TRAilblazing

A Parallaxes Capital Podcast

S01 E06 – Competitive Advantage: Parallaxes is Redefining the TRA Market (March 20, 2024)

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 Host – Saish Setty

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Welcome to TRAilblazing: capitalizing on Tax Receivable Agreements. A Parallaxes Capital podcast that is here to guide you through the world of tax receivable agreements. It's time for TRAilblazing.

Intro – 00:13

Welcome to another episode of TRAilblazing. In today's episode, we'll discuss the barriers to entry in the space and shed a little light on the secrets behind Parallaxes' competitive advantage and how we're carving out a unique position in the market. Today, you'll have myself, Saish Setty GC of Parallaxes, along with Andy Lee, our CIO, for what I'm sure will be a great conversation. Now, the motivating factor behind this podcast is the fact that a common question we get from stakeholders is, well, what sets Parallaxes apart? Why haven't there been more dedicated competitors coming into the space? There are probably five major reasons as to why substantial competition has not yet encroached on the space– at least not just yet. And I'll let Andy kick it off with the first one.

What sets Parallaxes apart – 01:05

Absolutely. So number one, that's around domain expertise. I don't think you see many of the best and the brightest coming out of school saying, I want to be a master of the universe and I want to do it in tax. Many deal professionals hear the word tax and literally run away. Unfortunately, from the tax world, many are incredibly familiar with tax code, but often struggle to translate it into English. I would say many deal professionals viewed that annual tax filing obligations in April to be worse than going to the dentist.

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01:36

It gets kind of offensive to all of our friends that are dentists and hopefully not too many of them listening into this. But that does ties in a bit to the next point, which is the duration of the underlying opportunity. Now, if you said that TRAs were a one-year piece of paper, sure, then there's likely a host of firms that would field a competitor, but these are long-duration assets, many private credit vehicles, for example, that would target this opportunity if they could, have five to seven-year lives associated with them. And for a little bit of context, Parallaxes' first fund was actually a 21-year vehicle.

02:17

Just as an aside when I know I look really young as an Asian American, but we definitely got the question if I was even 21 when we went out to raise our first fund.

02:25

That's great. I'm glad we actually do the video version of the podcast, highlight that point too. But just to close off this point, I mean TRAs, these are long duration assets and it could be challenging for a lot of parties to even hold these assets. And maybe, Andy, do you want to touch on return expectations? The third point?

Return expectations – 02:44

Absolutely. If you said this was an asset class that knocked out 40, 50% of returns, we would expect significant competition in this space. People would solve the duration issue. They would learn and educate themselves around the domain expertise required to play in the space. Unfortunately, the returns in the space are significantly more muted given the long duration nature of the cash flows. These cash flows are being compounded for a very long duration. And at such a high clip, if you were compounding at 40 or 50%, you would be delivering the seller cents on the dollar, let's call it sub 10 cents. And at which point of time, is there really a transaction to be done?

03:21

Yeah, definitely. And then to move into the fourth point, it's really the go to market motion here, which is driven by the lack of brokers. Now, go to market here is very challenging as this is not an intermediated space. Transactions often require one-on-one outreach. And from the broker's perspective, well how do they actually get paid? They're typically getting a commission based on the sale price. So they either want high sale prices and ideally frequent sales, or at least one of those two. And when you think about how TRA transactions operate, we're often like the parallel of a vitamin versus a painkiller. So Andy, let's say you wake up with a splitting headache, you'll immediately grab for a bottle of Advil or something like that. But you probably know that taking fish oil or something like that is good for you. You'll just never have the same urgency to do so. Like, nobody really wakes up and isn't a mad dash to grab their Flintstones vitamins.

04:25

I dunno. Those are pretty damn delicious.

04:27

I guess maybe we can exclude those gummy vitamins from this part of the analogy. But I mean, TRA sales are similar to the vitamins here. These are nice to have for a lot of sellers, but there's often not a clear catalyst for a seller to transact, and this can result in infrequent or unpredictable sales. And that further compounds the challenges for the broker community. Now, this also ties into the next point, and that's the size of these transactions. They just might not make sense for a broker who's typically compensated with fees that are tied to the transaction value of a deal. Andy, do you want to maybe speak to the size of the opportunities?

Size of TRA opportunities – 05:13

Absolutely. The size of each individual transaction that we found historically across the seven years that we've been in this space is about $4 million on average. So, that's primarily driven by the fragmentation of the TRA holder base that we are engaging with. Whereby, your counterpart at holder in a TRA, Saish, might sell, but you might for one idiosyncratic reason or another, hold onto the underlying asset, which makes this an incredibly challenging opportunity set to scale in earnest. So that was number five. I would suggest a sixth: I'd like to share in that regard, working to lay out in the next part of the discussion, our right to win as a firm, and that we are the sixth bearer to entry in this space.

05:55

Yeah, definitely. And hey, at Parallaxes, we do like to say that no advantage lasts forever. With enough time and money, any advantage can be overcome. Despite that, the challenge that we've set forth for our stakeholders is to build a long and durable competitive advantage that'll stand the test of time. And maybe one of the first prongs on that front is our track record. Andy, do you want to speak to that a little?

IRR – 06:21

Absolutely. So I'm going to hit this quickly. We have been able to achieve a 19% realized and substantially realized gross IRR, which translates into a 15% net IRR since inception through February of 2024. And what we mean here by realized investments are ones that are fully paid off and by substantially realized, we're looking at investments that are north of a 0.5 times DPI, and we also include another investment that is an oil flow services business.

DPI – 06:50

Definitely. And there was a Bloomberg piece earlier this year that sported, the title of DPI is the new IRR, and we're proud to share that over our existence. Parallaxes is close to returning almost a one times MOIC on all the capital that we've ever deployed across our funds and co-investment vehicles of our flagship vehicles, three out of four of our existing funds have at this point returned the majority of their capital to their investors. And our fourth fund, which is actually a 2023 vintage, has already returned over 35% of its capital to investors as of the end of February. Moving into the second point, it's really coming back to our portfolio. Our portfolio is unique. It can't be easily replicated by new entrants at this point. We've acquired stakes in over 20 companies since our inception. And with that, there's no significant industry concentration across our portfolio.

TRA administration – 07:54

All but two of our TRA issuers are publicly traded. And looking at this group as a whole, there's a weighted average EBITDA of about 1.2 billion and a weighted average enterprise value of 7.4 billion. Our portfolio has an attachment point of 25% of LTV and a 2.2 times total leverage level or a 1.5 times net leverage level and a median 4.8 times interest coverage ratio. And in each case, these figures for EBITDA enterprise value leverage, these are all weighted based on the undiscounted principal balance of each of those positions. Meanwhile, in terms of credit quality, about 16% of our portfolio has no significant debt, and about 27% are double B rated. And in each case, these figures are based on our estimates of the net present value of the relevant TRAs. Now, taken together portfolio. We have established positions with embedded call optionality that allow us to increase our investment in various TRAs. As a result of some of these toehold or smaller positions, we're actually able to begin building a dialogue with the company itself and provide them perspective as to what best in class TRA administration reporting, what any of those things might look like. In time, we develop a very trusted relationship with the company itself and are just better equipped to transact in the future. And Andy, the third point here, pre-underwriting the universe, you want to give our listeners a little bit of that?

Pre-underwriting – 09:35

Absolutely. We're looking to start on third base versus starting on the home plate in so far that as we think about the various options that we're pursuing across all 150 plus existing TRAs that are out there, we have from a credit perspective, developed 40 to 60-page memos on every single name. And we've been endeavoring to do that from a credit legal and tax perspective.

09:59

Yeah, so on the legal side, we've prepared initial legal diligence memos for nearly all of what we view to be the investible universe of TRAs. And these memos, they summarize, highlight the key terms and conditions of the TRA, which ultimately does inform deal pricing and structuring. And as Andy alluded to, we're hard at work undertaking a similar exercise on the tax diligence front to refine our approach to estimating projected taxable income and the utilization of TRA collateral. To Andy's point, I mean pre underwriting the universe enables us to deliver greater speed and certainty of execution for TRA sellers. With a cooperative seller and a cooperative company, we can actually close on a transaction in as quickly as two weeks given all of the pre-work that we've done and completed for many TRAs. And how about the fourth prong Andy, like our team?

10:56

Absolutely. So we have a dedicated team. We with a singular focus of owning the opportunity set. We're incredibly proud of the small but mighty team that we've built who come from a diverse array of backgrounds. We like to refer to a page from the Immortal Bear, Stearns Memos from the chairman, highly recommended reading for our listeners, but we seek to recruit for individuals with what they call PSDs all poor, smart, and a desperate desire to be rich. We've built a dedicated go-to-market team and established coverage efforts to help mitigate the impact of the J curves through our LPs.

Obsession with TRAs – 11:31

Yeah, and Andy, I think you lead by example here by having, I think on average, what, 32 or more external discussions on a weekly basis. And I think a lot of our LPs have actually commented on this similar fact that we have unique founder market fit. I mean, Andy, you're obsessed with this space. I think your 2:00 AM Gchat messages are a common occurrence, and I think a lot of our friends and investors have described your obsession with the space. And maybe to put it politely as batshit crazy.

Recruiting – 12:01

That's a new one. Look, I like to refer to a blog post dot. Sam Altman of OpenAI has shared, it's called, “What I Wish Someone Had Told Me”, number one on around that list was optimism, obsession, self-belief, raw horsepower, and personal connections are how things get started. That was likely the case for the first five years of Parallaxes. Sam's second point was the one that hit me hard, that being cohesive teams, the right combination of calmness and urgency, and an unreasonable commitment are how things get finished. And to that end, we've brought together a number of talented individuals like yourself alongside us for this journey. We're looking to supplement the team as we migrate from generalist to specialists and roles that we're looking for include a kick-ass tax director, a bomb senior counsel, and business development ninjas among others to help supplement our efforts. Look, we've led the industry in redefining the TRA market by shutting what was previously a one-sided argument as to the efficacy of the product. We've educated the media that TRAs bring significant value to the ecosystem and which has resulted in features in quotes and publications, including the Wall Street Journal, Bloomberg Institutional Investors, Forbes, and for the Financial Times.

13:15

And we continue to be a thought leader in this space, or at least try to be with the publication of our annual white paper there. We work to educate the broader community on Tax Receivable Agreements, where the market is going, frankly, where we'd like to see the market going. We also love to put out our TRA league tables where we highlight the amazing law and accounting firms that are focused on TRAs. And I mean, as our listeners who probably know, we also launched this podcast that's focused exclusively on TRAs

13:46

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Cost of capital – 13:50

Yeah, seriously. And on the sixth point, this is just an advantage cost of capital. Unsurprisingly, we're extremely focused on our cost of capital. We previously had a financing facility with a large bank, which we've since paid off, and we've been able to create avenues that'll hopefully allow us to achieve an investment-grade rating for our debt, and we expect to approach the public securitization markets. Recently, we've seen a rated paper price at a bit over T plus 200 BPS, and we'd probably expect our paper to price a bit wide of that, given the esoteric nature of our asset class.

14:28

Work harder, Saish. We need to grind that down.

14:31

I'm trying my best. But alongside that focus on cost of capital, Andy, I know you have some plans for our fee structure as well.

Fee structure – 14:39

Look, we're trying to drive alignment with our investors in the way that we only want to get paid when they get paid. So today, we're actively seeking to mitigate the upfront fee drag from our credit vehicles. So today we charge a one and a half and 20 to our investors, and we're looking to migrate that to a zero and 30. The first amount, the one and a half, refers to a management fee, which is an annual fee, typically paid on commitments, whereas the 20% refers to a performance fee, which is generally charged only on profits generated by the company. So, we would like to be more so compensated out of the performance fee. And in our instance, we'll only get paid whenever our investors get paid.

15:21

And this might sound odd to a lot of our listeners, I'm sure in the investment management business, there are a lot of folks that seek to maximize fee revenue. And this is probably especially true of publicly traded investment managers. Since public market investors generally crave the predictability of those management fee revenue streams that tend to be a lot more predictable. And when you see this in practice, KKR, Carlisle, for example, believe they recently raised funds from retail investors that had a 2% management fee, but no carried interest whatsoever.

Management fee vs Carry – 15:59

I remember meeting with the founder of a publicly traded private equity firm, and when I shared that I was excited to finally get to carry a legacy and Lone Star funds that I had participated in, he said, you are so young—
—it's all about the management fee, carry, that's fool's Gold. That deeply shaped my perception as to how private equity firms think about performance. We're actively as a firm, Parallaxes, are swimming in a different direction, what many are seeking out there as a firm. Parallaxes is the plural of the word parallax, which is an astronomy term to look at an object at a different angle, arriving at a different vantage point. And for us, we look at problems from a different angle to arrive at a different solution set. Parallaxes was named to convey our mission as to what we're building people here to work tax and inherently think brain damage, and that the speaker probably doesn't speak English or speak it well. We're here to change that. Taking a very different view that tax is innovative, forward leaning, and most importantly commercial. Many are focused on the here and now. Parallax is focused on being long-term. We're missionaries, not mercenaries, and our jobs are to be stewards of the industry.

17:12

Amazing, and thanks, Andy. And thanks to all of our listeners to tuning into today's episode. Don't forget to hit that subscribe button. Please stay updated on future episodes and your support means the world to us.

17:24

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Further Reading

DPI – 06:50

DPI is the new IRR