Altera Investments

2020 Midyear Playbook: Navigating a way through

A Note From the Author

PREAMBLE

To say that we are living in – and investing in – strange times would be an understatement. The COVID-19 pandemic is an unprecedented crisis for humanity, with governments, companies and financial managers responding in extraordinary ways to the profound challenges created by the virus. While we don't profess to have any special insights into how the current situation will unfold more broadly, this report offers perspective on how our certain areas of the alternatives space might react and perform.

As a firm, Altera is a step removed from the traditional wealth manager and our scope is limited to the private markets. However, given that our investor base is comprised of RIAs and private investors, we try to approach things through a lens that considers the client portfolio as a whole. A positive externality of this "allocator's perspective" is that it often illuminates themes that go undiscovered when peering through a tighter aperture. In the same way, this report looks at the big picture and is hopefully a useful reference for investors thinking about their tactical allocation strategy.

Lastly, we are well aware that writing a manager's report in such times is a risky pursuit. You can write smart, insightful letters quarter after quarter and nobody notices; then you write one letter that misses the mark and everybody's talking about it. We hope you enjoy our synopsis as we attempt to capture the essence of this very unique moment – and hopefully, history will be kind to us all.

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MACRO

A quick review of the current environment is warranted. We think it can be summed up as follows:

The domestic economy just suffered its worst economic contraction since the Great Depression, with the pandemic likely being the greatest exogenous shock in modern economic history. As a result, the economy froze for a quarter of the year and global cash flows virtually ceased. In response, policymakers had to replace those cash flows or risk global financial disorder. This included record-setting stimulus, in both size and speed, to stabilize the economy and restore investor confidence in the capital markets.

The second-order effects of the situation outlined above include:

1. The reduction of rates to near zero has increased demand for risk assets
2. Liquidity creation has pushed up asset prices
3. The monetary and fiscal response was largely indiscriminate
4. The long-term effects at the corporate and household level create new uncertainties
5. Policymakers are willing to provide support into future with bounds unknown

These interventions and their second-order effects have humbled many professional investors and serve as a reminder that public policy response matters greatly. After the Great Financial Crisis (GFC) the Fed's balance sheet essentially became the balance sheet of the banking system. Due to the ballooning debt balance, the Fed ostensibly has indirect controls over the U.S. Treasury – and is further removing already blurred lines with corporate America. Policymakers walk a fine line between preventing economic calamity, avoiding future moral hazard, incurring unsustainable levels of public debt, and controlling the stability of currency. The sustainability of the recovery walks an equally fine line as we move forward in the election cycle.

PRIVATE MARKETS OUTLOOK

Altera has a unique seat at the intersection of the real economy and private capital markets. This crossroads is particularly challenging to navigate right now because it is telling two different stories. Unlike the GFC where tremors began in the financial sector before moving through the rest of the economy, the current crisis primarily began on Main Street. Today, Wall Street has mostly recovered from the March downturn, while the real economy has barely begun to; Wall Street has effectively been bailed out while programs designed to assist Main Street have been largely inadequate. Real risk remains that COVID-19's effect on consumer activity will last long enough to morph into a financial crisis. The path forward is extremely uncertain and will ultimately depend on the trajectory of the virus.

Another disconnect exists between the public markets and their private counterparts. There is usually a lag between public markets falling and private opportunities beginning to surface. In the GFC, public markets fell much more than private markets, so private capital moved into the stock and bond markets until prices eventually reached somewhat of an equilibrium. However, the recent melt-up in equity and credit markets has uprooted this relationship, as public prices have deteached from their private counterparts and the real economy.

Although prices may remain in a non-equilibrium state for protracted periods of time, at some point they converge with reality due to reallocation or deallocation of capital. A great example of this inevitable convergence is WeWork – a prosaic operating business that was branded as a technology-empowered, futuristic innovator with boundless possibilities. Rather than describing itself as an unprofitable office landlord that depended on unusually short leases from its tenants, WeWork presented an

image that was a complete mirage. However, the quickly growing, high-cash-burn company's flame burned out when it unsuccessfully tried to tap public markets and ran out of liquidity. WeWork's collapse highlights the sometimes-grim intersection between the real and financial worlds.

Unicorns aside, the ratio of total value created in the private markets, relative to that of the public markets, has increased substantially in the 21st century. Public companies are older on average now than they have ever been and are returning more capital than they are issuing. Consequently, the majority of the enterprise growth in our economy is occurring in private markets. And as private capital sources have expanded, the advantages to a public listing are slim. The only major reason to go public today is for founders to "cash-out" and monetize their investment. Against this backdrop, we think investors are currently much better compensated for risk in private markets.

Current Themes

The 2020 economic shock has been devasting for many businesses and will certainly leave lasting scars. However, dislocations like this are usually catalysts for disruptive change. We see several clear implications and trends emerging from the crisis so far:

DIGITALIZATION. The economy is shifting from analog to digital as companies are taking action to accelerate automation initiatives. Necessity being the mother of invention, consumer changes, and supply chain ruptures are forcing transformation in many business models. Companies have found new efficiencies and new ways of doing things, enhancing overall productivity. The remote shift in workforce and business communications will forever change how businesses think of labor. And the longer both employees and employers get used to new ways of working, the less likely things will simply return to the way they were before.

The companies that most aggressively adapt and extend new ways of operating will turn this crisis to their advantage.

ACCELERANT. Tends that were already underway have been amplified. In a period of months, industries have achieved levels of technological change expected to occur over a decade. Events that would typically span years have been compressed. Technological disruption has elevated many business models while damaging others. Some value creation plans for traditional businesses need to be re-written; others need to be thrown out entirely. Business models that were suspect before COVID, are likely destroyed in a post-COVID world. Non-essential retail has seen a dramatic decline in revenue as in-store operations have ceased. No part of retail is immune from this trend, as this accelerated shift to e-commerce has pushed even the most online-resistant goods forward on the inescapable journey to full online acceptance. The scramble to reestablish supply chains during the pandemic further underscored their inflexibility and opacity, forcing companies to become more self-reliant. It is unclear which of these trends are permanent and which are temporary, but the rate of change has almost certainly been increased.

PRICE-DISCOVERY. We expect the volume of private investments to decline in the short term as bid-ask spreads are wide in various markets. Armed with little reliable data in a constantly shifting environment, buyers and sellers are hesitant to reprice private assets right now. Private market pricing has a propensity to adjust slowly to changes in value anyway. In buyout markets, multiples have stayed up because of residual demand from pre-COVID deals underwritten in 2019. But the massive changes brought about by the economic paralysis make it difficult for dealmakers to develop conviction around valuations. That shows up in the anemic market for exits, which are depressed across the globe. This is part behavioral and part structural. Sellers are anchored to prices from months ago and unwilling to sell at a subdued price. They will stay

away from the deal table unless they are forced to transact. Over time, buyer and seller views on pricing will converge and pressure to sell will build. But for now, private market activity will be subdued, as sellers are unlikely to exit at a discount unless they absolutely must. The effect on private equity and private real estate funds is slower cash distributions and longer holding periods.

SELECTIVITY. Human judgment will be increasingly important, and opportunities will be more company- or asset-specific going forward. Deep sector expertise matters now more than ever as sectors are evolving or deteriorating rapidly. Prudent risk management is critical to control the downside and shrewd judgment to recognize the upside. There will be greater dispersion between top and bottom management teams over the next five years, and alpha will be highly correlated with skill and alignment. Managers can no longer count on multiple expansion and will have to generate returns through value accretive means, including expanding markets and products, improving revenue, and optimizing costs.

DISTRESS. Despite a surplus of dry powder and swift recovery in asset prices, the magnitude of the pandemic's economic shocks will create opportunities for the tactical investors. Until recently, most of the corporate distressed opportunities in the market were concentrated in secularly challenged industries. Virtually overnight this situation changed profoundly, and pockets of distressed pricing have started to emerge in various asset classes. Over the past several months we have seen an influx of opportunities focused on solving very specific liquidity or covenant issues borrowers face. These are generally strong businesses experiencing dislocation or capital-constrained owners/lenders.

In Private Debt and Real Estate markets, many GPs tried to pull out of previously agreed-upon deals, sometimes invoking material adverse change (MAC) clauses. Many Private Equity firms

pursued public equity (PIPE) deals while others pivoted to pure distressed transactions. Going forward some markets will experience capitulatory forces that echo the distressed cycle from 2008-09 while others will take a different path as private credit markets have shifted away from traditional banks since the implementation of Dodd-Frank in 2010. Overall, the ability to access attractive opportunities across the business sphere will be abundant for the well-capitalized investor in the under-capitalized market.

LIQUIDITY. Before this exogenous shock, the world was sitting on record "dry-powder", but also leverage levels surpassing 2007 highs. The sudden halt in economic activity caught seemingly healthy companies off-guard. The significant operating challenges in this environment coincide with a point in time when there is also a maximum level of corporate debt. As a result, many sound business models are facing specific liquidity or covenant pressures. Moody's and Standard & Poor's have already begun slashing credit ratings. Companies have tried to strengthen their balance sheet by reducing capex and R&D. This ripples throughout the market as one company's capex is another company's revenue. Furthermore, reduced R&D supports cash-flow in the short term but lowers future growth potential.

A bright spot has been capital markets, which remain open in most industries. Not surprisingly, companies have been tapping this well as much as possible. The second quarter saw one of the highest-ever levels of junk-bond issuance by private-equity-backed companies, at more than $31 billion, according to Dealogic. It was the sixth-highest level for any quarter on record and the highest since 2014. The short-term effect of this liquidity rush has been positive by pushing the draconian default scenario out of the money, but over the long run, it is dilutive to equity value and will likely weigh on future growth.

CLARITY. A crisis brings clarity in several forms. As an investor, it is easier now to filter good management from bad, as we saw how leaders handled the crisis. Decisions made at the peak of the cycle have shaped current portfolios and will dictate what firms must work with through this period. Weakness has been exposed in cash burning growth companies dependent on subsequent private capital raises and unable to grow in a low demand environment. Real Estate has become more challenged as an asset class with deteriorating fundamentals for retail, hotel, and possibly office properties. More broadly, it gives a sneak-peak into how humans will interact and utilize different property types in the future.

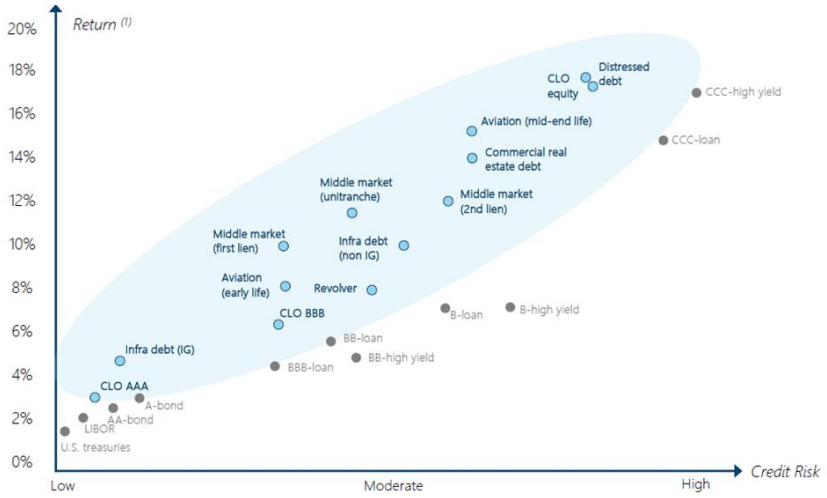
MARKET CALLS

Private Debt and Shadow Lending

A major story from the last decade has been the emergence of non-bank lenders. These lenders take many forms but are predominately private, unregulated entities directly originating loans. Every dollar of private equity needs about $2 of leverage, so as those funds are raised and deployed, they create growing demand for debt financing. The growth in private credit is, in part, to fill that financing need.

The other side of the equation is the growing appetite to invest in private credit funds, particularly from institutional investors. Pension funds, endowments and insurance companies are all seeking ways to earn higher yields and believe the risk-adjusted returns in private credit are attractive.

Figure 01: Risk versus yield in private lending markets



Source: JPMorgan Asset Management, "Private Credit Strategies: An Introduction", as of 8/31/19

Short-term performance figures for private debt funds are expected to be their worst since the GFC. As an early indicator, most public PE firms marked down their credit portfolios between 11% and 16% in Q1 2020 (Bain).

Many of the "Mega funds" saw the advantage of investing on both sides of capital stack in the GFC and have diversified offerings. Many of the business development companies ("BDCs") that trade on public exchanges today are owned by the same GPs. And while BDCs have become increasingly popular vehicles for retail investors to access the yields available in private debt markets without sacrificing liquidity, it is important to remember that liquidity cuts both ways. This year has served as a reminder of why illiquid assets belong in illiquid structure. The tremors in credit markets in the second half of March gave us a glimpse of how quickly Wall Street banks can raise repo rates and markdown or "run away from" illiquid assets. Many of the highly leveraged vehicles saw permanent NAV declines as they tripped covenants and were unable to meet margin calls. The stock market equivalent does not represent a legitimate exposure to the alternatives.

Leveraged Buyouts (LBOs)

According to Bloomberg, M&A activity fell by 50% and PE buyout deal count dropped 75% in the first half of 2020, the lowest level since the depths of the euro-zone crisis in 2012. However, the industry has $2.6T of dry powder on a clock that needs investments, and there's ample incentive to put this money to work soon. As the industry learned after the last recession, smart investments made near the bottom of the cycle tend to produce above-average returns if you move decisively. We have already seen a snapback in activity since May, with the tech sector constituting a rising share of activity. Given the strong balance sheets and the broadly stressed environment, it seems likely buyouts will accelerate, with less mature companies ill-equipped for this period as a primary take-out candidate.

Though add-on acquisitions have been an increasingly important part of sponsor-backed M&A for the last decade, the COVID-19 pandemic has propelled their use to new heights. PE add-on deals accounted for just over 70% of all buyouts in the past quarter.

Add-ons allow PE shops to pursue a buy-and-build strategy for a company, which can help bolster an already established portfolio company and increase earnings. The "platform" and "roll-up" PE-owned portfolio companies will be the most acquisitive candidates, as their capital structure viability is reliant on successful merger integration. This strategy will be key as PE firms attempt to cut their losing portfolio companies and increase the exit multiple for their portfolio.

Venture Capital

The effect of size on performance is even more pronounced in VC, which is arguably the most cyclical private market. Angel & seed-stage startups may require less funding to stay afloat during difficult times versus late-stage startups with higher cash burn rates. Moreover, PE firms have grown increasingly fond of crossing the wall and investing in VC-backed companies. The main targets are often lower-market high-growth tech (software/SaaS) firms, which are easy to add-on and integrate with portfolio companies.

Down and flat rounds occurred at a level not seen since the financial crisis, as investors are paying more heed to overall capital structures. Many have turned to more creative capital structures to raise funds, including an increased use of "equity kickers" through warrants, modeling out what an equivalent anti-dilutive mechanism would result in to establish price.

The length of the pandemic's effect is crucial for the VC exit environment. Exit count in 2020 is tracking to be the lowest since 2011, and value is pacing to drop back toward the levels seen pre-2017 (Pitchbook). The short-term aspect of this drop in liquidity is crucial, as an extended economic decline would change some longer-term behaviors around commitments to VC. Investors have traditionally relied heavily on in-person meetings before making new investments. Venture firms generally became much more

conservative around transactions as the pandemic hit the US in March and early April, leading to a downturn in both VC dollars invested and number of deals completed in Q2. Portfolio companies followed suit, adopting an understandably cautious outlook as they sought to reduce their burn rate through layoffs, cost-cutting, and curtailed expansion plans.

It Pays to be Early

There is a similar trend across the alternatives space: very few managers have succession worked out. Most senior managers are unwilling to pass on the firm to capable middle-managers due to subjective factors (i.e. Massive Egos). Consequently, many middle managers spin out and start their own fund. If we get early warning of a spinout, we are usually interested in exploring options for strategic partnerships. Many first-time funds are not as risky as they appear because they have been executing the strategy for a long-time. The area where first-time funds do struggle is in figuring out how to manage business aspects of the fund. This can be addressed by pairing the manager with an institutional quality operational partner. This provides one of the best opportunities to capture lower-market alpha by investing before the fund reaches a size with significant competition and fewer investment targets.

Impact Investments

Despite the impact of the COVID-19 pandemic on markets and the economy, sustainable and impact-oriented investments shined more brightly, in relative terms. In public markets, sustainable investment strategies outperformed their conventional brethren. A general underexposure to energy, and overweight to growth played a role. In the private markets, investors connected the dots between the pandemic and climate change. Telehealth, along with ventures that seek to democratize health access continued to attract capital, as did ventures focused on education, agriculture tech and energy efficiency. The general theme was the resilience of secular trends underpinning the long-term viability of impact companies and funds.

The Best Offense…

…is a good defense. Sophisticated allocators have built out core exposures to alternatives with the concerted plan to build long term wealth through unique, non-correlated, independent investments. These groups remain committed to the asset class over the long term and recognize the importance of maintaining a steady pace of commitments to diversify vintage years.

The Largest 20 Endowments and the Super Endowments (in reference to their size) of Harvard and Yale held 55 percent in traditional asset classes with the remaining 45 percent allocated to alternatives. This additional diversification employed by the larger US Endowment Funds is one of the reasons for their superior long-term investment performance. This is the type of market where asset selection is key and dislocations are abundant. The best way to access those opportunities is in pools of dry powder that are not constrained by liquidity, leverage, or concentration. In a self-serving, but relevant interview, Blackrock stated, "*The key conclusion, however, remains: An allocation to private assets can potentially enhance a portfolio's returns, with little increase in liquidity risk*."

Closing Thoughts

CONCLUSION

Given high valuations in public equity markets and lower yields in fixed income, we believe alternatives – especially those presented in the Lower-Middle Market - offer a strong solution as investors look to mitigate those pain points.

Throughout the current crisis, we refer to the common principles and preferences that our investments share:

1. Focus on investments backed by hard assets
2. Invest in recession resilient assets with durable business models
3. Maintain diversification across vintages, assets, and structures
4. Avoid situations where financial engineering is the primary driver of returns
5. Take the "long view" – in order to maintain optionality and not get stuck holding undesirable exposure if the music stops

Although we remain macro-aware, we will not dedicate much time trying to predict the direction of the market - there are simply too many unknown and undefined variables. We will continue to rely on our core competency of identifying individual investment strategies that provide the option of owning for the medium to long-term.

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