
Navigating Volatility Through the Secondary Market



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KEY TAKEAWAYS

- Market volatility is likely to continue throughout 2022 in our view, which should help boost secondary deal flow for several quarters.
- Secondaries investors, such as Adams Street, seek to leverage their deep GP relationships with the goal of benefitting from access to timely and accurate financial data, potentially providing better insights into what we believe are high-quality, undervalued funds.
- During uncertain times, we think the ability to deploy capital in companies with relatively predictable business models, prudent levels of leverage, and non-cyclical growth opportunities is critical.

If public market investors needed a reminder that bull markets don't last forever, it duly arrived in the form of significantly heightened volatility during the opening weeks of 2022.

Markets began the year with multiple concerns, led by a surge in coronavirus Omicron variant infections, US core inflation reaching multidecade highs, and the onset of a tightening cycle by central banks led by the US Federal Reserve.

As everyone digested these issues, a further shock came when Russia invaded Ukraine. Over and above the sheer humanitarian concern generated by the conflict, additional economic uncertainty was introduced as already existing worries about supply chain and labor shortages grew.

Volatility like this has historically struck fear into a portion of public market investors. After surging almost 29% in 2021, the benchmark S&P 500 index shed almost 8% in the first two months of 2022. Bond markets have also experienced whipsawing, with the yield on 10-year Treasuries climbing 40 basis points over the first six weeks of the year before declining 20 basis points after the invasion and rising 43 basis points to 2.15% over the first two weeks of March.¹



De-Risking Portfolios

In private markets, we have witnessed that such disruption can often encourage institutional and high net worth investors to de-risk their portfolios. The sale of such positions can quickly become a priority as unfunded commitments exacerbate a need for liquidity. And because public market corrections can drive the private equity portion of a portfolio above target or mandated levels on a relative basis, deal flow can rise in secondary markets.

Overall market volatility can also stall planned exit horizons, fueling emerging GP-led transactions, as GPs look to pair their best assets with LPs that can accommodate an extended duration.

Another impact of an accelerating move to higher volatility is that it can widen the gap between reported Net Asset Value (NAV) for private equity funds and the intrinsic value of portfolios.

Reported NAV has historically been a good proxy for value when markets are stable and performing predictably well, making it easier to buy the market and compete for secondary deals based on their cost of capital. But that becomes less appealing in more volatile periods when underlying company and sector performance tend to cause GP valuations to diverge.

Price Discovery

In some cases, the stated NAV may be significantly below intrinsic value because of the reporting lag in private markets. When it is harder to assess price accurately, informed buyers have a clear advantage. Secondaries investors, such as Adams Street, often seek to leverage their deep GP relationships with the goal of benefiting from access to more timely and accurate financial fundamentals and trading data of portfolio companies, potentially providing better insights into what we believe are high-quality, undervalued funds.

During uncertain times, we find it prudent to prioritize a secondaries market strategy targeted at specific GPs, companies and sectors that have demonstrated relatively durable characteristics and focus on trying to find opportunities with value arbitrage.

Staying Focused

We think the ability to buck broader market trends by deploying capital in companies with relatively predictable business models, prudent levels of leverage, and non-cyclical growth opportunities is critical. Most often, finding well-managed companies that offer a valuation cushion relative to intrinsic value means working with sponsors with conservative valuation policies and experience managing through multiple previous periods of market volatility.



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With public equity valuations still at elevated levels, inflation hitting multidecade highs, interest rates rising, heightened geopolitical risk, and COVID morphing into an endemic disease, we believe that volatility will likely continue throughout 2022.

In our view, while that is likely to boost secondary deal flow for several quarters, we, as secondary investors, remain committed to focusing on managers who rely on proven investment rigor in sectors they have deep experience and relationships in. ■

1. Source: St Louis Federal Reserve Economic Data (FRED), accessed 03/17/2022



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