ACTIVE INVESTMENT COMPANY ALLIANCE
Excellence beyond indexing

Liberty Street's Munafo Tells The Two Stories Facing Private Equity Now

Friday, May 5, 2023

Chuck Jaffe, in this episode of The NAVigator podcast interviewed Christian Munafo, chief investment officer, in Liberty Street Advisors, which runs the Private Shares Fund. Read the Q&A below as Christian says there are two stories dominating the private equity markets, with high-performing well-financed private innovation companies being proverbial unicorns compared to less-differentiated, less-capitalized companies which are more prone than ever to failure due to conditions in the capital markets. Rising rates have resulted in more opportunities coming to market, but have also made it harder for many firms to find the financing they need at reasonable levels.

Christian Munafo

The podcast can be found on AICA's website by clicking here: https://aicalliance.org/alliance-content/pod-cast/

CHUCK JAFFE: Christian Munafo, chief investment officer at Liberty Street Advisors is here, and we're talking private equity and hunting unicorns now on The NAVigator. Welcome to The NAVigator, where we talk about all-weather active investing and plotting a course to financial success with the help of closed-end funds. The NAVigator is brought to you by the Active Investment Company Alliance, a unique industry organization that represents all facets of the closed-end fund industry from users and investors to fund sponsors and creators. If you're looking for excellence beyond indexing, The NAVigator's going to point you in the right direction. And today, we're looking in the direction of private equity with Christian Munafo, chief investment officer at Liberty Street Advisors, which runs the Private Shares Fund, that's an actively managed, continuously offered closed-end interval fund, and it started its life as the SharesPost 100 Fund, but it is now the Private Shares Fund, and you can learn more about it at PrivateSharesFund.com. Christian Munafo, welcome back to The NAVigator.

CHRISTIAN MUNAFO: Hi Chuck, it's great to be back.

CHUCK JAFFE: So let's talk first about private equity and just where things are right now and what you're seeing happening for the rest of this year. Because this has been a market that has been challenged, that looks like it's got some pretty significant challenges ahead, and some pretty significant unknowns with things like debt ceiling and how that might play out in defaults or non-default, but private equity had a really interesting and rocky year with the rest of the market in 2022. Let's start with just where are we right now in terms of recovery, rebound, and what you see happening next.

CHRISTIAN MUNAFO: Sure. Look, we went through a period that borrowers from Alan Greenspan of exuberance in the years leading up to Covid and certainly during and then, I guess, 24 months or so subsequent to the outbreak of Covid, where you just had a surge in capital allocation and capital raising across private markets. We focus almost exclusively on late-stage venture capital and growth-oriented companies, so I'll steer most of my comments towards that segment of the market. And that segment of the market also saw a tremendous amount of capital inflows and deployment, in many cases, Chuck, from investors that historically have not been very active in the space. You've got a lot of investors chasing alpha and looking for returns outside of traditional public equities and strategies that they're familiar with, and as a result of that we've had a supply/demand imbalance essentially created that raised valuations, arguably to levels that were not sustainable. And so for the past several quarters, particularly as the Fed has really accelerated rising interest rates to try to reduce inflation, we've clearly seen not just the turnaround in public market sentiment, but also private market sentiment. So I would say right now we're going through the process of essentially trying to remove a lot of that exuberance. Doesn't happen overnight, but from our perspective anyone investing in these types of asset classes needs a longer term perspective. These are not strategies that you should have a trading or momentum-driven mentality for, and you also can't paint the entire landscape in our view with a broad brush. To oversimplify, think of highly differentiated, high-performing, well-financed private innovation companies, they're in a much different state than less differentiated, lesser performing, thinly capitalized companies. That's not to say both will not face challenges, because they will, but the latter are much more prone to down rounds, perhaps even sold on the cheap, or in many cases, shutting down. Whereas the former are primarily focusing on execution, getting their cost structures in line, and if they have to raise capital, the high performing ones are largely doing so at better valuations than previously raised at. Some are flat, some may be down, but overall they're faring pretty well. It's taking longer to raise capital, but it's pretty much a tale of two stories when it comes to our view of what we're seeing in the overall private market. So this is not going to cure itself overnight, but again, investors with a long-term perspective, in our view, Chuck, looking forward, can get some really attractive entry points when you have market dislocations like this which we can talk about further.

CHUCK JAFFE: They get attractive entry points, but I also wonder if the hunting grounds are as fertile. Now I mentioned as we were just coming into this that we're going to talk hunting unicorns, which is distinctly a part of what you do. I'll let you explain what that means for anybody who's going, "What does he mean by hunting unicorns?" But we're really talking about particularly good opportunities. And I'm curious because once you get a higher rate environment where it's harder for companies to get certain types of financing where they might be more likely to look for private equity and issuing private equity, et cetera, does that make it that there are more unicorns out there? Does it change the ability to hunt unicorns? And does it change how much diligence you have to do to make sure that the companies you're getting have the actual ability to be that success, wonderful story?

CHRISTIAN MUNAFO: Yeah, I mean, the universal response to all the questions you just proposed is yes, and so we can deconstruct each one. First of all, it's important to point out that there's been this very significant trend where over the last 20 years private companies have just continued staying private for longer and longer, and so today's late-stage, venture-backed, growth-oriented companies would have been public 15–20 years ago. These companies are typically generating hundreds of millions if not billions of revenue, some of them are profitable, some may not be but they're on the path to profitability, but these are businesses that you could now compare to what we used to think about for small mid-cap growth companies in the public market. So first of all, we just had a real big evolution in terms of how the public and private markets have evolved, and there's a lot of reasons for that, whether it's wanting to avoid regulatory pressure, the costs and burden of going public, and also wanting to avoid volatility. And also there's been a massive amount of capital that's been allocated to private markets, including our asset class, over the past couple decades with the advent of these interval funds and democratization strategies that really give more investors the ability to access this asset class. So that's one thing that's really been driving the growth of these higher value companies, they've just stayed private longer and grown into much larger market caps inside the private market, which they would have historically done in the public market. Secondly, you're absolutely right, in a zero percent or near-zero percent interest rate environment for a protracted time period, it's fairly easy for companies to raise capital. What that creates in most situations historically is a pent-up supply of companies that may actually not be that differentiated, and once you have a market turn and different macro factors that actually create more challenging conditions for these types of companies, it really starts to separate the wheat from the chaff. You can figure out which companies are going to have more issues and which companies are better [inaudible]. So a lot of time is spent not just trying to identify good opportunities from a valuation perspective, from a discount perspective, but which companies actually can sustain themselves? Which companies are actually truly differentiated to survive the long haul? And so pricing is very important, but you don't want to pay a low price for a low quality asset, so this environment we're in right now, investors need to be incredibly careful because in our view there are a number of assets that we would categorize as low performing, at-risk assets. But again, we have to separate those from the higher caliber, higher performing assets where the negative market sentiment really creates, in our view, an attractive entry point to get into these highly unique companies and high-caliber securities in them at attractive prices, so you absolutely need to be incredibly diligent.

CHUCK JAFFE: But if I put these two things together, your outlook for the industry and the conditions you were just talking about, it looks like we have a pretty strong, vibrant market to support the venture capital world, but that also means selection's going to be really important. I mean, whether it's your fund or anybody else's, whoever is buying, whoever is going to be supporting the venture capitalists is going to have to be particularly choosey because a robust environment doesn't just mean more success, it means more failure. And in the venture capitalist world, a low batting average is still success, but you've got to still put enough in play, right? So we will expect to see both good and bad even though we like this environment, right?

CHRISTIAN MUNAFO: Correct. You're absolutely going to see, again, the tale of two stories, where you have a lot of companies are going to be experiencing challenges with regards to their business models, with regards to their ability to raise capital. Let's not even start talking about how artificial intelligence is going to create a whole new of onslaught of challenges for companies that are not early adopters of it and able to really figure out how to utilize that to continue to support their own business models. So you're going to have companies like that that are going to face hardships, and there's other companies on the opposite side again that we think are going to prevail, but these environments are challenging for everyone. And the interest rate point is a very important one, but there is a bit of a differentiation too in private markets I just want to point out very quickly. When we talk about private equity, you typically think about these buyout stage companies which are investing in arguably larger but perhaps less exciting, older economy type companies, so much less growth, but higher profitability, higher cash flow. Those companies typically rely upon capital markets and debt and leverage to execute their business models, so interest rate risk rises quite dramatically and the cost of capital really hurts that segment of the market if it's not properly managed. In the venture capital and growth segment of the private markets, these companies typically don't have debt, and quite frankly many of them don't deserve debt, so you don't really have that direct impact of interest rates. Your bigger risk is how are interest rates going to impact an investor's decision to allocate equity capital? So it's more equity capital risk inside of the capital structure of these businesses, less so on the risk of defaulting on covenants that you have in your capital structure from a debt perspective.

CHUCK JAFFE: Christian, really interesting. I've got more questions, I just don't have more time, so we'll just have to have you back on The NAVigator in the not too distant future to see how it's all playing out.

CHRISTIAN MUNAFO: Well, I always look forward to speaking with you, Chuck. Just let me know and happy to revisit.

CHUCK JAFFE: The NAVigator is a joint production of the Active Investment Company Alliance and Money Life with Chuck Jaffe. And yes, I am Chuck Jaffe, you can learn all about my hour-long weekday podcast at your favorite podcast app or on MoneyLifeShow.com. To learn more about interval funds, closed-end funds, and business-development companies go to AICAlliance.org, the website for the Active Investment Company Alliance. They're on Facebook and LinkedIn @AICAlliance. Thanks to my guest Christian Munafo, chief investment officer at Liberty Street Advisors, which runs the Private Shares Fund, an actively managed, continuously offered closed-end interval fund. Learn more about it at PrivateSharesFund.com. The NAVigator podcast is new every Friday, make sure you don't miss anything by following along. We'll see you again next week, until then, happy investing everybody.

Recorded on May 2, 2023

To request a particular topic for The NAVigator podcast please send an email to: TheNAVigator@AICalliance.org

Click the link below to go to the home page of Active Investment Company Alliance to learn more: https://AICalliance.org/