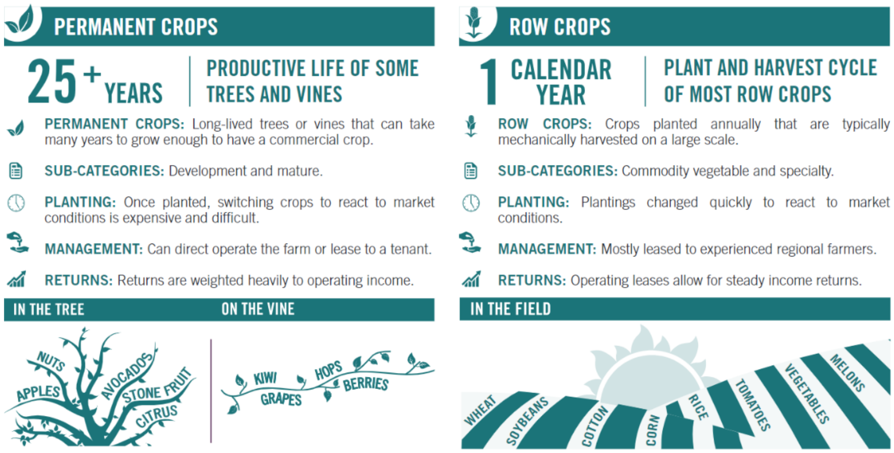
Dispatch from the Research Desk

2019 First Quarter

Thematic Viewpoints

Farmland: Farmland was an area of focus throughout the quarter on the back of investor requests. While most asset classes failed to generate a positive return in 2018, the NCREIF Farmland Property Index gained +6.74%. In general, farmland provides a consistent low volatility absolute return profile that is uncorrelated to other major asset classes. In addition to a stream of income, farmland tends to perform better during periods of higher inflation, especially when inflation is linked to higher commodity prices. This benefit provides a positive long-term backdrop to the asset class, particularly given the anticipated long-term driver of growing global food demand.

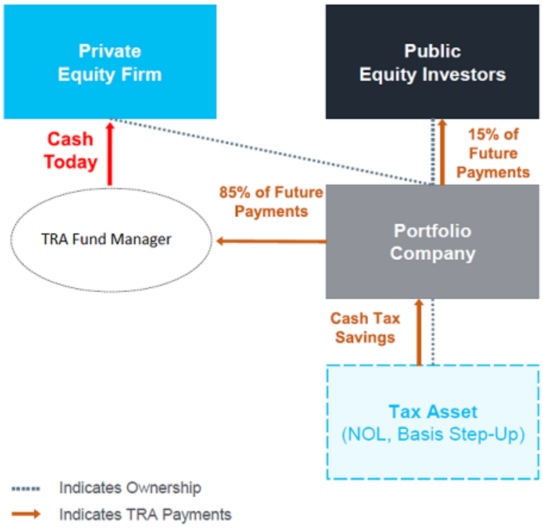


Source: PGIM

One crucial decision to make in farmland investing is whether to purchase and lease or purchase and operate farms. Leasing may have credit exposure but provides stable bond-like returns. Rental income returns are typically lower than operating returns, but they also exhibit lower volatility. Cash rents tend to be sticky as operators enter into multi-year contracts at fixed prices and provide partial upside optionality to the land-owner related to commodity prices. Operating farms introduces greater downside commodity exposure risk but provides more control for efficiency/improvements to further drive returns. Farmland return-improvement strategies include typical financial tools like leverage and M&A as well as farmland-specific techniques to increase yield, transition to organic, enhanced water rights, vertical integration (ex: packaging, processing, distribution), etc. Location is an important consideration in farmland investing, as different regions offer different soil types, climates, topographies, policies, etc. For example, Iowa is 90% corn while California grows over 200 crops. With a different mix of crops and diversification comes a wide range of risk/return outcomes. Generally, there are two types of crops, row or permanent. Row crops are also called field crops or grains (i.e. corn, wheat, soybeans, etc.) and can be planted annually. Permanent crops are often trees, bushes, and vines that are perennial. The expected returns for permanent crops are higher than for row crops, but the commodity risk is higher and investment period is much longer. Permanent crop investments tend to involve operating risk, as switching crops can be expensive and difficult. In January 2019, the Alaska Permanent Fund announced it would shift its target farmland allocation from 80/20 to 60/40 for row/permanent crops for its ~$850 million portfolio in pursuit of higher expected returns.

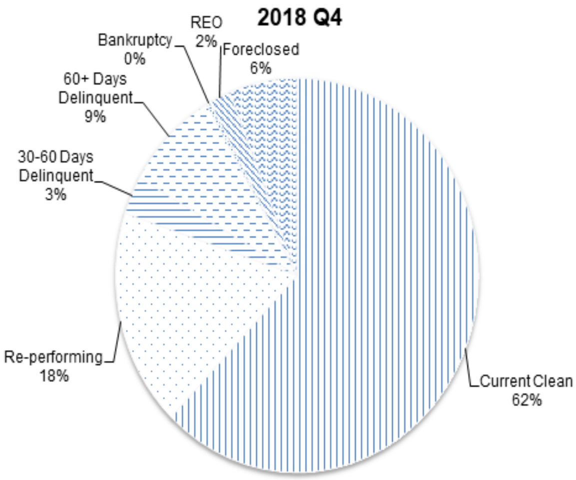
Source: Sierra Club

Transportation Equipment Leasing: Investor allocations in 2019 have continued the trend of the last several years, pursuing illiquid yield-oriented investments with expected low correlation to traditional equity and credit markets. Transportation equipment leasing strategies fall under the real assets market segment and generally involve mission-critical assets that generate attractive cash yields after maintenance CapEx, have long useful lives, and stable residual values. Due to regulatory changes post global financial crisis, bank activity in these areas remains constrained, to the point where alternative capital can earn attractive rates of return by filling the void. In addition, these strategies can have attractive tax characteristics for taxable US investors, with the ability to depreciate assets on an accelerated basis (1 to 7-years), generating passive losses that can be carried forward or offset against other passive gains. The most common of these strategies is in aviation finance. While there is cheap capital available through bank financing and the securitization market for early stage aircraft, Atrato Advisors has identified a number of funds focused on mid to end-of-life assets. The managers in this portion of the market typically underwrite to attractive mid-teens returns with low leverage and under the assumption that the realized value at the end the lease is the terminal value of the aircraft (sometime resale value and sometimes scrap). That said, these teams endeavor to extend leases at attractive rates and successful execution materially increases IRR potential. These managers also engage in the intensive exercise of parting-out valuable airframe and engine parts to enhance residual value. These activities have high barriers to entry as they rely on partnership within the industry. Similarly, we have found similar dynamics in other transportation sectors such as railcars and maritime assets (barges). Both sectors are generally sleepier than aviation, characterized by shallower decline curves of residual value and less “Wall Street” capital, with managers focused on partnering with existing industry manufacturers to ensure access to assets as they are produced. While all of these transportation sectors have some correlation to GDP growth, managers are capable of mitigating many of these risks by diversifying their lease termination dates and exposure to commodities/counterparties. There is fair amount of dispersion in counterparty credit quality between the various asset classes and specific fund managers.



Source: Undisclosed Manager

Tax Receivable Agreements (TRAs): As defined by law firm Ropes & Gray, TRAs are agreements entered into by a company in connection with its IPO to monetize post-IPO tax attributes for the benefit of pre-IPO owners and investors who purchase rights to payment under TRAs from such pre-IPO owners. To simplify the legalese, a TRA is a monetization of a tax benefit that can be based on tax credits, operating losses (NOLs), good will, amortization and property depreciation. This asset class was created by the private equity industry which saw that the market did not properly account for tax assets on balance sheets, so they decided to retain the benefits for Limited Partners post-IPO. According to Ropes & Gray, PE firms started to take greater note of this strategy when Blackstone held its IPO, as the partners were able to keep 85% of tax deductions for pre-IPO partners. Generally, that 85/15 split on tax assets is common between the PE firm and the company. The asset class offers interesting tax advantages because investors receive capital gains rather than ordinary income and the pay-out is inversely correlated to corporate tax rates (higher tax rates mean the tax asset is worth more). The downside is that tax assets represent unsecured claims. We spoke to a manager that pursued a TRA-focused strategy at a blue-chip PE firm before spinning out to manage partner capital for a debut fund. The manager is now raising capital for its second fund and expects to raise more capital given their knowledge of the investable universe (~150 sponsor backed IPOs from 2011-2015 with about 50 holders on average), which they view as a barrier to entry. The focus on earlier vintage IPOs is key, as the unsecured nature of their claims leads them to emphasize recurring revenue business that have deleveraged post-IPO. Overall, this manager expects to generate returns in the mid to high teens and can deploy $150 million annually in transactions of about $10 million each.



Source: National Credit Union Administration

Recapturing Principal Forbearance in RMBS: The market for RMBS has been positive for years, with home price appreciation, high employment, and low housing supply all contributing to healthy market conditions. Price volatility has also benefited from the general movement of RMBS from private equity and hedge fund owners to real money pensions and insurance companies with lower costs of capital. The issue for managers has been to identify pockets of additional return opportunities in an otherwise competitive market. The legacy RMBS market is $250-300 billion in size and one manager estimates that there is $15 billion of principal balance forbearance from the crisis-era that the market has largely forgotten and is not appropriately accounted for in trustee reports. Given the positive home price appreciation trends of the last decade, troubled loans from the global financial crisis are generally reperforming and have healthy equity cushions. In the event of a home sale at a premium to the stated principal and forborne principal amount, the total amount will be paid into the trust. In this instance, the forborne principal is essentially an off-balance sheet asset. The exercise to identify and estimate the potential forborne principal amount is a data intensive statistical exercise and the ultimate outcome is difficult to time and realize. Even if only half of the estimated $15 billion in forborne principal can be realized, then the profit opportunity is material.

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ATRATO ADVISORS®

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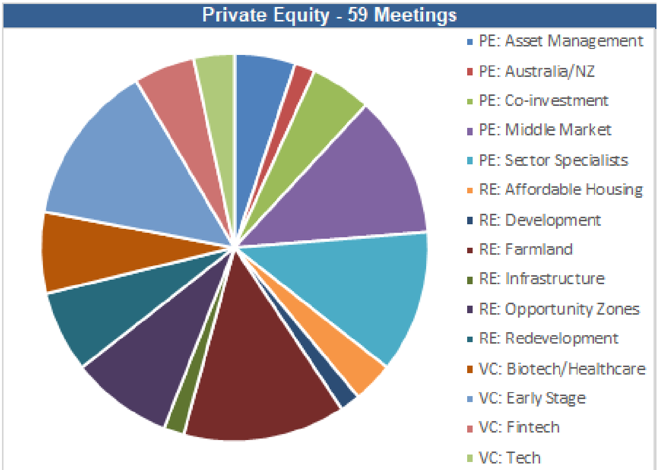
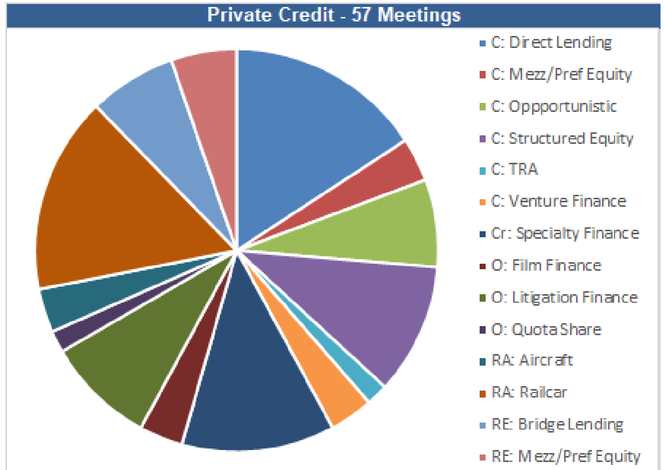
Research Calendar

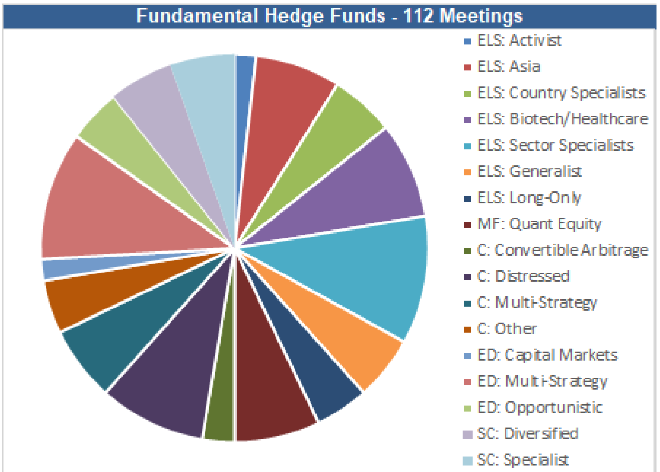
During 1Q19, Atrato Advisors conducted 252 calls and meetings across 178 management companies within the alternative investment industry. By primary investment designation, the research coverage broke down as follows:



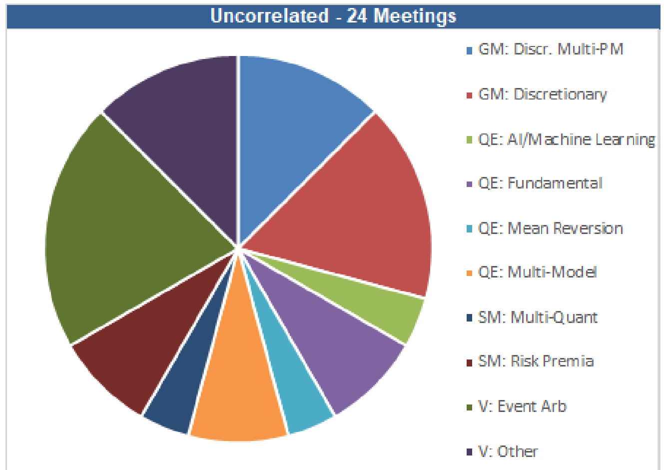
Private Equity (PE), Real Estate (RE), Venture Capital (VC)



Corporate (C), Consumer (Cr), Other (O), Real Assets (RA), Real Estate (RE)



Equity Long/Short (ELS), Mutual Fund (MF), Credit (C), Event Driven (ED), Structured Credit (SC)



Global Macro (GM), Quantitative Equity (QE), Systematic Macro (SM), Volatility (V)

About Atrato Advisors

Atrato Advisors (www.atratoadvisors.com) is a boutique consulting firm that provides highly individualized research and advisory solutions to the alternative investment allocator community. We work with family offices, wealth management firms, asset managers, fund of funds, foundations and endowments looking to expand the scope and depth of their alternative investment coverage, partnering with them on sourcing, portfolio construction, manager research and/or operational due diligence.

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