Adams Street

Top Considerations for Investors in Secondaries: How Buyers Are Navigating Opportunities and Challenges

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The most frequent question we hear from institutional investors now, not surprisingly, is: Are there secondary opportunities in the market today? The quick and direct answer is equally unsurprising: "Not many." However, a closer look at the topic reveals a more nuanced and complete answer: "Not right now, but we anticipate a large volume of quality opportunities in the coming months, and a secondaries buyer needs to be prepared, yet vigilant."

Following the COVID-19 outbreak, the secondaries market anticipated meaningful disruption to underlying portfolio companies and future markdowns. Consequently, secondary buyer appetite quickly abated, and many would-be buyers have chosen to sit it out and wait for more clarity on the impact of the economic shutdown on underlying portfolios. Given depressed pricing levels, almost all sales that were in process were suspended, as sellers did not wish to sell at substantial discounts. For the near term, we believe the majority of transactions will involve "forced sellers" motivated by some form of distress.

That said, our experience during the Great Financial Crisis suggests that being a *prepared* buyer is critical in such periods – and that is definitely the position we are working toward as investors right now. This article suggests some key considerations for investors in secondary strategies to properly evaluate how buyers are approaching opportunities and negotiating the challenges of the market.

Identifying Sources of Opportunity

Periods of market volatility often create interesting investment opportunities, and we believe the secondary market is uniquely positioned in that regard. While business owners would normally be unlikely to sell a high-quality company during a market downturn, some private equity LPs feel distress during volatile periods, either driven by a need for liquidity or as a result of an over-allocation to private equity from the denominator effect. These LPs may therefore be forced to sell best-in-class private equity funds.

The secondary market has historically functioned best for buyers like Adams Street during these moments, when sellers are forced to sell their best funds and effectively become price takers. However, the majority of LP sale opportunities may take three to six months to transpire, given the level of price uncertainty and volatility right now. We anticipate that the most likely source of buying opportunities in the near term will be GP-led deals. We think many funds will be challenged to find capital to support great businesses impacted by COVID-19, particularly in older funds that don't have sufficient unfunded capital available to inject. We have spoken to hundreds of GPs in the last several weeks, and the pipeline of these opportunities appears to be very real.

However, as investors, we anticipate that GP alignment will continue to be a key consideration in every GP-led opportunity. In our view, avoiding dysfunctional situations is just as important as getting good value. Selectivity – picking the right opportunities and backing the right GPs – is, we believe, going to be even more vital in the current market than it has been over the last few years.

Preparation is Key

While there may be many opportunities on the horizon, secondary buyers are rightfully asking: How can we underwrite today given the volatility? The consensus is: "Not very easily." However, we believe there are proactive steps that can be taken, and while they may not necessarily lead to an increase in near-term closed transactions, they certainly help prepare for a time when opportunities become actionable.

Our experience has taught us that an important step toward becoming a prepared buyer is leveraging deep GP relationships to stay close to what is happening within their funds. That means:

- Looking for areas where positive themes are developing – be that companies, sectors, or countries – should provide an advantage when it comes time to buy.
- Identifying which companies are showing the most resilience as this crisis unfolds, by focusing on their capital structures, solvency, and liquidity.
- Determining which portfolios are positioned to recover quickest. While businesses in many portfolios are "hibernating" during the economic lockdown, the best GPs are simultaneously developing plans for switching these companies back on.
- Assessing, with the benefit of extensive data analysis, how managers are approaching the valuation of their portfolios.

By proactively and continually analyzing a range of quality funds, and looking out for positive developments at underlying companies, we think a secondary fund manager will be better positioned to move quickly to deploy capital when pricing stabilizes and deal volumes ramp up. There will be a window when pricing is optically more palatable for sellers yet still favorable for buyers, and we think it is vital to be prepared to quickly take advantage of those dynamics.

Avoiding Potential Traps

While we anticipate great opportunities in the future, we believe there are several traps to watch for in the secondary market regarding

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valuations and performance, many of which have been exacerbated by current market conditions and may lead to dispersion in performance going forward. These concerns are illustrated in the chart below.

Potential Issues

Asset Quality
- Choice between high-quality, durable assets vs. large discount
- Low-quality, discount assets rely on market strength for success

Leverage
- Many secondary buyers have used excessive leverage
- Leverage amplified gains, but now amplifies declines

Portfolio Construction
- Large exposures to single-asset transactions
- Lack of portfolio construction discipline

Timing
- Early use of subscription line and SPV leverage in new funds
- Late or final close investors stepping into materials losses

- The first and most important issue, in our view, is ***Asset Quality***. Many secondary buyers have been purchasing mixed-quality assets in their diversified portfolio trades over the last several years. These might be tail-end investments, levered or cyclical assets, or (in several older, larger buyout funds) some concentrated public holdings. These portfolios would certainly be more susceptible to material declines in value.
- The second potential issue is ***Leverage***. Throughout the last cycle, levered secondary transactions were widespread. It's not so much the capital call lines, although in some cases those are very large facilities, but one should be concerned with the additional leverage assumed at the deal level. Of course, performance wise, multiple layers of debt can 'juice' returns when valuations are tracking up every quarter. But this can obviously work in the other direction: leverage can magnify valuation declines as well.
- Another factor is ***Portfolio Construction*** discipline. We think this is especially relevant in the GP-led segment, where there have been some large, concentrated positions taken. For example, continuation fund transactions, which involve rolling the last few remaining assets of a fund into a new vehicle at the end of its normal life, will often by definition have a concentrated asset profile. Over the last 1-2 years, we have even seen many deals with just a single company being rolled forward. While there have been some good companies and GPs involved in these transactions, the size of the exposure many buyers have been taking in these deals may drive wider return dispersion and potentially require meaningful additional capital through the down-cycle.
- The last issue relates to ***Timing***. Depending on the stage of fundraising of a particular fund, it is possible they are already substantially invested. It is fairly common for secondary funds to be 30-50% committed by the time they hold a final close. Ordinarily, that is an attractive proposition for a late closing investor, because they should be coming into an uplift from early investments. But, the opposite could be true right now, as some of those early deals could find themselves underwater in the next few quarters. Of course, this issue will be exacerbated if the underlying fund manager has been using a capital call line for these early investments. As investors in underlying funds, we would expect this to be the case for most.

In Conclusion

While we think there will be a great investment opportunity in the secondary market in the coming months, we believe it is important to be measured – a prepared mind with GP-informed, company-level insights will be vital. In our opinion, and as has been our focus, investors who are allocated to the secondary market should not only be looking at the way secondary managers approach GP-led and LP sales-related deal flow over the coming months, but also how they are safeguarding portfolios against attributes that will be challenged in the current environment. ■

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