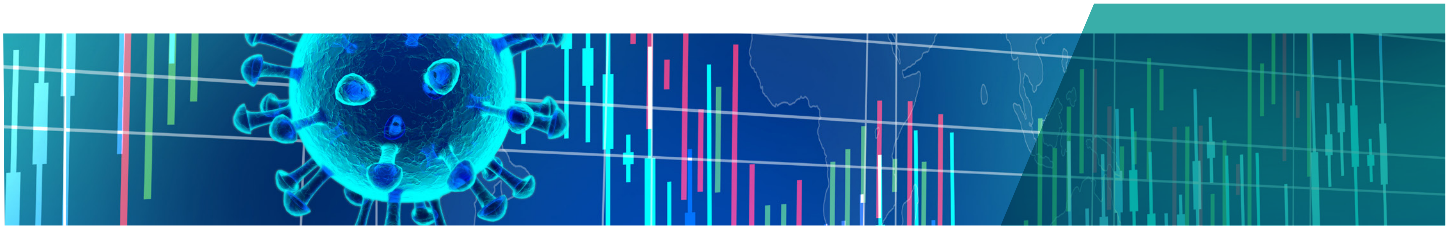
The Secondary Market under COVID-19: Learning from the Great Financial Crisis



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With the COVID-19 pandemic causing unprecedented dislocation across all financial markets, secondary investors are searching for a roadmap to guide them through the turmoil. Many LPs have asked whether the Great Financial Crisis (GFC) of 2008-2009 might provide some relevant direction. But, comparisons between the GFC and the Coronavirus disruption remind us of the Tolstoy quote, “Each unhappy family is unhappy in its own way.” We could say the same about “unhappy” periods in the financial markets.

True, the GFC was the last time we saw a market dislocation as severe as the one we are experiencing today, and it can be helpful to analyze and understand the commonalities across downturns. However, we should acknowledge that there are different drivers this time; the key one being the chronic corporate earnings disruption under COVID-19 versus financial institution distress in the GFC. As such, the prevailing market volatility may be with us for a longer stretch this time around. Protracted volatility risk, along with a low-yield environment and lack of M&A exit opportunities, may put liquidity pressures on many investors, and that will shape the decision-making of secondaries buyers and sellers.

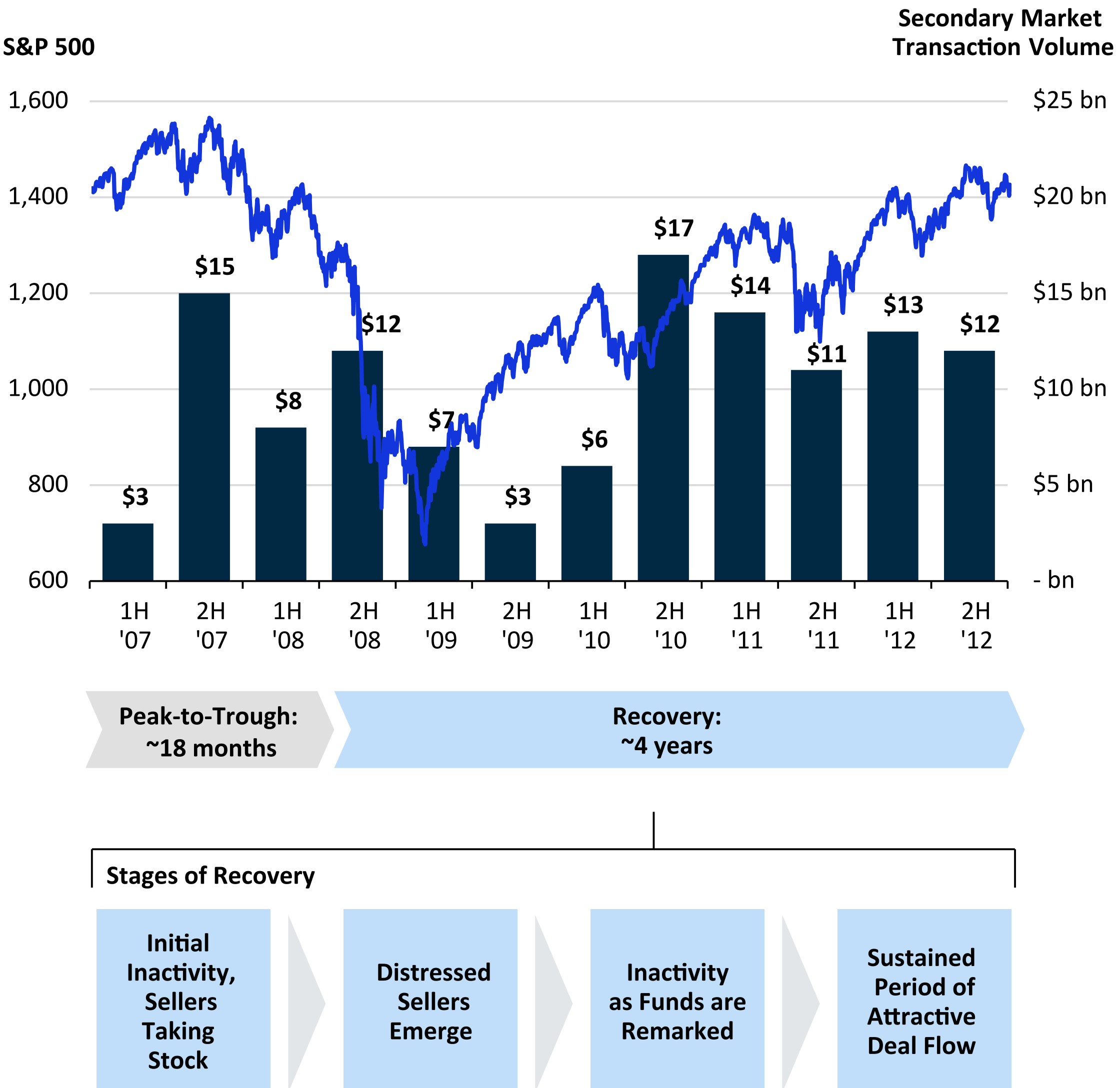
The GFC: Implications for Deal Flow

While certain dynamics do differ, we can learn some lessons from the GFC particularly in terms of LP behavior. The chart on the next page published by Greenhill Secondary Market Review 2020 and Capital IQ shows secondary deal volume mapped against the S&P 500 for the period leading up to and following the GFC.

As illustrated below, there were four distinct phases of deal flow in the traditional LP market from 2007 to 2012:

- First, we saw a period of ***initial inactivity*** right after Lehman collapsed, as sellers took stock of the magnitude of their issues. This lasted for about three months into the fourth quarter of 2008.
- In the next period, ***distressed sellers emerged***, although for a short window and generally in the form of single fund interests or smaller targeted portfolio transactions. This period produced outstanding investment returns for secondary investors that were active at this time. There were very few, if any, large portfolio sales (>$300 million).
- The third phase was another period of inactivity as ***fund valuations were remarked*** and buyers gained more confidence. This lasted nearly a year throughout the second half of 2009 and the first half of 2010.
- Finally, we saw a sustained period of ***attractive deal flow*** which ran for over three years at discounted pricing and at a low point in the economic cycle. While the GFC did not catalyze forced selling for these LPs, it did create a need for portfolio management. This period produced prolonged attractive investment returns for secondary investors.

What Can We Learn from the GFC about Secondary Sale Timing?[1]



Preparing for a Wave of Distressed Sellers

The takeaway is that, while not assuming history will repeat itself, we should aggressively prepare now for a potential initial wave of distressed sellers, followed soon thereafter by a prolonged attractive period of motivated portfolio management driven sellers. Based on our insights and interactions, we believe the most likely drivers of near-term distressed secondary deal flow are:

- Operating distress and disruption at corporations and institutions.
- A slowdown in distributions from decreased M&A.
- Public market valuation decreasing at a faster pace than private equity.
- Private equity portfolio companies facing liquidity issues.

That said, as we have spoken with potential sellers in recent weeks, our sense is that the early liquidity stress we saw in the GFC is not evident yet. However, many LPs have been asking about the pacing of future capital calls, which would imply, at the very least, that they are prioritizing liquidity planning within their portfolios at this time.

As opposed to technical stress within an investment portfolio, i.e. 'denominator effects' caused by falling public valuations, we believe traditional LP sale transactions will be driven more by operating stress at institutions and corporations as this crisis unfolds. At Adams Street, we are paying attention to several critical areas of operating stress where we can help provide liquidity solutions:

- ***Universities*** have high fixed-cost structures and may face extended periods of fewer students on campus, higher scholarship requirements, and fewer alumni able to make grants. This combination could create acute liquidity needs at university endowments.
- ***Corporate pensions in Europe*** are tightly tied to the performance of their underlying operating companies. With distress in many of these companies, their pension funds may need to look to the secondary market.
- ***High-net-worth individuals***, particularly those who own businesses in the energy, hospitality, or retail space, have meaningfully committed to the private equity asset class. They may need to find ways to generate cash to support their businesses.

GP-Led Transactions Have Emerged as a Key Tool for Fund Managers

While holders of private equity are feeling distress, it is also clear that many underlying portfolio companies in private equity funds are feeling the impact of the pandemic. During the financial crisis, GP-led transactions were in their infancy and were not considered by most fund managers to resolve liquidity issues within their funds. We believe there are several reasons GP-led transactions could be an important solution for fund managers in this crisis:

- ***GP confidence*** in accessing the secondary market has steadily grown over the last five years and today is considered a mainstream portfolio management activity for fund managers.
- ***High-quality businesses*** with otherwise predictable and stable demand have been extraordinarily disrupted by this pandemic. But GPs managing these companies are facing short-term liquidity needs or extended hold periods that the traditional capital markets are not well positioned to resolve.
- ***High inventory*** of fully invested funds (pre-2015 vintages) that don't have sufficient unfunded capital remaining to provide emergency support to their companies.

Indeed, due to the volume of GP-led transactions in recent years and the corresponding growth in familiarity of GPs with the potential options available to them in the secondary market, we expect GP-led activity to be a core driver of secondary volume both in the near term (liquidity focused), and in the coming years as GPs seek to manage extended portfolio duration.

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Invest in Solid Businesses with a Long-Term View

Whether the reason for the market turmoil is the GFC or COVID-19, Adams Street's approach to the secondaries market remains unchanged during such periods of dislocation. We believe investors should focus on acquiring high-quality, durable businesses across economic cycles. During the GFC, we focused on best-in-class managers, low-levered assets, less cyclical companies, and segments of the economy that we determined would be most resilient. We think that sounds like the right approach for this market, too.

The other important investment philosophy is to take a long-term view. The key is to find great companies at attractive entry valuations. That means evaluating the long-term core earnings power of a business to identify an attractive entry point given the circumstances of today's market. Those were the types of opportunities that made sense during the GFC – and, in our view, those that secondary investors should be seeking now. ■

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1. Source: Greenhill Secondary Market Review 2020 and Capital IQ