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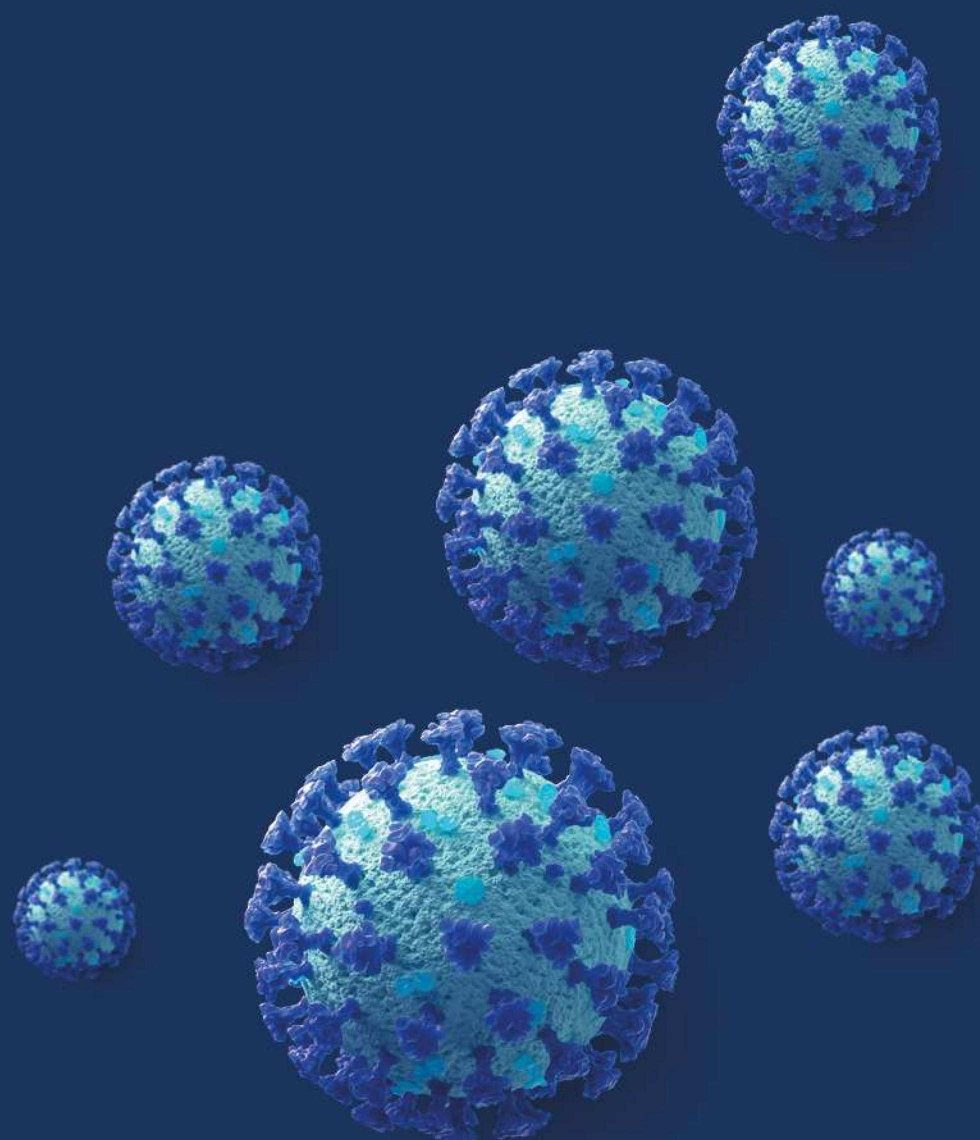
Searching for Opportunities in a Crisis



April 2, 2020

Searching for Opportunities in a Crisis

We are frequently asked about what opportunities we believe will emerge as people move past the shock of the market volatility and start looking forward. We will attempt to lay out a roadmap for the sorts of dislocations and opportunities we believe investors will find as the markets inevitably recover from the COVID-19 crisis.

Some Historical Data

While the current crisis is primarily driven by health issues, it can be illustrative to look back at the vintage year returns coming out of the Global Financial Crisis (GFC). Because the early-cycle opportunities in credit tend to be more robust and fleeting than in private equity, we are presenting the 2009-2010 returns for various debt categories. The equity-oriented opportunities tend to emerge once stability returns, so we are showing historical returns for 2010-2012.

Multiple vintage years are presented in the table as new fund formation in the wake of a crisis tends to be thin and a larger universe that includes funds formed in subsequent years is more representative of clients' potential exposure. The use of middle second quartile results reflects typical experience for most investors with well-constructed and diversified portfolios. All indices are from Burgiss Private IQ.

Strategy	Vintage(s)	Mid 2nd Q IRR	Mid 2nd Q TVPI
Sr Private Debt	2010*	11.3%	1.34x
Mezzanine Debt	2009-2011	12.0%	1.47x
Distressed Debt	2009-2011	13.1%	1.52x
PE Secondaries	2010-2012	15.9%	1.60x
US Buyout	2010-2012	19.7%	1.93x
Global Buyout	2010-2012	17.3%	1.80x
Venture Capital	2010-2012	20.0%	2.37x

*Due to the limited sample size, 2009 Senior Private Debt was omitted

NOW – Providing Liquidity

The opportunity in the near-term is to provide liquidity where there are forced sellers of otherwise high-quality assets. We expect the first wave of opportunity to be across the credit markets. Opportunities tend to exist where either buyers exit the market for a time or holders are under pressure to generate liquidity both of which creates a significant market imbalance. We saw this in early 2016 when some credit hedge funds were unwinding. The opportunity is typically for short-term gains of around 10% to 30%. Because the duration of the opportunity is short, the multiples earned tend to be modest with high IRRs driven by the shorter hold periods.

Dislocation funds are typically raised on a contingency basis and activated if the opportunity set warrants. In recent years that has meant that the funds would go undrawn. However, in the current environment we are seeing such funds actively investing. A number are also being raised on very short timelines to pursue trading-oriented opportunities.

Distressed debt funds will acquire loans at depressed levels and work with the borrower on a restructuring that would allow repayment of the loans. This process takes time, so historically the multiples earned have tended to be fairly consistent, however time degrades IRR. In addition, the opportunity for capturing returns may last for some time, as it will take a period of stability to be able to assess the value of a company or assets securing the debt. Expected multiples of 1.5x would be in line with prior cycles as seen in the table at the beginning of the paper. Be aware that it can be painful to invest early in the cycle as distressed companies can continue to deteriorate and full recoveries are not assured, especially if the crisis drags out. The GFC was a particularly weak cycle for distressed corporate investing due to the shallow recovery, whereas investors made significant profits in the mortgage market.

Private debt (origination) timing is good as credit spreads have widened. Coming out of the GFC there was a period where returns north of 12% could be earned in the types of senior debt securities that last year were yielding about 6%. Even just looking at 2010 returns for Senior Private Debt strategies, it was possible to earn an 11% IRR with fairly modest risk.

There were also attractive returns to be made in the subordinated debt market as yields were north of 15%. However, such opportunities tend to be fleeting and spreads tightened within the typical investment period of a closed end fund. It will likely be a vintage of higher returning private debt funds, but one should not expect spectacular returns. Mezzanine debt returns from vintage years 2009-2011 were 12%, but there were only two mezzanine debt funds in the 2009 universe so the ability to capture superior returns were quite limited.

Special situations investments in the form of highly flexible mandates seem timely. The flexibility is necessary given that we do not precisely know where the best opportunities will lie. Structured credit, sector-specific strategies, asset backed debt, and various specialty finance strategies would fall into this opportunity set. Selecting a fund with a flexible mandate puts the asset selection decisions into the hands of someone who is closest to the market and can act quickly as opportunities emerge. This is a similar rationale for why multi-strategy hedge funds are an important part of one's hedge fund portfolio.

Relatively Soon – Mispriced Assets

Secondary private equity was one of the best opportunities that came out of the GFC. Pricing was as low as 60% of net asset value and the private equity market performed well for the next decade. It may take a year or more for the current investment opportunity set to fully evolve. The underlying economy needs to stabilize in order to be able to price portfolios. In the near-term low-ball pricing could be offered to account for the eventual valuation declines, but more likely is that the market will freeze as the bid-ask spreads increase significantly. Vintage years 2010 and 2011 had the highest pooled cumulative returns in the last twenty years at 1.60x and 1.63x respectively. We believe this sector will likely be a good place for deploying capital, but there is a lot more capital available in the hands of potential buyers than there was ten years ago.

Hard assets such as aircraft will likely go through a period of distress, and this may be a good entry point for investors. A clearer picture of supply and demand would be necessary to enter this space with a reasonable level of confidence.

Energy would have been an area of interest even without COVID-19 as the Saudi/Russia feud drove down the price of oil just as demand was negatively impacted by the current pandemic. Although fund managers may claim otherwise, we believe that successful returns in energy are significantly determined by the relative price of energy commodities when the fund is deploying capital. Now would seem to be an extremely favorable environment for new investments, but potential balance sheet issues with existing upstream companies make an entry via the secondary market quite complex despite significant discounts. Some clarity will likely come once we get past April, when lenders can reassess the reserves backing their loans to their problematic companies.

Recovery

One of the effects of a public market downturn can be that investors find that they are over-allocated to illiquid assets. As such, some will rebalance through the secondary market, but it is more common for such investors to reduce their future commitments and the allocations to even their highly rated fund managers. That tends to leave space for new investors in historically access-constrained fund managers. This opportunity to form new relationships or expand one's key relationships can be a source of significant long-term value. The highest returns coming out of the GFC were earned in US Buyouts and Venture Capital assuming one was able to invest in middle second quartile funds that are the mainstay of well-constructed diversified portfolios.

As shown in the opening table, returns coming out of a down cycle can be quite attractive. Although one might assume that the depth of the GFC would have favored the early cycle strategies over the long-term plays, there was a fairly consistent ordering of risk and return from private debt through venture capital. If one has sufficient liquidity, the current market volatility should provide attractive opportunities. Stay the course with your core managers and prepare to make some opportunistic allocations should attractive opportunities arise.

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