

US and European Buyout Markets: Seizing Opportunities and Assessing Challenges



Jeff Diehl, Managing Partner & Head of Investments, recently moderated a Q&A with Primary Investment Team Partners James Korczak and Sergey Sheshuryak, in which they discussed how US and European buyout managers are navigating the COVID-19 pandemic. They shared how different sectors have fared historically through periods of economic dislocation and discussed industries Adams Street is monitoring for recovery as global economies begin to reopen. They also highlighted the opportunities that Adams Street anticipates for new investments in the next economic cycle.

Q: What types of deals are being completed today?

JK: The first wave of deals we have seen are add-ons to existing portfolio companies that were in the pipeline or pre-identified by industry, if not by management team. Those are easier for GPs to get done because they don't have to vet a full management team. Growth capital deals (buying a minority stake in a company) are also getting done because they generally require less financing. The pipeline is starting to fill up with "regular way" LBOs. We think companies that have shown resilience and can demonstrate their growth path will be the first to transact in this environment.

Q: What are your expectations regarding markdowns for the second quarter?

SS: While it is still early, it currently looks like markdowns in Q2 are not going to be as bad as Q1. Public markets have recovered quite significantly, so we believe some market comps are going to improve in Q2. It also looks like trading in Q2 is ahead of expectations, with some companies actually trading up through April. A combination of these two factors suggest that Q2 should be okay from the perspective of assessing overall markdowns.

Q: In terms of valuations, you mentioned Q1 valuations were down 10 to 15 percent, but what does the public markets bouncing back mean for Q2 valuations?

JD: Public markets are bouncing back in the second quarter but we don't expect private markets to bounce back as quickly. Private market valuations often lag on the way down – and also on the way back up. We could see some bounce in recovery due to correlation with the uplift in the public markets. However, managers tend to use a weighted average criterion on their valuation policy, such as public equities, private comps, and discounted cash flow analysis. That's part of the reason why you typically see more muted declines in the private markets, and why we expect to see a more muted recovery as things pick up.

Q: Could you touch on expected capital calls and distributions?

JK: Based on discussions with GPs and an analysis of the GFC, we expect modest capital calls, definitely at much lower levels than last year. Call activity will then likely ramp up in 2021. The use of capital call lines will help smooth these calls out. On the distribution front, we have received distributions from deals that were in process as the COVID-19 crisis took place. Public market run-up has led to more liquidity. In several instances, stocks were distributed and/or liquidated by the GP from public market holdings within our buyout portfolios. So, more upside surprise on exits initially, which we anticipate will fall back in line with initial expectations.

JD: Stock distributions from our GPs, which we usually move expediently, continue to be quite strong for companies that have gone public. Secondary sale opportunities, block trade opportunities, etc., continue to increase. We're definitely seeing more liquidity initially than originally anticipated.

Q: You mentioned tech and healthcare industries being less impacted than other sectors. Do you expect the 2020 and 2021 vintages for industrial and consumer-focused buyout funds to be good vintages?

SS: The valuations and market comps of industrial and consumer sectors (industrials in particular), are definitely suffering more than the technology, software, and healthcare sectors. It will likely take longer for deals in these areas to pick up again. When they do, they are likely going to be attractive because they will be repriced more than other sectors. The German Mittelstand industrial deals in 2009-2010 are instructive examples.

These deals took longer because the difference between bid and ask expectations took longer to adjust in that sector. However, these deals and vintages performed very well when the markets recovered. Industrials and consumer are going to be bifurcating within themselves. They are going to be areas which may suffer from market comps, but are actually doing pretty well. For example, parts of special chemicals, which feed into pharma and biotech, are actually performing very well. We think all sectors will ultimately benefit, including industrials and consumers, but it is important to not catch a falling knife but wait for the right deal.

Q: Has the fundraising environment changed?

JD: We think it is fairly straightforward to continue due diligence or make a recommitment with investors that know a given manager, either current clients or prospective investors. From what we've seen, that activity has remained consistent. The biggest challenge is establishing new relationships from scratch. Building the confidence that one needs in order to entrust a manager with their capital takes time. And the process is certainly different when operating remotely.


Investors are also dealing with their own unique situations.

- How much do they allocate to the private markets?
- Where were they in building that allocation pre-pandemic?
- Was their PE program very mature?
- Did those allocations change?

When the public markets collapsed, people were concerned about denominator effects if they were fully allocated. That seems to have abated with the recovery.



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Q: How are you conducting due diligence on managers; on GPs you know well, versus say, ones that maybe are newer to you?

JK: This is something that we had to sort out quickly. Coming into the dislocation, deal flow in the pipeline was strong. Opportunities that were in process prior to the dislocation got done relatively seamlessly. Zoom and other technology platforms helped tremendously.

But the crisis is not over. How will due diligence evolve if travel is limited and group meetings don't take place this year or into 2021? That's where Adams Street has a significant advantage. We have deep relationships with general partners around the world. There is existing trust with the general partners that we're going to do business with over the next couple vintage years.

But the environment is certainly different and we'll need to continue adapting.

Q: As for money on the sidelines, do you think people will return any of that capital in rebate fees, or will they put the money to work? And what are buyout managers doing to adapt to the current climate and take advantage of opportunities with their dry powder?

JK: We don't anticipate seeing give-backs in underlying funds, but it is still early

days. However, that could change if deal activity remains somewhat frozen a year from now. Managers are increasing their dry powder to go after opportunities in a better valuation environment. What are they doing to prepare and use that capital? We believe that having a flexible strategy is an advantage.

For distressed-oriented investors, opportunities will take time to play out. If you can buy distressed debt and convert it into equity, or if you can just buy distressed companies with equity, your time has come. You've been waiting 10 or 12 years for your market, and it is here. Investors with the flexibility to do more "regular way" LBOs are more advantaged because a nice portfolio can be built. Just being able to do growth capital deals, as well as control deals, is an advantage. We've seen some interesting deals done at good valuations with solid companies that are going to be around for a long time. We suspect we'll see more of those as time goes on.

Q: Has your focus changed or are you sticking to your existing investment philosophy?

SS: Adams Street has a long-term investment strategy which is key to successfully navigating an unprecedented time like we are all living in today. Companies which are not significantly disrupted by the pandemic will be able to complete transactions. Bid and ask



spreads for these sectors are going to be narrower than those that are distressed. We have a heightened focus on sectors going through growth, change, and dislocation, like technology and technology-enabled healthcare. Distressed opportunities and some of the industrials will take longer to pull through, but we have no plans to exit those sectors. We believe they will ultimately present interesting opportunities.

We are spending quite a lot of time understanding the impact of COVID-19 on existing portfolios. Why is that important? We don't want current portfolio problems to draw the focus of GPs from new investments in the potentially more attractive vintages of 2020 and 2021. We want to make sure that they can take advantage of opportunities that we think are likely to become available. ■

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