

Q&A with Jeff Akers and Pinal Nicum: Addressing the Top Questions for Investors in Today's Secondary Market



Jeff Diehl, Managing Partner & Head of Investments, recently moderated a webinar with Jeff Akers and Pinal Nicum, in which they shared thoughtful responses to key questions that are top of mind for investors as they navigate the risks and opportunities in the secondary market. This Q&A presents a summary of questions submitted during the April 28, 2020 webinar.

Q: In this dislocation, which is different from past downturns that were more financially triggered, how are you pricing secondary opportunities? What criteria worked in the past and what are you having to add or change for today's transactions?

JA: Our approach to the market remains unchanged during periods of dislocation. Adams Street focuses on acquiring high-quality, durable businesses across economic cycles with deep insights from the underlying managers we are investing with, and that continues to be the case. During the global financial crisis (GFC), we were active in acquiring best-in-class managers, lower levered assets, or companies that were less cyclical. That is a pillar of our strategy - to be focused in picking specific segments of the economy that we think will be most resilient. We also take a long-term view and focus on finding great companies and assets at attractive entry points. Businesses that we believe have long-term core earnings power at attractive entry points, given the circumstances of today's market, are a big focus.

Q: What are the methodologies or approaches that you're using to determine Q1 valuations for Adams Street's portfolios and any initial estimates of what will happen?

PN: Our methodologies won't change with this crisis. Guidance from GPs about their underlying portfolios will feed through to the valuations. We would hope that we will experience lower than market levels of declines in the underlying assets. In our experience, quality assets, managed by top GPs, tend to see more resilience. We expect markdowns to be in the range that we've seen in our Primary program, given the high degree of similarity with the asset types and GPs that we've built in our secondary portfolio.

Q: The market seems to be expecting more of a V-shaped recovery. How are you thinking about it, and do you think that's the case?

JA: The secondaries team members at Adams Street are not macroeconomists, but we do have fairly interesting insights from the underlying GPs we invest with regarding how companies are responding. There are likely to be private equity portfolio companies with a wide dispersion of reactions to the pandemic. Frankly, it's going to take time for many companies to recover, but we are also aware of companies that are still thriving. Our strategy is really designed to be targeted, so we're not looking to make investments based on a swift recovery. We believe success should be dictated by attractive business models, strong growth themes, and best-in-class GP stewardship, not economic cycles. In that regard, our underwriting is currently contemplating very little liquidity over the next 12 months, because we expect muted capital markets and M&A activity.

Q: Is there a risk that price dislocations may not materialize today given the higher competition/dry powder out there?

PN: This is a question really about whether the markets are over capitalized. There is probably going to be lower secondary volume in 2020. That's the expectation given the first half of the year has been a bit of a wipeout for secondaries and the market has been in shock for the last couple of months. That said, from our experience, it is sometimes trickier investing in a hot market than in a slower one because you are more likely to see irrational pricing and potentially irrational seller asks in a hot market.

In isolation, we're not really concerned about 2020 volumes and whether there is an overweight or underweight of capital. It's not something that impacts our investment activity that much, however if a firm is looking to commit \$2, \$3, \$4 billion dollars a year, that could create heat at the top end of the market in the second half of the year. Looking at the GFC, for example, 2009 was generally quiet from a secondary perspective, but Adams Street was very active. The same goes for other shorter-term shocks that we saw afterwards – the Eurozone crisis in 2011 or the credit shock in the second half of 2015. For us, it's about being ready for actionable situations. We think there are going to be plenty of those opportunities in the coming years.

Q: You mentioned that some secondary funds face vulnerabilities. Do your secondary funds face the same vulnerabilities as the ones mentioned?

JA: Adams Street has had a defensive posture in the market for the last several years but, to be clear, our portfolio is being impacted by COVID-19 and we're going to see markdowns in Q1. Our strategy will play out over the next several quarters as we see fund performance, and we believe we are well-positioned relative to the following three vulnerabilities:

- In terms of quality portfolios, 80% of our secondary portfolio is in GPs also backed on a primary basis. We've done a red/yellow/green assessment of our portfolio, company by company, and analyzed it from a demand and capital structure/liquidity perspective. We currently feel very good about our exposure across both



Targeted Strategy

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key dimensions. The portfolio has a balanced duration profile meaning we do not anticipate being overly exposed to M&A activity over the next year. The technology sector, with lots of businesses possessing predictable recurring revenue streams and conservative capital structures, is slightly overweight in our portfolios which we think is a positive.

- We have never used third-party leverage in a secondary transaction at Adams Street. We have a subscription line of credit, only in our most recent secondary fund, which is currently at about 17% of total commitments. As shared before the pandemic, it is our intention to pay down a large portion of that throughout 2021. Importantly, leverage or a need for near-term distributions has not been a part of underwriting at any point. We believe we are well-positioned relative to many of our peers that are big users of leverage, both at a deal and fund level.
- The third item is concentration. We actively manage concentration risk in our portfolio through a series of fund management tools. Our most recent secondary fund does not have any company which represents more than 2% of total fund commitments. There have been a number of transactions over the last couple of years in which we have managed concentration levels by sharing available exposure with competitors. We brought them in to participate in the deal to manage our concentration risk.

Q: Do you anticipate that there will be a wave of secondary transactions which involve LP co-investments in individual portfolio companies, which have grown to be so popular over the last several years?

PN: There has been a ramp-up in LP co-investment programs over the last few years and we would expect that there will be portfolios of co-investments for sale as investors seek to de-risk. In fact, we just closed a transaction which involved acquiring both fund positions and a co-investment position within a portfolio. So this type of situation is already happening and we expect to see more.

Q: You mentioned you spoke to 100 GPs. Have you started placing rescue capital? Through which vehicle? A secondary vehicle or a separate vehicle? How large is that opportunity set and what is the timing like?

JA: In our view, some of the very immediate term, 30- to 60-day, liquidity issues that were facing companies and fund managers, are being addressed outside of the secondary market in the credit markets. Secondary market solutions, while still short duration investments, often have a lot more structure and more protections. We anticipate that the longer the impact of the pandemic plays out, the more acute capital needs will be. For example, many funds that are late in their life have great companies they believe in, but they will need capital to support these companies to make their way through this period. The size of that opportunity for secondary investors could be enormous, and we think we are likely to see opportunities in this segment of the market before we see traditional LP trades. From our secondary funds, we're looking for opportunities to acquire groups of companies, for the most part, where there's a known set of assets and strong GP alignment.



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Q: Do you think some corporations might look to shed their corporate VC/PE programs if they are also looking to conserve cash going forward?

PN: GP-led transactions weren't a huge phenomenon post GFC, however, one of the areas that was active was carveouts. There were several large transactions in which banks and corporates moved assets and teams off their balance sheets. There could certainly be situations like that in this downturn. It will likely be a while before groups can execute carveouts at a valuation that they feel is fair, and they aren't the easiest transactions to execute from a secondary side, or the seller's perspective. If a corporation has chronic cash needs, there may be other ways to raise capital in the near-term ahead of spinning a corporate venture team out. However, further out, if there is repair to balance sheets that needs to be done, say in one or one and one-half years, it is an option they could pursue and we may be interested to evaluate . ■

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