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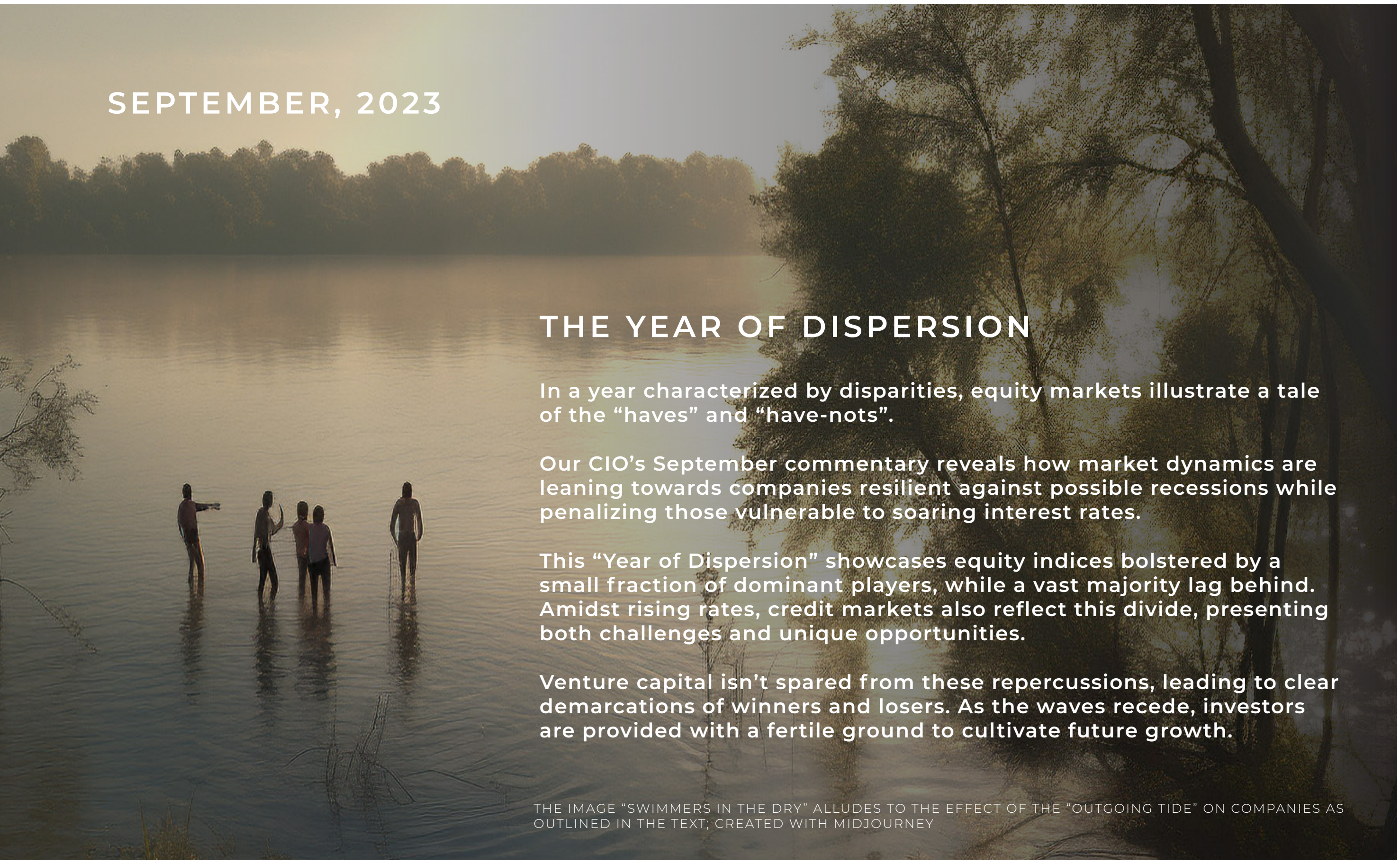

SEPTEMBER, 2023

THE YEAR OF DISPERSION

In a year characterized by disparities, equity markets illustrate a tale of the "haves" and "have-nots".

Our CIO's September commentary reveals how market dynamics are leaning towards companies resilient against possible recessions while penalizing those vulnerable to soaring interest rates.

This "Year of Dispersion" showcases equity indices bolstered by a small fraction of dominant players, while a vast majority lag behind. Amidst rising rates, credit markets also reflect this divide, presenting both challenges and unique opportunities.

Venture capital isn't spared from these repercussions, leading to clear demarcations of winners and losers. As the waves recede, investors are provided with a fertile ground to cultivate future growth.

THE IMAGE "SWIMMERS IN THE DRY" ALLUDES TO THE EFFECT OF THE "OUTGOING TIDE" ON COMPANIES AS OUTLINED IN THE TEXT; CREATED WITH MIDJOURNEY

Equity markets seem to be defying the reality of pricing an increasing probability of an earnings-driven recession.

Still, upon closer examination, there is some logic to the surface-level appreciation of many concentrated equity indices and their disparity relative to broader, more equal-weighted indices.

Our thesis is that the markets reflect the performance of the "haves" and the "have-nots". The "haves" are those companies with rich cash balance sheets and strong recession-resilient revenue models. The "have-nots" are those highly leveraged companies facing increased interest expense due to remarkably higher rates.

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David brings over 37 years of experience and expertise in focused investment programs in both capital and private markets.

He holds a J.D. degree from Brooklyn Law School and a Bachelor's degree in Finance and Economics from the University of Delaware.

1 THE ELITE TEN VS. THE REST

US Equity indices, as represented by the S&P 500 index, are up approximately 19% year to date (YTD). This has been driven by roughly 10 stocks (the haves) which comprise 27% of the market value of that index, contributing to 80% of the YTD return.

Pareto's 80/20 rule applies[1]. The other 490 companies have a return of 4.5% YTD[2]. Hence, dispersion is wide in the sources of returns in the equity markets. Debt-financed share buybacks are not as compelling when debt costs were marginal.

2 CREDIT CRUNCH TALES

Dispersion is also a dominant theme in the credit markets, with the pain of higher rates being felt most acutely in the lower quality credits. Overall, debt-to-EBITDA multiples are not nearly as elevated as they were pre-2008 Global Financial Crisis.

Still, interest expense as a percentage of EBITDA is definitely rising, leading to diminished profitability as rates have risen substantially, especially at the more speculative end of the credit markets.

Banks have a reduced appetite for leveraged loans, and the notion of refinancing old debt with new higher-rate debt from a smaller subset of active lenders is a cause for concern in the large end of the syndicated leveraged buyout (LBO) loan market. Higher interest expense as a percentage of EBITDA reduces free cash flow previously available for capital expenditures (CAPEX), marketing budgets and debt repayments.

Vultures on the sidelines eagerly await an impending rise in default rates that an earning recession would compound.

3 VENTURE CAPITAL'S SURVIVAL GAME

Similarly, at the venture side of the Private Equity (PE) market, companies burning through cash and having business models built on ultra-cheap capital are running on the fumes of 2021 capital raises.

Most general partners (GPs) are now trying to triage their portfolios between the ones they fund and those they let die or combine with another firm to create cost savings and/or revenue scale. This environment leads to dispersions in winners v. losers in the venture space as well.

4 SPOTTING SILVER LININGS

All of these above conditions are healthy by-products of the Fed's policy to keep rates higher for longer and cause rational "creative destruction" of the private sector's malinvestment under the era of easy money in 2020-21. The outgoing tide has definitely revealed those who were "swimming naked", as Warren Buffet once quipped.

Still, the opportunities are there now for investors to pick up higher quality companies at attractive valuations and position their future portfolio for strong prospective multiples on capital driven by execution of operationally lead growth.

The cost of capital increase is good for new money going out the door today, but it is punitive for companies with weaker value propositions, again creating a higher dispersion of returns for investors going forward.

[1] The Pareto Principle, also known as the 80/20 Rule, specifies that 80% of consequences come from 20% of the causes, asserting an unequal relationship between inputs and output.
[2] Source: Bloomberg; ALP calculations

5 CAPITALIZING ON CHANGE: A STRATEGIC APPROACH TO PRIVATE EQUITY

Our emphasis in the Private Equity markets has been consistently aimed at the lower middle market cash flow positive deal set, with most of the return attribution being driven by operationally lead EBITDA growth.

The new paradigm of higher capital costs applies across the board to all companies, and the new environment weans out the weak, creating a more abundant and fertile total addressable market (TAM) for the stronger players..

Respectfully,
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