FAIRGREEN CAPITAL PARTNERS

FAIRGREEN CAPITAL PARTNERS - MARKET INSIGHTS

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PUBLIC OR PRIVATE (OR MAGNET) SCHOOLING? . . . ARE INVESTMENTS SIMILAR?

PREFACE

For several decades, the public/private school debate has been a hot topic around adult (and kid's!) tables. The common refrain is that the powerful teachers' unions have put a stranglehold on public school education. The lack of choice has made parents and school systems captive to this model, which does not allow for sufficient choice and provides a suboptimal outcome at a high cost. Some parents have "opted out", putting their kids in private schools while still paying for the public system. Some states and school systems have allowed magnet schools to run alongside the public schools and compete for the same public dollars and students.

I think most would agree that school teachers are NOT overpaid and hold a vital role in shaping the future leaders of America. Teachers' unions are not inherently the issue and are often very helpful in advocating for teachers' rights, but we are still left with a system that is imperfect at best.

THE US SCHOOL SYSTEM AND THE INVESTMENT MARKETS PARALLEL

I would like to draw a parallel between the US school system and the investment markets used to allocate capital to companies via public debt, private debt, and equity markets and suggest that they are also unbalanced.

First, for some context, the Federal Reserve maintains that it will not raise interest rates any time soon; the 10-year US Government interest rate remains at a historical low, despite increasing indications of inflation: March CPI rose by 0.6%, and there's the recent extraordinary increase in money supply, driven by monetary and fiscal stimulus, M2 has expanded over 24% in the last year.

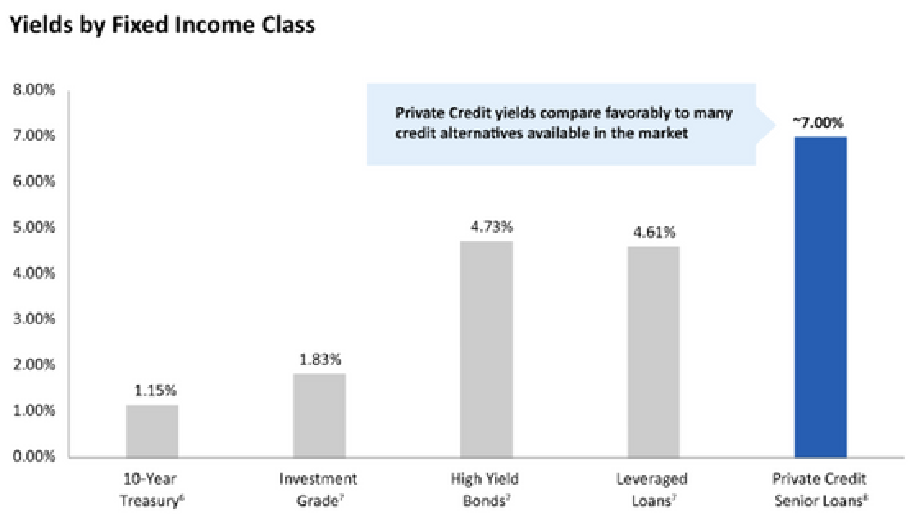
Interest Rates are Well Below Historical Averages

Source: Refinitiv LPC.

INVESTOR FUNDS ALLOCATION

Public market debt is priced off the Treasury curve (actually the swaps curve, but largely the same assuming normal market dynamics). As a result, it is very difficult to argue that fixed-income markets are attractive right now. If I were back in my old job at PIMCO, I would be struggling to make the argument that public fixed income is attractive right now!

So, if not public debt markets, where within the broader fixed income markets should investors look to allocate instead? As you can see from the table below, there are still very attractive yields in the private credit space on an absolute and a relative basis (when compared to public market fixed income).



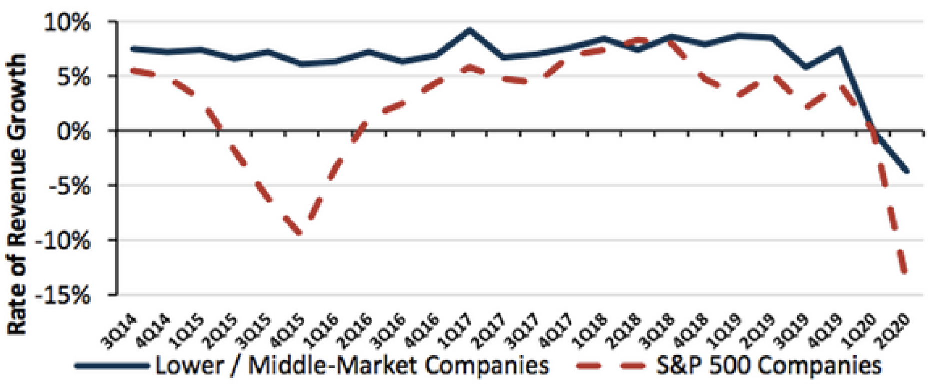
Source: Adams Street Partners

THE LOWER MIDDLE MARKET

The attractive return on private credit has been driven by a move away from traditional bank lending in the aftermath of 2008, as banks become more reluctant to lend to lower middle market companies, resulting in an "unbanked" portion of the private debt market. Additionally, business owners often prefer private debt financing given the speed and flexibility of these lenders compared to traditional banks.

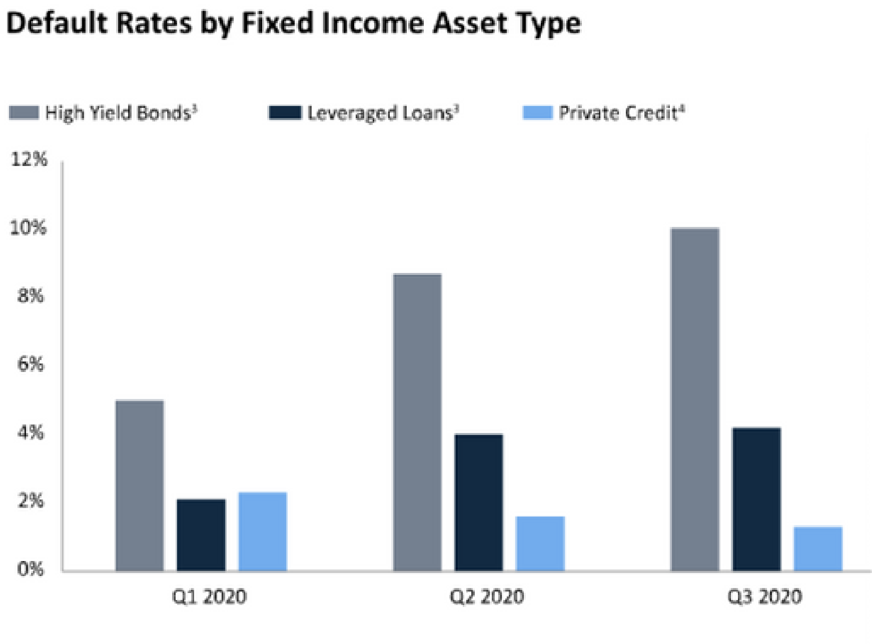
The illiquidity premium at this stage of the investment cycle between private and public markets offers meaningfully greater returns for investors when compared to investment-grade corporate bonds - with comparable or lower risk, particularly in the lower middle market end of the private credit universe where there is less lending competition.

Taking a closer look at the risk/return profile, revenue growth of firms in the lower middle market outperforms S&P 500 firms, and thus, if one can originate loans to well-run businesses in non-cyclical industries, private credit lending can be a very desirable strategy on both a return and risk-adjusted return basis.



Source: Star Moutain

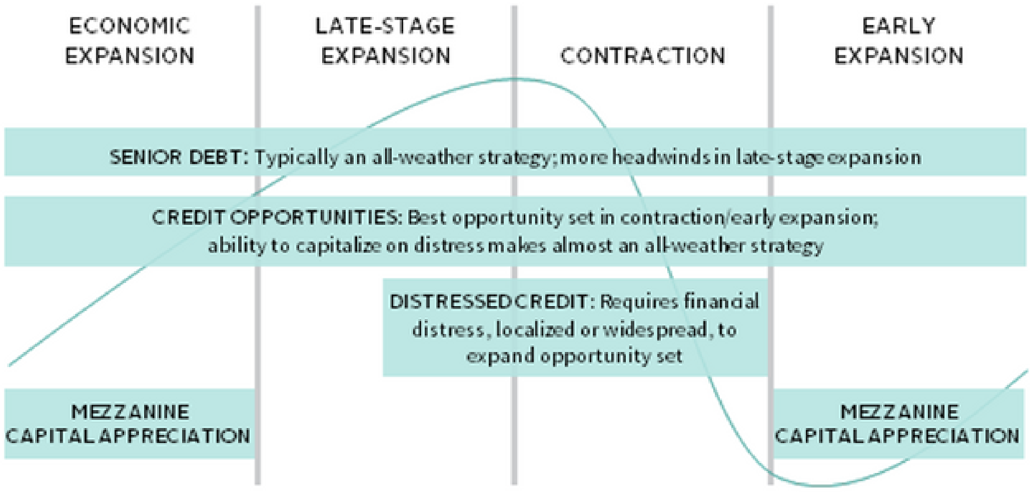
One of the other many advantages of private credit is the low default rates as a function of these lightly banked firms not having the same access to leverage. As you see below, the leveraged loan default rates in the second and third quarters were comparable to those witnessed during the Great Financial Crisis. In contrast, the private credit default levels never rose above 2% throughout 2020. A tale of two cities, to quote Dickens!



Source: Adam Street Advisors

Which way is the pendulum swinging, one may ask. The private credit market has rebounded since early 2021. The long bull run in credit markets pre-COVID 19 saw a rise in leverage levels, a steady narrowing in borrowing rates, and a general loosening in lender covenants as yield-starved investors competed to lend money to both public and private companies.

In the middle market lending space, this trend ended abruptly in March 2020, with many companies needing to draw credit. Since then, new issue loan spreads in the private credit market have risen, covenants have tightened, and equity cushions have become more substantial, reflecting a significantly more lender-friendly market dynamic.



Source: Cambridge Associates

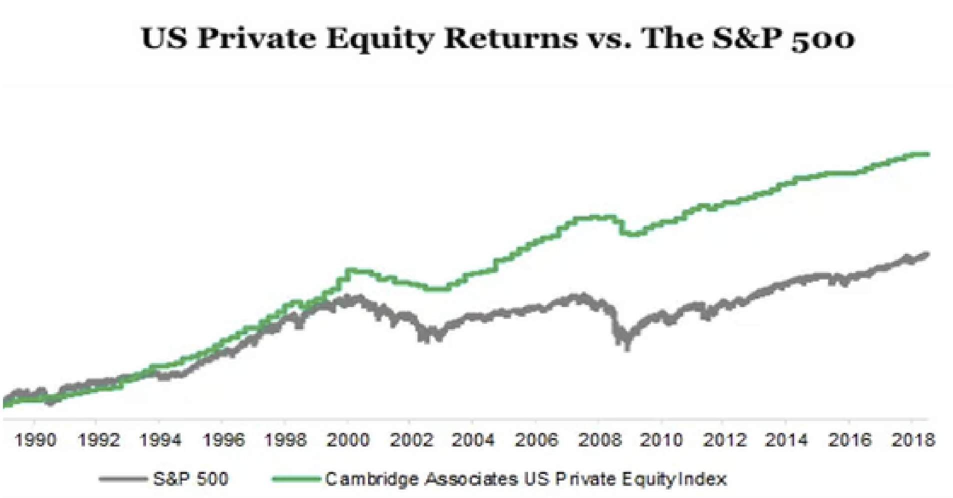
Given current market dynamics and spreads, the markets presently favor pulling your kids out of public school and putting them in private school (aka private lower middle market credit). Fortunately, there is a lot less unrest in moving capital (than humans!) from public to private markets, but just as with selecting private schools, careful thought needs to be given to which private market – as not all establishments are created equal.

Equity Markets:

Now let's turn to a discussion of public vs. private equity. Again, to set the table, the S&P 500 trades at record levels and has had its best 365-day return since pre-World War II with a 76% return from its lowest point in 2020. Will the market continue its ascent with firms like Coinbase and Tesla carrying their heavy price tags? Given current market trends, it seems unlikely unless valuations continue to expand from some unknown exogenous shock to the positive, which no one can foresee. Akin to playing the lottery to become rich, there is a chance, but don't bank (yes, pun intended!) on it!

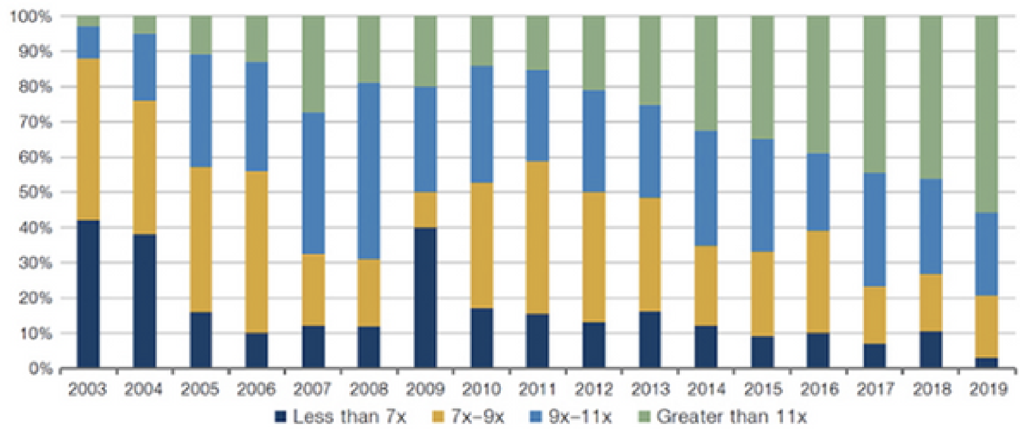
PRIVATE EQUITY MARKET

How does the private equity segment look in comparison to its public counterpart? Interestingly, private equity has outperformed the S&P 500 since 2000, as shown in the chart below.



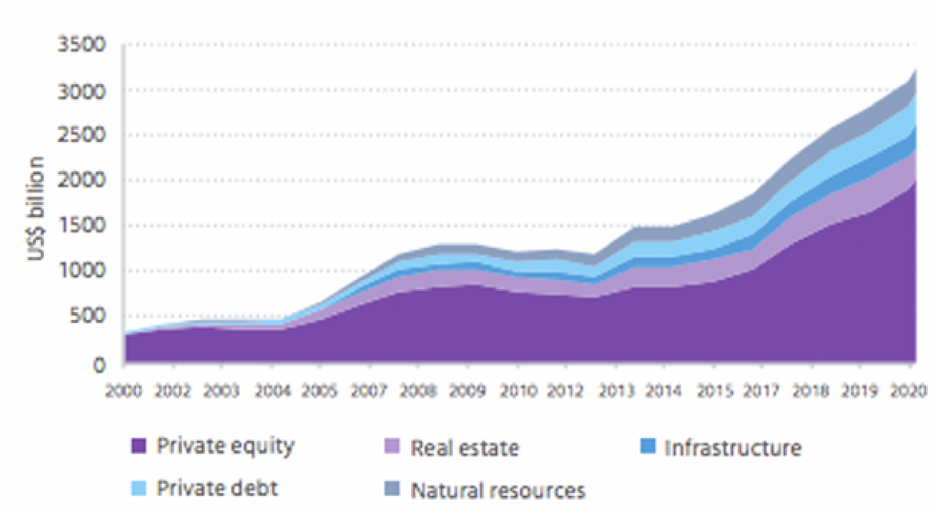
Source: CFA Institute

Private equity returns have been generating performance primarily by applying greater leverage to transactions and through multiple expansions. The chart below shows the average EV/EBITDA purchase price multiple for U.S. buyout deals. The market is highly competitive, and large capital pools are chasing the same opportunities, making manager selection very important as there is a significant disparity between the top cohort and the rest of the field. (Just as there are significant differences between top private and not-so-top private schools).



Source: Man Group

Another interesting phenomenon occurring within private equity is the significant amount of unallocated capital, thus telling us that there is a growing inability to find good companies to buy. Selecting managers operating in underserved and niche segments of the market is imperative as they can avoid these premium prices and deliver attractive returns. This argues for leaving your kids in public school but perhaps moving to a new school district to find smaller class sizes and dedicated teachers (rotation out of FANGs into more value-oriented and globally diversified companies while also seeking select venture investments).



Source: Preqin as of end of 2020

FAIRGREEN CAPITAL PARTNERS DIVERSIFIED PORTFOLIO

FairGreen Capital Partners leverages our network to research high-quality and experienced managers and invest our own Partner capital in these managers to deliver a diversified portfolio. The key to a vibrant capital market (and school system) is choice, and one size does not fit all.

There are times to increase liquidity and other times to harvest the illiquidity premium; today's markets favor private schools (private lower middle markets, venture, and select focused PE), but it is finding the right manager (teacher) that will ultimately define success.

AUTHOR - KYLE THEODORE, CFA

HEAD OF AMERICAS

Mr. Theodore is a senior advisor and Head of Americas for FairGreen Capital Partners. He joins FairGreen Capital Partners from Insight ($900+ billion AUM). Previously, Mr. Theodore was Insight's US Head of Consultant Relations Business Development Team, responsible for the oversight of consultant relationships business development in North America.

Before Insight, Mr. Theodore worked at PIMCO ($1.9 trillion AUM) for 18 years as a senior member of the consultant relations business development team and was pivotal during his nearly two-decade tenure in growing PIMCO's AUM to $2 trillion. He also led PIMCO's cyclical forum business cycle segments.

Prior to joining PIMCO in 1998, Mr. Theodore was a member of the Treasury Department Investment Group at The Walt Disney Company. His first job in finance was with Valuemetrics, a valuation and transaction advisory services company in New York.

He has 20+ years of investment experience and an MBA from Yale University. He earned an undergraduate degree from Claremont McKenna College and is a CFA charterholder.