Dispatch from the Research Desk

2019 Third Quarter

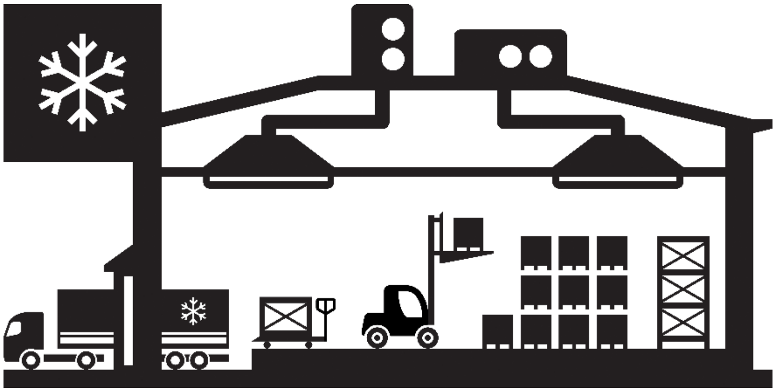
ATRATO ADVISORS®

Thematic Viewpoints

<u>Co-Investments:</u> In recent quarters, Atrato has sought to formalize a process around sourcing and offering co-investments to clients on a structured and/or ad-hoc basis. Our main focus has been to further develop and foster relationships with managers to access deal flow. Our emphasis has been on manager relationships augmented with our usual combination of qualitative and quantitative analysis on the co-investments. While a significant part of the process has been reconnecting with managers that we have monitored for a long time, we have also expanded our network by speaking with allocators, emerging managers, and databases/fintech platforms focused on co-investments. This process has included comparing deals across various sets of peers and conducting competitive analysis. Other analysis is more deal specific; for example, a recent solar transaction required substantial diligence on tax credit structure (grandfathered rate), depreciation schedule (federal and state), credit risk, operational management/servicing, annual cash flow, after-tax returns (K-1 impact), and exit potential (sale or securitization). Atrato's co-investment opportunities have spanned hedge funds, private equity, venture capital, and real estate, although we view venture capital co-investments as more opaque and having even more negative selection bias than the other strategies. Investors should not expect a free pass for co-investments unless they are an existing investor with the firm/fund, but co-investments do come at a significant discount to fund fees (0% management fee and 10-20% incentive fee as a baseline). Hurdle rates or preferred returns are additional kickers for investors. Unsurprisingly, the larger allocators have been able to structure highly favorable economics with funds relative to the baseline. That said, smaller investors have been able to achieve highly favorable economics with firms where their incremental capital is meaningful, even if it isn't business changing. According to various industry surveys, about two-thirds of HNWI expect to participate in more co-investments. Overall, we believe investors can find value through co-investments by concentrating into high conviction situations, capitalizing on family domain expertise, and expanding into ESG where it is an allocation priority.

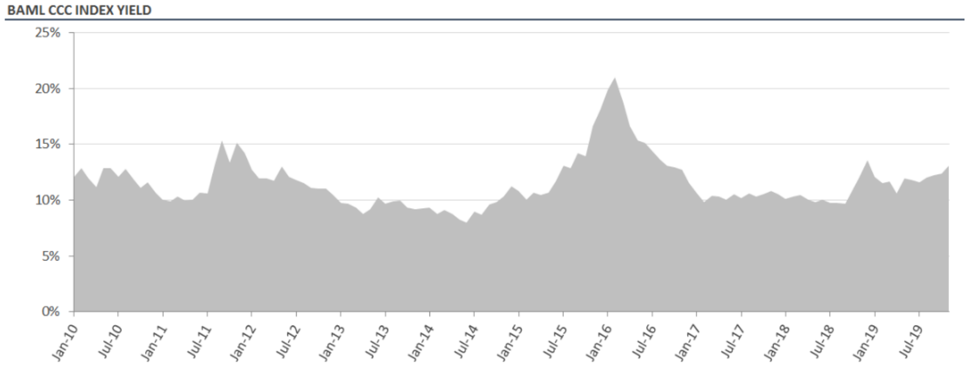
While the growth in co-investments has been a headline positive for hedge funds, most equity long/short funds have struggled to maintain interest from investors in recent years. For well-established alternatives businesses with ample assets, co-investments are a mechanism for expanding margins and selling incremental capacity on a position-by-position basis when the strategies are already effectively at capacity. For funds that are still looking to scale their businesses or are offering co-investments while their fund-management businesses decline, these are fundamentally worse businesses than they otherwise would be (lower fees, investors not committed, more back-ended incentive structures, no portfolio/smoothing benefits). In the next cycle, co-investment investors will be directly exposed to illiquidity issues, no netting on incentive fees, and mark-to-market volatility inherent in single investments.

<u>Refrigerated Storage:</u> We have noticed a recent proliferation of articles and investments from managers in refrigerated/cold storage or food-related warehouses. Overall, the growth of cold storage is attributed to the evolution of e-commerce and online grocery sales, with FMI/Nielsen expecting online grocery sales to grow from 3% of total grocery sales in 2017 to 13% by 2024 (or $19 billion to $100 billion). A major private equity firm has a Los Angeles-based joint venture with a business focused solely on the space that has a first mover advantage as well as access to proprietary data on comps, rents, tenant improvements and leads. The manager believes the sector is somewhat opaque given that only ten brokers in the US specialize in these properties. Their investment approach has been to focus on properties with moderate vacancies and requiring light rehabilitation rather than new construction. Stabilized refrigerated warehouses on a standalone basis tend to trade at a cap rate premium of 100-150 bps over dry industrial warehouses, but portfolios ($100+ million) of stabilized refrigerated warehouses are in high demand from public and private REITs at substantially tighter cap rates. This fund has committed $135 million of equity to date with typical equity checks of $6-7 million with expectations to deploy about $100 million per year going forward. They estimate their performance to date at a 28% IRR with a 1.5x MOIC, with the best sale generating a 50% IRR. According to a WSJ article, Lineage Logistics, a private-equity owned refrigerated storage company, is expanding into Asia with its purchase of Emergent Cold from Elliott Management for $900 million. Elliott will maintain an equity stake in the combined equity. The article reiterates the view of the manager mentioned above by stating "demand for cold storage space outpaces supply." We also spoke to another manager that approached the space through a different asset class. They invested via a two-year bridge loan with warrants while the company was private, and it has performed admirably since its IPO which led to a 40% IRR for the deal. Lastly, multiple panelists at a conference mentioned the space as an interesting but expensive opportunity.



Source: MHRA

Distressed: A trend worth highlighting so far in 2019 is the underperformance of distressed strategies. Despite the broad recovery across equity and more liquid credit indices in 2019, stressed/distressed credit and post-reorg equity positions have lagged significantly and weighed on distressed investor returns. With the decline of middle market focused distressed funds over the past few years, the marginal buyers of middle market loans have been rules-based CLOs that have experienced strong issuance. The BAML CCC Index Yield stood at 13.1% as of November 30th, its highest all year. Furthermore, the percentage of loans trading below 80 cents on the dollar ticked up to 3.5% in the third quarter, which while not indicating systemic issues, does seem at odds with the continued low level of defaults. The weakness has been mostly tied to energy, with 16.5% of US oil and gas loans priced below 80 cents as investor fatigue has peaked among distressed managers that have been in the trade for several years. Other sectors including retail, healthcare and legacy telecom are exhibiting signs of weakness as well. We think this trend has broad implications for the small remaining universe of distressed managers that are focused on stressed credit, with managers indicating that opportunities stand out against the backdrop of broadly expensive markets elsewhere. If the credit cycle were to turn significantly, we think the CLO sector could be a site of significant pain, while presenting a deluge of opportunities for distressed managers with a middle market focus.



Another trend worth noting is the poor performance of post-reorg equity positions. The standard playbook by distressed managers is to restructure overly-indebted companies, receive back-end equity in under-levered capital structures that allow them to monetize their holdings at gains as the equity buyer base rotates to the long-only community. This process has broken down and holding periods have extended as the post-reorg equities continue to trade at significant discounts to peers. One aspect of this is attributable to the market environment and another aspect is attributable to changing constituents within reorganizations. Companies that have had to file for bankruptcy in the benign macro/credit conditions of the past several years are generally flawed businesses or in structurally declining industries. The weakness has been exacerbated by the fact that restructured companies are being left with higher amounts of take-back debt. This has occurred as more CLOs have participated in restructurings rather than selling distressed positions. CLOs have limits on receiving equity, and therefore need to create reorganized capital structures with ample debt. A few managers mentioned their belief that the weakness in post-reorg equity might be hitting a crescendo, as the valuation differentials between formerly distressed companies and their peers have allowed them to build relative value trades that look compelling. While the continued weakness in post-reorg equity may not present any near-term directional opportunities, it is clear that the low level of defaults has changed the market and participant structure around reorganizations, particularly the transmission mechanism of under-levered reorganized equities from distressed holders to the long-only community. For current market dynamics to change, CLOs need to be forced out of the reorganization business, which will only occur when there is a wave of defaults that threatens their non-performing assets limit.

Emerging Market Litigation Claims: During the quarter, Atrato met with a fund focused on litigation claims within a specific emerging market. The firm has invested $700 million into these legal claims since 2007. The original legal claims are against the government as well as private or quasi-government entities, like utilities, and originated from land expropriations from individuals and illegal tariffs levied against private companies in the 1980s and 1990s. The process for the recognition and calculation of these claims is well defined; however, many holders of the legal claims are willing to sell their claims at considerable discounts due to the lengthy litigation periods and economic/political volatility. The firm typically takes exposure to claims well into the process and after the supreme court has confirmed the plaintiff has the right to seek its claims. The risk taken by the fund is in the calculation of the final claim amount, though the team works with on-the-ground legal experts and focuses on cases where precedent should be a material driver of assigned claim value (simple calculations and arbitration with judicial and private experts). Once the claim amount is settled, the value of the claim needs to be included in the budget of the public entity going forward (typically the following year, depending on size and quantity of claims). Post-merit but pre-calculation (claim value) cases will typically take 3-6 years to be resolved. Approximately 25% of the fund's exposure will be to post-merit and post-calculation cases, which come with lower returns but relatively well-defined durations of approximately 18 months. The fund is USD-denominated with unhedged exposure to the underlying country's currency because of the challenge in predicting exact claim amounts and timing of cash flows. This risk exposes fund investors to country-specific currency volatility, requiring a moderate to positive forward-looking view to support an investment.

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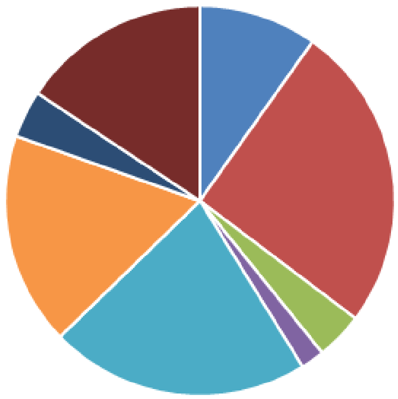
Research Calendar

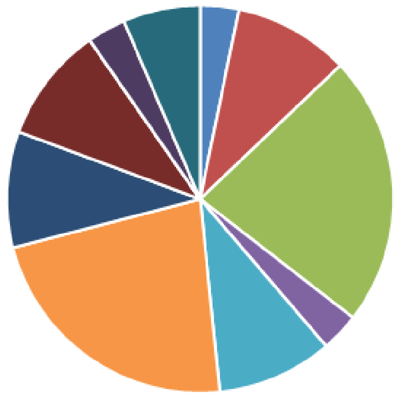
During 3Q19, Atrato Advisors conducted 173 calls and meetings across 144 management companies within the alternative investment industry. By primary investment designation, the research coverage broke down as follows:

Private Equity - 51 Meetings



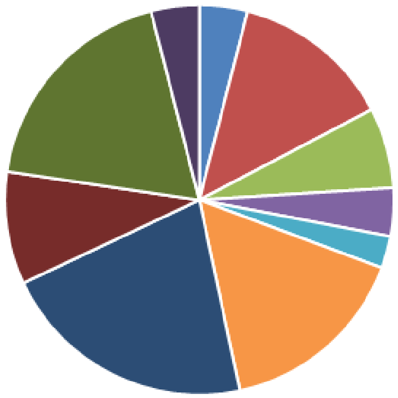
* Private Equity (PE), Real Assets (RA), Venture Capital (VC), CO: Co-Investment(s)

Private Credit - 31 Meetings



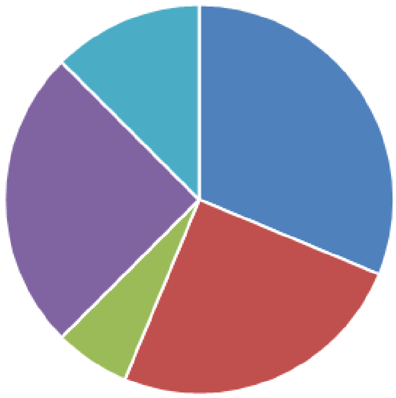
* Credit (C), Other (O), Real Assets (RA)

Fundamental Hedge Funds - 75 Meetings



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

Uncorrelated - 16 Meetings



* Global Macro (GM), Quantitative Equity (QE), 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.

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