KEYNOTE INTERVIEW

A two-speed market?

With GP-led deals taking the spotlight in the secondaries market, Jeff Akers, head of secondaries investments at Adams Street Partners, shares what that could mean for risk-return profiles

Traditional LP portfolio trades stalled in the face of pandemic-induced volatility. In response, secondaries players shifted their attention to a new breed of GP-led deal, often featuring high-quality single assets. They are now also joined by some well-known GP names that are establishing teams focused on this corner of the market.

These dynamics, combined with strong fundraising totals in recent years, have the potential to fundamentally change the secondaries market. We caught up with Jeff Akers, partner and head of secondaries investments at Adams Street Partners, to discuss how he sees the market shaping up, the implications for investors in secondaries funds and how to find value in an increasingly competitive market.

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Q As fundraising has ramped up among secondaries players, how is competition shaping the market?

We are very bullish on the expansion of the secondaries market broadly and believe there is room for fund size growth. It remains an attractive place to invest. We now see around 60 percent of the dry powder in secondaries residing in funds sized above $5 billion. That means there are some really interesting pockets of inefficiency in parts of the market, especially in transactions below $150 million in size. Many buyers that scaled up find it is much harder to justify these smaller deals. The other point is that you can't look at the market as a single pool of capital pursuing one type of transaction. The diversity of options now – GP-leds, traditional LP deals, large and small, targeted deals – means that not everyone is competing in the same space. I continue to believe that while there is ample capital, there is also ample value to be found.

Q And what about the potential for competition from GPs themselves as some shops are setting up secondaries capability?

We are seeing some large buyout platforms enter the GP-led secondary market – and they often have a focus on single

Q LP trades have garnered less attention over the past year. What developments do you see in this part of the market?

It feels as though investors are thirsting for LP trades right now, as many secondaries funds feel underweight in this part of the market. I think this competition means that some players will be competing on cost of capital. But there are pockets of inefficiency where it's possible to gain an edge – we always look to leverage our GP relationships, where there are better sourcing opportunities than the broader market. We think there could be some strong returns from lower mid-market transactions, while for more broad-based diversified LP portfolios it will be difficult to bring an edge to the deal.

We will see more LP trades as the year progresses. They came to a standstill in Q2 2020 as deals were canceled when the pandemic struck and then few new deals came to market. The GP-led space skewed the market in the second half of 2020, but there were still some very attractive LP-led deals to be done that were bespoke, smaller situations. These trends have persisted through Q1 2021, but we think the market will rebalance from the summer onwards.

assets. We'll see how that evolves in terms of how many GPs will be open to having their peers as LPs in their continuation funds. But there does appear to be capacity for new entrants in the single-asset GP-led space given its growth.

I think a more interesting question around single-asset GP-led deals is how existing investors manage a level of concentration that they have never dealt with before. Smart buyers will think very hard about the concentration levels in their funds and place limits on the amount they take in a single company. The syndication market that grew around these situations is an interesting development. We can act as lead investors and syndicate post-deal, but we're also able to access the syndication market ourselves. GPs care about who they partner with and that affects who gets selected as an investor in these processes.

Q How do you see this playing out, given the difference in risk profile between a traditional secondaries transaction and a more concentrated GP-led deal?

Investors in secondaries funds will need to thoroughly consider their commitments and where their capital is allocated. If they are investing in funds that execute more specialist and more concentrated GP-led transactions, they will need to ask whether that is a secondaries strategy or whether it's actually more like investing in a buyout fund. What should it be benchmarked against? Who is the competition?

As a secondaries investor, one of the key features you offer your LPs is risk management and diversification – that's how you generate outstanding, risk-adjusted returns. If you are backing GP-led deals, you have to focus on concentration limits and take a much more proactive view of portfolio construction than with LP fund positions. You can do this by taking intentionally smaller holds on deals.

If you can create a balanced portfolio of LP- and GP-led deals, the combination can create an interesting complement: on the LP trades you can gain diversified exposure and shorter durations to mitigate the J-curve and produce strong IRRs; with

GP-led deals, you have greater concentration, longer durations and the potential for higher multiples on the upside. As a result, I think we may see the development of a two-speed market.

Q What will drive a renaissance of LP trades?

Last year's Q4 was spectacular for private equity returns. That's important because when sellers know there are good returns coming, they have a hard time transacting with stale NAVs – they have been waiting for Q4 valuations to come out as these will form the basis for pricing. The delayed processes from last year also mean there is pent-up demand from sellers that didn't transact in 2020, as well as buyer demand. Sellers will take the opportunity to capture strong pricing on the secondaries market.

Strong longer-term fundamentals will also underpin activity, including the recent high fundraising totals in the primaries market and moves towards more active portfolio management by LPs. It's hard to believe that there will not be a big uptick in LP trades as we move further away from volatility.

We were active buyers in the post-financial crisis period, but it's very different this time; we are not seeing the same type of liquidity-driven sellers. Still, there are some very attractive opportunities from motivated LPs ready to transact, such as endowments having trouble getting people back to school or family offices with too much exposure to covid-hit sectors, such as consumer.

Q What has high pricing meant for competing in deals?

It's really important to look at pricing – and that's true across different deal types. There is huge variation on pricing even though the perception is that it is high across the board.

High quality traditional LP deals in the buyout space are currently trading at or close to par, but venture capital and tail-ends are selling at discounts. For more diversified larger portfolios, cost of capital is the main determinant of who wins the deal – but to do that you have to accept a lower return.

"There are some really interesting pockets of inefficiency… especially in transactions below $150 million in size"

"Smart buyers will think very hard about the concentration levels in their funds"

Adams Street has always focused on price relative to intrinsic value, as opposed to NAV. That means that even though pricing has recovered relative to last year, there remains an opportunity to acquire where you have high conviction.

Q Given the volatility in pricing, to what extent have you seen deals collapse because of an expectation mismatch?

We have seen deals get pulled for pricing, often times because the public markets have performed so well. Secondary players are not willing to pay huge premiums on Q3 2020 valuations and so they are waiting for Q4 valuations. In some instances, we've seen GP-led deals evolve because of the strong performance of underlying companies – portfolios end up broken up and assets sold individually. This said, we've seen GP-led deals evolve, and sometimes get broken up, as processes elongate and the performance and perceived valuation of underlying companies shift.

Q So overall, are secondaries the safe, diversified bet they always used to be?

This question is evolving. For us, asset selection is what drives outperformance, while diversification limits the downside. There are many risks buyers can take on: leverage, asset quality, GP-buyer alignment, concentration, etc.

So, some specialists now say that secondaries are not the safe, diversified bet they used to be, but that's because they are positioning themselves more as a buyout fund with greater concentration risk. More traditional secondaries players, by contrast, are much more focused on risk management and building diversified portfolios that generate the traditional characteristics that investors seek through secondaries – mitigation of the J-curve, known assets, diversification and so on.

I do think there will be a higher dispersion of returns for investments made in 2020 to 2021 because of the concentrated nature of some portfolios. Over the longer term, the market and players will adapt and different funds will offer investors a choice of risk profiles. ■