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FROM THE CIO

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"BAD BETA"

Alpha Leonis Partners' CIO reflects on the unwinding effects of post pandemic government fiscal and monetary stimuli. As the global economy has faced rising interest rates to a degree rarely seen in the last 40 years, we argue that the era of "leveraged beta" is over.

At least for now.

MAN KAYAKING AT RIVER

The unwinding effects of the post pandemic government fiscal and monetary stimulus is now underway. Excessive liquidity creation during that period first flowed into the capital markets (mostly risk assets) but now this has essentially "spilled over" into the economies globally and inflation is now widely evident in many sectors of these economies. Inflationary pressure has been further exacerbated by the economic consequences of the war in Ukraine specifically around commodity prices and the disruption to many supply chains.

The world's central banks, with the US Fed taking the most hawkish stance, are hence trying to combat this inflationary pressure by shrinking their balance sheets and raising interest rates. This has naturally affected all financial asset pricing in public and private markets.

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1 RATES AND INFLATION DRIVE FINANCIAL ASSET PRICING

Rising rates most materially affects longer-duration earnings stream strategies as well as longer-dated fixed income instruments. The bond market, which is generally perceived to be a place for safety, has witnessed one of the worst types of performance in a long time because only rarely in the last 40 years has it faced rising rates to the degree that we have witnessed recently. Similarly, companies with negative cashflows and a dependency on raising more capital, have been punished by the markets even though their earnings outlook may not have changed. The cost of risk capital has gone up and those companies dependent on the now more expensive capital have seen their values decline the most precipitously. The most important driver of financial asset pricing whether it is long-dated earnings growth themes or long-dated fixed income are rates and inflation. Most of the rapid increase in rates has already occurred and some are asserting that with a recession on the horizon that US rates and inflationary expectations have peaked.

Pandemic conditions are reversing

Looking back at the last three years with some hindsight it is clear now that the pandemic had a few consequences. First, interest rates plummeted as global economies went into lockdown. Secondly, liquidity infusions were massive as governments reacted in fear to thwart off a possible depression by adding tons of stimulus to the global economy. Now all the conditions of the pandemic are in reversal: economies are wide open (except for China) there is rebound demand everywhere, supply chains are jammed and to top it off the assault on Ukraine has sent the geopolitical risk premium much higher. Equity markets are therefore in the process of revaluing based on new interest rate levels, inflation and geopolitical risks and the sustainability of earnings growth (recession or not).

Clearly, these conditions present challenges for financial asset allocation because in situations where there is either inflation or stagflation (slow to no real growth but inflation) most financial assets offer dubious protection. These conditions affect investment strategy within the realm of private capital strategies, too, but in general an increase in the cost of long-term risk capital is actually a very good thing for investors with this type of longer-term horizon. New transactions in the private capital markets might slow as GP's either focus on existing portfolio companies or the uncertainty about future values that puts some sellers and buyers on the sidelines. Transactions might be on pause until there is greater visibility on rate increase cessation and certainly deals are getting priced now with a recession as a base case. On the other hand, as public markets may enter a period of being "oversold" this may create attractive "going private" opportunities in the future.

Our view is that the era of "leveraged beta" is over, for now, at least as long as rates are rising and recession risks are becoming more imminent.

What is an investor to do under these conditions? It is our opinion that absolute positive returns can best be generated by alpha (skill-based) strategies whether in the public markets or private markets and it is in these types of conditions where certain strategies within the private equity universe have the most powerful relative advantage compared to leveraged-beta strategies.

In addition to exposure to commodities, which can be extremely volatile, and in our view should be used sparingly and tactically, there are themes within the private equity world that remain attractive right now. Before diving into this, let's recap how we look at different themes or hypotheses in the investment world and then describe how we think it is most prudent to execute in today's environment.

2 HOW WE LOOK AT DIFFERENT THEMES OR HYPOTHESES IN THE INVESTMENT WORLD

Value-based vs. hyper-growth strategies at the poles

There are value-based strategies which are slower growth and based on near-term and more probable cashflows. This is the type of company or focus area that typically supports leverage and hence is in the "strike zone" for many leveraged buyout approaches (LBO's).

Then on the other extreme are "hyper growth" themes that are not producing near-term cashflows per se but offer the promise of significant back-end loaded earnings. Obviously, this area involves much more forecasting risk in those earnings as they are less certain and further in the future. This is the "strike zone" of many venture capital strategies.

Mature growth strategies form a middle ground

In between these two poles are mature growth strategies which might already have a stable cashflow positive component (e.g., SaaS models) but also offer more back-end loaded growth in earnings on top of current cashflows.

Pricing risks is a skill, not an art

Within all these approach types, there are variants and mixtures of different investment hypotheses, and it often boils down to investment judgment of a skilled manager to properly price the risks inherent in any hypothesis. Choosing companies that can succeed requires specialized industry expertise and this is especially true today when the potential winds of stagflation are present. Also, skilled owners can create the growth by feeding capital to new products or acquiring synergistic "add-ons".

What has happened in the first five months of the year is that the most "speculative/frothy" areas of the market have been reset to reflect the increased cost of capital today. For example, areas hurt the most are things like crypto (no earnings), and super long-duration earners that are in cash-burn mode today. Instead, investors have flocked to defensive equities, companies with perceived stable near-term cashflows and abandoned long duration upside tail earnings themes as well as starting to discount cyclical or economically exposed earnings streams.

That said, in the public markets some of the selloff has been a bit indiscriminate, meaning that even cashflow positive models/themes have reset to a lower price level, but for the most part it has been the cashflow negative segments that have corrected the most in price.

3 TWO PRIVATE EQUITY AREAS THAT ARE LIKELY TO HAVE SOME CHALLENGES

Pure LBO: Leveraged cyclicals that have risk to their earnings because of:

- Rising rates, affects interest costs on their balance sheets unless the interest rate risk has been hedged.
- Rising labor costs adversely affects profit margins in labor intensive industries.
- Rising material costs affects margins too but also might affect revenues because of an actual decline or absence of supply in goods will affect a company's ability to sell products (supply-chain blockage).
- Risks of a recession also adversely affect the demand side for certain companies and industries.
- Rising rates affects back-end multiples on EBITDA and any investment that relies on a multiple expansion and an arbitrage to another market should be strongly questioned.
- Skilled managers or executors do however price all of the above factors when underwriting a transaction, but to us these are the key risks in LBO's and especially large-cap LBO's that are priced off public comparables (PE beta).

There will, however, come a time when a public equity price might reflect despair and lost hope and at this point the going private LBO and mergers & acquisition game would start again.

Late-Stage Pre-IPO financings: (which for the most part but not always, is essentially a "Greater Fool[1]" theory of investing). This area was in effect "beta-driven" meaning dependent on the arbitrage of public versus private valuations and since public valuations have fallen, the arbitrage gap between public and private has closed. Secondly because many of these investment hypotheses were driven by selling the "hype" of a cashflow negative company to a relatively unsophisticated public market and now that this public market is "not there" for an exit "bailout", these cashflow negative companies face increasing risks of "down rounds".

[1] The greater fool approach is premised on buying an asset knowing that its value is somewhat questionable but that some other investor that is a greater fool will pay a higher price in the future irrespective of those investments intrinsic value. https://en.wikipedia.org/wiki/Greater_fool_theory.

As many of these companies are cash burners, they are dependent on further capital to achieve profitability and now that the cost of public and private capital has gone up these valuations are challenged. Anyone who has followed the ARK Innovation Fund knows that high multiples on cashflow negative companies have been hurt the most and, within PE, strategies that were all big ticket unicorn hunters have also had a reset to valuations.

At some point these cash burners will die from terminal dehydration but the survivors will prosper due to lessened competition. This culling of weak business models in the period from 2002-2003 set the stage for strong successes of many of the digital giants today.

4 AREAS OF THE PRIVATE EQUITY MARKET THAT STILL HAVE A SOUND INVESTMENT HYPOTHESIS

Companies that have a plausible path to profitability or are already profitable and are demonstrating this with tangible and sustainable revenue growth because their value proposition is better, faster, cheaper than the competition/incumbents. If a company is offering a remarkably superior product or service, this is a great line of defense in almost any macro-economic scenario and especially in stagflation (slow real GDP high inflation environment). This is the case with almost every area of the Knowledge Economy which tends to be intellectual property based and inclusive of a wide range of software/intelligent solutions.

Software that saves on labor costs especially in the areas of Fintech, Insurtech, transportation, automation etc. and furthermore software that saves and mitigates material costs such as themes of the circular economy, automation, and logistics software, all have improving earnings outlooks in stagflation and increasing valuations in deflationary conditions. Therefore, to us, these companies are defensive in nature and represent a strong industry for capital allocation in a wide range of economic scenarios.

While software and technology as a broad category have been hit in the public markets, a closer look into this industry or any industry for that matter, reveals that the division in performance cuts across the lines of companies that are either high-growth/cash-negative companies or slower-growth/cash-positive companies. In our proprietary research[2] we have segmented these areas as long-duration and short-duration equities. Long-duration equities started to selloff as the US rate environment started to become more hawkish, while short-duration equities have been more resilient.

Subscription based software models that have extremely strong retentive customers at high margins are essentially like bonds with very stable-recurring recession-resilient cashflows. These models are, in our opinion, one of the best places for capital protection and growth in a stagflation environment but also their revenue models command significant premiums in deflationary environments.

The attraction of these companies from an investors point of view is also that they are serving a wide spectrum of industries and markets so that an investor can structure a highly diversified portfolio.

An area that has been hit especially hard in the public markets, merely because it is a quite long-duration strategy, is biotechnology. Here I am reminded of one of my prior pieces where I quoted Oscar Wilde:

> *“A cynic is a man who knows the price of everything, and the value of nothing.”*

The markets right now will be full of cynics because the media informs most of us constantly about price but not necessarily about value.

Dedicated dry powder for domain experts

Fundamentals for the biotechnology industry are still exciting and promising because the combination of the complete mapping of the human genome, plus CRISPR technology plus artificial intelligence make for a powerful trifecta in accelerating the pathway for new drug discoveries. We are excited to have dedicated dry powder allocated to domain experts to take advantage of the crushed public and private company valuations which for the most part, has little or nothing to do with the advancements of knowledge and technology in this industry. The ground is still very fertile for “planting optionality” in drug discovery”.

We also remain positive on selective growth LBO’s and “roll-up” strategies. These approaches are largely premised on consolidation economics, which has three parts:

1. labor savings (which is more important now as inflationary forces make them more pronounced)
2. using broader technology/software on a larger scale and finally
3. buying smaller entities at lower discounted EBITDA multiples and rolling them into the larger platform.

[2] Please contact us if you wish to review our research on Equity Duration.

All of this is execution dependent and therefore mostly dependent on the quality and skill of management and a control shareholder. An issue here is of course that these hypotheses are often dependent on incremental capital for acquisitions/roll-up assets and we can assume that the cost of this capital has gone up in the current market. This affects target valuations, and we trust that aligning with strong management teams skilled in executing roll-ups, extracting synergies, and using technology more proactively will still produce strong returns for patient capital.

5 FINAL THOUGHTS

Many skeptics worry that the current market selloff is the beginning of a longer period of troubling times for the capital markets more broadly speaking. Harrowing remarks like “this is 2002 all over again” are starting to circulate in narrow channels of the media.

The flamethrower of truth will burn out unsustainable and unprofitable business models

I would like to address this and note that there are of course some similarities and of course differences. Similarities of the period after 2002 and the period today are that in each case the flamethrower of truth has and will burn out unsustainable and unprofitable business models. Speculative froth has been or will soon be eliminated.

A better playing field for the survivors

This sets the stage for better fundamental conditions for the survivors that have sustainable profitability and real value-creation for customers/shareholders. The removal of marginal speculative capital has now meant that the cost of capital has increased, and this is very good for longer-term capital that is stewarded by thematically focused alpha-focused managers who are not underwriting for a beta arbitrage.

The markets are likely to remain challenging as long as there are uncertainties of further rate hikes and potential for earnings threats due to a looming recession.

We think that these uncertainties are already in some areas fully priced into financial assets and that we are now at the early stages being set for superior returns on capital.

Generally speaking, long-duration cashflow negative companies (venture rounds especially) will likely face systemic challenges so long as the macro environment is combating higher rates but as soon as rates peak, and investor sentiment goes through its cycle of denial, desperation, panic and capitulation... valuations will trough and a new cycle of positive investor sentiment will begin starting with reluctance, optimism, excitement followed by exuberance. The cycle repeats, only the players change.

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