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Silent Wave Rising: Private Asset Funds for Private and Retail Investors

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Agenda

- Recent evolution of investing in private funds
- Developments with private asset managers
- Transition to a larger private investor base
- Contrast between private and institutional investors with respect to private funds
- How fund managers address the needs of the private investors
- How analytics can help both private investors and managers understand, select, and structure investment in private funds
- Conclusions

Trends for Private Fund Investments

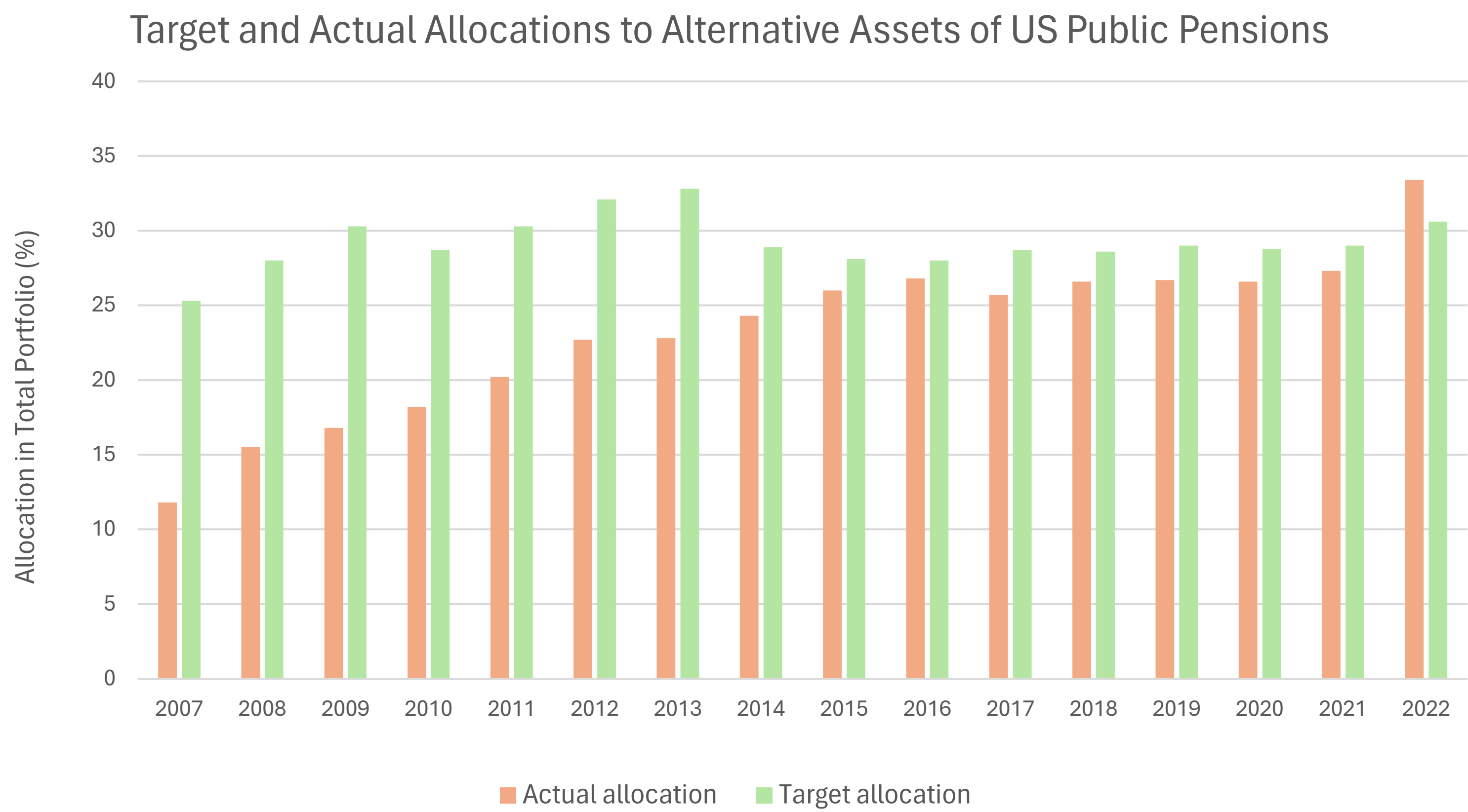
- Over the last decade, allocation of institutional investors to private assets increased from often single to double digits, up to 50% of their total portfolio

- The trend was due to several factors:
  - The reduction of the public universe of stocks due to many companies being taken private in attempt to boost their returns by changing their management, efficiency, synergies, or capital structure
  - The parallel increase of private funds offering participation in such opportunities on a diversified basis
  - An increased importance of technological advancement in the economy which gave rise to numerous early-stage investment opportunities
  - Desire by institutional investors to diversify in untapped and larger asset base
  - Increasing need for investment in infrastructure and natural resources due to population growth and need for replacement of depreciating real assets
  - The search for yield due to easy monetary policy and decrease in bond yields

Trends for Private Fund Investments (cont'd)

- There were several implication of these developments for institutional investors
- Many perceived the steady increase in allocations to have reached an upper reasonable limit, where it would be imprudent to grow any further.
- The global pandemic and the following economy of higher inflation and interest rates decreased the opportunities of fund managers to exit investments, reducing the liquidity flow to LPs, while making levered investments costlier and riskier.
- Large institutions also grew in clout as providers of capital, increasingly seeking opportunities outside of LP funds, like co-investing alongside GPs or direct investments.
- Many also sought to free up capital by selling large stakes of their private portfolios to FOF managers that would distribute to smaller investors.

Trends for Private Fund Investments



Source: Pensions & Investments, Preqin

Trends for Private Fund Managers

- Alongside the developments for private fund investors, there were related changes for the fund asset management firms.

- The demand for private funds proliferating many "emerging" managers alongside long-established private manager firms.

- The pandemic however, reversed that trend, by making less established managers riskier for institutions to invest in, causing many to go out of business or merge with larger firms.

- Some of the most established private fund management firms changed their legal structure to corporations that allowed them to trade in the public markets.

- Due to the flattening trends in institutional allocation, increasing costs, and the lack of exit deal flow the industry faced some headwinds

Trends for Private Fund Managers (cont'd)

- The private fund management firms responded in several ways
- The lack of exists necessitated the creation of numerous "continuation funds" which gave private fund investing a new image where "evergreen" is an option.
- This allowed managers to keep AUM fees flowing and take advantage of the option to wait with respect to exits.
- Simultaneously, the managers continue to seek new source of capital to a broader investor base
- During the last decade it also became more common for managers to capital raise from "semi-institutional" investors – i.e. family and multi-family investment offices. To keep this trend, private fund investing needed some degree of "democratization".

“Democratization” of Private Fund Investing

- Private investments are private on purpose - to limit the investor base. Small investor base means sharing less information and higher degree of trust. Information asymmetry allows sourcing early opportunities in a sustained fashion.

- Private investments are also illiquid by design for the same reason. Liquidity carries a hefty cost in the form of disclosure requirements by securities laws.

- The trend to acquire a larger number of smaller investors means compromising to some extent with the “private” and “liquidity” barriers.

- Therefore, the players in this larger market have to conform to a more complex set of rules and requirements.

Infrastructure of a Broader Market

- There are often unseen analogues between private and public markets:
  - Dealer markets and market makers' analogue are funds of funds and secondaries funds , although acting at a much slower clock and more subtle fashion.
  - Broker market's analogue are exchanges that cater to accredited investors

- Some large financial institutions are uniquely positioned to play a role in the "democratization" of private asset investing by virtue of having:
  - Cost efficient access to due diligence services
  - Established investment product distribution channels
  - Established trust due to name recognition.
  - Economies of scale when acting as FOF managers who can also act as market makers for their own fund product and provide liquidity to retail investors who want to enter and exit the fund at any given time.

Family Offices: Forerunners of "Retail" Funds

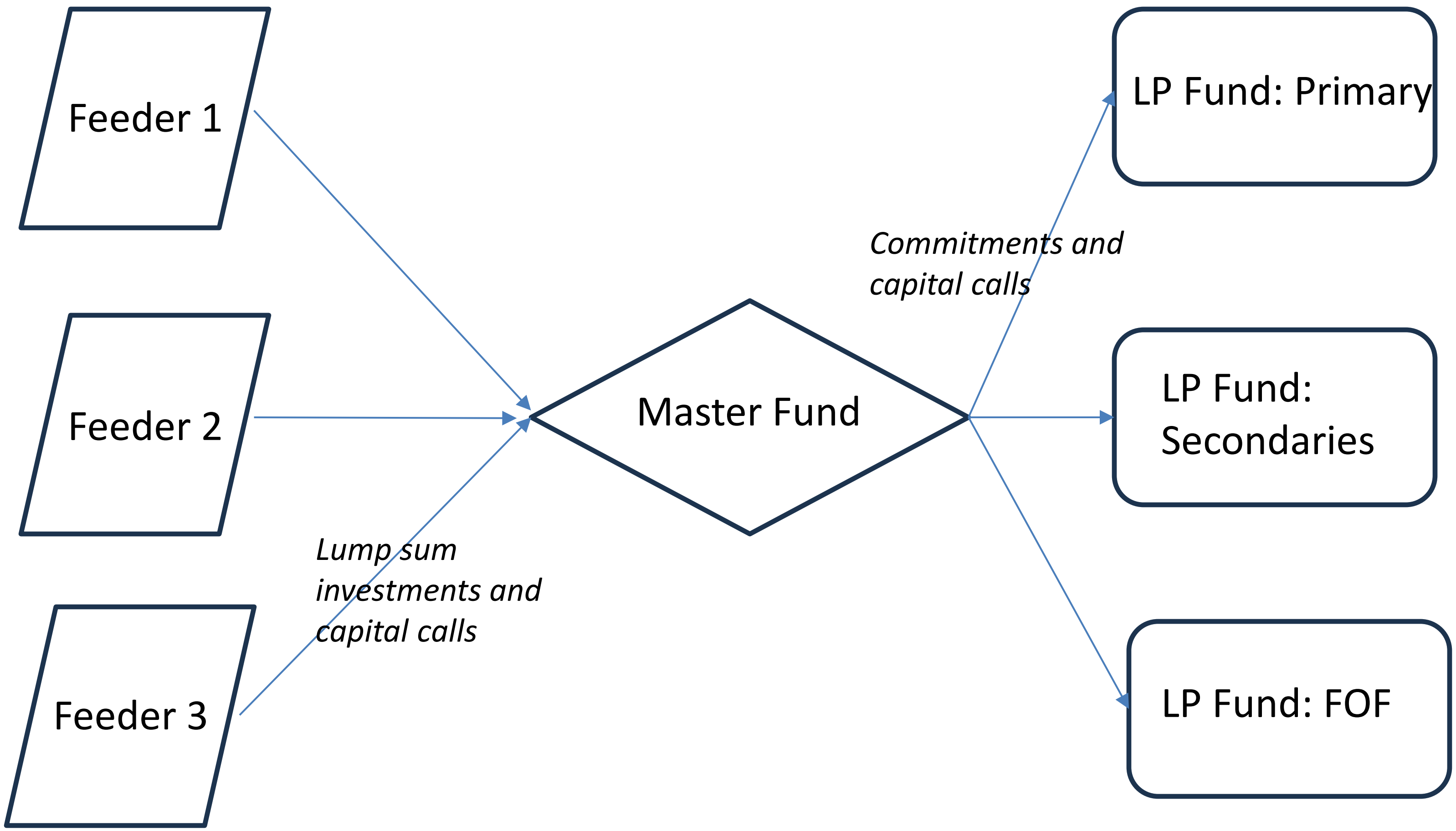
- By virtue of often having to serve multiple families or family members, these organizations were early adopters of fund structures that enabled investing in private funds

- These structures often took the form of feeder funds where smaller amounts contributed by investors, are eventually pooled into larger master funds that could meet the minimal capital commitment requirements of the usual LP primary funds

- Feeder funds not rarely have characteristics that may differ in the cross-section for the same master fund and differences may concern the size and timing of both the capital calls and distributions

- Having different pools of capital allows putting all the capital at work for some investors, while delaying it for others, depending on their liquidity circumstances

Feeder Fund Flows



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Private vs. Institutional Investors

- Institutional investors:
  - Have professional staff and vast resources to perform operational and investment due diligence,
  - Understand the risks involved,
  - Have sufficient capital ability to diversify across fund managers, and
  - often have significant clout over fund managers as large sources of capital
  - Have long liquidity horizons
  - Have some sophistication to plan commitment pacing and maintaining allocation

- Private and Retail Investors:
  - Generally, do not have access or expertise in due diligence
  - Do not have professional understanding of the risks posed by private assets
  - Write smaller checks to fund managers than institutions
  - Have shorter liquidity horizons

How Private Funds adapt to Retail Investors

- Guarantee some level of liquidity to investors by offering:
  - Interval funds: offer the investor to partially or fully sell their stake in the fund back to the manager or other interested investors at some periodicity – e.g. quarterly, or annually
  - Tender offer funds: they are similar to interval funds but offer the ability to sell under a more flexible schedule and conditions

- Structure retail private vehicles as Evergreen funds :
  - The "usual" LP funds have limited life – 10 to 15 years
  - They also require liquidity planning to have available cash to meet capital calls
  - Retail investors do not have the sophistication to plan the replacement of fund investments that naturally divest over their lives
  - They also prefer lump sum investment rather than staggered "capital call" style investment
  - Perpetual "share"-style funds alleviate these challenges for the retail investors

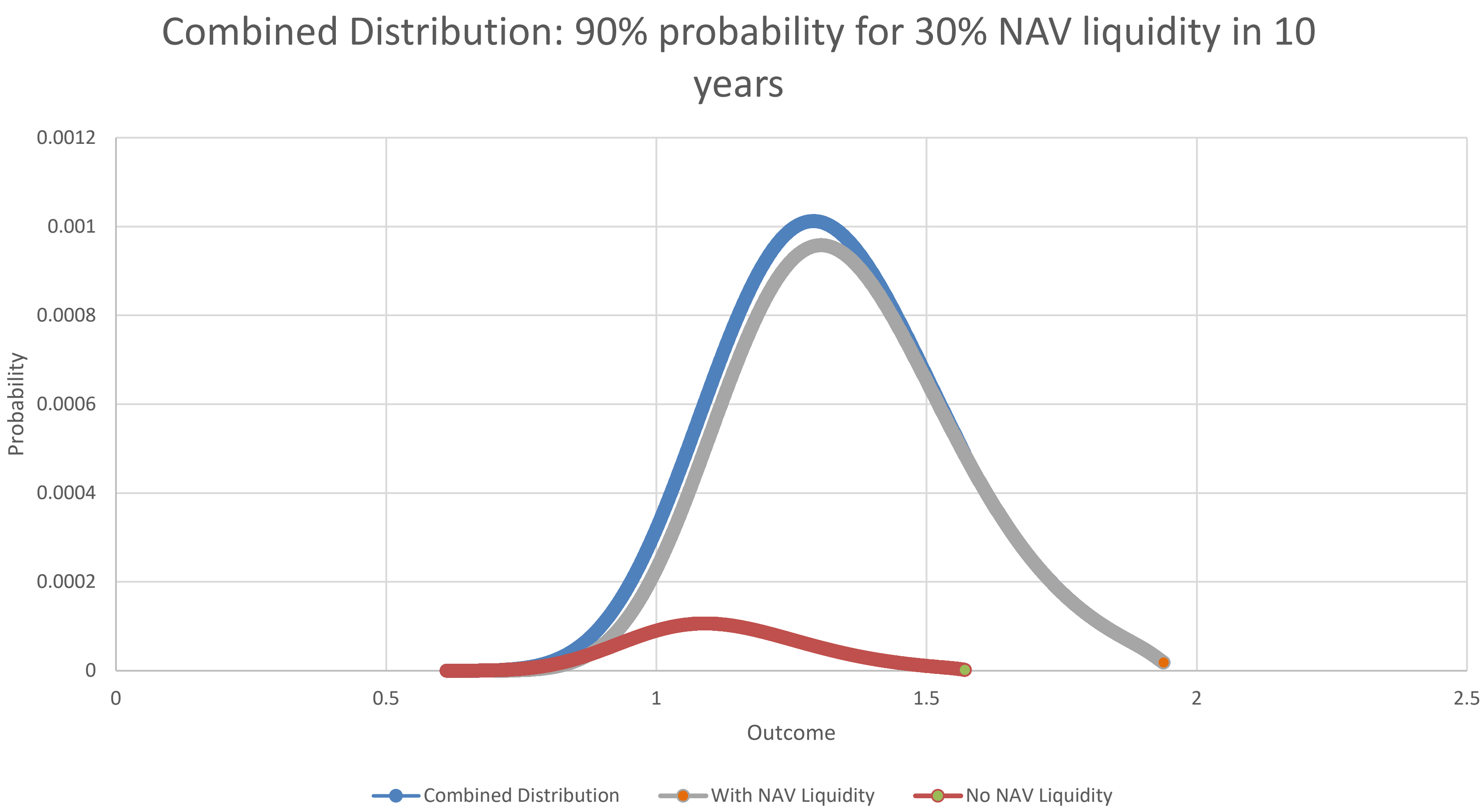
Guaranteed NAV Liquidity

- In case the fund is structured to guarantee some partial NAV liquidity to investors over some period (i.e. interval and tender offer funds), this has some implications for both the fund management as well as the investor optimal portfolios.

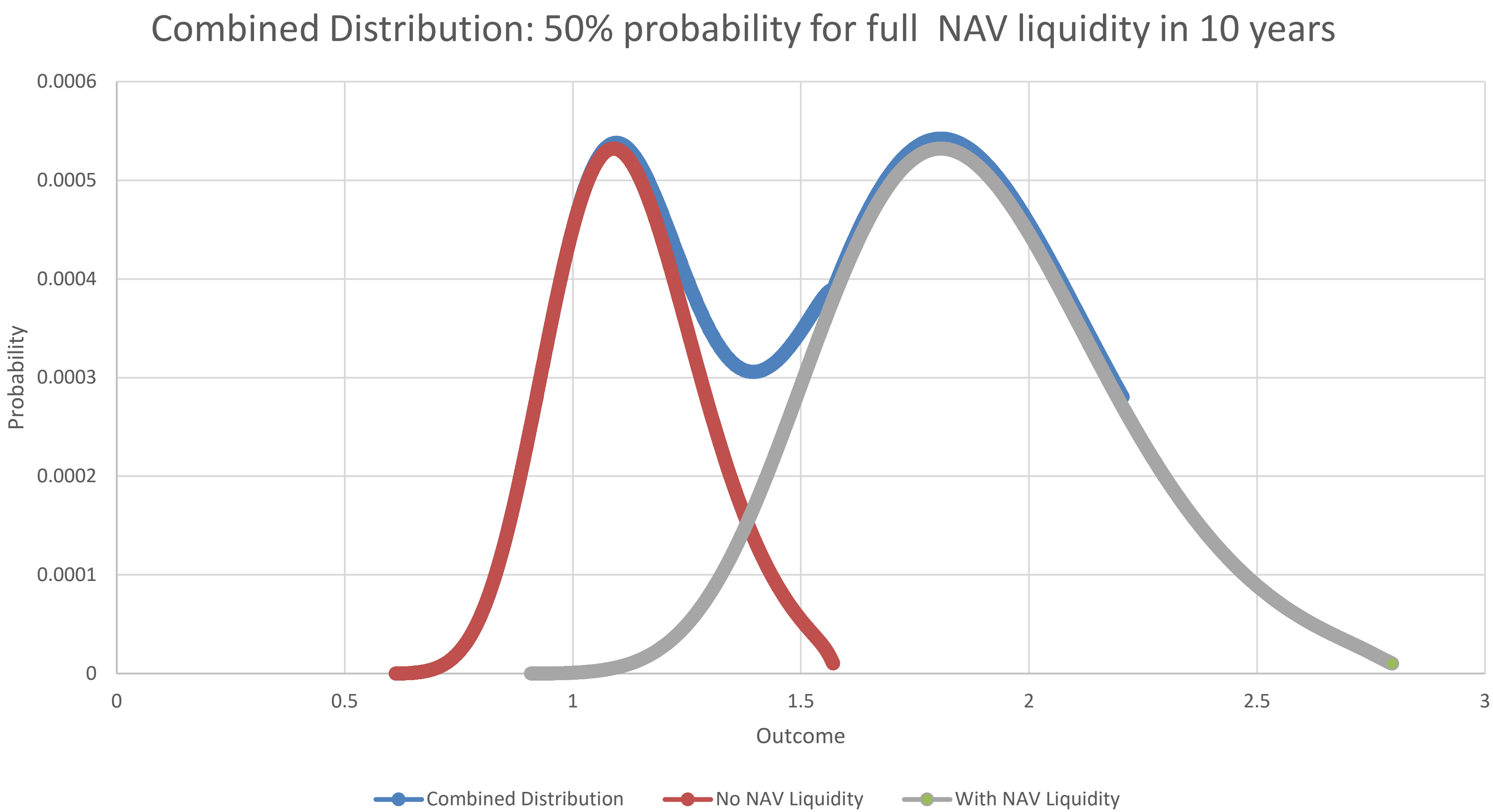
- Optimization of the fund holdings:
    - The multiperiod liquidity-based optimization which we have discussed previously, is also ideally suited to create a fund of private funds portfolios that maximize expected return and assure that distributions will meet capital calls for the underlying funds.
    - The liability side of that portfolio can include also an additional level of distribution that can go towards "redeeming NAV" for a fraction of investors that want to exits early

- This type of guarantee changes the liquidity characteristics of the private investment from the investor perspective – it becomes more liquid than a conventional LP fund.

Hybrid Fund A - Investor Perspective



Hybrid Fund B – Investor Perspective



More on Guaranteed NAV Liquidity

- From the perspective of the investor that is invested in the fund, the source of return changes from simply the natural cash flow pattern of the fund to include the fully or partially liquid value of NAV future time horizons. This is distinct from the way institutional investors who invest mostly in traditional LP funds view return generation.

- This type of guarantee changes the liquidity characteristics of the private investment from the perspective of the investor that envisions exiting the fund at some point in the future but also from the perspective of an investor that may enter the fund when the first investor exits.

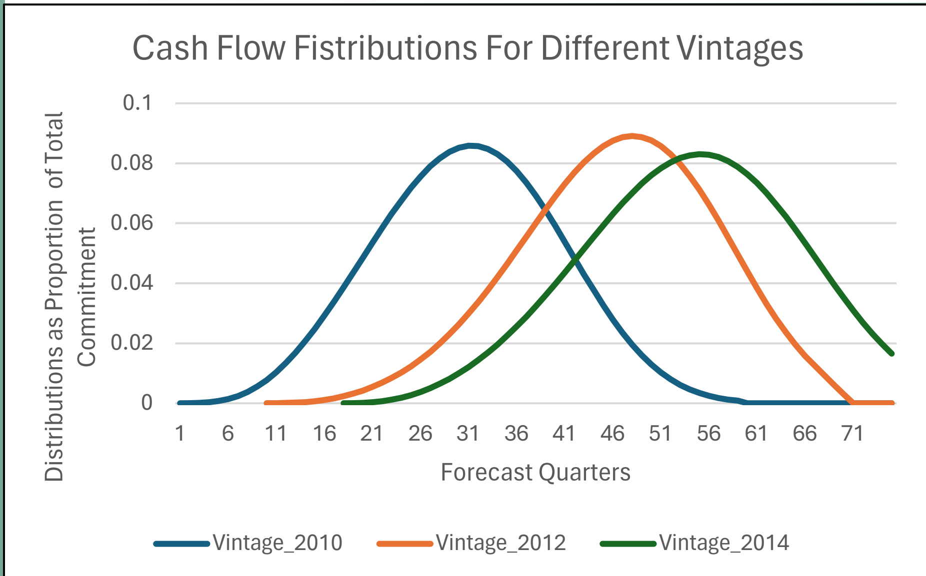
- In that situation their allocation to the such a fund becomes a simple problem of allocation rather than an asset-liability planning problem. This is because now the new investor simply allocates the share in the stake equal to NAV rather than committing capital calls to the fund

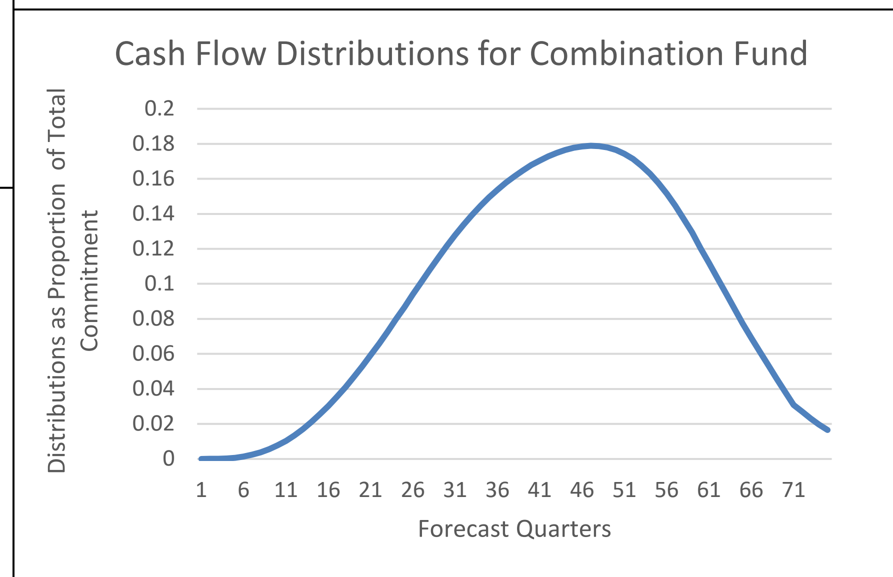
How Evergreen Funds Work

- The Evergreen feature of the funds means that the capital base of invested assets does not deplete – i.e. either stay constant or grow over time.
- For this to occur one or both of two conditions should be met:
  - New investors contribute cash even if no existing investors exit the fund
  - Portion of distributions, in comparison to LP funds, is withheld to meet capital calls from new commitments.

- There are several dynamics we should keep in mind:
  - Somebody buying in the fund at NAV reflecting "in the ground" investments is simply replacing an existing investor
  - Fair NAV valuation is needed for exit and entrance into the new fund
  - For issuance of new shares in excess of exits, to keep the uniformity of the fund share value, the assumption is implicitly made that the new capital will go towards investments of the same character as the existing "in-the-ground" investments

Distribution Patterns with Different Vintages





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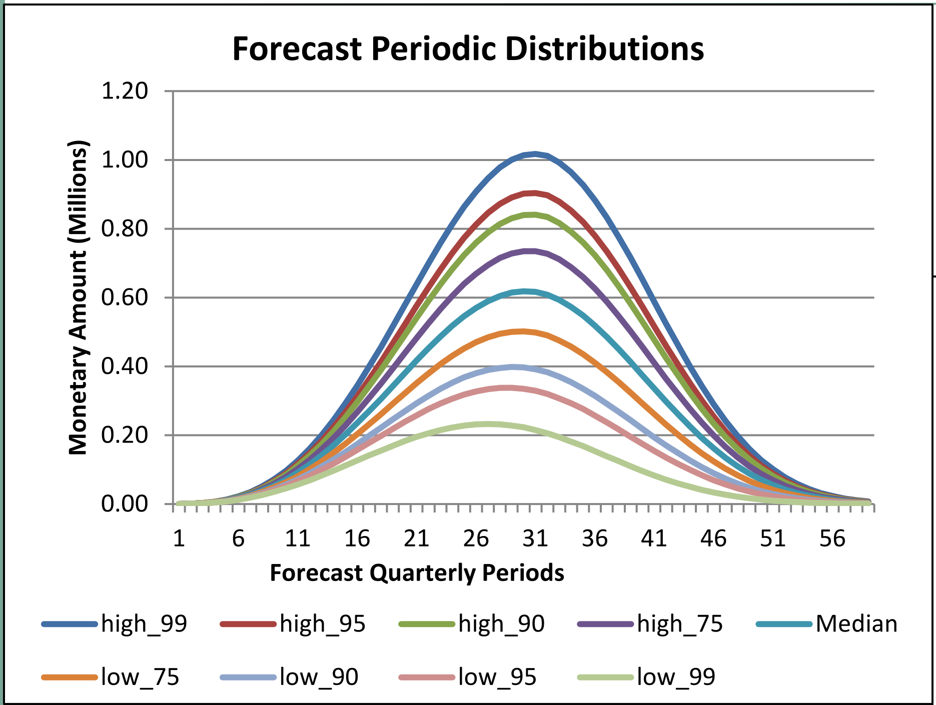
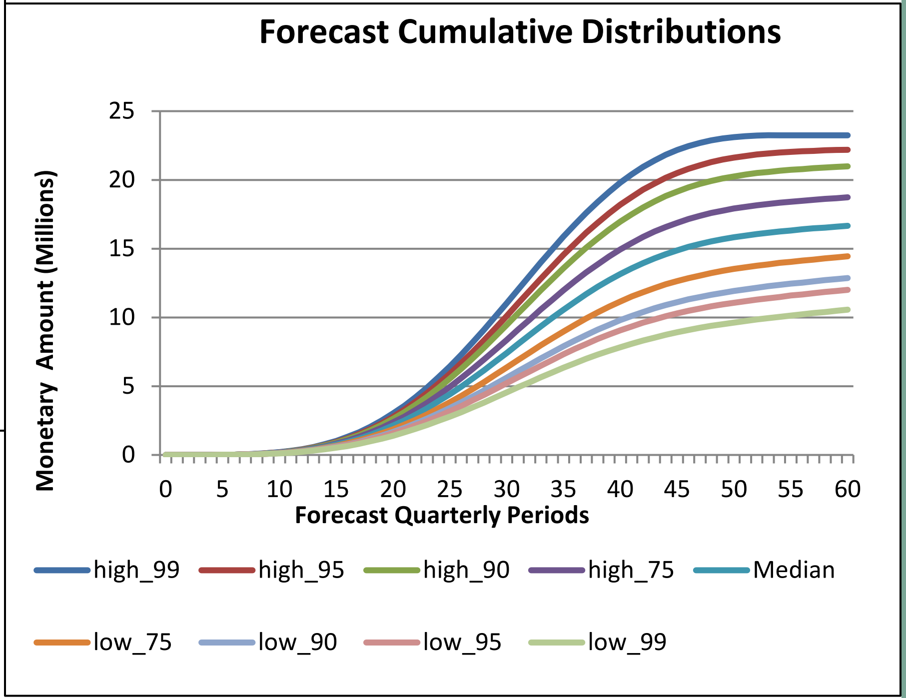
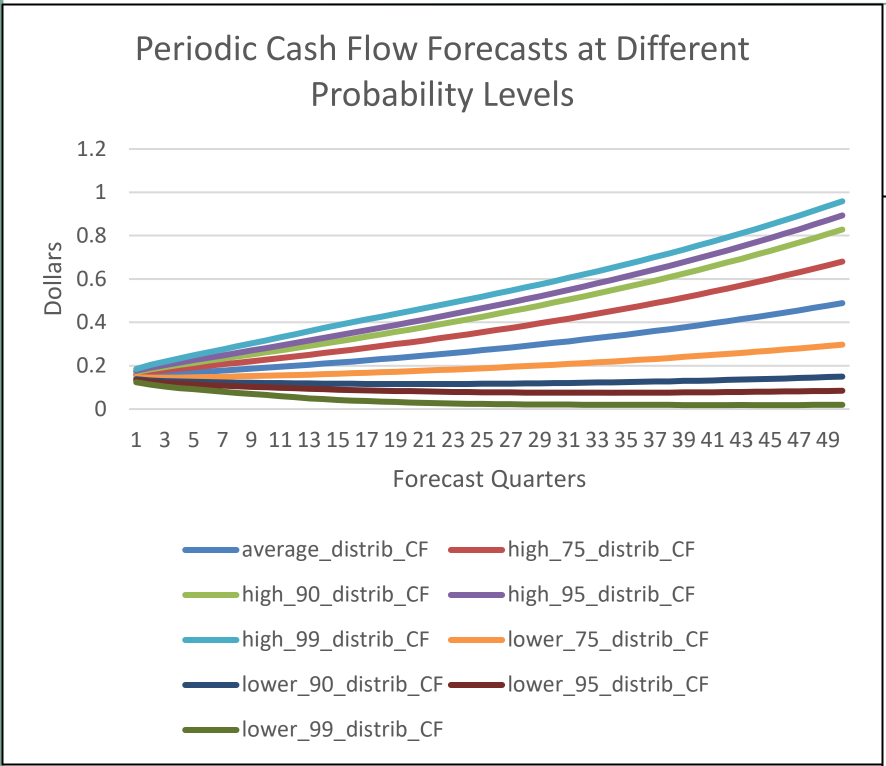
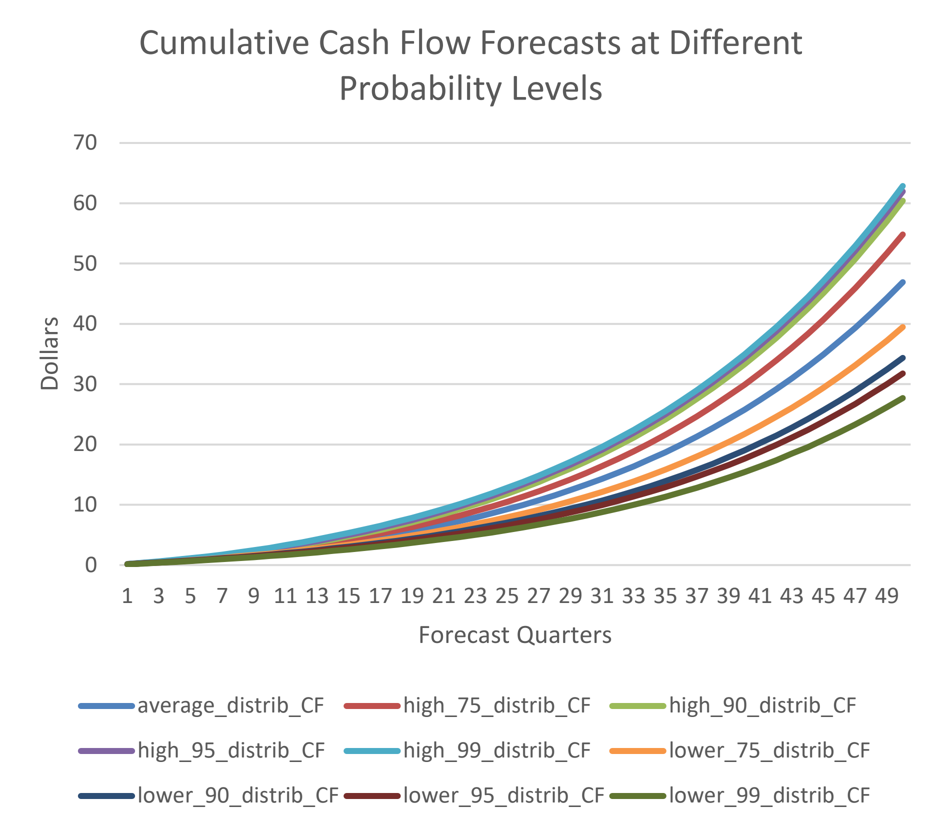
Distributions for a Traditional LP Private Fund





Distributions for an Evergreen Private Fund





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Conclusions

- The guaranteed liquidity goes hand in hand with the evergreen feature of the retail fund. Liquidity of the fund stake invites participation of investors that would like to continue holding stakes in the fund, which would likely be a meaningful exercise if the fund does not have a set maturity.

- Managing intricate and continuous fundraising, capital deployment, and guaranteed liquidity, add complexity to the job of the Retail fund manager in comparison to LP fund manager's job.

- For investors, the existence of retail private funds offers both new opportunities and risks that advisor analytics of prior model and technology generations are not equipped to handle.

- Northfields is well prepared to address all the challenges of forecasting the risk and return characteristics of these funds and estimate their fair value at any point in time.

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