December 2023

Asset Allocation Report – Private Markets

Context

In 2022, global central banks took action to address inflation, successfully reducing price increases in 2023 by raising interest rates. As a result, inflation slowed to mid-to-low single digits.

While the economic conditions vary globally, it is noteworthy that the major economy has demonstrated resilience, largely propelled by robust consumer spending. The strength of the labor market has played a pivotal role in maintaining high consumer confidence. Consequently, the recent decline in inflation across developed markets and indications of moderated economic growth in the U.S. have sparked optimism for a soft landing.

Market experts project stable interest rates across major central banks in the coming months. However, if inflation decreases, analysts speculate that the U.S. and European central banks may consider rate cuts around mid-2024.

As U.S. inflation gets back to normal, it's like a domino effect, setting the stage for a series of expected rate cuts across Latin America. This phenomenon is already evident in certain countries where interest rates have rapidly decreased, prompting investors to actively seek opportunities that promise higher returns.

In this context, the landscape favors **private markets**, given their adeptness at providing uncorrelated returns, mitigating traditional asset volatility, seizing market fluctuations, and delivering higher returns.

Private markets operate under special investment conditions and a unique business model. The success of these companies depends on specific strategies, decisions made by management, industry trends, and internal factors. Managers in this field **actively work** to enhance and manage company performance, emphasizing **value creation**. As a result, their hands-on approach allows them to **adapt** to challenges and uncertainties in the market, ensuring a more resilient and responsive management of their investments.

Private Markets Implications

In the current economic scenario, investment activity has slowed, evident in a decline in overall deal activities. Managers are facing challenges in identifying attractive exit opportunities, influenced by factors like cautious market sentiment, economic uncertainties, and sellers expecting higher valuations.

Consequently, Limited Partners (LPs) have experienced constrained cash availability for reinvesting in new funds, compounded by the impact of the denominator effect, affecting fundraising within private markets.

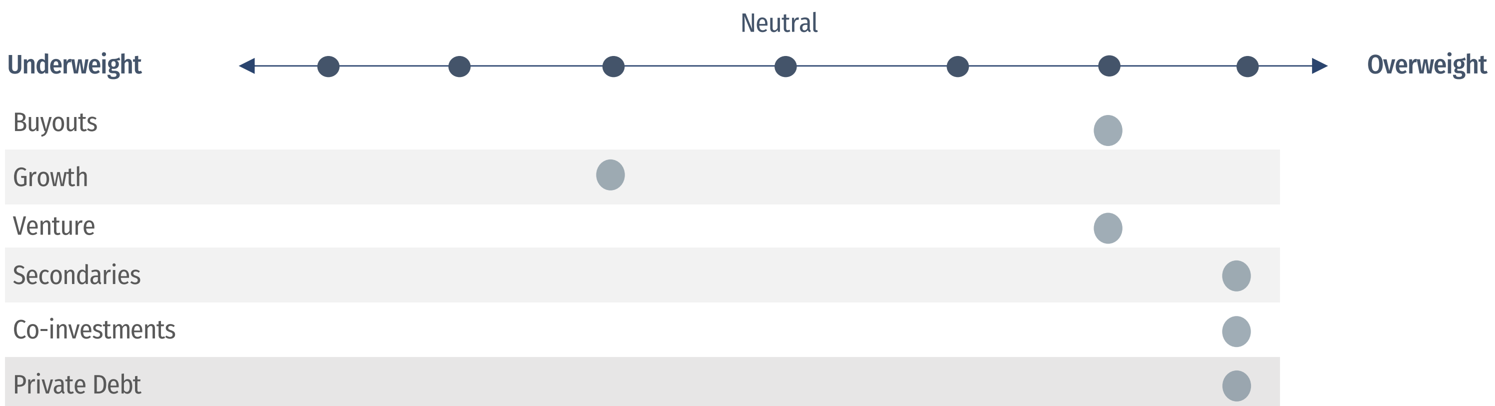
Despite these challenges, the market is currently witnessing a narrowing of the "bid-ask" spread as the price expectations of buyers and sellers align. This alignment has led to an overall decrease in entry valuation multiples, reactivating investment activity.

*At the same time, LPs continue actively seeking alternative assets, aiming to fulfill their needs for risk-adjusted returns and diversification, especially in the face of market and geopolitical uncertainties. Recent surveys reveal a robust inclination among almost half of the respondents to **increase their exposure** in the coming months, with 44 percent expecting to maintain their current levels*[1]*.*

Considering expectations for prolonged higher interest rates and limited prospects for a bullish stock market, alternatives such as private equity are gaining recognition as resilient sources of return in the face of potential ongoing market volatility.

Private Markets Views

The following summarizes the view in private markets based on a 12-month Outlook for each strategy. It is crucial to note that within these strategies, specific considerations will be addressed in each of the following commentaries. This view cannot be generalized to all managers as each one is unique.



[1] 2024 LP Survey, SS&C Intralinks, Inc

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Buyouts

Over the past two years, Private Equity firms have skillfully navigated challenges arising from inflationary pressures and a high-interest-rate environment.

In response to macroeconomic challenges, GPs have prioritized **add-ons**. According to Pitchbook data, 76% of U.S. private equity deals in Q1-Q3 2023 involved an existing portfolio company acquiring another, a notable rise from the 2013 figure of 59%.

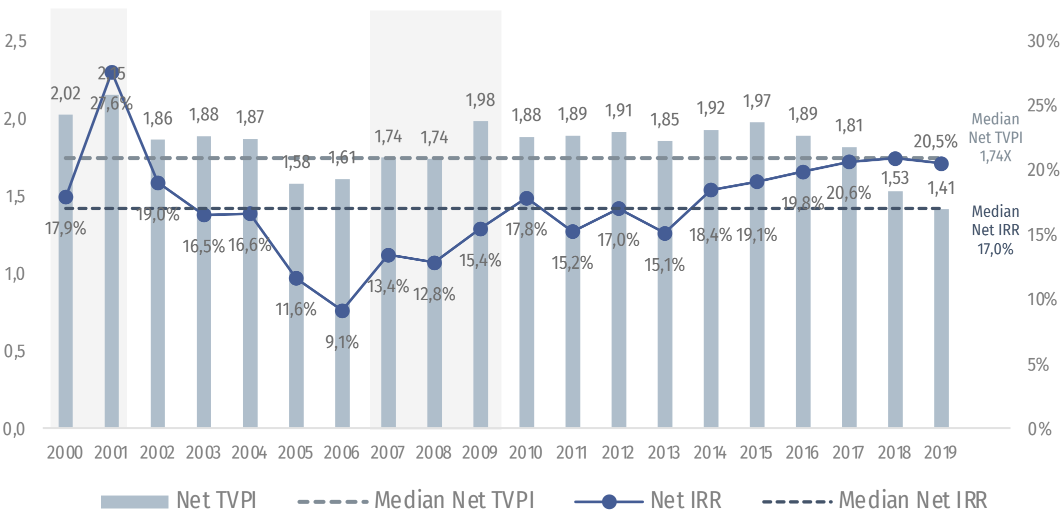
As a result, Buyout firms focus on growing existing portfolio companies to boost EBITDA multiples, using less leverage than new platform investments. This strategic response to the current economic landscape effectively increases the portfolio's value by strengthening revenues and EBITDA.

Furthermore, buyout managers have demonstrated innovation and adaptability, capitalizing on favorable opportunities for promising investments. This ability is rooted in the following factors:

- Focusing on **mature companies** with established revenue streams and positive cash flows. These businesses exhibit greater resistance to market fluctuations, ensuring steady cash flows even in turbulent conditions.
- **Embracing long-term** investments that allow ample time for value creation and strategic exits during favorable market conditions. This patient approach aligns with an extended investment horizon, providing a strategic advantage in navigating uncertainties and maximizing returns over time.

Moreover, Historical data consistently shows the success of new commitments to vintages initiated during economic downturns, reinforcing that timing is not a decisive factor in this industry.

Buyout Performance by Vintage Year (2000-2019)



Source: Preqin Pro, HMC, as of most-up-to-date. Left axis corresponds to Net TVPI, and right axis to Net IRR

Empowered with substantial control, private equity managers fortify companies against economic challenges through hands-on strategies, including operational improvements, cost-cutting, and efficiency enhancements. This proactive approach significantly enhances overall resilience during economic downturns, as illustrated in this exhibit.

Areas of focus

- **Top quartile and managers with high consistency** since current environment may lead to increased return dispersion among managers.
- **Lower leverage**. GPs who do not heavily depend on leverage to generate value might be more resilient, , especially amid potential risks from a new wave of refinancing at higher interest rates.
- **High-quality.** GPs focusing on high-quality companies with strong fundamentals—solid balance sheets, stable cash flows, and competitive advantages—ensure stability in adverse market conditions.
- **Sector selectivity.** Non-discretionary product or service providers often have more stable cash flows. GPs steering clear of cyclical sectors may avoid heightened volatility in economic downturns.
- **Operational improvements**. Prioritizing long-term value, operational improvements, and control over portfolio companies is key to constructing resilient portfolios.

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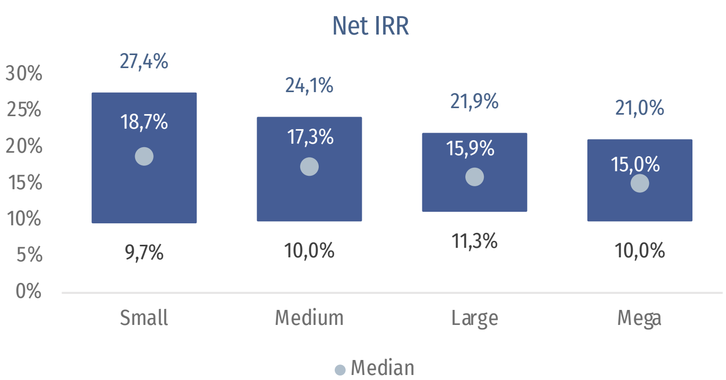
- Regarding **fund size**, which can be seen as a proxy for transaction size, smaller vehicles exhibit greater dispersion but achieve a higher median, as expected. On the other hand, Mega funds show lower dispersion and a lower median due to increased competition. Therefore, while mid-buyouts may appear as a sweet spot, achieving superior returns depends on investors consistently selecting the best options.

Buyout Performance by Size (Vintage 2000-2019)



	Small	Medium	Large	Mega
Median TVPI	1.80X	1.73X	1.72X	1.68X
Median DPI	152.1%	126.8%	131.9%	117.1%

Source: Preqin Pro, HMC, as of most-up-to-date. Performance equally weighted from vintage 2000-2019 considering European and North American funds. The boxes size in the graph at left indicates the difference between top and bottom quartile returns. Small funds are smaller than US$ 500 Mn, Medium funds are between US$ 500 Mn and US$ 1.5 bn, Large funds are between US$ 1.5 bn and US$ 4.5 bn, and Mega funds are greater than US$ 4.5 bn.

Buyout Performance by Geographic Focus (Vintage 2000-2019)

- In terms of **geographic focus**, data between vintages 2000 and 2019 shows no significant differences attributed to the globalization of businesses. This suggests no distinct preference for any specific geographic region.

	Net IRR		Net TVPI		DPI (%)	
	North America	Europe	North America	Europe	North America	Europe
Top quartile	24.9%	26.0%	2.25X	2.18X	196%	196%
Median IRR	17.1%	18.1%	1.77X	1.75X	139%	140%
Bottom quartile	10.0%	10.8%	1.42X	1.42X	73%	78%

Source: Preqin Pro, HMC, as of most-up-to-date. Performance equally weighted from vintage 2000-2019

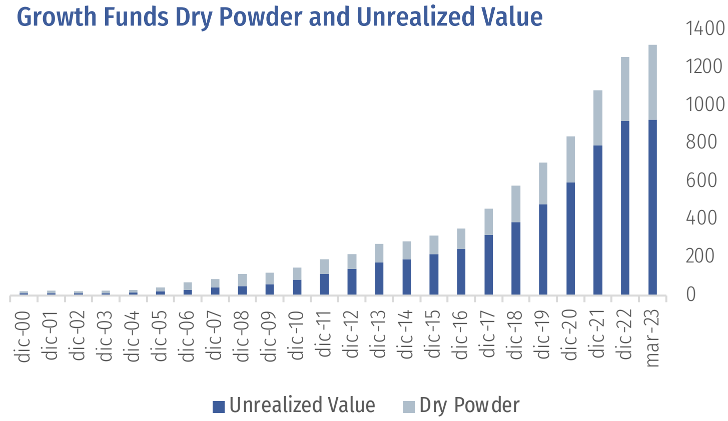
Growth

Between 2021 and early 2022, the growth sector experienced a significant surge, propelled by an abundance of liquidity in the asset class (refer to Dry Powder Exhibit). This surge triggered heightened demand for companies within this category, potentially propelling their growth beyond initial expectations and contributing to elevated valuations within this segment.

However, the subsequent economic environment, marked by high interest rates and inflation exceeding target levels, did not align with the anticipated rapid growth. Shifting market conditions further reached a point where the initially high valuations became unsustainable. Consequently, growth funds heavily invested during this time are currently facing a decline in the value of their assets.

Additionally, the careful approach adopted by GPs and management teams to strengthen balance sheets comes with a drawback. This approach, perceived as conservative in growth strategies, has raised doubts about future growth prospects. Consequently, valuations of companies, initially built on optimistic expectations, have weakened or decreased, impacting returns for recent vintages.

Growth Funds Dry Powder and Unrealized Value



Source: Preqin Pro, HMC, as of most-up-to-date.

Change in Net TVPI December 2021 vs. March 2023

Vintage	# Constituent Funds	% of Funds with Decreased TVPI	Δ Net TVPI (%)
2016	24	63%	-13.5%
2017	21	76%	-14.4%
2018	36	61%	-14.5%
2019	22	45%	-16.7%
2020	27	56%	-16.5%

Source: Preqin Pro, HMC

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The prevailing market dynamics, favoring companies with positive cash flow or break-even, have also posed fundraising challenges for growth firms. Investors in this segment have become more discerning. As a result, LPs are **reassessing** their interest in the growth sector in the short term, prompting questions about the strategy's appeal to new investors.

However, it is essential for investors to recognize potential opportunities for growth and favorable returns in the future as valuations correct offering lower entry points. Once these companies grow and improve financial performance, valuation multiples may expand, leading to higher exit valuations.

Venture

The VC asset class has faced two key challenges in 2022 and 2023: 1) Downward pressure on late-stage VC-backed company valuations, which corresponds to broad corrections in public market valuation multiples for growth/technology companies, and; 2) An IPO window that has effectively closed over the last two years. This combination of trends is reflected by adverse short-term returns for indices that measure the aggregate performance of the asset class.

Performance Private Venture Capital Index

Strategy	YTD	1-year	3-year	5-year	10-year
Venture capital	0.75%	-8.23%	17.37%	16.38%	15.38%

Source: Pitchbook, HMC, as of june 2023. This index captures the return earned by investors on average in their private capital portfolios, based on the actual amount of money invested in private capital partnerships.

Late-stage venture/growth funds have been disproportionately impacted by these trends. These strategies are more capital intensive (larger companies require larger investments to scale), have shorter target investment timelines (which are disrupted in the absence of IPOs), and are less resilient to material markdowns.

Early-stage venture funds tend to be more resilient under these conditions as investment timeframes are much longer (8-10+ years in many cases) and, therefore, less sensitive to current conditions of exit markets, and valuations are much lower and less sensitive to public market fluctuations. This long-term approach benefits current LPs since GPs are not pressured to exit companies during economic downturns.

Most importantly, early-stage venture investing is characterized by "power law" returns – historically, a small number of companies tend to drive a disproportionate share of returns in a portfolio. A significant level of write-downs and write-offs is expected in any fund vintage, regardless of the macro environment.

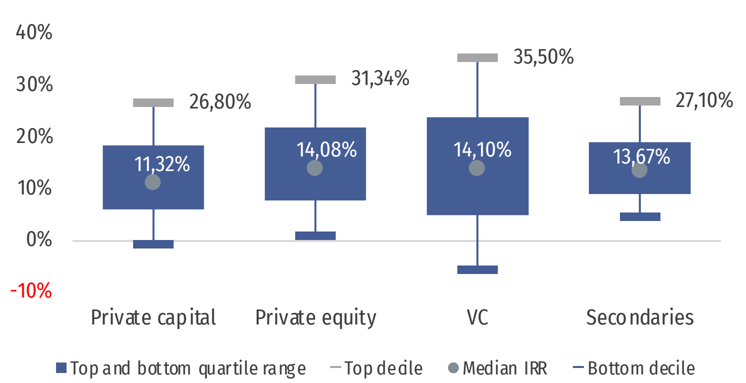
Looking ahead, the fundamentals of the VC asset class (highlighted below) suggest this strategy is well-positioned to navigate challenging and changing market conditions:

- Venture-stage companies are less susceptible to interest rate fluctuations than traditional businesses since they primarily use equity financing, which protects them from direct impacts on capital costs.
- The valuation of venture capital investments, especially in early-stage startups, primarily focuses on growth potential rather than near-term cash flows or macro conditions. Factors like market opportunity, technology and business model innovation, and competitive positioning drive successful investments over time.
- The long-term orientation of venture capital tends to give GPs more flexibility to avoid exiting companies during economic downturns.
- Historically, great companies tend to be launched across market cycles. Adverse macro environments often create a window of opportunity for entrepreneurs and venture-back startups as larger incumbents – especially public companies – are forced to cut spending on R&D, marketing, and talent acquisition.
- Periods of relative capital scarcity tend to create an attractive dealmaking environment for VC investors, with more favorable entry valuations and deal terms (including downside protections), as well as more selective portfolios (demonstrating stronger growth/operating fundamentals).

Areas of focus

- **Fund of Funds Combining Primaries + Opportunistic Secondaries**: Recent, prevailing economic volatility has created a window of opportunity for targeted FoFs to establish positions with historically access-constrained GPs through primary fund allocations, as well as opportunistic secondary transactions, as prominent LPs have been forced to rebalance their portfolios and incrementally scale back allocations to the VC asset class. This approach creates exposure to GPs with strong performance across cycles, with diversified strategy and vintage exposure.

PE Dispersion (vintage years 2005-2018)



Source: Pitchbook, as of March 2023

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- **Top-Tier Managers:** Manager selection, and access, uniquely defines the VC asset class. Historically, the performance of top VC managers is highly persistent across funds (~2x the rate of persistence for top PE managers), and top VC managers tend to outperform their peers across asset classes. At the same time, the performance gap between the top and bottom VC managers is very high relative to other investment strategies.

Secondaries

Secondaries funds are thriving as investors navigate exit channel challenges and explore alternative liquidity options. Strategies focused on enhancing liquidity are increasingly attractive within this landscape.

In this context, GP-led secondaries, with continuation vehicles, have emerged as the preferred tool for sponsors to secure investor liquidity. As a reference in H1 2023, GP-led secondaries, totaling USD 18 billion, accounted for 42% of the overall volume[2].

Concurrently, amid the current macroeconomic landscape, there's also an increasing buy-side capacity for credit and distressed assets, along with a growing interest in real assets and VC exposure. This expansion is seen in the increased size and number of dedicated fund strategies, reflecting fund managers' strategic diversification to capitalize on emerging opportunities.

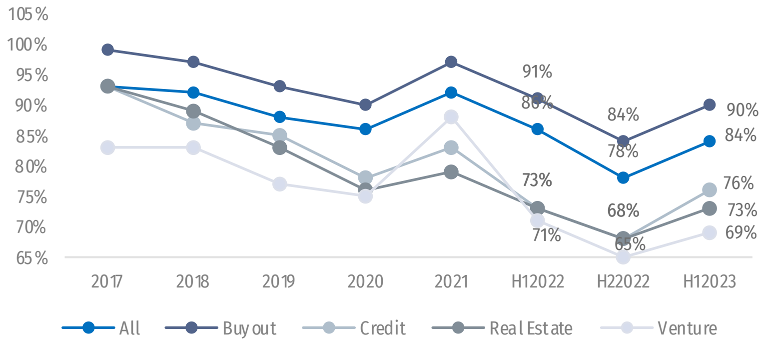
From an LP's perspective, although secondaries historically offered diversification and a shallower J-curve, current trends indicate a preference for strategies that provide greater differentiation. While secondaries offer stability, their lower dispersion[3] has prompted investors to explore alternatives that better align with their goal of surpassing average market performance.

However, with a well-balanced mix of GP-led and LP strategies, secondaries funds continue to present a compelling option for LPs looking to capitalize on the current environment. In addition to the traditional characteristics of the asset class, LPs can realize additional benefits from the following:

- Secondaries managers focus on high-quality assets in familiar sectors, managers, and geographies, enhancing their strategy and increasing the likelihood of success. GP-led transactions also offer collaboration opportunities with top-tier managers in specialized domains, further contributing to favorable outcomes.

- Secondaries transactions frequently involve acquiring assets at a discount, strategically optimizing returns based on subsequent asset performance, and providing LPs with early positive returns. Recent market dynamics reveal an average high bid of 84% of NAV, indicating ongoing adjustments as confidence returns to buyers and sellers. Despite this rebound, discounts persist, with less than 1% of funds priced above 100% of NAV and older or less desirable funds often trading below 75% of NAV.

LP Portfolio Pricing (% of NAV)



Source: Jefferies, H1 2023 Global Secondary Market Review.

Coinvestments

Like the secondaries outlook, co-investments play a crucial role in providing both liquidity and capital for portfolio companies, contributing to the overall resilience and adaptability of investment strategies. Specifically, co-investment is expanding its scope beyond new deals, with an increasing emphasis on "mid-life transactions."

Similar to the case with GP-led transactions, co-investments let investors collaborate with **top-tier managers** in specialized domains. This strategic alignment ensures guided investments, boosting the potential for **positive returns and minimizing risks**.

Moreover, co-investments prove beneficial in scenarios where a J-curve is expected. These structures can provide cost efficiencies, enhancing the overall investment performance. Reduced fees and shared due diligence costs can mitigate the financial impact linked to an extended J-curve.

These factors collectively underscore the advantages of co-investment in an environment that may experience increased performance dispersion among managers and transactions.

Key Monitoring Points PE

Given the unique factors in private equity, summarizing key points is challenging, but vital areas include monitoring investment activity, investor distributions, and, in some cases, the leverage level of underlying assets.

In VC, exit dynamics are pivotal, especially considering that over the last 15 years, VC-backed IPOs have accounted for approximately 70% of total VC exit proceeds. Monitoring the trend and performance of IPOs is thus crucial within the VC ecosystem, as it is key to realizing gains from investments.

[2] *Jefferies, 1H 2022 Global Secondary Market Review*
[3] *See exhibit PE Dispersion in Venture Section*

Contact us hmccapital@hmccap.com www.hmccap.com

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Private Debt

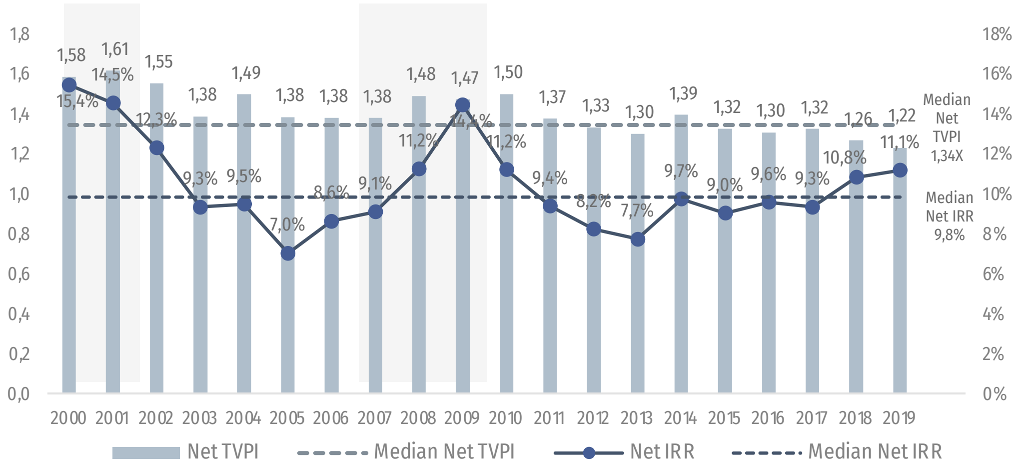
The ongoing financial market disruptions are driving a shift towards private credit providers. This change is influenced by recent challenges in the banking sector and is fueled by the flexibility provided by alternative credit structures.

Amid macro uncertainty, borrowers increasingly prefer direct lenders for reliability and execution certainty. Although banks have resumed underwriting activities, this is primarily for the highest-rated borrowers. Consequently, Private Debt GPs are **stepping in to fill the gap**, financing larger companies that typically use syndicated financing, resulting in favorable terms, robust structures, and precise documentation packages.

The current scenario provides a somewhat clearer outlook on interest rates, minimizing surprises and and helping GPs make informed decisions and seize opportunities effectively. The benefits of this strategy in the present context can be summarized as follows:

- **Floating rate nature**. This characteristic has led to significantly higher yields, surpassing historical levels and making it an appealing choice for investors seeking robust performance.
- Private debt transactions offer **structural protections** like covenants and repayment priority, mitigating risks during economic downturns and preserving investor capital. **Collateralized investments** provide additional security, offering investors a claim on specific assets in case of default.
- In addition, this is a favorable time for lenders to enhance the new issue premium through call protection or premiums, limiting early redemption and compensating for potential loss of future interest payments.
- Private debt GPs often have more **active involvement** in invested companies than public debt holders, presenting opportunities to influence financial restructuring and optimize returns.
- The short-term nature of private debt funds also enables **agile responses** to market changes, seizing emerging opportunities. In addition, it provides faster returns, helping investors navigate challenges from interest rate volatility and inflation.

Private Debt Performance by Vintage Year (2000-2019)



Over the years, private debt has proven to be an all-weather strategy, consistently demonstrating resilience and stability. The strategy's ability to weather economic downturns is evident in its track record. Notably, this exhibit showcases that private debt has delivered no negative returns, even during recessions or market disruptions. This robust performance underscores the enduring strength and reliability of private debt as a strategic investment choice.

Source: Preqin Pro, HMC, as of most-up-to-date. Left axis corresponds to Net TVPI, and right axis to Net IRR

Areas of focus

- **Direct Lending:** Direct lending excels in a prolonged high-interest rate environment by prioritizing companies with strong fundamentals. Senior secured direct lending, known for stability and reliable income, is a core allocation. However, investors can also enhance returns and manage risk by diversifying with higher-yielding and less correlated strategies. Additionally, incorporating levered classes can provide an extra edge.
- **Special Situations/Distressed:** These strategies thrive in challenging economic environments, using expertise to identify and invest in opportunities, potentially acquiring assets at discounted values, and benefiting from the recovery of distressed companies.
- **Hybrid:** Acquiring discounted debt with an equity exchange option offers significant return potential. As the debtor company improves financially, the obtained equity can appreciate substantially, making it an appealing choice for investors.
- **NAV Financing:** In the current environment, GPs face challenges in securing leverage and financing for companies, GP commitments, or credit lines. NAV financing emerges as a versatile solution, providing stability and adaptability with reliable returns and a lower risk profile, secured by the NAV of the fund's underlying investments.

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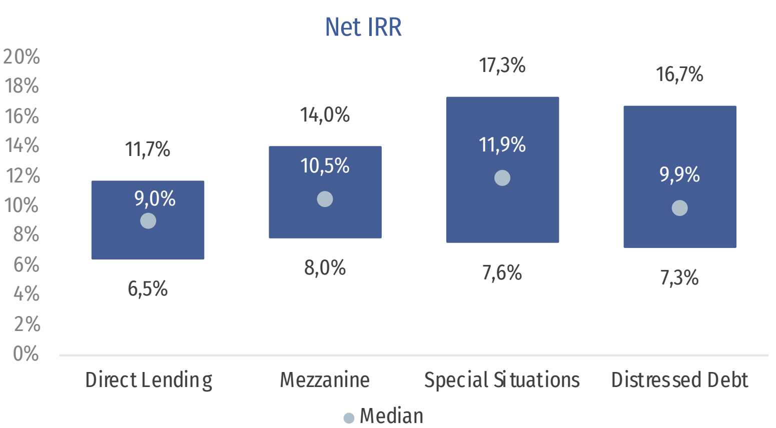
Upon a detailed examination of the track records within this asset class, it's evident that performance has demonstrated a robust balance between risk and reward. Notably, special situations and distressed debt stand out for delivering the highest returns, followed by mezzanine and direct lending. This data empowers investors to customize their approach, considering their risk tolerance and return expectations.

Regarding Direct Lending, note that Preqin data might omit leverage returns, which are frequently substantial, often double digits or above mid-teens. Consequently, investors are advised to consider levered classes for potentially higher yields

Private Debt Performance by Strategy (Vintage 2000-2019)



	Direct Lending	Mezzanine	Special Situations	Distressed Debt
Median TVPI	1.23x	1.36x	1.38x	1.41x
Median DPI	73.3%	122.2%	79.8%	117.4%

Source: Preqin Pro, HMC, as of most-up-to-date. Performance equally weighted from vintage 2000-2019. The boxes size in the graph indicates the difference between top and bottom quartile returns.

Key Monitoring Points

While private debt presents various benefits, investors should be mindful of the following context and recognize the importance of ongoing monitoring:

- *Private credit has shown robustness, supported by the strength of the U.S. economy and the proactive steps taken by sponsors and lenders to avert liquidity challenges among susceptible borrowers. However, some companies are yet to feel the complete effects of rising interest rates.*
- *A noteworthy aspect is that almost 40% of the direct lending market is set to mature by the end of 2025 (vs roughly 15% of broadly syndicated loans, according to Bank of America). This sizable maturity raises concerns about meeting obligations in challenging economic conditions or high-interest rate scenarios.*
- *Default rates have recently risen, and there is an anticipation of further increase (to 2-4% by year-end), though still significantly below Global Financial Crisis levels. In this market, it's vital for GPs to monitor portfolios closely and maintain strong workout teams to navigate challenges.*

About HMC Capital

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Founded in 2009, we have been pioneers in alternative investments development for our clients.

We offer customized services to our clients, with unique academic and educational approach. Access to specific on demand technical trainings and Masterclasses in partnership with the best universities of the world.

More than **US$ 14 Bn** in assets under management and distribution from institutional, multilateral & private investors.