

Navigating Private Asset Strategies

BUILDING STRONGER PORTFOLIOS

4Q 2023 Alternative Investment Outlook



LIVE WELL. SLEEP WELL.

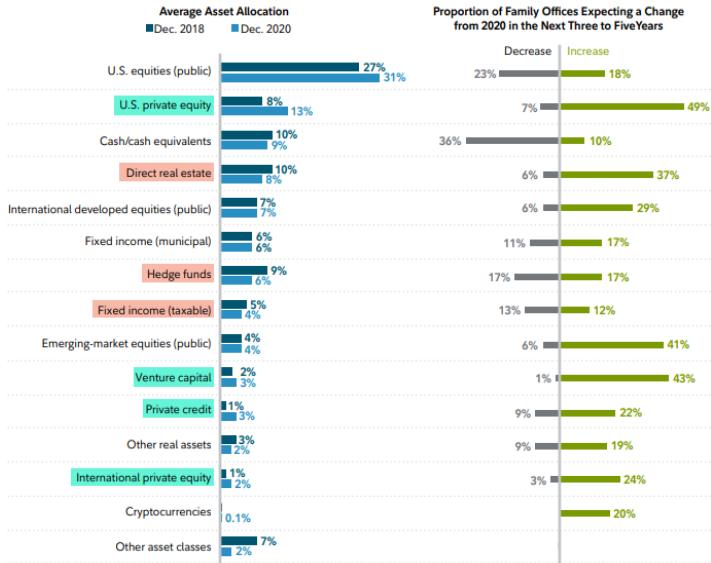
Investment Themes for Private Assets

1. Family Offices, Endowments, and Foundations are increasingly allocating assets in alternative investments, attracted by their potential for diversification, strong risk-adjusted returns, and other benefits.
2. Private capital's consistent outperformance across multiple timeframes, including a post-COVID surge yielding nearly double the returns of the S&P 500, underscores its resilience and value-creation capabilities, advocating for a long-term investment strategy that leverages different asset classes' ability to adapt to market conditions and capitalize on operational improvements.
3. In a challenging 2023 capital environment characterized by LP liquidity constraints, larger, more experienced funds attract greater commitments, underscoring the importance of stability, expertise, and adaptability for achieving investment objectives.
4. The complex cash flow dynamics of private capital, influenced by fund characteristics and market trends, highlight the need for LPs to diversify and strategically align their commitments to mitigate potential shortfalls and ensure portfolio resilience.
5. GPs are holding investments longer, deploying dry powder more creatively, and navigating market valuation expectations and IPO options with caution in response to the lowest exit-to-investment ratio since the Global Financial Crisis and rising financing costs.
6. Private assets have historically shown robust returns amid economic challenges, thanks to a blend of macro insights, proactive management, and a vision to capitalize on adversity. A balanced liquidity and active asset management strategy, informed by data-driven insights, is the key to unlocking value.
7. In Real Estate, the preference for larger, experienced managers and the divergence between private and public real estate performance highlight the evolving complexities of the asset class and the need for a nuanced strategy.
8. The stark disparity between public and private real estate returns in 2022, driven by macroeconomic factors, shifts in workplace culture, and record redemption requests for nontraded REITs, signals a complex landscape that demands nimble strategies, transparent practices, and keen sector analysis.
9. The emergence of private debt, boosted by the appeal of floating rate notes in a rising interest rate environment, offers diversification opportunities but requires careful monitoring of credit metrics in a changing market.
10. The application of leverage varies considerably among managers, ranging from long-term debt financing to more flexible short-term borrowings and off-balance sheet options, with differing criteria for calculating leverage ratios based on risk tolerance, objectives, and regulatory considerations; Wellspring focuses on capital preservation strategies and senior secured debt aiming for levered returns between 11-15%
11. Amid a venture market deemed "most investor-friendly" in nearly a decade, characterized by lower startup valuations and provisions safeguarding investor interests, Wellspring advocates for diversification across top-quartile managers known for identifying high-growth, disruptive technologies, underscoring the current advantage held by investors in negotiations.
12. In light of a 30.5% year-over-year decline in late-stage startup exit activity in H1 2023, Wellspring advises risk mitigation through diversification across sectors and development stages, cautioning against exponential growth projections and advocating for investments in startups with realistic trajectories and clear exit paths.

The Growing Tilt Toward Alternative Investments

How Family Offices are Investing

How are family offices investing?



Past, Present, and Future: An Examination of Family Office Investment Programs. Overview of the 2021 Family Office Investment Study. May 2021. The 2021 Fidelity Family Office Investment Study is based on data from 127 Fidelity family office clients. Includes 105 single-family offices and 22 multi-family offices. The study was fielded from February through May 2021.

- Allocation to Alternatives:** Alternative investments encompass a wide range of non-traditional assets and strategies outside the domain of standard equities, bonds, and cash. This includes hedge fund strategies, private equity, venture capital, private credit, and real assets. Alternative investments are diverse and complex, and their adoption varies based on investor needs, objectives, and market perceptions. While their inclusion can provide numerous benefits, investors must navigate this landscape with well-informed decisions, especially given the complexities involved in manager selection, cost and performance analysis, cash flow forecasting, transparency issues, and liquidity considerations. Failing to heed these steps often leads to subsequent issues and challenges.
- Endowments, Foundations, & Institutional Exposure:** Endowments & Foundations, which include tax-exempt educational and charitable organizations, have the highest allocation to alternatives at approximately 32%. These organizations often possess longer time horizons due to their operational perpetuity. Conversely, institutions allocate less towards alternatives, with 23% of their portfolios. Public pensions, facing underfunding challenges, lean towards higher allocations to liquid alternatives and equities. In contrast, private pensions veer towards long-term bonds to match their asset duration with liabilities. Alternatives comprise approximately 9% of total invested assets in the broader market.
- Family Office Exposure:** According to a 2021 study by Fidelity (chart on the left), data shows that Family Offices are likely to increase their exposure to alternative investments in the coming years. Notably, 41% of Family Offices plan to raise their stakes in private equity. The appeal of alternatives lies in their potential to enhance returns, reduce risks, and enhance portfolio diversification. Additionally, these investments serve as a reliable income source and safeguard against the erosive effects of inflation. Today's typical Family Office allocates between 25% and 30% of its assets to alternative investments, with increased exposure to PE, Private Credit, and Venture Capital.
- Wellspring Recommendation:** The growing interest of Family Offices in alternatives reflects the changing dynamics of the investment landscape and the increasing availability of accessible investment structures. Wellspring recognizes alternative investments' potential benefits in diversifying portfolios, generating attractive risk-adjusted returns, and aligning with client objectives. However, managing and controlling risk is crucial when incorporating these investments. As the investment landscape evolves, Wellspring will continue exploring alternative opportunities that optimize portfolios to achieve long-term wealth preservation and growth.

Private Asset returns have outpaced the S&P500

	10-year	5-year	3-year	1-year	Q4 2022**
Private equity	16.8%	19.9%	23.3%	3.8%	-0.7%
Venture capital	16.6%	22.8%	26.4%	-10.9%	-0.8%
Secondaries	13.7%	18.4%	23.0%	2.0%	-1.8%
Real estate	12.2%	11.0%	12.3%	5.8%	-1.0%
Private debt	9.2%	7.7%	7.1%	2.1%	-1.0%
Real assets	6.7%	8.0%	11.9%	14.4%	6.0%
Private capital	14.4%	16.9%	20.1%	-0.5%	-0.1%
S&P 500	14.1%	11.9%	11.7%	-18.1%	7.6%

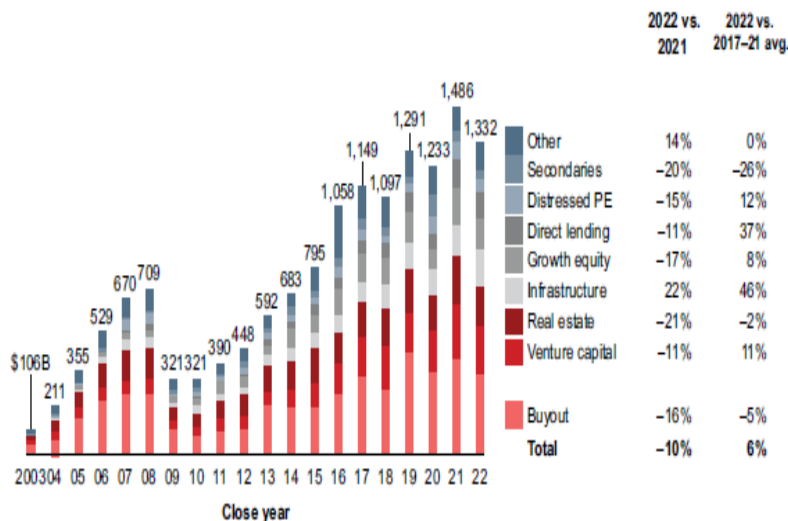
Source: PitchBook As of December 31, 2022

- **Return Consistency:** Over each of the time periods shown (1, 3, 5, 10 years), private capital has demonstrated the ability to outperform the S&P500. The long-term investment horizon of private equity aligns with the industry's ability to weather short-term market volatility and economic cycles. Unlike public market investments, which are subject to daily market fluctuations, private equity investments are typically held for several years, allowing firms to navigate market downturns and capitalize on recovery periods.
- **Performance Benchmarking:** post-COVID, *private equity* returns remained higher than public market equivalents. As of mid-year 2022, private equity funds had generated an impressive total return of 98%. This figure is nearly double the 51.7% return achieved by the S&P 500 during the same period. For the three-and-five-year periods ending Dec 31st, 2022, private equity returned an annualized 20.1% and 16.9% vs. 11.7% and 11.9% for the S&P500, respectively. We attribute the strong performance of private equity funds in the face of challenges to the industry's ability to create value through operational improvement and strategic growth initiatives.
- **Wellspring Recommendation:** Despite private assets' challenges, the industry has a history of adapting to market conditions and finding opportunities for long-term investors. Performance benchmarking reveals that private assets have consistently outperformed public market equivalents, showcasing the value-creation potential of the industry. Investors can capitalize on the opportunities by taking a long-term view and recognizing the resilience of private capital.

Fundraising in 2023

Navigating LP Hesitation & Capital Concentration

Global private capital raised, by fund type (\$B)



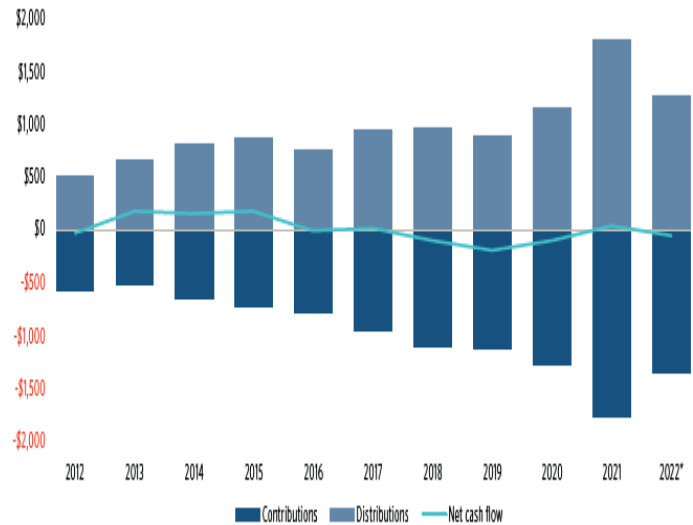
Notes: Buyout category includes buyout, balanced, coinvestment, and coinvestment multi-manager funds; includes closed funds only and represents the year in which funds held their final close; excludes SoftBank Vision Fund; excludes natural resources
Source: Preqin

- Challenging Capital Environment:** Private asset fundraising faces a challenging environment in 2023. Limited partners (LPs) are dealing with cash constraints, causing hesitation in committing new funds. These constraints can arise from various factors, including liquidity concerns, fund performance considerations, and allocation decisions.
- Strong Performance in 2022:** Private assets demonstrated solid performance in 2022 despite extended fundraising periods. Managers raised over \$1.3 trillion in private capital globally, marking a 10% decline from 2021's total. The cumulative five-year fundraising total reached \$6.4 trillion, unprecedented in the industry's history.
- Shift in Fund Dynamics:** The number of buyout funds reaching their target declined by 43% in 2022. However, the decline in the total value of capital raised was less pronounced at 16%, driven by larger, experienced funds attracting more commitments. The trend towards more established larger funds suggests that LPs increasingly view stability, longevity, and expertise as essential in uncertain markets. Wellspring believes the GP's *lessons learned*, bench strength, and industry experience over multiple cycles to be key differentiators.
- Shorter Cycles:** With a surge in capital and shorter commitment cycles, LPs are feeling the strain. Over the past decade, fund vintage intervals declined by 35%, leading to higher LP commitments. This raises questions on the sustainability of the commitment pace and LPs' ability to stay the course.
- Potential Longevity of Portfolio Companies:** Historical data indicates that certain buyout funds could prolong holding periods by a year or two, subsequently impacting fund performance. Wellspring is actively modeling fund capital calls and distributions to assess the potential effects of extended holding periods on performance and client cash flows.
- Wellspring Conclusion:** The private asset industry is undergoing a transformation that necessitates adaptability, clear goal setting, effective risk management, and agility. Stability, top-quartile expertise, and specialization are key drivers of success in this rapidly evolving industry. By embracing these principles, fund managers and LPs can better navigate the changing environment, achieve their investment objectives, and deliver value to their investors.

Decoding Cash Flow Complexity

The Interplay of Fund Distributions & Commitments

Private capital cash flows (\$B)

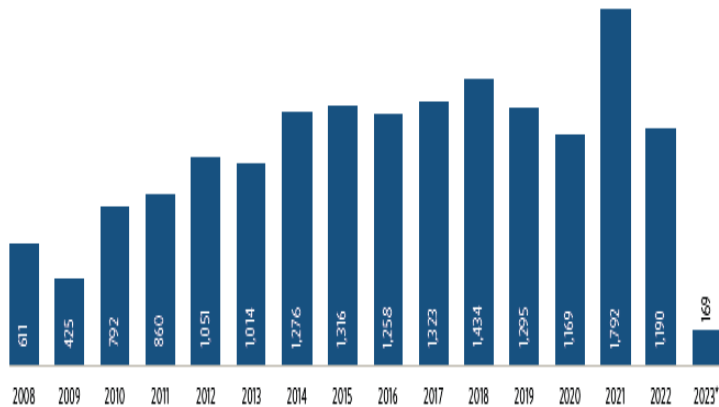


Source: Pitchbook • Geography: Global
*As of December 31, 2022

- Cash Flow Nuances in Private Capital:** The interplay between limited partners (LPs) and general partners (GPs) in private capital involves complex cash flow dynamics that are marked by a variety of factors, including fund size, vintage, and individual strategies. The recent decline in distributions coincides with a broader trend of reduced exit activity, which could impact investor sentiment.
- Distribution Decline:** The chart on the left shows that the decline in distributions in 2022 compared to 2021 (bars on top of the graph) also impacts commitment levels (bars on the bottom). When distributions decrease, LPs receive less cash flow from their investments, impacting their ability to make new fund commitments. Growing fund sizes and emerging new funds also impact cash flow dynamics, pulling capital from a more extensive base, while seasoned, smaller vintage funds disburse from limited invested capital.
- According to Pitchbook:** the private equity industry is a significant force in the global financial landscape, managing trillion dollars in assets. The 1,439 active PE firms in the U.S. alone, overseeing \$2.6 trillion in AUM, demonstrate the industry's scale and impact. Globally, the total AUM for PE firms reaches an impressive \$4.4 trillion, underscoring the industry's global reach and role in driving economic growth and innovation.
- Denominator Effect:** The timing of Limited Partners (LPs) commitments can have a significant impact on the distributions received. When the public market experiences a decline, the value of illiquid assets, such as private equity investments, does not adjust as quickly. This means that the proportion of the LPs' portfolio allocated to private assets *increases* relative to the portfolio's total value, even without any new capital being deployed into the asset class. This situation, known as the denominator effect, can potentially lead to overallocation to predetermined targets. Some LPs may find a higher percentage of their portfolio invested in private assets than initially intended. This overallocation can occur because the value of the public market investments has decreased while the value of the private assets has remained relatively stable.
- Wellspring Recommendation:** we believe the best approach to managing private assets is a blend of diversification, cash flow alignment, and a nuanced understanding of fund dynamics. Diversifying commitments across various fund sizes and vintages helps mitigate risk. Aligning commitments with evolving market trends positions LPs advantageously. Considering individual fund attributes, such as distribution patterns, aids in strategic portfolio management. By implementing these strategies, LPs can navigate the complex private capital landscape with greater potential for success.

Navigating the Exit-to-Investment Ratio Strategies & Outlook for in a Challenging Market

PE exit count

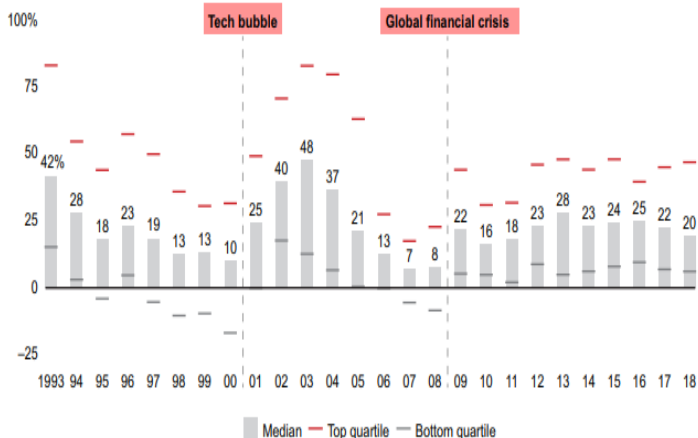


Source: PitchBook • Geography: US
*As of June 15, 2023

- **Exit-to-Investment Ratio:** The exit-to-investment ratio is a measure of the amount of money that private equity (PE) firms receive from exits, such as mergers and acquisitions (M&A) and initial public offerings (IPOs), relative to the amount of money they invest. The ratio has declined recently, reaching its lowest point since the 2009 Global Financial Crisis (chart on the left). Factors contributing to the decline in the exit-to-investment ratio are multifaceted. One such factor is the rising cost of debt, which increases the financial burden on firms seeking to finance investments. The economic slowdown and weakness in the IPO market have reduced business valuations, further exacerbating the situation. Each presents challenges by lengthening holding periods and moderating internal rates of return (IRRs). Nevertheless, firms are proactively adapting by implementing various strategies: 1) extending holding periods in anticipation of improved valuations. 2) employing innovative deal-making strategies, such as debt financing, joint ventures, and alternative structures, to facilitate transactions. 3) directing investments toward higher quality assets that exhibit reduced sensitivity to economic downturns.
- **Valuation Convergence:** For transaction volumes to normalize, buyers and sellers must find common ground and agree on an acceptable valuation. This requires open communication, negotiation, and a deep understanding of the underlying value drivers of the transacted business or asset. Various factors, including market conditions, industry dynamics, financial performance, growth prospects, and perceived risks, can influence valuation expectations. Buyers typically seek to acquire assets at a price that reflects their future earning potential and aligns with their investment criteria. On the other hand, sellers aim to maximize the value they receive for their assets.
- **Wellspring Expectations:** Given the ongoing uncertainty in the market, we expect the exit-to-investment ratio to remain muted in the near term. We also expect private equity firms to continue investing in quality businesses demonstrating resilience and growth potential. We see add-on and M&A activities as well as operational improvement as continuing to transform the business. In addition, recruitment of new talent, and implementation of best practices, which have historically yielded above-average organic growth, remain in motion.

Private Assets' Resilience & Growth Amid Economic Shifts

Global buyout deal IRR by year of entry



Notes: Includes fully and partially realized deals; all figures calculated in US dollars; post-2018 data not shown, as most deals entered later than 2018 are still unrealized
Source: DealEdge powered by CEPRES data (as of December 22, 2022)

- Private Assets Resilience:** History has shown that private assets are resilient in volatile markets. As the chart on the left shows, private equity buyout funds posted positive IRRs even around periods of increased volatility and stress, such as 2000 and 2008. We believe there are several reasons for this resilience.
 - Macro-integrated decision-making:** By blending macroeconomic and industry-specific insights, managers can identify assets likely to outperform in challenging environments. For example, a manager might invest in a company well-positioned to benefit from a particular government policy or economic trend.
 - Proactive asset management:** Managers who proactively run their operations can often pick up market share and improve profitability through strategic decisions and financial support.
 - Adversity-driven expansion:** Managers can seek to expand businesses and capture new market opportunities in anticipation of when conditions improve, leading to significant long-term growth.
- Wellspring seeks to partner with Fund managers looking to transform companies through operational improvements and growth initiatives versus financial engineering. These improvements may include:
 - Cost reduction:** helping companies identify and eliminate unnecessary costs. This can be done through various methods, such as negotiating better contracts with suppliers, streamlining operations, and reducing headcount.
 - Revenue growth:** helping companies grow their revenue by expanding into new markets, developing new products or services, or improving their marketing and sales strategies.
 - Productivity improvement:** helping companies improve productivity by investing in new technologies, training employees, and streamlining processes.
 - Risk management:** helping companies improve risk management by implementing new policies and procedures and better monitoring their risk exposure.
 - Governance:** helping companies improve their governance by strengthening their board of directors, implementing new controls, and improving transparency.
 - Culture:** helping companies improve their culture by creating a more focused, results-oriented, and entrepreneurial environment.

Real Estate Fundraising in a 'Higher for Longer' Market

Real estate fundraising activity



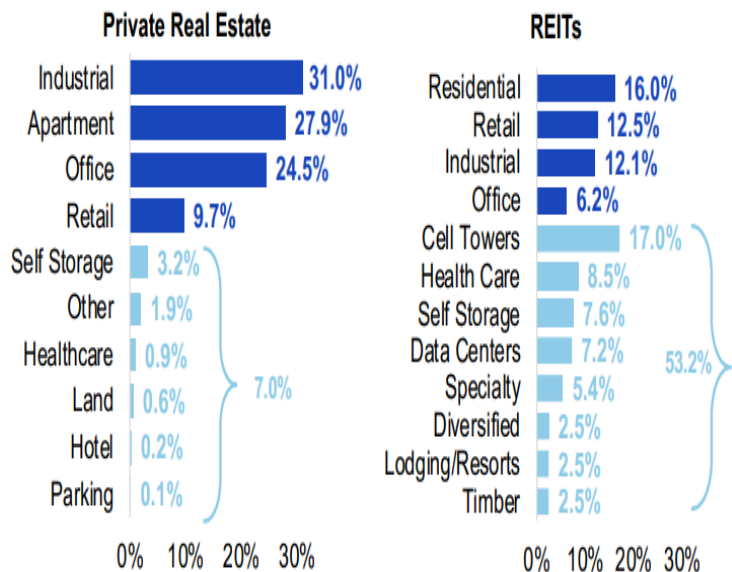
Source: PitchBook | Geography: Global
*As of December 31, 2022

- **Higher for Longer:** The private real estate market faced a challenging year in 2022, which continues in 2023, as higher interest rates and inflation weigh on activity. Fundraising and dry powder levels both declined while sector performance diverged. Fundraising fell by 28.4% to \$128.6 billion in 2022 (chart on the left), driven by interest rate hikes and inflation concerns. This was the most significant decline in fundraising since 2009. Dry powder levels, or the amount of capital available to be invested, fell by just 13.0% from \$486 billion to \$423 billion between 2021 and 2022, suggesting that investors are still interested in real estate but are being more selective about where they invest.
- **Concentration Trend:** Experienced managers secured 79.2% of 2022 total capital, reflecting a growing hesitancy by LPs to fund new construction projects. LP capital was primarily allocated to funds with over \$1 billion in AUM.
- **Performance Divergence:** Private real estate reported a positive IRR of 0.5% in 2022, while public real estate suffered a negative 27.9% decline. Publicly traded real estate investment trusts mark their assets to market daily, meaning their share prices reflect the current market value of their underlying assets, even if those assets have not actually been sold. Private real estate, on the other hand, is not required to mark its assets to market. This means that the value of private real estate assets can and often does lag behind the market by several quarters, as GPs may be reluctant to sell assets at a loss.
- **Wellspring Conclusion:** The "higher for longer" narrative suggests that interest rates and inflation might remain elevated until the Fed cuts rates. This could potentially suppress private real estate investments further. The preference for larger funds implies that small and mid-sized managers may face liquidity challenges. The disparity in vacancy rates between different asset categories suggests that some assets, like industrial properties, might become more coveted due to their low vacancy. At the same time, offices may remain under pressure due to higher vacancies. Established strategies with experienced managers might offer solace, but caution is warranted, particularly when considering specific niche strategies.

Navigating Real Estate

Public Declines, Private Redemption & Diversification

Property Sector Diversification



Source: NCREIF Open End Diversified Core Equity ending market value as of Q2 2022 via NCREIF; FTSE Nareit All Equity Index, equity market capitalization as of June 30, 2022 via Factset.

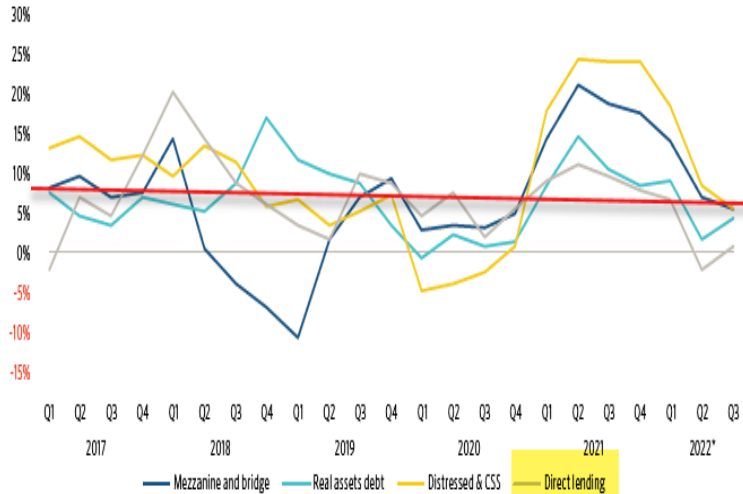
- Public Real Estate Turbulence:** The public real estate market experienced significant volatility in 2022, with the FTSE Nareit All Equity REITs Index declining -27.9%. Office REITs were the hardest hit segment of the index, with the FTSE Nareit Office REITs Index declining 37.6% for the year. This decline was mainly due to the shift to remote work, which has led to lower demand for office space. Apartment REITs also saw significant declines in 2022, with the FTSE Nareit Apartment REITs Index declining -32.0%. This decline was driven by rising rents and interest rates, making it more expensive for renters to afford apartments. Other sectors performed relatively well despite the overall negative sentiment. Storage, Data Centers, *Cell Towers*, and Healthcare have each experienced strong demand in recent years. The inelastic demand has helped insulate these properties from the broader market volatility.
- Redemption Requests:** In 2022, nontraded private REITs experienced a significant surge in redemption requests, reaching record levels. This was attributed to investor skepticism regarding the properties' valuations within these REITs. Investors expressed concerns about the accuracy of the property valuations and the potential impact on their investment returns. Nontraded REITs faced ~\$20 billion in unfulfilled withdrawal requests at the end of 2022. This unprecedented level of requests highlights the importance of transparency and accurate valuation practices. LPs rely on the valuation of properties within the REITs to assess the potential returns and risks associated with these investments. When there are doubts about the accuracy of the valuations, it undermines investor confidence and can lead to increased redemption requests.
- Wellspring Recommendation:** Investors should be aware of the risks associated with nontraded REITs and diligently evaluate the valuations of the underlying assets. Due to various factors, we expect the pricing gap between private and public real estate to narrow in 2024. Nontraded REITs may face ongoing challenges as investors demand greater transparency and accurate valuations. Publicly traded REITs will focus on sectors with inelastic demand and a clear path to profitability. Understanding the various sectors' demand drivers, potential risks, and profitability prospects is essential for making informed investment decisions.

Private Credit Dynamics

Capital Shifts, Lending Trends, and Risk Management

Private debt rolling one-year horizon IRR by type

One-year returns stay positive despite the rout in public markets



Source: PitchBook | Geography: Global
*As of June 30, 2022

- Emergence of Private Credit:** The private credit market is experiencing notable growth, driven by shifts in capital sourcing and a rise in direct lending funds. We believe the shift indicates a need for greater flexibility, customization, and resilience on the part of lenders.
- Direct Lending Appeal:** Direct lending funds offer floating-rate loans that attract investors in a rising interest-rate environment. These loans typically offer higher yields than fixed-rate loans, resulting in higher investor returns. In 2022, yields in the syndicated leveraged buyout (LBO) market reached an average of 9.9%. Direct lending funds, which also participate in this market, were able to secure similar or even higher yields leading to substantial current income for investors. The red line in the chart on the left shows the average yield from direct lending strategies over the past five years. As interest rates and inflation levels rise, we may see the average yield for direct lending strategies increase further. Firstly, these funds often lend to companies in more complex financial situations, which allows them to command higher interest rates. Secondly, direct lending funds have fewer regulatory constraints than traditional banks, enabling them to offer more flexible terms and negotiate higher yields.
- Covenant-Lite Influence:** Covenant-lite loans have reduced loan defaults and extended the timeline for a significant rise in credit defaults. These loans have less stringent financial and operational covenants than traditional loans and provide borrowers with more flexibility and fewer restrictions, allowing them to operate their businesses more freely. However, this also means lenders have less control over the borrower's financial performance and risk management practices. Wellspring partners with private credit managers who pay close attention to key credit metrics to gauge a borrower's ability to meet debt obligations and, importantly, successfully navigated both the 2000 and 2008 recessions.
- Wellspring Conclusion:** We believe private debt presents an attractive opportunity for clients looking to diversify their portfolios and access non-correlated cash flows. However, investors need to remain vigilant on default metrics, such as credit quality and debt service coverage ratios, and be able to assess individual managers' credit metrics. Thorough due diligence and credit risk monitoring of respective managers is crucial to mitigating potential risks associated with floating-rate loans.

Private Credit Dynamics

Risk, Return, and Leveraging Insights

	CAPITAL PRESERVATION STRATEGIES		RETURN-MAXIMIZING STRATEGIES		OPPORTUNISTIC AND NICHE STRATEGIES	
	SENIOR DEBT	MEZZANINE	CAPITAL APPRECIATION	DISTRESSED CREDIT	CREDIT OPPORTUNITIES	SPECIALTY FINANCE
Also Known As	Direct Lending	Subordinated Capital	Subordinated Capital, Structured Equity	Distressed Debt, Special Situations	Special Situations	Asset-Backed Finance, Esoteric Assets, NPL strategies
Strategy	Capital preservation through senior or stretch senior instruments with extensive creditor rights	Origination of par, performing junior debt	Origination of par, non-dilutive, private equity substitute capital in the form of junior debt, preferred, or structured equity	Purchase of "stressed" and distressed debt	Providing more complex financing arrangements	Structure or purchase of cash flow streams generated by either a physical or financial asset
Return Drivers	Coupon	Coupon	Equity gains, fees	Recovery in debt prices, interest payments, or restructurings	Interest income, original interest discount, and equity upside	Cash flow recovery or enhancement through active servicing
Targeted Fund-Level Returns (Gross IRR)	6%–10% (unlevered) 11%–15% (levered)	13%–17%	>15%	>15%	>15%	7%–20%
Investment Period (years)	2–3	4–5	4–5	2–3	2–4	2–4
Term of Fund (years)	5–8	8–10	8–10	6–10	5–7	5–8
Competition	Intense competition from other direct lenders, CLOs, and some hedge funds	Stiff competition in covering private equity sponsors	Less competition than traditional mezzanine as the unsponsored market is much larger than the sponsored	High level of competition from hedge funds and credit ops funds	Competition varies but is highest in "crowded trades" that attract disparate pools of capital, like, most recently, shipping	Generally limited competition but with some "crowded trades"
Funds' Ability to Influence Restructuring Process	Influence correlates with control. Fewer lenders mean greater control and greater influence. More lenders means less influence	In distress, mezzanine funds must pick sides, by aligning either with equity or with the senior lenders	Capital appreciation providers can assume control of a company in distress if necessary	Can be very high and is frequently part of the manager's strategy	Similar to that of distressed credit managers and capital appreciation strategies	Don't typically seek to influence

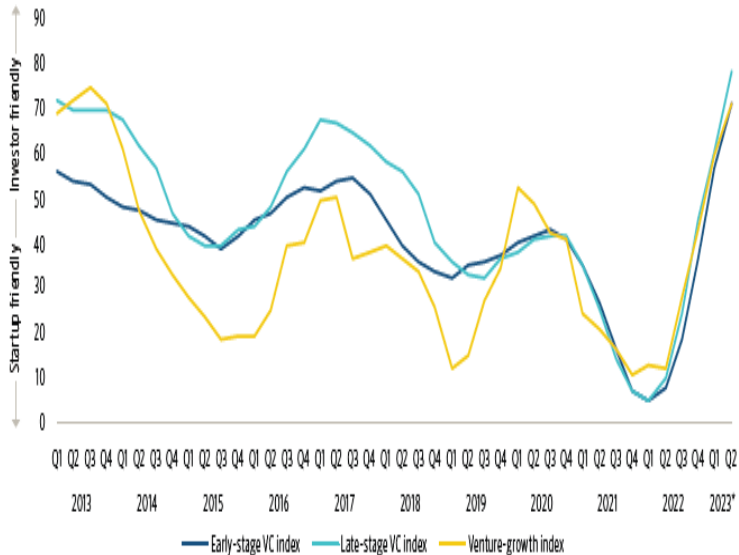
Source: Cambridge Associates LLC

- Different types of Leverage:** In its simplest form, leverage refers to using borrowed funds to finance an investment. However, the definition and application of leverage can vary significantly among investment managers. There is no one-size-fits-all approach to defining and utilizing leverage in investment strategies. For some managers, leverage may only include long-term debt, such as bonds or loans. This type of leverage is typically used to finance long-term projects or acquisitions. Other managers may have a broader definition of leverage, which includes short-term borrowings or off-balance sheet financing. These types of leverage may provide more flexibility in managing liquidity and capital requirements.
- The criteria to calculate leverage ratios and the specific types of debt considered can also vary among managers. Some managers may focus on traditional financial ratios, such as debt-to-equity or debt-to-assets ratios, while others may use more complex metrics tailored to their specific investment strategies. The choice of metrics depends on the manager's risk appetite, investment objectives, and regulatory requirements. While some managers may prioritize maximizing flexibility and potential returns, others prioritize safety and take a more conservative approach to leverage. These managers focus on maintaining a low level of debt and may be more selective in their borrowing activities.
- The chart on the left highlights different credit strategies and their respective risk and return profiles. It serves as a helpful tool for investors in understanding the varying approaches to leverage among different managers. It provides insights into the trade-offs between risk and return associated with varying credit strategies.
- Wellspring limits client exposure to capital preservation strategies (highlighted in yellow) and focuses almost exclusively on managers who invest in senior secured debt, with targeted levered returns of 11-15%.

Shifts in the Venture Landscape

Investor-Friendly Environment Amid Valuation Changes

US venture market has turned the most investor friendly in nearly a decade
 VC Dealmaking Indicator by quarter



Source: PitchBook • Geography: US
 *As of June 30, 2023

- Shift in Venture Landscape:** Pitchbook's VC Dealmaking Indicator, shown in the chart on the left, indicates that the current venture market is the **"most investor-friendly"** in nearly a decade. In an investor-friendly environment, the terms of the deal tend to favor the investors rather than the entrepreneurs. This means that investors have more protection for their capital and greater control over the startup. In an investor-friendly deal, the startup's valuation may be lower as investors seek to mitigate risk. Additionally, there may be more restrictions and provisions that protect the investors' interests. These provisions can include liquidation preferences, which ensure that investors receive their investment back before other stakeholders in the event of a liquidation. Anti-dilution provisions may also protect investors from diluting their ownership stake if the company raises additional funding at a lower valuation. Furthermore, investor-friendly terms may include more rigid governance requirements, giving investors a more significant say in the decision-making process of the startup. These provisions are implemented to protect the investors' capital and reduce the perceived risk associated with the investment. An investor-friendly deal is common in a tighter capital market, where funding is scarce, or when the startup is perceived as riskier. In such situations, investors have more negotiation leverage to maximize their control and investment protection.
- A startup-friendly environment** is characterized by terms that favor the entrepreneur. In such an environment, the startup's valuation tends to be higher, and there are fewer restrictions and onerous provisions. Startups have greater operational freedom and flexibility to pursue their growth strategies. A startup-friendly climate is often seen when capital is abundant, and investors compete to invest in high-potential deals. In this scenario, entrepreneurs have more negotiation leverage and can secure favorable startup terms.
- Wellspring's Recommendation:** When investing in venture capital, the more "investor-friendly" the market, the better. Wellspring considers it prudent to diversify investments across top-quartile managers. These managers have a track record of success and are known for their ability to identify quality opportunities and drive outsized growth. Top-quartile managers prioritize unique ideas and business models with a clear path to the market. They seek startups that have the potential to disrupt industries and create significant value for investors. These managers understand the importance of adaptability and innovation in an ever-changing market environment.

Late-Stage Startup Dynamics

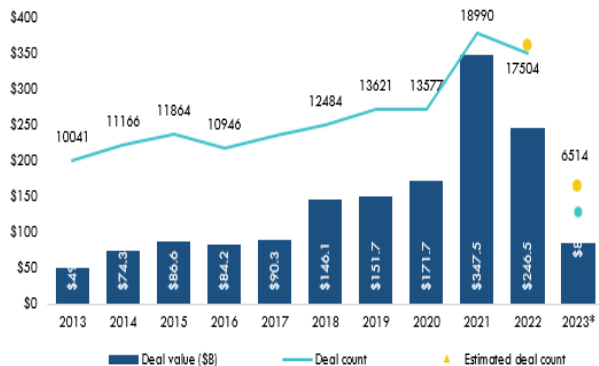
Exits, Acquisitions, & IPOs

US VC deal activity

	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023*
Deal value (\$B)	\$49.6	\$74.3	\$86.6	\$84.2	\$90.3	\$146.1	\$151.7	\$171.7	\$347.5	\$246.53	\$85.64
Deal count	10041	11166	11864	10946	11792	12484	13621	13577	18990	17504	6514
Estimated deal count										582	1681
Actual + estimated deal count										18086	8195
Angel and seed	4551	5232	5733	5179	5399	5527	6016	6046	7980	7090	2233
Early-stage VC	3288	3440	3525	3231	3543	3657	3749	3516	5393	5108	1942
Late-stage VC	1705	1942	2087	2040	2313	2674	3167	3268	4639	4448	1930
Venture growth	497	552	519	496	537	626	689	747	978	858	409

Angel and seed	45.3%	46.9%	48.3%	47.3%	45.8%	44.3%	44.2%	44.5%	42.0%	40.5%	34.3%
Early-stage VC	32.7%	30.8%	29.7%	29.5%	30.0%	29.3%	27.5%	25.9%	28.4%	29.2%	29.8%
Late-stage VC	17.0%	17.4%	17.6%	18.6%	19.6%	21.4%	23.3%	24.1%	24.4%	25.4%	29.6%
Venture growth	4.9%	4.9%	4.4%	4.5%	4.6%	5.0%	5.1%	5.5%	5.2%	4.9%	6.3%

*As of 6/30/2023



- The Shifting Exit Landscape for Late-Stage Startups:** The exit landscape for late-stage startups has experienced a notable shift. In the first half of 2023, there has been a relatively low exit activity, with deal activity amounting to \$85.6 billion. This figure represents a decline of 30.5% compared to the first half of 2022 and a significant drop of 50.7% in the same period in 2021.
- Wellspring's Recommendation:** To properly manage risk, we recommend diversifying venture investments across numerous sectors and developmental stages, spreading risk, and lessening the impact of any single investment not performing as expected. Investing in a portfolio of companies at different stages of development and in different sectors increases the chances of successful investments offsetting any potential losses.
- It is also important to be realistic when evaluating potential investment growth trajectories. As indicated by data from the U.S. Bureau of Labor Statistics, the high failure rate of new businesses highlights the importance of being cautious when investing in startups. Approximately 20% of new businesses fail within the first two years, 45% within the first five years, and 65% within the first ten years. This means that the pool of companies with the potential for exponential growth is already significantly reduced due to these high failure rates. Companies and managers that project exponential growth, known as "hockey stick" growth, should be viewed skeptically. While exponential growth is possible, it is rare and achieved by only a few startups. According to CB Insights, less than 1.0% of all startups become "unicorns" or private companies valued at \$1 billion or more, often considered a proxy for exponential growth.
- By avoiding companies dependent on unrealistic growth projections and focusing on platforms with a clear exit path, broad diversification, and a realistic understanding of growth potential, Wellspring believes clients are best positioned to succeed in venture capital.

Risks and Disclosures

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