
Investing in Secondaries: Opportunities Favor the Prepared Mind



Jeff Akers
Partner & Head of
Secondary Investments

Pinal Nicum
Partner, Secondary Investments

When Adams Street last provided an overview of the secondaries market in May we addressed a question which was being frequently asked by institutional investors: “Are there secondary opportunities in the market today?” Our answer at the time was: “Not right now, but the coming months will bring some great secondary opportunities. Buyers need to be prepared, yet vigilant.” We have seen our prediction come to fruition.

To understand where the secondaries market is headed, it is helpful to look back over the past year. Secondary market fundamentals were very strong at the start of 2020. Thanks to record fundraising in the primary market over the last five years, a solid inventory of funds for the secondary market has been ensured. Furthermore, growing acceptance by both LPs and PE firms to use the secondary market as a portfolio management tool has fueled the opportunity set, with increasing GP involvement a key characteristic of the market.

From Pandemic Slowdown to Market Rebound

Following the onset of the pandemic in March, the secondary market stalled as investors scrambled to assess the fall-out of enforced lockdowns on their portfolios. The slowdown proved to be remarkably temporary. As lockdowns eased, the secondary market rebounded strongly. Most of the positive fundamentals that existed at the start of the year remained intact, particularly in the burgeoning GP-led segment. In that segment a GP organizes a liquidity event through the secondary market for their LPs, where deal volumes have proved extremely robust.

As a result, there was a rapid rebound in market activity during the third quarter. Bid-ask spreads have tightened and opportunities to acquire high quality assets at what we view as discounts to intrinsic value have increased. New inefficiencies have appeared in the market. An increasing segmentation of buyers is also creating opportunities for buyers of transactions below \$150 million and there is further evidence of growing GP influence

on secondary transactions, including restriction of the buyer set. Importantly, the high valuation environment of recent years has begun to ease, and more realistic seller behavior is creating an attractive secondary buying environment.

At this writing, the market is also witnessing several other positive developments. Several promising Covid-19 vaccine breakthroughs have been announced and the US presidential transition appears to be on track. Nonetheless, the environment is likely to remain volatile for some time, particularly in terms of company level performance. This will make knowledge of underlying trends and access to data key elements to investing successfully.

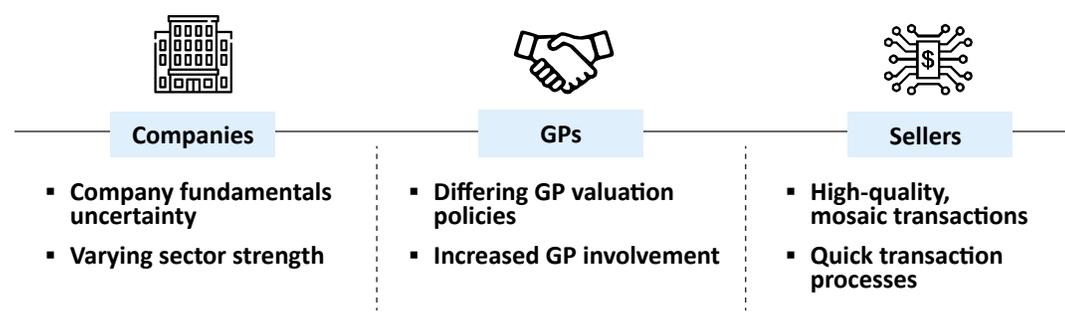


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Market Dynamics Create Opportunities

Adams Street believes that current market conditions will create opportunities for appropriately positioned buyers.

Key Characteristics of Today's Market



- **At the asset level**, we are operating in a period where it is difficult to develop a clear understanding of company fundamentals and growth and profitability forecasts without deep and extensive analysis. This is mainly because the pandemic is having a markedly different impact on different segments of the economy. Some sectors, notably software, tech-enabled business services companies and healthcare, are thriving, while brick-and-mortar retail, energy and aerospace companies are challenged.
- **With regard to fund managers**, we have seen varying approaches to valuation in response to the pandemic. Some managers have taken aggressive markdowns to reflect the prevailing realities of their portfolios. Others retained their previous valuation levels in the expectation of a recovery in the future. Accessing company level information to assess specific valuations is therefore even more critical than usual in identifying undervalued funds and assets. Further, as previously noted, GPs have increasingly involved themselves in the transfer process as they focus on partnering with long-term investors during difficult times.
- **Sellers are increasingly motivated.** Traditional LP transactions are being driven by slower distributions, operating stress at some underlying companies, and a need for liquidity. Furthermore, as in prior volatile periods following dislocations, LPs often reassess their portfolios and seek to rebalance through the secondary market for several years thereafter. We are seeing sellers increasingly open to “mosaic sales” in which they break up portfolios for sale to multiple buyers—which allows buyers to acquire funds on a more targeted basis. Often, in our experience, the transaction is accelerated and sellers are receptive to pre-emptive offers, which can shorten the price discovery process and produce attractive competitive situations.



These market dynamics are creating inefficiencies in the secondary market. To take advantage of these inefficiencies, we believe buyers will need: 1) strong GP relationships; 2) a systematic analytical approach to asset selection; and 3) a “prepared mind” based on a solid understanding of the market, sectors and individual companies.

First, in our view, the ability of a buyer to leverage GP relationships will be especially valuable at a time when the viability of underlying company assets may be uncertain due to the pandemic. GP access is always important, but particularly so during periods when buyers can benefit from specific company level insights—or be burned by idiosyncratic risk.

Second, we believe buyers need to take a targeted approach to identifying attractive assets. While purchasing a broad index of mixed-quality private equity assets may have served investors well during the long bull market, we think it is now important to focus on growth sectors and resilient and defensive assets. In our opinion it is also important to invest alongside managers that have taken a more conservative approach to the valuation of their portfolio assets.

Finally, we think it is important for a successful buyer to have a “prepared mind” in order to identify and take action on targeted assets. That means: 1) being on the lookout for sectors, countries or individual assets that are positioned to benefit from positive developments; 2) identifying companies whose capital structures, liquidity and operational flexibility provide resilience during times of crisis; and 3) spotting which portfolios are positioned to recover soonest.

Adams Street continues to believe there will be significant opportunities in the secondary market in the coming months and years. Well-informed, disciplined buyers will be rewarded with opportunities to acquire positions in defensive, growth-oriented companies - from high quality managers - at prices well below intrinsic value. ■

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