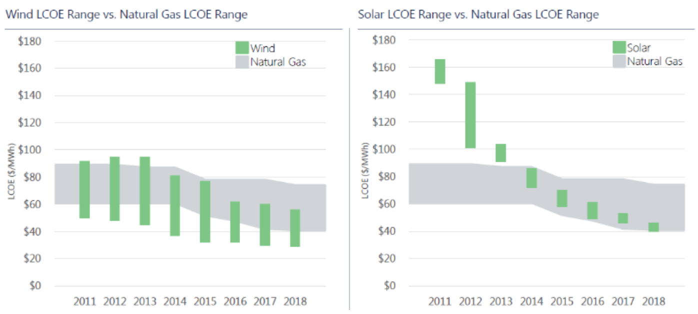
Dispatch from the Research Desk

2019 Second Quarter

ATRATO ADVISORS®

Thematic Viewpoints

Renewable Energy: Renewable energy is a burgeoning aspect of client portfolios, and Atrato noticed an uptick in conversations this quarter as an element of broader investor interest in ESG themes over the past year. In the US alone, the investment need for renewables assets is expected to be over $150 billion by 2025. The solar and wind spaces, particularly projects that are in excess of $50 million in size, are dominated by institutional buyers and forward-looking returns are modest as a result (mid-single digits). We have focused our research time on managers partnering with developers or purchasing projects in the $5-25 million range, where yields are a couple hundred basis points wider (in the low double digits) than traditional projects. While these projects tend to come with 6-18 months of construction risk, they are generally backed by long-term (15-20+ years) Power Purchase Agreements (PPAs) which ensure long streams of stable cash flows for the usable life of the assets upon completion. The usable life of most renewable assets is about 30 years, with major maintenance milestones at 15 years. The assets can be leveraged because of the typical length of PPAs (15-20+ years) and overwhelming exposure to investment grade offtakers (unrated municipalities are often offtakers as well). Debt on these structures is typically floating rate, but managers often swap into fixed rates in order to eliminate interest rate risk from their portfolios. There are multiple exit options for these portfolios once they are aggregated to scale ($500+ million): securitization, public listing as a REIT, sale to a large infrastructure/renewable sponsor, or sale to European institutional buyer (lowest cost of capital in the space). The ideal exit will realize several hundred basis points of cap rate compression to generate capital appreciation on top of the yield profile of the assets, though a positive return profile does not rely on meaningful compression. One deal-specific opportunity identified over the quarter came from a manager whose specialty has historically been in traditional energy (i.e. E&Ps). This manager first deployed capital to the renewable space following the boom/bust period that was fueled by subsidies and venture capital. Since that washout, investors have focused on unsubsidized wind and solar that is competitive with or even cheaper than traditional fossil fuels (as discussed above and in the graph to the right). This manager is in the process of partnering with a leading developer and setting up a direct investment (in a fund structure) into residential solar installation. Investors get the benefit of depreciation on the assets, pass-through tax credit exposure, and the ability to leverage the tax credit to enhance returns.



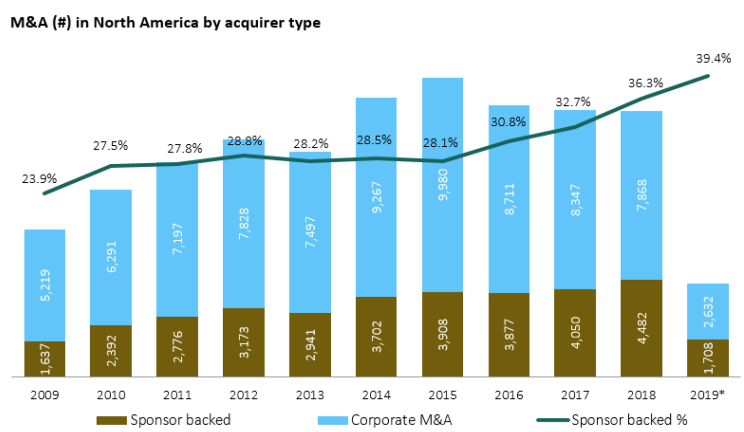
Source: Lazard | LCOE = Levelized Cost of Energy

Oil & Gas: On the other end of the spectrum, Atrato Advisors has witnessed investors abandon the traditional energy sector in public and private markets across mid-stream and up-stream businesses. With the general investor retreat from these markets, certain managers have sought the opportunity to purchase or finance upstream assets that are positively cash flowing based on current production and where Proven Developed Producing reserves cover the majority, if not all, of their investment. These assets have CapEx needs to expand production well below existing cash flow. While many lending strategies focus on the best acreage in the best basins, some of the equity investors are focusing on non-core assets that are being sold by E&P companies as they consolidate around their core assets. The producing assets in both strategies tend to be established, have well understood decline rates and significant remaining development upside based on barrels in the ground. We have seen both lenders and equity investors looking to protect themselves by having the companies hedge forward production prices aggressively, emphasizing that commodity prices do not need to rise for attractive IRRs to be realized [lenders hedging for the life of their loan (3-5 years), equity buyers hedging for 6 years]. Lenders are protecting themselves through amortization schedules and excess cash flow sweeps while equity investors are seeking to de-risk investments by distributing cash flow from the onset. The equity investments carry some advantage for taxable investors as well because depreciation can be realized over seven years. This area of credit markets seems to be one of the few where the supply and demand of capital is strongly in favor of the lender, allowing them to negotiate on terms and covenants and choose to lend to experienced management teams with attractive collateral/cash flow characteristics.

Consumer Strength: While many readers of this dispatch may be aware, we think it is worth emphasizing the strength of the US consumer in the now decade-plus recovery following the Great Financial Crisis. Despite the rhetoric around trade wars and rate cuts, the data on the US consumer has remained exceptionally strong in 2019 across almost every economic data point available. The most prominent employment numbers paint a picture that is very strong with a 3.7% unemployment rate, unemployment claims at a 50-year low and sustained wage growth above 3.0% in 2019, despite sub-2% inflation. While much is written about the student loan crisis, household debt service payments as a percentage of disposable income have been below 10% for the last five years, versus the previous historical low of 10.25% in 1980. The amount of equity that US households have in their homes similarly sits at all-time highs, as consumers have been loath to refinance and cash out equity as they did in 2005-2007. Consumer strength was confirmed in the initial first quarter GDP report, which saw consumer spending rising at a

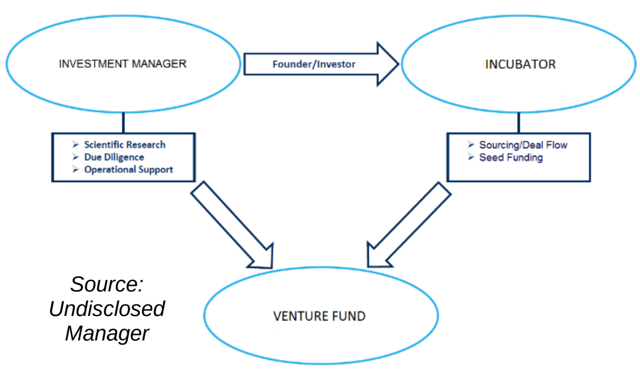
4.3% rate. This consumer strength is confirmed in conversations with managers, especially those doing rediscount lending across consumer and auto lending, where they receive data as often as weekly on cuspier sub-prime borrower payment trends. These managers continue to see data that points to consumers getting stronger rather than weaker. Given those market dynamics, we do not see any evidence of a consumer-led recession on the horizon and would need to see data moderate before we would even begin to worry about one. While consumer strength is priced into many markets, we believe strategies oriented towards the consumer will continue to perform well, especially on a relative basis versus other corporate or globally exposed counterparties. A variety of structured credit and private credit strategies have direct exposure to consumer-backed collateral, many of which have attractive risk/reward profiles due to their short durations and distributed cash flow.

PE/VC Funding & Deals: Investor demand for growth remains implacable across public growth stocks and private equity and venture capital funds (often in TMT and healthcare). In previous dispatches, we have discussed the significant amounts of capital raised by PE/VC funds, citing dry powder at an estimated $1.0 trillion in addition to the planned increases in commitments by investors. In the 3Q18 dispatch we discussed that deal volumes had set a record before the year was even over and the size of the largest deals was growing tremendously. As the IPO markets have remained strong, Silicon Valley Bank expects that the flood of capital from these exits/IPOs will lead to a virtuous cycle of investors receiving capital back from funds, entrepreneurs starting new ventures, and LPs reinvesting in the next fund vintages. Preqin stated in its 2Q19 PE and VC Update that 41% of funds closed in the first half were in market for six months or less, which shows that managers have had relatively seamless fundraising processes. According to PitchBook, PE-led acquisitions accounted for almost 40% of North American M&A volume in 1H19, which is a continuation of a trend from its average of about 30%. Valuations on private equity transactions remain elevated, with managers communicating that attractive deals are consistently trading at mid-teens or higher EBITDA multiples (versus 10-12x multiples seen just a few years ago). The high level of sponsor activity, including sponsor-to-sponsor transactions, and level of available capital to allocate brings about questions regarding how competition is impacting forward returns. Valuations, the size of funding rounds, the length of time that companies are remaining private, and exit strategies have all changed in response to the influx of capital this cycle. We expect that exuberant PE/VC capital activity will present opportunities down the road for distressed managers, secondary private equity funds and lenders that can step in to provide liquidity to funds that run into trouble late in their investment periods. However, these opportunities will takes some time to emerge as the large amount of dry powder currently available in the market will allow prevailing trends to continue in the near to medium term.



Source: PitchBook **as of June 30*

Captive Incubators: There is a growing trend of captive incubators within venture firms. Incubators are typically managed with only General Partner (GP) capital and do not provide access for Limited Partners (LPs). The growth of internal incubation platforms has occurred as early-stage funding rounds have occurred later in the start-up life cycle, in larger size and much more competitively. The advantage of an internal incubator is that very small and very early stage GP investments can give priority access to LP funds when the companies are ready for additional funding rounds. With often 1-3 years of exposure to the management teams and businesses via the incubator, the information asymmetries are materially reduced between the management teams and the GPs. This creates a more favorable dynamic in investment selection by the GP on behalf of LPs. One major question that arises is how companies move from the GP investment pools/funds to LP funds. In some instances, we have seen managers look to assign a reasonable market-based valuation, even if they and co-investors allocate all the capital (so the real market value is not tested). In other instances, managers have sought to transfer the companies over to the LP Funds at cost to mitigate the conflict of GP ownership mark-up into the next funding round with LP capital. Incubators are likely to become more prevalent as managers seek ways to avoid the high level of competition for on-the-run transactions.



Source: Undisclosed Manager

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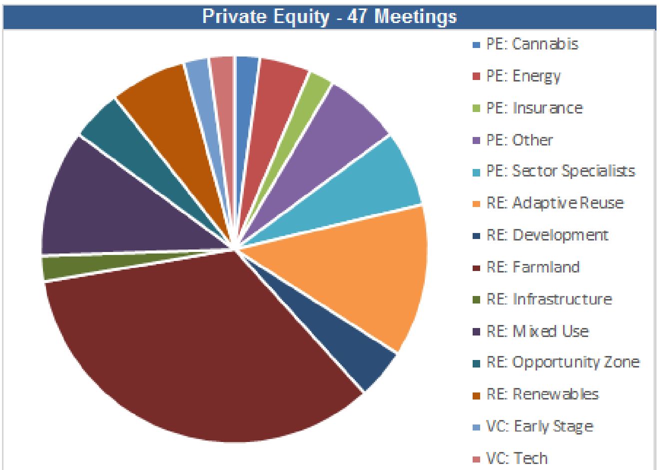
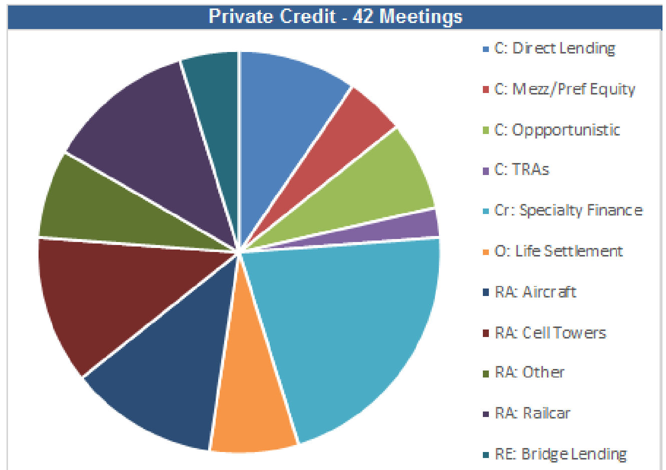
Research Calendar

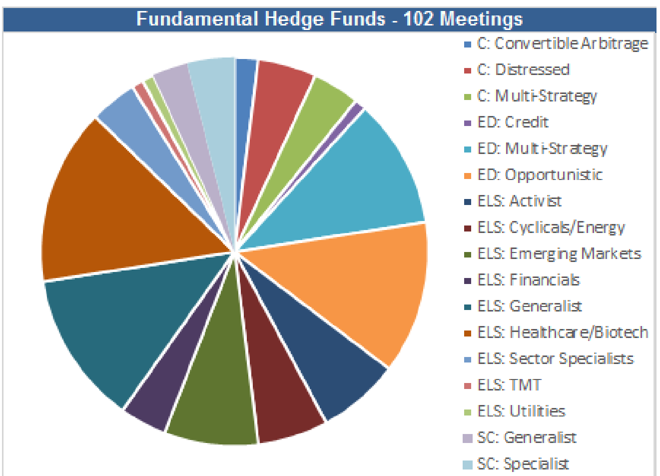
During 2Q19, Atrato Advisors conducted 229 calls and meetings across 174 management companies within the alternative investment industry. By primary investment designation, the research coverage broke down as follows:



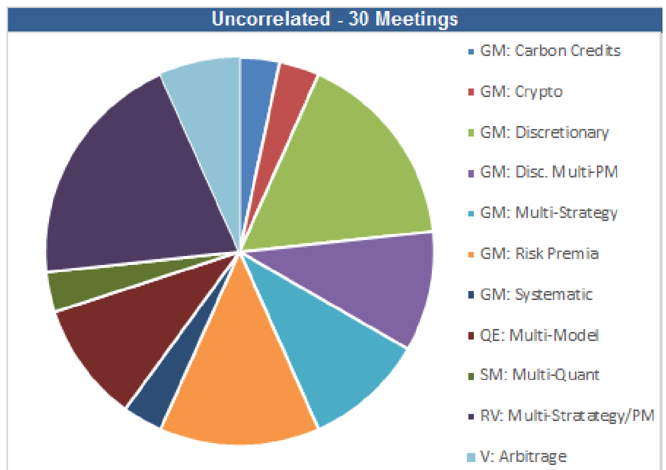
**Private Equity (PE), Real Estate (RE), Venture Capital (VC)*



**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), Relative Value (RV), 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