APOLLON

WEALTH MANAGEMENT

PRIVATE MARKETS: CREATING VALUE

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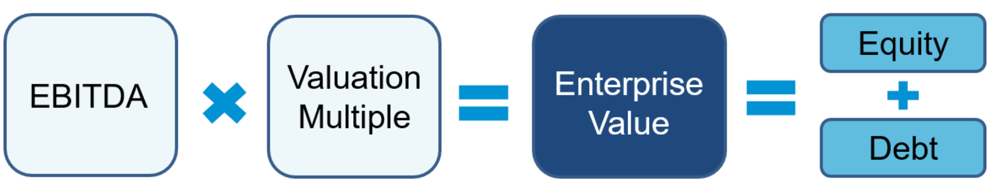
Uncovering how private markets managers create value for investors

- Private equity firms' ability to control companies enables them to enact change and create value during their hold period
- Sophisticated operating resources can create the ability to grow earnings by institutionalizing processes, innovating, expanding products as well as geographically and rationalizing costs
- Increasing the quality of a company by diversifying and stabilizing sources of revenue can lead to multiple expansion
- Thoughtful structuring with regards to leverage de-risks the investment and allows for increased flexibility

Private equity firms are uniquely positioned to create value within their portfolio companies due to their controlling interests in the businesses.

The specific strategy for increasing value varies with each investment, however, the strategies can be categorized into one of three areas: earnings growth, multiple expansion or structuring. Investments have the highest probability of outsized returns when all three of these components work in tandem.

Before diving into each, it is important to understand the building blocks of valuation within private equity. The most common methodology is the multiple approach. When private equity firms buy and sell their portfolio companies they pay a multiple of that company's earnings, or Earnings Before Interest, Taxes, Depreciation and Amortization (EBITDA). The market multiple is based on comparable companies in the industry and validated through an auction process conducted by an intermediary. The EBITDA and the valuation multiple equate to an enterprise value; a combination of equity and debt, as shown in the graphic below.



Given the valuation methodology for private equity backed businesses and the levers owners can pull in order to impact a company, there are three ways private equity firms can enhance the value of a portfolio company:

1. Earnings growth: increase earnings and cash flow through organic and add-on revenue growth and increase margins
2. Multiple expansion: sell the company for a higher multiple than paid at acquisition
3. Structuring: lower debt levels to increase the equity while maintaining enterprise value

Creating value through earnings growth

Private equity firms buy companies with the intent of growing EBITDA. This growth can be organic – within the existing business, or inorganic – through accretive mergers and acquisitions. There are wide varieties of strategies to grow the earnings of a portfolio company, carried out by both internal and external resources of a given private equity fund.

<u>What is EBITDA, anyway?</u>

The concept created in the 1980s to allow companies with high levels of capital expenditures ("CAPEX") to access the debt capital markets. Essentially, the metric was developed to approximate the cash flow of a company if it no longer invested in growth CAPEX. This measurement gave lenders and investors an approximation of the sustainable cash flow and enterprise value of a company to protect their downside.

EBITDA = **Net income**
+ Interest expense
+ Taxes
+ Depreciation
+ Amortization

However, EBITDA should be scrutinized. In today's market, EBITDA is often not what it originally was drawn up to be. Now, it includes additional "add backs" such as extraordinary items, accounting adjustments, one-time items and pro-forma adjustments. With the evolution of this non-GAAP metric, comes a broad and varying definition of what EBITDA is that can have meaningful impact on a company's valuation.

<u>How do private equity funds grow EBITDA?</u>

The first step to grow EBITDA is building a team with the requisite knowledge and experience.

Private equity firms deploy a wide variety of team structures and external resources to maximize growth of EBITDA. Oftentimes, it is a combination of internal investment and operating resources paired with external operating executives and advisors.

Operational experts are highly-specialized within a specific industry, business model or functional discipline (e.g. human resources, supply chain, technology, etc.). Regardless of the mix of experts, the relevance of their experience is key. In other words, *does the team have a proven history of meaningfully growing EBITDA at similar companies and is it repeatable going forward?*

Organic growth drivers

Top line growth	Reduce expenses
Geographic expansion	Margin improvement
Product expansion	Supply chain optimization
Customer diversification	Cost rationalization

Organic growth is the expansion of earnings at a portfolio company without mergers or acquisitions.

Depending on the company's size and maturity, organic growth initiatives can vary widely. The most common areas for improvement are team and technology. Many successful, growing founder-owned companies are product-focused have not invested heavily in technology, sales and finance.

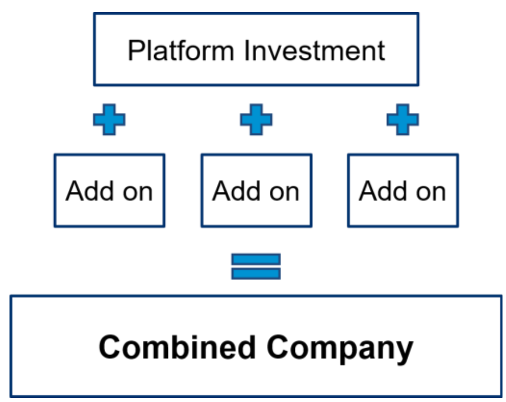
Providing capital to invest in the business and implement best practices, private equity firms can unlock a company's organic growth. Examples range from upgrading to a CFO from a controller, deploying technology including a best-in-class ERP system and CRM to measure progress and create efficiencies to building out a dedicated sales effort.

Private equity firms also make significant investments in a company's infrastructure upgrading the property, plant and its equipment. Making meaningful investments and implementing best practices, private equity firms better position themselves to grow products, customers and expand into new geographies. The private equity firm can also grow EBITDA through cost reductions. Depending on the health of a company's underlying business, it could be incurring unnecessary costs, have inefficiencies in its supply chain or improperly priced their products.

Regardless, private equity firms must identify a company's most profitable, differentiated products and services and deliver the resources needed for it to expand. This does not happen instantly. It can take years to effect a positive impact on the company's financial performance – exacerbating the j-curve associated with private equity.

Inorganic growth drivers

An alternative means by which to grow EBITDA is to make meaningful and strategic acquisitions, or "add-ons", to supplement the investment in the original portfolio company.



This can be a lucrative strategy, particularly when there are a number of functions that can be shared by both entities and the private equity firm purchases the additional EBITDA at lower multiples than the company.

Purchasing cash flow at or below the valuation of the original investment is accretive and adds to the EBITDA of the portfolio company. Add-on acquisitions are common in service businesses within highly fragmented industries (e.g. ophthalmology practices, regional landscape companies, etc.)

Multiple expansion

Akin to price-to-earnings ratios in publicly-traded securities, private companies transact on a multiple of earnings.

Typically, cash flow positive companies with lower to moderate growth transact at a multiple of EBITDA while higher growth, EBITDA negative companies trade on a multiple of revenue. Given these dynamics, the value of a company can increase solely from an increase in multiple, regardless of changes in earnings.

	EBITDA	Valuation Multiple	Enterprise Value
Entry	$5 million	5	$25 million
Exit	$7 million	7	$49 million
Change	$2 million	2	$24 million
		Value created from EBITDA	*$14 million*
		Value created from multiple	***$10 million***

A number of factors can contribute to multiple expansion; generally, this is a component of return where managers have less influence. The reason is the supply and demand components of the market can easily overshadow areas that might lead a business to warrant a higher multiple, such as quality.

Inefficiencies in sourcing

The majority of private equity transactions are performed by intermediaries including business brokers and investment banks. This often generates the highest price, resulting from the bidding process and price discovery. By disintermediating the formal auction process, or sourcing investments directly from business owners, private equity firms can purchase companies at more reasonable valuations.

Size plays a significant role in this process as larger, more sophisticated companies are more likely to undergo a broad auction process while smaller founder-owned companies tend to engage less sophisticated intermediaries or sell directly. Also, smaller founder owned companies are more inclined to look for a partner and price is not the only determinant in selling the company.

While this is not always the case, private equity funds that have differentiated sourcing capabilities designed to engage smaller intermediaries and business owners directly have the opportunity to purchase companies at below market valuations. Differentiated sourcing can come through various means including dedicated business development professionals, networks of executives and operators with longstanding industry and sector specific relationships.

Being a partner of choice, as opposed to the highest bidder, private equity funds can find value on the buy. However, this is not a free arbitrage as companies sourced via these means may have less sophisticated management teams and lack the institutionalization possessed by larger companies. For this reason, asset selection, diligence and operating capabilities are critical in order to find the right company at the right price.

Once acquired, private equity owners can execute a wide range of strategies including diversifying clients and revenue bases, de-risking the capital structure and upgrading management teams, all of which can increase the quality of a business and lead to higher multiples.

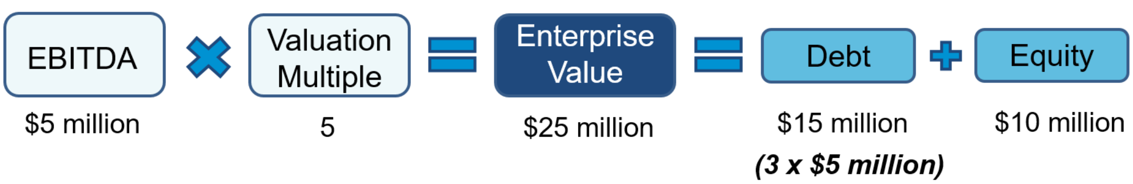
While not sustainable for enduring outperformance, skilled private equity funds can generate multiple expansion that is a product of sourcing and value-add; not just market forces. Those that are able to do so, purchase companies though an inefficient process, build better businesses and sell them through a highly efficient processes.

Structuring

Private equity backed companies are typically structured with a combination of equity and debt. The underlying combination can include a variety of instruments such as common and preferred equity, senior loans, mezzanine debt, warrants, etc. More commonly, the private equity firm (and any co-investors) own the equity while a bank or alternative lender secures the debt. The debt is backed by the underlying cash flows of the company and has first claim on assets in the event of default. Similar to purchase multiples, debt is issued at a multiple of earnings.

In other words, how many years' worth of earnings is a lender willing to lend to an underlying company? There is a wide variety of structuring employed in today's market, ranging from entirely unencumbered companies to those leveraging over 7x EBITDA.

Portfolio company with $5 million in EBITDA, valued at 5x, with 3 "turns" of leverage



Private equity funds pay down debt with portfolio company cash flows during the hold period. Since the debt is on the balance sheet of the portfolio company and not the fund, paying down debt over time increases the value of equity, even if the enterprise value does not change at all.

This can be further magnified if the underlying EBITDA or valuation multiple increases. The dynamic can incentivize private equity funds to maximize debt levels; especially when interest rates are low and generate return solely through financial engineering. The leverage enhances returns. However, it also creates more risk should the underlying company underperform.

There are a number of ways private equity funds view debt. Some view it as an amplifier of returns while others perceive it as a mechanism to invest in the company and grow earnings. Other private equity funds do not use any leverage, instead redistributing the cash flow back to investors instead of paying down the debt. Also, some private equity firms will recapitalize their portfolio companies once stabilized. If EBITDA, for example, has grown meaningfully, a private equity firm can pay off the original debt, reissue at the same or higher leverage levels, and take their chips off the table and pay a dividend back to investors.

Private equity funds must use discretion when determining the appropriate structure for their underlying companies. For example, if the company operates in a highly cyclical industry like oil and gas where earnings can be volatile, they are typically conservative with leverage. On the other hand, if the company is not in a cyclical industry and has a high degree of recurring revenue, it may warrant higher debt levels on the balance sheet.

As debt remains available, inexpensive and valuations elevated, it is critical to back private equity funds that produce the right-sized balance sheet for the company being acquired.

Formula for success

A firm's success is measured by its fund level returns, however, it is its path to that end which serves as the key indicator of repeatable outperformance. An investor's skill can be measured through the value created in their portfolio companies, and the firms poised to consistently add value do so through earnings growth. Often, it comes down to having highly-focused and specialized operating resources, unique sourcing relationships and a conservative approach to leverage.