TIFF INSIGHTS

TIFF THOUGHT LEADERSHIP

Portfolio Positioning to Manage Through Market Cycles

TIFF Private Equity Team

July 2020

As we continue to absorb and assess developments in our private equity portfolio in light of the COVID-19 pandemic and ensuing global recession, we thought it would be helpful to review how we built TIFF's private equity (PE) portfolio over time, and importantly, why we designed it this way.

It has been less than five months since financial markets and untold numbers of businesses around the globe were turned on their heads, seemingly overnight, following one of the most robust decades for equity investors in history. Unfortunately, scenarios like this serve as a valuable reminder why taking *measured* risk in private markets is critical to achieving long-term results. Rooted in this philosophy, we have built a PE portfolio that seeks to maximize the probability of sustaining strong returns during bull markets, to preserve capital and outperform public markets in downturns, and to continue a steady pace of capital deployment that might otherwise be absent during recessions and periods of distress. These latter two points are particularly relevant to what we are experiencing today – a truly unprecedented time that has the potential to generate highly attractive, new private equity investment opportunities. The four main strategies that comprise TIFF's PE portfolio are: lower and middle market growth equity, lower and middle market value and deep value control buyouts, flexible mandate and distressed strategies, and early stage venture capital.

Lower and middle market growth equity. TIFF has focused on sector specialists that seek to back small companies with significant growth potential at attractive relative values and with highly structured securities. Investing in the senior-most security with an attractive liquidation preference in a capital efficient business can provide a degree of downside protection as a company's enterprise value can decline by a large amount before our capital becomes impaired. In addition to that downside protection, our managers can participate in uncapped equity upside as fundamentally strong businesses continue to scale over time. While markets can clearly impact these small companies, and managers can pick the wrong businesses to back, the success or failure of these growth equity investments will be driven by the business plan and the team, not just macro timing. As we think about the prospects of our growth equity managers deploying capital in a recession, founders of these businesses may still desire growth capital to bolster their balance sheets in an effort to hit the ground running coming out of the downturn. Since these founders typically continue to own a majority, or at least a large minority, of the company after one of our managers invests, they aren't necessarily looking to maximize their valuation today as there is a much larger payout in front of them if they can continue to grow their company alongside their private equity sponsor. This may result in less of the bid-ask spread issue often seen in PE during a recession.

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Lower and middle market value and deep value control buyouts. Within deep value, TIFF has focused on managers in the lower middle market seeking to buy fundamentally strong companies that are out of favor for any number of reasons. While these PE managers typically acquire a company through its equity, they are always looking to pay prices well below intrinsic value and use conservative leverage. The downside protection in this case comes through controlling solid businesses bought at attractive prices. The upside comes from transforming the business operationally to effectively grow the top and bottom lines while improving the company's organization. There are many ways to find profit in these investments, even if multiples contract from the time of entry. Typically, in the early days of a downturn, managers can struggle to find new value investments, as only the most stressed businesses will opt to sell control at reduced prices – likely businesses that already had significant problems prior to the downturn. As the economic contraction continues, more good businesses with bad, overleveraged capital structures will capitulate and look for rescue financing or a new owner (in or outside of a bankruptcy process). Our deep value buyout managers should be well positioned to take advantage of the opportunity to add these businesses to their portfolios at attractive prices.

Flexible mandate and distressed strategies. Within this segment of TIFF's private equity portfolio, we've backed managers who have an explicit mandate to buy mispriced assets at discounts to intrinsic value through any security -- debt or equity. These strategies typically come with a differentiated return profile with better liquidity earlier in their funds' lives relative to longer-term control or growth equity strategies. While the flexible mandate for these managers can identify applicable opportunities in most market environments, they often have the best opportunities to deploy capital in an environment of increased volatility. In a downturn, as companies default and the system becomes taxed, financing can become difficult to obtain, and managers focused on distressed credit opportunities may have a wide variety of attractive investment opportunities to buy mispriced assets and provide capital for troubled balance sheets.

Early stage venture capital. In venture, it is certainly more difficult to find strategies that may protect capital in a downturn. Companies in our current portfolio will need to cut cash burn and prepare for a poor environment in which to raise follow-on capital. Great businesses with great founders will be best positioned to survive and emerge from the recession with leaner, stronger companies; whereas, less-differentiated businesses with weaker founders likely won't have the seemingly never-ending spigot of venture funding we have seen in recent years. Given the power law distribution of venture returns (venture returns are typically driven by a very small number of outlier companies), we believe our portfolio of venture managers will continue to back the best emerging companies at the earliest stages. As we've experienced, early stage venture capital brings the potential for outsized alpha generation that may be less correlated with public markets. Companies like Google, Facebook, Uber, and Honey are often invented and funded at times that don't correlate with broader market trends. As a result, we invest in top-flight venture capital managers due to their inherent long-term upside potential. Early stage venture managers

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are positioned to maximize ownership and influence at company formation. The success or failure of a company can certainly be impacted by the fundraising environment but may be more greatly impacted by the quality of the startup and the founding team. We purposely avoid late stage venture managers that take increased valuation risk (and thus large mark-down risk), and coincidentally provide less ownership and opportunity to drive upside value.

As we continue to track developments within our current PE portfolio, we are also focused on identifying the most attractive go-forward investment opportunities. We are reminded that private equity has historically performed its best when long-term capital can solve for deep inefficiencies that liquid capital providers are restrained from pursuing. During this pandemic, TIFF's PE team has made new commitments to five high-conviction PE managers that have been in the portfolio for several years. We are certain that substantial inefficiencies within markets and companies will continue to emerge, and we continue to believe that private equity represents a vital part of a portfolio positioned to outperform public equities over market cycles. The discipline to stay the course has never meant so much as it does today.

If you have any questions, please contact us at 610-684-8200.

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