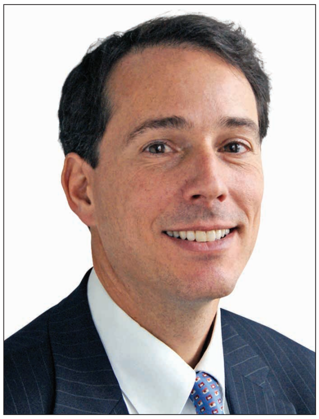
KEYNOTE INTERVIEW

Mid-life opportunities



Sponsors are increasingly looking for co-investment partners to support growth ambitions in existing portfolio companies or to generate liquidity, say Neuberger Berman's David Stonberg, David Morse and Joana Rocha Scaff

Q How has appetite for co-investment evolved?

David Stonberg: Demand for co-investment has grown dramatically over the past two decades. Co-investment has evolved from a haphazard, episodic set of investment opportunities offered to LPs by GPs to a main source of equity capital for those GPs to get their transactions done.

Co-investment platforms like ours have actively encouraged that evolution by ensuring that we have dedicated co-investment capital available to our GP relationships irrespective of market cycles or dislocations and a deep bench of experienced investment professionals ready to help and underwrite transactions.

This is especially true in the current environment where many co-investment participants are on the sidelines due to over-allocation to the broader private equity asset class – the "denominator effect". We have seen this before, having invested through the global financial crisis. These groups on the sidelines will undoubtedly be back, but in the meantime platforms such as ours with dedicated co-investment capital are uniquely positioned to fill the void.

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Q What challenges do mid-life deals present in terms of alignment?

Joana Rocha Scaff: We have invested into the existing portfolio companies of third-party private equity sponsors for many years, in order to provide capital solutions to address any needs that those portfolio companies and sponsors may be facing. The most common situation involves capital for growth, and in particular for M&A – both buy-and-build strategies and transformative acquisitions.

We are also increasingly seeing situations where a sponsor is looking to generate liquidity for existing LPs through a partial exit. Traditional exit routes are extremely challenged in the wake of the war in Ukraine and macro slow down, but LPs are still demanding liquidity in order to invest in managers' latest vintages. We are able to help those sponsors crystalize a portion of the value that exists in a portfolio company by acquiring a minority stake. Demand for those mid-life solutions has certainly proliferated over the past 12-18 months.

But you are right. We may be misaligned on valuation, and we are misaligned on duration, and so it is vital that we have strong due diligence capabilities, as well as structuring skills and the ability to independently set value.

We negotiate provisions in our agreements that aim to protect our investors' capital because we do often come in at a valuation that represents a mark-up to the sponsor's original investment. After all, we generally invest in businesses that are thriving and where the initial investment thesis is working out. Those legal protections are important, but nothing fully compensates for the due diligence we do upfront on both the assets and on the intentions of the lead sponsor.

David Morse: Few co-investment teams are comfortable with these mid-life deals. They tend to be uncomfortable with doing that primary diligence. They are uncomfortable with creating their own models, doing their own quality of earnings work and coming up with a valuation. They believe they can only be aligned at time zero, when the deal first gets done.

However, given our backgrounds, we are confident in establishing a fair valuation and in negotiating the relevant structures and this is a major differentiator for us as a capital provider. We are not just asking our GPs for a piece of their deals; we are asking them what is going on in their portfolio and then helping to provide a solution.

One final driver we are seeing for mid-life transactions involves capital structures. If a sponsor negotiated a debt package in 2020 or 2021, that debt is likely to go much further into the capital structure than would be possible today and will be cheaper in terms of credit spread. That sponsor will therefore be loathed to go back to market, ending up with a smaller debt package that costs them more. Selling to a minority investor allows you to keep that original debt package in place, whilst still generating the liquidity that you need.

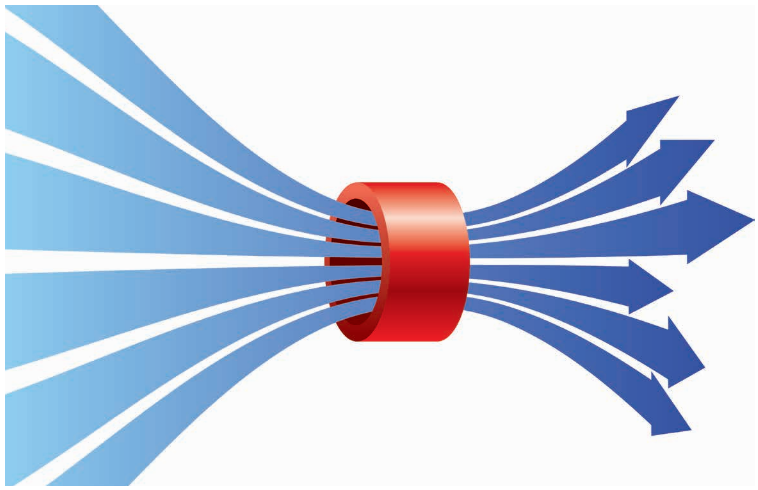
We carried out our first mid-life deal in December 2006 and today those transactions represent over a third of our business. In an environment such as this, where there are very few change-of-control transactions happening, these mid-life deals are an important and attractive part of our dealflow.

Q What are you seeing in terms of demand for co-investment among GPs?

Joana Rocha Scaff: The demand for co-investment among GPs is higher than ever given tight debt markets. More equity is now required to get deals done. We are also experiencing a highly challenging fundraising environment which means that many GPs are looking to stretch their existing capital base further by making use of co-investment partners.

The situation has been exacerbated by the fact that LP co-investors that have traditionally participated in post-signing deal syndications have retrenched, which has made it risky for GPs to rely on syndication processes. GPs are therefore focusing on finding co-underwriting partners instead.

We are also seeing more mid-life co-investment opportunities – the provision of capital to existing portfolio companies in order to support growth strategies or generate liquidity.



Q How do these mid-life deals fit in with the continuation vehicle phenomenon? Do you see them as competitive strategies?

DS: The lead private equity firm will determine what makes most sense for their fund and for their investors. Sometimes it will be a continuation vehicle. Sometimes it will be a sale to a minority investment partner. Sometimes it will be both. A minority sale can be used to catalyze a continuation vehicle event. One of the benefits of our platform is that we are able to provide both solutions to our GPs. We just want to partner with the very best private equity firms on their very best assets in the most constructive way that we can.

Q What constitutes the very best assets? What are you

looking for in a co-investment opportunity?

DS: First, we look at the industry that the asset operates in. A good industry will not be overly cyclical. It will have higher than GDP growth, good customer and supplier diversification and will not be heavily exposed to commodity prices. It will also have good free cashflow dynamics and not be too capital intensive. Then we look at how well the company is positioned within that industry and the strength of the management team.

Next, we examine whether we are looking at the right private equity firm for the asset, with the right value creation plan. Does the thesis make sense in the context of the firm's past successes? Finally, we look at valuation and capital structure. Does the price make sense relative to the opportunity set and does the capital structure make sense relative to the value-creation plan and the risk-reward profile on offer?

Q Have you seen much movement in valuations for these high-quality businesses?

DS: We haven't seen valuations come down materially, but processes have moved in the buyer's favor. Time pressures are not the same and the ability to carry out due diligence, do quality of earnings work and get access to management has improved. Those things are very important in terms of underwriting.

JRS: I absolutely agree. We are not seeing wholesale discounts on valuations for high-quality assets, but processes are much more buyer-favorable than they were two to three years ago. There are far more bilateral processes taking place, or situations where two counterparties are approached in order to create a bit of competitive tension. But there are far fewer full-blown auctions. That has resulted in materially better access to information and better access to the management of the underlying company, which is extremely important in terms of investment decision making. Prices may not be significantly lower but the level of knowledge and conviction you can take into a transaction is significantly higher.

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>
> **JOANA ROCHA SCAFF**

DM: The world changed dramatically in the second half of 2022 and since that time, everyone has been expecting valuations to come down. High inflation. High interest rates. War in Europe. It is easy to understand why everyone believes that a recession or at least a correction is around the corner, but that corner keeps getting pushed out. That degree of uncertainty has left many sitting on the sidelines so instead of valuations declining in any dramatic fashion, dealflow has declined instead.

I would add that when we look at the 240 or so companies in our co-investment portfolio today, we have not seen a broad deterioration in operating performance. We are not seeing margins squeezed. If buyers start to have serious questions about the go-forward performance or growth prospects of businesses, then that is when the other valuation shoe will drop. But we just haven't seen that degradation of performance as of yet.

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>
> **DAVID MORSE**

DS: It is hard to describe this as a buyer's market, but it is also hard to describe it as a seller's market, which is why I believe that GPs are more inclined to want to continue as investors in assets that they already own today – continuing to add value to their most favored portfolio companies. That is creating really interesting opportunities for us to make mid-life co-investments, as well as opportunities for investment in continuation vehicles. It is an area where our sponsor partners want to engage with us more than ever before. ■

David Stonberg is deputy head of alternatives and the global co-head of private equity co-investments at Neuberger Berman, David Morse is global co-head of private equity co-investments and Joana Rocha Scaff is head of European private equity.