PRIVATE MARKETS: OUR PHILOSOPHY

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Our areas of focus within the private markets

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- The number of private equity investment options has never been higher.
- The largest set of investment opportunities is the lower-middle market. Its natural fragmentation creates more favorable valuations and flexibility to grow small businesses.
- Specialists and operationally focused private equity managers are uniquely positioned to create value using their expertise to improve efficiency and drive earnings growth.
- Alignment of interests among investors, funds and portfolio company management creates the incentives necessary to succeed.

With demand from institutional investors growing, the amount of money invested in private equity and the number of private equity funds has reached an all-time high. According to Boston Consulting Group[1], in 2018 a record 2,296 private equity firms were active in the market, seeking to raise an aggregate $744 billion.

With the increasing competition among firms to identify investment opportunities and create value, we believe private equity firms possessing the following characteristics are poised to outperform their peers:

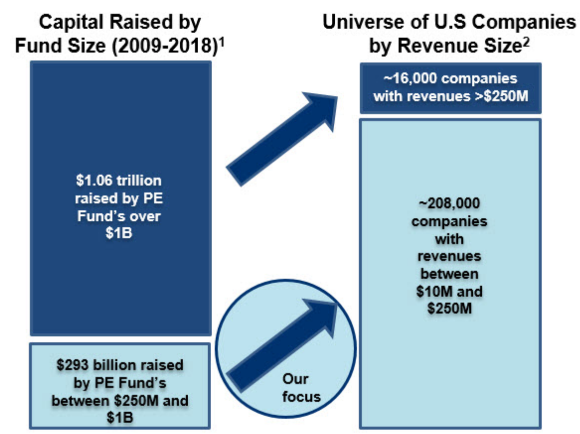
1. Adequate size funds to effectively invest in the most attractive segment of the market
2. Acute focus on areas of expertise and strength
3. Alignment across the fund manager, its investors and underlying portfolio companies

Raise the right amount

Fund size is a primary way to categorize a private market strategy and firms continue to raise larger funds. Pitchbook found, in 2019 the average buyout fund raised almost $1.7 billion, representing an increase of nearly 70 percent compared to 2018. The industry also saw an acceleration in the number of "mega funds"; those greater than $5 billion.[2]

Despite the attention and enormous amount of dollars raised at the larger end of the market, we believe the most compelling opportunities are in the lower-middle market; a segment which has historically outperformed.

The lower-middle market, typically defined as private equity funds raising between $250 million and $1 billion, coincides with the largest segment of private companies and the highest degree of sector fragmentation. Funds this size usually target companies whose revenues are between $10 million and $250 million dollars and with enterprise values of up to $100 million.



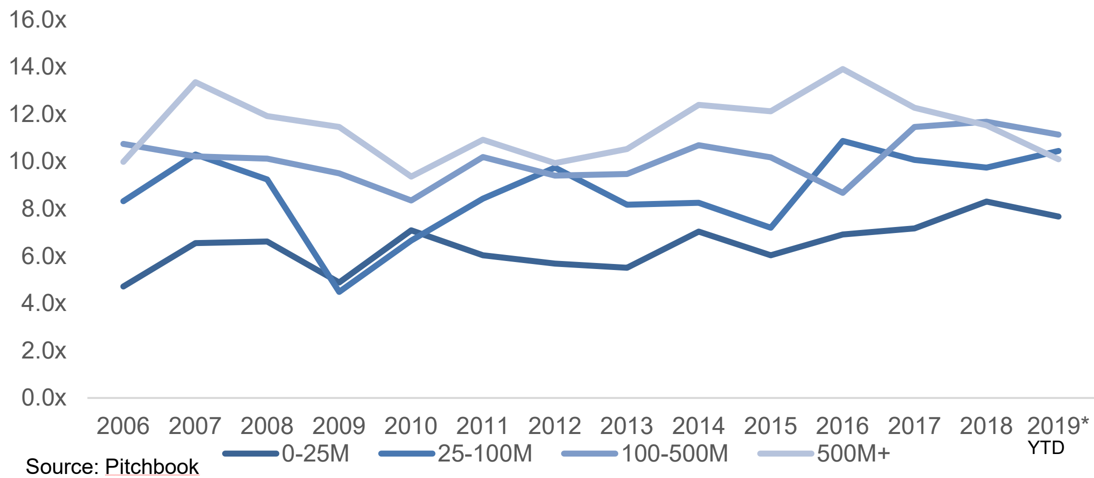
[1]Capital raised statistics are from Pitchbook article "1Q_2019_US _PE_Breakdown"
[2]U.S Companies statistics are from Dun & Bradstreet. Based on Commercially-active businesses in the U.S. (defined as firms that have obtained a D-U-NS Number and that sell and receive goods and services and utilize credit transactions in their business

Past performance does not indicate future performance.

This segment accounts for approximately 93 percent of the investable private companies. However, it only attracted 23 percent of the dollars raised between 2009 and 2017.

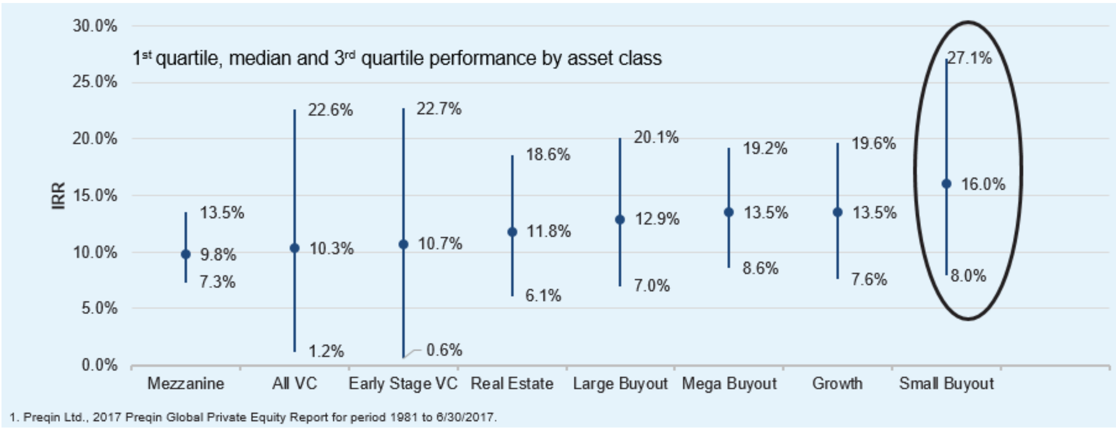
Companies of this size tend to be less institutional and, historically, have not been well served by investment banks which has resulted in inefficient sale processes and lower entry multiples. Lower multiples in this space may be warranted as the companies' lack the professionalism of and have higher fail rates than larger, more established organizations. As companies grow larger and more institutional with heavily trafficked transaction processes, naturally, they warrant higher valuations.

Global PE Deals - Median EV/EBITDA multiples by deal size



Source: Pitchbook

The abundance of small businesses is met with attractive downstream demand; especially today, with billions of dollars from private equity firms and strategic buyers searching for healthy, growing companies. These positive supply and demand dynamics, as well as opportunity for operational improvement, are key reasons the lower-middle market has outperformed larger private equity for almost four decades. The fragility of businesses associated with these firms, however, has created wide dispersion among top and bottom quartile performers, emphasizing manager selection and the need to find firms with the specialized skills to create value.



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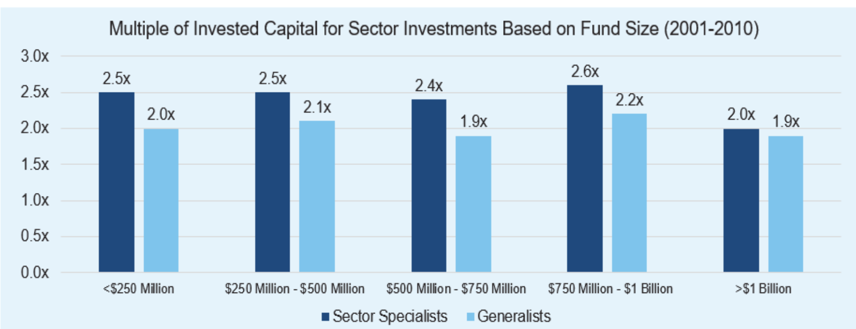
Focus on what you do best

With more than 208,000 companies comprising the lower middle-market, focus is paramount. Private equity managers whose specialized expertise prioritizes operational focus can effectively source transactions to create value. Areas of focus can vary, but most often is demonstrated in the following ways:

Sector Focus	Structural Expertise	Thesis Driven
• **Industrials** • **Consumer** • **Software/Technology** • **Healthcare**	• **Distress/turnaround** • **Bankruptcy** • **Corporate carve-outs** • **Take-privates**	• **White paper research** • **Thematic** • **ESG/Impact**

Sector specialists focus on industries that require specific technical skills. Oftentimes, these industry-specific firms have decades of operating and investing experience. That experience can have numerous benefits including: sourcing, performance improvement, earnings growth and exits. The value sector specialists bring to founders and management teams, and are able to execute on during the hold period, is illustrated by their historical outperformance compared to their generalist peers.



1. Cambridge Associates: "Declaring a Major: Sector-Focused Private Investment Funds." Analysis based on 717 sector specialists and 3,013 generalists over the 2001-2010 period.
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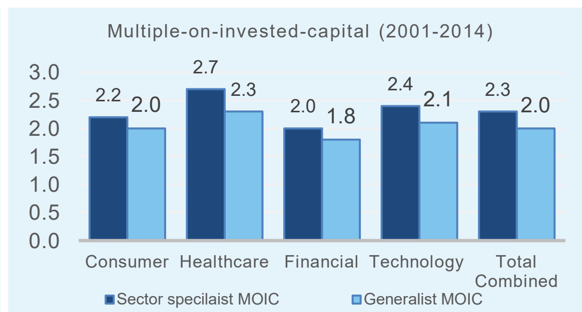

Source: Cambridge Associates. Data represents realized and unrealized investments within the Cambridge Associates buyout and growth equity benchmark initiated between 2001 and 2014. Data as of 30 September 2017.

Industry specialization isn't the only way for private equity investors to differentiate themselves. Some firms focus on specific transaction types or situations. These firms may be generalist by sector, however, possess the structuring expertise to navigate complex transactions. Regardless, if it's a corporate carve-out, take-private or turnaround investment, the inherent complexity of these transactions requires a highly specialized skill set and experience.

The final focus is thesis-driven idea generation. The themes can be: a specific subsector, business model, geography or macroeconomic trend. Taking a thesis-driven or thematic approach, private equity firms can drill down on a specific type of company strengthening its focus on both sourcing opportunities and deploying operational skills to create value.

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Align investors, funds and company management

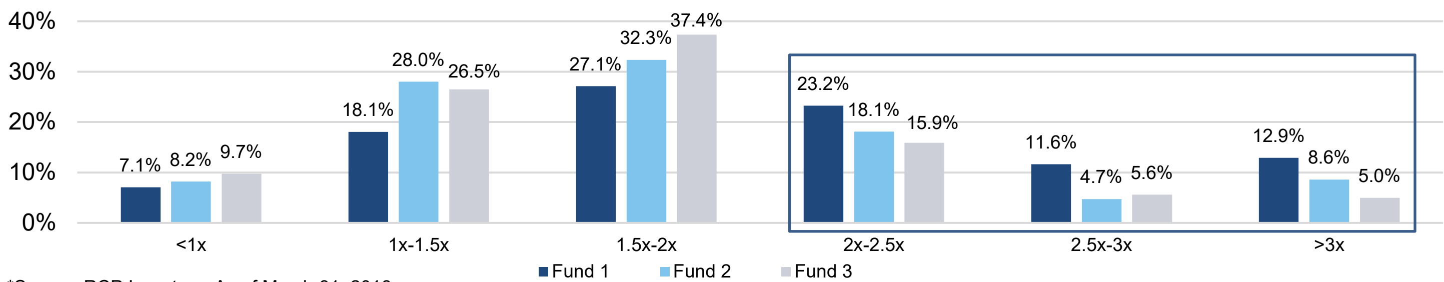
Alignment comes in different fashions. First, is the fund aligned with its investors? A fund typically aligns itself with investors economically through either terms or the team's investment into the fund. Investor-friendly terms, such as a preferred return or reasonable carried interest waterfall, demonstrate a commitment to creating value for Limited Partners (LPs).

By committing a significant portion of their personal net worth to a fund, private equity firms' demonstrate they are "eating their own cooking" by aligning themselves personally with the performance of the fund. Economic alignment is especially prevalent where economics are driven more by performance based fees rather than management fees.

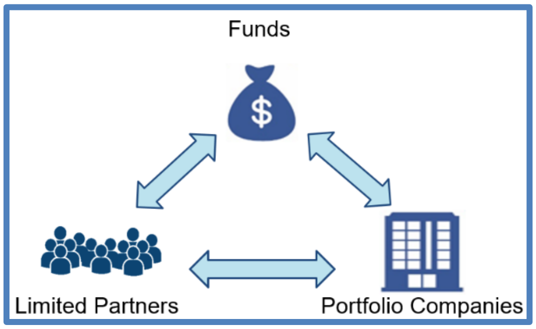
Economic alignment strengthens the bond between LPs and General Partners or GPs; however, reputational alignment is also important. This is true with emerging funds, where a team's reputation and track record is on the line. Oftentimes, new private equity managers' personal net worth makes up an outsized contribution to their inaugural funds so they have both financial and reputational motivation to do well. If successful, investors supporting first-time funds also have the added benefits of access to successor funds, potential term negotiation, advisory board seats and co-investment opportunities.

To no surprise, private equity firms earlier in their lives have historically outperformed. This can be attributed to insatiable appetite for success as fund investors seek to establish a track record during their prime earnings years paired with performance driven economics.

Distribution of Net Multiple on Invested Capital by Fund Number



*Source: RCP Investors. As of March 31, 2016



In addition to aligning with their LPs, it is also important for private equity funds to align themselves with the founders and management teams at the companies they invest in.

Successful funds incentivize their management teams with substantive equity ownership or the option to obtain it. By tying company performance to compensation, management teams are in-step with their private equity owners. This bond can be strengthened on the first day if a founder or seller reinvests a significant amount of the sale proceeds back into the company. If the management team is well-aligned with its private equity owner, and the private equity firm is aligned with its LPs, all parties are incentivized to succeed.

Private market investors must evaluate several factors in order to determine the best investment opportunities for their portfolio. From the vast opportunity set within private equity, we focus on the segment of the market that gives our clients the best formula for long-term success. We assert well-aligned, smaller funds with a specialization are key ingredients to the formula.

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About the Authors:

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Brian is responsible for performing due diligence on private equity and hedge fund managers for potential inclusion in client portfolios. He serves on the firm's Hedge Fund and Private Markets Research Teams. Prior to joining the firm in 2013, Brian interned at The Private Bank. Brian received a BS from Iowa University in Business Management with a concentration in Finance and is a Chartered Alternative Investment Analyst (CAIA[SM]). Brian plays in multiple intramural hockey leagues as well as intramural basketball, softball and flag football and was a Top Five finisher in the National Red Bull Crashed Ice Cross Downhill Competition.

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Curt directs DiMeo Schneider's Global Private Markets research effort, which includes private equity, private real assets and private credit. He also serves on the firm's Investment and Discretionary Committees as well as the Global Hedge Fund Strategies and Global Public Markets Research Teams. Prior to joining the firm in 2014, Curt audited private equity and hedge funds in PwC's financial services assurance practice in Chicago and Boston. Curt received a BBA in Finance and Economics, cum laude, from the University of Miami, a Masters in Accounting from the University of North Carolina at Chapel Hill and is a Certified Public Accountant. In his free time, Curt enjoys music, saltwater fishing, Miami Hurricanes football as well as trying new foods, bourbon and craft coffee.

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Michael is a Senior Research Analyst in the firm's Global Private Markets group. Within this group, Michael is responsible for sourcing and performing due diligence on investment opportunities across private equity, private credit and private real assets. He is also member of the firm's Global Public Markets Committee and Global Real Assets Committee. Prior to joining the firm in 2015, Michael was a Financial Analyst at General Growth Properties and a Research Analyst with Caldera Investment Group. Michael graduated from the University of Chicago with a BA in Economics and was a star point guard on the basketball team. Michael is a CFA® Charterholder. His jump shot is still the best in the office.

[1] BCG-Private-Equity-Is-Hot-but-Not-Overheating-Apr-2018
[2] https://pitchbook.com/blog/what-are-mega-funds