North Sky CAPITAL

Third Quarter 2020

Quote of the Quarter

"When you are going through hell, keep going."

— Winston Churchill

From Dark to Light

Overview

- **Introduction**
- **Current Market Conditions**
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- **We are moving our MN office, other North Sky news**

Intro – We're Gonna Get Through This

When we wrote our Q1 commentary, we were in the early phase of a virus lockdown, the S&P 500 index had lost one-third of its value and Saudi Arabia and Russia were jostling in an oil price war. Six months later, the S&P 500 index has regained all that ground, many states have re-opened for business, school is beginning and we are talking about new peace agreements in the middle east that almost no one saw coming. Quite a turnaround in many regards.

That said, the remainder of the year looks like anything but smooth sailing. We still have pandemic concerns, big tech stocks have had quite a run and seem over-valued (see data below), the West Coast is ablaze, we have riots and looting in our cities, a Supreme Court seat is open and it is a raucous Presidential election year. Given the events year to date, the October surprises could be biblical. As Samuel L. Jackson said in Jurassic Park, "Hold onto your butts."

Ticker	6 Month Performance	P/E
AAPL	+79%	35
AMZN	+61%	122
MSFT	+31%	36
GOOG	+26%	33
FB	+57%	31
TSLA	+300%	1,096

Data as of market close on 9/29/20

We were more active than normal at North Sky this summer. Uncertain times lead to new opportunities, and we were sourcing and analyzing a wide variety of interesting investment opportunities all summer long (more on this below). Given the above chart, we fielded many inquiries in Q3 from investors who were selling public equities and seeking lower-volatility, longer-duration assets where they could ride out 2020 and beyond. We also received inquiries from investors looking to make their first impact investments and seeking an experienced team to help them do so. There have been a lot of those "first time" requests over the last two years.

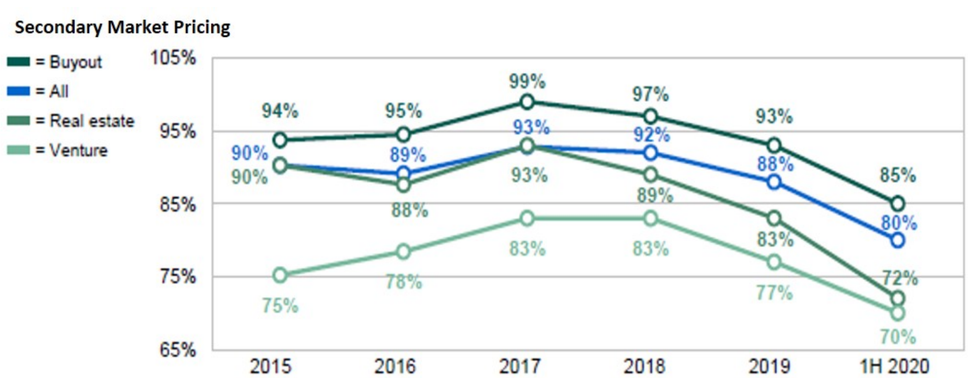
To be sure, there is much to contemplate when making investments today—economics, technology, demographics, politics and more. It seems 2020 has been a highly unusual year, and many people have been operating outside of their comfort zones throughout it. But a return to normalcy seems around the corner. The storm clouds will pass. We will move from dark to light…just not until we get to the other side of this election. Until then, North Sky Capital will keep taking advantage of market dislocation in the impact secondaries market, positive trends in areas like renewable natural gas and community solar for our sustainable infrastructure funds and our proven ability to find opportunity in under-served markets in both good times and bad. Although the news headlines seem chaotic, let's continue working to make the world a better place. Through perseverance, focus on our mission and kindness in word and deed, we will get through these trying times together.

Current Market Conditions

Impact Secondaries

Our impact secondaries funds invest across a broad spectrum of sustainability sectors, such as renewable energy, electric vehicles, healthy food & beverages, indoor ag, wetlands mitigation, healthcare, energy storage, energy efficiency, waste reduction and more. There are several themes worth noting:

- **COVID Disrupted Secondaries Market in 1H20.** Secondaries deal activity was significantly interrupted in the first half of the year. Greenhill reported a 57% decline in activity during the first half as the bid/ask spreads remained too wide to translate into an influx of new deal volume. Total secondary volume decreased to $18 billion in 1H20, the lowest level since 1H16. Additionally, the average high bid across all strategies fell 800 basis points from yearend 2019 to 80% of net asset value (see rolling bid chart from Greenhill below).



  As businesses have begun to reopen, we have seen the market for secondaries pick up steam. We observed a sharp uptick in secondaries deal flow in early August, which we attribute to asset prices having been revalued somewhat and buyers and sellers again finding common ground regarding transaction prices. We expect the second half of the year will make up most of, if not all, the lost ground from the first half.

- **But Secondaries Fundraising Continued to Surge.** While transaction volume slowed in 1H20, fundraising did not as investors turned to secondaries as part of a broader shift towards special situation strategies following the COVID market disruptions in March and April. According to Preqin's First Half Secondaries report, new secondaries funds raised approximately $44 billion in the first half of 2020, with nearly 82% of that amount going to the three largest funds in the market. Big funds typically write big checks (e.g., hundreds of millions of dollars) to efficiently put their capital to work. Large transactions tend to be intermediated on both sides, which leads to highly competitive processes that are typically priced to perfection. At this upper end of the spectrum, leverage is regularly used to get returns to pencil, syndicates are increasingly common and deal structures are constantly evolving to create differentiation among buyers. By contrast, the impact secondaries market, where we focus, represents a tiny fraction of the overall secondaries market. Smaller deal sizes (<$50 million) in impact secondaries limits interest from intermediaries and larger funds, neither of which can be bothered with small, cumbersome transactions. As a result, transaction dynamics are typically healthier and pricing more rational. Despite the surge in fundraising in traditional secondaries, the impact secondary market has remained essentially unchanged since we first entered it in 2013. Sourcing attractive opportunities in an idiosyncratic market like impact secondaries requires a proactive approach and in this niche we benefit from our extensive network of GPs, LPs, consultants, brokers, bankers, lawyers and accountants built up over the past 20 years.

- **Broadening Secondaries Tool Kit.** There is a WIDE variety of transaction types available within the secondaries marketplace. Just a few years ago the market was dominated by what is referred to as a **traditional secondary**: the purchase of a limited partnership interest in an existing fund. As competition at the upper end of the market has increased, so have the types of structures used by secondary funds. Secondary managers turned to **GP-led fund restructurings** whereby a secondary manager offers a fund's existing limited partners the option either to immediately cash out or to roll their investment into a new special purpose vehicle sponsored by the secondary fund. Typically, in the new SPV, the GP's economic incentives are reset, the exit timeline is extended and additional capital is made available to support the portfolio. Next came **single asset restructurings**, an offshoot of the GP-led restructurings, whereby secondary funds purchase an equity or debt position in a company with or without the ongoing support of the general partner. More recently, there has been a proliferation of **preferred equity financings**, which can occur either at the fund or limited partner level. In such financings, the secondary fund provides capital and in return receives a preferred share of future cash flows from a defined pool of assets. General partners like this structure when their portfolio needs a little more growth capital and time to mature but capital commitments from LPs have been fully drawn. On the other hand, a big institutional investor may use this type of structure when it does not want to fund more capital commitments but also does not want to walk away entirely from the investments. There are often bureaucratic reasons for doing this such as a shift in allocations away from private equity or a short-term cash shortage. The main benefit of the structure is the parties to the transaction don't need to agree on the current value of the assets, just a framework on how to share proceeds when the assets are sold in the future.

- **SPAC Attack.** We would be remiss not to mention one of the hottest topics in the public and private markets, **special purpose acquisition companies** ("SPACs"). These blank check acquisition companies develop an investment thesis, raise capital through an IPO and then search for and hope to acquire a privately held company. Approximately $40 billion has been raised so far in 2020 for 101 SPAC vehicles. Following the high profile acquisition of Nikola Motors by a SPAC earlier this year, there has been heightened interest in both sustainability-themed SPACs and impact companies seeking to get acquired by SPACs as a fast-track to the public markets that avoids the expensive and cumbersome parts of the traditional IPO process. In certain circumstances, we believe this can be a win-win proposition for private market investors (quicker monetization of their investment vs a traditional IPO) and public investors (more investment opportunities with no investment minimums and freely tradable). But not all SPACs are created equal and not all companies seeking to be acquired by a SPAC are ready to be public companies. Caveat emptor!

Sustainable Infrastructure

Our sustainable infrastructure strategy focuses on investments in clean energy, waste and water projects in the United States. Overall these markets held steady in the third quarter, as market participants acclimated to the new normal of low interest rates for the foreseeable future, business development activities with social distancing protocols and relatively stable energy prices compared to the steep decline and sharp recovery from March to June.

- **Consistent Performance Across North Sky Portfolio.** Our portfolio performed well in the third quarter. Our existing operating assets achieved at or near their budgeted results in Q3, in large part due to the strength of the counterparties/off-takers we have selected for our projects. We have almost no exposure to commercial or residential real estate risk within our portfolio. Energy and water infrastructure remain essential industries per federal and state COVID guidelines, and we are happy to report that none of our sites experienced a workplace interruption. Furthermore, we achieved important construction milestones on several East Coast solar projects and agreed to purchase a hydroelectric plant as a bolt-on acquisition to our hydro portfolio. Exit discussions on certain operating assets in our portfolio advanced in Q3, and we expect some to close in Q4 as buyers seek to fulfill their annual capital deployment targets.

- **Focus on Renewable Fuels.** In the current marketplace, we see particularly favorable conditions for making renewable fuels investments. Often overshadowed by the larger number of deals and people employed by the solar and wind sectors, renewable fuel opportunities have been bolstered recently by the December 2019 five-year extension of the biodiesel tax credit, and regulatory clarification of the California Low Carbon Fuel Standard in June 2020. Earlier this quarter, major fuels companies including Exxon, Phillips66 and Marathon all announced big renewable fuels projects or retrofits in California. North Sky is one of the few private equity teams with firsthand experience investing in renewable fuels facilities, and we anticipate making further investments into this burgeoning sector.

- **Progress in Opportunity Zones.** In Q3, we continued our sustainable infrastructure investment efforts within opportunity zones, which deliver a triple bottom line to investors: the potential for strong investment returns, high environmental and social impact and capital gains tax benefits. In stark contrast to the gentrification complaints arising from opportunity zone transactions done by real estate developers earlier this year, our infrastructure strategy has received very positive feedback from state and local administrators for embracing the intent of the opportunity zone legislation.

- **Looking Ahead.** The Presidential election is looming, and in our next report we will discuss what the outcome means for infrastructure investing. In that report we will also share our thoughts on the possibility of an investment tax credit extension and COVID's impact on the availability of tax equity for infrastructure projects. It is worth remembering that this sector has continuously expanded for over 15 years through every possible combination of political parties controlling the executive and legislative branches of government. The current framework for renewable energy was cast in 2005, with the passage of the Energy Policy Act. Renewables have seen steady growth ever since. Last year, energy consumed from renewable sources surpassed energy from coal for the first time in 130 years, and just a few days ago, the Governor of California pledged to ban all sales of new gasoline-powered vehicles by 2035. Recently, a longtime oil and gas investor inquired about deploying capital into sustainable energy. When asked why, he replied, "This green thing ain't goin' away." We agree.

Conclusion

While the dynamic and rapidly evolving backdrop demands attention and thoughtful strategy, experienced investors should be able to benefit from tailwinds that emerge out of longer-term secular trends that favor impact/ESG investments today. We are well positioned to do just that in the impact secondaries and sustainable infrastructure markets.

North Sky News

- After more than 20 years downtown, we will be moving North Sky's headquarters on December 1 from Minneapolis to 701 East Lake Street, Suite 350, Wayzata, MN 55391. We are growing and needed more space. Also, concerns over employee safety reached a breaking point in June, necessitating the move. We look forward to hosting you in our new office soon.
- We recently refreshed our website to highlight North Sky's experience in impact investing and showcase the positive environmental and social impact of our investment strategies. If you have not visited our website in a while, please do, and let us know what you think. www.northskycapital.com You also will be seeing more frequent updates from us on Twitter and LinkedIn. Please follow us on Twitter at @northskycapital.
- If you are interested in learning more about the first investment in our Opportunity Zone strategy, please email Julie Lewis (jlewis@northskycapital.com), and she will provide you access to a short webinar.

Let's Keep Talking

We are eager to hear from you. Please contact us through the below hyperlinks if you have:

- an interest in impact investing and would like to learn more about how we can help you take the first step,
- interest in learning more about the projects in our Opportunity Zone program,
- an existing impact investment that you would like to sell, or
- a sustainable infrastructure project in need of financing.

Upcoming Events

We are regular speakers and attendees at key industry events. We hope to see you at these upcoming events:

October 18 – 23, 2020	SOCAP20 Virtual: A Global Impact Summit, Big Path's "Impact in Action" Session
February 3 – 6, 2021	Sorenson Winter Summit, Salt Lake City, Utah
March 2 – 4, 2021	Confluence Philanthropy 11th Annual Practitioners Gathering, Los Angeles, California
June 14 – 16, 2021	US SIF Forum 2021, Chicago, Illinois

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