Private Capital: How a Good Manager Makes All the Difference

Speaker Key:

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

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00:00:07	DP	In part two of a three-part series, Kevin McCreadie, AGF CEO and Chief Investment Officer, weighs in on the opportunities and risks of investing in private capital, with special guest 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.
00:00:43		So, let's go onto round two, and we'll talk a little bit about opportunities and risks, given that backdrop that we've just talked about, I'm curious to know where some of the best opportunities lie right now in the world of private capital.
00:00:57		And, maybe, Ash, I'll start with you, and you can just throw in an asset class or a strategy that think is particularly a good opportunity right now, and maybe, some reasons why.
	AL	I'll go on two ends of the spectrum first. So, private credit, I think, is great right now, for a few reasons. The capital-constrained environment we talked about earlier. In most cases, in private credit, you're short term and you're floating rate, and so you've been seeing increased returns as rates have gone up.
00:01:30		And right now, what we're seeing in some of the stuff we're involved in is you're getting better pricing and better credit, at the same time, to the point, earlier, that Kevin made, and better terms. And so, that is a great place to be, and there is going to be, again, a lot of

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		opportunity to put out capital. There is a demand for capital out there right now because a lot of traditional sources are short, in terms of putting that capital out. So, I'll put that on one end of the spectrum.
00:02:00		The other end of the spectrum, and maybe I'm biased because of my background but I think real estate, if you're willing to take a little more risk and you have a very good manager who knows what they're doing, could be, this year, a really interesting place to invest, quite frankly. Especially if you, again, are very good and are very selective and you follow the flight to quality in the office space, I think you can probably make some very good money if you invest today or in the next six months, whatever the right timeframe is.
00:02:33		And I do think, at some point, you'll see, generally, real estate assets that don't deserve to be pulled down into the mud, being pulled down into the mud.
	DP	Robert, anything from you?
	RO	Well, I can't disagree with private capital... Private debt. The credit markets are fantastic. I was looking at a couple of deals in the broadly syndicated market that two years ago, you would have been 50% more in leverage to get the pricing you're getting.
00:03:06		It's really exceptional. It's just wow, I can't believe what's in front of me, if you're an investor. So, you have a really great opportunity to put money to work, great returns, and have way more control over governance that you would never get before, where everything was covered [unclear]. So, I do like private debt, for sure.
00:03:26		It doesn't matter when you ask me this, private equity is always going to have great opportunity. I think if you have a manager that you trust, that doesn't feel this compulsion to put money to work all the time... We start with a place of, generally, they don't have that, but newer managers might have that, so you've got to be a little bit more careful, you've got to really know your people well. But I think it's going to be a great opportunity for private equity investors, for sure. I think the ones who put money to work

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		in this environment, we're going to get them at better valuations.
00:03:55		Look at their models. They're coming in, they know the rates aren't going to get higher. Inflation's not going to get higher. You've had supply chain issues and talent issues that you've found a way to work through. You can evaluate your management teams in a way you've never been able to do it in the last ten years because everything was up. So, how do you evaluate a great management team of a portfolio company that you're hoping to be a portfolio company of yours? In a grey market, in a tough market, you can see all the great decisions they make and the mistakes they make, and then, you can decide, is that the right team for you.
00:04:28		So, I think it's a great time for private equity managers to find good assets. I'm a long-term believer in Infra [?]. I just feel like the yields... People run away from the yields because they think they're too low for what they can get. But when you actually look at the why you're doing it as a diversification of your portfolio, I think it's a great asset class, and even better in this environment because you're getting really reoccurring revenues.
00:04:59		Maybe a slightly lower yield, but compared to historical levels, fantastic in returns.
	KM	Yes, I agree with what both these guys said. I'd say on the real estate side, I too am like Ash, my interest is being piqued here because I'm seeing very sophisticated family offices. Looking around for midtown New York real estate vacancy rates dropping because of work-from-home. Some smart money is going to start to wake up to some of those opportunities.
00:05:27		I also think private debt is going to be in one of the best places. It could be. And then, I'd say, I'll throw two other ones in there, back to Robert's point on the private equity space. I think early stage venture, when you lay off this many technology people in California and send them home to code in their parents' basements, there's going to be incredible innovation that comes out of this. My son works in the venture space, and they have never seen more business plans, in the last couple of months.

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00:05:57		So, if you've got a timeframe that's in front of you, that's not tomorrow but over the next ten years, you're going to make some great returns there. And I'd throw one more. I think inflation's going to be with us for a bit. I think Robert's right, infrastructure's going to have a place with that. A lot of those contracts get repriced with inflation. There's some metric there. And I'd say agriculture, potentially, is an overlooked asset that I think in our private portfolio, if you believe there's going to be some inflation, that may do pretty well.
00:06:28		And so, you can say they're higher rates, but there's a lot of opportunity with what the three of us just said there.
	RO	You know what's different is if we had the same conversation ten years ago, we might have come up with the same asset classes, but one other thing that's a little different is the significant focus now on value creation at portfolio companies, regardless of what asset class you're in. This need to drive greater value because you're not necessarily going to get it from multiple expansion when you sell.
00:07:00		Now you've got great managers who've got value creation expertise, or they use it externally. The big funds have big teams of operating partners that help them drive through and drive value at the portfolio company. There's synergies between portfolio companies that you've never seen before. So, there's this opportunity that a tougher environment causes even more inward-looking for the funds, to drive greater value, knowing that the markets may be a little tough for a little while.
00:07:27		So, all that creates a better opportunity when you, ultimately, sell, whether that's three years from now or five years from now.
	DP	So, lots of opportunities, is there anything in the realm of private capital that you're like, no, I just can't get my head around it just yet?
	KM	I'm probably more biased because of dealing with the public market space. There's stuff in that growth equity bucket in the private side, where these are companies that probably have valuations that are in private

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		portfolios, or funds that are marked at levels that we would have taken them public years ago.
00:08:05		So, their inability to go back to the market for more capital, they're still, probably, companies that are not cash-flowing at the level they would need to be to be public. I think those are going to be a bit challenged in the near term. It could opportunity, but right in the nearest term, the IPO market is shot, those valuations are here, they probably have to go back and get money at much lower levels.
00:08:30		So that would be one. And I'd say, maybe, Robert and I are different, I think the buyout part is going to be a little bit challenged in the near term, especially with the banks pulling back. Yes, the private credit market will be there to replace some of it, but some of the deals that got done was almost free money are going to get done here at these levels. So, the opportunity set, maybe, different in the near term, there.
	AL	Yes, I'd probably answer that in a slightly different way. I would say you can find, probably, good opportunity in any of the sectors if you had the right manager.
00:09:02		The trick is when getting the risk and return profile that you want correct, but really, then going out and finding the right manager that actually knows what they're doing in the environment that Robert was describing around value creation, and Kevin was describing around getting sure that capital stack and multiples, when they buy, are all right. I think this is about choosing your manager, right now. You can construct your portfolio with the sectors you want, but the difference is going to be who you get to do it for you.
00:09:32		I think that's the market we're in right now that's going to differentiate, if you're an investor, how you do coming out of this time.
	RO	Yes, and from the LP side of things, there's been a trend for a long time now of consolidation of managers, where you're trying to pick the really great managers that will do well. It wasn't like we weren't expecting a tougher market.

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		It was going to happen, it just probably took a little longer than we expected it to happen, so that will help.
00:10:00		There's going to be failures like there is in everything. There will be portfolio companies, we saw 16 companies went bankrupt in the first three months, those are portfolio companies and private equity funds in the US. They're all good funds. So, there will be challenges, for sure. To Kevin’s comment on growth equity, I think the growth equity space is a good one. What’s, unfortunately, happened in that space is I think the definition of growth equity has gotten a little blurred.
00:10:27		Where sometimes it’s ventures, sometimes it’s true growth equity, and what we’ll see is this idea, where, okay, we’ve chosen not to show profitability. We could, but we’re going to continue investing in the future. That sounds growth orientated to me. If that wasn't really true, you're going to see that over the coming years, and some of those will fail, and there will be a shake-out of the growth equity arena, which is a good thing because there was too money raised for growth equity as an asset class.
00:11:00		It just took off, it was one of the best performing asset classes over the last couple of years, that needed to come down because it just seemed like, wow, what a great asset class. It wasn't there before and all it does is go up. But, of course, you're financing, fundamentally, companies that weren't generating profits, but the expectation is that they could at any time when they stop deciding to grow. They're not all like that.
	KM	If you think about what happens here, a strategic buyer comes in and finally gets comfortable with a multiple on that, or some other fund that comes along, and again, the opportunities on the buy side are at a different multiple than where they have been priced in the past.
00:11:37		So, my comments probably reflect more about those companies in existing funds today, versus if you were going to invest into this next environment, you probably could make some money there.
	AL	Robert raised an interesting point, where he used the term definition. It seems a little semantic to talk about how people define some of these sectors, but we talked about

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		infrastructure and it being an attractive asset class in today’s environment.
00:12:03		I think when we were talking about it, and when Kevin described things repricing with inflation, we’re thinking very traditional infrastructure. Now, if you look at definitions of infrastructure, if you look at definitions of secondaries, these definitions have all broadened. They're not wrong, you just have to now look at the right profile and the right characteristics of what it is you think you're getting. And then you have to pick the right manager.
00:12:28		There's energy infrastructure, which you have to be careful about what part of the energy cycle are you, are you midstream, are you upstream, are you downstream, where are you, and does that truly have the same characteristics as the traditional infrastructure that everyone thinks of.
	DP	So, I want to pick up on that because I think that's really important for an LP or limited partner, how do they make the most of their opportunities, while also minimising the potential risk? Management has come up a lot in this conversation, so how do you choose a good manager or a right manager?
00:13:04		What are you looking for? What are the attributes that make somebody a good manager, versus not a good manager?
	AL	Look, from our perspective, we’ve been spending a lot of time with managers, not necessarily as an LP but diligencing them in much the same way. I think Robert alluded to this earlier, right now is actually the perfect time to be doing a lot of diligence on managers because you will really get to the bottom of that value creation aspect of how they operate and their operating partners, and how good they are at that part of the business.
00:13:36		As well as looking at whether the structures in financing they put in place on their 2018 and 19 deals were resilient enough for them to have anticipated, not exactly what happened but something was going to happen, and they could withstand it, or their capital buffer, or whatever the case is. But that's diligence. That's a lot of diligence. And

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		that is don't rely on other people's diligence, as well, I think is the case.
00:13:59		And then, the other aspect of it, I would say, is don't put all your eggs in one basket. If you're a smaller LP or a smaller institution, you've got to be pretty careful about saying you're going to go do private equity and putting all your money with one manager. That's a lot of concentration risk.
	RO	Yes. A couple of things. So, if you have the capacity to invest in an LP... Sorry, into a GP, and you look at this environment and say well, I can get better terms and conditions.
00:14:35		Management fees might be a little bit better than they were five years ago. If I'm looking for co-investment opportunities, that is where the fund does a deal, buys a company, and they're looking for other investors to partner up with them on that and you have the capacity to do that, you can get those rights today that you couldn't have got five years ago.
00:14:55		And in some cases, you can get five to one, is a ratio that a lot of people are using right now, where you could say five times the number of... I'll get five times the number of co-investments that I would have from my initial investment as an LP. So that's a fantastic thing, you get better terms and conditions. And then, back to the valuation side of things, you can really see a team, how they work together. They'll have had challenges, and how have they worked through those challenges. You'll have access, you can interview portfolio companies, how did it work with them, good and bad.
00:15:29		And as my mother told me, you talk to somebody for over an hour, they're going to tell you everything. So, if you can get someone in that position to actually talk to you for an hour, you can actually learn a lot. So, it's a great time to be able to evaluate people, as we talked a bit earlier, and so, you can actually get to what is really an outstanding manager that's worked in really great times and, also, some challenging times. And even the great times we've had over the last ten years, there's been challenges.

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00:15:55		And every subsector has had issues to work through. And so, have an ability to work through those and then see the outcome of that. We've had COVID, and now we've had even bigger issues, lots of things to work through.
	KM	Free money and having multiples had a lot of sense, so we're about to see who the good managers are, in terms of a reset on multiples, potential slow-down in the economies. I think, to Robert's point, and Ash, good management teams are going to show themselves here.
	DP	To your point, is that a bit of a concern that we might be running it because there's lots of challenges that a lot of managers haven't faced over the last few years, that all of a sudden, who you thought was a good manager isn't a good manager?
00:16:39		And then we run out of good... There's not enough good managers to go around for the demand that there seems to be for private capital, especially as we democratise the arena, a little bit.
	AL	Yes, I wouldn't say managers that, maybe, haven't dealt with this struggle, as much, are going to fail. I would just say they'll have a steeper learning curve.
00:16:58		And while they're battening down the hatches on their existing portfolios, they might miss some of the new opportunities because they're so focused on getting through. I think at the end of this, you'll have a lot more better managers because they'll all have gone through the struggle. So, at least, in my opinion, the suggestion is not that you'll see managers failing and collapsing, it's more that some of them will have a steep learning curve because they just haven't seen this before.
	RO	And we're creating new management teams all the time. As these funds get bigger, the teams, they splinter off.
00:17:30		You'd love to keep the same team together forever, but it doesn't always happen, so teams break away and they create their own funds. The institutions have been great groups to spawn off teams. So, you've seen, coming of out the big pension funds in Canada, as an example, several dozens of, actually, new groups come out of those

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		institutional investors. So, there's lots of opportunity for new managers to come out that have had great pedigrees, have had great institutional backing, and learnings that they're now able to recreate that as new managers.
00:18:01		But there still will be some failures. There'll still be failures of portfolio companies. It's a disaster if you close up the fund because it was so negative that you have, maybe, three or four deals. It doesn't happen very often, but it does happen. Of course, it certainly will.
	AL	Yes, I think the fundraising environment, as well, may slow down that new manager formation naturally, or will slow it down naturally, which will have the added benefit of some of these teams staying together longer, through this.
00:18:34		Easy is not the right word, but it was relatively easy to go out and find some money in the last few years. As that becomes harder, less people will do it, but that will create stronger managers because now the retention is higher and it's easier, not easier, to retain people, and hiring, which was very, very difficult for the last few years, has loosened up a little bit. So those existing managers that get through this and do well will be better for it, and their employees will stick around and be more experienced.
00:19:04	DP	Okay, I want to get to the future of private capital. Before I do that, there's just, maybe, one last question on this idea of due diligence, and maybe I'll start with you, Ash. We've talked a little bit about manager and terms and conditions. Especially as this gets democratised, and you have a lot of new investors who are unfamiliar with private capital and they want to get into this space, I'm thinking size and scale of a fund, or the actual asset type that they might be entertaining.
00:19:39		How important is it to really understand what, obviously, they're getting involved in?
	AL	Yes, so, obviously, underlying strategy is hugely important because that's how you're deciding how much and what allocation, and how you're building it into your portfolio. So, definitely, understanding their underlying assets, how they deal with them, and what the characteristics are is huge.

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00:20:00		The other aspect of diligence, to hit directly on your point about democratisation, and I think the institutional investors, over the last little while, have become very, very focused on it, are things like governance and compliance. How they make the decisions to make the investments, what's the checks and balances in the system, internally? I think as more and more less experienced investors start to get into this space, through some of these new vehicles, that is a protection for them.
00:20:32		That even if they don't, necessarily, become as sophisticated on the underlying investments themselves, at least they can get themselves up to speed on the checks and balances their manager has in place, the governance, the compliance. If they're under any regulatory regimes, depending on the structure that they're investing in, things like that, I think, are directly relevant, especially for retail, certain pockets of high net worth.
00:20:58	RO	So, I'll just add one thing on the diligence side for a high-net-worth individual. I think it's a hard asset class to navigate on your own. I think you do need institutional support in some way, or an advisor who's got perspective. It's not an easy thing to just go and... Because everyone's trying to add alternatives as a differentiator to what they're doing. But then, knowing do you want to be in an industry-focused fund, like a healthcare fund, or do you want to be in a generals' fund?
00:21:27		Do you want to have exposure to the US and Canada, do you want to be in big deals or small deals? We talked about, four or five of the asset classes, but there's several other subcategories you could throw into the mix. You put all that into the equation, it's very hard to determine. And then, now, you have evaluate of those, where are great managers and what, really, are a cultural fit to you, and match up with how you think about the world. That's a hard thing to navigate through. So, like anything, you probably have to do that methodically.
00:21:56		I would suggest you have to at least get some professional support to do that, someone who actually has walked the walk and can navigate through that because it's a really difficult environment to get through.

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	DP	Okay, I think that brings round two to a close. To hear the rest of the conversation with Kevin, Ash, and Robert, round three of our private capital series is now available at agf.com/podcast. Or by subscribing to Apple Podcast, Spotify, Google Play Music, Stitcher, Podcast Attic, and Pocket Casts.
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