Navigating a Robust Private Market: Trends in Buyout and Venture

Jeff Diehl
Managing Partner & Head of Investments

Miguel Gonzalo, CFA
Partner & Head of Investment Strategy and Risk Management

Kelly Meldrum, CFA
Partner & Head of Primary Investments

KEY TAKEAWAYS

- As investor interest in private equity grows, managers are increasingly adding product line extensions to diversify their offerings
- Many venture managers are transitioning into multistage or "full stack" managers that invest across the growth cycle
- Buyout fund size scaling has remained relatively steady over the past decade, with successor funds consistently increasing in size by 50% from the prior vintage
- The time managers are taking to return to market with successor funds is compressing

The COVID-19 pandemic accelerated several global investment trends, especially for private markets, which experienced increased interest due to strong historical performance.

Two major factors helped every Adams Street strategy to outperform our model return expectation in 2020 and 2021.

First, our goal is to select terrific managers of funds and companies operating in sectors going through growth, dislocation, and change. These sectors, and the best companies operating in these sectors, benefited from COVID tailwinds that created structural behavioral changes and an accelerating adoption of technology. This resulted in exceptional fundamental company performance over the past two years.

Second, access to private debt and equity capital remains robust, which helped fuel liquidity through full and partial exits via M&A and IPO transactions.

The continued positive investment returns for Adams Street and our industry have resulted in three clear trends for venture capital and buyout managers.

These trends – product line extensions, fund size scaling and increased investment pacing – make it more challenging for investors such as Adams Street to build private markets portfolios that can outperform while maintaining target allocations.

The trends have reinforced the importance of Adams Street's vigilance on investment due diligence as well as adhering to our long-standing portfolio construction and risk management philosophies as we look to optimize return per unit of risk for our clients' portfolios.

In our experience, the venture funds that have had the most investment success are those that began as early-stage investors and grew into later-stage investors

Expanding Product Lineup

As investor interest in private equity grows, managers are increasingly adding product line extensions to diversify their offerings. Some managers allow investors to select these funds a la carte, while others require investment in the full basket of products. Investors must therefore ensure that they understand the edge managers bring to origination and execution of high-quality investments across their platform.

The buyout funds Adams Street invests in are increasingly evolving into comprehensive, multi-product platforms that allow investors to access a variety of products. The typical pitch is that managers are trying to capitalize on their inherent deal origination advantages that complement their core or flagship fund.

The proportion of managers with multi-equity product platforms within the Adams Street portfolio has surged to 48% from 18.2%[1] in the early 2000s. The product extensions typically focus on a particular geography, a sector such as healthcare or technology, a company size classification, or a minority strategy vs. control strategy.

Full Stack Venture

Many venture managers are transitioning into multistage or "full stack" managers that invest across the growth cycle. Instead of just offering seed or Series A early-stage investments, they are increasingly investing more capital throughout the growth lifecycle of their most successful companies. Today, more than 75% of the venture firms Adams Street invests in are "full stack" multistage platforms, versus just 12.5% in the early 2000s.[1]

In our experience, the venture funds that have had the most investment success are those that began as early-stage investors and grew into later-stage investors, as it is more difficult to pivot in the other direction due to the challenges with deal origination and brand.

We believe focusing on proven early-stage managers who are extending their franchises into growth has a greater probability of success, assuming they staff their organizations to help companies with typical late-stage scaling challenges.

Expanding Fund Sizes

Strong historical returns coupled with increased investor interest can result in managers scaling their successor fund size relative to their prior vintage fund.

The average size of a new investment fund compared with the prior fund is a key consideration for our Primary investment team, since managers that scale too quickly are at risk of strategy drift which, in our experience, can lead to poor returns.

It is critical that investors assess this risk and determine whether the scaling can be appropriately managed.

Our data show that buyout fund size scaling has remained relatively steady over the past decade, with successor funds consistently increasing in size by 50% from the prior vintage,[1] which is reflective of the expanding scope of available investments and capital in the private equity space.

Similarly, the venture capital sector had a record-breaking year through June 2021 on almost every metric, and Adams Street's venture capital fund managers are also consistently increasing their successor fund sizes relative to prior vintage funds. Venture funds Adams Street invested in over the past decade averaged approximately a 40% size increase versus their predecessor.[1]

As mentioned above, the rise in multi-product, full-stack managers allowed funds to increase in size while also providing differentiated extension products.

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Compressing Time

For both buyout and venture funds, Adams Street has seen considerable compression in the time between the final close of one fund and the first close of its successor. The faster managers come back to market, the more difficult it is for investors to underwrite the manager, since much of their on-the-run fund portfolio is unrealized and has investment theses that are still playing out.

Within Adams Street's buyout portfolio, the average time managers took to come back to market shrunk to 2.7 years in 2020 and 2021, from an average of 3.8 years pre-pandemic – an unusually significant compression.[1]

Data reveal that the technology sector was a catalyst for this reduction. By embracing the acceleration in digital transformation since the onset of the pandemic, managers found more interesting investment opportunities and returned to market more quickly. By comparison, the back-to-market time for other sector managers including healthcare, industrial, and consumer still averaged 3+ years.[1]

In addition to accelerated technology adoption, changes in long-term capital gains taxes in the US helped spark the sale of many privately held, longstanding family businesses in 2020 and early 2021. From what we have seen, many of these companies were purchased by buyout funds, creating an uptick in deal activity that further contributed to the reduced time to market for successor funds. However, a large number of managers believe that this was a unique confluence of circumstances, and we expect 2022 to be more in line with historical trends.

In venture, the average time taken by managers in the Adams Street portfolio to return to market compressed to two years in 2020 and 2021, from 2.5 years pre-pandemic.[1]

Again, technology was a key driver as venture investors embraced digital transformation across all industries after the onset of COVID. This groundswell persisted into 2021 before cooling in the fourth quarter, with venture rounds now taking longer to come together in a climate of full valuations and public market uncertainty.

Fundamentals of Success

The trends outlined above highlight the importance of manager diligence and raise challenges for investors in managing their target allocations to the asset class.

It is challenging for investors to navigate the terrain when successor funds are larger, managers are returning to market more quickly, and there is a larger menu of products that may be packaged as a bundle.

As investors in this changing climate, we first conduct thorough bottom-up diligence on managers, including their staffing model, origination capabilities, portfolio company performance, and their true edge for stated strategies.

Second, we aim to maintain appropriate discipline on important risk management factors such as manager selection, time diversification, and diversification by subclass, company size, sector, and geography.

Future Opportunities

We currently expect deal activity to remain high in 2022 as businesses and entrepreneurs look to liquidate holdings at what they perceive to be healthy valuations. This is especially likely within the tech, healthcare, consumer, and advanced manufacturing sectors, which have all seen structural tailwinds from the pandemic.

Companies in these sectors that have little to no leverage – an advantage in an unpredictable interest rate environment – and are growing faster than the economy, can withstand valuation compression and still generate solid returns under current circumstances.

Our strategy of investing in growth sectors with lower leverage increases our confidence that our portfolios are reasonably well protected from rising rates and compressing valuation multiples.

No investor can foretell the valuations of companies in which underlying managers invest.

However, we can remain disciplined in the things that we can control, such as portfolio construction and risk management, and stay true to the strategy that has contributed to Adams Street's success for 50 years: Working with managers who target intelligent investments in sectors experiencing dislocation, change, and growth. ■

1. Source: Adams Street Partners data as of June 30, 2021.