

## **Can private equity bounce back?**

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**Allison Nathan:** Can private equity bounce back? In the last two years, rising rates and geopolitical uncertainty have dampened both fundraising and deal activity for private equity funds. Some even question how much more growth the asset class can see in today's higher rate environment. So, is there merit to these concerns? Or is PE about to turn a corner?

**Alex Blostein:** There's no doubt that higher interest rate environment is going to have an effect on private equity returns. So, when you think about the next couple years, we do think private equity returns will be more subdued versus what you've seen in the past.

**Allison Nathan:** I'm Allison Nathan and this is Goldman Sachs Exchanges.

For today's episode, I'm first speaking with my colleague Alex Blostein who covers the asset management industry and capital markets for Goldman Sachs Research to discuss the challenges and opportunities facing the private equity industry. I'll then turn to Mike Nickols and Gina Lytle from our Global Banking & Markets business to discuss the evolution of the space and the types of deals that are happening today. All are joining me in our New York studio.

Alex, welcome back to the program.

**Alex Blostein:** Great. Thanks for having me. Pleasure to be here.

**Allison Nathan:** So, we all know what's going on in public equity markets. They have been off to the races this year. When I checked my monitor before I left, the S&P 500 was up almost 10 percent year to date. We're not halfway through the year. So, pretty impressive performance. But

private equity markets don't seem to be faring as well. Give us some numbers on that. And, you know, talk to us about what private equity returns have been doing recently.

**Alex Blostein:** Yeah, sure, thanks for having me again. So, you're right. Private equity returns year to date are hovering around 2 to 3 percent, so below what you're seeing in the public markets. Now, there's important two things to remember, one, public markets tend to be a little bit more volatile. Private equity markets less so. So, the starting point here really matters.

So, if you go back and you zoom out a little bit, going back to pre rate hike, so kind of thinking about the end of 2021. So, over the last two and a half years, the cumulative return for private equity funds has been about 15 percent. When you look at the S&P, it's been a little bit below that, especially on an equal weighted basis. There have been a lot of conversations around the concentration of public market returns, which is, obviously, very true. On an equal weighted basis, the private equity funds have done a decent amount better when you kind of zoom out beyond the kind of year to date results.

**Allison Nathan:** But that period pre rate hikes was an exceptionally robust returns period for private equity. And now it looks like, as you said, not as much volatility in private equity markets. But it looks like there's been some slow down.

**Alex Blostein:** Sure.

**Allison Nathan:** So, talk to us a little bit about that because, obviously, we're in a higher rate environment. A lot of people are wondering if that has been a drag on returns and is going to remain a drag on returns.

**Alex Blostein:** Yeah, for sure. So, there's no doubt that higher interest rate environment is going to have an effect on private equity returns. So, when you think about the next couple years, we do think private equity returns will be more subdued versus what you've seen in the past. Part of that is companies adjusting to higher cost of capital on the financing side of things. And part of that is really vintage concentration.

We spend a lot of time on this. Where if you look at the pace of deployment the industry has seen in 2020, '21, '22,

kind of through that period of ultra low interest rates, it was significantly faster pace of deployment than what we've seen in prior years. So, those are going to be the returns that are going to be harder to get back to this kind of 15 to 20 percent net IRR range, which is what most private equity firms tend to shoot for. So, that's part of the problem, for sure.

**Allison Nathan:** And if we think about that deployment challenge ahead, we hear a lot about dry powder and that there is a substantial amount of dry powder in the industry right now. Give us some context for how big that is and, you know, why that's such a challenge.

**Alex Blostein:** So, dry powder, just to kind of level set, it's effectively capital commitments that have not been put to work yet, right? So, it's money sitting on the sidelines that LPs committed to, but private equity firms have not invested that yet.

So, today globally, that's a \$2.5 trillion number. It's a record by a mile. If you think about leverage on top of that, this equates to about \$5 trillion of purchasing power. So, a substantial amount of capital that should be put to work

over the next several years.

Now, the challenge of course has been the fact that the pace of deployment has been really slow. There are really kind of two problems with that. One is the industry ran way too fast in 2020/21/22. And just to put some numbers around that, in 2023 the pace of deployment slowed down to only about 40 percent of the dry powder relative to 50 percent annual average of deployment pace as a percentage of capital available. In '20/21/22, that percentage was closer to 70 percent. Right? So, the industry deployed a ton during that period of time. So, naturally there's going to be a little bit of a pullback. So, that's the first issue.

The second one, the bid-ask spread between buyers and sellers, while it's narrowing, is still probably a little wide. And back to your point about interest rates, that obviously has a lot to do with it. So, certainty around rates is helpful. Credit spreads are tightening. So, financing is becoming much more available than what we've seen in 2023. So, all of that sets for a recipe for more deployment over the next couple of years. But for now, it's been pretty slow.

**Allison Nathan:** So, we're basically saying there's too

much capital chasing too few opportunities, and that, in itself, is going to be a drag on returns.

**Alex Blostein:** Yeah, I think that's part of it. I think that the bid-ask spread dynamic that we talked about earlier is an important factor here as well where a lot of the deals in the sponsor community are sponsor to sponsor. So, for a private equity seller to agree with a private equity buyer, they ultimately have to agree on a, probably, a lower multiple because the cost of capital is higher today than it was three, four, five years ago when that sponsor number one bought whatever that asset, right? So, that's still a challenge that the industry is working itself through.

**Allison Nathan:** And so, we've talked a lot about the deployment side, what about the fundraising side? There's tons of capital to deploy. So, are we just seeing funds pull back from fundraising?

**Alex Blostein:** Yeah. That's 100 percent right. So, corporate private equity has been one of the harder places to raise capital in over the last two years now. In 2023 there's about \$700 billion of capital raised. And while that sounds like a big number, it's actually the lowest annual

amount since 2017. And there are really two reasons for that. One is there is this over allocation dynamic. So, you probably heard a lot about this kind of denominator effect where the public markets have underperformed. The private market returns have been better. So, a lot of institutional investors look like they're over allocated relative to their target. That is solving itself. Back to your first question around public markets, obviously, having a really nice year.

The bigger problem, I think, for the space is the pace of return of capital. So, there've been very few realizations. And for capital to get called, you need to give people money back. And that's something that the industry continues to struggle with. Over the last 12 months has been one of the lowest paces of capital return to LPs. And similar to deployment, it's starting to look a little bit better. But we think it's going to be a long and kind of fairly dragged-out process.

**Allison Nathan:** But do they necessarily need to raise as much given that deployment has slowed down? Or am I misunderstanding that dynamic?



**Alex Blostein:** Well, look, I think the private equity firms are in the business of charging fees on capital that they raise, right? So, they always want to raise more money. The reality though is, to your point, there's a lot of dry powder on the sidelines and there's a lot to kind of work through before we need to kind of raise incremental capital. We think that's definitely part of the dynamic in the space right now.

**Allison Nathan:** So, if we take a step back and think about, really, the past decade where we've seen so much growth in private equity. New firms. New niches. Bigger funds. Is that growth sustainable? Like, is this a blip? Or is there some kind of sea change going on in the industry?

**Alex Blostein:** Yeah, I think there are two things going on. So, first just to kind of contextualize this a little bit, private equity industry is about a \$10 trillion AUM space. And over time, it's been growing at 15 percent a year annually. Over the period of '20/21/22, that growth has accelerated to 30 percent. Right? So, we've overgrown. And I think the period over the next five years is going to be getting back to normal. So, slower growth. Yes. But still growth.

The second point that's important is where that growth is actually going to come from. Because our view has been that US pension plans, which is a huge slug of investor dollars in this part of the market, are pretty full. So, I think the growth is going to have to come from other channels, whether it's outside the US. Middle East. Asia, in particular. Those are the two markets that are kind of younger and we'll probably be able to dedicated more time and resource and capital to this part of the market. The other one is the wealth management industry. The retail investor, individual investor, however you want to define it, is still significantly under allocated to private markets broadly, including private equity versus the institutional marketplace.

So, when I think about the kind of change in allocations and change where the capital is going to come from, those are going to be the two areas that we think will be a lot more active. So, firms that have more exposure to that part of the market should be able to grow faster than the ones that are more mono-lined and then, perhaps, too much exposed to the kind of US institutional channel.

**Allison Nathan:** But haven't retail investors historically been less invested in this space just because it's more opaque and it's less liquid? So, is it appropriate for retail investors?

**Alex Blostein:** Yeah. And there are products that are being developed now to partially address that. So, you're 100 percent right. There has been very limited participation from the pure retail investor in this space. But even the high net worth channel that could afford some illiquidity has not been super active in this part of the market.

So, what we're starting to see now is the more traditional funds, so GPs, LPs, stealth funds, you know, X, Y, Z firm goes out, raises \$20 billion. There's more capital that's starting to come in from high net worth networks to the typical fundraises. And then there's been a launch of semi-liquid products that will give you a little bit of liquidity, up to kind of low single digit liquidity versus can't touch your money for ten years. And that is really meant to address more like lower end part of the market, make it a little bit more available because the allocations there are pretty minimal for now.

**Allison Nathan:** Understood. And there are also other asset classes that are giving PE a run for their money these days from what I understand. So, are you seeing asset allocators move to some other areas of the private market space at the expense of private equity?

**Alex Blostein:** Yeah. I think it's part of this dynamic as well. And we've talked about private credit quite extensively, even on this podcast in the past. We think that's part of the difference this time around.

So, when you look at private credit markets today, given the fact that the base rate is in 5 percent, 6 percent, and on top of that, the credit spreads are in a 5 plus 100 basis point range. So, right there you're getting almost a double-digit return being senior in a capital structure versus back to the first question about the prospective returns for private equity, probably not going to be 20 percent over the next five years.

So, the spread between equity and credit has just gotten a lot more narrow. And being higher in the capital structure for effectively a lot less risk with similar type of returns just makes a lot of sense.

So, private credit probably taking some share from private equity. And we think there are other asset classes: private infrastructure, for instance, is getting a lot of focus as well. So, yes, I think there are kind of shifts underneath the overall private markets backdrop that are also unfolding.

**Allison Nathan:** Right. We also did a recent podcast on infrastructure for that reason as well.

**Alex Blostein:** There you go.

**Allison Nathan:** So, if you think about the future of private equity, let's say over the next decade, will private equity funds make up a big share of the average investor's portfolio? How do you see that evolving?

**Alex Blostein:** Yeah. Private equity's not going anywhere. Right? So, private equity will continue to be a very sizable and important part of allocations. But we do think there will be one much greater dispersion between different managers. Back to that vintage concentration dynamic. I think that the returns that we're likely to see over the next three years, four years, will dictate which

managers will be more successful in their ability to raise their next vintage fund, call it '26/27/28. So, that's part of it.

The second is where is the capital going to come from? So, we do think the big firms getting bigger is an important theme for the whole space. So, LPs coming to GP for multiple solutions other than just looking at private equity will also enable some of these larger firms to gain share where they can construct allocation across private equity, private credit, infrastructure, etcetera.

And then there's wealth. It's a channel that requires a lot of resources. It costs a lot of money to participate in and distribute through. And if that's an avenue of incremental growth for private equity firms, we do think the larger firms should be able to participate in that theme much better than some of the more monoline companies.

**Allison Nathan:** Right. So, if you kind of summarize that and you think about the outlook for private equity companies, which ones are going to perform better and which ones are going to struggle over that decade you just described?

**Alex Blostein:** Yeah, so we like the more diversified firms. Bigger is better. I think that's one. I think the second is global. As we talked about Asia and Middle East as large pools of capital. They're going to be very additive to fundraising. And exposure to wealth. So, those are the three key pillars that we think will be very important when it comes to success of private equity firms going forward.

**Allison Nathan:** One last question is that the private equity firms themselves seem to be taking this in stride, some of them, and actually shifting their overall strategies to broaden out their mandate a bit. How are you viewing that?

**Alex Blostein:** I think acquisitions have been a little bit more prevalent in this space than we've seen in the past. And that goes back to the need to be multi asset, to diversify, and to be more global. So, we do think both organic and inorganic consolidation in this part of the market is likely to continue. We've seen a handful of deals in this space already where, call it the more monoline firms, let's say more private equity-centric firms, are trying to do more things in credit or infrastructure. And they're

getting into that part of the market through M&A. Others are choosing to build it internally. That takes time. So, we think consolidation in this part of the market is something that probably makes sense.

**Allison Nathan:** Alex, thanks so much for joining us.

**Alex Blostein:** Great. Thanks for having me.

**Allison Nathan:** I'll now turn to Mike Nickols and Gina Lytle from our Global Banking & Markets business to discuss what they're seeing in the deal making environment and how private equity firms are deploying capital. Mike, Gina, welcome to the program.

**Mike Nickols:** Thanks for having us.

**Gina Lytle:** Thanks for having us.

**Allison Nathan:** So, Mike, let's me start with you. Not too long ago private equity was all the buzz. I mean, we saw eye-popping growth in the asset class. And just really strong investor interest. Very strong performance heading out of the financial crisis. But the last few years have been



a very different story. So, what's been going on? And why such a large shift in fortunes for the asset class?

**Mike Nickols:** Look, I think the asset class certainly is not dead by any stretch. We came out of the global financial crisis of the late 2000s and it was a time where the industry had experienced a significant amount of growth, very accommodative rate policy around the world. And so, if you think about that, the industry really got to a large size.

Coming out of that, the industry is in a place where it's much more mature, right? And you've gone through an environment, you know, the capital markets weren't as well functioning. LPs allocated a lot of capital to the space. That's been harder to, with the lack of well functioning capital markets, higher rates, it's been harder for a lot of those firms to effectively return capital to their LPs, their clients at the end of the day. And so, that's really, for lack of a better word, gunked up the system, if you will, in terms of the amount of capital coming back to them.

I would say that if you think about where the industry's going, it's a cyclical space. And we think we're in the

middle of a cycle now. And I think there's a lot of runway looking forward for the space to grow in a meaningful way from here.

**Allison Nathan:** Just to get a little bit of background, a lot of people think of private equity investments as ones where you actually are not going to get your money back for a long period of time, right? These are generally long-term investments. So, just talk us through though what that cycle usually looks like and what it looks like today then.

**Mike Nickols:** Yeah, sure. It's interesting. So, typically there are, you know, plus or minus ten-year funds where you typically have a five-year investment period and a five-year sort of local harvesting period for these funds.

Now as the run up to, say, the end of 2021, what you had is firms raising money year over year, more quickly, at larger sizes. And so, people became very allocated to the space overall. I think what we're seeing now is more of a reversion to what's more normal in terms of a fundraising pace and a fundraising step forward. But having said that, given the amount of allocations that people have made in

the past, i.e. clients have made to the space in the past, they need to see some of that capital come back to them before they can actually move things forward.

**Allison Nathan:** Right. So, these are clients that invested several years ago and now want to see some cash.

**Mike Nickols:** Yes.

**Allison Nathan:** Understood. Gina, Mike briefly mentioned the higher rate environment. Let's talk about that a bit more directly because, of course, it's now looking less and less likely that the Fed is going to cut interest rates substantially this year. Some are even saying that they won't cut at all or they'll even hike. How much does that really matter? Do private equity firms need lower rates to perform?

**Gina Lytle:** So, taking a step back since the great financial crisis through to the beginning of 2022, the industry had the strong tailwinds. They had good macro conditions. We had a low cost of borrowing and the strong consumer. That was a good environment. That was conducive to deal making.

Now, as we've moved forward the last two years, it's been more challenging. There has been less certainty. And we've had 11 rate hikes. And so, that's driven up the cost of financing and it has hampered deal making.

And so, where we sit today, it feels like there's less uncertainty to what we just experienced so rapidly over those 11 rate hikes. And we're starting to see a path to cuts. And that's going to create a more robust deal making environment.

**Allison Nathan:** Right. So, we're still facing a higher cost of capital. But the uncertainty around the rate path is much lower.

**Gina Lytle:** Exactly.

**Allison Nathan:** Understood. But I remember a year ago talking about this big valuation gap and essentially view of the world between buyers and sellers. Sellers having just a much higher price in mind than buyers. So, is that still the case? Or how has that gap evolved? Has it narrowed? Mike, what do you think?

**Mike Nickols:** What we actually see is people have become what I'll call more realistic around what's the equilibrium around the return capital on one hand and wanting to achieve the best outcome on the other hand in terms of value. And so, what you actually see is people transacting where they think they can get a very good return. Maybe it's not the best they possibly could have gotten, but there's a balance between actually holding onto the asset for longer and really playing things forward. And so, we've seen that converge a bit.

One of the other things that we've seen a lot of is really public to private deals in terms of private equity firms taking a lot of public companies private, i.e. where the private market kind of sees value, vis-à-vis where the public market stands. And really seeking to capitalize that. And then going through whatever the particular private equity firm's playbook is to make any of these portfolio companies enhanced in terms of performance.

**Allison Nathan:** And that really was the traditional playbook, right? Like, we would see a PE sponsor by a non-public company. They'd grow it. They'd improve it. And

then it would go public. But as we all know, the IPO market has actually been pretty slow. So, how big of an impact has that had on the industry and deal activity?

**Mike Nickols:** I think that's been a very big impact on the overall industry because you basically take away one of the big pillars in terms of people getting liquidity on these assets over time. And I think, obviously, we've seen some green shoots in the IPO market. We expect that hopefully to continue over time. And our expectation is that sponsors will look to take advantage of that as time plays on. In particular for larger assets that don't really lend themselves to being sold to a strategic or being sold sponsor to sponsor, if you will. And so, we definitely think that's a trend that will pick up over time. But it's certainly one of the big sleeves that people have had less of an option of using over time.

And again, the drum beat of needing to generate liquidity will only increase over time. And like all markets, you know, you have a cyclical to, you know, the IPO market. And so, as we see more and more deals get done that are constructive, that will, obviously, open the aperture, if you will, for other people to consider going down that venue.

**Allison Nathan:** So, where are the types of deals that are getting done? What do they look like? And where are investors most focused right now?

**Gina Lytle:** It's amazing how much the industry has changed. On the exits that we've been seeing, PE managers are getting more creative given those three primary exit channels for them have been challenging. Those exit channels are selling the asset to another sponsor; selling the asset to a strategic; or taking companies public.

So, we're seeing a general trend of companies that are staying private for longer. And we're also seeing a lot of minority and co-control deals where they're partnering with other sponsors. They're looking to do continuation funds. They are looking to structure equity solution and also fund financings. And so, there's a lot of innovation and creativity that sponsors are bringing to the table.

**Allison Nathan:** When you say continuation funds, what is that?

**Mike Nickols:** Sure, look, the secondary market for

these assets has continued to evolve over time. You can think about a wide spectrum and it continues to grow, which is to say if you think about LP secondaries, i.e. clients who want to get liquidity against broad, you know, level of positions across different funds, that's a longstanding market where, you know, deep market where people can sell their positions in size, you know, typically at a discount as part of that.

There's also what we'll call the GP led market or continuation deal market where a sponsor has an asset, in these days typically an asset that is well performing. And they effectively get outside investors to come in as part of, you know, they set up a special purpose vehicle. Get outside investors to come in. And effectively roll a lot of their own economics in terms of carry into the vehicle. And allow existing LPs to get liquidity as part of that. And you're seeing that happen a lot more. We think that's a concept that has real staying power within the industry.

We've also seen the rise of net asset value financing, i.e. loans against the portfolio to use for purposes of distributions and also to do strategic add-ons for the portfolio. And then there are other structured investments



that people have thought about more broadly in terms of finding liquidity solutions in the context of this space.

**Allison Nathan:** And so, when we think about that secondary market in general, how big is that?

**Mike Nickols:** I think about the secondary market as a very, very large market, \$100 billion plus type market annually where you're effectively in a place where that's going to continue to grow. If you just think about the private market ecosystem broadly speaking, if you take a view that it's going to grow over a period of time, which seems to be the general consensus, you know, we could debate the level of growth within each asset class, but we think that's going to become a vital part. And then some of the structures that we talked about beyond the traditional, what I'll call LP secondary market, i.e. client liquidity market if you will on the private side, we think that's going to continue to grow over time.

**Allison Nathan:** Okay, interesting. Let's pivot a bit to talk about the actual business of private equity. If we think about the macro and deal making environment we've been discussing, how has that affected private equity's strategic

decision making?

**Mike Nickols:** Given the size and scale of the industry where it sits today, inherently the growth in the space is going to be slower, all else equal, going forward. And again, sometimes it'll be faster. Sometimes it'll be a little bit slower. But all else equal, you know, you probably have taken one step down in terms of growth overall as you look forward over a period of time.

Having said that, I'd say in our own dialogues within the industry, people are of two minds. One, they stay in their lane. They do what they do. And they're really excellent at it. And there's always going to be a home for people who have produced really, really good returns and are in a really good place. Now, obviously, there are broad macro factors that could force performance into a more negative place in a point in time. And so, people have to be willing to live with that.

And on the other end, you know, you certainly have players who think about should they have a more diversified platform? Things like, you know, alternative credit, private credit. Things like infrastructure. Things like real estate. I

do think clients look at private equity now and the days that we're in in terms of what is the expertise, what is the value add, what is the ability of a firm to manufacture returns, in terms of actually driving value at the portfolio companies. And I think that's going to be much more of an emphasis going forward, quite frankly, than it may have been over the last ten plus years, you know, within the year ended 2021.

**Allison Nathan:** So, what are you watching, Mike and Gina, that would make you more optimistic about this space into the second half of this year into 2025 or less optimistic?

**Mike Nickols:** Yeah, I think there are two things that I'm looking out for. One is a sign that we'll see lower rates at some point in time. And it doesn't have to show up immediately. But something that, you know, at least there's some glide path on that people can see.

And then second is more well functioning markets where people have the confidence to sort of access them because I think once you get the fly wheel moving in terms of more liquidity for the assets, certainly more tailwind for

valuations and so on and so forth, I think that gets the fly wheel moving again, which basically allows for clients to continue to allocate.

I think some of the factors that we talked about in terms of where people are in terms of being more discerning in terms of who they're allocating to and so on and so forth, I think that will persist. I think we've entered just a more mature part of the movie, if you will.

**Allison Nathan:** Mike, Gina, thanks so much for joining us.

**Mike Nickols:** Thanks so much.

**Gina Lytle:** Thanks for having us.

**Allison Nathan:** This episode of Goldman Sachs Exchanges was recorded on Monday, May 13<sup>th</sup> and on Wednesday May 1<sup>st</sup>. I'm your host, Allison Nathan.

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