Dispatch from the Research Desk

2019 Review & Outlook

Thematic Viewpoints

A Note of Caution (Zombie Funds): A recent industry report estimated that about $1.3 trillion of investor capital is in zombie funds globally. While we believe the report overestimates the figure given it casts an excessively wide net, we still believe zombie funds could grow and be an unwelcomed guest within portfolios. Zombie funds, which can be any investment vehicle but are usually private equity, venture capital, or hedge funds, are defined differently depending on the source. A good summation for a definition is any fund that operates below breakeven (often ballparked at $100 million) or a fund with poor performance that lingers on to the dismay of its investors and leaves the sponsor with limited opportunity to raise future funds. Having to pay 2% per year to a manager that has destroyed value is a tough pill to swallow, especially if investors are locked up for almost a decade. While fees tend to end when the official fund life ends, the assets can remain in limbo with little incentive to be worked out by the managers. While a recent FT article citing the aforementioned report brings this topic into the limelight, other reasons to mention zombie funds include the ease with which we have seen private managers raise assets and the recent debacle involving the bankruptcy of a private equity portfolio company. To start with the bankruptcy, an energy company filed Chapter 11 in late January and the private equity sponsor with an 80% stake had its $775.5 million investment marked at ~1.0x as recently as September. Not only is the investment outcome unfortunate, but the rapid hit to NAV goes against the smoothed and delayed NAV transitions investors have come to expect from their private equity investments. With respect to capital flows, investors have been so attracted to private equity that managers in the space have been able to reach their target raises in short order (see private equity secondaries below), with material increases in subsequent fund raise amounts and shorter periods between new funds. Private equity reporter Dan Primack of Axios summarizes the environment well: "fundraises were a tougher slog and had lengthier cycles, but now they feel as mundane as annual holiday parties." Given the magnitude of capital flowing into the space and lower than expected go-forward returns, the bottom quartile will be notably painful for investors after these fund lives end, and many of these funds could be zombies for years before they return whatever capital is left to investors. The takeaway from these issues is that we are keen to ask managers about their underperforming investments, fundamental performance of portfolio companies, and the NAV process to try to avoid stale or generous marks.

Private Equity Secondaries: Atrato met with several private equity secondaries firms/funds to round out the year. The general premise for interest in secondaries stems from the win/win/win scenario for successful secondaries transactions. The seller, GP, and LP can benefit from liquidity not otherwise available in private markets. Secondaries also provide ballast to a portfolio given their ability to minimize or eliminate J-Curves, further diversify portfolios across deals and vintages, deploy capital faster, smooth cash flows, and potentially augment returns when more forced sellers enter the market in distressed periods. With that said, distress and discounts to NAV are not the only reasons to look into the secondaries space. One potential reason to consider secondaries is for an interesting first step into private equity for certain investors, especially for those investors that might not have the ability to create a fully diversified private asset portfolio. We also believe that secondaries funds charge lower fees than industry norms. Secondaries transactions have evolved in recent years as GP-led deals now account for about two-thirds of volume. These deals tend to offer better risk/return outcomes for secondaries funds but tend to require strong relationships with GPs. The growth in private equity secondaries has steadily risen since the global financial crisis, as the increased willingness of sellers has attracted more buyers in a symbiotic cycle. Some industry research estimates $100 billion of secondary transaction volume in 2019. Private debt secondaries are newer, so the number of funds dedicated to the asset class can be counted on one hand. We expect the growth of private debt secondaries to increase in the coming years, as the capital flowing into the broader private debt space has been astronomical, albeit with an infantile secondaries market. A large player in the secondaries space raised $14 billion for their Fund IX, which surpassed their fundraising target and was 39% larger than their Fund VIII. Another manager we met raised more than their hard cap. It is unsurprising to see substantial growth in this sector as it matures. For allocators that haven't considered the space yet, we believe the opportunity set in the next crisis will be extremely compelling. In this cycle, the proportion of allocator portfolios dedicated to illiquids has increased, with substantially more direct exposure to funds and single assets. In the next cycle, we expect secondary volumes will increase materially, and that discounts from non-economically driven sales will be substantial across all asset classes. We have sought to understand the alignment of interest between all parties involved and minimize conflicts.

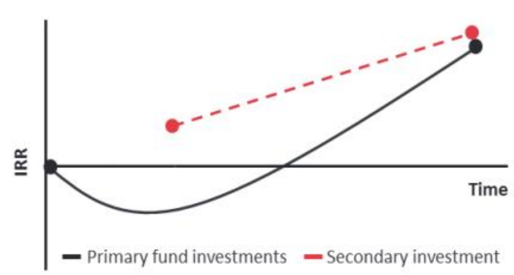
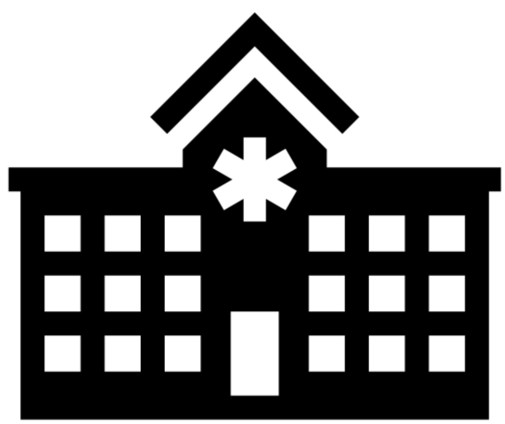


Figure 11: IRR profile of primary and secondary investments
Source: Capital Dynamics, for illustrative purposes only.

Mineral Rights / Energy Royalties: For the past several quarters, we have written about the weakness in the energy sector. While oil prices have found a fairly consistent range between $50-60 a barrel over the past few years, natural gas prices declined throughout 2019 and finished just above $2 per million BTU. This gas price decline coupled with investor fatigue led to extreme weakness among energy debt and equity securities in 2019 and over the prior two years. While we believe that value exists up and down the energy chain, we have conducted substantial diligence around the mineral rights asset class. Mineral rights are property rights to exploit a plot of land for sedentary minerals or fluid minerals (oil and gas) below the earth's surface. Mineral rights can be separate from property ownership. Mineral rights owners are entitled to a negotiated share of the cash flow of the mineral production on the property, without any cap-ex required (an important distinction from working interests). Mineral rights as a strategy has had an exceptional tailwind over the past 10+ years, as the shale revolution has led to development and production on previously unproductive acreage. In addition, continued technological advances have significantly reduced the time it takes to drill, frac and complete each well, with impressive per-well productivity gains that were not broadly anticipated. While short-duration, high current production proven and producing assets are quite competitive and often are sold for mid to high single digit IRRs, we have found more attractive strategies that mix current production with longer-term development that comes much cheaper and can generate much higher multiples on invested capital. While betting on where producers will drill future wells seems like a risky endeavor, the amount of technology available from mapping and geological surveys and the technological playbook of fracking mitigate many of these risks. We have preferred managers focused on core US basins (Permian, Eagle Ford, DJ, etc.) as low cost regions perform better in lower commodity-price environments. We also prefer managers focused on smaller dollar purchase prices below $5 million, as competition increases materially above that size from publicly traded firms with lower costs of capital. Atrato Advisors has identified one particularly compelling manager that has developed a highly differentiated business model to finance smaller transactions, structuring its investment with subordinated capital to limit downside risk and focused on shorter-duration investments with IRRs of 20-30%.



Medical Office Real Estate: During the quarter, Atrato evaluated opportunities in the medical office space as part of a broader theme involving niche real estate assets that are less economically sensitive, have secular tailwinds, and can be acquired at higher cap rates to support a buy and hold approach through a cycle. However, these assets can typically also be aggregated and flipped to institutional buyers at compressed cap rates to enhance the IRRs should conditions remain unchanged. With the population of baby boomers aged over 65 increasing at 3-4x the rate of the rest of the US population, the demand and utilization of medical offices are increasing as doctor visits per year increase with age. Large institutional buyers including REITs tend not to participate in property-level acquisition strategies, because most medical office buildings are too small at 50,000-70,000 square feet and $10-20 million values. The size of the buildings is typically determined based on the population density in the local area, and typically around a major hospital asset. In many instances, local health systems are the major tenants and/or owners of the medical office assets, and sourcing directly from them drives the sponsors ability to purchase at attractive prices. Health system sales tend not to be primarily motivated by price, though they are economic actors, but by assurance that there will be no operational disruptions at the properties. One fund we spoke with has been able to purchase assets in the mid-6% cap rate range and aggregate and sell portfolios to institutional buyers in the 4.5-5.5% cap rate range. The constituent assets tend to be considered core, with very little value-add activity. The strategy tends to be focused on fully or nearly-fully leased buildings, and medical offices have historically tended to have 500 bps less vacancies than traditional office. Modeled NOIs tend to increase by about 2% per year based on existing lease terms, with distributable cash flow increasing from about 5% to 7% over the life of the fund. With successful exits of aggregated portfolios of $100 million or more, low to mid-teens returns are achievable. The major fundamental risk to the strategy is health system consolidation causing redundancy in certain types of medical services in a local market, though demand for space is typically high and tenant defaults are low (particularly for specialists).

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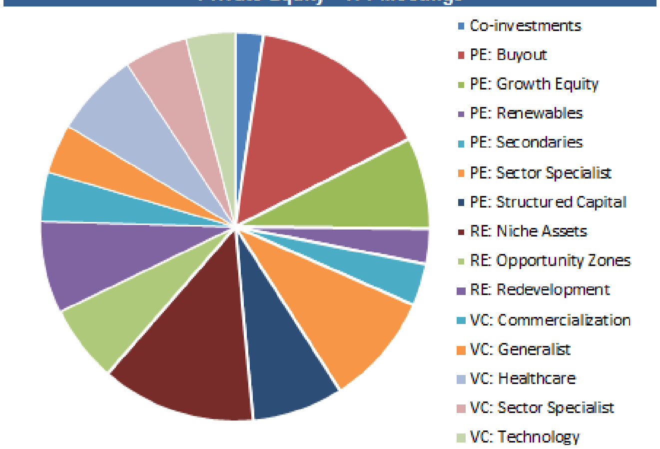
ATRATO ADVISORS®

Research Calendar

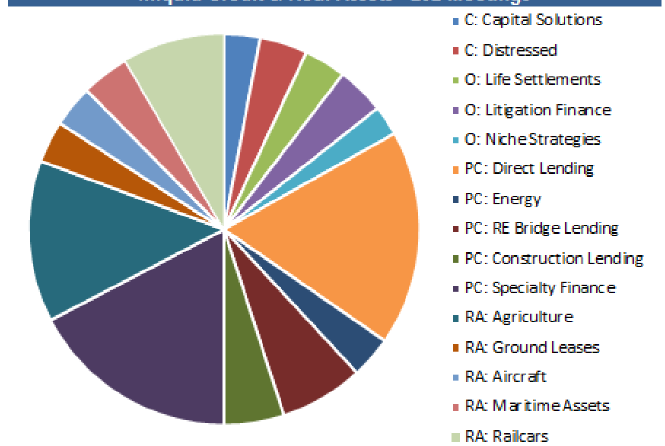
During 2019, Atrato Advisors conducted 951 calls and meetings across 588 management companies within the alternative investment industry. By primary investment designation, the research coverage broke down as follows:

Private Equity - 171 Meetings



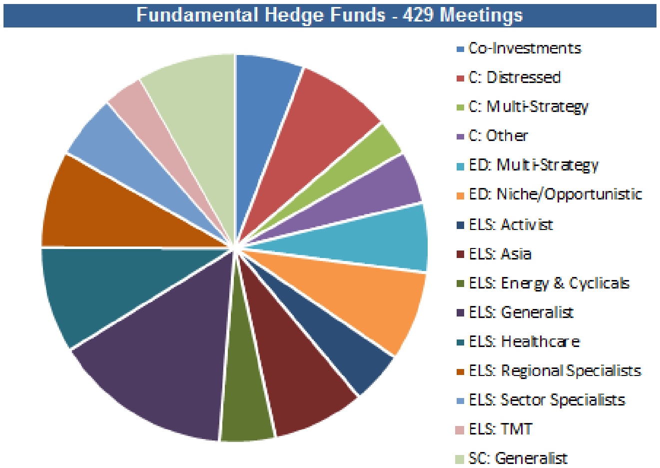
** Private Equity (PE), Real Estate (RE), Venture Capital (VC)*

Illiquid Credit & Real Assets - 202 Meetings



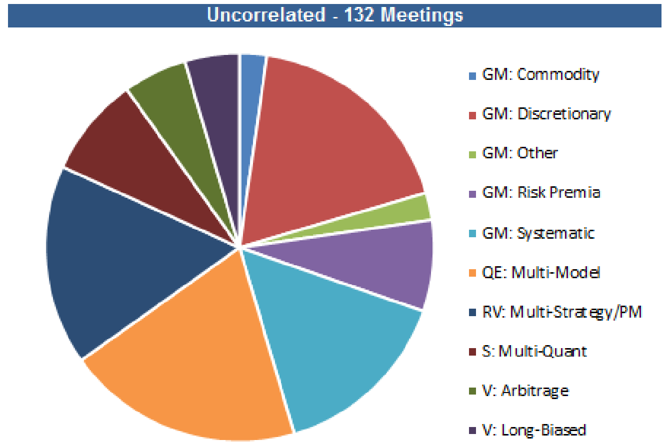
** Credit (C), Other (O), Private Credit (PC), Real Assets (RA)*

Fundamental Hedge Funds - 429 Meetings



** Credit (C), Event Driven (ED), Equity Long/Short (ELS), Structured Credit (SC)*

Uncorrelated - 132 Meetings



** Global Macro (GM), Quantitative Equity (QE), Relative Value (RV), Systematic (S), 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.

Contact

Brian Reich
President
breich@atratoadvisors.com
(212) 582-2200