A WORD FROM ADAMS STREET PARTNERS

Private markets optimism rises as headwinds ease

Adams Street Partners' latest global private markets survey finds that investors are increasingly confident that recent headwinds that weighed on deal activity, liquidity, and returns are easing, says Jeff Diehl, Managing Partner & Head of Investments at the Chicago-based firm with $58 billion in assets under management.

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Jeff is responsible for the overall management of the firm and oversees the investment teams' processes and strategies. He joined Adams Street's Growth Equity team in 2001 and focuses primarily on growth investments in application software, financial technology, and consumer internet. Jeff previously served as a Principal for The Parthenon Group.

What is your outlook for private markets in 2024?

Jeff Diehl: I'm optimistic about private markets in 2024.

Inflation and rising interest rates over the past couple of years led to a slowdown in deal activity and liquidity as bid-ask spreads widened for private company transactions. Rates appear to have peaked and are stable, and may modestly decline this year, which should close the spread. That should result in a pickup in deal activity and liquidity, so we expect to see a gradual return to normalcy after a couple years of pretty significant headwinds.

At a portfolio company level, fundamental performance continues to be robust overall, which is very positive, as we don't see any signs of recession.

The results of our annual survey indicate that the investor community shares our optimism. Investors have had a good experience with private markets, which they believe are well positioned to outperform more liquid options over the long term, so we're seeing an uptick in target allocations.

What are the biggest risks facing investors this year?

JD: Our annual survey showed that the key risks on our investors' minds are election uncertainty; geopolitical conflict; and inflation and interest rates—which impact every asset class, not just private markets.

Roughly half the world's population have elections this year. That's truly exceptional, a lot of critical mass, which creates uncertainty for global financial markets around regulatory changes that could result from leadership and policy shifts.

There's also concern about the implications for supply chains and cross-border trade if geopolitical conflicts expand, or additional ones flare up.

Then there are the twin perils of inflation and interest rates. Central banks have been laser-focused on taming inflation, but inflation can be stubborn. Our investors therefore wonder if rates will be higher for longer than people expect. That would likely create challenges, especially for lower-growth, highly levered assets such as real estate.

How do you anticipate interest rates will impact private markets?

JD: There's no question that higher interest rates dampened deal activity over the past couple of years, particularly in the buyout space as the availability of debt capital—a key component in most deals—became more constrained.

However, it should help if rates stabilize or modestly decline in 2024.

But our focus is on getting exposure to some of the best private companies, so we don't pay too much attention to the interest rate climate, because our experience over more than 50 years tells us that great companies can succeed in any interest rate environment.

Do you see the environment for exit and deal activity improving?

JD: Some substantial companies that are private today would likely be public in another environment, given their size and growth profile. There is optimism that the IPO window will reopen for venture-backed companies. Our expectation is that we'll start to see that happen in the second half of 2024.

Also, many companies that raised venture capital a couple of years ago are now seeing cash balances declining. That means later-stage growth equity companies that opt to stay private will likely have to return to market. That creates opportunity at a time when some nontraditional investors such as hedge funds have exited the market, leaving an imbalance between capital demand and supply.

We anticipate venture deal and exit activity to improve.

In the buyout space, it's been a story of debt availability declining as interest rates climbed, creating that bid-ask spread problem between buyers and sellers. But if rates begin to tick down, we should see a pickup in buyout activity as that spread starts to close.

Is AI overblown or a new megatrend? What does it mean for venture investors?

JD: We've seen several waves of technological evolution and revolution over the years and think AI is the latest such iteration, as do our investors, according to our survey.

AI has the potential to upend how businesses interact with each other, as well as how consumers interact with business and with one another. We're starting to see that today, but we're still at the very early stages of it becoming reality.

We do not think AI is a blip on the radar. We think it's a meaningful, long-term, revolutionary opportunity, and investors should consider tapping into it through venture capital, where we think most of the disruption will happen.

What makes private credit attractive?

JD: First, the return that can be generated in a private credit security tends to be higher than the yield that can typically be achieved in comparable liquid debt securities with similar risk. Investors find that yield premium very compelling.

Second, unlike most liquid fixed-income securities, private credit is floating rate, and there is less risk of running afoul of mark-to-market issues, which caused problems for regional banks with large, low-yielding Treasury positions in early 2023.

Also, a substantial portion of that extra yield and floating rate benefit is achieved through cash yield via quarterly coupons, allowing some of the advantages I described to be realized more quickly.

Unlike other private market asset classes, private credit can provide a short-duration benefit through that cash coupon.

Because of these characteristics, our view is that a well-constructed private credit portfolio can closely rival median buyout returns in the current interest rate climate. If rates stay higher for longer, that could persist for a while.

What should investors look for when assessing private markets investment managers?

JD: We think sustainable value creation is ultimately driven by revenue growth. So, first and foremost, we try to identify managers that are positioned to take advantage of growth, dislocation, and change, because that's what private markets excel at.

We favor managers that focus on companies where strong and sustainable revenue growth leads to margin expansion and market share gain. These are the drivers of return we focus on and are the fundamental structural factors that have historically determined a company's ability to thrive across market cycles. We sidestep investments where returns primarily come from factors such as excess leverage, cost reductions, and rising valuations. That can work well in up markets, less so in down markets. In short, we seek to invest in repeatable alpha rather than levered beta.

The second factor is the team. Are they experienced and have they collaborated successfully across a long period of time? And, finally, has that team consistently produced attractive returns through thick and thin? Because results matter and dispersion of returns in the asset class is high. Although the future can't be guaranteed, we think a history of generating strong returns is a good indicator that a team can do it again.

Read all the insights from our latest Global Investor Survey.

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