INVESTMENT PERSPECTIVES

CapitalDynamics
TRULY INVESTED.

JANUARY 2019

FINDING STRONG VALUE IN A MORE CAUTIONARY ENVIRONMENT

KEY COMMENTARY

THE U.S. ECONOMY IS IN ITS 10TH YEAR OF EXPANSION, MAKING IT THE SECOND LONGEST EXPANSION IN HISTORY. HOWEVER, THERE IS GENERAL UNCERTAINTY ABOUT THE ABILITY OF THE MARKET TO CONTINUE ITS UPWARD TRAJECTORY.

Significant growth in dry powder is perpetuating a competitive pricing environment coupled with a slowdown in exit activity, increasing monitoring loads in most U.S. private equity managers' portfolios.

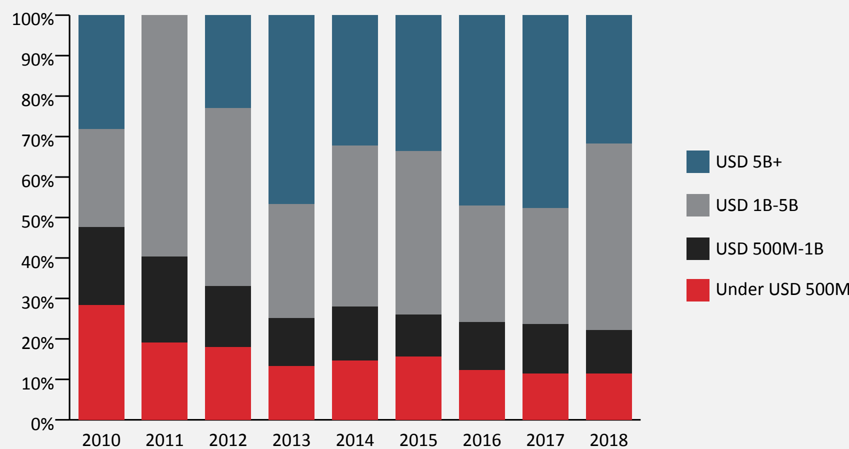
Despite the resulting risk of return compression, high-quality managers with specialized and strong operational value creation skills in the U.S. middle market remain well positioned to generate attractive returns.

"U.S. MIDDLE MARKET REMAINS ATTRACTIVE DESPITE RISK OF RETURN COMPRESSION."

THE STATE OF THE U.S. PRIVATE EQUITY MARKET

U.S. private equity fundraising continues to be very strong. The largest percentage of capital raised is flowing into funds between USD 1.0 – 5.0 billion. With effectively no Y-O-Y growth in the number of managers in this stable part of the market, these same managers are generally increasing their fund sizes quite substantially, garnering 46% share of total capital raised by the end of 2018, dramatically above last year's share of total capital raised. Dry powder for new investments is currently USD 1.1 trillion as of December 2018, according to Preqin.

FUNDRAISING BREAKDOWN BY SIZE (VALUE)

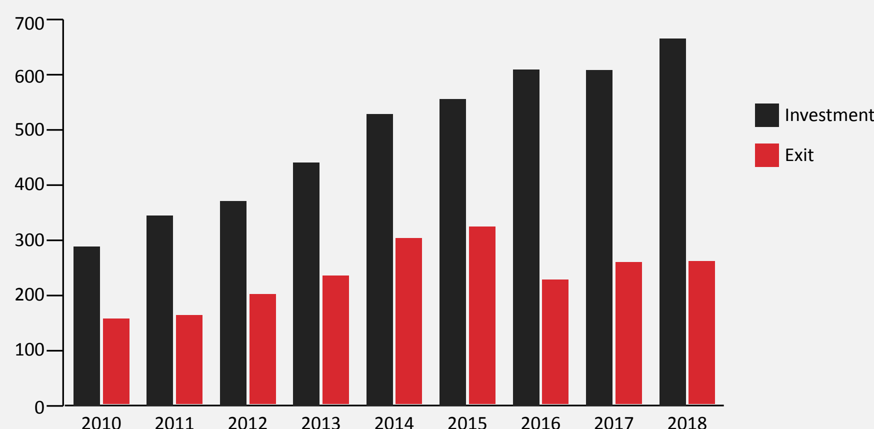


Source: Pitchbook 2018 Annual US PE Breakdown. January 2019.

"80+% OF FUND INVESTMENT OPPORTUNITIES BY COUNT ARE WITHIN THE BELOW USD 1 BILLION SEGMENT."

In turn, Capital Dynamics is very mindful of the commensurate increase in competition for deals in this segment of the market. We are watching closely purchase price multiples paid for businesses across our portfolio compared to the overall market and in our evaluation of new managers. The pace of new investments surpassed the number of exits by 2:1 in 2018. With slower exit activity, we are seeing an increase in fund extensions. According to Pitchbook data, 53% of 2004 vintage buyouts are still active. Secondary buyouts are becoming a more common exit path, representing over a half of all private equity exits in 2018.

INVESTMENT AND EXIT VALUE, USD BILLION



Source: Pitchbook 2018 Annual US PE Breakdown. January 2019.

"PACE OF NEW INVESTMENTS BY COUNT SURPASSED EXITS BY MORE THAN 2:1 IN 2018."

HOW DO WE GAIN COMFORT WITH A PENDING DOWNTURN?

A rigorous evaluation of entry pricing relative to a manager's value-creation skill sets and historical performance in the prior downturn matters increasingly when a risk of downturn also increases. We will see only in time whether premium prices paid today for higher quality companies with purported strong growth trajectories and stable customer bases will be able to achieve attractive returns on future exits and whether these companies will have been resilient in a market downturn. As such, we appreciate managers who tend to leave multiple expansion totally out of their underwriting assumptions with respect to exit multiples. Some managers even further model in slight multiple contraction.

> **"MULTIPLE EXPANSION SHOULD MOSTLY NOT BE INCLUDED IN UNDERWRITING ASSUMPTIONS WITH RESPECT TO EXIT MULTIPLES."**

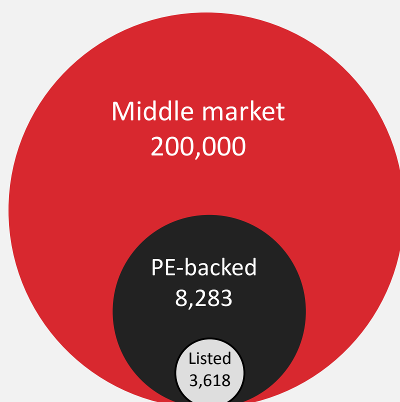
WHY FOCUS PRIMARILY ON THE MIDDLE MARKET?

These are increasingly cautionary times, but there also remains strong reason for investment optimism with proper manager selection.

Capital Dynamics seeks and is able to find highly attractive middle market managers consistently achieving strong and thoughtful exits, in disciplined time frames, at attractive exit valuations, across varied sectors and strategies within the U.S. middle market. In large part, this is because the U.S. middle market has robust investment opportunities.

According to the National Center for the Middle Market's Q3 2018 Middle Market Indicator, there are over 200,000 middle market companies, which employ 47.9 million people and cumulatively represent one-third of private sector GDP. On a combined basis, these companies would form the third largest economy in the world. Importantly, these companies have proven to be resilient throughout changing economic environments, as evidenced by the addition of 2.2 million middle market jobs during the financial crisis between 2007 and 2010. In the years since the financial crisis, middle market employment and confidence have surged. Through middle market private equity, investors get access to a much larger universe of investment opportunities compared to listed equities.

NUMBER OF U.S. COMPANIES



> **"THE U.S. MIDDLE MARKET OFFERS PLENTY OF ATTRACTIVE INVESTMENT OPPORTUNITIES, WITH VERY LIMITED PRIVATE EQUITY PENETRATION TO DATE."**

Source: The National Center for the Middle Market Report Q3 2018, Pitchbook PE-backed Inventory Report Q3 2018. Bloomberg, Warrington College of Business Administration, University of Florida; University of Chicago Center for Research in Security Prices.

Middle market companies are less affected by global financial market factors (FX movement) and more by local market dynamics. The middle market additionally offers three viable paths to liquidity for investors: sales to strategic buyers, sales to other financial buyers or an IPO. Meanwhile, the exit of large- and mega-cap companies tend to be heavily IPO-weighted. IPOs are more subject to market conditions, and it generally takes over 18 months to fully liquidate public securities. As a result of all of these positive attributes, as well as the white space opportunity (given that only an estimated 5% of middle market companies are private equity-owned), there exist significant opportunities for private equity investment in the middle market.

Recognizing that U.S. middle market private equity managers have generally outperformed other private equity sub-asset classes, Capital Dynamics has built out its expertise in this sub-segment, developing extensive processes, a strong reputation and an essential ecosystem of relationships imperative to successful investing in this market sub-segment. Capital Dynamics has further adopted the view that U.S. middle market companies with under USD 1.0 billion in enterprise value offer the greatest risk-return opportunity for private equity investors and, as such, Capital Dynamics primarily invests in a highly select group of GPs focused in this size range. This view is predicated on several factors.

1. The value creation outperformance from middle market funds is mainly driven by operational improvements, e.g., salesforce effectiveness, new product/customer expansion, transformational add-ons, upgrading management, resolving succession issues, and is less dependent on external factors.
2. The high availability of investment opportunities allows for a steady investment pace.
3. On average, investments are made at lower valuations, a characteristic of this less efficient market, often into companies which are family-owned and possess the opportunity to grow regionally/nationally.

In line with this context, the managers we most frequently select are:

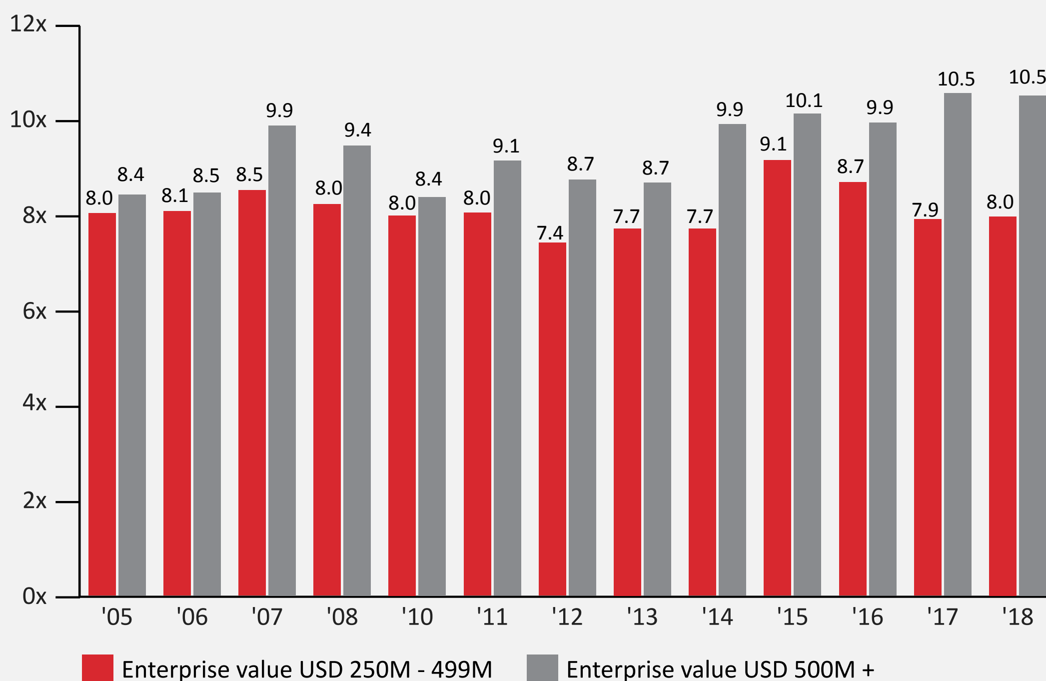
- entering investments at lower than market to fair entry purchase multiples/valuations,
- adding strong operational value and
- driving growth across their portfolio companies through factors they can control, such as operational improvements (cited above).

"Managers with these capabilities offer compelling investment opportunities from a risk/return standpoint irrespective of market cycles and are essential to why we remain optimistic for continued strong return prospects."

IS MULTIPLE EXPANSION STILL POSSIBLE?

According to Standard & Poor's M&A Stats (December 31, 2018), companies below USD 500 million in Enterprise Value ("EV") traded at 8.0x EBITDA in 2018. Other than in 2015 and 2016, the purchase price multiples for these businesses has remained stable around 8.0x EBITDA since 2005. Furthermore, these businesses continue to trade at lower price multiples when compared to companies above USD 500 million: 8.0x EBITDA vs. 10.5x EBITDA in 2018. There has not been an instance in the below dataset when this relative attractiveness has not been the case. As a result, managers that can grow businesses from the first category (below USD 500 million EV) to the second (above USD 500 million), either organically or via add-ons, should protect themselves from multiple compression and could continue to benefit from multiple expansion.

U.S. BUYOUT ACQUISITION PRICES: EBITDA MULTIPLES



Source: S&P M&A Stats. December 2018. Acquisition prices exclude fees and expenses. Transactions exclude add-on acquisitions.

Another trend that has emerged strongly since the global financial crisis is a proliferation of the "buy and build" approach. While prior to the global financial crisis (GFC), few managers actively pursued "buy and build", it has become a mainstay in value creation strategy among many managers. Nowadays, managers can buy a company as a platform for expansion and consolidation to increase its size through a series of accretive acquisitions. Private equity firms are becoming specialists in the creation of sector champions. According to various market sources, the number of add-on acquisitions exceeded that of new buyouts in the past three to four years whereas prior to the GFC such transactions barely made a quarter of the overall deal flow. This approach helps create value in two ways:

- through multiple expansion due to averaging down the entry prices as a result of acquisition of smaller companies that typically command lower valuations and moving up the chain in size, as mentioned above, and
- the realization of synergies and creating a scale that boosts both top and bottom lines of private equity-backed companies.

CONCLUSION

Capital Dynamics strongly favors price disciplined managers with strong and specialized operational value creation skills, enabling them to secure more attractive pricing at entry. This quality is largely driven by semi/proprietary sourcing, relevant industry expertise and networks, and their convincing management that together they can very strongly enhance value in the business. Managers that have a proven track record of improving company operations, management teams, increasing sales, new product innovation and a focus on strong strategic value creation will be favored by management teams and prior owners. While not typically part of our underlying managers' initial investment underwriting, we consistently find that managers demonstrating the above-mentioned qualities and characteristics are able to exit their investments with multiple expansion in this environment and had been able to do so in the prior downturn too. Thoughtful exit planning is also a key consideration in their initial underwriting. Managers that have skills to build better and sustainable businesses are more likely to withstand any potential downturn and deliver attractive returns for our investors.

> **"CAPITAL DYNAMICS STRONGLY FAVORS PRICE DISCIPLINED MANAGERS WITH STRONG AND SPECIALIZED OPERATIONAL VALUE CREATION SKILLS."**

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[1]As of September 30, 2018.

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