PRIVATE CAPITAL QUARTERLY

THIRD QUARTER 2021

INSIDE THIS ISSUE

FEG investment advisors

Private Debt Markets, The Last Bastion of Yield

Private debt as an asset class was borne from the ashes of the Great Financial Crisis (GFC) of 2007–2008. During that period, publicly traded corporate debt traded at historically wide spreads. This led investors to allocate assets to long-only bank loans and high yield funds whose prices had been beaten down amid the dislocation, and also led them to take advantage of potentially higher returns found in illiquid drawdown funds focusing on all types of distressed and special situations investment opportunities.

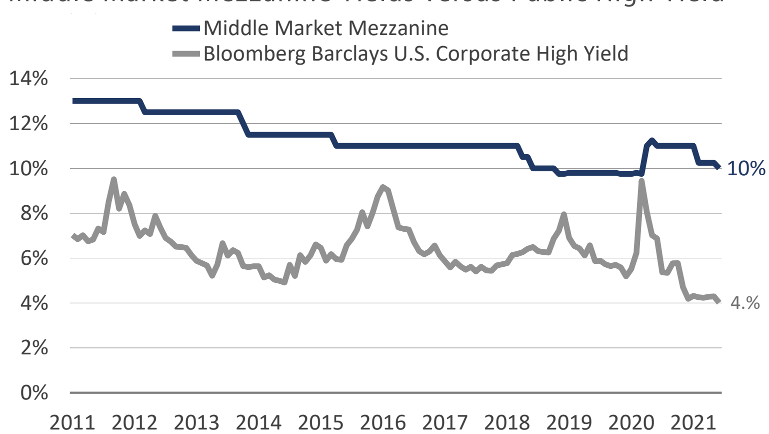
As the economy gradually recovered, an influx of regulatory requirements affecting financial institutions (i.e., the Volcker Rule) limited the activities of banks and led to a flurry of new asset managers looking to take advantage of these changes. These new asset managers referred to themselves as "direct lenders," and while some already had established viable, institutional-quality credit platforms, others seemingly came out of the woodwork of Wall Street's former investment banks. The former typically had established track records showing proof of concept, but many of the latter managers had no identifiable lending track record or had an obscure track record showing loans made with "proprietary capital" that were difficult to analyze. As a result, FEG generally chose to recommend established direct lenders to avoid the business risk associated with newer managers.

Private lending strategies tend to exhibit relatively stable yields over long periods of time with a meaningful illiquidity premium versus public market equivalents (i.e., bank loans and high yield bonds). However, this tendency can evaporate for short periods of time during public market technical dislocations, as witnessed during the peak points of volatility in the GFC and in early 2020 due to COVID-19. As spreads for bank loans and high yield bonds normalized in the years following the GFC and in the market rebound from COVID-19, the illiquidity premium for private lending re-emerged. As it did in those years following the GFC, the re-emergence of the illiquidity premium for private lenders has shifted away from distressed and special situations investors in favor of direct lenders.

Direct lending has received more than its fair share of publicity over the past five-to-seven years and it has in fact become a meaningful part of the private debt asset class. According to Preqin, direct lending is the most popular strategy within the private debt asset class, accounting for roughly 40% of total assets under management as of March 30, 2021. Other strategies comprising the asset class include distressed debt, mezzanine debt, special situations, and venture debt. As indicated on the private debt chart, direct lending as of early this year, has the most assets under management and dry powder of all private debt strategies.

MEZZANINE YIELDS WIDER THAN PRE-COVID LEVELS

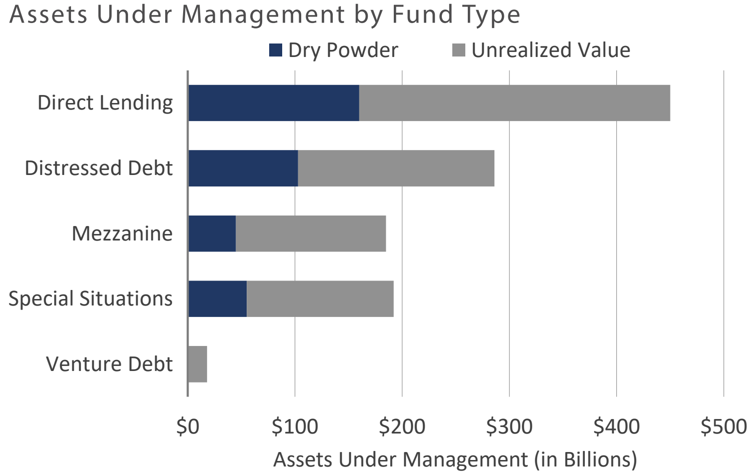
Middle Market Mezzanine Yields versus Public High Yield



Data sources: ICE Indices, SPP Capital; Data as of October 31, 2021

DIRECT LENDING OUTPACING OTHER PRIVATE DEBT STRATEGIES

Assets Under Management by Fund Type



Data source: Preqin Pro; Data as of March 2021

As implied previously, one of the most important determinants for an investor considering an allocation to a private lending fund is an illiquidity premium versus a public market equivalent. This illiquidity premium must be meaningful enough to properly compensate the investor to justify the lack of liquidity over a period of years versus a public market equivalent. For example, a reasonable public market equivalent for direct lending might be the S&P LSTA Leveraged Loan Index, which captures the "beta" of the broadly syndicated bank loan universe.

At the end of the third quarter, 2021, the bank loan market had a yield to maturity of ~3%. Compared to a pool of direct senior loans made on an unlevered basis to private equity sponsored, U.S. middle market companies, these senior loans—which represent a "middle of the fairway" type of risk profile—yielded ~5% to 6% at the end of the third quarter, representing a 2% to 3% illiquidity premium.

That premium may or may not be enough to attract investors to a direct lending fund, so managers have come up with two different ways to increase the illiquidity premium and attract more investors. The first is to use leverage, which has been the norm since the term direct lending came into being. Depending upon the amount of leverage used, direct lenders can provide net returns to investors closer to 8% or better, which can improve the illiquidity premium by an additional 2% to 3%. The second way a direct lender can generate a higher risk premium in a loan portfolio is the "old-fashioned" way, which is making loans with a higher risk/higher return profile. This approach incorporates higher default risk and greater variance of the return profiles for individual loans within the loan pool. Investors considering direct lending funds should strongly consider which approach they are most comfortable with before investing.

Conclusion

FEG was one of the earlier firms to recommend private lenders directly from our traditional fixed income portfolios, having done so for more than a decade. Although direct lending has seen increased interest and growth in recent years, FEG continues to emphasize mezzanine debt lenders due to their stability and consistency with regards to the illiquidity premium for junior capital versus senior capital, relative to public market equivalents. In other words, it is more straightforward to assess the risk/return profile for a mezzanine debt lender than that of a direct lender.

As took place in response to the GFC, the massive stimulus programs aimed at combating the volatility caused by COVID-19 have caused spreads for bank loans and high yield bonds to tighten materially, leading to wide illiquidity premiums for private lenders of both junior and senior capital. When coupled with miniscule default rates for bank loans and high yield bonds due to record-setting new issuance and wide-open credit markets, the environment no longer favors distressed and special situations investors. As such, the landscape within private debt as an asset class today favors the lenders.

PRIVATE EQUITY

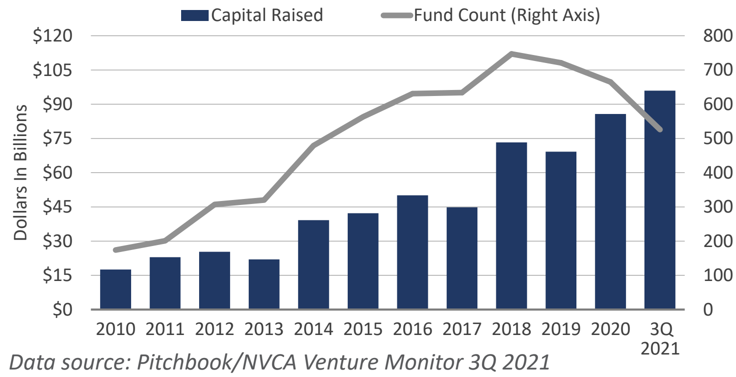
Venture Capital

- Venture capital activity in 2021 is at or near record levels across a variety of metrics, as the venture industry has shown resiliency and growth throughout the COVID-19 pandemic.
- U.S. venture funds raised $96.0 billion in the first three quarters of 2021, compared to $85.8 billion in all of 2020. Expectations are for venture funds to raise over $100 billion for the first time in history following last year's record levels. Funds with $1 billion or more accounted for approximately 40% of all capital raised in 2021.
- Venture-backed companies received $83 billion of capital in the quarter across over 3,500 deals, bringing the year-to-date total to $238.7 billion, which exceeds last year's total.
- Mega-deals—financing rounds of $100 million or more—have driven investment activity for the year, with nearly 600 deals closing with $136.5 billion of capital in 2021.
- Crossover investors—hedge funds, public asset managers, etc.—are participating at previously unseen levels, coinciding with the size of the financing rounds and high valuations.
- Pre-money valuations continued to rise during the year for venture-backed companies across all stages, particularly for later-stage financings—i.e., Series C and Series D.
- Exit activity through the first three quarters reached record levels in 2021, driven by a robust IPO market and active acquisition activity.
- Higher valuations coupled with a record exit market pushed venture fund performance higher, with median performance in recent years in excess of 20% internal rates of return (IRR) and top-quartile IRRs above 30%.

INVESTOR IMPLICATIONS

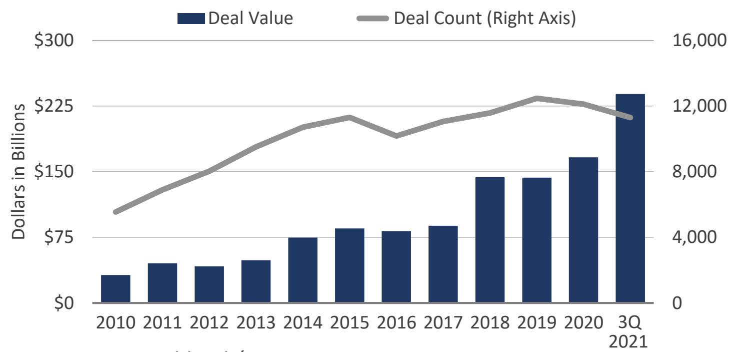
Investors should be prepared for volatility due to the high valuations and capital flows.

U.S. VENTURE CAPITAL FUNDRAISING EXCEEDS LAST YEAR'S TOTAL



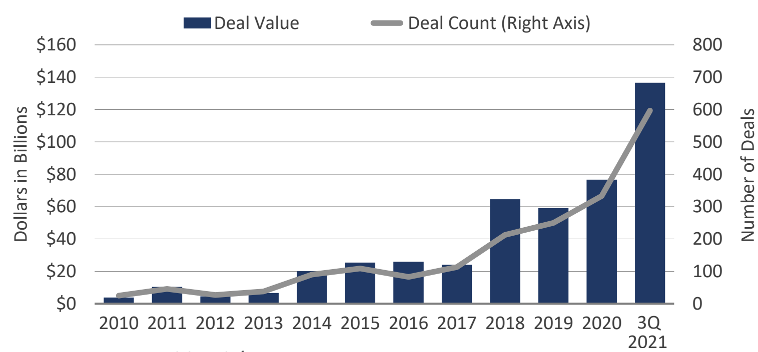
Data source: Pitchbook/NVCA Venture Monitor 3Q 2021

U.S. VENTURE CAPITAL INVESTMENT ACTIVITY ON RECORD PACE



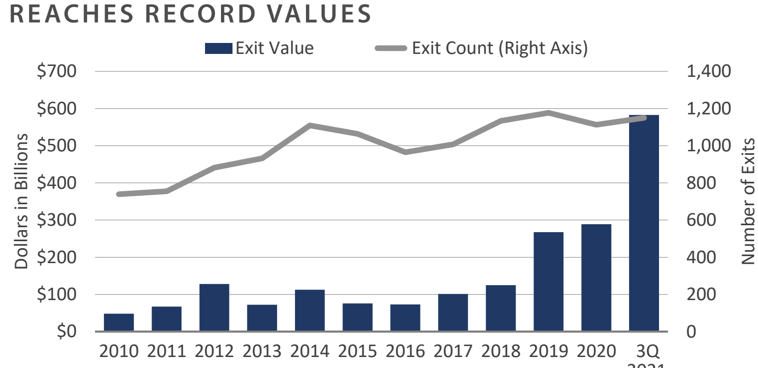
Data source: Pitchbook/NVCA Venture Monitor 3Q 2021

MEGA DEALS REACH UNPRECEDENTED LEVELS



Data source: Pitchbook/NVCA Venture Monitor 3Q 2021

U.S. VENTURE CAPITAL EXIT ACTIVITY REACHES RECORD VALUES



Data source: Pitchbook/NVCA Venture Monitor 3Q 2021

Leveraged Buyouts

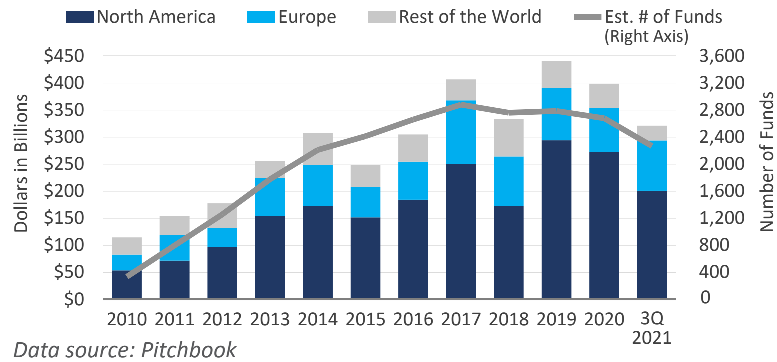
- Private equity fundraising has surged throughout 2021. As of September 30, 2021, global leveraged buyout funds closed on roughly $320 billion of capital commitments.[1] Approximately 63% of these commitments were to U.S.-based private equity funds.[2]
- Deal activity has remained robust for the year, particularly in the U.S. Year-to-date, both deal value and volume are up more than 20% from the same period in the prior year.[3] Add-ons have accounted for more than 70% of transaction volume.[4]
- As of September 30, 2021, the median U.S. private equity buyout purchase price multiple was 12.8x earnings before interest, taxes, depreciation, and amortization (EBITDA). The median Debt/EBITDA ratio was 6.5x EBITDA.[5]
- Year-to-date, U.S. private equity exit value and volume are up 203% and 86%, respectively, from the same period in 2020.[6] At this pace, 2021 is expected to be a record year for exits. Trade sales to strategic or financial acquirers represented most of the U.S. private equity-backed exits by volume.[7]
- Private equity performance was strong through the second quarter of 2021. The spread between top quartile and bottom quartile remained above 1,000 basis points.[8]

INVESTOR IMPLICATIONS

Private equity markets remain very active. Deal activity, exits, and fundraising are all at healthy levels. Investors should maintain caution though and continue to partner with experienced managers focused on creating value via operational improvements as opposed to financial engineering.

FUNDRAISING ON RECORD SETTING PACE

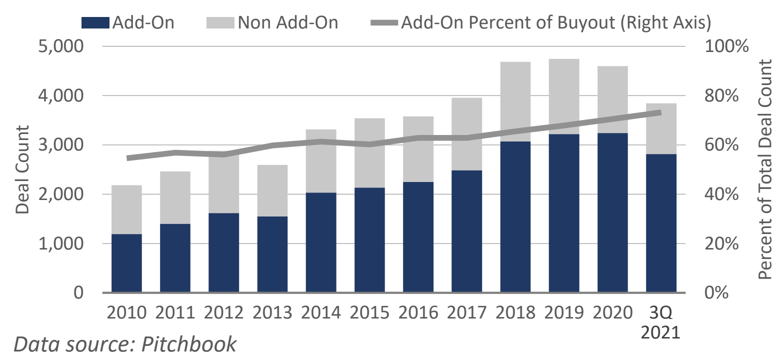
Buyout Fundraising and Estimated Number of Active Funds



Data source: Pitchbook
Data reflects the number of global buyout funds with a final closing in the current vintage year plus the prior three vintage years.

CONTINUED FOCUS ON ADD-ONS

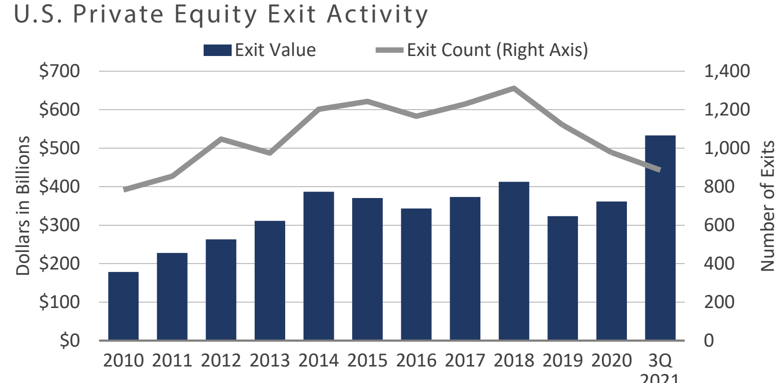
Add-Ons Percent of Total Buyout Activity



Data source: Pitchbook

ROBUST EXIT ENVIRONMENT

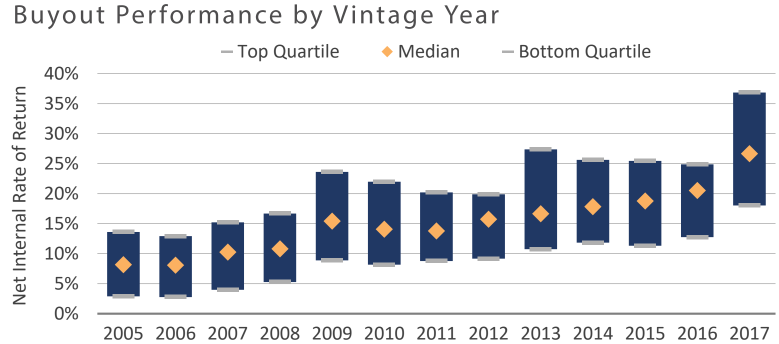
U.S. Private Equity Exit Activity



Data source: Pitchbook

STRONG PERFORMANCE FOR RECENT VINTAGE FUNDS

Buyout Performance by Vintage Year



Data source: Thomson One

[1-7] Pitchbook; Data as of September 30, 2021
[8] Thomson One; Data as of June 30, 2021

PRIVATE DEBT

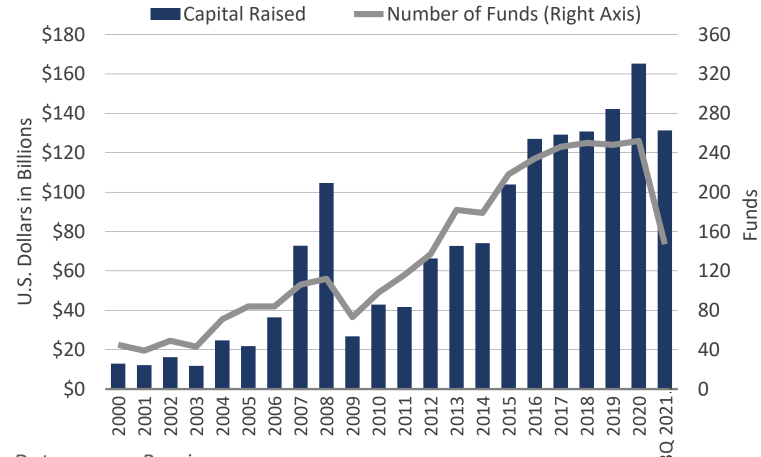
- The third quarter saw continued strength in the public credit markets. On a year-to-date basis, bank loans gained 4% while high yield bonds gained 4.7%.[1] Despite tight spreads, both sectors are in the process of delivering their coupon for 2021.
- According to Preqin, third quarter fundraising totals are generally lower than second quarter numbers. This year has been no exception, with $41 billion raised in the third quarter—$7.2 billion less than in the second quarter. Nevertheless, 2021's third quarter fundraise was materially higher than third quarter 2020 and 2019.
- Coupled with the sustained recovery in spreads for bank loans and high yield bonds throughout the year, fundraising for distressed debt funds continued to moderate, with only $5 billion raised versus $10.5 billion in the second quarter.[2]
- Further solidifying its case as a viable asset class, the number of private debt funds in the market has more than doubled since January 2016. At that time, 265 funds were targeting $118 billion. Compare that to October 2021, in which 691 funds targeted $291 billion. Notably, while the number of funds in the market has increased, the average size fund being raised is modestly smaller.[3]

INVESTOR IMPLICATIONS

Amid the sustained recovery in the public credit markets and increase in the illiquidity premium versus public market equivalents, private debt favors lenders versus distressed investors.

PRIVATE DEBT FUNDRAISING ON TRACK FOR ALL-TIME HIGHS

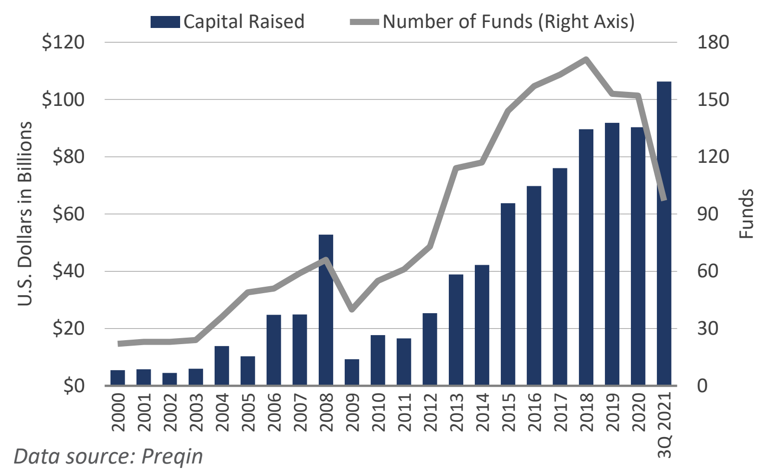
All Private Debt



Data source: Preqin

PRIVATE LENDING FUNDRAISING REACHES A NEW RECORD

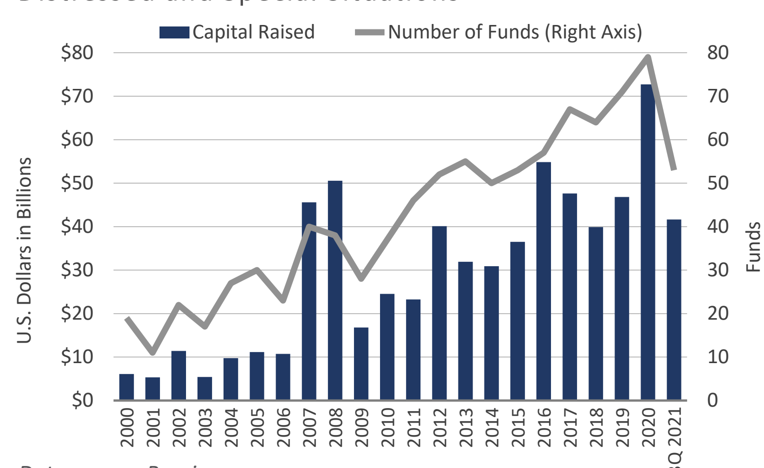
Direct and Mezzanine



Data source: Preqin

YEAR-TO-DATE DISTRESSED AND SPECIAL SITUATIONS FUNDRAISING IS OFF ITS 2020 HIGH

Distressed and Special Situations



Data source: Preqin

[1] Ice BofA US High Yield Master II Index and Credit Suisse Institutional Loan Index
[2-3] Preqin Quarterly Update: Private Debt Q3 2021

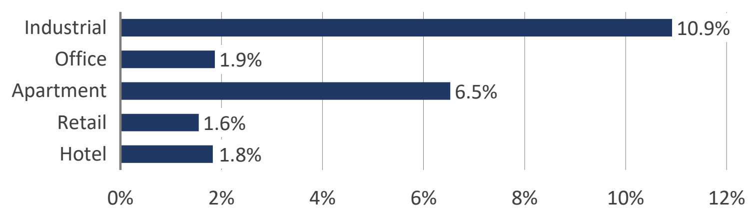
PRIVATE REAL ESTATE

- The National Council of Real Estate Investment Fiduciaries (NCREIF) Property Index (NPI) posted a gain of 5.2% during the third quarter and returned 12.0% on a trailing one-year basis. Industrial properties continued to outperform, with a total return of 10.9% in the third quarter and 32% on a trailing one-year basis. Alternatively, retail properties underperformed, with only a 1.6% gain for the quarter and a slight gain of 0.7% on a trailing one-year basis.[1]
- According to Real Capital Analytics, third quarter transaction volume totaled more than $193 billion, an increase of 19% compared with the same period in 2019—prior to the pandemic—and the biggest quarter on record for commercial property sales. Year-to-date, transaction volume has exceeded $450 billion, also a record high and surpassing the previous record from 2007.[2] Third quarter activity was largely driven by asset sales in the apartment and industrial sectors, which comprised 60% of total volume.[3]
- Industrial real estate continues to post record gains, with double-digit gains bolstered by surging e-commerce growth and warehouse/logistics demand. Apartment properties also continue to experience valuation increases, driven by double-digit rent growth—particularly in Sun Belt areas—and cap rates falling into the mid-3% to low-4% range, according to Green Street data.[4]
- A new breed of non-traded REITs (NTRs) being offered to high-net-worth individuals (HNWI) seeking yield-oriented investments have seen massive capital inflows in 2021. Blackstone's "B-REIT" fund attracted $20 billion in new inflows during the first nine months of the year and Starwood, KKR, and Ares are raising similar funds. Factoring in leverage, these funds now have buying power in excess of $100 billion. Although these vehicles have different return objectives than value-add or opportunistic real estate funds, they are nevertheless becoming larger players in the market, as evidenced by Blackstone's BREIT acquisition of Home Partners of America for $6 billion in real estate value.[5]
- One of the most notable developments this year has been the resurgence of the Commercial Mortgage Backed Securities (CMBS) market. In the first nine months of 2021, financial institutions made $102 billion in loans to property owners that were securitized into commercial mortgage securities, the highest volume for a nine-month period since 2007.[6]

INVESTOR IMPLICATIONS

The combination of extremely low bond yields, high volumes of capital flowing into private real estate, and debt markets with financing available from multiple sources has the potential to drive continued price increases for commercial real estate. There is no widespread "distressed opportunity" in real estate at this time, however, retail and hotel properties have still not fully recovered to pre-pandemic levels. All of these factors point to growing competition for deals and could set the stage for lower returns.

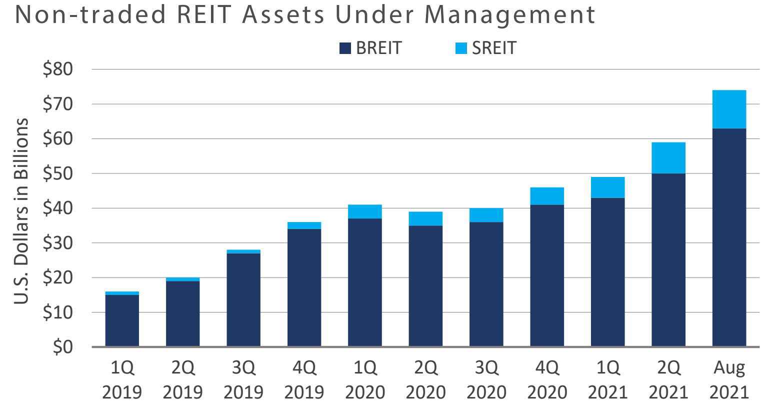
INDUSTRIAL OUTPERFORMS, RETAIL LAGS



Data source: NCREIF; Data as of September 30, 2021

NON-TRADED REITs SEE RECORD GROWTH

Non-traded REIT Assets Under Management



Data sources: Blackstone, Starwood, V3 Capital; Data as of August 31, 2021

[1] NCREIF; Data as of September 30, 2021

[2, 3] Real Capital Analytics, Third Quarter 2021

[4] Green Street Commercial Property Outlook, September 2021

[5] Reuters, June 22, 2021

[6] Grant, Peter, Commercial Real-Estate Sales and Values Surge to Records, The Wall Street Journal, October 26, 2021

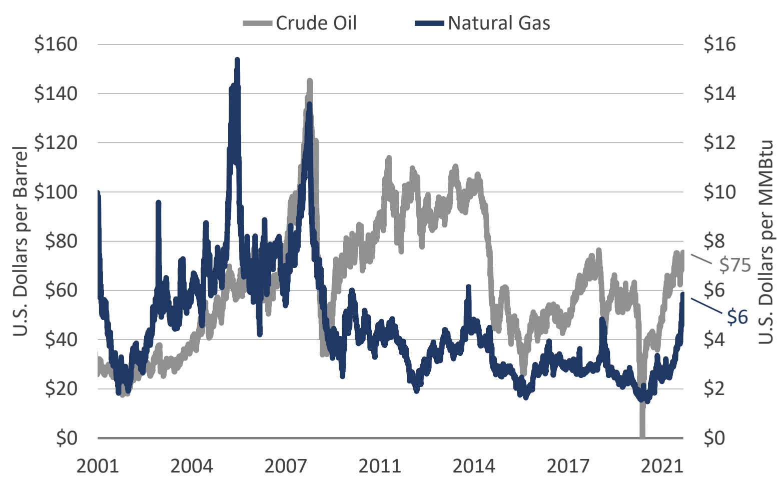
NATURAL RESOURCES

- Oil prices rose 2.0% in the third quarter to close at approximately $75/barrel. Year-to-date, oil prices were up 55% as of September 30, 2021. Subsequent to quarter-end, oil prices increased to above $80/barrel in October, reaching a seven-year high. Multiple factors contributed to the rise in oil prices, including the ongoing reopening of economies following pandemic shutdowns, concerns about the ability of major energy producers to ramp up output, and challenges related to the shift to renewable energy sources. Cuts in capital spending by upstream energy companies also fueled worries about potential supply gaps as demand recovers.[1]
- Natural gas prices also reached multi-year highs during the quarter, gaining 60% to close at $5.87/MMBtu.[2] The combination of surging demand into the winter, limited supply, and rapidly depleting inventories, export demand, and a period of underinvestment over the past seven years, drove natural gas prices higher. Additionally, as energy companies have cut back on crude oil production, there has been a significant decline in associated natural gas and natural gas liquids which are produced along with oil.
- Despite improving oil and natural gas prices, fundraising for upstream energy funds remains extremely challenging, with many endowments and foundations pledging to divest of fossil fuels and unwind their private energy investments. Much of the capital being committed to private energy today is in renewables or "energy transition" strategies, and many upstream managers have pivoted to these types of offerings. Earlier in the year, EnCap completed fundraising for its first Energy Transition Fund at $1.2 billion, and other managers have launched similar funds.[3]
- The total U.S. rig count during the third quarter, as measured by Baker Hughes, was 521 rigs—an 11% increase over the 470 rigs at the end of the second quarter and double the lows reached in 2020. Year-over-year, the U.S. natural gas rig count has increased 32% and the U.S. oil rig count is up 130% from the lows in 2020. Notably, however, rig counts have not increased at the same pace as commodity prices and remain well below levels seen at the prior peak.[4]

INVESTOR IMPLICATIONS

The dramatic improvement in energy-related commodity prices from the lows of 2020 has been remarkable, but thus far has failed to attract capital from investors. As a result, energy remains one of the only sectors in the private equity landscape that has not seen major inflows, creating an attractive environment for investors with capital to deploy, as competition for deals has diminished. With the ongoing focus on "energy transition" and moves by investors to divest of fossil fuels, this will likely be the case over the intermediate term. As such, the upstream energy sector stands out as one of the few areas of the market characterized by limited capital availability. Meanwhile, the industry continues to right-size by paying down debt and emphasizing free cash flow generation. This stabilization is reflected in the performance of public energy stocks, with the S&P 500 Energy sector gaining 43% year-to-date through September. These trends ultimately have the potential to impact private equity energy and resources funds, which have underperformed over the past decade.

OIL AND NATURAL GAS REACH MULTI-YEAR HIGHS



Data source: Bloomberg, L.P.; Data as of September 30, 2021

[1,2] Energy Information Administration www.eia.gov; June 30, 2021
[3] Preqin, Data as of June 30, 2021
[4] Baker Hughes; Data as of October 2021

INDICES

Bloomberg Barclays US Corporate High Yield Index represents the universe of fixed rate, non-investment grade debt. Eurobonds and debt issues from countries designated as emerging markets are excluded but, Canadian and global bonds (SEC registered) of issuers in non-EMG countries are included. The index includes the corporate sectors: Industrials, Utilities, and Finance, encompassing both US and non-US Corporations. See www.bloomberg.com for more information.

The Russell Indices are constructed by Russell Investment. There are a wide range of indices created by Russell covering companies with different market capitalizations, fundamental characteristics, and style tilts. See www.russellinvestments.com for more information.

The FTSE NAREIT Composite Index (NAREIT) includes only those companies that meet minimum size, liquidity and free float criteria as set forth by FTSE and is meant as a broad representation of publicly traded REIT securities in the U.S. Relevant real estate activities are defined as the ownership, disposure, and development of income-producing real estate. See www.ftse.com/Indices for more information.

The S&P 500 Index is capitalization-weighted index of 500 stocks. The S&P 500 Index is designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

The NCREIF Property Index is a quarterly time series composite total rate of return measure of investment performance of a very large pool of individual commercial real estate properties acquired in the private market for investment purposes only.

HFRI ED: Distressed/Restructuring Index — Distressed/Restructuring strategies which employ an investment process focused on corporate fixed income instruments, primarily on corporate credit instruments of companies trading at significant discounts to their value at issuance or obliged (par value) at maturity as a result of either formal bankruptcy proceeding or financial market perception of near term proceedings. Managers are typically actively involved with the management of these companies, frequently involved on creditors' committees in negotiating the exchange of securities for alternative obligations, either swaps of debt, equity or hybrid securities. Managers employ fundamental credit processes focused on valuation and asset coverage of securities of distressed firms; in most cases portfolio exposures are concentrated in instruments which are publicly traded, in some cases actively and in others under reduced liquidity but in general for which a reasonable public market exists. In contrast to Special Situations, Distressed Strategies employ primarily debt (greater than 60%) but also may maintain related equity exposure.

Information on any indices mentioned can be obtained either through your consultant or by written request to information@feg.com.

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Past performance is not indicative of future results.

Investments in private funds are speculative, involve a high degree of risk, and are designed for sophisticated investors.

An investor could lose all or a substantial amount of his or her investment. Private capital funds' fees and expenses may offset private capital funds' profits. Private capital funds are not required to provide periodic pricing or valuation information to investors except as defined in the fund documents. Private capital funds may involve complex tax structures and delays in distributing important tax information. Private capital funds are not subject to the same regulatory requirements as mutual funds. Private capital funds are not liquid and require investors to commit to funding capital calls over a period of several years; any default on a capital call may result in substantial penalties and/or legal action. Private capital fund managers have total authority over the private capital funds. The use of a single advisor applying similar strategies could mean lack of diversification and, consequently, higher risk.

All data is as of September 30, 2021 unless otherwise noted.

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