Monthly Investment Update
A Focus on Alternative Investments

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Private Equity: An Evolving PE Landscape

Over the last few months, we have held several meetings with different general partners (GPs) in the traditional private equity (PE) space. Following these conversations, we take a look at the main topics and themes which are posing key challenges for the industry in the short to the medium term.

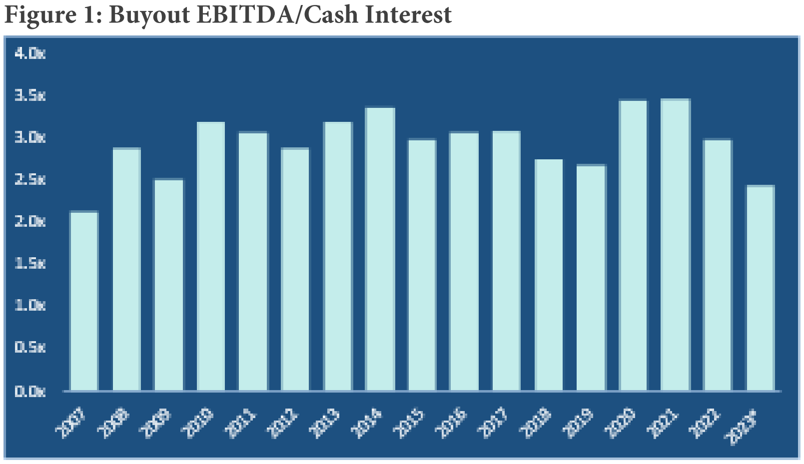
Challenges to the buyout model

The challenges in closing buyout deals persist due to the combination of the lack of available credit and the ongoing high cost of credit. Private credit initially helped bridge the funding gap that resulted from the slowdown in the leveraged loan market, but its momentum seems to be waning. In terms of activity, buyers remain hesitant as valuations have not decreased sufficiently. Buyout purchase prices, standing at 11.5x EBITDA for the first three quarters of 2023, have only marginally decreased from the peak of 12.2x in 2022. This lack of substantial reduction, coupled with the challenging debt environment, hinders buyer enthusiasm.

While corporate defaults and bankruptcies have remained subdued in both the leveraged loan market and the broader global developed business landscape, the number of credit events are picking up. Revenue and EBITDA growth of small-cap public companies have started to slow, suggesting an increased risk of failures.

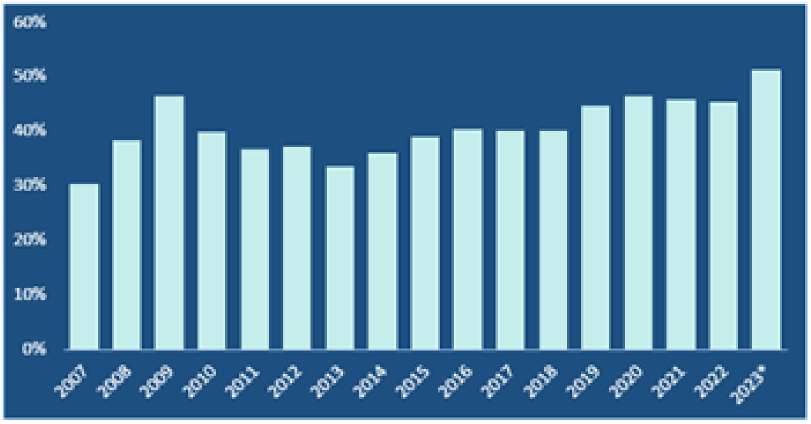
On the side of the deals being closed, deal types that are less dependent on access to new debt have taken share of the PE deal market. Add-ons, for example, continue to account for nearly eight out of every 10 buyouts, in part due to a more accommodating credit environment but also due to much smaller deal sizes. More interestingly, there is a recent increased in interest in PE growth deals, which for the first time will likely outnumber leveraged buyout deals for the year. The reason for this is that the strategy pursues deals with a minority structure that invests in fast-growing companies that are a better fit with the current market backdrop. In the same vein, EBITDA interest coverage ratios for deals closed in 2023 in the buyout space have been reduced to 2.4x from the market peak of 3.5x – these are levels not seen over the last 10 years. Moreover, sponsors have increased equity contributions, which moved above 50% for the first time in at least 15 years. This shift, although it provides a more secure financial foundation for buyout deals, outlines the greater hesitance to use debt, and its impact in expected returns.

Figure 1: Buyout EBITDA/Cash Interest



Source: Pitchbook.

Figure 2: Equity Contribution %



Source: Pitchbook.

"Companies acquired through LBOs between 2016 and 2020 are experiencing a notably slower exit pace than anticipated based on pre-2016 rates."

The Exit Drought Worsens

The deterioration in exit activity has deepened, with the value of PE-backed exits hitting its lowest point in at least 30 years compared to its long-term trend. Companies acquired through leveraged buyouts (LBOs) between 2016 and 2020 are experiencing a notably slower exit pace than anticipated based on pre-2016 rates. For instance, only 24.3% of LBO-acquired companies in 2019 have exited – a stark contrast to the baseline expectation of 39.8%. As per the conversations with different GPs, the scarcity of exits has led to a substantial increase in the holding period for buyouts. The median age of current buyout-backed companies has extended to 3.3 years, and nearly 35% of these entities have been held for more than five years, underscoring the challenge of realizing timely returns on investments.

This trend, in turn, is shaping a negative outlook for fundraising in the coming four quarters, as the prolonged holding periods and diminished exit opportunities create headwinds for the distribution of capital back to investors and the subsequent re-ups in successor funds.

Figure 3: Rolling Six-month Exit Value Relative to Long-term Trend (Z-Score)

Source: Pitchbook.

"PE entities are compelled to redirect their attention toward authentic and sustainable value creation."

Change in the PE Model Paradigm

During the industry's early days, substantial value was derived by streamlining operating costs. A subsequent phase witnessed funds generating robust returns through financial engineering amid a favorable low interest rate setting and ascending valuations. However, the current scenario reflects a departure from this trend, marked by higher interest rates that elevate the cost of debt.

Consequently, PE entities are compelled to redirect their attention toward authentic and sustainable value creation. The imperative for value creation during a PE firm's ownership is heightened, with portfolio companies pressured to accelerate profit growth in response to the rising cost of capital. Successful transactions now hinge on the resilience and quality of businesses, with investors tasked with intensifying efforts to propel growth and prepare companies for sale. Close collaboration emerges as a key theme, as private equity firms adopt a hands-on approach with portfolio companies. This collaborative effort aims to navigate financial headwinds, ensuring continued growth and improved cash flows within the challenging economic environment. The broader economic weaknesses prompt companies to reassess day-to-day strategies, presenting an opportunity to innovate solutions that optimize cash management and foster resilience.

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Conclusion

The ever-changing global landscape further amplifies the importance of proactive intervention. Digitalization, decarbonization, and deglobalization are some major themes compelling PE firms to actively intervene, ensuring businesses stay relevant in a rapidly evolving environment. This proactive stance becomes a driving force behind value creation. The emphasis on collaboration, resilience, and innovation underscores the multifaceted strategies required to navigate a complex and rapidly changing economic environment, ensuring sustained high returns could be delivered.

Venture Capital: Themes Shaping the Third Quarter

Venture deals continued their downward trend in the third quarter of 2023 with the total number of deals remaining pretty far from 2021-2022 numbers. The venture capital (VC) landscape in Europe and the US exhibited distinct trends across stages, marked by adaptation and strategic responses to market conditions.

- **Seed stage:** There was a notable increase in median deal sizes, reflecting founders' efforts to extend their runway amid compressed valuations in Early-stage. Median pre-money valuations increased during the quarter, further eroding the step-up between Seed and Early-stage.
- **Early-stage:** The impact felt by those closest to the public markets has trickled down into the earlier stages. These deals saw rising median deal sizes but compressed pre-money valuations as illustrating startups' challenges in a tight-capital, investor-driven market.
- **Late-stage:** Europe's Late-stage deals showed resilience with strong median sizes and valuations, while the US experienced declines in both areas, indicating a more cautious investment climate.
- **Venture Growth:** This stage faced the toughest conditions, with significant drops in valuations/deal sizes and extended times between funding rounds, as companies sought to delay external capital needs. In the US, a shift in the venture capital market was evident, with investors securing more favorable terms, higher median equity stakes, and increased instances of cumulative dividends in deals.
- **Down/Flat rounds:** Down and flat rounds jumped to 26.9% in Europe and 26.4% in the US. Remarkably, the proportion of down rounds in the third quarter reached a 10-year peak, at 17.1% in the US and 21.3% in Europe. The increase in down and flat rounds, which had been anticipated for some time, reflects numerous startups running low on capital and facing a challenging fundraising landscape to survive. This contrasts with the more startup-friendly financing environment of 2021, characterized by rapid growth and high valuation multiples.

"The increase in down and flat rounds, which had been anticipated for some time, reflects numerous startups running low on capital..."

Trends by Stage

Seed

Deal metrics at the Seed stage have remained steadfast against market headwinds. In the third quarter, Europe and US median Seed deal sizes increased to a record high of USD3.3 million and EUR2 million respectively. This increase suggests founder interest in maximizing runway and avoiding Early-stage rounds at compressed valuations.

“Seed-stage startups are taking more time between financing rounds to demonstrate growth and achieve attractive valuations...”

In Europe, median pre-money valuations reached their highest level of the year, at EUR5.6 million, but are still 11% below their 2022 peak.

US median pre-money valuations reached a record high at USD12 million, up 7% from the last quarter and 9% from the previous year, closing the gap between Seed and Early-stage deal valuations. This trend is leading to an erosion of value creation between stages, as evidenced by the 2023 year-to-date median Early-stage step-up falling to near five-year lows of 1.6x. Value creation between stages is crucial to propelling startups through fundraising cycles, and for many investors, a weaker increase in valuation between rounds can signal underlying issues and prompt greater caution. To address these challenges, Seed-stage startups are taking more time between financing rounds to demonstrate growth and achieve attractive valuations that attract new investors’ interest. Consequently, the graduation time from Seed to Early-stage increased from 1.19 years in 2022 to 1.37 years in 2023.

Early-stage (A – B)

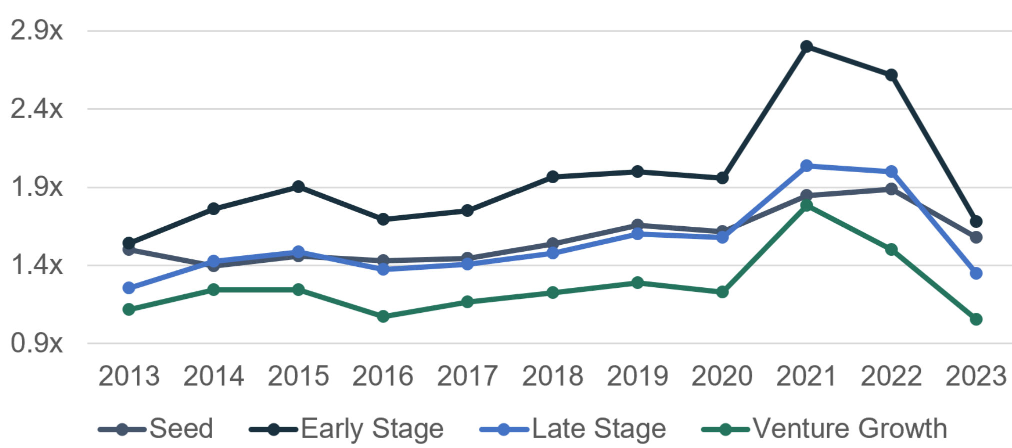
In Europe, the quarterly median deal value saw an increase during the third quarter, reaching EUR1.8 million (+20% versus the second quarter). However, the year-to-date median remain slightly lower versus 2022. This contrasts with declining pre-money valuations, which have fallen for the first time in a decade, dipping from EUR5.7 million in 2022 to EUR5.3 million this year (i.e. -18% compared to the second quarter and -7% versus 2022). In this scenario, startups are offering more equity for the same deal size to secure funding in a tight-capital, investor-dominated market.

In the US, both median deal size and pre-money valuation remain significantly below recent years. The median deal size for Early-stage investments showed a slight recovery in the third quarter, reaching USD5.0 million, yet it still falls short of the USD6 million seen in recent years. This is likely due to an increase in extensions/bridge rounds in an effort by startups to avoid raising a new round in which they may be unable to meet investors’ financial-performance expectations. Additionally, start-ups raising new rounds are minimizing their capital needs in this harsh environment. This is confirmed by the median pre-money valuation remaining compressed at USD40 million (versus USD46 million in 2022) influenced by a rise in flat rounds and a more investor-centric deal-making environment.

Additionally, the narrowing gap between early and Late-stage US deal valuations is diminishing the value generated between stages. The year-to-date median step-up in valuation from early to Late-stage has dropped to near-decade lows of 1.7x, coupled with an increase in the median time between funding rounds from 1 year to 1.26 years.

“In Europe, trends in Late-stage deal sizes and valuations have, surprisingly, been resilient.”

Figure 4: Valuation Step-up



Source: Pitchbook – Q3-23 US VC Valuation Report.

Late-stage (C – D)

In Europe, trends in Late-stage deal sizes and valuations have, surprisingly, been resilient. We would normally associate heavier declines in valuations and deal sizes with more mature areas of the VC ecosystem, as they are more reliant on exit markets and public benchmark valuations (which have also markedly corrected over the last year). However, in the third quarter, the median Late-stage deal size hit a 10-year quarterly record high of EUR4.7 million, elevating the 2023 median to EUR3.5 million, a 9%

increase compared to 2022. Similarly, median valuations surged by 30% from the second quarter, bringing the 2023 median to EUR10.3 million, just 4% shy of the 2022 record.

In the US, the late-stage continues to suffer, with fewer companies seeking to raise rounds in this challenging environment. The Q3 2023 median Late-stage deal size was USD5.9 million, an 8.0% decrease from the prior quarter, setting the 2023 full-year median to a six-year low. Pre-money valuations grew quarter-by-quarter, reaching USD63 million in the third quarter – a 21% discount from the peak in 2021.

"Late-stage startups have scaled their businesses and secured larger streams of recurring revenue, enabling them to better model their businesses' cash flow and supplement their external financing needs."

In the US, valuation step-up between stages and the median time between rounds dropped to 1.35x and increased to 1.72 years, respectively. These trends suggest that many Late-stage startups have scaled their businesses and secured larger streams of recurring revenue, enabling them to better model their businesses' cash flow and supplement their external financing needs. Similarly to Early-stage companies, startups forced to return to the market due to low cash reserves and weak revenue streams are striving to minimize the capital they need to raise in a deal-making environment where step-ups are at decade lows.

Venture Growth (Pre-IPO)

The venture-growth stage remains the most difficult for deal-making, due to mismatches in founder and investor valuation expectations and weak exit markets. Additionally, venture growth companies sit the closest to public benchmarks. Despite several notable VC-backed IPOs in 2023, their subsequent lackluster stock performance has made many venture-growth stage startups hesitant about pursuing public listings as a liquidity option. Instead, these companies are increasing their cash runways through headcount and variable cost reductions while evaluating acquisitions as exit. Consequently, the median time between rounds has reached a five-year high of 1.46 years, as venture-growth startups try to delay the need for external capital. Those forced to return to the market are facing harsh realities.

In Europe, through the third quarter, the median value of venture growth deals saw a 17.4% decline compared to 2022. Additionally, median valuations experienced the most significant drop across all stages, being 26.1% lower in the first nine months of the year compared to the entirety of 2022.

Meanwhile in the US, the venture-growth stage has seen the most significant compression of all venture stages, with the Q3 2023 pre-money valuation of USD260.0 million representing a 56.5% decline from the Q1 2022 record high. While there has been a quarterly improvement in median pre-money valuation, the step-up in valuation for venture-growth companies remains compressed at 1.05x compared to the peak of 1.96x in 2021. This stage heavily relies on the participation of non-traditional investors to support larger financing rounds and to signal the strength of a startup to other investors. The withdrawal of non-traditional investors has driven the median deal size to $11.9 million, a seven-year low, and 62.1% lower than its 2021 record high.

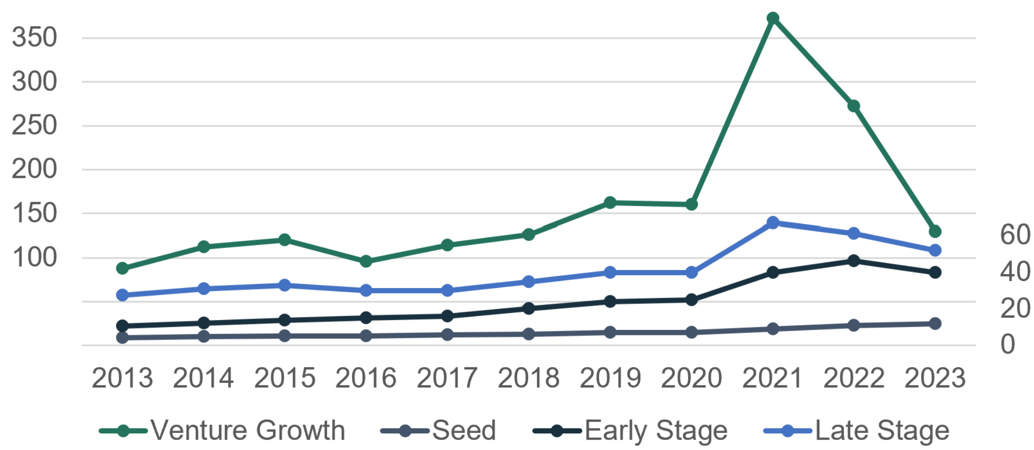
"Risk appetite appears to be returning to venture/growth markets, albeit in a polarized manner."

The capital deployed in US larger deals (both over USD50 million and over USD100 million) is approximately 75% down from the peak and is now more aligned with the five-year pre-bubble average. However, these larger deals are crucial indicators of the market's belief in healthier exit markets. Executing deals over USD50 million and USD100 million is challenging in any market, but particularly so if investors lack confidence that they will be able to monetize these illiquid positions within a roughly three-year horizon.

Risk appetite appears to be returning to venture/growth markets, albeit in a polarized manner. If we categorize tech verticals into "risers" and "fallers," the risers are nearing 2021 highs for large deals as a portion of all deals done in that vertical, whereas the fallers continue to reach five-year lows. This bifurcation in the market's willingness to deploy capital may provide insight into which technologies or companies investors have the highest conviction in leading the reopening of the IPO market. The sectors experiencing significant rises in USD50 million to USD100 million deal size as a portion of total deal activity include cybersecurity, oncology, space tech, climate tech, and AI. These risers are also seeing premium valuations and step-ups between rounds compared to the fallers. Major declines in this deal size as a portion of total deal activity are observed in supply chain tech, robotics, drones, B2B payments, crypto/blockchain, and predominantly supply chain tech.

“Even top-performing companies were not exempt from this challenging fundraising environment, facing higher equity shares acquired by investors.”

Figure 5: Median Pre-money Valuations ($)

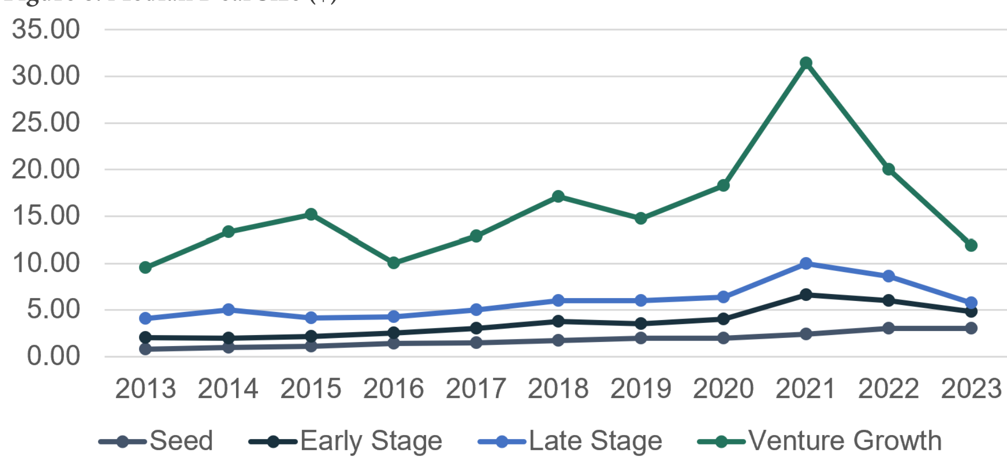


Source: Pitchbook – Q3-23 US VC Valuation Report.

Deal terms

In the third quarter of 2023, the US venture market favored investors in ways not seen in nearly a decade. Venture firms used their increased negotiating power to secure more favorable terms, including larger equity stakes, higher dividend shares, and liquidity participation preferences. Annually, almost all VC stages saw an increase in the median equity stake acquired in 2023. The pre-Seed and venture growth stages experienced the highest increases, reaching decade-record highs of 24% and 15%, respectively. For Seed, Early-stage, and Late-stage, the median share acquired increased compared to 2022, reaching 25.2%, 23.6%, and 20.0%. Even top-performing companies were not exempt from this challenging fundraising environment, facing higher equity shares acquired by investors. Additionally, as of Q3 2023, 23.1% of US VC deals featured cumulative dividends, a nine-year high, with liquidity participation preference reaching its highest level since 2020 at 9.3%, up from 8.9% in 2022.

Figure 6: Median Deal Size ($)



Source: Pitchbook – Q3-23 US VC Valuation Report.

“While the multi manager model itself is not new, what was once a niche part of the industry has grown in popularity.”

Hedge Funds: The Rise of Multi-Strategy Managers

While the multi manager model itself is not new – some of the largest and well-known firms in the space have been around for over 30 years – what was once a niche part of the industry has grown in popularity. Assets have grown exponentially over the past few years to reach USD872 billion, according to HFR data.

Over the past few years that have seen a succession of market turbulences, these firms have strongly delivered on their mandate, making them a valuable and increasingly sought-after exposure among investor portfolios – including ours. We take a look at the current multi-strategy manager landscape and its evolution over the recent years, and provide our perspective on this segment of the industry.

"As the multi-manager segment has expanded over the years, new business models have emerged to compete with the traditional multi-manager hedge fund firms…"

Different multi-strategy models

Multi-manager hedge funds or hedge fund platforms are a type of investment organization that employ a multitude of specialized managers across strategies, operating as one entity, where the underlying individual portfolio managers have discrete P&L responsibilities. Some of their main features include:

- They are investment vehicles in which the manager oversees several independent portfolio management teams.
- The overall structure is responsible for integrating risks and overseeing all operational activities, while investment decisions can be centralized or decentralized.
- They deploy capital across many multi-asset opportunities across both fundamental and quantitative strategies.
- They aggregate and manage the risks generated by the underlying investment teams, relying on large investments in technology and teams of investment and IT professionals.

As the multi-manager segment has expanded over the years, new business models have emerged to compete with the traditional multi-manager hedge fund firms i.e. the ones that have pursued a multi-manager approach since their launch. Indeed, several single-manager hedge fund firms have converted to/launched multi-manager structures (that is particularly true for macro funds). Large asset management platforms have also launched multi-manager products leveraging existing strategies/talent pools as well as the scale and infrastructure of their organizations to compete in the space. Finally, fund of funds have also begun to build multi-manager products to compete with traditional offerings.

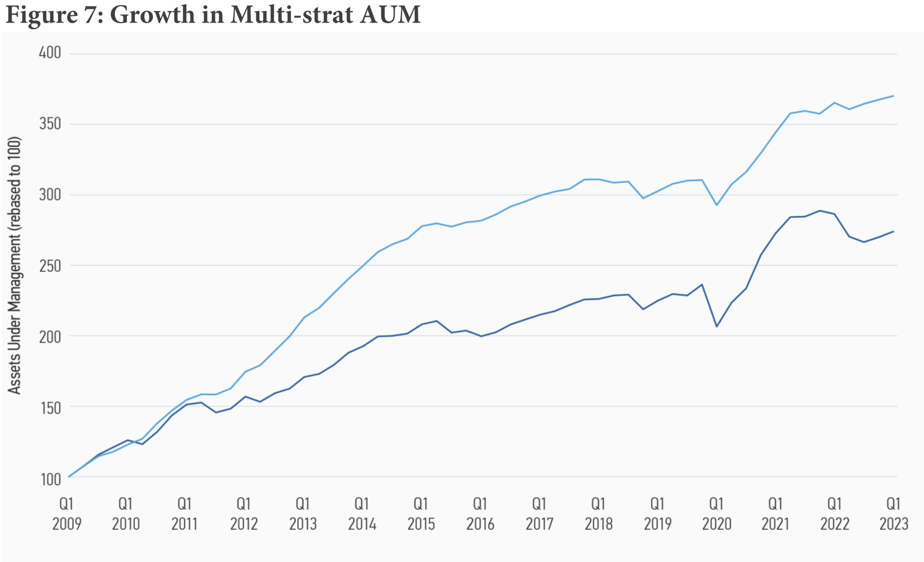
While all these models differ in their approach, the goal of each remains the same i.e. to allocate to a wide range of investment strategies across asset classes. Multi-strategy firms thrive to find portfolio managers whose return streams are uncorrelated to each other, coupled with pre-defined risk management guidelines and a dynamic/efficient allocation of capital toward what they perceive as the most attractive opportunity set. The aim is to deliver higher risk-adjusted returns, lower volatility and correlation to equities/fixed income markets, which should result in better downside protection during markets selloffs.

Evolution of the multi-strategy landscape

"We have seen a number of new launches and strong growth from competitor firms to capture the excess demand…"

The rise of the multi-manager model is very much apparent from the growth in assets that has largely outpaced the overall hedge fund industry, especially in recent years. Another interesting development is that, while the category of multi-strategy funds used to be dominated by a handful of well-established and very large players, many of these firms have reached their capacity limits in recent years. Consequently, we have seen a number of new launches and strong growth from competitor firms to capture the excess demand from investors.

Figure 7: Growth in Multi-strat AUM



Source: eVestment. As of March 31, 2023. Note: Data rebased to 100.

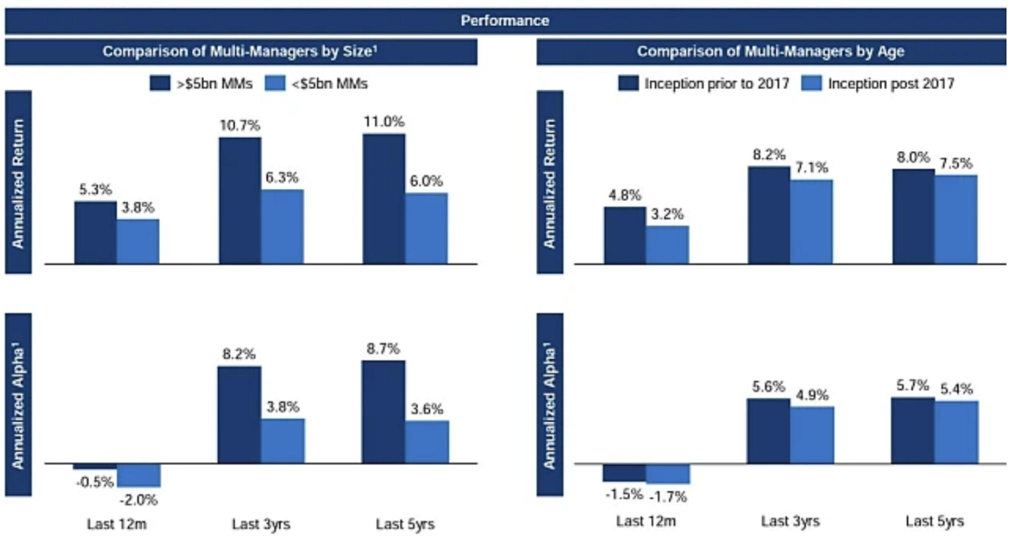
Asset growth and performance

One of the principal drivers of the recent growth in multi-manager funds has been the asymmetric return profile that they have been able to deliver especially as the past few years have been marked by a succession of market turbulences. It is however important to note that the absolute level of performance generated by these funds has been good but not outstanding, and rather they have been able to distinguish themselves with the quality of their returns. Indeed, they have been able to perform through different market environments, delivering positive returns on aggregate over the past five years, with a clear advantage for the largest and longest established firms.

"It is however important to note that the absolute level of performance generated by these funds has been good but not outstanding..."

However, the current market environment marked by higher interest rates and volatility raises the question of the sustainability of this outperformance. It will likely imply an increased reliance on active trading-oriented strategies and a higher capital allocation efficiency given the renewed competition for capital from the yield on cash.

Figure 8: Performance of Multi-strategy Managers



Source: Barclays Prime Services. As of September 30, 2023.

"War for talent" / fees and terms

With assets quickly growing, the most visible consequence of the growth in the multi-manager space has been the intensification of competition dynamics. The competition for investment professionals (the so-called "war for talent") has consequently become a dominant theme and a topic well covered by the financial press.

"With assets quickly growing, the most visible consequence of the growth in the multi-manager space has been the intensification of competition dynamics."

Indeed, talent acquisition remains the largest constraint for asset growth at these firms given the lack of operating leverage of their model that is significantly more headcount-intensive than a single-manager strategy both for investment and non-investment staff. These dynamics have fueled demand for talent in line with asset growth in recent years, and when combined with the formulaic payouts for PMs, this has resulted in the extension of liquidity terms for the funds – in some cases to multi-year redemption schedule, to extend the duration of their capital base and the use of the expense pass-through model either full or partial which has now become the market standard. A pass-through model is typically used instead of management fees, though those with a partial pass-through will charge a small one. In addition, firms will also charge the typical 20% management fee.

The idea underpinning that model is that by being able to command pass-through expenses from investors, firms will be able to be more competitive in terms of PMs compensation and other areas of the firm such as technology / infrastructure, effectively creating a moat around their business and bringing higher barriers to entry. However, as we have seen in recent months, the large operating costs that are passed-through are also a double-edged sword as they will strongly impact net returns if the firm is not able to keep on performing over time.

“We view multi-strategy funds as one of the building blocks of a diversified hedge fund portfolio...”

Figure 9: Fee Models

Funds by Fee Models		
Fee Structure	**Pass-Through Expenses**	**Common Fees***
Full Pass-Through	• Performance-based Compensation to PMs and Strategy-Specific Expenses • Infrastructure costs (Operations, IT, etc.)	MF: 0% PF: 20%
Partial Pass-Through	• Performance-based PM compensation • Strategy-Specific Expenses	• MF up to 2% to pay for infrastructure costs • In a few cases, particularly if charging 2/20, pass through expenses are capped • PF from 0% (only one instance) to 20%
Non Pass-Through	None (investors are only charged standard fund-level expenses)	• 2/20 standard (up to 3/30) • Some managers offer multiple share class options, which trade off lower MF for higher PF

Source: Barclays Prime Services. As of September 30, 2023.

Our perspective on multi-strategy managers

The growth of the multi-strategy model has been largely driven by the increased interest from investors, including ourselves, who have been attracted by the quality of the returns that they have delivered. On our side, we view multi-strategy funds as one of the building blocks of a diversified hedge fund portfolio, given their ability to dynamically allocate across strategies coupled with strong risk management, business moat and their ability to access top talent. That said, capacity issues have started to emerge recently and we also remain careful with the extension of liquidity terms.

The growth of the space has also effectively created barriers to entry and many investment talents end up deciding to join these firm rather than launching on their own, therefore making multi-strategy firms hardly avoidable.

The flipside of the growth we have witnessed over the past years for that part of the industry has also been a growing market footprint, positions crowding and the increased occurrence of deleveraging events, which all bear careful monitoring. Finally, while recent net returns have been sufficient to justify the costs, performance will have to remain sustained to justify an allocation over time.