Christian Munafo, Chief Investment Officer @ Liberty Street Advisors on Private Equity Markets

Wednesday, October 4, 2023

Christian Munafo sat down with Jane King on October 4th, 2023 for a NAVigator Interview and discussed the Private Equity Markets.

Christian Munafo

The podcast can be found on AICA's website by clicking here:
[Christian Munafo, Chief Investment Officer @ Liberty Street Advisors on Private Equity Markets - AICA (aicalliance.org)]

Jane King: The Liberty Street Funds offer investors and financial advisors mutual funds sub-advised by independent boutique managers who possess expertise in their asset classes, and because Liberty Street focuses on the boutique managers, financial advisors can provide value-added strategies and actively managed differentiated value-added portfolios for their clients. And with me is Christian Munafo, the chief investment officer and portfolio manager at Liberty Street Funds, so great to have you here.

Christian Munafo: Great to be here, Jane.

Jane King: So let's start with just over the past couple of decades as private markets have become really innovative technologically, disruptive in the marketplace, explain what you're seeing there.

Christian Munafo: Yeah, so I think most of the technology and innovation historically we've seen has come from the private markets, so a lot of these companies tend to get started privately, they get financed privately, and as they scale there's other access points for them to grow either through public markets, sometimes they get acquired, sometimes buy-out firms may take them over and inject additional capital. But there's been a really big development over the past couple of decades, that as these companies are staying private for longer it's requiring all different sorts of capital and liquidity solutions.

Twenty years ago, 25 years ago, your average venture-backed company would go public within about four years from inception and the market caps were maybe around a half billion dollars. Today those same companies are staying private on average for at least 12 years, some cases 15-20 years, and as a result of that they're growing into much larger market cap businesses inside the private market.

There's a couple of important takeaways from that. First, if you're a public market investor that doesn't have access to private market strategies, that means you're arguably missing out on a substantial amount of capital appreciation as these companies are scaling inside the private market which many used to do historically inside the public market. But the other takeaway is that as they're staying private for longer, those lifecycles, those protracted lifecycles can create friction inside the ecosystem; so your founder, employee, investor may not have the same timeline.

Jane King: Interesting.

Christian Munafo: Right? And so as that's really developing and those companies stay private for longer, it creates friction inside the ecosystem which sophisticated investors can sometimes take advantage of.

Jane King: Yeah, so why are companies staying private longer? I remember, as you said, 20 years ago all the excitement was doing IPO and go public. What kind of confluence of things happened that's forcing this to take place?

Christian Munafo: Yeah. There's three main reasons, so there's other reasons. We think the three main reasons are first regulatory challenges and administrative burdens of being a public company have been a bit of a turnoff for a lot of groups, especially when they're not sitting on massive amounts of cash, it's expensive to be a public company. So one, I would say regulatory and administrative burdens. The second, when we look at the companies we focus on, which are these really high-profile private innovation companies, when you're trying to disrupt a sector or an industry, you may not want to be focused on hitting your next quarterly earnings by a penny.

Jane King: I see.

Christian Munafo: Right? And so some of these companies would want to see their businesses grow and scale and further vet out their business models inside their private market to avoid unnecessary volatility. But perhaps the most important reason is the private market capital base has just expanded dramatically. When we look at the venture capital ecosystem, which we focus on, over the past 10 years alone there's been over a trillion dollars invested in this asset class. Most of that towards the area we focus on, which is the later stage, which are companies that are typically doing hundreds of millions or billions. These are real businesses that 20-25 years ago they would have already been public.

Jane King: Yeah, would have been public for a while probably at that point.

Christian Munafo: Correct.

Jane King: This does create inefficiencies in the market. They're not on the open market, you don't have all the market makers and the liquidity of things.

Christian Munafo: Right.

Jane King: How is that helping or hurting what you do and what investors see?

Christian Munafo: Yeah, you nailed it. So there's no structural liquidity like we have with the ubiquitous exchange for public listed securities, and so in order for groups to achieve liquidity you have to really understand the complex capital structures of the ecosystem, which is not for the faint of heart. The good news is over the past couple of decades there's also been a development of what we call the secondary market, where there's investors who allocate capital to help provide liquidity for participants in this private market ecosystem who need it. Whether you're a manager of a fund, a limited partner of a fund or a portfolio company or employee or investor within, there are increasing ways that investors can get liquidity.

But because of the lack of the ubiquitous exchange and liquidity, groups can take advantage of those information asymmetries and price inefficiencies to really negotiate, in many situations, what can be favorable terms where you can buy assets in the private market below their fair market value or their intrinsic value. And when you have periods like we have now, and we've had for the past 18 months, highly dislocated periods allow groups like us to negotiate even more favorable terms.

You have to be highly selective. We were talking earlier about interest rates, this proliferation of longer zero percent interest rates really created a lot of risk taking in the market, and we would argue a lot of companies and fund managers probably raised capital it wouldn't have if people were more disciplined, if there was a more rigorous diligence process, so there's going to be some pain. So the market's bifurcated, but we think that if you have a long-term perspective and you understand how private markets work, you can really optimize these conditions.

Jane King: Yeah, and I'm also thinking about people who there's a lot of upside that takes place in that private area that you don't get in the public area, so this is depriving some people of those gains that aren't part of the original investment group.

Christian Munafo: Yeah, 100%. So we've done some analysis going back roughly 15 years, what we tried to do was see if we can empirically show how a private market investor in a venture-backed company that goes public compares to the public market investor who waits to access those companies at the IPO price if they're so fortunate to get that, which most cannot.

Jane King: Right.

Christian Munafo: Or the first trade. And what we've seen across the dataset of roughly 800 tech-based companies that went public over this time period, the private market investor who just came into that last round, so not even at a discount to it or a prior round, they vastly outperform that public market investor. So Jane, to your point, we think that it's important for all investors, if they have an access desire for technology, innovation and disruption, to increasingly look for ways to access them into the private market.

Jane King: Yeah. How do you see the current market conditions then? And the rising interest rates, is that changing things for you? Will we start to see the IPO market be more active at some point in the future?

Christian Munafo: Interest rates are definitely having a ripple effect we think through the entire economy. The good thing for us about the venture ecosystem is these companies typically do not have debt, quite frankly many of them, most of them don't deserve it. These are not companies that are printing cash necessarily, and so you don't have that direct impact from the interest rates increasing but you have indirect impacts because their underlying customers may be facing pressure. So they may be buying less widgets than they would have purchased in the past or taking longer to make decisions, so you're seeing protracted sales cycles and so ultimately that's impacting growth in some areas of the markets. So I think that's part of it.

I think the good news is we are starting to see some green chutes, so we are seeing that companies are going out and raising capital, they're getting more conviction. We're seeing more capital being deployed by investors. There's still an imbalance, there's more companies seeking capital than there's capital willing to be committed to them at this point but that's starting to loosen up. It's a fantastic time to be negotiating terms, so for capital deployment we think this is a very attractive time to be investing.

We are starting to see the public markets open up a bit. I think we have a long way to go here, we had some companies get out, we think quite frankly there's better quality late-stage private companies that are pre-IPO that are in the docket that hopefully we'll see coming out over the coming quarters, but you really need to have a longer term perspective when investing in private markets to benefit and access.

One of the things that we've tried to do, and you're seeing other groups do, is make private markets more investable, so you're seeing more innovative structures. We have a 1940 Act interval fund we're using that removes a lot of the inefficiencies and administrative burdens and high minimum investments, qualifications that typically are required. We've been doing that for about 10 years. So I think you're seeing more groups offer more solutions to broaden the access to alternatives and private markets, and we think overall that's a good thing for the ecosystem.

Jane King: Very interesting, Christian. Thank you so much for sharing your expertise.

Christian Munafo: It's a pleasure. Thanks, Jane.

Recorded on October 4, 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/

Disclosure: *Views and opinions expressed are for informational and educational purposes only as of the date of production/writing/speaking and may change without notice at any time based on a multitude of factors. Speaker's/presenter's/author's opinions are their own and may not necessarily represent the opinions of AICA, its Board, or its staff. Materials may contain "forward-looking" information that is not purely historical in nature, such as projections, forecasts, market return estimates, proposed or expected portfolio composition, and other items. Listed closed-end funds and business development companies trade on exchanges at prices that may be above or below their NAVs. There is no guarantee that an investor will be able to sell shares at a price greater than or equal to the purchase price or that a closed-end fund's discount will narrow. Non-listed closed-end funds and business development companies do not offer investors daily liquidity but rather offer liquidity on a monthly, quarterly or semi-annual basis, often on a small percentage of shares. Closed-end funds often use leverage, which can increase the fund's volatility (i.e., risk). Actual distribution amounts may vary with fund performance and other conditions. Past performance is no guarantee of future results. This material is not intended to be a recommendation or investment advice, does not constitute a solicitation to buy, sell or hold a security or an investment strategy, and is not provided in a fiduciary capacity. Shares of closed-end funds are subject to investment risks, including the possible loss of principal invested. Closed-end funds frequently trade at a discount to their net asset value (NAV).*