

CalALTs
California Alternative Investments Association

2021 Insights in Alternative Funds

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About CalALTs

The California Alternative Investments Association (CalALTs) is a not-for-profit membership organization whose members include alternative asset managers, investors and service providers who are dedicated to the continuing evolution of the alternative asset management industry in California. Originally founded in 2010 as the California Hedge Fund Association (CHFA), CalALTs continues the mission of fostering meaningful connections among its members and a vast network of thought leaders, influencers and peers who share investment ideas, best practices and industry intelligence that drive tomorrow's success. The organization hosts education and networking events for members and its digital and social platforms provide members with the relationships, information, and opportunities to generate better outcomes.

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ESG in the Alternatives Industry – The Evolution of the 'S'

Turn on the morning news and one topic dominates the conversation—ESG. It is the meaning of these three powerful letters that has caused global disruption and changed the way people look at the world and the role they play in it. How can three initials that were a relatively unknown concept a few years ago have started a revolution in investing?

Environmental, Social and Governance (ESG) criteria are a set of standards for a company's operations that socially conscious investors use to screen potential investments, according to Investopedia. The Environmental (E) criteria consider how a company performs as a steward of nature; the Social (S) criteria examine how the company manages relationships with employees, clients, suppliers and the community; and the Governance (G) criteria assess how a company defines leadership guidelines, executive compensation, internal controls, audit processes and shareholder rights. Increased awareness and public discourse around ESG has put a spotlight on the investment industry and made a tangible impact.

Ninety-six percent of the top 50 asset managers have championed their commitment to sustainable investing by signing on to the UN's Principles for Responsible Investing

Over the past year, matters relating to social and racial justice have caused unrest and discontent, especially in the private equity industry. As a result of such focus on the 'S' or social factors impacting businesses, there has also been a greater push to promote ESG as a whole across funds and portfolio companies with equal emphasis placed on the 'E', 'S', and 'G'.

Asset managers and private equity firms have realized that their investment strategies need to apply ESG standards or risk LP discontent. (Bain) Ninety-six percent of the top 50 asset managers have championed their commitment to sustainable investing by signing on to the UN's Principles for Responsible Investing, launched in 2006 (Institutional Investor). Signatories have grown from 100 to over 3,000—a testament to the rising awareness and demand surrounding responsible investing. Accompanying the ESG criteria is the concept of sustainability, which refers to the long-term viability of a business relating to the heart of corporations: the people. Conceptually, ESG and sustainability have taken on greater importance in the industry, yet their definitions have become more obscure and the lack of standardized metrics can cause confusion among those who are unfamiliar with the concepts.

Still, many asset managers, especially in the alternatives industry, have become focused on integrating ESG analysis and sustainability factors into their portfolios. Increased investor demand and regulation have driven private equity and venture capital firms to take action, especially those with preexisting principles aligning with ESG values. According to Preqin, 63% of alternative assets in the EU are sustainably invested and 37% of total assets are sustainably invested in North America. (PREQIN)



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ESG in the Alternatives Industry – The Evolution of the 'S' (cont'd)

Historically, there have been many challenges in quantifying the impact of the 'S' on company performance, which has caused investors to more closely analyze the 'E' and the 'G' while, oftentimes, discounting the 'S'. Recently, however, the importance of the 'S' has been particularly emphasized as the world has become more attuned to diversity and inclusion. Even so, the industry has struggled to implement and enforce any standards around the 'S'. The attention that the concepts of diversity and inclusion have commanded, however, have made it abundantly clear that social factors impact consumer behavior, investment trends, company decisions, and, most importantly, the future of the planet.

Analyzing the sustainability of a company and its overall adherence to ESG standards is inextricably linked with the ways in which the company treats and interacts with all of its stakeholders. Measuring the 'S' gives investors pause, because they question what it truly means. Examining the social aspect of ESG starts by asking the right questions, such as:

- **Is the firm's workforce diverse?**
- **Is employee sentiment relatively positive?**
- **Does the company respect human rights across the supply chain?**
- **How does the company contribute to its local community?**

Investigating these questions and the ways in which companies respond to social trends and politics can have significant impact on company performance. (SP Global) It is therefore essential when evaluating the sustainability and ESG metrics of a business to hone in on the contributing social factors. As many alternative asset managers have already realized, ESG investing has become synonymous with 'doing well by doing good,' instilling hope that it is never too late to build a better tomorrow. It starts with transforming the way business is done today.

Social factors impact consumer behavior, investment trends, company decisions, and, most importantly, the future of the planet

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Private Equity Valuations During Volatile Times

The COVID-19 pandemic threw the financial markets into a dramatic upheaval during 2020. Private equity (PE) fund managers, in charge of shepherding many of the world's small and medium-sized business, were faced with tenuous circumstances, including severe slowdowns in revenues, a lack of collectibility of receivables and the need to cut costs across the board. This left valuation committees, in charge of valuing underlying portfolio companies every quarter, in a challenging spot. In this article, we will examine some of those challenges and how managers adapted as best as they could to the circumstances.

PE managers expect short-term volatility to stay, and the performance of many companies may continue to whipsaw until we reach a stable state with mass vaccination and herd immunity of a global populace.

ASC 820 prescribes certain boundaries for valuation that fund managers must stay within to maintain compliance. In periods of volatility, such as those we are currently experiencing, regulators, auditors and investors may become concerned about the elevated risk associated with the quarterly marks constructed by valuation committees. PE managers were faced with a period unlike any other. Government-mandated shutdowns that commenced in the beginning of the second quarter led to steep markdowns in public stock prices. Considering that the market approach uses public stock values of similar companies as the base to measure private companies, PE firms had to be more rigorous in evaluating the valuation marks of the portfolio companies they had investments in. Some of the approaches they undertook included:

- Challenging the weight applied to the income approach vs. the market approach.
- When using the income approach, challenging the discount rate assumptions with a specific focus on the company-specific risk premium of portfolio companies
- For companies in industries deeply impacted by the COVID-19 pandemic (airlines, hotels, gaming, oil and gas, etc.), researching industry publications to put a neutral and unbiased lens on normalized forward earnings or forward multiples used in these valuations.
- Valuation committees frequently tapped into outside valuation specialists to help them perform a more robust and independent analysis so fund stakeholders would gain further comfort in the quarterly marks.

Looking ahead through 2021 and into 2022, despite the promise of increased vaccine distribution in 2021, certain industries (such as travel) may struggle to retain the same customer volume level they experienced before the COVID-19 pandemic, especially with many companies advocating for more permanent acceptance of the work-from-home environment. However, companies in these industries are expecting to see an uptick in revenues during 2021, fueled by pent-up demand from segments of these customers. For instance, with respect to the travel industry, some believe that leisure travel may exceed levels seen pre-COVID-19 outbreak, as households with increased savings in their bank accounts look to use some of those savings on vacations.

Valuation committees will, therefore, need to continue staying extremely vigilant in monitoring the fluidity of our times and focus on monitoring key assumptions and methodologies to ensure they are tracking the value of their portfolio companies appropriately. PE managers expect short-term volatility to stay, and the performance of many companies may continue to whipsaw until we reach a stable state with mass vaccination and herd immunity of a global populace. Increased oversight by the SEC under the new administration has the potential to bring further scrutiny on valuation committees of PE funds managed by registered investment advisors. This raises the stakes somewhat, but with three quarters of challenging pricing under their belts, PE managers should feel confident about their process and commitment to providing fair marks to their investors.

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How the Pandemic Changed Private Equity

During the Spring of 2020, measures to prevent the spread of the coronavirus hampered a wide array of businesses. Similarly, office closures and travel stoppages put the brakes on private equity deals and fund closings in the early spring. As mask-wearing and social distancing became more ordinary, the industry began to adjust to its new circumstances, and activity rebounded in the fall.

The global pandemic will leave an imprint on private equity, like most businesses, for years to come. Three ways that the COVID-19 pandemic changed private equity can be summarized as: virtual, tech, and SPACs.

Virtual is reality

While fundraising volumes in Q1 2020 mirrored 2019 levels, sheltering in place dampened fund closings during Q2 and Q3. Fundraising bounced back in Q4 with volumes exceeding $100 billion (Chart 1), as managers began to adapt to less mobility.

The preponderance of web meetings favored funds with strong relationships established prior to the pandemic. While limited partners (LPs) had the opportunity to meet more funds virtually, LP commitments in 2020 showed a "flight to quality" to better-known funds.

If travel restrictions remain through the end of 2021, emerging managers will have a harder time competing for capital against better known funds because LPs are hesitant to invest with fund managers they haven't met in person.

Less than 10% of LP respondents to a Probitas Partner survey indicated that they are pursuing managers they have met only virtually. However, newer managers are using this time to expand their network of interested LPs by scheduling anytime, anywhere web meetings. In fact, many funds holding virtual annual meetings in 2020 benefited from higher attendance from more senior LPs since travel was unnecessary.

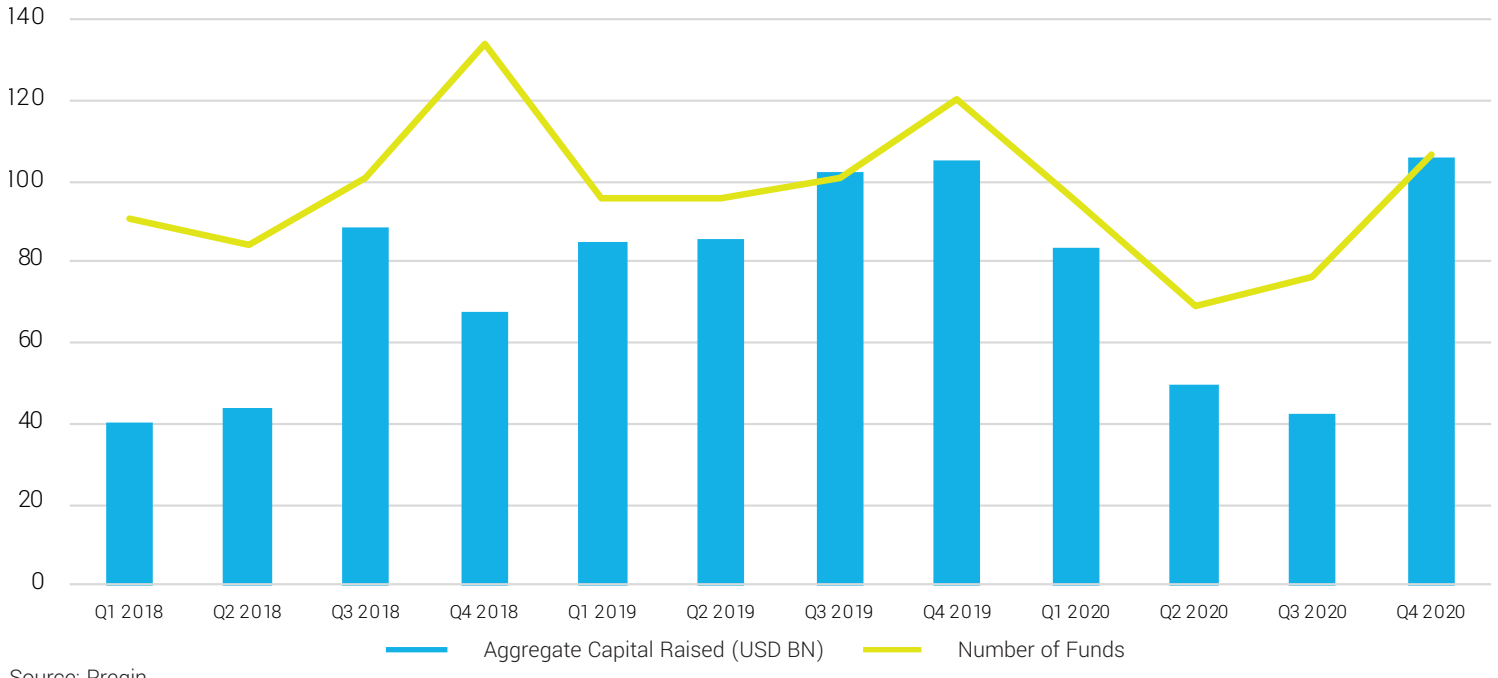
Tech takes the lead

If venture capital is synonymous with innovation, buyouts have been associated with mature industries – but no longer. The reliance on and growth of tech companies during the pandemic cemented their importance to private equity investing.

First, tech companies, including venture-backed tech companies, became the largest recipient of private equity capital. In 2020, information technology received 29% of investments, compared to 16% in 2011 (Chart 2). [Consider if other years should be included. Eg., 2010, 2015 and 2020] As the world relied on tech to communicate, make purchases, and work remotely, tech companies became more attractive, cycle-resistant, growth assets. Even before the pandemic, tech unicorns had relied on private equity for infusions of capital, needed to grow large enough for traditional public offerings.

Indeed, three of the largest global private equity firms include California-based, tech investors: Vista Equity Partners, Thoma Bravo, and Francisco Partners.

Aggregate Capital ad Number of Funds Raised, US-Based Funds



Source: Preqin

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How the Pandemic Changed Private Equity (cont'd)

SPACs are here to stay

One alternative to seeking liquidity through the traditional IPO or acquisition is the special purpose acquisition company (SPAC). In 2019 only 59 SPACs went public raising $12 billion, and in 2020 247 SPACs held public offerings raising total gross proceeds of $75 billion – a 525% increase.

Private equity firms, such as TPG Capital and The Gores Group, have also sponsored SPACs. Compared to typical funds, SPACs allow PE sponsors to seek assets that may not fit LP requirements and may exit on faster time horizons with attractive economics. PitchBook predicts that at least 20 private-equity backed companies could go public via SPAC this year.

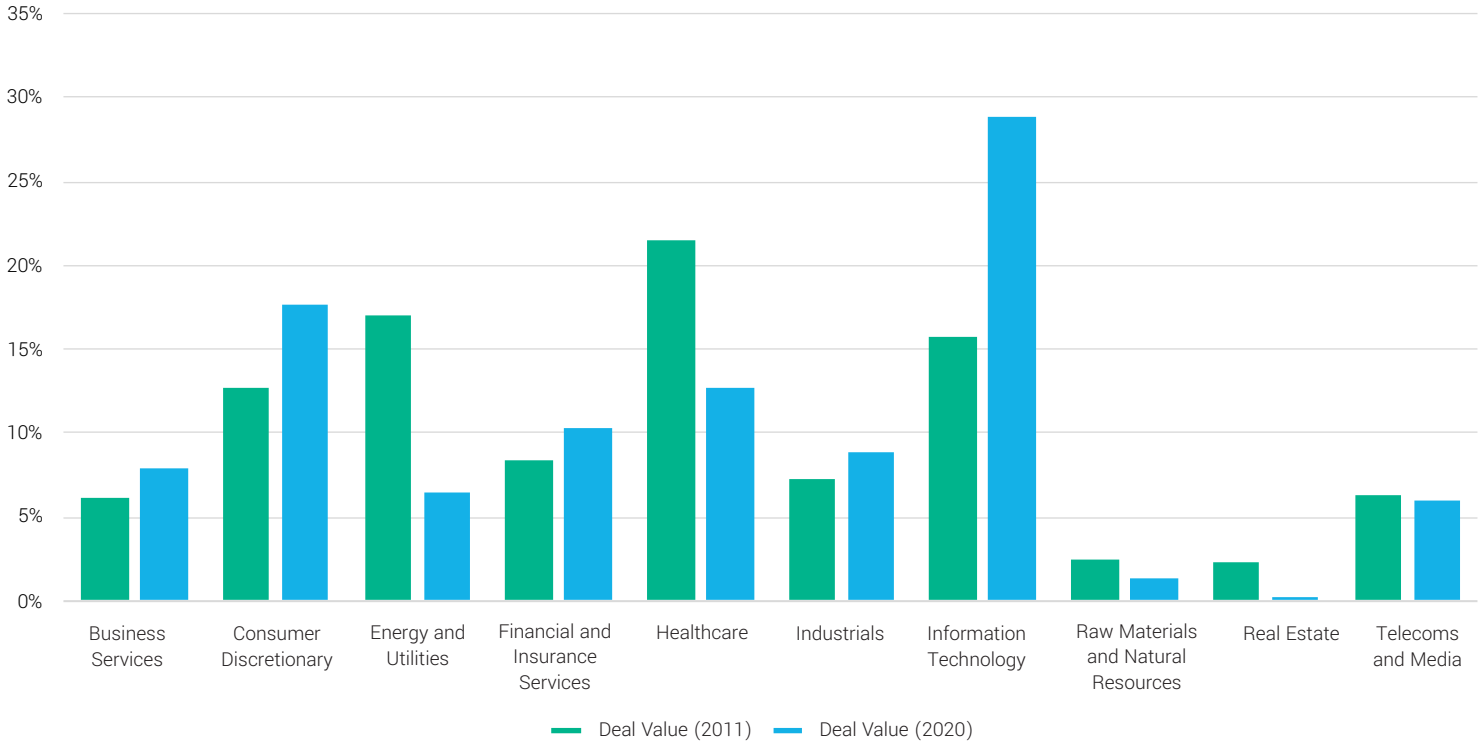
Are SPACs just a fad? Retail investors' demand for more public company targets and private companies' desire to find simpler paths to exit uncover a market gap that SPACs fill. While the pace of SPAC formation may eventually slow in 2021, this exit option adds more flexibility and vital liquidity to a traditionally illiquid asset class.

Adaptation and resilience

With COVID-19 vaccinations ramping up, the industry seems to have weathered the worst of the coronavirus pandemic. Despite much uncertainty during this time, GPs continued to deploy capital and LPs honored their commitments. After an initial pause in the spring, industry trends have settled into a predictable pattern, showing less volatility and speculative behavior than in public markets. The adaptability of private equity investing is the strength of the asset class, which makes it resilient to unpredictable interruptions, such as a global pandemic.

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Private Equity Investments by Sector in 2011 and 2020, % of Annual Total



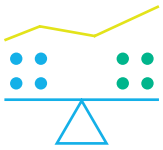
Source: Preqin. Private equity investments include buyouts, growth capital and add-on investments.

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How Diversity and Inclusion is Disrupting the Private Equity Industry on the Path to a More Equitable Society

March 25th, 2020 has come to embody a tipping point of disruption and hopes for transformation, largely precipitated by the tragic death of George Floyd. Representing one injustice too many, the events of the day have called for racial justice and equality across all facets of life. While financial services firms have become more attuned to the movement towards greater diversity and inclusion in the workplace, the private equity industry has lagged in its response to incorporating effective diversity and inclusion standards in its practices.

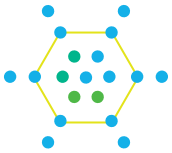
Although the general alternative investment industry acknowledges and emphasizes the importance of diversity and inclusion, the actual application and action necessary to drive change has been lacking. A combination of factors have slowed the progress of diversity and inclusion among private equity firms, including insufficient data supporting the overall benefits of a diverse workforce, unconscious biases prevalent across GPs, and a lack of initiatives focused on recruiting and retaining diverse talent. A 2019 study by the IFC found that "private equity and venture capital funds with gender-balanced senior investment teams generated 10 to 20 percent higher returns compared with funds that have a majority of male or female leaders" (IFC). However, females only make up 9.9% of senior management at private equity firms (Preqin).



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Even though LPs are concerned with performance, they also pay attention to diversity as an indicator of a firm's culture and ability to incorporate different perspectives in order to create value. Despite the fact that LPs continue to demand more accountability when it comes to diversity and inclusion, on average, the private equity industry has been slow-moving. The Knight Foundation found that firms owned by women and minorities managed only 1.3 percent of the $69 trillion in assets under management in the U.S. (Knight Foundation). Furthermore, a Morgan Stanley study found that firms invest in white males based on potential; however, for women and people of color, it is based on demonstrated track record. One potential roadblock to achieving diversity in the workforce is the predominately white male force leading the private equity industry.

As long as diversity remains absent from these leadership positions, it is more likely to filter across the organization and impact hiring patterns. The question remains—is the private equity industry willing to change? The answer hinges on their acceptance of the fact that a workforce which represents diversity in culture, gender and thought is a stronger, happier and more successful one.

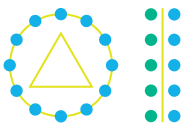


Studies suggest that diversity in leadership can lead to increased innovation, supporting the case for more diverse leadership across deal teams and operating teams.

It is apparent that there is a disconnect between the importance LPs place on diversity in senior management and the way in which GPs perceive the significance of such interest. Attaining diversity in the workplace begins with strong goals and metrics to attract diverse talent. Distinct recruiting and retention initiatives to promote diversity is a key first step. Studies suggest that diversity in leadership can lead to increased innovation, supporting the case for more diverse leadership across deal teams and operating teams (BCG).

Rectifying this issue does not end with achieving diversity, it continues with inclusion, a requisite component for firms to exemplify if they want employees to feel secure and confident in sharing ideas and being their best, authentic selves, which can, in turn, empower them to succeed.

While 2020 was both unprecedented and unpredictable, it ushered in a new wave of social awareness and focus on key priorities for private equity firms. A survey conducted by EY showed that larger firms were prioritizing inclusion and diversity among ethnic minorities while mid-sized firms reported an increased emphasis on gender representation (EY). If these results are any indication, the path to transformation looks brighter ahead. It all starts with giving those who have long awaited their chance to speak the opportunity to become part of a more diverse and inclusive future.

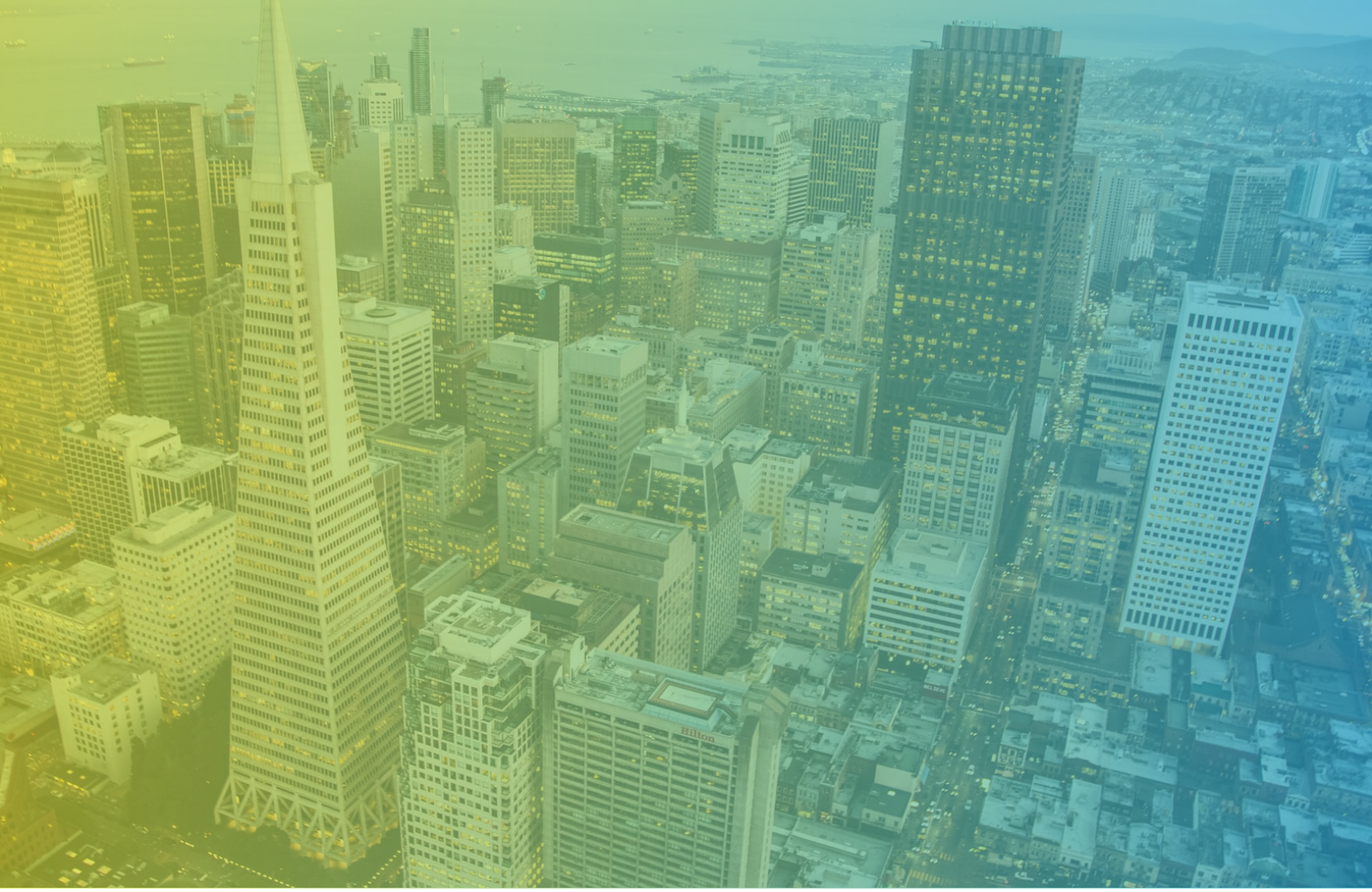


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Disclosure

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