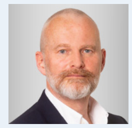
DPI MAXIMIZATION IN PRIVATE EQUITY

Searching for growth in the undervalued and the novel.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DEFINITIONS:

- SME – small, medium enterprise
- PE – private equity
- MOIC – multiple of invested capital
- DPI – distributions to paid-in capital
- MM to MM PE is the strategy of acquiring mid-market size companies (EBITDA ~>$20M) and through roll-up or growth exiting when the company is still mid-market size (EBITDA ~>$50M).
- SME to Lower MM PE is the strategy of rolling up small & medium sized companies (EBITDA ~<$10M) to create lower-mid market sized companies (EBITDA ~$20M) for exit.

INTRODUCTION:
Distributions to Paid-In Capital ("DPI") measures the cash returns to investors relative to their initial capital. DPI offers a picture of liquidity and mark-to-market returns and is set apart from IRR reporting which of necessity can only be derived from comparables before the portfolio disposition at the end of a fund's hold period. The essence of DPI is its measurement of a fund manager's success in growing and realizing value throughout the investment term in the form of ongoing distributions and exits. It provides a direct link to what investors ultimately seek: liquidity via regular cash distributions. Additionally, DPI's simplicity makes it a useful tool for benchmarking and guiding allocation decisions.

This report considers how different private equity strategies may have different intrinsic DPI generating qualities – in particular, we evaluate how a SME to Lower Mid-market roll-up ("SME Buyout") strategy in an open-ended structure with non-discretionary cashflow sweeps (ongoing and on exits) can generate superior run rate DPIs compared to traditional private equity approaches such as MM to MM PE ("MM Buyout").

DISCUSSION:
Private equity funds are typically structured as closed-ended vehicles, with limited interim distributions. In addition, the PE market is concentrated on businesses in the mid-market and larger (EBITDA ~>$20M), transactions that are characterized by acquisition multiples that can be significantly greater than 10 times. Such strategies tend to reinvest free cash flow into growth CAPEX to drive returns and rely heavily on leverage to augment these returns.

In contrast, SME Buyout represents a less competitive segment within the PE sector, as evidenced by the significantly lower acquisition multiples. SME Buyout tends to have the ability to generate higher operating and exit cash flows per dollar invested, thanks to these lower acquisition multiples (less than 7x) and higher relative multiple expansion upon exit. This, in turn, reduces the reliance on growth or leverage as a critical driver of returns. The resulting higher distributable cash per dollar invested increases SME Buyout's potential to produce DPI.

CORE Returns		INCREMENTAL Returns
Consolidation and Exit Focus **Assembly Line of Roll-ups**	**Integration Technology** **Speed of Roll-ups**	**Distributing Structure** **Enhancements on Traditional PE**
Acquire in **target sub-verticals** to reach transactable scale rapidly in less than 48 months	Capture **multiple expansion from the integration of very low-cost SME market earnings** in serial roll-ups to create MM companies	Structural features to facilitate DPI maximization
Focus on accretive multiple expansion driver: ▪ Average acquisitions 5-7X ▪ Average exits 9-11X Do not pay for growth - acquire @ <7 times	Consolidating SMEs requires a high level of integration and operational excellence due to smaller deal size and relative lack of technology, monitoring, reporting, forecasting etc sophistication in SME businesses. Managers must have approaches, systems, and technology to manage this complexity. Serial consolidations in sub-verticals creates an "*assembly line*" of roll-ups Special Distributions – exit sub-verticals on regular cycle to generate continuous equity returns for investors	▪ Evergreen/open-ended vehicle ▪ Normal and Special Distributions – all distributable operating cash and gains on sub-vertical exits swept to unitholders on non-discretionary basis ▪ Special Distributions can happen within hold periods (i.e. early return of capital) ▪ Return harmonization ensures all receive same IRR regardless of subscription timing

The following factors are a quick summary of what we believe are the key differences that drive SME Buyout's ability to produce DPI.

		SME Buyout (SME to Lower MM PE)	MM Buyout (MM to MM PE)
1	Acquisition & Exit Multiples	Lower	Higher
2	Relative Multiple Expansion	Higher	Lower
3	Speed to Complete Roll-ups	Quicker	Slower
4	Speed to Exit Roll-ups	Quicker	Slower
5	Need for Growth	Lower	Higher
6	Need for Leverage	Lower	Higher
7	Distributable Cash Generation	Higher	Lower
8	Exit Distributions	Frequent, Continuous	Infrequent, Terminal

Let's expand on these parameters in turn as expressed in an open-ended investment vehicle:

1) Acquisition Multiples: Less than 7 times which, in businesses with good cashflow conversion, leads to superior run rate distributable cash flow (1/7 = 14%) and a larger percent of total returns being cash distributed on an annual, run rate basis**.** **7 times or less acquisition model is DPI maximizing.**

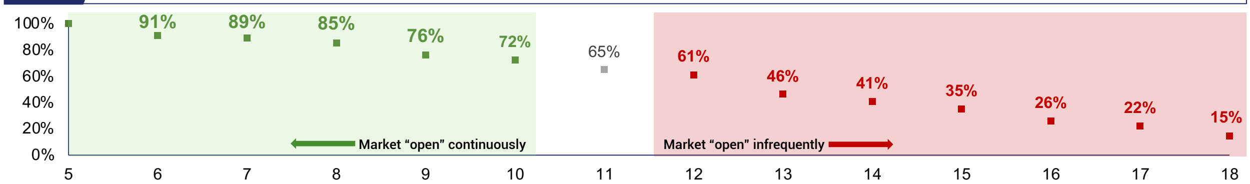
2) Relative Multiple Expansion: Despite lower exit multiples, SME Buyout strategies experience higher relative multiple expansion. Therefore, such strategies tend to generate underlying terminal IRRs which are higher than traditional MM PE and consequently **lower the need to invest cashflow into growth as a return driver which in turn is DPI maximizing.**

3) Speed to Complete Roll-ups: We believe the capture of the multiple expansion from the rapid consolidation of low-cost SME earnings streams into single lower MM earnings streams (do not pay for growth - acquire at less than 7 times) is a superior return driver. However, consolidating SMEs, while accretive, requires a high level of integration and operational excellence due to smaller deal size and relative lack of technology, monitoring, reporting, and forecasting sophistication in SME businesses. Fund managers must have the systems and technology to manage this complexity. Acquisitions must be reliably integrated into sub-verticals which in turn act as single, consolidated operating entities for exit purposes. Integration must be rapid and accurate to reduce investment life cycle time which is critical to IRRs. **A sub 48-month investment life-cycle timeline is DPI maximizing.**

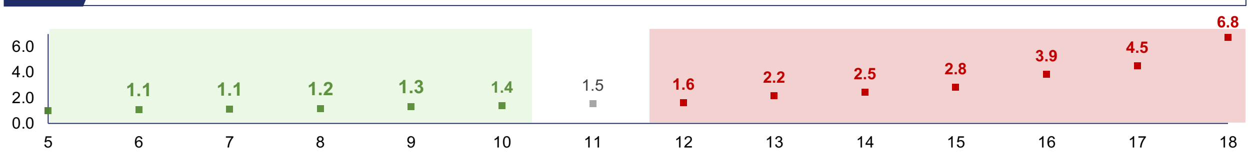
4) Speed to Exit Roll-ups: SME Buyout can have shorter timelines to go full lifecycle and allow earnings growth to be an ancillary return driver rather than a core requirement. **An assembly line of shorter life-cycle roll-ups is DPI maximizing.** The following is a simplified analysis of the return potential of SME Buyout versus MM Buyout accounting for the need to obtain higher exit multiples in MM Buyout and consequently having "*smaller exit windows*":

Step 1: Account for the linkage between S&P earnings multiples and private market multiples by adjusting an annual S&P P/E series dating back to 1971 (adjustment was to reduce public P/E multiples for a 3% illiquidity return premium to derive an implied time series of private asset multiples).

Step 2: Liquidity premium adjusted P/E series used to estimate time the private market is transactable at any target multiple (% of years):



Step 3: Adjust realizable exit timing based on target multiple (multiple of base exit years):



5) Need for Growth: SME Buyout larger relative multiple expansion and larger exit window translates into a shorter, more accretive time to go full life cycle – buy, integrate then exit – so it requires less growth than MM Buyout to generate the same returns as the simple example below demonstrates:

Assumptions:

	SME	MM
Target acquisition multiple	6	10
Target exit multiple	9	13
Earnings size	5	25
Annual EBITDA growth rate	2.0%	17.4%
Unadjusted exit timing (years)	1	1
Exit period adjustment based on target exit multiple	76%	46%
Grossed up exit timing (based on target multiple)	1.3	2.2
Total years to exit @ target multiple	3.8	4.7

Results:

SME	Roll-up Period					Exit Period	
Year	1	1.5	2	2.5	3	3.5	4
Cumulative Earnings	5.0	10.1	15.3	20.6	26.0	26.5	
Investment Flows	-30.0	-30.0	-30.0	-30.0	-30.0		238.9
Distributions	1.3	2.5	3.8	5.2	6.5	6.6	
IRR							13.6%

MM	Roll-up Period					Exit Period			
Year	1	1.5	2	2.5	3	3.5	4	4.5	5
Cumulative Earnings	25.0	54.7	89.8	131.5	181.0	207.5	243.6	286.0	
Investment Flows	-250.0	-250.0	-250.0	-250.0	-250.0				2,574.0
Distributions	6.3	13.7	22.5	32.9	45.2	51.9	60.9	71.5	
IRR									13.6%

Conclusions:

SME strategy doesn't require a bet on **outsized growth** (which MM does as evidenced by this exercise)	SME strategy generates i) higher distributions per dollar invested + significant integration and synergistic benefits of targeted strategy, and ii) shorter hold duration

6) Need for Leverage: SME Buyout has less need for leverage to drive returns as high run rate distributable cash generated from low acquisition multiples and shorter times to exits coupled with greater relative multiple expansion are sufficient to generate 15%+ annualized returns with material annual DPI components on an unlevered basis. Compare this to the more typical 5-6 turns for MM Buyout strategies (JP Morgan Asset Management). The addition of debt consumes distributable cashflow until the debt can generate incremental growth and clearly adds investment risk – in a higher rate environment **lower leverage tends to be DPI maximizing**.

7) Distributable Cash Generation: Assets in an SME Buyout can be acquired at less than 7 times. All things being equal, this approach should generate inherently **higher levels of run rate distributable cash flow per dollar invested which is DPI maximizing**.

8) Exit Distributions: Evergreen vehicles with **non-discretionary ongoing and exit proceed sweeps are DPI maximizing**. What is created is an "*assembly line of roll-ups*" in various stages of maturity and therefore an investor could expect a regular, frequent flow of special distributions from exits, rather than a single delayed terminal wind-up.

CONCLUSION:
Analysis supports the conclusion that the SME Buyout space in a suitably structured open-ended vehicle can provide compelling DPI.

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