altera

Q1 2022 Perspective

(Still) Turning the Corner

It is perhaps disingenuous to cite excessive valuations in any investment update – especially when the public markets are in decline, as they have been for much of 2022. As most investors know, valuations are poor timing tools and are seldom the catalyst for the next bear market. Yet, success when investing in deals, whether in a public or private market, is not removed from the price paid. Higher valuations have been closely associated with sub-par returns. So, it behooves investors to be cognizant of the price they pay.

As an advisor in the lower and middle market private investment sphere, valuation is implicitly part of Altera's DNA. Our focus on this segment is a recognition that elevated valuations are more likely to be present in the segments most traveled by global capital sources. From sovereign wealth funds to pension plans, from family offices to insurance companies, literally hundreds of billions of dollars need to be productively deployed on an annual basis. More money chasing the same deals drives up acquisition prices, lowering future returns to investors. However, such mega-sized investors just cannot participate in the lower end of the size spectrum.

Emerging from the pandemic, ultra-low interest rates worked in concert with fiscal support to keep both public and private markets afloat and vibrant. Turning the corner into a more normal economic environment, growth surged and is now beginning to moderate. Therefore, investors are charged with being highly selective in what appears to be a newly inflationary environment.

Altera's footprint in the lower and middle markets is a conscious decision to seek more attractive valuations, and our focus on investing in real assets and alpha generating strategies means that inflation might not be such an enemy after all.

MACRO

One year ago, the macro environment was characterized by record-scale stimulus programs that helped motivate investors to wade back into "risk assets." From a market function and economic activity perspective, these programs were highly effective. Real GDP growth, which slumped by more than 3% in 2020 rebounded by 5.7% in 2021. Economic conditions in early 2022 remain generally robust at the national level, but pricing pressures abound, and excess liquidity has found its way into assets of all types. Likewise, employment levels appear full, but their composition is differently comprised from prior periods.

These shifts mean that trends that were underway pre-pandemic (digitization, remote work, sustainability, etc.) might appear to be taking a back seat in 2022. Inflationary pressures and a clear outlook for rising rates have spurred an investor rotation out of stocks or to "old economy" sectors that have the highest operating leverage.

Investors with an eye on secular trends and company results (as opposed to just watching share prices) will see that these themes remain well in place and continue to grow, albeit divorced from market price action (as elevated valuations return to more defensible levels.) Investors may also notice the effects of inflation expectations on investor behavior, with spreads narrowing in previously esoteric sectors, such as self-storage, that have both pricing power and only modest cyclicality.

Other aspects of private market activity continued to evolve in 2020 and 2021. The emergence of SPACs (special purpose acquisition companies) as another avenue for private companies to exit to the public markets adds another twist to the saga of "companies staying private longer", and ESG factors, once a trend, are now firmly entrenched in analyses by private investors and fund sponsors.

Let's not forget that just two years ago, investors got their first taste of extreme public market volatility in a decade. This experience continues to shape investor attitudes towards using private market vehicles as part of their investment program. Surveys suggest that investors will continue to ramp up their exposure to private investments in 2022, attracted to the relative stability and to managers' recently demonstrated ability to affect the investment outcome during difficult periods.

Also factoring into investor decision making is the idea of "crisis investing". While expansive monetary policy may have prevented the creation of "deep value" opportunities, many investors are aware that commitments made during such periods tend to be among the best performing "vintages".

Only time will tell if this turns out to be the case with this cycle. But investor motivation suggested that greed had exceeded fear in 2021. The CNN Money Greed & Fear Index confirms this view of investor optimism. This equally weighted composite of seven market indicators hit an Extreme Fear level of 10 at the outset of the coronavirus pandemic in March of 2020. It had rebounded to an Extreme Greed reading of more than 80 by late 2021. (It is presently in the 30s as investors grapple with rising rates, inflation and a stock market correction).

This brings us back to the initial premise: investor selectivity will be key to profitable investing in alternatives. Venturing off the well-worn path of capital flows should improve one's chance of success.

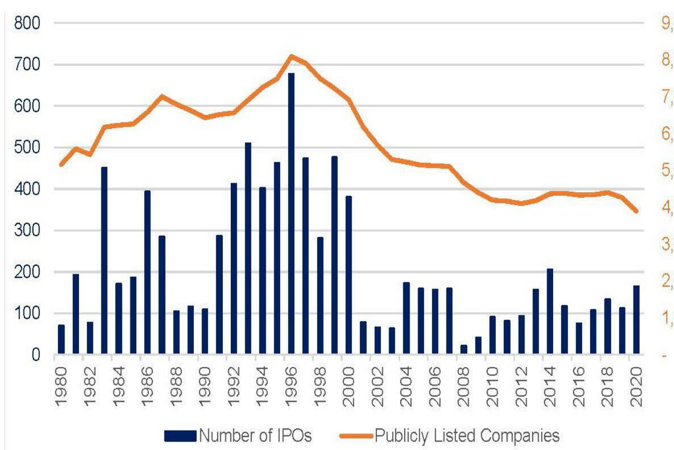
TRENDS & THEMES FOR 2022

While COVID-19 remains stubbornly part of life and business in the U.S., capital is still flowing robustly into many financial assets. Investors must now focus on identifying sectors that can provide attractive risk-adjusted returns. In this section, we explore some themes that will shape these opportunities and investment outcomes.

PRIVATE EQUITY – STAYING PRIVATE FOR LONGER

Companies are remaining in private ownership for a longer periods of time. As Exhibit 1 indicates, the number of public companies in the U.S. has declined by nearly 40% over the past 30 years (while the number of large, unlisted firms has climbed by nearly half).

Exhibit 1: Public Listings and IPOs Have Declined



Source: "Listed Domestic Companies, Total," The World Federation of Exchanges, 2020. Jay Ritter, "Initial Public Offerings: Updated Statistics," University of Florida, June 2, 2021.

One can debate the cause of this shift, and the relative merits of public versus private ownership, but as investors, we need to understand its impact on our own investing activities.

One consequence of the private for longer phenomenon is the development of an ecosystem for nurturing private companies into profitability and perhaps even prominence. Of particular note, is the part that private equity (PE) firms have played during the COVID-19 pandemic. In many cases, PE firms and sponsors played a critical role in their portfolio companies' survival. Contrary to the pop culture vision of PE firms as vultures, these teams interfaced with management to cut costs, manage liquidity, renegotiate leases, apply for PPP loans and, in general, position their companies to emerge intact on the other side.

We also see this beneficial ecosystem in the private credit industry where investor groups have replaced banks for much of the lending that has been regulated away from the banking sector. Hardly passive players, like their private equity cousins, private credit managers can play a critical role in the management of their portfolio holdings. They, too, helped companies survive an economic downturn that few could have predicted or prepared for.

As investors in private capital vehicles, this is inherently a positive underlying trend, providing a healthy flow of deals from experienced, professional managers. As always, selectivity remains critical as deal terms, manager tenure, and their ability to enhance deal value can vary greatly.

INVESTOR ATTITUDES – STILL POSITIVE TOWARDS PRIVATE

With market volatility a continuing challenge, and elevated public market valuations casting doubt on future returns, investors remain committed to private markets as a source of both diversification and return generation.

A recent survey by Natixis (Exhibit 2) shows that a substantial majority of institutional investors in private markets are considering an increase in their exposure, funded largely from U.S. equities.

Exhibit 2: Institutional Investors Are Still Increasing Allocations to Alternative Investments

	Increase	No Change	Decrease
Infrastructure	53%	44%	(3%)
Private Debt	43%	48%	(9%)
Private Equity	41%	50%	(9%)
Absolute Return Strategies	34%	55%	(11%)
Real Estate/REITs	33%	52%	(16%)

Source: Natixis Investment Managers, Global Survey of Institutional Investors, December 2020.

Another (broader) study reveals investor motivations: 80% of investors surveyed by McKinsey agree that private markets are less susceptible to short-term volatility than public markets. And an even higher 85% of investors expect private investments to continue to outperform public markets over the long term[1].

DRY POWDER – AND PLENTY OF IT

Much has been made of the uninvested capital that resides in the PE industry. This substantial amount of dry powder is a product of robust capital raising, of course, and causes some to suspect this is evidence of the worst of conditions for PE returns (too much money chasing too few deals).

According to S&P Global, 25 private equity firms hold more than $500 billion of

80%

Investors agree private markets are less susceptible to short-term volatility than public markets

85%

Investors expect private investments to continue to outperform public markets over the long term

Source: [1]Adam Street Partners, *Leveraging Opportunity in Change: Navigating the Trends Shaping Private Markets in 2021 and Beyond*, March 2021.

committed capital that has not been invested or allocated. These firms account for just over 22% of the total $2.286 trillion in total global dry powder, as estimated by Preqin[2].

Venture capital follows a similar pattern with U.S. firms setting new fundraising records in the third quarter of 2021, raising $96 billion.

The growth of private equity over the past two decades, means that nearly every year presents a new record level of dry powder, with no real correlation to future returns. On the other hand, it is well proven that the date a private equity fund concludes its capital raising (known as the vintage year) plays a significant role in the determination of returns over time. It is only in retrospect that investors know if they have chosen a favorable year. For that reason, advisors often advocate for diversification of vintage years in client portfolios.

A 20-year study by eFront[3], a financial software firm, found that periodic financial crises, from the dot-com bubble to the Global Financial Crisis (GFC), were more important to fund IRRs than were valuations at the time of fund launches. Implicit in this argument is the ability of existing funds to acquire additional positions at attractive prices mid- and post-crisis, mitigating some of the damage that a crisis had on exit valuations.

For the most extreme example of relative returns by vintage year, Mercer[4] calculated that 2006-vintage buyout funds (that invested in the bubble prior to the 2008 GFC) posted a median IRR of just 8.1%. By comparison, 2009 vintages were able to snap up post-crisis bargains, generating a median IRR of 13.9%.

Again, it is only with perfect hindsight that an investor could exploit such a spread in returns. And this differential is the most extreme example from the past two decades. But it is clear that vintage year matters. Portfolio construction should therefore incorporate multiple vintages that can be acquired either through primary issuance or through secondary market purchases (which, incidentally, can often be acquired at a substantial discount to NAV).

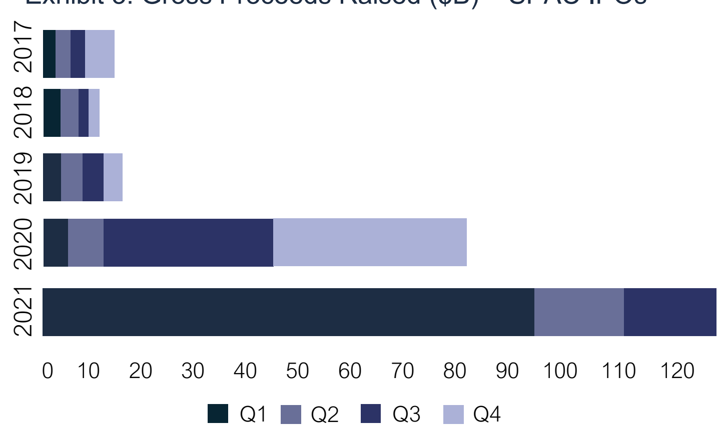
Investors would also be wise to prioritize those segments, such as the lower middle market, where valuations still remain attractive, and where the weight of dry powder among mega funds is less likely to impact future returns.

SPACS – INVESTORS' FRIEND OR TROJAN HORSE?

It is likely that over the past two years, investors have heard more about SPACs than in the preceding ten years combined. Put simply, SPACs are acquisition vehicles formed with the intent of purchasing a private company. This, in itself, is not problematic, and conceptually, this structure could be far more efficient than the traditional IPO process. But a review of the fee structures of such vehicles, lighter regulations around financial projections, and their lack of financial performance post-acquisition, reveals a structure that is often more suited to the sponsor's wealth creation than that of the investor.

Through Q3 2021, SPACs raised more than $121 billion across more than 500 IPOs, surpassing

Exhibit 3: Gross Proceeds Raised ($B) – SPAC IPOs



Source: S&P Global Market Intelligence, October 2021. Analysis includes global initial public offerings for SPACs with a closed date between January 1, 2017 and September 30, 2021.

Source: [2]S&P Global Market Intelligence, *Half A Trillion Dollars of Dry Powder Held By 25 PE Firms*, August 2021.
[3]eFront, *Private Equity Valuations During Downturns*, April 2020.
[4]CAIS Group, *The Diversity Potential of Private Equity Vintage Funds*, September 2020.

2020's record of $80 billion. Yet despite the recent fanfare, SPACs aren't new, having first launched in the 1980s. In their more modern iteration, these structures require shareholder approval for the acquisition, have opt-out provisions for shareholders who disagree, and impose time limits on completing the acquisition.

Structures continue to evolve to include variable incentives to induce sponsors to pursue quality deals and lower overall costs. But the bottom line is that this is an expensive means by which a company can go public, costing 3x more than that of a traditional IPO.

Negatives aside, companies and investors should watch this space with both caution and interest. The SPAC process will become more refined over time, potentially providing private companies and their investors with another means to a profitable and expeditious exit.

INFRASTRUCTURE – POLICY WINDS AT YOUR BACK

The "infrastructure bill" has been a fixture in Washington for as long as any of us can remember. But this time the bill passed, and now exists as the Infrastructure Investment and Jobs Act. This law earmarks $65 billion for a range of sectors, from bridges to broadband internet, from clean energy to brownfield clean up. The incentives built into the law will encourage investor dollars to flow to many of these projects.

The allure of infrastructure is its stability and its cash-generating properties, making it a favorite of investment entities, such as insurance companies, who have long-duration liabilities. The survey presented in Exhibit 2 shows it to be the top choice for increased allocations. Infrastructure is also finding a place in the portfolios of high-net-worth investors, thanks to a low interest rate environment that has made traditional fixed income a less interesting alternative for income generation.

In examining this sector, one needs to differentiate between public and private infrastructure as their characteristics are vastly

*Nearly **$5 trillion** needs to be spent each year to meet our needs for clean energy and water, grid modernization, and broadband communications networks*

different. Public infrastructure includes electric and gas utilities (40% of the S&P Global Infrastructure Index), pipeline companies, and the occasional airport. Its liquidity is a two-edged sword, able to convert to cash in a moment, but with high correlations to other portfolio assets. With a 2.4% yield and a beta of 1.01 (iShares Global Infrastructure ETF), it's hardly the diversifier or income source that investors are seeking.

Private infrastructure is different, and the funds to build more is sorely lacking, which means private capital needs to fill the gap. According to Global Infrastructure Hub, a not-for-profit organization created by the G20 nations to advance their infrastructure agenda, nearly $5 trillion needs to be spent each year to meet our needs for clean energy and water, grid modernization, broadband communications networks as well as expanding our highways and replacing our crumbling bridges.[5]

From the investor perspective, private infrastructure brings sought after characteristics: Projects often have monopolistic pricing and inelastic demand. They generally have stable cash flows, often with built-in inflation hedges that can deliver relatively high yields to investors; and infrastructure tends to be durable, lacking a need for significant maintenance for as much as 50 years.

The upfront investment is significant, which is why both public and private money are needed to address this gap. Investors are already funding wind and solar power generation around the world. Broadband networks are being built with government incentives and private money. Highways have historically been the purview of governments, but toll roads and bridges are an answer when taxes cannot fund the need.

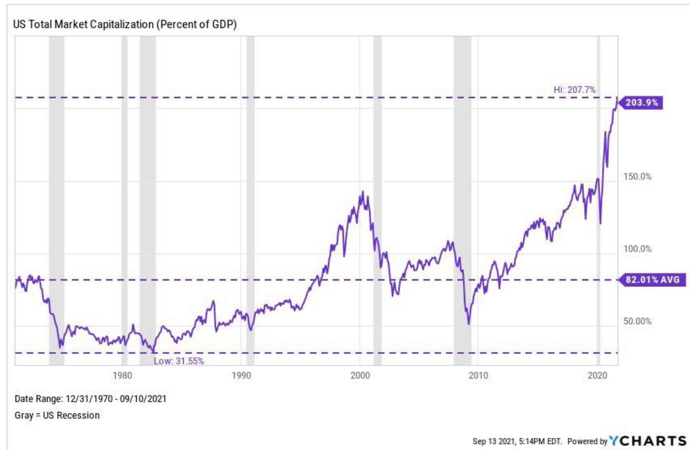
Source: [5]Global Infrastructure Hub, *Infrastructure Demand: A Major Global Challenge*, October 2017.

The biggest challenges for investors are illiquidity, exits, and the scale of the commitment needed to participate. Infrastructure funds that are geared to institutional investors may demand a $5 million commitment from an investor. Firms like Altera have a role to play in creating vehicles to access such funds, while having clearly determined exit mechanisms and manageable investor minimums.

PUBLIC EQUITIES – THE FROTH WHIPPED HIGHER

As the Preamble suggested, mentioning valuations is a bit of a fool's errand given they provide little help in timing asset allocation decisions. And given human nature as it is, a strongly upward price trend encourages investors to maintain their holdings of what might be termed "overvalued" share. With the NASDAQ Index having entering a correction phase in January 2022, that trend is breaking down.

Exhibit 4: Market Cap to GDP Shows Overvaluation



The Natixis investor survey referenced in Exhibit 2 shows that these institutional investors are allocating assets away from US public equities and towards alternatives. 36% of these investors plan to reduce holdings of US stocks while only 25% plan to increase their exposure. In that same survey, these institutions expressed a net 50% favorability towards infrastructure (53% plan to increase and 3% plan to decrease), along with +34% for private debt and +32% for private equity.

One could surmise that US equity valuations are at the core of these attitudes. Indicators such as the Schiller CAPE P/E (10-year average PE) and the so-called "Buffett Indicator" (the market cap to GDP ratio, shown in Exhibit 4) and even the S&P 500 dividend yield are all pointing in the same direction: Stocks remain richly valued.

What should investors do with such information? The institutions mentioned earlier appear to be allocating capital away from US stocks. Advisors with a fiduciary duty to maintain appropriate risk levels for their clients should be considering similar action.

IMPACT & ESG – IT'S EVERYWHERE

In 2022, this headline is hardly an overstatement.

Environmental, Social and Corporate Governance (ESG) investing, once on the fringe, has become a real trend, and incorporating ESG issues into research and reporting has become the standard operating procedure for many asset managers.

> *"Valuation indicators are all pointing in the same direction: Stocks remain richly valued."*

As an investor-driven phenomenon, managers have rightly responded to this interest in ESG strategies as they would for any new source of demand. Not only are there more impact-oriented investment options available, but the management principles behind dedicated ESG solutions are being employed in more traditional strategies as well.

Case in point, Altera's 2021 venture partner Oval Park Capital, who chose to employ an impact lens when evaluating opportunities. As a result, their mix of investments touched impact themes such as health, sustainable agriculture, renewable energy, and water technology without altering their return targets.

From a capital raising perspective, the Fund did not seem to have been harmed by this additional aspect of their methodology. They have broadened their potential base of investors by reporting on their success in addressing these societal needs, while also reporting on their fund’s financial returns.

We expect this trend to continue in 2022 and beyond, as the lines become increasingly blurred between "impact" and traditional strategies. In truth, this is a natural evolution of the investment industry -- recognizing the outsized impact that investor capital can have on non-financial issues, while exploiting those opportunities at the nexus of social impact and financial return.

Closing Thoughts

We have stated this for years and believe it just as much today: *High valuations in public equity markets and low yields on fixed income will continue to drive investors towards alternative investments. Currently, elevated levels of volatility may reinforce these trends.*

But alternative investments are not created equal. With the weight of massive capital raising, and the fees associated with assets under management, it will be tempting for many managers to deploy capital at lower returns. For those investors whose size allows it, niche strategies in the lower middle market offer a compelling option.

Altera's approach has only been strengthened by the challenges of COVID-19 and a newly inflationary current. Seeking durable strategies based on value-add techniques provides a healthy underpinning of "alpha". Resilient business models with pricing power will increasingly be sought by investors, and strategies rooted in the real economy, not in financial engineering, should continue to prove their merit. Those that can include social impact with attractive financial potential will increasingly find a tailwind.

If there is anything that investors have learned, it's that the environment will continually change. So, Altera will persist in playing the long game, identifying those opportunities that we believe will compound wealth over time, while also providing investors with the benefits of measurable impact, true portfolio diversification and income generation.

About Altera

We are a private asset investment firm focused on investing in the lower middle market. We back experienced fund managers and independent sponsors across private equity (buyout, growth equity and venture capital), real assets (real estate and infrastructure) and private credit (senior, junior and opportunistic). We aim to deliver attractive investment opportunities to family offices, high net worth individuals and registered investment advisors.

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March 2022