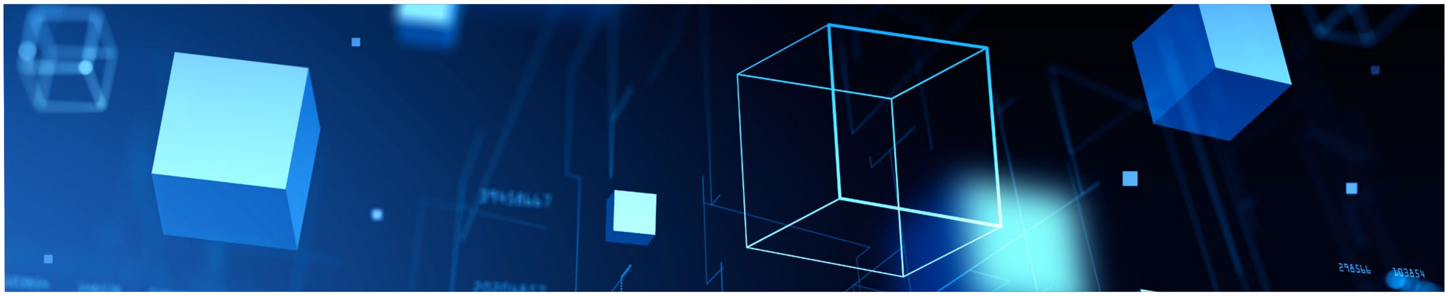
Capturing Secondary Market Structural Benefits – A 3D Perspective



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KEY TAKEAWAYS

- The traditional benefits of secondary investing – discount at entry, shorter duration and increased diversification – are critical to generating attractive risk-adjusted returns
- An evolving secondary market requires buyers to be prepared and purposeful in their investment and portfolio construction approach to target and optimize such benefits
- Secondary buyers with deep fund- and company-level insights gained from long-term GP relationships and private market data are typically well placed to deliver the structural benefits LPs desire

Driven by advances in filmmaking equipment, production techniques, and visual effects, 3D movies came a long way in the 56 years between the 1953 sci-fi classic “It came From Outer Space” and James Cameron’s iconic “Avatar”.

Secondary investment strategies have similarly evolved over time. In addition to traditional LP-led transactions, the range of transaction types has expanded to meet the needs of secondary investors, GPs, and LPs. Solutions now include GP-led continuation vehicles, tender offers, preferred equity, fund recaps and asset sales, captive team spinouts, and structured liquidity solutions, among others.

But at a fundamental level, the rationale for secondary market participants remains the same – secondaries can provide structural benefits with the potential to generate strong equity returns with relatively lower dispersion rates.

At Adams Street, we think of these structural benefits in terms of three Ds – discounts, duration, and diversification.

First Dimension: Discounts

Secondaries are often acquired at a discount, which can help mitigate the impact of the J-curve and provide immediate unrealized gains.[1]

However, not all discounts are created equal, making it important to appropriately analyze the fund and companies' valuation policy, growth profile, and risks, among other factors consistently over time.

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Thorough reviews by secondary managers can enhance the likelihood of accurately determining the value of underlying companies relative to their holding value in a fund. Given differing GP valuation policies and company quality, not all gaps between price and value are reflected in a discount. Many "value buys" can be based on an arbitrage that only becomes clear in subsequent quarters – or even at the point of exit. Access to comprehensive and unique real-time operational data and longer-term GP valuation trends can provide an information edge that boosts the chance of spotting such arbitrage opportunities. As such, real-time access to GPs, paired with historical valuation data, can drive unique insights to determine which managers and companies have the most conservative valuations.

Sourcing and diligence advantages that often derive from buyers with large and long-standing GP networks can also increase the potential to capture arbitrage when participating in secondary transactions where GPs restrict buyer lists, since less competition often means less efficient pricing.

And finally, a targeted approach, typically characterized by buying one or two managers at a time in a transaction, can help to isolate the benefits of any early gains found.

Second Dimension: Duration

The nature of secondaries inherently results in shorter duration, since investors are acquiring funded portfolios later in their life to benefit from the expected near-term harvesting of the underlying companies.

This target fundedness and duration profile can benefit an investor in numerous ways. It can significantly reduce or eliminate blind pool risk, provide access to a fund at different points in the value creation curve, and drive near-term cash distributions.

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The shorter duration of secondary investments can be attractive to LPs seeking strong, often more consistent cash yields and a realized return on their investment more quickly than is typically possible by investing in other private markets strategies.

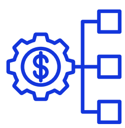
Bottoms up underwriting, combined with exhaustive asset reviews, provide insights about exit timing, and inform portfolio construction by providing a detailed view on the current duration profile, along with a fund's liquidity pattern. These insights help a secondaries buyer to dynamically target deals with specific duration profiles that meet broader fund objectives.

Practically, within the GP-led corner of the secondary market, this can lead to a focus on multi-asset transactions, which have historically provided a shorter duration profile compared with single-asset transactions.

And focusing a strategy on high-quality managers and companies can position a portfolio to drive predictable, early liquidity even when there are surprises. Quality is especially important in low liquidity environments like today's. Growth is a key driver of performance across cycles, so best-in-class companies are more likely to command competitive auction processes at exit, increasing the likelihood of liquidity when GPs seek it. Lower quality portfolio companies can be hard to sell, especially in a constrained exit environment.

Third Dimension: Diversification

While we fundamentally believe that a targeted secondaries strategy that leverages the structural benefits mentioned above can create outperformance, diversification and portfolio construction are important tools to control risk and optimize returns.



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A high-touch portfolio construction approach to diversification can result in some of the lowest dispersion rates in the alternatives universe, while still producing strong absolute equity returns.

Instead of allowing sellers of "market deals" to dictate the profile of a fund, sound diversification means proactively and dynamically allocating capital to targeted deals based upon the existing exposure profile of the secondaries fund. This requires continuous monitoring of the risk variables of new deals to ensure optimal portfolio construction.

The Benefits of 3D Vision

A targeted secondary investment strategy that leverages long-tenured GP relationships to drive sourcing and diligence advantages can offer distinct structural benefits to LPs that are key to generating attractive risk-adjusted returns.

To optimize these benefits for LPs, secondary buyers' sourcing and diligence should involve consistent, detailed reviews of GPs, funds, and companies. Company-level examinations should include current and potential financial performance, operating momentum, underlying market strength, business model durability, and market appetite from strategic and financial buyers to acquire the company. Moreover, insights need to be calibrated over time as part of regular ongoing monitoring, rather than opportunistically conducted when a deal is on the horizon. Secondary buyers that benefit from long-term GP relationships and private markets data are often best positioned to carry out this approach.

As long-time secondaries market participants, Adams Street believes there are almost always good investments available for sophisticated secondaries buyers. Certain periods provide even more attractive opportunities, and we think now may be one of those times. ■

1. Due to the illiquid nature of private equity investments, such gains are limited to reported valuation as such investments may not be realized, potentially for years and valuations are both subject to (i) change and (ii) as discussed below, the accuracy of the GPs valuation procedures.

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