Liberty Street's Munafo Says Opportunity Is Knocking For Private Shares

Friday, August 18, 2023

Chuck Jaffe, in this episode of The NAVigator podcast interviewed Christian Munafo, chief investment officer at Liberty Street Advisors, which runs the Private Shares Fund. Read the Q&A below as Christian says that the perceived higher risks in challenging environments like the one we are facing today often lead to attractive opportunities and oversized future gains, which makes current conditions attractive for private equity and venture capital investing.

Munafo notes that private markets are more stable than their public counterparts, but signs of improvement are there now, leading him to believe the asset class will see better relative performance moving forward.

Christian Munafo

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CHUCK JAFFE: We're talking private shares and venture capital with Christian Munafo, chief investment officer at Liberty Street Advisors, welcome to The NAVigator. This is 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 will point you in the right direction. And today we are looking at developments in the private markets with

Christian Munafo, chief investment officer at Liberty Street Advisors, which runs the Private Shares Fund, which is a continuously offered closed-end interval fund that trades under ticker symbol P-R-I-V, as in private, PRIVX. Learn more about the fund at PrivateSharesFund.com. And to learn more about interval funds, business-development companies, and closed-end funds generally go to AICAlliance.org, the website for the Active Investment Company Alliance. Christian Munafo, welcome back to The NAVigator.

CHRISTIAN MUNAFO: Thanks Chuck, great to be with you again.

CHUCK JAFFE: Let's start with the landscape, because we can all see what the market is doing, what is happening with the various indexes, but the landscape for the private market, that's a little tougher for us to see. So right now, as we're watching a market that has been narrow and frothy and kind of directionless, what are you seeing on the private markets?

CHRISTIAN MUNAFO: To kick things off, I would say that we are starting to identify a number of signals which lead us to believe that overall sentiment is improving for private markets, but I'll come back to that. I think it's safe to say that the private market in general has continued to face a challenging landscape through the first half of 2023. You can observe growth rates, I think having slowed in many situations, capital deployment rates are contracting, valuations remain compressed, exit activity's muted, so there's a number of examples to point to which would lead one to believe that the private market environment has been challenging. But we also must not forget, this is all very standard for this stage in this cyclical rotation. To your point, Chuck, on public markets, while public and private markets are not directly correlated, there is an overlap in terms of sentiment and confidence. And when you look at private markets, which typically have less transparency, lower liquidity, more difficult access to information, the market tends to shy away from those types of opportunities in these types of markets due to a perceived increase in risk. And that's unfortunately not a great tact to take as we look historically for investor behavior, the perceived higher risks in challenging environments often lead to very attractive opportunities and outperformance in subsequent years, so when you least think it's attractive for capital deployment, that tends to be the best time for capital deployment. And I would just add one more thing to that, the year-to-date rally across many of the public indices has been a bit misleading given it's primarily driven by a fairly small subset of the overall market which is largely comprised of companies with the largest market caps. So for example, if you look at the top seven mega cap companies, they now make up more than 50% of the entire NASDAQ 100 and roughly 30% of the S&P 500, so there's definitely a bit of skewing there. And let's not forget those indices were down, NASDAQ 30%, S&P more than 20%, Russell 20% last year, while the private markets remained fairly stable. So I think you need to take everything into context, there's absolutely been an exciting rally in public markets, private markets tend to behave differently, they never go up as fast or go down as fast, it's a more stable progression. So overall, it's definitely been a challenging environment but we are seeing signs for improvement.

CHUCK JAFFE: Private companies are no more immune to any of the economic conditions than anybody else. When you start talking about supply chain issues, they affect everybody, or inflation and interest rates affect everybody. So let's look at the management side, is management of private companies doing anything different than management we would expect from public companies to navigate in these conditions? Do they have certain benefits from being private that help them be better positioned for these times?

CHRISTIAN MUNAFO: The first response I would say is not all management teams are created equally in the public and the private markets, and so you have companies in both public and private markets who were taking proactive measures to brace themselves 18-24 months ago for what they foresaw as a higher probability of a more challenging landscape, while others kind of kept their feet on the pedal. And so one, I think we have to acknowledge that not all companies are the same in terms of their operational capabilities and excellence. What we're seeing from the better capitalized, the better managed companies in the private markets is there's absolutely continuing to be more discipline in terms of how the companies are operating, are spending, are executing. A lot of companies have trimmed the fat, if you will, trying to right-size their businesses. They're lowering their burn rates to basically get them to profitability more quickly, if they're not already profitable. You still have a lot of companies sitting on tremendous cash balances given how much money was raised over the past few years, but you have other companies that are less fortunate, and they have to be much more efficient with how they're managing capital. So I think management overall, for the better managed companies, are being very thoughtful in terms of execution. They're not trying to be all things to all people, it's a bit of back to basics, focusing on your core competencies, staying in your lane, doubling down where you're seeing progress and good results. Then you have the other side of the equation where you have some groups that unfortunately just continue to struggle with accepting the reality of the environment that we're in, and those are companies that I refer to, I think the last time we spoke several months ago, that I would put into this kind of bifurcation, where you have higher performing, better managed companies that are for the most part plowing forward, albeit not without challenges. Because like you said, whether you're public or private, there are macro issues you have to face. But you have other companies that just haven't really been able to get things assembled in a more organized manner, and those companies are facing significant headwinds as they run out of capital, so it's a bit of a bifurcation.

CHUCK JAFFE: Generally, let's get your market outlook and then help us frame an expectation. Because every investor looks long-term and says, "Oh, the stock market's going to deliver 10% on average a year," but in the conditions that we've got and whatever you're going to tell me you see as your market outlook, what's your expectation or what's a fair expectation of what private equity and venture capital can deliver in these conditions?

CHRISTIAN MUNAFO: One other question you raised which I didn't address is are there benefits to executing as a private company versus a public company? A lot of these types of conversations that we're having absolutely further validate why companies continue staying private longer; making changes to your headcount, shutting down divisions, et cetera, those are much harder decisions to make as a publicly traded company. If you perhaps miss your growth estimates or your earnings, et cetera, you have a lot more insulation when you're making those types of adjustments in the private market, which is I think another reason again why companies continue staying private longer because there absolutely are benefits. In terms of the sentiment, look, I think there's a few things I'd point out that we've been tracking that we think are signals of an improving condition. While the capital deployment rates as I noted have remained muted, we are seeing deal count, so the number of companies raising capital and the amounts that are those that are closing picking up, so that leads us to believe that for venture-backed growth oriented companies we're seeing an increased demand, which is a positive signal. Let's not forget there's still $200-300 billion dollars of unfunded capital commitments in this ecosystem, so there's a lot of money here left to protect the ecosystem, that number is roughly double where it was five years ago. We also think there's a bottoming out happening in secondaries, and again, secondaries, for your audience, refers to the purchasing of private assets which could be in the form of buying fund interests from existing investors in private equity oriented funds or buying private companies securities directly from shareholders in those companies, we focus on the latter. And while the discounts basically over the past 12 months have been in the 50% range relative to last round, so very attractive, we are actually seeing a bottoming out from various data providers, and also the conversations we're having internally. So there seems to be some pushback, which is a signal that the sellers are getting more optimistic. We also see something, Chuck, that we call in the market "rights of first refusal", this is a provision where a company or an existing shareholder in a company may have a right to prevent an existing buyer to buy into that company, by having that right they can basically purchase that instead of a new buyer. It's called the right of first refusal provision, it basically dictates how securities in secondaries can be facilitated in a company's capital structure. When you see companies and existing shareholders executing those provisions, it's typically a signal that they feel the companies are undervalued and that they are taking a bullish stance by putting more capital to work. We're actually seeing the execution of those rights of first refusal increase. And then lastly I would just say that we're seeing a pick-up in M&A and IPO activity, the levels are still very muted relative to what we saw several years ago, but we're absolutely seeing a pick up. We've got more than 200 venture backed companies waiting to go public, which is the highest levels we've seen in two decades, and the conversations we're having with bankers, with companies, co-investors, there's a view that we're likely to see a pick-up in late 2023 and certainly next year.

CHUCK JAFFE: Christian, great stuff. I want to have you back so that we can see what's happening as those venture companies come to market and we see if that pick-up occurs in the context of everything else that's going on in the market. I'm looking forward to that conversation already, but thanks for this one today.

CHRISTIAN MUNAFO: Thank you, Chuck. Yeah, we're certainly not out of the woods and anything can happen in today's macro and geopolitical landscape, but we are definitely getting more optimistic about sentiment so I look forward to following up with you in the coming months.

CHUCK JAFFE: The NAVigator is a joint production of the Active Investment Company Alliance and Money Life with Chuck Jaffe. And yep, that's me, and you can check out my hour-long weekday on your favorite podcast app or by going to 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, on Facebook and LinkedIn @AICAlliance. Thanks to my guest Christian Munafo, chief investment officer at Liberty Street Advisors, which runs the Private Shares Fund, a continuously offered closed-end interval fund under ticker symbol PRIVX. Learn more about the fund at PrivateSharesFund.com. The NAVigator podcast is new every Friday, and we'll be back next week with something new. Follow along on your favorite podcast app to make sure you don't miss a thing, and until next week, happy investing everybody.

Recorded on August 17, 2023

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