Private Capital: Why Patience Can Be a Virtue in Today's Challenging Market Environment

Speaker Key:

DP	David Pett
KM	Kevin McCreadie
AL	Ash Lawrence
RO	Robert Olsen

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DP In part one of a three-part series, Kevin McCreadie, AGF's CEO and Chief Investment Officer, discusses the current landscape for investing in private capital, with special guests Ash Lawrence, Head of AGF Private Capital, and Robert Olsen, Partner, Vice-Chair and Private Equity Leader at Deloitte Canada. I'm your host David Pett, let's get into it. Kevin, as always, and Ash, new blood. Is that the right term, new blood?

AL New blood yes, I think so, I think that's the right term, yes.

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DP Yes, thanks for coming in.

AL You're welcome.

DP And we've got a special guest, not that you're not a special guest Ash, but we've got a special special guest in Robert Olsen, who is a partner and vice-chair at Deloitte Canada. And you're also the lead in Canadian private equity, is that right, Robert?

RO Yes, that's bang on.

DP Excellent, I googled you, just so you know, before. And it says here in your profile that you are a former world-ranked amateur boxer representing Canada. So that's super interesting to me, so I want to just talk a little bit about that. So how long ago was that and when you say world-ranked where did you get in terms of your rank?

RO 17th in the world.

DP Wow, great stuff

RO But it was 40 years ago.

DP 40 years ago.

RO Yes, so.

DP So would that be competitions like Pan Am and Commonwealth?

RO Yes, Commonwealth, Pan Am, I didn't make the Olympic team but I fought for the chance to go and lost in the finals. But I had the unfortunate situation where we've had two world champions in Canada up to that point and one of them was in my weight division ever, like so you never had a world champion before before I had that poor opportunity to fight a guy that was so good, number one in the world.

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DP So was that, what was your weight class?

RO 156, so 71 kilograms. So Shawn O'Sullivan.

DP Shawn O'Sullivan.

RO Yes.

KM Shawn O'Sullivan, oh I remember him.

DP I was going to say it was either Willie deWit or Shawn O'Sullivan, right.

RO Yes, Willie deWit was [inaudible].

DP And also there's a Scotty Olson, not related I think it's a different spelling.

RO No, not related but I know Scotty, yes.

DP Yes, there you go.

KM See he's got one of the more iconic pictures on his wall when he does a Zoom call, right. I think it's Ali-Frazier, right?

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RO Ali-Liston actually.

KM Ali-Liston, yes.

RO Yes, where Liston's down and Ali's quite happy because he was, you know, not so pleased with him and yes.

DP That's when he won the heavyweight championship for the first time right, against?

RO Yes.

DP Yes.

RO And I have a couple of pictures like that, so it kind of depends on where you catch me on a Zoom call, but yes.

AL And you've boxed a little bit right Kevin?

KM A little bit yes, nothing like that though.

DP No? Is this as a kid, like a teenager, or?

KM Yes in college too a little bit, yes.

DP Oh right, there you go. How about you Ash?

AL Not my kind of thing, no.

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DP So me neither but I do have, my boxing story is that I was born on March 8th 1971 which is when Frazier and Ali fought for the first time, I think it was called the Fight of the Century I think was how they billed it. And Frazier won that one and then there was I think two rematches, right, including the, we're talking about the Thrilla in Manila, right.

AL That'll be 50 years ago on 25, 2025.

DP Thrilla in Manila, right, that was I think 73?

AL 75.

DP 75, okay yes.

KM 75, that was around my birthday.

DP There you go.

KM Yes.

DP There you go. So…

RO I grew up watching those fights on closed circuits, so my father would take me for my birthday gift every year to see a closed, you know, closed circuit fight. And it'd always be in an arena or…

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DP Because that's the way you had to do it back then there was no pay-per-view, right, if you wanted to watch it. Okay, let's get to what we wanted to talk about and that's private capital and sort of where we are today and then where we might be in the future. So in the spirit of Robert's amateur boxing career I've split this up into three rounds, which I think is the way amateur boxing works, still three rounds, although I understand that it may be five rounds sometimes but I didn't have enough questions for five rounds.

So we're going to stick with round one and we're just going to talk about private capital in the current environment. So clearly in the investment community I think most people see this as being a very challenging environment. And in particular the rise in interest rates and the fact that we're dealing with high inflation for the first time in decades to the levels that we have over the last year. My question for you to start and maybe we'll go with you Kevin first and then we'll go around the tale is just how is this impacting private capital investments?

KM A couple of things are at play here, when you have a year like last year in public markets, fixed income markets, all publicly traded assets are down pretty hard, probably the worst fixed income market we've had in 40 plus years. And in equities and when you look at folks who had private assets right, they all did pretty well. And so we had what you call this denominator effect, right, where those allocations actually ballooned because everything else went down, right.

And so part of it is, yes, you're coming off of a year like that. Two, when you really go backwards and say you've also come off of 15 years of near zero interest rates, where a lot of things worked, right. I look at it and say and as we get into this year yes, maybe people are a little bit overallocated but you know, higher interest rates are something we normally live with. This is not an abnormal period of time.

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How we got back to normal was, as you and I have talked many times, was a little vicious going from near zero last March to now in the case of the US of 5%, Canada just shy of that and in Europe, from a negative interest rate to three and change. It's the speed of that that is the adjustment.

But you know, on the private markets I'd say frankly there are going to be great opportunities because of that dislocation. It may be a different set of opportunities than what we went through but the backdrop, you maybe have to be a little bit more thoughtful about how you allocate to different pieces of the private markets. But this kind of backup in rates actually gives you some opportunities.

DP And then Ash your perspective is quite unique as the head of AGF's new private capital business, and when you started it was probably a little different environment than it is today. So it'd be interesting to see hat your perspective is on all of this?

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AL Yes, I think I'd echo what Kevin is saying. I think he specifically said the speed of the rate increases, I think that negatively hit everyone public or private, quite frankly. However, private capital strategies oftentimes do their best when things like what's occurring now constrains capital. If there's less capital around and you have capital and you need to invest that capital or want to invest that capital all of a sudden you're getting better terms, better opportunities, better returns.

And I think it's a little bit of a double-edged sword right now in the private capital world because it is a great time to actually be putting out money. You've got to batten down the hatches a little bit on your existing portfolio because of the speed of that rate increase. And interest rates, you know I sometimes argue with my former real estate colleagues about the impact on the valuations in the real estate world and I sort of kick the can on the fundamentals.

You can debate fundamentals all the time but you can't really debate interest rates are where they are and that's just math. So there's no avoiding that. However, if capital has decreased out there and businesses still need financing, whether equity or debt, and you have it, you're in a pretty good position.

DP And then Robert, some thoughts on this?

RO Yes sure, a couple of things. Firstly, I think you can take two different perspectives on where the market is. The numbers suggest you're down a lot but if your starting point is 20 and you go to 2022 you'd say yes, M&A is down 40%, private equity in Canada is down 50% to 75%. But actually you kind of look back previous year to that to 2020 you actually say well actually we're doing pretty well. And then if you break it down by sector you can find great pockets of opportunity.

And so, and actually we've had some of the best, depending on where you are in the market some of the upper end deals actually have had some of the best trades ever in what was a really challenging environment. So it's a bit mixed, you can't say it's a great year, it was a bad year. But it is back to historical standards it's pretty exceptional but we're so used to always going up and to the right and that doesn't always happen. And we're in a bit of an adjustment period and that will probably go on for a little while.

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KM I'm going to make one other point there. In history if we go backwards, and I think backwards to the pre, the financial crisis of 08, right, we had a ten year bond in the US yield at 4.6%, right. You had mortgages that had six handles on them, right. So these are to levels that are restrictive, it's back to that pace and speed, right. So if you go back to those markets they were pretty good markets for private assets in 06, 07 before the crisis.

DP So Robert I just want to go back, in terms of how higher rates actually manifest in your world, what is the impact in terms of deals? Like how does it change the game if you will? You mentioned that there's some bifurcation happening but I'm just curious to know how that all comes about because of the higher interest rates?

RO Yes, well the first thing is it affects how much leverage you can put into a deal. And the amount of leverage you put into a deal affects what kind of return you're likely to get. And so if you take a more conservative set of assumptions on growth rates because we're in a tougher environment you're already going in with higher interest rates we'll come back to. But higher inflation which is going to impact profitability, you say well, it's going to impact my return.

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And then you have to expect the seller is going to accept a lower multiple for their business, if we're going to use a multiple of EBITDA as a way to think about value. And if they're not prepared to do that, which often happens when you have a change in the environment like we've gone through, then you have maybe a seller will sit on the side lines so you end up with less activity which is what we're seeing right now. In the last six months we've seen a drop in activity, which is not to suggest there isn't the market because there's still deals getting done it's just not as many.

And typically there's a reasonable period of adjustment for the bid ask to match up. If you look at past periods pre-financial crisis, go back to the recession before that actually several recessions, usually the bid ask takes 18 to 24 months to match up. So to get back to buoyant activity where it's absolutely going to go up from where it was you need the bid ask to get closer. It doesn't mean there aren't lots of deals getting done but it won't be back to where it was.

KM Ash knows what I call this problem, I call it the sellers will want to pay, will want yesterday's multiple and the buyers want to pay today's multiple.

RO Yes. Who wants to sell at less than your buddy just sold, right.

AL That's one of the other places the rubber hits the road right now for private equity or private capital managers is if you set aside current trades that you might be looking to do, the business you bought in 2019 have you done enough in that business, have you created enough value or created enough new cash flow in that business to cover now your debt costs with the financing that you assumed and put on in 2019.

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Are you in a position to cover that cost or get rid of that or is your business in a position where you can sell it into the market and you've created the value, you've created the quality cash flows that people will still pay that value for it today.

DP Is that true on both sides of the equation? Equity and credit? Or is it a different dynamic when you're talking about private credit?

AL I mean it's the same dynamic impacting the debt and equity in a different way, right. So the debtor's looking at whether they're going to continue to get paid and the equity is looking at whether they're eating all the value away in their equity slice of the cap stack.

RO But just to jump on the private debt piece a bit for a second. What's really interesting is firstly the Canadian markets and the US markets are quite different when it comes to M&A deals. In Canada majority of deals get financed by the banking market, like it controls so much of what goes on here, similar to what you have in Australia. In the US LBOs are by and large majority of them are done by private debt groups.

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And so when you see some regional banks in the US failing that absolutely causes worry and there's worry of contagion and so on. But on the private debt side it's a wonderful opportunity to put more money to work because there's greater opportunities. Will the costs be a little bit higher therefore the value that a private equity purchaser is prepared to pay might come down a bit. But there's still a willingness and availability of capital to do a deal, but we've got to end up with matching up with bid ask.

AL Yes, funny story so we're talking to managers in the US right now to potentially partner with AGF on providing private credit solutions. And sometimes we have these conversations over a period of months, so we have material from a manager from a few months ago, their pitch deck if you will, and we've got a new version. And right away in that new version there's a new slide about the regional bank stress and how much opportunity is going to open up for the private credit market especially in that middle and lower-middle market because of the stress in the banking market.

Like they are right on it, immediately it has a lending opportunity. And they view it as I am now into better credit in terms of the borrower and better pricing in terms of my coupon and my interest rates.

KM And better terms.

AL And better terms, yes. More covenants, more restrictions, more say in the business, more controls.

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DP And Robert you said it's different between the US and Canada but does what's happening in the US influence what might happen with the market in Canada?

RO Well a couple of things. Firstly, what I'm not suggesting is there isn't a private debt market in Canada, there is. It's just it doesn't form the greatest percentage of the deals that get done, necessarily. So there's still a private debt market here, of course. So there is, like the market is still strong for deals generally but private debt has a better opportunity really all is I'm trying to make the point on.

AL Yes, I think that's right. It's a different but similar dynamic in Canada on the debt side, not so much the regional bank crisis in the US but the banks are pulling back a little bit in some of their former borrowing tools, so to speak. And they've got regulatory capital buffers they want to meet, they've got margin issues on the balance of their business so they like customers that provide more than one line of revenue to the banks. And in Canada the banks are 80 or 85% of the lending market.

KM Yes, in the US right now you have a bunch of banks looking at their deposit base fleeing because they have an alternative, they can go buy a T-Bill for 5% for four weeks right now, right. In 15 years of leaving your money in a chequing account for free because there was no alternative all of a sudden people have woken up. It's not just about Silicon Valley banking and the tech sector, it's because we have alternatives now. And so if you're worried about your depositors is going out the door you're not funding a lot of new loans.

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The borrowers are still there. They're going to go to the private market because they want to grow their businesses, they need to invest. And I'd say the same dynamic holds true in Canada even though we're not experiencing the bank fuss. Every bank's CEO here is also looking at their deposit base and saying let's be careful. You look at the senior loan officer survey that came out in the US yesterday credit is tightening up pretty quick. And credit tightening is essentially banks saying you know, maybe I'll take my time making this next loan, maybe I'll price it differently.

That money will go potentially to the private market where again, if you're an investor in that market you're probably going to have the best set of returns you've had in a long time. Give the fact that base rates have moved up significantly since last year and now the ability as assets to really command some different terms.

RO Well to your point on the US system you have a whole system of regional banks that were doing fantastically well, where you're paying basically no rate of interest to your depositors and you're lending it presumably at a higher rate for mortgages. Which is kind of the biggest place where they're putting their money. And then you have this inverted yield curve where you're actually not getting great yields on your long-term mortgages and now your deposit base is saying I want to go elsewhere. So does it cause an upside down situation for regional banks, for sure.

And that is exactly the kind of conditions you need to have a really great private debt market and then as the market adjusts to perhaps slightly higher rates, better valuations, then you actually end up in a really good place.

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KM I mean one of the things about private markets which I've always loved is you can be very tactical. There's always going to be opportunities and dislocations, right. So if you're raising money now for a distressed real estate fund you might actually have some pretty good opportunities in the next couple of years. Especially with not just higher rates. And this problem maybe at the banks is that has to get refinanced but also the fact that we've had a secular change maybe in the commercial real estate market called work from home, right.

So again, if you're raising money at half capital you can take advantage of different points in time, the buyout market may be different. Those borrowers, to your point earlier Robert, are paying a lot more today to finance a transaction, they can't put as much debt on. Therefore the size of the entity they can buy is going to be different, right. So that may not be as opportunistic today as it was when rates were much lower. So I think you have tactical ways to think about the near-term future with private markets, they're still going to give you a pretty good return.

AL Yes, I can tell you the distressed guys have been waiting for a long time for their day in the sun again. They thought they had it with COVID in 2020 and the window was so small. There is a boat-load of money around April in 2020, April, May and then the window closed. And almost none of it went out, they've been sitting on it or returning it in distress vehicles.

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RO Yes, well I follow the bankruptcy totals in the US which is really helpful because it helps us what's going to happen in the future and it's still quite low. If you look at portfolio companies owned by private equity funds 16 filed for bankruptcy in the first three months of the year, so 16 of a population as big as the US. So it's still tiny and I think that was 11% of the total bankruptcies. So private equity is still doing relatively well.

And I come back to something that Kevin said got me thinking about great managers in private capital always find a way to go, whether it's an up market or a down market great managers find a way. They either find the deal flow, they find a way to get a deal done, but they continue to succeed in challenging environments because you have an ability to pick and differentiate your strategy with others. And you really see it in the private market.

DP And I get the sense that that's even more, I'm guessing that also exists on the public markets but it sounds like there's a little bit more opportunity on the private markets to be, to succeed in challenging times, if you will?

AL I think you can differentiate yourself in the private markets, right. Because that really means in most cases being actually a skilled operator of businesses, right, to get them through this, if that's the challenge you're doing, to get to the other side. Which a lot of times you'll see private firms if they believe in that business they will double down and they'll push their way through.

You look at some of the historic deals during GFC that they managed to hold through turned out to be some of the best deals some of the larger firms ever did. They just managed to make it through the GFC and then the returns went through the roof for them. But that's hard to do and if you've had ten, almost 15 years of everyone being buoyed a little bit by the markets on the private side and being able to make decent returns without necessarily being a skilled operator of businesses, well now it matters again.

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RO Yes, they're very different the public and private markets, not to suggest there aren't great managers in both markets, it's not that. It's in the private markets you're making very concentrated bets. Like a fund may make ten investments but you have significant influence over what's going to happen with that portfolio company. And so it's a different style of investing.

But for me in evaluating managers I find it's easier for me to actually, because I can actually evaluate them on a smaller set of criteria and see how they do in up and down markets, how the team works together. It becomes a better way for me to evaluate a great manager.

DP So given everything we've said I just want to throw out a couple of other things that are obviously top of mind with investors right now. And one is heading in you talked about credit conditions tightening, what happens if we do hit a recession? Does that complicate matters any more than they already are, or just some thoughts on that?

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KM Yes, I mean I don't think it's, public markets and private markets are going to have different timeframes. You know I'm a public markets guy as well, right, and we all talk about having these long-term timeframes but we measure ourselves every day. You're a long-term investor but yet we benchmark ourselves and we look at relative peer sets daily, monthly, quarterly, right.

I think when you're in the private space I think there's the ability to control the asset to drive returns, and you can be a little bit more patient than in the public markets. And a recession will hit both at the same time but the opportunity set because of that timeframe development that will make that investor take a really longer term view on the private market may end up benefitting you more in that dislocation than when the public markets guys react. And they react to such a short timeframe.

So I would say the recession to me is an opportunity if you're in the private space. In the public space, again, we're going to be at the whim of the psychology of the end investor to a degree.

AL Yes, I would agree with that. I would also say we've had this rates of jumped in a short period of time and then we've had this predictive mode of when that recession is coming for quite a while now. And so those in the private equity world no matter what sector you're in you have been preparing for this, you've been working on your capital stack anyway because of the interest rates. So you're trying to put some resiliency in the capitalisation of these assets and you've been working on your business to get ready for this from an operations perspective already.

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So I would think by the time, if that recession really hits, yes, everyone will be impacted because GDP and growth and everything goes down and you can't avoid that. But there has been a period of time here where to Kevin's point if you're in control of your business you've been preparing yourself.

KM It's the ones that come out of the blue and get you that no ones prepared for. But to Ash's point we've been, you know even in the venture space or really growth stage guys have been hoarding cash now for almost a year, waiting for this recession. So it's a little different because it's not being sprung on us.

RO Yes, and the thing because you're not forced to, you can control your pacing. You're not forced to put your money out today versus tomorrow, you can kind of wait on it if you think that's the right choice. And the good managers do do that. And the good managers also will come out with great vintage years. Like when you look back on this timeframe ten years from now some of the best returns you'll see over that period will have been from deals that got done just coming out of the market that we're in now. So it's a wonderful time for managers to put money to work.

But you know, as you have a sense that the market is kind of flattened out a little bit which it probably hasn't done yet, but once that happens it'll be a great window of opportunity for those private managers to put all that money that they've been sitting on to work and you'll see lots of great deals get done. Which is exactly what we've seen following every great slowdown in the economy.

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DP To that point you talked a little bit about the private manager has probably, there's a little bit more patience involved in this, right? You don't have to necessarily be as reactive. How much attention do you pay to what the public markets are doing on a day to day basis in terms of making decisions on the private side? Because is that just, is it noise or is there something that you do need to kind of keep an eye on?

KM I think the risk is if you're a forced seller, if you've got to sell because you've got a, you know the classic example out there in the private markets where you have an open-ended fund with private assets, right, in a, I don't know, I'll make up. We've seen a couple of big real estate funds that are open-ended right now and that are having problems. So if you're a forced seller in a new environment and you can't do the things to help yourself that's where I see the risk.

If you're putting money to work, to Robert and Ash's point, I mean you're going to pick and choose and you're going to actually be able to generate probably higher returns than you've had in the last couple of years because of the opportunistic way you're thinking about it. I think it's the forced seller that I worry about.

AL Yes, and I would say sort of having been the practitioner of private capital you look at the public market for a couple of things. And some of them are indirect, right. You look at them for one, which is occurring a little bit now with fundraising, the impact on your investor base, because it does impact allocators. So you obviously have to take that into account if you're pooling up the money to put out in this environment.

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The second thing you look at it for is opportunities, right. So in some cases the further the public market goes down the more opportunities you're going to see from sort of plucking from the public into the private markets. And you do to some degree look at it for sentiment or specific sector reasons.

But in most cases you're largely looking at the broader macroeconomic picture that is actually causing that movement in the stock market, which is always going to be a little bit exaggerated versus the private markets, interest rates, the Fed, geopolitical stuff, like that impacts everything. But the public markets you sort of indirectly look at but not necessarily as a negative.

RO Yes and I think another area, like just kid of moving it different direction but it's still a public versus private is you're both competing for the same assets in some cases, right. So when the public markets are really doing well they have an ability to pay up and it's still going to be accretive to the shareholders and they will pay up. And when they're down there's an opportunity for someone who's purely focussed on long-term value, doesn't have to show their next quarterly earnings from that company because they're going to be private until they decide otherwise.

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And so you have this ability to actually win out in a tougher environment as a private investor and that creates great opportunities for private capital managers. Both can do well but that window of opportunity kind of shifts a little bit in a down market when public markets are down and you can't buy something that's going to be accretive necessarily.

DP Ash you mentioned geopolitics, I've always been curious to know whether, because they do create lots of volatility on, especially if there's some sort of event risk to that. Do they create that type of volatility on the private markets or is it again more of a thing that you're looking out for but doesn't day to day really impact what you're trying to accomplish?

AL It's more of the latter but it's not as immediate as in the public markets. Something happens in some part of the world, China, Ukraine, the public markets react immediately. The private markets are thinking, I'm just going to use an example, they're thinking of supply chain or how am I getting those parts out of China now. Or they're thinking about those kind of business operations issues or they're thinking about the movement of capital and whether it's impacting the movement of capital and the financing markets and the credit markets. Because those do impact them day to day on a deal basis.

But they're not reacting, again, think of them as business owners, right. If something happens in some part of the world that is going to have macroeconomic effects business owners don't immediately sell their business, right.

KM And the multiples don't change.

AL And the multiples don't move, yes.

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KM In the public markets and geopolitical events nothing has changed in the earning stream typically but the multiples change because people take risk off the table.

DP Okay, ding ding, I think that's the end of round one, guys. To hear more from Kevin, Ash and Robert, round two of our private capital series is now available at AGF.com/podcast, or by subscribing to Apple podcast, Spotify, Google Play Music, Stitcher, Podcast Addict and Pocket Casts.

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