Where Does Competitive Edge Exist in the Secondary Market?

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KEY TAKEAWAYS

- Competitive edge still exists in an evolving secondary market, dependent on a buyer's positioning and access
- The benefits of an existing primary platform and associated relationships are difficult to replicate and provide select buyers potential access and diligence advantages
- Recent volatility and continued uncertainty are expected to favor targeted secondary buyers who have a bias towards quality and returns driven by fundamentals
- Small- and mid-market funds possess attractive characteristics for secondary buyers that we believe should persist
- Mid-sized secondary buyers are operating in an undercapitalized sub-segment of an already undercapitalized market, resulting in attractive competitive dynamics

A question that arises in an evolving secondary market that has seen a proliferation of large funds and new entrants is whether competitive edge and the opportunity to produce excess returns still exists.

We believe the answer is yes, so long as some combination of four key transaction attributes is present. While these elements individually can lead to market inefficiency, taken together they tend to reinforce one another.

Leveraging Primary Relationships

A minority of secondary market purchasers have robust primary capabilities that often come with deep general partner (GP) relationships and Limited Partner Advisory Committee seats. These can give secondary buyers a process and due diligence advantage in traditional LP-led and GP-led transactions.

Related to process, many of the best GPs restrict who they allow as a replacement LP in their funds. This creates a narrower buyer universe that limits competition to purchase any one fund interest. Sourcing and gaining meaningful allocation to hard-to-access, oversubscribed GP-led transactions can be improved by the depth of the relationship with a GP, where prospective buyers can leverage relationships to gain an early look at a potential transaction along with the opportunity to help shape the portfolio for sale.

When it comes to due diligence, buyers with better access to the underlying GP's deal leads, GP valuation materials, and assessments of the fund's performance can enjoy a distinct advantage. In many cases, the insights captured as part of a robust due diligence process reveal otherwise hard-to-identify opportunities for near-term liquidity, gaps between net asset value and where near-term value may be realized, and underlying resiliency and risk in portfolio company business models.

Avoid Index Buying Through a Targeted Strategy

Many secondary transactions come in the form of highly diversified portfolios of LP interests.

During periods of historically low interest rates and a roaring bull market, where exit multiples were driven higher, secondary investors were able to benefit from buying "levered beta". More recently, however, broader market volatility has led to significant variation in sector performance, manager valuation policies, approach to financial leverage, and company-level performance. We believe asset selection is especially important during periods when the index experiences volatility and the underlying performance of funds and companies is varied.

Focusing secondary purchases on top-quality managers, high-performing assets in growth sectors, and then diversifying these investments at the fund level can allow buyers to construct a portfolio with attractive and durable underlying company fundamentals. This historically has meant buyers can generate returns from discount at entry as well as from underlying growth in the value of the assets purchased.[1]

Access to the best-performing funds and managers can serve as a key source of competitive edge for select secondary market buyers, particularly targeted investors focused on SMB funds where the potential for outperformance is greater

We think today's secondary market provides ample opportunity for buyers to pursue this strategy. Many secondary portfolios are ultimately sold in pieces to multiple buyers, because of the buyer restrictions already mentioned, or as sellers seek liquidity for only a portion of the portfolio they are marketing.

Growth in GP-led transactions has provided another avenue to target specific transaction and manager attributes. We view GP-led transactions as a permanent and growing tool GPs can use to bring high-quality, defensive businesses to market. And for secondary buyers, GP-leds are a strong compliment to the targeted options in the traditional LP secondary market.

Focus on Small- and Mid-Market Buyout Funds

The appeal of acquiring small- and mid-market buyout (SMB) assets in the secondary market is driven by two core factors – access and return potential.

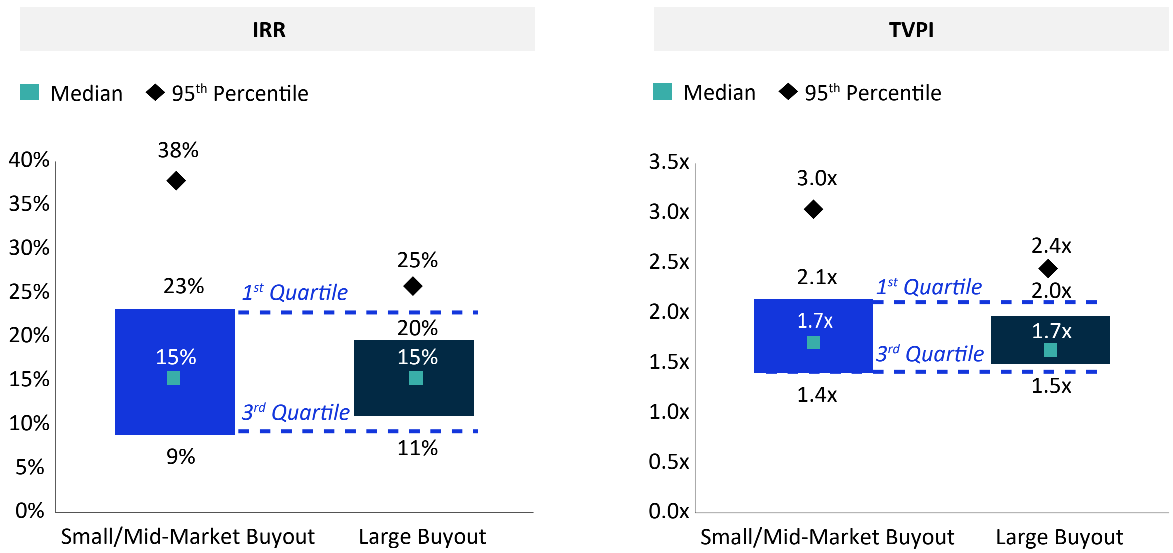
Access to some of the best opportunities can serve as a key source of competitive edge for select secondary market buyers, and we believe secondary investors targeting SMB funds are well placed to capture this edge. SMB funds tend to have smaller LP bases, and we find that SMB GPs place a higher value on existing relationships with their primary capital providers than other segments of private equity. As a result, the potential benefits that accrue to secondary firms that also have strong primary relationships are often even more pronounced with SMB GPs.

Additionally, we see more variance in valuation policies in the SMB space, which requires an ability to track and analyze a manager's approach over time. Wide dispersion in valuation policies can make it more difficult for a generic buyer to understand the valuation parameters of what they are acquiring. In turn, buyers who can pair robust, long-term data sets with access to deep company-level underwriting have a distinct advantage in diligencing less competitive transactions for these interests.

SMB funds also provide an enhanced risk-return profile when compared to large buyout and this can be particularly true when investors have access to some of the best GPs (see Figure 1). We believe this will continue due to key performance drivers, including more avenues for value creation, multiple paths to liquidity across market cycles, and a greater chance of outperformance. We expect this dynamic will be positive for SMB secondary buyers with primary relationships in the target space and deep expertise in underwriting these assets.

Small- and mid-sized companies generally have more room to improve operational efficiencies and a greater potential to impact growth. These companies are often in the early stages of institutional capital, meaning they have yet to realize the full potential of the operating expertise that institutional investors can bring, such as experienced management teams, technology and infrastructure upgrades, and synergistic cross-selling among the ecosystem of portfolio companies. The size of the businesses also allows more agility when implementing improvements compared with their larger counterparts.

Figure 1: Access to the Best SMB Funds Can Drive Outperformance[2]



Focus on Undercapitalized Segments

While the secondary market continues to attract capital, overhang (defined as years of transaction volume that can be completed with current equity dry powder) remains low relative to other segments of the private equity market.[3]

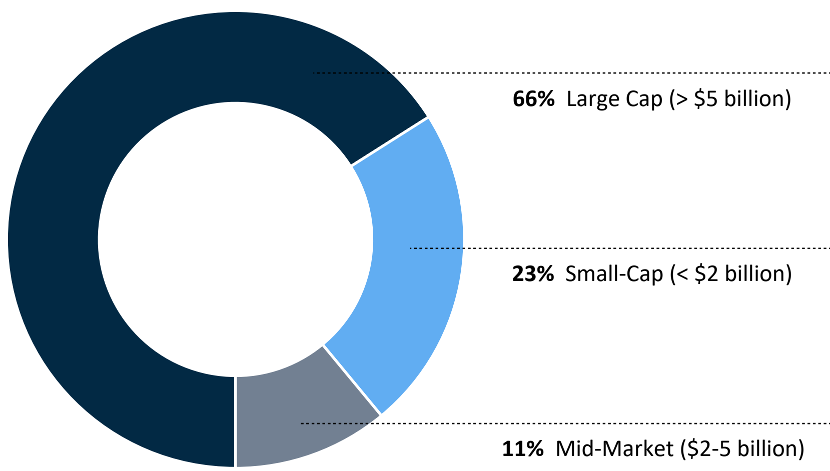
But the buyer universe is no longer homogenous, with various secondary buyers pursuing specific segments and/or transaction sizes. As Figure 2 shows, dry powder held in secondary funds is concentrated at the large end of the market. Fundraising data shows that, in recent years, many historically meaningful mid-market buyers have shifted focus to larger deals as they have raised large funds to invest in secondaries, while new entrants have generally come into the market at the smaller end without the benefit of existing GP relationships or a record of acquiring secondary interests.[4]

Further, new retail capital raised through funds registered under the U.S. Investment Company Act of 1940 have generally focused on large and diversified transactions that mid-market buyers do not target, according to our market observations.

All of which creates an imbalance in the mid-market, where fewer buyers are actively participating, leading to more attractive competitive dynamics. Transactions between $50 million and $250 million generally have a lower depth of competitive bidding from credible buyers. Pursuing such transactions aligns well with other pockets of competitive edge already mentioned. Targeted transactions and SMB funds often trade in the $50 million to $250 million range, further enhancing the benefits of other pockets of market inefficiency.

Figure 2: Dry Powder Concentrated at Large End of the Market[5]

Secondary funds with more than $5 billion in dry powder account for about two-thirds of total available.



Competitive Edge Can Enhance the Allure of Secondaries

Fundamentally, the allure of secondaries remains the attractive absolute and risk-adjusted returns the asset class has historically delivered while providing structural benefits such as discounts, earlier liquidity, diversification, and shorter duration.[6]

But as the market evolves, the ingredients required to provide these benefits also evolve. Identifying a secondary fund manager that pursues the key sources of competitive edge is critical. When done well, those sources can reinforce one another. We believe that competitive edge is fundamental to outperformance in the secondary market and that select focused buyers with deep relationships have the best opportunity to deliver attractive outcomes. ■

1. There can be no guarantee that estimated discounts are accurate, that a discounted investment will ultimately be successful, or that any such discount will be realized. Past performance is not necessarily indicative of future results.
2. Source: Based on Burgiss data as of June 30, 2024. Numbers are subject to updates by Burgiss. Burgiss is a recognized source of private equity data, and the Burgiss Manager Universe includes funds representing the full range of private capital strategies; however, it may not include all private equity funds and may include some funds which have investment focuses that Adams Street Partners does not invest in. Data and calculations by Burgiss, sourced on October 6, 2024. The returns presented herein do not represent the return of Adams Street or any particular Adams Street Partners fund or investor. Small/Mid-Market Buyout defined as funds less than $5 billion. Large Buyout defined as funds greater than $5 billion.
3. Source: Jefferies H1 2024 Global Secondary Market Review, July 2024
4. Source: Preqin and Secondaries Investors as of June 2024
5. Source: Campbell Lutyens 2024 Secondary Market Overview
6. There can be no guarantee that estimated discounts are accurate, that a discounted investment will ultimately be successful, or that any such discount will be realized. There can be no guarantee as to the timing or attractiveness of liquidity events. Past performance is not necessarily indicative of future results and there can be no guarantee against a loss, including a substantial loss of capital.

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