KEYNOTE INTERVIEW

The agility test

Co-investment funds can enable investors to pivot their portfolio construction to reflect a fast-moving investment landscape, says managing partner and co-CEO of SwanCap Partners, Florian Kreitmeier

Q How would you describe LP appetite for co-investment funds, and how has this changed over time?
Co-investment is definitely a popular theme. We see appetite from LPs increasing – this trend has been in motion for the past few years, and we see no signs of it slowing down.

While it has primarily been institutions at the larger end of the LP universe that have embraced co-investment in order to enhance returns and achieve greater diversification, we are now seeing many smaller set-ups considering co-investment in their portfolio approach. At the same time, however, GPs tell us that while LPs regularly raise their hands when it comes to co-investment opportunities, few have the resources or ability to transact.

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Q What are some of the advantages of the co-investment fund model, particularly in the current market environment?
For LPs interested in committing to co-investment funds, it is all about enhancing portfolio returns. Co-investment is a great way to gain exposure to attractive assets, to proactively manage your capital deployment pace and to improve the cashflow profile of your portfolio. You are also able to lower your overall effective fees, as co-investment is in many cases carried out on a no fee, no carry basis.

In the current environment in particular, co-investment funds have the added advantage of being agile. Co-investors can adapt their strategy to reflect the investment landscape, going overweight or underweight on certain areas, lead investors and sectors within their portfolio construction.

However, that doesn't mean a volatile strategy: it means following a disciplined and consistent investment approach on one hand, while at the same time being agile in order to ensure an investment strategy and portfolio construction that reflect new realities.

Q What are some examples of agile asset selection and portfolio construction that reflect the megatrends underpinning today's market?
There are so many examples out there

right now. Just think about digitisation or decarbonisation: these are topics that have long been on the agenda but have rapidly gained additional prominence in recent years. Indeed, when it comes to the importance of ESG, it feels as though there has been a paradigm shift in the institutional world. Investors are effectively asking for a double bottom line today, which means that next to their financial return, you need to show a positive environmental or social impact.

This means ESG and sustainability dimensions will be an important indicator of future performance, either promoting or restricting value creation. At SwanCap, we believe in ESG and sustainability as a value driver and an alpha generator. So, that dimension needs to be factored into investment decision-making in a much more prudent and comprehensive way.

Equally, sustainability has become an investment theme in its own right, with more and more capital flooding into the space. We are able to adapt our investment strategy to reflect such evolutions, putting more emphasis on these topical sectors.

Q How does the explosion of GP-led, single-asset deals factor into your strategy?

The dramatic increase in GP-led secondaries transactions is another example of a profound market change that we are able to respond to. These deals represent an attractive opportunity in terms of scale. But, more importantly, the quality of the opportunity set has improved significantly. Single-asset, GP-led transactions today tend to involve the best GPs in the market and the star performers in their funds.

As a result, we have seen a number of extremely attractive single-asset, GP-led deals recently. We believe the familiarity that the GP has with those high-quality assets reduces downside risk and, in conjunction with a clear, actionable value creation plan, we believe these deals offer highly attractive risk-adjusted returns. We expect to be active in this space going forward.

Q What do you look for in a co-investment opportunity?

There is a great deal of uncertainty in the market, which can be difficult to factor into decision-making. There are a number of wild cards in play, ranging from geopolitics to how the pandemic ultimately plays out. Then there are inflationary pressures – and the fiscal policies that governments choose to employ to control them – as well as implications from governments' actions to fight the climate crisis.

Our response to that uncertainty is to focus on controlling what we can control and to be highly selective in our search for high-quality businesses and partnerships with best-in-class GPs and management teams. Clearly, we look out for businesses in growing and resilient sub-sectors – so-called 'secular growers'. Cashflow-yielding assets with strong market positions, recurring revenues and pricing power are attractive. We are also looking for beneficiaries of transformational changes that we see in certain industries, while being careful to differentiate between long-term tailwinds and temporary shifts in order to identify the real winners.

Lastly, we factor in the prevalence of potentially inflated valuations during our decision-making. This is a key metric to consider, as these days it can often result in a great company not necessarily being a great investment.

> *"At SwanCap, we believe in ESG and sustainability as a value driver and an alpha generator"*

Q What would you say makes a good co-investment fund manager?

Experience across economic cycles is today more important than ever. You also need to be highly disciplined and have a sophisticated investment and portfolio construction approach. In order to execute on such a value-enhancing co-investment strategy, you first need access to a broad set of high-quality investment opportunities to choose from. You need to be able to source the very best from across multiple sectors and geographies, and you need to be able to work with the very best GPs. That, in turn, requires a dedicated team with the right skill sets, relationships and expertise to analyse opportunities and understand the nuances and deal setting of specific transactions.

Finally, you need to build a diversified, well-balanced portfolio. Any co-investment programme must be sufficiently diversified to optimise the overall risk-adjusted return of the portfolio. As we always say, minimising mistakes and reducing the downside risk is as important as creating value and capturing the upside.

Q What future do you see for this part of the market?

The LP appetite that we see in our own co-investment funds tells us investors recognise that a well-thought-out co-investment programme can be a highly attractive and value-enhancing part of an overall portfolio strategy. Co-investment can help LPs diversify their alternatives allocation; as such, demand for co-investment funds will remain.

Meanwhile, from the GP perspective, co-investment can be a useful way to right-size equity cheques and strengthen relationships with core LPs. Done the right way, co-investment really is a win-win-win, and so we see a promising future for the market. ■