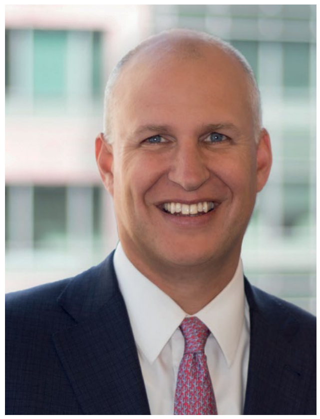
KEYNOTE INTERVIEW

The secondaries paradox



The overallocation and liquidity pressures driving LPs to slow new fund commitments are also the reason why now could be an ideal time to be a secondaries buyer, say Adams Street Partners' Jeff Akers and Joe Goldrick

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Q What is driving both the buyside and sellside in the LP-led secondaries space today?

Jeff Akers: For the past 10 to 15 years, the secondaries market has been accepted as a tool for portfolio management, and many sophisticated LPs have tapped into the secondaries market to rebalance their portfolios and manage risk. While that portfolio management driver continues to this day, we also now have, if not distressed sellers, then certainly highly motivated sellers. That is because, with the decline in public markets creating a 'denominator effect' where total portfolio value has fallen, some LPs are overallocated to private equity and starved of liquidity in a slow exit environment.

In a bid to generate liquidity and reduce their private equity exposure, investors are increasingly turning to the secondaries market. This has led to a decrease in private equity allocations and, in some instances, the elimination of unfunded commitments. However, this seemingly contradictory trend is also freeing up capital for those LPs who wish to reinvest in their most trusted managers as they raise new funds. The primary impetus behind this sell-side activity is the desire to create liquidity in a market that is currently experiencing a shortage of it.

In terms of the buyside, we believe we are in a market where there are high-quality assets for sale and strong discounts still available. There are also interesting opportunities for structuring transactions with deferrals and other mechanisms with the goal of creating attractive underwritten returns. So, on the buyside, the key driver is as simple as great assets at great prices.

Q What do you see as the key structural benefits of secondaries funds?

Joe Goldrick: We think of the advantages that secondaries bring in terms of the three Ds: duration, which is typically shorter than a primary private equity fund; discount, which can accrue early returns and offer some J-curve mitigation; and diversification across vintage, companies and GPs. When you put those three things together you frequently get lower risk with similar return potential to a primary fund, particularly on an internal rate of return basis.

The three Ds also mean you are getting immediate cash yield. Even in times of low liquidity, like now, we are still seeing cash yield because we are buying companies mid-stream and because diversification means a wide range of exit routes and outcomes are available.

Q To what extent are those benefits shared by both LP and GP-led secondaries?

JG: The benefits of duration, discount and diversification are well understood in the context of LP-led secondaries, but in our view, and in the past six to nine months in particular, a lot of those attributes are applicable to the GP-led market as well. That is particularly true if you skew towards multi-asset deals.

Because liquidity has been in such short supply, GPs have become significantly more willing to present continuation vehicle solutions to LPs with discounts applied than was the case a year or two ago. The ability to buy quality assets at a discount and then allow growth to compound the returns is what is driving strong appetite for both LP and GP-led secondaries, and that is why secondaries fundraising remains stronger than some other areas of private markets.

Q What do the liquidity and overallocation issues that are driving secondaries sales mean for LP appetite for secondaries funds, and why is this a good time to be adding to allocations?

JA: We believe the secondaries industry is an attractive long-term asset class that can generate strong returns across cycles with some of the lowest dispersion rates in the alternatives universe. Having said that, private equity could well be in for longer hold periods. It is already an illiquid asset class, but it could become more illiquid still, given the slowdown in IPO and M&A activity. In that context, secondaries can be used to provide investors with shorter durations, which is a great reason to consider adding this strategy to existing allocations. Secondaries also provide an opportunity to revalue and reprice older vintages, producing early returns to offset potentially slower value appreciation elsewhere, which can make it an interesting value play in today's market as well.

Q Which is preferable, a 25 percent discount on a lower grade asset or a 10 percent discount on a top-quality asset?

JG: We view growth as the main driver of outperformance. It is always a temptation to buy assets at a big discount, but often those discounts correlate with lower quality. Performance at the point of liquidation is driven by a combination of discount and growth. In fact, across our portfolio, approximately 20 percent of returns have been driven by discount and about 80 percent by growth. In this environment, you can clearly see that it is only the best-in-class companies that are being bought and sold in private markets, so that is where you want to be. If you can get even a 10 percent discount on those quality assets, then that is really additive.

It is also important to note that different managers have different valuation policies, so the headline price is not the only driver of discount. Sometimes, buying into a better quality fund with a more conservative valuation policy at a 10 percent discount actually represents a much bigger discount to a mark to market or fair value. We have found that the predictability of achieving returns with high-quality GPs and high-quality assets is strong. They have been more likely to surprise you on the upside and less likely to surprise on the downside. So, overall, we would prefer the top-quality asset.

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JEFF AKERS

Q Conversely, why is now a bad time to be cutting or postponing allocations?

JA: It is very hard to time the market and so you always want to be ready. Some of the best windows have occurred when LPs have the least capital to commit. The paradox of secondaries is that LPs' lack of liquidity to invest in secondaries funds is precisely what makes those periods such attractive times to invest in the secondaries market. As a long-time secondaries market participant, we think there are almost always good investments available for sophisticated secondaries buyers, but certain periods have provided even stronger opportunities and we believe now may be one of those times.

Q Why are strong GP relationships so important in what is an attractive, but also a volatile, secondaries market?

JG: Volatile markets are correlated

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>
> **JOE GOLDRICK**

with uncertainty – whether that be around company prospects, valuation multiples, financing, or a combination of those.

Strong and well-tenured GP relationships can provide key advantages in that type of environment. They help to cut through uncertainty and allow a secondaries buyer to have more accurate, real-time insights about company performance and what buyers may be willing to pay for companies in the market.

The best GPs can also be restrictive about who they allow as a replacement LP in a fund. Some of the most attractive deals we have done involved situations where the GP limits competition to a small set of buyers who are already investors in their fund and we pick two or three funds out of a larger portfolio.

These invitation-only opportunities increase during periods of volatility because GPs want to strengthen primary relationships to support ongoing fundraising in a difficult market and want secondaries processes to operate as efficiently as possible.

We believe our volume of interactions has deepened our insights into GPs and helped us become more informed buyers, in some cases leading us to opt not to pursue certain deals while adding conviction for other opportunities.

Q Presumably GP relationships are particularly important when it comes to GP-led transactions?

JA: When it comes to GP-led secondaries deals, investors with a primary platform may be offered significant access to the GP's firm leadership, allowing buyers to be proactive and educate the GPs about the market. In turn, this can help craft transactions that are beneficial to existing LPs, to buyers and to the GPs themselves.

Over the past three to four years, when continuation vehicles have become increasingly prevalent, access to many of the best deals in the market has been reserved for those that the GP knows well, or because the GP has carved out an allocation for its primary investors.

Q How do you ensure alignment with GPs?

JA: There are two elements to alignment. The first is economic alignment – the ability to influence terms and ensure the GP is putting significant capital and carried interest at risk. Those are helpful elements, and in many ways requirements, in our deal selection process.

What is often overlooked, and what we believe to be as – or even more – important, is moral alignment. At Adams Street, our investment philosophy brings to bear the strength of the GP relationship across our strategies, from funds of funds to co-investment and private credit, on all of our deals. That creates this moral alignment where GPs recognise the importance of the relationship across those strategies. You want to be on the same side in terms of dollars and cents, but it is as important to be likeminded and to have joint longer-term interests at stake. ■

Jeff Akers is a partner and head of secondaries investments at Adams Street Partners and Joe Goldrick is a partner on the firm's secondaries investments team