POST COVID – STAY COMMITTED TO PRIVATE MARKET INVESTING

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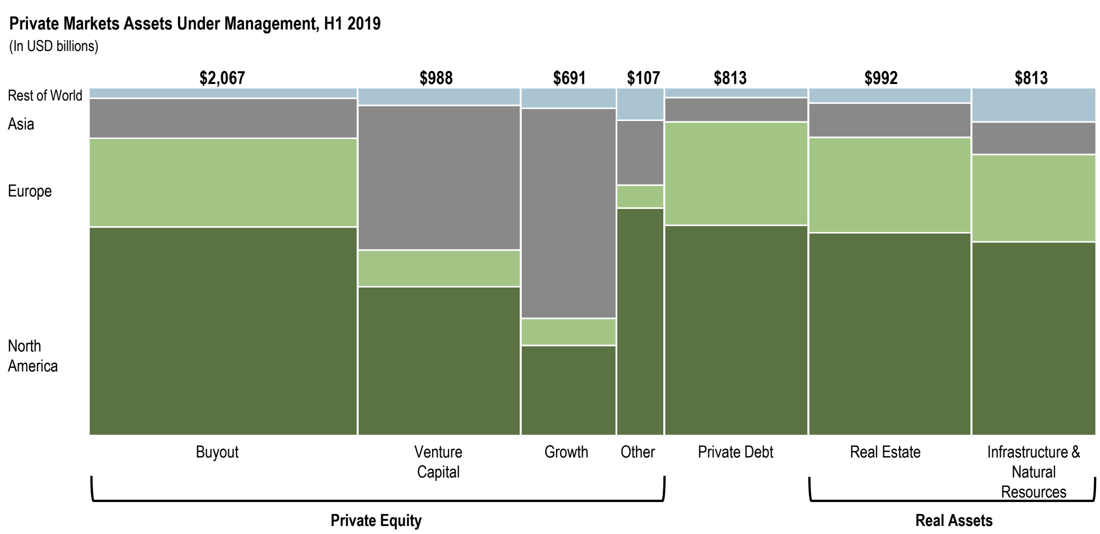
Regardless of your predictions and planning for a recession in 2020, it is highly unlikely that your outlook included a global pandemic. Since late February, it has been a confusing time with conflicting economic signals. Yet, as always, uncertainty brings opportunity if you know where to look, and investors today should be on the offensive and stay committed to private market investment opportunities. Furthermore, investors should consider new strategies that often emerge in today's volatile market as evidenced by what occurred during the global financial crisis (GFC) over 10 years ago.

Today, some private market investors are taking a "wait until the dust settles" approach, which may not be as safe as it sounds. Staying out of the private market probably means missing out on opportunities that offer strong risk-adjusted returns given depressed valuations caused by the premium expected for providing liquidity to sellers of illiquid assets. Private market investors who underperformed during the GFC of 2007-2009 were often those who deployed capital too late or simply sat on the sidelines. Like public markets, "buying on the dip" is a prudent investment strategy although it is sometimes difficult to know when the "dip" occurs. That is why you should stay consistent and patient when investing in private markets as evidenced by the following table illustrating private equity returns outperforming during the GFC *(EY, "Why private equity can endure the next economic downturn," March 2020).*

Median return of a 2006 vintage fund:	Median return of a 2009 vintage fund:
8.1%	13.9%

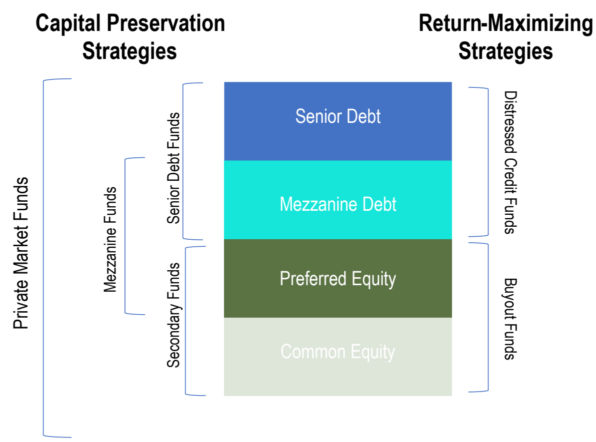
During the GFC, most owners of private market assets focused on defensive strategies, such as injecting equity into an existing fund and/or company to cure a liquidity requirement. This time around, experienced investors should look for offensive strategies, such as acquiring more ownership in an existing portfolio company by purchasing shares from shareholders who need liquidity.

Markets and Investment Strategies Evolve
As the private market has grown over the past decade, new investment strategies have developed given the larger supply of assets. According to a 2020 McKinsey report, from 2009-2019, private market assets under management grew by $4 trillion (from $2.5 trillion to $6.5 trillion) during this period with private equity accounting for approximately 60% of net new capital.



One of the most compelling private market strategies that gained significant momentum during the GFC has been the PE secondary market. This market, which stood at $88 billion at the end of last year, up from $18 billion in 2007, has helped fuel PE's overall growth over the past 10 years *(Institutional Investor, "Opportunity Grows with the Private Capital Secondary Market," Sept. 16, 2019).* Traditionally, the secondary market was a place where investors who were new to PE could get their feet wet, which is still true today. What is different from pre-GFC times is that now seasoned PE investors continue to participate in what is now a mature market. Family offices and other institutional investors find the secondary market attractive because it often presents an opportunity to acquire numerous assets through purchasing multiple fund interests culminating in a well-diversified portfolio containing hundreds of underlying companies that provides good downside protection. As with all maturing markets, unlevered returns are coming down, but they still provide an opportunity worthy of a look in any portfolio.

Capital Preservation vs. Money Multiple
As was the case during the GFC, questions are now being asked about the ideal strategies for today's investment landscape. When looking at PM opportunities, investors will typically focus on two key investment objectives: capital preservation and the money multiple potential. This illustration provides a simplified overview using a company's capital structure to illustrate the multiple types of risk that investors review, Capital Preservation vs. Return Maximization:



Illustrative Corporate Structure

It is not lost on any seasoned investor that the more risk you take the more return you will demand. The diagram above illustrates that relationship. Debt holders get paid out first, then everyone else below the debt holders. That is certainly a less risky position, but you are unlikely to experience significant capital appreciation.

When pursuing riskier strategies, investors obviously want to experience substantial capital appreciation. Venture capital and distressed debt, among others, quickly come to mind when chasing money multiple; but over the last 20 years other strategies have emerged. Rather than make only a primary "blind-pool" commitment to a limited partner (LP) interest in a PE fund, since the GFC investors have plowed billions into co-investment opportunities to acquire securities in a single company alongside their managers where they have an LP interest at work. Co-investment and private equity secondaries are clearly two strategies post-GFC that have become more mainstream. Each has a mix of capital appreciation and downside protection elements that do have a place in a private market portfolio.

Stay Offensive, Stay Consistent, Stay Patient, but do not be Complacent
Evolution of the private market continues as new strategies are being developed in response to the large supply of private market assets and investors. This will continue post Covid-19. Beyond picking a strategy that aligns with your organization's goals, there are other lessons learned from the GFC that investors must consider:

- Investment, manager, and security selection is key given the wide dispersion of returns in private market investment strategies. Do not underestimate the importance of finding the right investment manager who has the experience to navigate this market and the demonstrated ability to uncover value.
- Challenge your "re-ups" to managers during this time to make sure the team and strategy in this market still algin with your broader portfolio construction goals.
- Do not try to market time a point of entry – private market investing should be, for the most part, a marathon, not a sprint.
- Stick to what works for you but remain open to slight modifications and new opportunities.
- Be on the lookout for new or improved investment strategies that will emerge as they did after the GFC.

Private markets evolve and investors should too.

Chris Lawrence is founder and managing partner at Labyrinth Capital Partners. Chris has worked in PE for more than 25 years. He has led or co-lead 56 private market transactions via all of the emerging strategies mentioned above, representing $620 million in deal commitment.