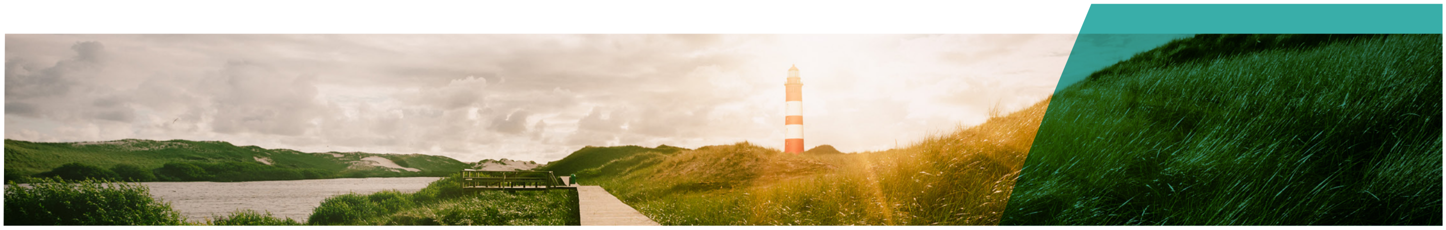
Secondary Market Outlook



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Despite the global health and economic challenges the pandemic presented in 2020, the year also provided an opportunity in the secondary market not seen since the Global Financial Crisis.

Investors are typically drawn to secondaries to take advantage of their structural and cash flow benefits, and importantly their ability to capitalize on market inefficiencies. Therefore a surge in interest last year was not surprising.

2020 Recap: A Tale of Two Halves

While the first half of 2020 saw an initial slowdown in secondary market activity due to the onset of COVID-19, the latter half of the year experienced a very strong rebound.

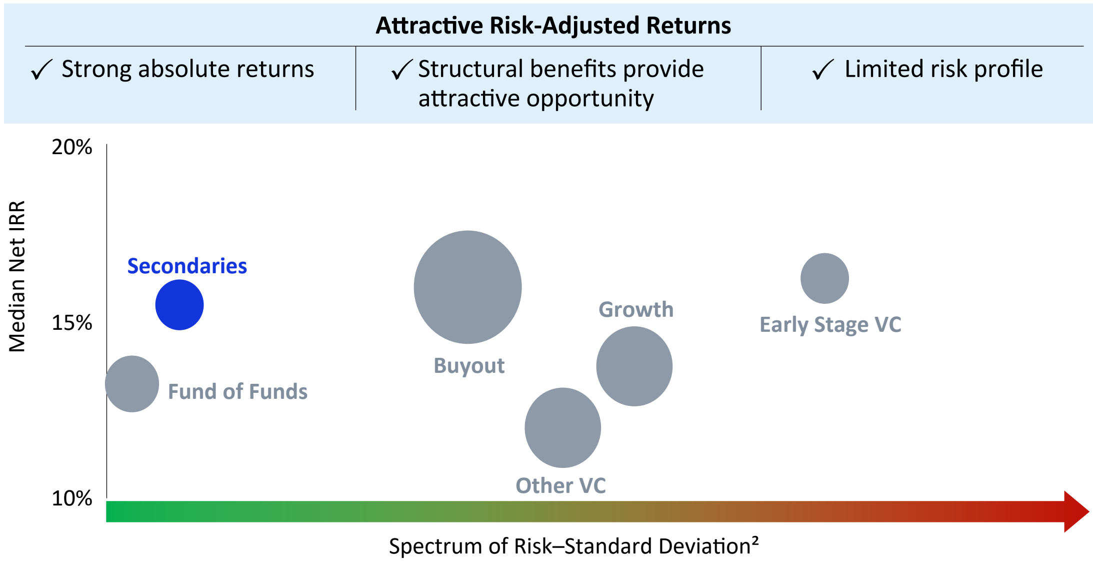
ATTRACTIVE STRUCTURAL BENEFITS

- Shorter duration
- Discount at entry driving j-curve mitigation
- Strong diversification

CAPITALIZING ON MARKET INEFFICIENCIES

- Market volatility driving attractive arbitrage opportunity
- Segmentation of buyer universe leaving gap in middle market
- GP involvement creating opportunity for select LP

Figure 1: Growing Secondary Market with Attractive Risk-Adjusted Returns[1]

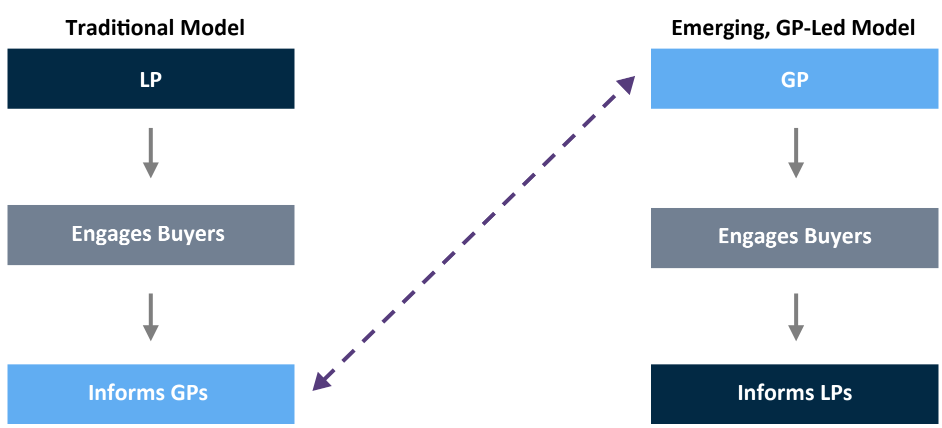


In March, when the US and European economies shut down due to the pandemic, the investment deal pipeline effectively dried up and sales were postponed, leading to very few transactions from March to May. Relative to the global financial crisis of 2008, there were fewer distressed situations and many sellers remained in "wait and see" mode. The first six months of the year saw deal volume at just $18 billion,[3] but activity flourished in the second half of 2020 when deal volume reached $42 billion[3] – nearly matching the levels of 2H 2019 – with GP-led transactions leading the way.

Unlike the traditional LP-interest sale, the GP-led model involves underlying fund managers organizing liquidity in their own funds.

GP-led transactions grew to account for nearly 50% of the total secondary market last year

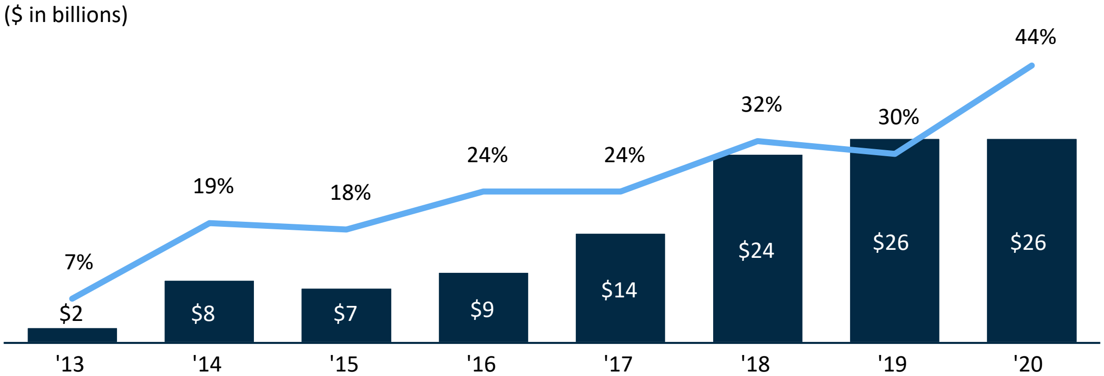
Figure 2: Anatomy of a GP-Led[3]



GP-led transactions grew to account for nearly 50% of the total secondary market last year. As part of this shift, we also saw a rise in single-asset transactions, a sub-set of the GP-led market. In a single-asset transaction, a GP drives liquidity for its LPs through the sale of a single company into a continuation vehicle, which is capitalized by secondary buyers.

Figure 3: GP-Led Market Volume and Share of Total Secondary Market[3]

($ in billions)



While single-asset GP-led transactions can create an attractive opportunity for buyers, we do think they also present new risks. Namely, secondary buyers take on increased concentration and underwriting risk. Given the concentration level of these transactions, deals are often syndicated to multiple buyers. Further, many of these transactions test buyers looking for stronger economic alignment between the managing GP and the buyer group. Heightened GP awareness, high-quality companies, and the increased prevalence of deal syndication helped propel single-asset transactions to their highest transaction volume in history.[3]

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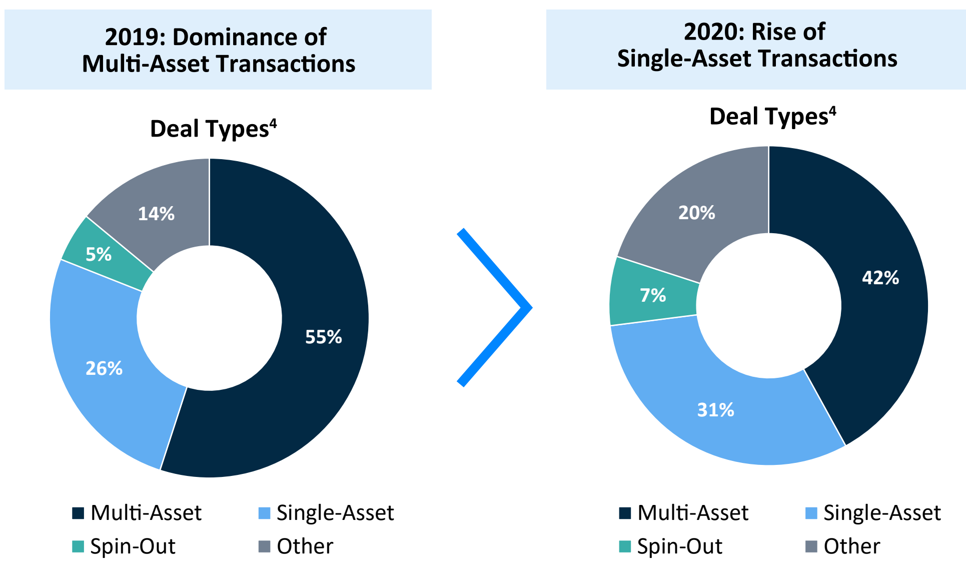
Figure 4: Global Secondary Transactions Trends[3]



Traditional LP transaction volume saw a sharp decrease in 2020; however, within this portion of the market there was a strong increase in mosaic solutions, or situations in which a seller's portfolio of funds is split up and sold to multiple buyers. Mosaics grew as a proportion of the overall market as buyers demonstrated increased selectivity, and the purchase of an index of private equity funds became less appealing. This dynamic created very attractive opportunities for buyers with a targeted strategy.

Other factors that contributed to market inefficiencies last year in the LP market include a wider range of portfolio knowledge and conviction leading to a higher dispersion of bids, an increased importance placed on information access (i.e., real-time company updates, understanding of valuation policies), limited competition for mid-market portfolios (under $150 million), and an emphasis on higher quality funds that are more restrictive on transfers as sellers looked to optimize pricing.

While 2020 may have seen a significant decline in traditional LP transactions, that pent-up supply lends a positive outlook for LP transactions in 2021

Finally, 2020 rewarded high conviction buyers. Specifically, buyers who were able to capture unique insights from GPs and identify best-in-class assets and arbitrage opportunities, buyers who were targeted and could adeptly angle their capital toward the most resilient sectors, and buyers who remained disciplined around portfolio construction and alignment in GP-led transactions.

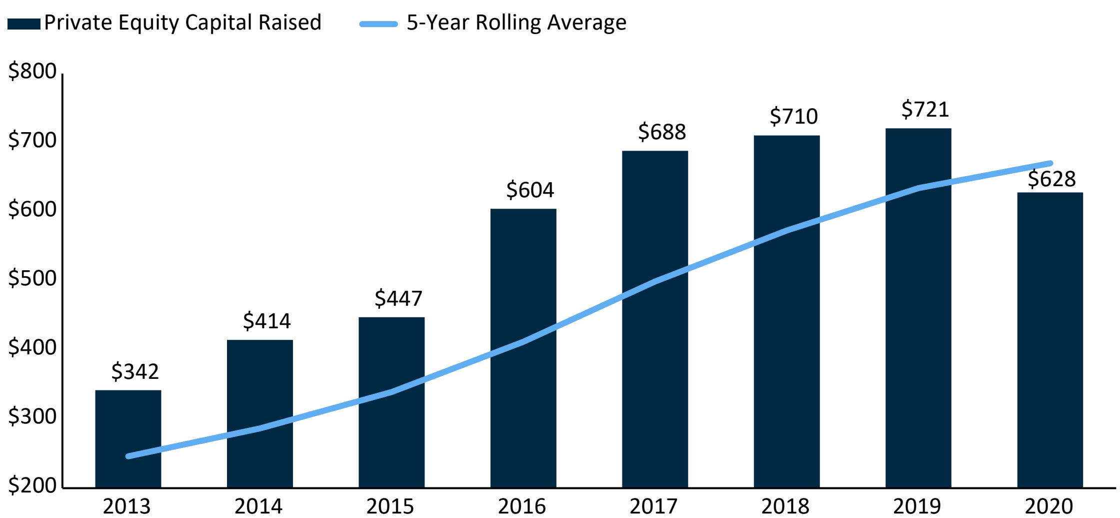
While the second half of 2020 yielded positive results in the secondary market, we believe 2021 and beyond have the potential to be even more compelling.

2021 Outlook: The Stage is Set for Robust Growth

After assessing the key factors that drive secondary transaction volume, we anticipate that 2021 will bring substantial deal flow.

Figure 5: Private Equity Fundraising[3]

($ in billions)



SECONDARY MARKET VOLUME HAS REPRESENTED ~12%[5] OF TOTAL PRIVATE EQUITY FUNDRAISING

The level of private equity fundraising over the preceding five years, or the inventory of primary funds that could trade in the secondary market over the next several years, has touched record levels recently – despite a slight stall in fundraising in 2020. With an increase in both global fundraising and a steady rise in the proportion of funds that are likely to ultimately trade in the secondary market, the secondary market is currently primed for growth.

While 2020 may have seen a significant decline in traditional LP transactions, we believe the current pent-up supply lends to a positive outlook for LP transactions in 2021. Uncertainty in the market forced many sellers to delay their sales processes. Now, with NAV levels mostly recovered and a continued focus on portfolio management, sellers are beginning to show positive signs about trading in today's environment. This said, many investors also expect continued market volatility as economies attempt re-opening, leading to a healthy supply of highly motivated sellers.

The GP-led market exhibited extraordinary resilience in 2020 and we currently expect this deal type to continue growing in popularity in 2021, particularly in light of increased awareness of GP-led transaction opportunities and single company transactions. Increasing numbers of GP-led deals now focus on strong companies in resilient sectors, attracting more attention from buyers - and the growth in buyer syndications allows for larger transactions.

All of this contributes to the continued growth of secondary funds, driving dry powder to record high levels – yet the universe of buyers has continued to segment. More than 60% of dry powder in the market today is in funds greater than $5 billion in value,[6] and this concentration at the high end of the market creates substantial competition for larger transactions.

Adams Street sees ample opportunity in the middle-market space, and through our analysis of key growth drivers identified in 2020, we have high expectations for secondary investments in 2021. We believe that buyers who demonstrate strong conviction, targeted investing, discipline in GP-led transactions, and a focus on quality will be positioned for success now and in the years to come. ■

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1. Source: 2020 Preqin Global Private Equity & Venture Capital Report. Data set includes funds with vintage years of 2007-2016. The size of each sphere represents the capitalization across all funds considered for the analysis. Standard Deviation for each strategy is as follows: Fund of Funds (6%), Secondaries (7%), Buyout (13%), Other VC (15%), Growth (16%), Early Stage VC (20%)
2. Calculated as standard deviation of Net IRR. Net IRR is net of underlying general partner fees, carried interest and expenses.
3. Source: Greenhill, “Global Secondary Market & Trends Outlook – Jan. 2021”.
4. Classifications broken out by GP-led transaction volume.
5. Calculated as total secondary market volume as a % of a 5-year rolling average of private equity fundraising, averaged out from 2013-2020.
6. Source: Preqin as of January 2021

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