CIO Commentary

September 2nd 2020

The last few months have been full of emotional turbulence for many people for a variety of reasons. Lives were lost and just about everyone's lifestyle has been fundamentally and perhaps permanently altered as a result of COVID-19, the subsequent global lockdowns and the social tensions in many US urban centers. It affected employment, consumer behavior patterns, family structures, and in short, just about everything. Such turbulence has not however been evident in many headline stock market indexes, which have seen large-cap tech-dominated US indices being pushed to new highs. The beneficiaries of the global physical lockdowns were all businesses operating in the cloud (except airlines) which appear tone deaf to main street reality. Recent market sentiment in early September has brought into question the sustainability of technology's advances relative to "value-oriented/grounded" investment themes and after very impressive advances in technology sectors since March, we have witnessed a pullback and/or profit-taking action in the markets in early September after an unprecedented advance of over 10% in Nasdaq in August. As I write the tech-led selloff continues and it has essentially reversed the extraordinary gains observed in August.

Meanwhile the US IPO market has re-opened with certain iconic new tech companies going public with the queue of companies building and some massive listings on the horizon. Pundits are quick to try to explain these conditions and eagerly trying to determine if this early September's pause is a "buy the dip" opportunity or a structural pivot to the trends favoring technology that got reinforced since March of this year. Bears draw parallels to the 1994-2000 technology bull market where towards the end of it, all sorts of fantastic valuation metrics were justified like prices applied to the number of views on web pages. Today a similar metric is applied to social media apps/pages where pricing is a function of the number of followers, but also unlike 1999, many of the technology companies or apps have matured into high margin, cash flow generative machines. Conversely in 1999, these business models were still being tested and valuations were at much higher levels of optimism on future and perhaps unrealistic cash flow "potential". What has also changed is that the private equity industry has a much deeper pool of resources that apply across the full spectrum of company life cycle stages. Now the trends are that private equity is able to finance and support these companies for a much longer period of time. The IPO is no longer the only end game in town and now the SPAC, (special purpose acquisition company) the direct listing on the NYSE and an abundance of liquidity whether debt or convertible preferred are all robust and viable options for private companies.

We find ourselves again in a pivotal moment pertaining to a number of factors that drive successful long-term capital allocation. Like always there are aspects that are extremely difficult to predict and others where one has the potential for relatively higher clarity. Where we have greater conviction on a macro level are that:

- Interest rates being a function of central bank anxiety will remain in historic range bound lows and it's all about "relative accommodation" by global central banks, all of whom face similar challenges with some in stronger positions than others;
- Demographic trends are unfavorable for urban centers (favorable for suburban demands) because of declining youth cohorts ("20 somethings") relative to other cohorts which have a propensity to want safe places to raise families, contained virus risks, less civil unrest risks, and quality of life/bigger space and nature access etc. The lockdowns from March until June proved the efficacy of "work from home" for many service-oriented functions;
- The digitalization potential for transformation remains on the horizon; This might be the "end of the beginning" but it is not "the beginning of the end" and many more years, if not decades, remain ahead in digitally-driven transformation in the knowledge economy globally;
- The IPO window, that only recently reopened, is still going to be receptive to listing many companies in the pipeline and many have exceptionally high-quality business models with strong cash conversions;
- A vaccine will be approved and usable, but this will not mean that everything goes immediately back to pre-Covid-19 norms;
- The decades of the trend towards globalization has pivoted and is in reversal; supply chains will get restructured and some companies/industries and countries will slowly "on shore" manufacturing where they can and this will result in the likelihood that global equity markets might become more de-synchronized and global equity asset allocation will matter more than before;
- The above conditions most likely present relatively more challenged fundamentals for many emerging markets but not all (we do not consider China for example an emerging market) These countries/economies have higher dependencies on exports, more cyclical and commodity exposures, less diversified equity markets, less technology exposures and much higher currency risk relative to developed markets;
- Capital has less "passport restrictions" than people and will always seek to gravitate towards the least oppressive and tax-friendly regime. Because of massive stimulus, rising government debts and monetary expansions, taxation is likely to trend upward causing many to consider redomiciling. The cost of capital will rise where taxation increases.

Conversely, where we have reasons to remain cautious and guarded because of a lack of conviction and higher uncertainty for investors include the notions that:

- When global economic growth is faltering for the masses and wealth and economic security is unevenly distributed, this turns into a political battlefield and exposes countries and communities to higher risks whether it is within a country or between countries;

- Despite high remaining uncertainty regarding the US election which is less than 60 days away, the outcome of election, no matter who wins, will still be an environment of social tension because victory by one party will not immediately cure the social tensions that have been exacerbated by COVID-19;
- There are rising trends of receptivity towards socialist ideology in many countries; Millennials, having been hit with a weak jobs market in 2008 and now again in 2020 are particularly receptive to socialist ideologies promoted by the extreme left.
- Geopolitical risks are increasing too with China, US, Russia and Europe all posturing towards protecting national interests. Watch the headlines on US sanctions reaching into and affecting other nations and watch for counter punches.

All of the above macro-oriented factors plus many more go into our thought process when considering investing in private equity whether via a fund or directly into a specific company. As has always been the case, the advantages of investing in the private markets is that these risk factors while they cannot be eliminated, they can be modelled, priced in and or either accepted or specifically mitigated through negotiations. While the private markets are never completely immunized from macro-economic issues nor the whims and vicissitudes of the public equity and credit markets, we and many other allocators too, believe in the longer-term superiority of this method of equity capital allocation, especially for an allocation of capital to everything besides large-cap equities. The growth of the private equity industry continues to gain share relative to the public markets. Public markets have shown a widening gap between the valuations of large-cap versus small-cap and for the last decade or so. We believe this is reflecting the notion that the public markets only seem to be adequately serving the largest of global companies because of the trends towards passive investing. As a result, small companies that are public, are ignored, remain misunderstood and neglected from an analyst coverage point of view. These trends have been in place for years and is in many respects what has supported the growth of the number of companies supported by the PE industry relative to the public markets.

Our focus continues to be on inflection point growth capital strategies (revenue positive and established but rapidly growing customer bases and high gross margins), but can also include change of control LBO styles with a growth plan imbedded in it. This often translates into companies with a dominant quotient of intellectual capital or knowledge-intense industries across a wide spectrum. While many of these companies are utilizing software in some form, we believe that the software industry is no longer an industry that is dominated by common systemic risk and fundamentals. Because software applies to so many discrete and differentiated industries, we believe that one can achieve the virtues of diversification within many industries that software touches. We also believe that growth-focused buyout strategies, whether they are corporate carve-outs, roll ups or consolidation strategies that incorporate digital strategies, will remain attractive investment approaches going forward as well as a way to diversify our portfolio exposures by company stage of development.

The Covid-19 induced economic destabilization should lead many larger companies to refocus, shed off non-core divisions on the one hand, but it will also accelerate roll ups of certain industries that remain fragmented and inefficient. Roll up strategies that involve some heavy lifting and politically challenging cost cutting are often times only possible to be quickly executed by a strong governance and concentrated shareholder base with the control of a board of directors. A recent example of this in one of the client portfolios was the private buyout of publicly traded Dun and Bradstreet, a venerable 150 year-old company that was purchased by a private equity firm 18 months ago. The opportunity was to rationalize a legacy cost structure and unlock the value of an underutilized and enormous data set. After a period of private ownership of about 18 months, with a focused owner able to execute a "turn-around strategy" the company was able to relist on the public markets and generate approximately 3 times MOIC for the private equity investors.

David B. Pinkerton CIO
Alpha Leonis Partners AG
Zurich, Switzerland
September 2020