PEI Alternative Insight

PRIVATE EQUITY INTERNATIONAL

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Adams Street's move to smaller GPs

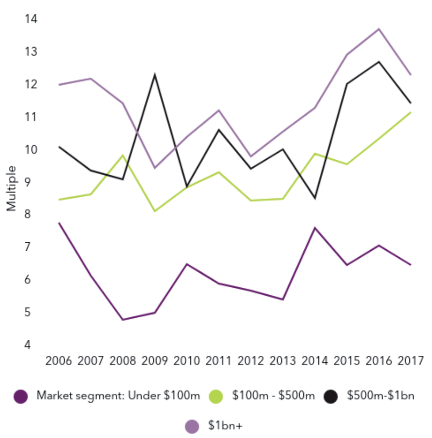
The firm has significantly altered its allocation to the lower end of the market in a bid to avoid possible macro-economic headwinds

As public markets begin to wobble, some private equity funds of funds find themselves well-prepared with a carefully curated portfolio of potentially downturn-proof managers.

Chicago-based Adams Street Partners could be one such player. Four years ago, the firm analysed more than 1,600 realised company investments made by funds in its global database since 1999 and discovered small-cap and mid-market GPs had achieved an estimated 2.5x to 2.6x return over the last two decades, while larger managers returned just 2.0x.

MEETING IN THE MIDDLE

Heightened focus on the mid-market has seen deal multiples in this segment soar since 2015



Source: Murray Devine; Pitchbook

While it may not be shocking to learn that smaller deals have the potential to outperform, what was a surprise was that small companies in the venture and buyout spaces are less likely to be impacted by systemic risks in the public markets, such as inflation. The research had significant implications for Adams Street's allocation to small and mid-caps; funds in these segments now account for around 75 percent of its global portfolio, up from 50 percent last decade.

"Mega-funds are pretty much a safe pair of hands that will get you a good return, but we think they're going to be exposed to a lot of market risk, particularly the availability of leverage," Miguel Gonzalo, head of investment strategy and risk management at Adams Street, explains.

"We're looking for smaller companies that are not subjected to leverage levels and high purchase price multiples. That's where we're trying to navigate this environment more so than ever in trying to stay out of the way of a correction if there was one." The allocation shift was achieved in part through taking a standardised approach to primary fund commitments, Gonzalo says. Keeping a consistent weight across GPs, regardless of fund size, compensates for blind-pool risk and results in a natural underweighting towards large-caps and overweighting to small-caps.

"In addition to getting you tilted towards the smaller end, it also mitigates the chance that any one fund does poorly, because quite often the best managers raise more funds, but if you follow them in and give them more money they may disappoint in a future fund," he notes. "Some of our mistakes are when we sit on the bus or stay with the GP one too many times."

Adams Street has reduced the number of GPs in its global portfolio from 100 to 40 over five years.

There are plenty of new opportunities for funds of funds targeting the small and mid-market segments. IK Investment Partners raised €277 million for its debut small-cap vehicle in 2016 and held a final close on its second of these funds on €550 million in February. Northern Europe-focused Triton had also exceeded the initial €350 million target for its debut mid-market fund that same month, PEI reported at the time.

Growing competition for small and mid-cap assets threatens to negate some of their potential for outperformance. US M&A multiples, including private equity buyouts, for deals between $100 million and $500 million rose to 11.3x in 2017, up from 9.7x two years prior, according to Murray Devine's *Private Equity Valuations Report 2018*. Multiples for deals above this segment dropped sharply last year, in part due to increased attention lower down the spectrum.