

Illiquidity and Creative Destruction

“Loading up companies with borrowing at a time of peak economic uncertainty allows private equity groups to de-risk their own exposure by taking cash out of the business. But the higher risk of defaults has consequences for stakeholders beyond the private equity owners.”

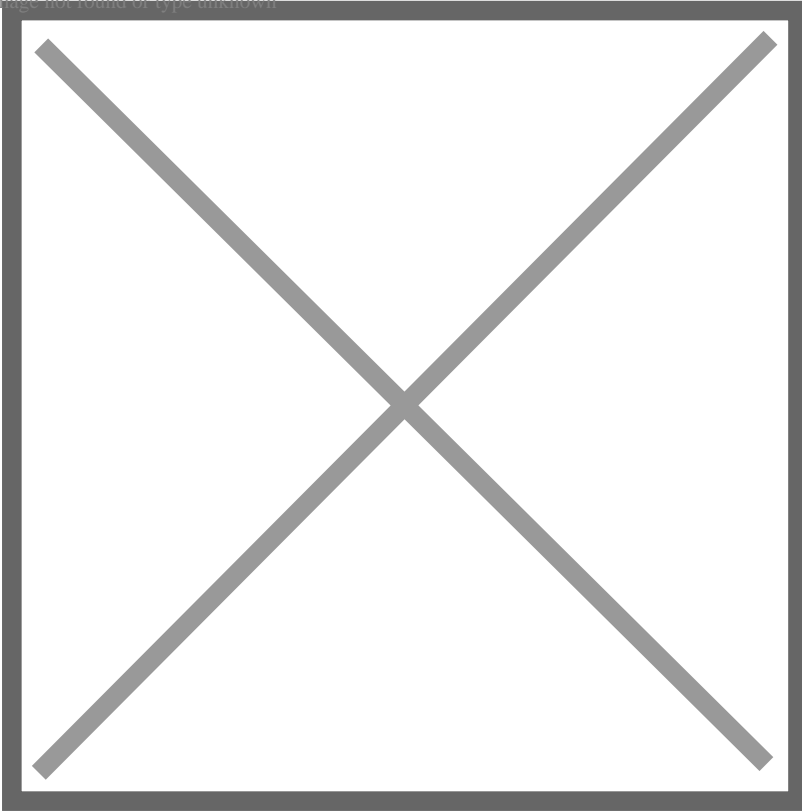
– Financial Times, September 2020

Winter came a few months early last week, as Snowflake (SNOW) had a highly successful Initial Public Offering, rising over 111% from its offering price in its first day of trading to a cool market cap of \$67.4B. With eight rounds under its parka belt prior to last Wednesday's IPO, the mountain-top ascent was a highpoint for a number of private investors, some of whom invested in the company as early as 2012. Of course, not all private investments turn out so successfully, but the rapid growth story underscores an important phenomenon that is the subject of this week's newsletter from Louis-Vincent Gave: the willingness to trade liquidity for the potential of income or growth.

Investors that participated in Snowflake's Seed Round in 2012 were likely expecting to have their capital tied up for at least ten years, which has become the average timeframe from founding to exit for fledgling venture capital-backed companies. Private investors that participate in the early innings of a company's development today likely have (or at least should have) similar expectations. However, a lot has changed in the world since 2012, and it's worth wondering why capital continues to chase illiquid investments in the midst of unparalleled uncertainty.

As Louis outlines, the hunger for income (i.e. a stable return on capital in the form of dividends or interest) and growth (i.e. outsized returns in the form of a company's market value appreciating) are two key drivers. The insatiable appetite for return in a near-zero yield world for US treasuries has pushed capital towards non-publicly-traded investment areas such as private equity (PE) and venture capital (VC) recently. This is in spite of the fact that private equity experienced its largest loss since the Great Recession in the first quarter of 2020. However, as shown in the chart below, both PE and VC returns rebounded in the second quarter of this year, which has likely been a catalyst for ongoing in-flows into them.

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The question becomes, is this type of illiquid asset allocation a successful strategy for today's investors? Read more below to find out what Evergreen Gavekal's Partner, Louis-Vincent Gave, thinks about the willingness to trade liquidity for the potential of future income or growth.

Covid came as a shock to the world, but in many cases it is merely accelerating fundamental trends that were already unfolding anyway. The US-China rift, the debasement of western currencies, the de-dollarization of emerging markets, the attempts to replace carbon energy with renewables, the increase in social tensions linked to living in multicultural societies: everything now seems to have gone into hyperdrive.

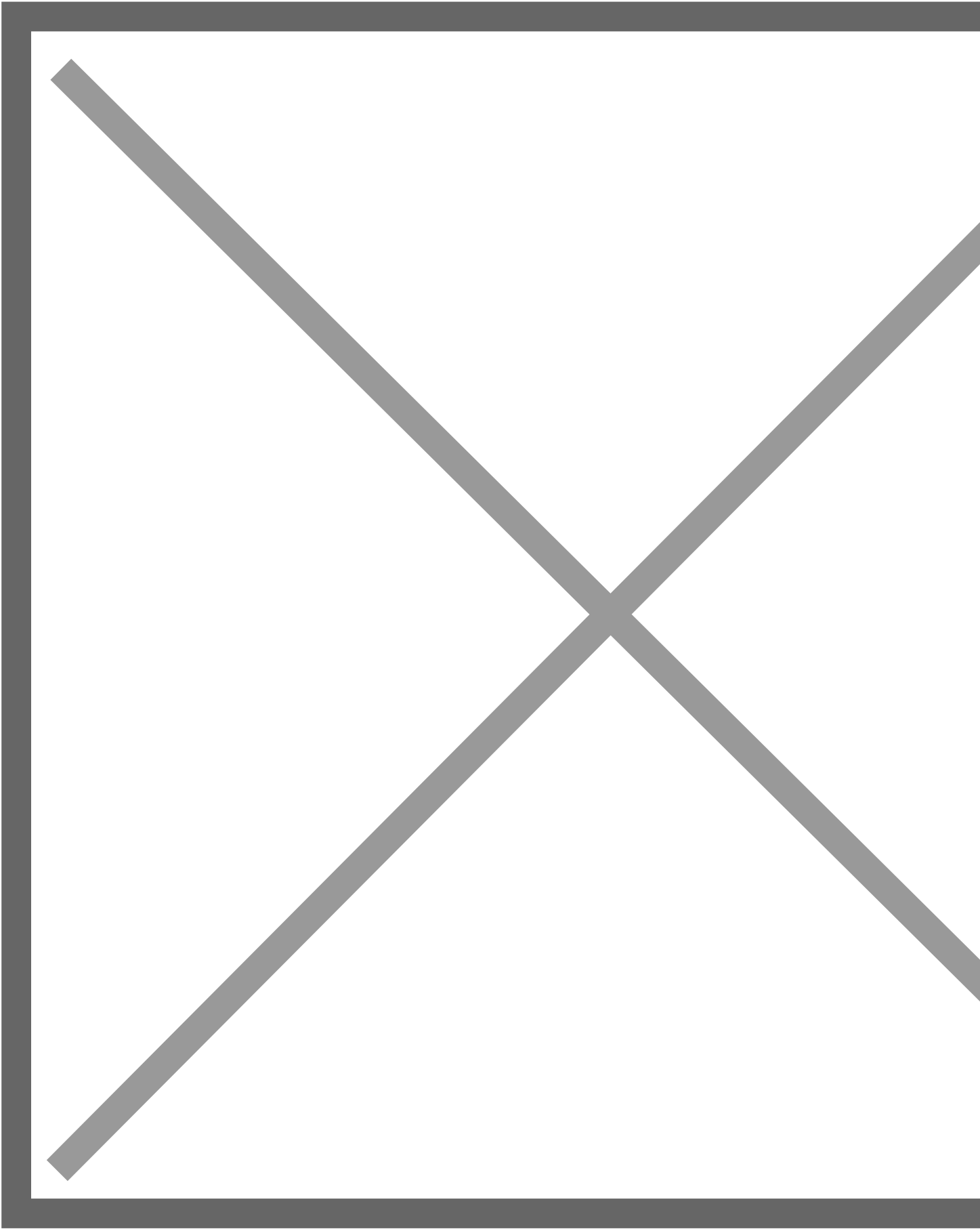
This probably shouldn't be a surprise. If there has been one constant theme in Gavekal's research over the last 15 years or so, it is that we are living in an age of accelerating creative destruction. This idea is the common thread that ties together the books Charles and I have written, from [Our Brave New World](#), through [A Roadmap For Troubling Times](#), to [Clash Of Empires](#), and it is one most clients seem happy to agree with.

And this forces us face-to-face with an almighty capital allocation paradox. As the world changes at an ever-increasing rate, and the future becomes ever more challenging, more and more money pours into private equity funds and other forms of locked-up investments. This is odd. In a world in which the future is increasingly uncertain, surely investors should be avoiding illiquid strategies like the plague, and instead falling over each other to seek shelter in the financial industry's more liquid offerings? Instead, we are seeing precisely the opposite.

To take one example: a year ago, owning an office building in Midtown Manhattan, London's Canary Wharf or downtown San Francisco might have seemed as "safe as houses". But in the age of the unexpected, what was a sure bet yesterday can turn into a certain loser today. Just

look at UnibailRodamco-Westfield, one of Europe's largest office and commercial property landlords. In two years, it has seen its market capitalization collapse from €27bn to €4.2bn. Two years ago, owning commercial and office space seemed like a good idea. Today, it is toxic.

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Alternatively, consider an investor who in January 2000 decided that new technologies were bound to change the way we live, work and play, and that the way to play this change was to put capital into the 10 tech companies with a market cap at the time of over US\$200bn (figuring that size and scale would be the key drivers of long-term performance). Our investor would have bought Microsoft, Oracle, Intel, IBM, Cisco, Lucent, Ericsson, Nokia, Sun Microsystems and Nortel Networks.

Reinvesting all his dividends, he would have ended up two decades later with one winner (Microsoft), three washes (Oracle, Intel and IBM), three big disappointments (Cisco, Nokia and Ericsson) and three donuts (Lucent, Sun Micro and Nortel). His total compound annual growth rate (dividends included) would have been 1.4%. And he would have missed out on the likes of Amazon (with a November 1999 peak market cap of US\$35bn) and Apple (US\$23bn in March 2000).

Clearly, in a single generation, the tech world has changed almost beyond recognition, and the companies which offered scale 20 years ago mostly failed to cope with that change despite all the advantages of size (or perhaps because of them?).

This makes investors' enthusiasm for illiquidity all the more strange. Why, in a world that is changing so fast, would investors rush headlong into illiquid strategies? Why should they so readily give up the opportunity to say: "The world is changing. My portfolio needs to evolve?"

There are two possible reasons: extra income, and extra growth.

In a world in which income is ever-harder to find, giving up liquidity (especially for those who do not need it immediately) in exchange for extra income might seem to make a lot of sense. However, more often than not, the excess income is delivered by gearing up balance sheets. And increasing leverage typically increases fragility. In a time of accelerating creative destruction, rapid societal shifts and growing geopolitical uncertainty, does increasing fragility (by increasing leverage) really make sense?

Gearing up balance sheets might make sense in an environment of structurally falling interest rates. As interest rates fall, asset prices get rerated and the value of equity increases rapidly. Of course, this cuts both ways: once interest rates stop falling and either flatline or rise, gearing, instead of boosting shareholder returns, begins to destroy them.

Not that rising interest rates are needed to destroy shareholder returns. Think again of a hypothetical Canary Wharf* landlord: gearing up the balance sheet to buy buildings whose yields were higher than the interest rates charged seemed like a no-brainer. Then Covid-19 hit, and rent payments stopped. Very quickly, the equity in the business was facing a wipe out. In this context, shouldn't the Unibail-Rodamco-Westfield faceplant raise questions over the value of the equity in a whole swathe of real estate private equity funds?

I could go on, but it suffices to say that with interest rates at record lows and with the world changing ever more rapidly, accepting illiquidity in return for the promise of increased income seems like a dangerously shortsighted proposition. Once again, investors are picking up pennies in front of steamrollers.

This leaves the prospect of growth as the only reason to accept illiquidity. This can make excellent sense: investors offering entrepreneurs both capital and time to succeed is what

capitalism should be all about. And in a world that changes ever more rapidly, the entrepreneur who can adapt, safe in the knowledge that he is backed by investors that are not pressed for time, has an important competitive advantage.

It follows that when looking at the illiquid strategies institutional investors have poured capital into over recent years, there are two key questions to ask:

- Is the competitive advantage of this strategy derived from some kind of financial engineering?
- Or does the competitive advantage of this strategy flow from the ability to identify **entrepreneurs and business leaders who need capital?****

In a world that is changing ever more quickly, the first type of strategy will become ever riskier. Meanwhile, in a properly functioning capitalist system, investors who are successful at implementing the second type of strategy will continue to be rewarded very handsomely indeed.

*Editor note: One of London's most prestigious business districts.

**Editor note: Evergreen would add "and also possess a dynamic business model or extraordinary intellectual property" to the second point above.

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