-signing-only deals by 0.5x, with an average gross TVPI of 2.7x (**Figure 12**). With time, we expect the pre-signing market to become more competitive. LPs that can gain an early-mover advantage may be well rewarded over the long run.

FIGURE 12: PRE-SIGNING OUTPERFORMANCE



Source: StepStone co-investment survey, as of September 30, 2023. Includes buyout co-investments from 2005 to 2021 and excludes co-investments held less than two years, as performance is not considered meaningful.

What do GPs value in co-investors?

In the context of a more challenging fundraising environment, co-investors with large primary programs will continue to be a strategic priority for GPs. This suggests a positive correlation between primary scale and co-investment deal flow.

FIGURE 13: WHAT DO GPs LOOK FOR IN A CO-INVESTOR?

Source: StepStone co-investment survey, as of September 30, 2023.
Note: Size of word corresponds to number of times the word appeared in GP open responses.

In addition, a flight to quality has resulted in increasingly competitive co-investment processes with shorter execution windows. Speed and execution are at a premium.

The importance of both primary dollars and the ability to move confidently at speed is reflected in our survey results.

- GPs say that an existing primary commitment and an LP's ability to move quickly were key factors they considered when selecting a co-investment partner.
- Further, when asked how LPs could improve as a co-investment partner, more than 50% of GPs responded that they should make faster "Yes" or "No" decisions on deals.

LPs increasingly are asked to make critical co-investment decisions on shorter timelines. Without the appropriate resources to execute and build conviction in an opportunity, LPs may have to opt out of certain deals.

What is important in building a co-investment portfolio?

BROAD GP REACH

An active primary investment program is at the core of any successful co-investment program: It provides the relationships that generate robust deal flow and the information advantage to assess the quality of GPs.

In general, GPs offer 3-6 co-investment opportunities to 4–10 investors per fund (**Figure 14**). Owing to this scarcity, even the most well-equipped LPs will miss out on some deals. To meet their co-investment allocation targets, LPs should curate a large and active network of GP relationships. Not only does this help with commitment planning, it also enhances asset selection and diversification. Having the foresight is one thing; having the resources to execute on it is another.

TIMING AND RESOURCES

Because of the array of benefits, many large private equity allocators aim to allocate upwards of 30% of their private equity portfolios to co-investments.

Roughly half of all LPs have indicated to GPs their interest in co-investment deal flow. According to our Sample, however, only half of those LPs with stated co-investment appetite have been able to participate in an opportunity when offered. This is because of challenges such as limited resources and liquidity requirements.

Direct co-investing requires in-house staff or third-party resources to source and execute transactions, the cost of which can be prohibitive. Separately managed accounts (SMAs) or commingled co-investment funds—which typically charge half of the standard 2/20 fee structure of private equity funds—are a middle ground for investors that have enough capital for co-investments but lack the infrastructure and breadth of GP relationships to build an in-house program. For those LPs where the size of the program does not support adequate deal flow, SMAs and commingled co-investment funds are a great way to build out their program without sacrificing on asset selection or diversification.

FIGURE 14: BROAD GP REACH IS NEEDED TO DRIVE SUFFICIENT DEAL FLOW

	Average small buyout fund	Average middle/large buyout fund	Average global buyout fund
Average per fund	11 deals $650M	15 deals $3B	29 deals $11B
Average co-invest per fund	3 deals $150M	4 deals $750M	6 deals $2B
Average pre-signing per fund*	1.4 deals $81M	1.0 deals $180M	0.5 deals $100M

Source: StepStone co-investment survey, as of September 30, 2023. Includes buyout co-investments from 2005 to 2023 for which StepStone tracks parent fund data.
*Pre-signing deals reflects pre-signing only deals.

UNDERWRITING CAPABILITIES

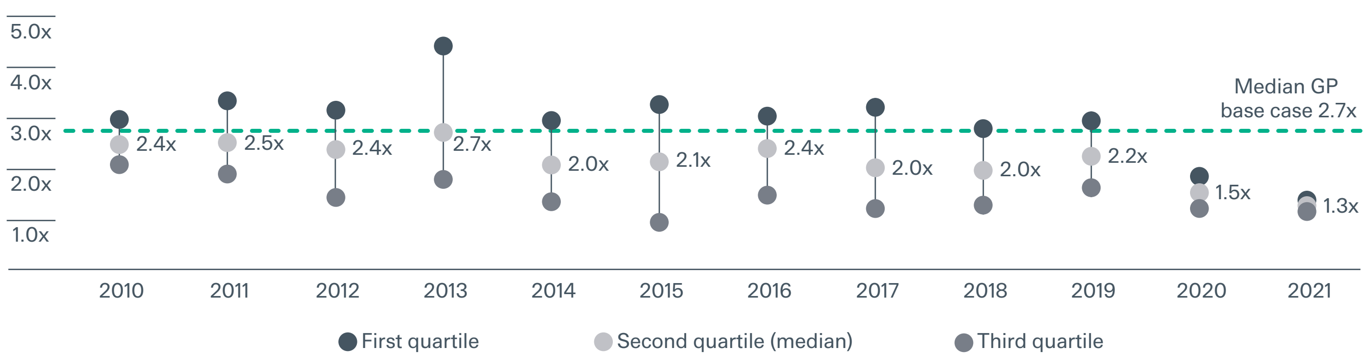
Underwriting co-investments to drive alpha requires more than just the GP's base case; having an independent view of the GP base case is important to calibrate assumptions on each sponsor's strengths, weaknesses and ability to execute on underwriting cases.

Our assessment shows that the median TVPI for mature co-investments held for more than two years across the Sample set is slightly lower than the median TVPI of GP base cases (**Figure 15**). This underscores the importance of understanding GP fit, asset quality and range of outcomes when assessing a co-investment.

High-quality co-investment teams will also be able to leverage independent networks for references and use proprietary databases to evaluate base case assumptions. This will potentially enhance underwriting for the GPs' due diligence efforts.

When evaluating co-investment opportunities, we leverage our proprietary database SPI by StepStone, which includes financial data for over 124,000 portfolio companies and transactions, as well as over 18,000 GPs. This data allows us to complete informed bottom-up and top-down underwriting on all transactions, including assessing whether an opportunity fits within a GP's "sweet spot."

FIGURE 15: CO-INVESTMENT PERFORMANCE BY QUARTILE



Source: StepStone co-investment survey, as of September 30, 2023. Includes buyout co-investments from 2010 to 2021. GP base case median based on deals reviewed by StepStone between 2012 and 2021 for which GP base case TVPI was entered into SPI.

Conclusion

Our experience and data suggest that co-investments still serve an important role in LPs' private equity portfolios. Co-investing has the potential to:

- Achieve high-quality private equity exposure at a reasonable cost;
- Nimbly manage diversification and augment a portfolio; and
- Help investors deepen relationships with GPs.

Ultimately, these factors should be considered as ways to improve the return profile of a traditional portfolio.

The co-investment market has experienced significant growth over the past several years. Despite this growth, our Sample suggests a robust near-to-medium-term appetite for co-investment, driven by a confluence of factors, including higher costs of capital, slower fundraising markets and pent-up transaction activity.

As market dynamics evolve and competition for co-investments intensifies, LPs with the resources and networks to strategically execute deals are best positioned to capitalize on these opportunities. For LPs with fewer resources, partnering with an established firm can help them better navigate this growing and complex market.

We are global private markets specialists delivering tailored investment solutions, advisory services, and impactful, data-driven insights to the world's investors. Leveraging the power of our platform and our peerless intelligence across sectors, strategies, and geographies, we help identify the advantages and the answers our clients need to succeed.

For more information regarding StepStone's research, please contact us at research@stepstonegroup.com.

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