Adams Street

Q&A with Jeff Diehl: A View of Private Markets During Disruption

Jeff Diehl, Managing Partner & Head of Investments at Adams Street Partners, recently hosted a webinar to discuss navigating private markets investing during the COVID-19 pandemic. Jeff shared his perspective on the current market dislocation, details of the actions that Adams Street is taking to manage existing portfolios, and offered a view on new private market investment opportunities. This Q&A presents a summary of questions submitted during the March 26, 2020 webinar.

Q: What is the correlation between public markets and private small and mid-markets? Any idea how it was during the 2008 crisis, and what it would be like today?

JD: If you look back in time - and we have done studies on this - when the markets dislocate everything tends to become correlated very quickly. What we found in the 2008 GFC is that the things that were most levered - the large-cap buyouts - took the most punishment in terms of markdowns. This is because when enterprise values have fallen, debt has not fallen, thus equities have fallen further. The small and midcap companies would have had less leverage and would have seen fewer markdowns; but by the same token when these small and midcap companies have recovered, they have tended to snap back more quickly. The key questions are: will there be companies that will be unable to weather the storm and get through the crisis? Or will there be majorly diluted financings that will occur? We are still trying to look at this through the system, but suffice it to say, correlation picks up meaningfully in times of dislocation.

Q: Can you speak to the availability of credit lines to GPs and comment on whether or not GPs can use these lines to ease the liquidity demands on LPs?

JD: When you do any cash planning you think about capital calls, distributions, etc. Obviously right now distributions are going to be challenged as you look at forecasts and the questions are: how much capital will get called from our GPs? Will lines of credit get pulled which could exacerbate that effect? Adams Street hasn't, at this point, seen banks withdraw lines of credit or limit their use - so that is a positive. However, this is a very fluid situation. We have to assess liquidity every day. The Federal Reserve's actions to encourage banks to work with their customers and not put them in a tough situation has really helped. The fiscal stimulus should also help embattled businesses get back on their feet. This is real-time and very difficult to see. None of Adams Street's lines of credit used for spacing out capital calls have been challenged at this point, and we know GPs are currently working through this situation with their various lenders as well.

Q: When do you expect company markdowns to flow through to financial statements?

JD: Given the fact that private market actors have really tried to include public market comps in their valuation methodologies, to the extent that they can, and not use old or stale valuations, we would expect to see some flow-through into the financial statements for the first quarter of 2020. Firms are working with their auditors right now to try and look at those public markets. We do know that most firms use a mix of public comps, private M&A transactions, and discounted cash flows, and we would expect some flow-through, but not full flow-through, from public marks. In the GFC the flow-through was about 50% of the public market decline. One of the challenges with the public markets is that no one really knows how to forecast their revenue and EBITDA for 2020 and thus few people know how much forward multiples have really compressed. We've seen numerous public companies announce their earnings and then effectively take that guidance completely off the table. So, the historical data on trailing financials is quite good, while the forward forecasts are frankly not reliable right now. The same scenario exists in private companies. We think we are going to see initial markdowns flow-through into the first quarter, and leveraged strategies will probably experience more of these markdowns than less levered strategies.

Q: Will our capital calls significantly increase relative to the last few years? We were recently caught by surprise by our private credit funds firms. How much lead time can you give us on capital calls?

JD: Right now, new investment activity for primary fund investing has continued. For other strategies - while there are things in the funnel and in process - the priority is figuring out what the specific needs exist at companies and funds, to put together our best forecasts across our investment teams. For certain private debt funds and secondary funds, if they are using a lot of leverage and that leverage gets reduced, pulled, or has a loan-to-value covenant broken, that could cause some significant problems. We are seeing that in BDCs and in CLOs and may see that in some secondary firms after the Q1 marks. We feel very good about our secondary and private credit funds' positions today, but we have to see how the market evolves and what lenders do with those assets. It could result in many actors in the private debt and secondary spaces seeing increased capital call activity.

Q: Any estimate on the markdowns percentage and timeline?

JD: Historically, private markets have lagged the public markets, both as assets get marked down, and as valuations are restored. We have some historical data to go by, but we also see different timing given some of the dislocations within companies and how that factors into the valuations. We have companies that have had some revenue streams completely go away, so it is very difficult to predict exactly what the markdowns will be. If public markets are down 25% year-to-date, our historical experience is that we would expect to see less than that - maybe half or less than half of that amount - in total markdowns from our portfolio. Again, we think there are some participants who have been very aggressive in their use of leverage. Some secondary funds, for example, those that are plain levered beta strategies, would be expected to have more significant markdowns than even the public markets as they take those mark-to-markets with leverage.

Investment Activity

New investment activity for primary fund investing has continued. For other strategies - while there are things in the funnel and in process - the priority is figuring out what the specific needs exist at companies and funds, to put together our best forecasts across our investment teams.

Q: Have Adams Street LPs cut back on commitments?

JD: In terms of GPs, we have not seen a slowdown in funds raised and about to be closed. We would expect a slowdown in both new deal commitments from our GPs as they try to assess their portfolios, and in fundraising, depending on how long the economic recovery takes. Adams Street, at this point, frankly, sees more opportunities. Our plans remain unchanged. We are excited about investing right now. We have the capital to deploy and hope to take advantage of some of the opportunities that might arise around liquidity solutions.

Q: How will capital calls look in 2020 and will there be opportunities to increase commitments as new opportunities come in?

JD: For Adams Street, we are currently analyzing what capital calls might look like this year. It depends on the opportunities that might surface. In terms of our GPs, the ones that have fewer portfolio problems are looking to be aggressive and find investments to do; the ones with more portfolio difficulties will be slower on the new deal front. And of course, the debt markets need to be cooperative on the buyout side in order for people to transact. Adams Street's message is we are open for business.

Q: Has GP fundraising completely halted?

JD: We don't think it will come to a complete halt, but do expect that the second half of 2020 will probably slow down. For funds that thought they might launch sooner, maybe their new deal activity slows down in the near term as they wrestle with portfolio challenges. So, we expect the second half of the year to probably slow down on the primary side where they may see some opportunities to step into commitments that have just been closed, as people run into liquidity challenges.

Q: How are buyout funds able to close new or refinance existing deals with debt markets effectively frozen?

JD: The Federal Reserve has given direction to banks to try to work with their customers and be accommodating. The Fed is, in effect, agreeing to repurchase different types of securities off their balance sheets and relax regulatory requirements so loans don't need to get classified into the same non-performing category as they would have previously. Right now, there is still new deal activity happening, but it has clearly slowed. We are seeing co-investment and private credit opportunities, but GPs have started to turn inward for those that have meaningful portfolios to really make sure they are being mindful of what is needed across their portfolios; this takes priority over new activity. The liquid debt markets are frozen but the private debt markets remain open with strong actors, including Adams Street.

Q: Could you please comment on the handling of credit lines? Will you keep them unchanged?

JD: We don't have any plans to change our credit line activity for our various products across the spectrum. We've been in touch with our lenders and at this point we don't anticipate any changes to the relationships.

Q: Does the potential inability for funds to get leverage for buyout transactions slow the pace of transactions and drawdowns from Adams Street?

JD: For primary funds, we think it will just be in terms of new fund commitments. We believe that the secondary market will probably pick up and that our private credit activity will have opportunities to increase as we could provide rescue financing or de-levering/liquidity to help people solve their specific portfolio company issues.

Q: What kind of impact are you seeing specifically in your VC portfolios?

JD: We think our venture capital portfolio should weather the storm reasonably well. It's interesting, if you look across our managers, they are doing the same triage activities that others are doing. Airbnb is seeing a huge impact on their business - people don't want to rent rooms inside of someone's apartment in New York City, for example. There are definitely companies in specific sectors/industries that have been impacted, but some of what's happening in the venture portfolio - such as the tech and healthcare sectors - is taking advantage of structural changes. We think our venture portfolio will have opportunities to access entrepreneurs who are trying to solve some of the problems that are created by this dislocation: vaccine treatments, new ways of interacting with one another, etc. We believe our venture portfolio is well-placed to be quite resilient.

Q: Do you see any opportunities in the online grocery market?

JD: Yes, there is significant activity currently and we have exposure through some of our venture managers. We believe that will be a structural trend that people will shift to for the foreseeable future.

Q: How well do you think private equity-backed businesses are positioned to endure this relative to the market vs other founder/owner-led peers? What is your view of how relative performance is likely to be amongst small/mid/large private businesses?

JD: We think private equity-backed businesses, because there is capital behind them, relative to a small business that is founder or owner-led, should fare better because of the capital players around the table providing solutions. Family-owned businesses right now are really struggling if they've been impacted by the volatility. There is no question that smaller companies with less liquidity and less cushion to withstand dislocations in demand or supply are likely to be more challenged. In analyzing our portfolio, we feel the impact will be sector-specific rather than size-specific. GPs are looking at this right now and feel confident they will figure out how to solve capital problems for businesses with durable models that have been temporarily impacted by the current drop in demand.

Q: How is Adams Street managing the expected exits in the portfolio? Would it be delayed exits, or decreased valuations?

JD: Liquidity, sales transactions, IPOs, and exit opportunities will all likely slow down. We have been working through a secondary transaction in which we have monetized some of our existing portfolios in the secondary market, which will result in some near-term liquidity. But, we do expect distribution activity will also slow. It dropped to 20% of normal levels for couple of quarters after the 2008 GFC before ultimately recovering.

Private Equity-Backed Businesses

We think private equity-backed businesses, because there is capital behind them, relative to a small business that is founder or owner-led, should fare better because of the capital players around the table providing solutions.

Q: Can you elaborate on when you expect to see distressed LPs accessing the secondary market? Also, do you expect GP or LP-led secondary deals to perform better in the near future?

JD: There are funds that may need to access the secondary market. For example, a buyout fund that is fully drawn; it has some companies left, and it needs to provide capital to one of those companies because they can't weather the current dislocation with just their debt providers alone. In this case, you need equity capital and can either go back to your LPs and raise an annex fund or upsize the fund. Maybe you could borrow against the remaining assets at the fund level, or maybe there is a GP-led transaction that could take place to allow LPs to either put money in or to take liquidity from a secondary partner who is driving the transaction.

There are numerous solutions that could happen when GPs' portfolio companies experience liquidity challenges, but it gets more problematic if GPs themselves don't have a lot of capital left to draw in order to support those companies. Thus far, in cases we've seen with LPs that are experiencing liquidity problems, they start by giving up commitments to funds that are being raised and then they make their way into the secondary market., but they probably need to get some sense of the Q1 marks. We have some secondary transactions that are in process right now and we are aggressively pursuing those that we like, but we need to have a bid-ask that will cross on those. So, it remains to be seen whether there will be real distressed LPs selling, but we are reaching out regularly to ensure that we help our GPs solve problems as they encounter them.

Q: What are you seeing on the ground in your China offices? Are things returning to normal?

JD: It is interesting. Our Japan, Korea, and China markets have returned to a much more normal state. It is difficult to know exactly what is happening on the ground with China regarding COVID-19 statistics, but they have seemingly come out on the other side. The reported cases do seem to be picking up in some of these markets on a small level, but their efforts in heavy suppression early on seemed to have paid off. We have asked employees, including those in Beijing, to work from home, so we are interacting with all of our Partners, GPs, CIOs, etc., through video conference.

Q: Can you give a breakdown of the portfolio by green/yellow/red categorizations?

JD: This is all a work in progress, and we will have a better sense of how our portfolio stands in another week or two. Every GP has a different situation depending on their sector focus and strategy. The travel industry has been completely dislocated. Hospitality or companies that rely on the movement and social gatherings of human beings have all fallen into the red, and the industrial companies that have had their supply chains disrupted also fall into the red or yellow-red category for the short term. We don't have an exact breakout yet, but would say, based on our conversations with GPs and looking at our own growth equity portfolio, private credit portfolio, and co-investment portfolio, that we believe Adams Street is in a good position to weather the storm with fewer problems than some market participants that we suspect might be a bit nervous right now given the levered beta nature of what's been happening over the past several years. ■