Global Strategy Market Perspective

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The Coronavirus (COVID-19) pandemic has had a swift and severe impact on the global economy and financial markets. The S&P 500 has dropped approximately 30% in one month and forecasts point to a recession in the United States through at least the first half of 2020. While every dislocation has some distinct similarities such as liquidity challenges, each one also has some unique features.

This dislocation has an unusual combination of a health crisis which has led to economic uncertainty which is leading to financial market dislocations and possible liquidity problems. Fortunately, central banks are taking aggressive action to prevent market illiquidity from happening. For example, the US Fed has slashed interest rates, offered regulatory relief to member banks, and instituted re-purchase programs across a variety of collateral types. The total liquidity injected into the system is likely to be $4 trillion in the US alone. In addition, politicians seem intent to provide financial assistance to businesses and employees impacted by the quarantine and shelter-in-place orders. This should help the economy regain its footing.

History has shown that severe market declines are often short-lived and eventually bounce back as uncertainty recedes. Public market investors may often find attractive opportunities during dislocations assuming they have capital and a prepared mind. Private market investors must possess these two features but must also have information and relationships that are essential for creating attractive and actionable opportunities. We believe that Adams Street is well-positioned in this regard and we would like to share our thoughts on both our portfolio and new opportunities.

Over the last several years, Adams Street has been a net seller given high valuations and late cycle behavior. We have largely avoided investments that rely on rising valuation multiples and extensive leverage to generate private equity returns. In addition, we have been backing fund and company managers focused on sectors going through structural dislocation, change and growth. While our portfolio will not be immune to problems caused by the current dislocation, we believe we are likely to have fewer problems than many market participants who have employed a levered beta strategy.

While it is impossible to predict the depth and duration of any dislocation, experience has shown that great opportunities can present themselves.

Adams Street is shifting our investment strategy from being net sellers over the last several years to buyers of high-quality funds and companies at over-sold prices. Historically, the best returns have often been earned by investors who skillfully managed through downturns. We believe that we are well-positioned given our prepared mind and the relationships we have with fund and company managers we know well and the information we have about their companies and funds.

The following provides a perspective on how we see opportunities across our five strategies in addition to a view into the current situation.

Co-Investments

Over the last 24 months Adams Street has evaluated co-investment deals with a particular focus on companies with resilient business models in defensive sectors. The diverse portfolio has been constructed across company size, sector and geography. The co-investment portfolio is not immune to current conditions and will likely see the valuation impact from the public market volatility. But we currently expect the portfolio to fare better than others that were not built assuming a defensive posture over the last couple of years.

Adams Street has been investing alongside high-quality lead GPs. Just as we were excited to partner with these GPs at the time of each initial investment, we are pleased to have these GPs leading our companies during this period of uncertainty. GPs with whom we have spoken have been transparent and offered detailed insights as to how they intend to proactively guide their portfolio companies through the current period.

We are targeting opportunities to invest at discounted prices in current GP portfolio companies that require equity to de-lever or address near-term liquidity, plus opportunities to replace weaker syndicate investors.

Growth Equity

The immediate priority has been to focus on our existing investment portfolio. Fortunately, our strategy has been to invest in growing companies that are solving an unaddressed need and have solid unit economics for cost-effectively reaching customers.

We believe that most of our portfolio companies are well-prepared to withstand the current financial and economic shock. Their cash burn rates are manageable, and most have strong investor syndicates around the table that have financial reserves to support them.

In periods of economic dislocation, it can take time for high-growth-oriented CEOs to shift their mindset to focus on operational effectiveness, efficiency and the bottom line to ensure the sustainability of the company. This does not appear to us to be the case with most Adams Street portfolio companies. We have seen CEOs take quick action to extend their runway (e.g. hiring freeze, cutting discretionary expenditures) and refocus their organizations.

The Growth Equity Team is targeting opportunities to invest in recurring revenue technology and healthcare businesses with controllable burn rates that can be invested in at attractive valuations. Conviction sub-sectors suffering current stress, but that we expect to bounce back quickly upon a recovery, also represent potential opportunities for us.

Primary Investments

Periods of volatility can produce great returns. We expect 2020 to be a successful vintage year, similar to 2008/2009 when the dislocation produced appealing entry points for PE buyers. Adams Street has committed $330 million to new funds year-to-date and we currently have 20+ GPs in various stages of due diligence representing another $1 billion of fresh commitments. We expect that this group will raise capital successfully despite the volatility based on the quality of the managers in our pipeline. Additionally, Adams Street committed $2.8 billion to new funds globally in 2019. Only 20% has been called thus far, indicating ample dry powder to take advantage of the anticipated favorable pricing.

Adams Street's global primary portfolio is diversified by industry sector, geography, time and manager. Importantly, in buyouts our emphasis has been on investing with highly experienced managers who employ lower levels of leverage thereby providing their companies with the financial flexibility to weather a downturn. For example, the average leverage employed by the US buyout managers with whom Adams Street has invested over the last decade is approximately 4.5x debt/EBITDA substantially below the US market average of 5.2x debt/EBITDA.[1]

Private Credit

Adams Street has been investing cautiously and selectively for some time and we believe the private credit portfolio is well-positioned for a downturn. In addition to being diversified in defensive sectors, company debt levels, cash equity cushions and loan covenants within the portfolio are strong and compare favorably to market averages.

As for Adams Street's existing private credit investments, widespread effects in the portfolio aren't currently expected, though some of our companies are likely to experience a negative impact. Adams Street's Private Credit Team is actively working to identify and monitor those investments on an ongoing basis. While conditions may change, we believe that most companies in the portfolio should withstand a slowing environment.

Private credit investing, for prudent investors and managers, remains in our view an attractive option and one that tends to improve when markets become disrupted. Active lenders, like Adams Street, can have significant negotiating leverage when this happens and we believe will be able to finance deals at unusually attractive terms and pricing.

If current market conditions persist, we anticipate that deals will continue to come with higher coupons, better terms and less leverage.

Secondary Investments

The secondary market is uniquely positioned to create interesting investment opportunities during periods of market volatility. Private equity LPs often feel distress during volatile periods (either driven by a need for liquidity or as a result of the denominator effect) and may be forced to sell high-quality private equity assets below their intrinsic value. This can create significant opportunities for secondary buyers who possess a strategy and the relationships to build conviction when others cannot.

Market activity has slowed materially. It is difficult to predict second half 2020 volume, though we do believe brokers have a solid pipeline of deals once markets stabilize. Select opportunistic trades from forced sellers may also be available in the 2nd quarter.

While market uncertainty remains, a long-term perspective is critical. Despite slower market volumes currently, we believe in the resiliency of our portfolio and desirable new investment opportunities ahead. Adams Street's current secondary fund, GSF6, is about 70% committed. Adams Street believes that it has ample dry power to target situations where either companies or LPs need near-term liquidity. ■

1. S&P LCD Report September 2019