Adams Street

The Impact of Public Market Dislocations on Private Markets

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Adams Street has been investing and managing risk in private markets for 50 years, including our first three decades as a part of larger, multi-asset class asset management firms. This provides us with a unique perspective on market dislocations and their impact on private markets portfolios and investment opportunities.

Public equities are experiencing a material downdraft as the US Federal Reserve raises rates and reduces its balance sheet to dampen inflation, which is running at an annual rate of 7-8%. As I write this in 2022, the S&P 500 is down 15.6%, the NASDAQ is 24.5% lower, and the Russell 2000 has dropped 20.2%. Most of these declines have taken place in Q2. The correction has been especially hard on currently unprofitable companies, including many recent IPOs. The Renaissance IPO ETF (ticker: IPO) is down 50% YTD and over 55% from its peak in early October 2021. Since the fundamental performance of companies in these public indices is largely unchanged since the beginning of the year, and certainly since the end of Q1, the correction is primarily a resetting of valuation multiples. Profitable growth has replaced growth at whatever cost.

I would like to share our thoughts on public market declines, the historical correlation of private market valuations to these declines, the anticipated impact on Adams Street's portfolio, and how we view future private market investment opportunities.

Recent Public Market Declines

Public markets are mostly rational due to a large collection of intelligent investors who analyze publicly available information as well as their own proprietary data and models. Occasionally, markets can become temporarily irrational due to emotions (mostly fear or greed). We believe the current correction is rational and healthy given the prior run-up and the rising interest rate climate. If there was an irrational period, it was more likely in 2021, where we saw a significant increase in public valuation multiples.

The fundamental value of a public company is determined by estimating future cash flows and discounting them back at a chosen discount rate. Higher discount rates are used for companies with less certain cash flows. When interest rates rise and inflation is high, the discount rate goes up, making the business worth less today.

Even with the declines in equity indices, few public companies we have tracked for many years, if not decades, from their private company days, are trading at what we view as fire sale prices. We do see some on the verge of being attractive long-term buys, creating an expectation of an increase in take-private activity by control buyout sponsors. Boards of companies whose stock prices have declined precipitously may be more open to these conversations, given the looming presence of unfriendly activists and the challenge of retaining key executives who are sitting on significantly less valuable unvested stock compensation.

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Finally, rising interest rates and valuation corrections are creating more debate about the risk of recession in the US and other developed economies. This fear, compounded by concern that the Fed's focus on inflation reduction could limit its ability to counter a slowdown, is likely adding fuel to the selloff fire. However, we don't think an extended economic contraction in the US is likely, especially given its ability to supply its own energy needs. Europe's significant dependence on Russia for oil and gas puts it at higher risk of recession, possibly a prolonged one. While Europe is working quickly to reduce this reliance, long-term solutions likely involve significant capital investment as well as a delay in near-term climate goals. It remains to be seen how this will play out.

Private Market vs. Public Market Valuations

When public valuation multiples rapidly rise or decline, it stands to reason that private valuation multiples should move similarly. While public and private markets are correlated, private valuations have nearly always adjusted more slowly and more modestly. There are three principal reasons for this.

First, private markets focus on investment cases that typically involve above-market growth and margin expansion over multiple years, making them less focused on the current public equity valuation environment when valuing businesses. If private companies grow faster than their market, investment cases can withstand some multiple compression from entry to exit. In addition, companies growing faster than the market should command premium multiples. As a result, private market deals are currently getting done at valuation multiples higher than public market multiples. This is common when large dislocations occur, and we expect that will continue in the near-term.

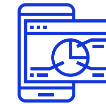
Second, valuation policies of private equity and venture capital firms typically involve a combination of methods that are weighted to arrive at a fair market value.

Control buyout sponsors typically use three methods - public comps, private comparable transactions, and discounted cash flow models. When public valuation multiples dislocate, control sponsors typically shift their weighting from public comps to discounted cash flows. This makes sense, given the multi-year investment cases and the fact that private markets are paying higher valuations than public markets.

Venture capital firms typically use a combination of public comps, private comparable transactions, and the last private financing valuation. When public market valuations rise, venture capital firms often apply discounts, sometimes significant ones, to public comps, and when public valuations fall, those discounts are typically reduced. However, venture capital funds have more variation in their valuation methodologies than buyout firms. So venture capital fund investors are wise to understand the chosen methodology and assess the appropriateness of valuation marks based on underlying company/fund performance. Regardless, the impact of private market valuation approaches lowers the volatility of private company valuations vs. public valuations.

Finally, the supply and demand of private capital clearly influences private market valuations. On the supply side, private equity and venture capital funds have raised significant amounts of closed-end fund capital over the last two years. In addition, private credit funds and BDCs have grown in popularity and size. This means there is a material supply of capital that has a ticking clock to be invested.

On the demand side, the volume of companies entering fundraising or sale processes typically declines when public markets are highly volatile. The combination of these two factors will likely cause a slowdown in near-term demand relative to the supply of capital which helps put a floor on valuations that will likely be higher than public market valuations. This should be especially true in levered buyout transactions where purchase prices are based on cash flows rather than revenue, and purchase prices are funded in part with relatively low-cost debt.



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Impact on Adams Street's Portfolio

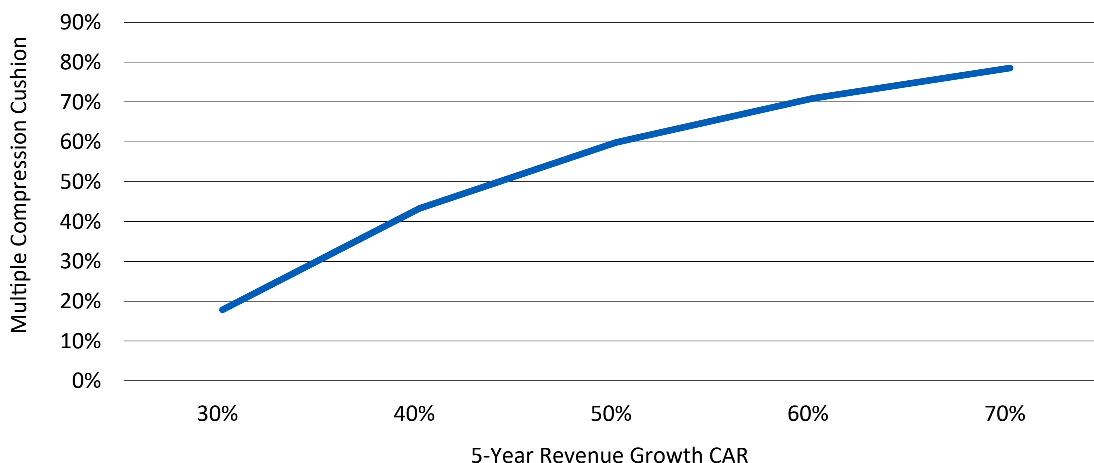
Our strategy is to invest in sectors going through growth, dislocation and change where value creation comes from top line revenue growth and margin expansion at the company level. Our strategy does not rely on significant use of low-cost debt or rising valuation multiples to generate returns – what we refer to as private market beta. In fact, for several years, our underwriting has incorporated some multiple compression. Achieving above-market returns with multiple compression can only really be accomplished when investing in companies that can grow above market rates.

Adams Street's NAV is primarily in private companies, with some public stock from companies who priced IPOs but are still under a lockup period. Our public holdings are likely to be highly correlated to declines in their public industry sector. Based on what we have seen in past market cycles, we estimate our private holdings will likely decline by about 60% of the fall in public markets. If public markets fall by 20% and we have 80% of our holdings in private companies, our models suggest we can expect an overall portfolio drop of approximately 13-14%.

If fundamentals and investment theses of our underlying private companies remain intact, short-term valuation declines do not trouble us given that our underwriting standards are designed to withstand some degree of multiple compression. The multiple compression that can be absorbed in an investment without degrading returns depends on the growth rate and leverage level of the underlying investment.

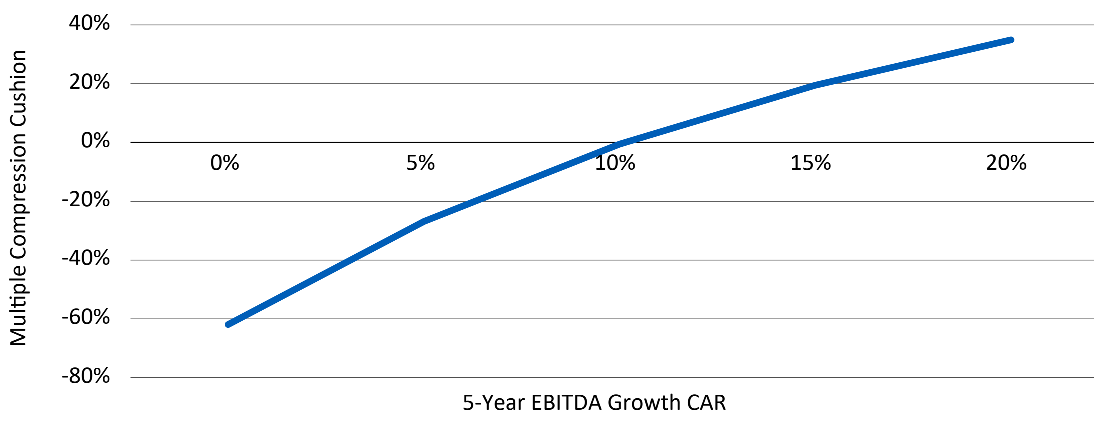
Our growth equity team typically makes investments in unlevered businesses growing at rapid rates pursuing large markets going through significant change. Figure 1 shows how we model a multiple compression cushion for an unlevered deal, based on its five-year compounded revenue growth rate. If an unlevered company can grow at 50% for five years, our analysis suggests the investment can withstand 60% valuation multiple compression without degrading the return; whereas at 30% annual growth, the investment only has an 18% multiple compression cushion, but if the investment is held for an additional year at 30% growth, that cushion grows to 37%. Growth is the key to providing an investment with valuation compression risk protection.

Figure 1: Unlevered Growth Equity Investment



Now let's look at the opposite end of the spectrum – a levered buyout investment into a GDP growth company using 50% debt and 50% equity at entry with assumed debt paydown of 5% per year. Figure 2 shows how we estimate the amount of multiple compression cushion this deal has based on its five-year compounded EBITDA growth rate. This graph shows that a 50% levered investment must grow EBITDA by more than 15% per year to have a 20% valuation compression cushion. Our model indicates that (i) if a levered business only grows EBITDA at a 5% annual rate, the multiple must EXPAND by 27% to maintain modeled equity returns; and (ii) if 5% EBITDA growth is achieved and multiples compress 20%, anticipated deal IRR would fall from 20% to 5%. Again, growth remains key.

Figure 2: 50% Levered Buyout Investment



The flip side of the above chart is the lens we employ when we lend money on a floating interest rate basis to sponsor-backed control buyout deals. Not only does private credit benefit from rising interest rates, our disciplined approach to underwriting results in an average loan-to-value ratio of 43%. In our modeling, the enterprise value of a company with a LTV ratio of roughly 43% could collapse by approximately 50% and would still be a money good loan. The historical odds of that type of value compression happening to a business with material cash flows is very low.

As we have said for many years, the segment of private markets that makes us the most nervous is levered beta. This strategy worked very well since the Global Financial Crisis as declining interest rates steadily drove valuation multiples higher. Paying full prices using maximum leverage to buy GDP growth companies with peak earnings has tended to work fine in rising valuation markets but can be a disaster when valuation multiples compress or when a recession hits. This has often been true for large/mega cap private companies where the only viable exit path is through public markets. In addition, to drive IRR performance, certain buyout and secondary managers have employed meaningful fund-level or Special Purpose Vehicle leverage on top of the leverage in the underlying portfolio. This can be a dangerous and punishing game when valuation multiples correct. As Warren Buffett says, "you only find out who is swimming without a bathing suit when the tide goes out." Rest assured we have ours on.

A more recent area of concern has been late-stage, pre-IPO tech investing, a category Adams Street generally avoids. This section of the market is usually rational, with investors conducting significant fundamental diligence, making realistic assessments of terminal value, and joining boards to help management teams scale. But it has often become irrational when public tech valuations have risen rapidly. "Casual tourists" with FOMO (fear of missing out) have appeared and taken rapid share of the pre-IPO market, acting like undisciplined traders instead of investors. During the internet bubble, hedge funds and mutual funds stampeded into pre-revenue private internet companies at huge prices, hoping for higher valuations at IPO. The high private valuations encouraged tech CEOs to raise and spend huge sums of money. While the strategy worked briefly, it ended in disaster when public markets corrected. The casual tourists exited the market with terrible returns, leaving private tech CEOs to aggressively cut staff and spending.

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In the last few years, this phenomenon returned. As public tech valuations inflated rapidly over the last 2-3 years, numerous hedge funds and corporations raised and rapidly deployed tens of billions of dollars into high-growth pre-IPO tech companies. This rapid deployment may have resulted in such firms often neglecting fundamental diligence, overestimating terminal value, and overlooking important governance rights and investor protections. This reached a fever pitch in 2021, with one prominent hedge fund investing in a new deal every two days (180+ investments a year), paying 100-200X+ revenue vs. already historically inflated public multiples of 20-35X. We have seen this movie before, so we expected it to end poorly. The recent public market correction effectively closed the IPO window and rapidly adjusted public tech multiples to pre-Covid long-term averages. The casual tourists are now taking massive write-downs and are exiting the market, leaving CEOs to adjust spending and private fundraising plans. While Adams Street's venture portfolio benefits from the cheap capital these tourists provide, we believe their retrenchment is healthy, bringing discipline to valuations, fundraising, burn rates, and governance.

Future Investment Opportunities

Market dislocations highlight the importance of experience in private market investing. Investors such as Adams Street who have worked through numerous market cycles are less likely to be paralyzed by emotion and fear when they see large declines in liquid markets. They are likely to remain calm, dust off their dislocation playbooks from 2001 and 2008, and begin proactively targeting great deal opportunities.

Fear, illiquidity, and asset allocation constraints have tended to lead to terrific buying opportunities in times of dislocation. In private markets, these typically have appeared first in the secondary market as liquidity constrained and over-allocated LPs begin to sell private equity holdings. The opportunities historically then quickly begin appearing in other sectors of the market in which Adams Street is active, such as our growth equity, co-investment, and private credit businesses. Our teams that price investments are excited about the new deal opportunities they expect in the coming months given current market volatility.

The team that is least able to take advantage of market dislocations on the new investment front is our primary team, since they are at the mercy of venture and buyout manager fundraising timelines. But our primary team typically only invests in seasoned venture, growth, and buyout managers who are similarly familiar with these market cycles; therefore, we expect uncalled capital from our primary team is poised to be called to take advantage of attractive buying opportunities.

A quick word on asset allocation. When public markets dislocate, some LPs can quickly become over-allocated to private markets since moves in the latter typically lag and are more muted. An unintended consequence is that some LPs stop making new private market commitments and/or sell their best assets into the secondary market. History shows that these actions often cause LPs to miss out on some of the best vintage years in the history of private markets.

During periods of such volatility, we have seen that many sophisticated institutional LPs temporarily increase their private market allocation target or reduce (rather than eliminate) new private markets commitments to ensure consistent vintage year exposure. Private markets will eventually adjust by either turning NAV into liquidity or by re-valuing businesses consistent with where public markets land. Experience has shown that LPs who pause or sell private markets holdings during dislocations often find themselves increasing commitments to future vintage years that have historically been less attractive than the vintage from which they abstained or sought to sell. This is an unintended market timing bet and as an investor we seek consistent long-term investment rather than trying to time the market.

Adams Street remains confident in our investment strategy and is excited about the investment opportunities in front of us. We appreciate your continued confidence and support, and we hope you find the above insights helpful and instructive. We remain at your service so please don't hesitate to contact us with any questions. ■

LEADING WITH FORESIGHT™

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*Firmwide AUM as of December 31, 2021 was $49.3 billion.