

Exchanges at Goldman Sachs
The 'Seismic' Shifts in Private Markets
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Alison Nathan: The private financial markets have grown exponentially in recent decades. But are the tailwinds that supported their growth turning into headwinds?

Mike Koester {sound bite}: So, for a variety of reasons, obviously the equity markets have come off, so the denominator effect is slowing things. This pace of investment, I think, is going to slow down. Which will slow the fund-raising. So, we're going to go from frenetic to a fast pace, faster than, let's call it, average. But I do believe the fundraising pace is going to slow during the course of this year and into next year.

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

[Music break]

Alison Nathan: The growth of the private markets has sharply accelerated in recent years as ultra-loose monetary policies drove investors towards illiquid markets that offered higher yields. But the private markets are also facing fresh challenges with rising interest rates and greater regulatory scrutiny. To help us break down the challenges and opportunities facing private market investors, I'm sitting down with Mike Koester, co-president of the alternative's business within Goldman Sachs Asset Management division. Mike, welcome to the program.

Mike Koester: Allison, thanks for having me.

Allison Nathan: So, Mike, just to set the stage. We hear a lot about private markets. But I'm not sure that that's really well understood. What do private markets actually encompass?

Mike Koester: Sure. So, the private markets or the alternatives space, those words are used interchangeably, effectively those are any investment that doesn't fit the public markets. A bond. A stock. Or frankly, cash or a loan.

So, an alternative investment is something that's an alternative to that typical equity, public equity, or bond.

Within that, the biggest areas are private equity, which is generally about 60 percent of the asset class. Private equity would include leveraged buyouts, growth equity, venture capital as examples. So, that's the biggest part of the private markets.

Real estate would be the next biggest, which is quite substantial. So, that could be, you know, development of real estate or long-term ownership of different types of real assets. Infrastructure, which as the name would suggest, is buying roads, ports, toll roads, airports, things of that nature. And then private credit is a very substantial part of the asset class. That has been growing quite rapidly. That's about a trillion dollars now and growing. But that has shown the most growth. And that's playing a very important role in the banking system. And is really acting as a compliment to the capital markets and then to traditional bank lenders.

So, that's the big pieces there. Private equity, real estate, as well as private credit.

The definitions -- sometimes we talk about private equity firms. That also includes the GPs or the general partners. That's the investment manager who's actually running and selecting the companies that they'll be investing in. And then you have the investors inside that private equity fund, sometimes those are called limited partners or LPs. They're the ones actually supplying the capital to the private equity managers. The private equity managers then are the one going out and actually making the investment selection in terms of the assets themselves.

Allison Nathan: So, if you think about investing in public markets versus private markets, how would you characterize some of the differences in terms of investing in them?

Mike Koester: Sure. So, in the public markets you can see a value every single day. You can choose to buy that stock, or you can choose to sell that stock. So, you have complete liquidity, and you can go in or out based on when you want to do that.

In the private markets, you don't have that luxury. So, you

make a decision going on into buy. And there's no liquid market. Hence the definition of private markets. It becomes much more difficult to sell.

Now, typically, we go into buying, let's say, a private equity with a view that we're going to own that for three or five years. So, we have a plan for what we want to do with the business over that three-to-five-year period of time. But you can't make a decision tomorrow to sell. It's a long process as to how you sell the business.

Most often these are controlled buyouts. So, it takes a long time if you're going to IPO a business, to actually sell all your shares. Or if you sell the whole business, you know, that's a full process in itself. But we are going in with a mindset that we're going to own these businesses for longer.

The other element that I'd say is that in some ways, you know, there's this whole passive very active debate in the traditional asset management world. Well, in some ways, the private markets are the ultimate active owners, particularly when you're talking about a controlled buyout where you control the whole company. So, in many ways it

is the ultimate in the active management space.

So, longer hold. Typically, more control. Much more active ownership. But you do not have liquidity. And that's a big trade-off of the private markets relative to the public markets.

Allison Nathan: So, give us a sense of just how big the private markets are today versus the public markets.

Mike Koester: By the very nature of the private markets, it's hard to know exactly how big it is. The best estimates that we've seen is that today's market, so private markets inclusive of private equity, private credit, real estate, infrastructure, et cetera, is about \$10 trillion in assets. So, just to give you a sense, that was about 5 trillion only about four or five years ago. So, the growth has been very strong of late.

But going back to the 2000s, the organic growth rate in the industry has been about mid-teens. So, the private markets have been growing very rapidly. However, to give you a sense, the public markets, the market cap of the MSCI world would be about \$60 trillion. If you looked at the

credit capital markets, that's probably another \$60 trillion. So, yes, while \$10 trillion sounds like a big number, and big relative to where we were about four or five years ago, it's still small in the overall context of the broader capital markets, if you will.

Allison Nathan: Right. So, \$10 trillion. So, still a drop in the bucket relative to broader markets. But if you think about the exponential growth that you have seen, what's really driven it?

Mike Koester: I think at the core of it is performance of the asset class overall in private markets and in each of the different set of asset classes. So, strong performance with attract capital. And it will attract attention.

The search for yield over the last many years, there has been a lot of attraction to the private markets. There's also an element of diversification that comes by investing in the private markets. These are all things that are very attractive to investors as to why commit to these strategies.

But I think, ultimately, if you look at the performance, that's what's really driving the flows. Three years, five

years, ten years, the benchmarks are very good as compared to a public market equivalent. We can all argue as to what is truly apples to apples in terms of a return versus reward. How do you calculate that return?

Allison Nathan: And are you seeing the investor base itself change? So, is it growing? Is it expanding in different ways? Are there new types of investors in the private markets?

Mike Koester: Yes. We are seeing a seismic shift, not to be too dramatic about that. So, of that \$10 trillion of assets outstanding today, again, private markets, hard to get perfect data, 5 to 8 percent of that is coming from the individual investor. The rest it from institutions.

So, if we go back to the origins of the business in the late '70s, '80s, it has predominantly been an institutional investor marketplace for a variety of reasons, regulatory reasons as well. But that has been the domain.

What is changing quite dramatically now is that it is become an active asset class for individual investors. And there's a series of things of consenting adults, if you will, that are causing that to change over time. One, again,

comes back to performance. So, the democratization of alternatives, part of that is these excess returns that have been available to very wealthy individuals or the institutional investors. How do you make that available to the individuals? So, it actually began in Europe where the regulations were easing to allow other, smaller individual investors to participate in the asset class. That has also come to the US.

What we're also seeing is a big focus from the general partner population. So, the private markets' alternatives firms. And what we see from some of the very large public alternative investors out there is that they're expecting to raise 20 to 30 percent of their next round of funds from the individual investor. That is a huge change from the 5 to 8 percent.

And then some would argue, and I don't think they're far off, that someday we could have as much individual investor capital as we do institutional investor capital. And that has very sweeping changes for how you raise capital, how private equity groups and other private markets players, how we capitalize funds, long-term duration, open ended, providing easy access, liquidity to that individual

investor. These are very big changes that are coming forward.

So, that's the biggest change in the investor base over the last few years.

Allison Nathan: You touched on this, but just give us a sense, if you could walk us through a little bit more in terms of the performance. You mentioned that it's a little bit trickier to gauge it in the private markets instead of the public markets. We don't have, you know, an S&P 500 to watch every day and beyond. So, can you just give us a sense of how you do gauge that performance in the private markets?

Mike Koester: Yeah, it's a great question, Allison. One of the challenges is when you raise a closed ended fund, you don't know the ultimate performance until that fund is finished. Takes a couple years to invest the fund. You try to create value over the life of the fund. And then you sell later. So, until you have the full set of cash flows, you actually don't, ultimately, know how that fund has performed. So, that is a long period of time to wait to say, "Did I make a good investment or not?" So, you have to do

with what you can. So, you have to look for evidence of progress being made in a portfolio. You look at cash flows. But one of the ways that over the last several years that people have tried to determine how are the private markets doing relative to the public markets is something called a public market equivalent, or PME.

And so, if you put a dollar into the S&P 500, at the same time you put a dollar into a private equity fund. And then, you know, that money came back five years later, how did you do? So, at the same time, and you match the timing, you put a dollar into the public markets as that same into one of these private market funds. So, that's the public market equivalent.

And what you will have seen by most measures is that excess rate of return over the public markets could be 300 to 500 basis points annually. Obviously, the power of compounding, that makes a very big change in the rate of return for a pension that may be trying to catch up in their funded status. Or to that individual investor. So, its very strong outperformance, that happens to be the equity markets. Something similar would be true, for example, in the private credit markets. So, looking at the high yield

market or the leverage loan market, if you'd put the same amount of capital at the same time into a private credit fund, you would see a couple hundred basis points of excess rate of return.

Now, the SEC is focused on the issue that you're talking about, Allison, and has put forward a proposed rule that is trying to use a consistent methodology in terms of the rate of performance.

So, now, the investor base is quite sophisticated. So, people are able to pull apart. We give them the raw data so that they can pull apart the returns to make it an apples-to-apples comparison. But I think the overall body of evidence would show that the private markets are delivering an excess rate of return over, call it a three, five, 10 year, even a 20-year period of time.

Allison Nathan: When we think back to the 1980s when the private market was just getting started, in my mind is just this big leveraged buyout phase. You know? You heard about so many prominent LBOs. But a lot has changed. Since then, we have seen, you know, greater scale. We've seen more global expansion. So, as you sit here today, what

do you think are the key forces shaping the industry versus what you saw in prior decades?

Mike Koester: Yeah. It is interesting, in the '80s and the '90s the big leveraged buyouts captured a lot of attention, including in the media. And movies were made about things, like, you know, RJR, which was done back in the 1980s. So, it captured a lot of the headlines.

But a lot of private equity was not just those big buyouts. It was actually minority investing playing a very important role in the economy.

But if I think what has changed the most from the 1980s, 1990s, even the early parts of the 2000s to today is how you actually make money in the private markets. So, again, I use private equity as an example.

So, in the early days, a lot of it was really around finding undervalued companies, putting a lot of leverage on it. So, RJR is an example. Had less than 10 percent equity contribution. So, more than 90 percent of that capital structure was borrowing against the cash flows of the business to actually fund the LBO. But if you fast forward

to today, that equity contribution is somewhere between 40 and 50 percent on average.

So, financial engineering was a very important feature of the first few decades of the private markets, and in particular, private equity. That recipe no longer works. You can't put in a dollar of equity, borrow a dollar of debt, and expect to make 20 percent rates of return or better.

So, what you really have to do now is you have to work hard for your money. You actually have to make what you buy better. And there are a lot of ways to do that. So, ourselves and many others, we've invested in the resources to help these companies that we buy.

So, if you buy a company for, let's call it, \$500 million enterprise value, and you own that business, the large, diversified alts managers like ourselves and a handful of others, we bring the resources of, let's call it, a \$50 billion enterprise to that \$500 million enterprise. So, we're helping them with everything from their digital strategy, transition their business from an industrial business to a technology-enabled business. We're able to buy one business, use it as a platform, and have strategic add-ons to build and grow a

better business.

In short, we're buying the house and we're making the house bigger and more valuable, and frankly, changing the growth trajectory of that business. That's how you make money in private equity today. You don't rely on financial engineering. So, that is actually the biggest shift from what was being done in the '80s, '90s, and the early 2000s to today. And that's a healthy thing.

Allison Nathan: And so, when you think about the private markets then and that business model you just laid out, how cyclical is it? And you know, I put it those terms just because we're obviously facing a lot of cyclical headwinds right now. There are concerns about recession. We have a war in Ukraine. Inflation. So, are you seeing the implications or the impact of that in the private markets? And in particular, on the fundraising side and on the performance side?

Mike Koester: Yeah. That's a great question and a fun one for me to answer because one of the things that sometimes I feel like gets lost is that what we're ultimately buying in the private equity business, we're buying equities. In the

private credit business, we're buying credit. In real estate, we're buying real estate.

The fact that it's private doesn't mean it's necessarily a different asset class. There are equities that are public. There are equities that are private. So, I think what we're not immune to is the economic cycle, and frankly, the valuation cycle, the default cycle, and frankly, the fundraising cycle. So, there's no doubt that it's a cyclical business.

Now, we hear all the time because of those growth rates, the last 20 years' mid-teens organic growth rates of the private markets. Oh, it's a secular grower. I do believe it's a secular grower. That presupposes that we can continue to earn overall excess rates of return. We will continue to grow at a nice rate going forward. But it doesn't mean that it's not interrupted.

So, we've been through two very significant fundraising cycles in private markets. You know, after the correction in the early 2000s. Certainly, after the financial crisis. The conventional wisdom at that point was you shouldn't invest in something that is illiquid, that's not transparent so you

don't actually know what's in your portfolio. And, you know, you want to be able to take your money out. So, that was a really tough period of time. Fundraising was very, very challenging.

Now, we've been on the flip side of that. Last year was a record year for fundraising in the private markets. That fundraising pace is continuing so far early in this year. But I think we're going from a frenetic pace to a quick pace. So, I think that fundraising is slowing down. But still, maintaining a very high rate of growth.

My observation is that the cycle for fundraising is much more driven by cash flows, particularly to the big institutional LPs. So, to the extent that we're doing a lot of selling of assets in the private markets, that money goes back. If the so-called denominator is helping you and the markets are growing, people are shifting more allocations into alternatives, these are all things that have fed what we've called the fundraising super cycle of the last two, three years, really from the time around the pandemic forward. It has been this super cycle where all these flywheels are going to feed the capital raising.

I think that will slow down. By the way, it takes two to tango. So, to raise the money, you have to have the GPs coming back to raise the capital. So, the GPs have been coming back quicker and more frequently than they ever have before. So, one year or two years to fully invest a fund. Asking those LPs to reup again and again. And we've heard, even in March or April of this year, many big institutional LPs saying, "I'm out of commitments for the rest of the year," because their private equity and private markets managers have come back so quickly, they've actually used their capacity. So, they're actually coming to some of the private equity groups saying, "Hey, can you wait to do your fundraising next year?"

So, for a variety of reasons, obviously the equity markets have come off, so the denominator effect is slowing things. This pace of investment, I think, is going to slow down. Which will slow the fund-raising. So, we're going to go from frenetic to a fast pace, faster than, let's call it, average. But I do believe the fund-raising pace is going to slow during the course of this year and into next year.

Allison Nathan: So, if we think about that pace of fund-raising that was very, very strong throughout the pandemic

and now, as you've said, we're seeing it slow somewhat, correct me if I'm wrong, was part of that just because the public market valuations for some of these very innovative companies, you know, had gotten to pretty extreme levels. And you know, people were essentially looking at the private markets as a more compelling opportunity? Do you see that? Because it seems like there is a valuation gap. So, talk to us a little bit about that valuation gap. Did it motivate some of the inflow you've seen? And are private market valuations going to converge with public market valuations? Where do you think that's headed?

Mike Koester: So, there's definitely a correlation between the public markets and private markets. But it's very rare that they're right on top of each other. So, sometimes the public markets are more attractive than the private markets. And sometimes the private markets are more attractive than the public markets.

There has been a lot of discussion at the moment, the public markets have corrected very quickly, particularly, you know, in the technology space. The main question is, you know, is the private market going to correct? And will it correct valuations fully to the public markets? So, there is

a lot of discussion about that right now.

I think one pragmatic thing is often missed, which is fundamentally a company is worth what somebody's willing to pay for it. And you have different types of buyers where these companies are worth more or less to different buyers.

So, as an example, when the public markets are roaring and are really valuing growth, you see-- just look at the activity of the private equity owners and what we in the industry does with our companies, you'll see us listing a lot of companies because you're getting a better rate of return from the public markets because the markets are valuing that type of high growth business differently than the private market is.

When CEO confidence is very high and shareholders are rewarding strategic investors for making acquisitions, right? So, there are long periods of time where a public company announces the acquisition of another company. They're paying a takeover premium. You'll see the acquirer stock go down. Well, then you see in handful of periods of time over, you know, the last 20 years, where their stock actually goes up. So, where that CEO is looking to make

accretive acquisitions, they can afford to pay more. They can also afford to pay more because they may have cost savings or other synergies that really makes that company more valuable to a strategic buyer.

And then there are some types of companies that more naturally should be owned in the private markets. And those businesses, they're often better owned by a family, for example, or by private equity firms. So, if we look at those statistics, just in terms of how many public companies there are, private companies there are, in 2000 there were about six or 7,000 public companies, give or take. Today, there are about 4,000. So, you've seen fewer companies in the public markets.

The private markets, there are about 2,000 private equity backed companies in the year 2000. Now, there's are about 9,000.

So, what is that telling me and how does that relate to your question about valuation? There have been long stretches over the last 20 years where certain types of companies, slower growth companies, often very good companies, very high cash flowing businesses, were companies that may

require investment over a multi-year period of time that will have a very long-term payback, that can be better managed in a private context than in a public context.

So, I think one thing that's important is that across those three different buyer universes, the public ownership, the private equity private ownership, or the strategic buyer, the value of a company will constantly be moving around.

And so, I think the important thing is to understand where each of those end markets are and how as a GP, how do you respond to that, both as you're buying companies, but also as you're selling companies?

Allison Nathan: So, do you think that trend of a shrinking public market and a growing private market will continue on average? I mean, is that a sustainable trend? Or has this just been an interesting moment in history?

Mike Koester: I think we're probably close to the end of that trend. I think a lot of this has played out over 20 years.

So, I'll give you one example. We hear a lot about, again,

companies staying private for longer. Well, that's only a subset of the private company universe, the 9,000 private equity backed companies that we mentioned just a moment ago. It's absolutely true that fast growing, young companies headed towards the public markets can stay private for longer. That choice wasn't around ten years ago. Not only is there more capital to allow them to stay longer, but you have, you know, those valuations were pretty full. And so, you could raise that extra private round and not face a lot of dilution before going public.

I think we'll see a little bit more of that trend. But a lot of it depends on where the valuations are. If the public market valuations are happy to go earlier, then some of these, you know, hybrid funds or these last rounds before going public. If the funds are going to give a lower value and the public markets are going to give a higher value, I think you'll see the public market dipping back in again.

So, that is going to toggle around. And I don't see that trend changing a whole lot. Fundamentally, many businesses, by far the best form of long-term ownership is the public markets. And if you're growing, especially in the technology space, that is the right ultimate destination for

a business to end up.

And I think you also see, again, some of the regulations in Washington are also trying to encourage companies to become public. And so, I think there are some countervailing forces that are coming through that I think will stabilize that trend somewhere near where we are now.

Allison Nathan: One of the things that's come up a couple times in our conversation is regulation where the private markets, historically, have been less regulated than public markets. So, you just mentioned regulators are trying to get companies to go public, maybe for that reason. But you know, how do you think about regulation of the private markets, where that is going?

Mike Koester: Well, I think both policy as well as regulation would like to see a very healthy, robust capital markets in the US and around the world, whatever regulator or policy maker we're talking about.

And so, one of the things that the US regulation is responding to is that growth of the private markets. So, \$10 trillion, that's significant and material in the context of

the functioning of, let's call it, corporate financing across the United States. That's a very big player. And so, the proposed rule making that came out from the SEC earlier this year around private funds, you know, was focusing on things like disclosures and transparency. And one thing I mentioned earlier, consistency of the calculation of rates of return. So, I do think some of this is a part of the fact that the private markets have become big players. And therefore, there is more focus, more scrutiny.

I think it's sort of a secondary effect of the regulation and policy makers that if there is more disclosure around private markets, it takes away one of the benefits of a company being in the private markets if they have to disclose a litany of things. I might as well just go public if I'm going to have to disclose them in either format of how the business is going to be owned. But I think that's a secondary effect. I think the primary effect is it's playing a big, important role in society. I mean, a very healthy one, by the way, filling into a lot of gaps where, whether it's bank financing or capital markets financing isn't necessarily getting to. So, it's a healthy part of the evolution in growth of the private markets, in my view.

Allison Nathan: But the fact that we don't have as much transparency, there is less scrutiny today of private markets. You hear a lot of times about, you know, risks building in private markets. And we don't have a handle on that risk. Over the years there has been a lot of discussion about the next, you know, bubble to burst will be somewhere in the private markets where we don't have great transparency.

So, how big of a risk are the private markets now that they've gotten much bigger from that perspective? And is there systemic risk that could build up in them?

Mike Koester: Well, I don't have a full answer. It's hard to see across the whole system. I don't think that there is a systemic risk at this point. Now, the markets have gotten quite big, the private markets. So, we all have to keep an eye on the quality of underwriting, whether that's in equity, private equity that we own, or real estate that's owned, or in private credit which has seen the most rapid rates of growth, even faster than in private equity or in real estate.

Part of the reason is that a lot of the risk has been pre-syndicated. So, if we look at the banking system and part

of what the challenges that we went through '08/'09, the banks were underwriting a lot of credit of all different types. Mortgage credit, corporate credit, et cetera. Holding that risk on their books and looking to syndicate into the broader marketplace.

What the private markets actually do is the exact opposite whether it's a private equity or private credit. You've actually pre-syndicated that risk to a group of LPs that want to hold it naturally for the long term. So, you don't have the sudden collapse. You don't have the risk in the banking system of a big commitment that sits on your books that all of the sudden the markets stop, and you can't move that risk.

So, I think inherently, that risk is spread further, and it sits in the hands of people, frankly, who can own that type of risk in their portfolio for a long period of time. And there's not that unwind risk. So, I do think it's quite different.

Now, underwriting standards is a different question. And so, it's important that, particularly in the credit markets, that it's an important part of financing corporate America.

And we have to make sure that the right places are getting access to credit. And frankly, the tougher credits, you know, probably shouldn't be getting access to credit.

I do think the profit motive is a very strong one to get it right for the people who are making those underwriting and risk decisions. So, I think that's going fine. But have we seen some markets get stretched a little bit, whether that's valuations or the depth of leverage? Yeah. Yeah, we're late in the cycle. And so, there are some things that are stretched. But I don't see that rising to the level of a systemic risk.

Allison Nathan: Let's end on a more optimistic note. So, if you think about the private market space right now, what are the investment strategies that look most compelling, that are growing the fastest right now?

Mike Koester: Well, there are actually quite a few that are really attractive. One I would point to is infrastructure investing. That is at the sweet spot of all sorts of mega trends that are going on, whether that's energy transition. Whether that's logistics due to e-commerce. Or even some of the geopolitical issues that are going on. So, investing in

infrastructure, to me, is really investing in the future of the data infrastructure. Things like data centers. The future of logistics, you see that both in real estate, as well as, you know, managing logistics firms getting products and, frankly, services to move around the world. And then you see energy transition. So, those would be three very big areas of development that the world needs.

The amount of capital that's needed is enormous. And so, to be able to step in to fill a real need and to, frankly, do it in a way that's getting very efficiently the people who need that capital for growth and earning reasonable rates of return, I think that is one of the areas that's very exciting.

Life sciences would be another area of focus. You know, you see, again, different type of real estate development that's going on. It's really about real estate and infrastructure or equity markets that are funding the future growth for our economy. And so, that's one of the things that really excites me about the private markets is it plays a very special role in helping to develop businesses and companies and really helping us get to the future more quickly.

Allison Nathan: Mike, thank you so much for joining us.

Mike Koester: Thanks for having me.

Allison Nathan: Thanks so much for joining us this Tuesday, May 31st, 2022, for another episode of *Exchanges at Goldman Sachs*.

But before we go, I'd like to share news about an exciting new project we've been busy with.

Every week on *Exchanges* I sit down with top Goldman Sachs leaders and thinkers to discuss how the most pressing macro-economic issues are moving economies and markets. But have you ever wondered how other top investors are navigating today's market headwinds?

In our new special series, *Exchanges at Goldman Sachs Great Investors*, Allison Mass, chairman of our investment banking division, and Katie Koch, our chief investment officer of public equity in our asset management division, will be speaking with some of the world's most respected investors about their investment strategies and views on markets and the global economies. Catch this limited run

series on the *Exchanges* feed starting this Friday, June 10th.

And if you enjoyed this show, we hope you follow on your platform of choice and tune in next week for another episode. Make sure to like, share, and leave a comment on Apple Podcast, Spotify, Stitcher, Google, or wherever you listen to your podcasts.

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