SCS FINANCIAL
Strategic Capital Solutions

INVESTMENT PERSPECTIVES

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PRIVATE EQUITY'S TIMELESS APPEAL

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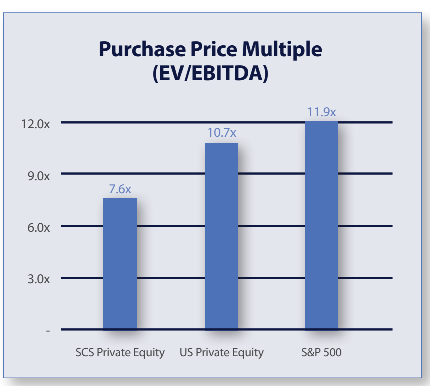
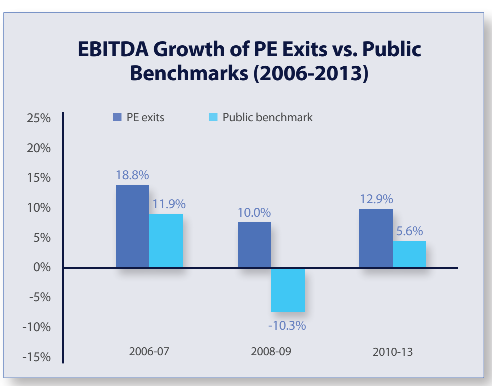
Main Points

- Private equity has inherent characteristics that make it an attractive allocation regardless of where we are in the market cycle.
- Managers can steer companies through dramatic growth and find opportunities in inefficient areas of the market where there is significant potential to generate alpha.
- We see a range of opportunities with managers who have been able to generate consistently strong returns through different economic and credit cycles.

Overview: Equity investors have faced a maturing market with high valuations and growing leverage levels, albeit due to robust earnings growth and low interest costs from historically low rates. Now, with public markets expected to deliver muted results over the next several years amid heightened volatility, many high net worth investors and institutions have been making strategic allocations to private equity for its higher return potential and enhanced diversification benefits. While private equity as an asset class is not immune to today's high valuations and other market forces that challenge investors, its inherent characteristics make it an attractive allocation regardless of where we are in the market cycle. Top private equity firms find a wide array of opportunities in companies across a diverse range of fragmented, inefficient industries. Private equity managers are able to steer underperforming businesses through dramatic revenue and earnings growth, and often find opportunities in inefficient areas of the market where there is significant potential to generate alpha. A private equity fund also can create shareholder value through its longer investment horizon, which is typically 10 to 12 years. Managers are shielded from some of the pressures of public markets, and investors are often able to purchase assets at a discount to public market comps and capture an illiquidity premium of 3% annually or more.[1] As illustrated in the chart at left, valuations of PE-backed companies have been at similar levels to those of public companies in the S&P 500 Index, but our managers have continued to find opportunities to buy companies at a meaningful discount to the broader market. According to an analysis from Ernst & Young[2], PE's "buy-and build," organic growth initiatives have led to EBITDA growth outperformance, as seen in the chart at right.





Sources: Left chart, SCS. Right chart, Ernst & Young. Please see back page for full charts disclosure.

Private equity's strategic attributes have driven SCS Financial's private investments program, which has invested more than $800 million across more than 30 private equity managers since 2011. Below we discuss where we are finding value in today's environment and the potential benefits of an allocation.

Value Creation through Active Management: SCS creates portfolios with unique, differentiated investments that are diversified across strategies, sectors and vintage years. We focus on finding a select group of private equity managers mainly in the lower- to middle-market who have sector and industry expertise to identify undervalued businesses with strong fundamentals and investment theses. The managers add value in a number of ways, driving growth and improving profit margins. Within the SCS program, we target managers who focus on the following:

- **Existing product growth**—Identify companies with potential for organic earnings growth: proprietary products and services, strong recurring revenues, high gross margins, diversified revenue sources and defensive business models that are uncorrelated to macroeconomic factors and serve "captive" audiences.

- **"Buy and build"**—Target fragmented markets with the goal of consolidation through accretive add-on acquisitions. Acquire and roll up a series of smaller, related companies at lower purchase price multiples to grow, realize operational synergies and create new industry leaders.

- **Active operational reform**—Develop new business plans and eliminate unprofitable business lines, and refocus management strategy on areas generating the highest free cash flow. Operationally-oriented managers can unlock hidden value by making undervalued assets more productive.

- **Capital structure efficiency**—Provide expertise to compute the most efficient mix of capital needed to finance ongoing operations and new capital expenditures. Managers determine the proper combination of debt and equity that yields the lowest weighted average cost of capital and maximizes returns for shareholders.

Ultimately the goal is to buy smaller companies, help them achieve their potential and sell them when they are properly scaled and professionalized into mid-cap companies. A successful exit strategy can generate a dramatic increase in the EBITDA (earnings before interest, taxes, depreciation and amortization) multiple paid, with a private equity firm in a typical scenario purchasing a smaller company for 6-8x its trailing 12-month EBITDA and selling it to strategic or larger private equity firms at 9-12x EBITDA, depending on the sector, growth and business model.

One such example is Pine Tree Equity's August 2013 acquisition of Miami-based Community Medical Group (doing business as Access Medical Group). Access Medical at the time was one of the largest independent providers of primary care physician services. The company operated 10 medical centers in Miami-Dade County and was poised for significant growth in its patient base as Florida implemented initiatives to more than double Medicaid enrollment in managed care programs. Pine Tree's expertise in working to professionalize and grow founder-run businesses allowed it to quickly step in and execute key operational and strategic changes including the hiring of a new CEO and COO, enhanced financial reporting and facility expansions. Patient membership nearly tripled. Pine Tree sold Access Medical in July 2015 after less than two years, generating a 12.4x gross multiple on its investment and a 293% gross Internal Rate of Return (IRR). Access Medical was just one name within a portfolio of six companies but its return represented 1.3x the total invested capital in the entire fund at the time of exit. Pine Tree's outcome with Access Medical was only the latest large win for the firm, and Pine Tree has produced a 6.7x gross multiple and a 69.2% gross IRR on its first seven exits since its formation in 2007.

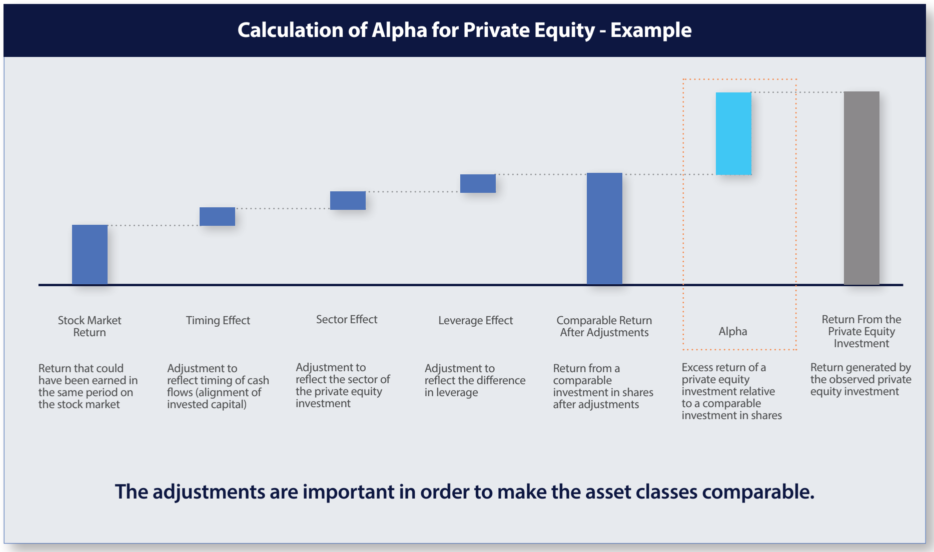
In other cases, a skilled manager can help turn around an undervalued firm with a strong brand and market share that is experiencing recent but solvable problems, such as Sycamore Partners' acquisition of Talbots in 2012. The Sycamore strategy utilizes an analytically intensive approach to acquire underperforming businesses at attractive values by focusing on complex situations and improving profitability. Its differentiated approach allows access to less competitive deals and leads to investments with highly attractive risk-adjusted returns independent of market cycles. For Talbots, the purchase came at an opportune time. The 65-year-old retailer's stock had been trading at around $1 per share, a drop of

94%, after a series of management missteps. Talbots had alienated its core base of older clientele by trying to reach out to younger shoppers, resulting in plunging sales and store closings. Sycamore completed its acquisition of the retailer in August 2012 in a deal valued at approximately $391 million, or about 0.3x revenue, which was one of the lowest revenue multiples ever paid for a US retailer in specialty M&A transactions. Sycamore brought in a new management team to completely restructure and reduce costs and restore the company's focus on classic women's fashion, resulting in an increase of approximately $190 million to Talbots' EBITDA. Sycamore later executed a sale-leaseback of company real estate in 2013, generating $62.4 million in proceeds that was distributed to investors. The growth in EBITDA and reduction in cost basis has resulted in a significant markup to 7.1x of Sycamore's initial investment in Talbots with 3.9x capital already returned. The Sycamore team has consistently been able to see value where others do not and has capitalized on their expertise to tackle complex situations, execute at cheap valuations, and aggressively reform underperforming businesses.

Within the current landscape, we are seeing a range of opportunities diversified across sectors and industries. In each case, the managers have a track record of creating significant equity value, even during difficult economic times, and generating consistently strong returns through different economic and credit cycles. SCS's pipeline of managers remains robust and continues to expand, including the following:

- New York-based Siris Capital is one of the few private equity firms that pursue an investment strategy centered on legacy technology companies with embedded venture assets. The firm's portfolio includes complex, middle-market companies across software, data communications and telecom. Siris focuses on opportunities in companies with a "bond-and-call option" profile that includes restructuring and product launches. The firm also has expertise in taking publicly-traded companies private, and is currently working on a take-private deal with Premier Global Services, Inc. ("PGi"), a provider of audio conferencing and web-based solutions.
- The Beekman Group invests in service businesses across consumer, healthcare and business services sectors with opportunities for operational improvements and EBITDA growth. The firm has expertise identifying companies at attractive valuation multiples and utilizing an "industry partner" to improve and upgrade financial and operational infrastructure and management. Beekman works with industry partners in each portfolio company, which enhances their capabilities throughout the investment process, including sourcing, evaluation of management teams, due diligence and value creation initiatives. A consistent theme has been the firm's ability to build equity value through an active approach to ownership. The firm structures transactions that emphasize downside risk mitigation with performance-based pricing contingencies.
- Trive Capital focuses on undermanaged, strategically viable companies that are facing complex situations and need substantial operational reform. In addition to requiring capital, these companies often are under-resourced and struggle to improve profitability without an operationally-oriented partner. Trive's portfolios typically include companies within the industrial, automotive and aerospace sectors. Attractive opportunities will always exist within turnarounds, distressed situations and restructurings, regardless of conditions in the economic, M&A or credit markets.

Potential Benefits: The SCS program focuses on several important attributes to drive value creation. First, we utilize rigorous research and analysis within a universe of more than 3,000 managers to source new deals. Manager selection is a primary determinant of performance in private equity given a wide dispersion of returns in the asset class. Second, we seek to invest in top-performing funds that are often difficult to access. Access is critical because many of the best managers are closed to new investors, and competition is growing due to new participants in the market, such as pension funds and sovereign wealth funds. Third, SCS's industry experience and relationships help to create an attractive investor profile that allows us to access oversubscribed funds. Active risk management to prevent permanent loss of capital underpins our investment process, through careful selection of a diversified group of managers with deep sector expertise. Numerous studies have shown that value-creation strategies have been a big driver of private equity's strong



Source: Golding Capital Partners and HEC Capital Partners.

performance versus public markets. For example, as illustrated in the chart at left, an empirical study of US and European private equity transactions between 1977 and 2010 found that the returns for private equity investments were dramatically higher than those of public equity investment due to the impact of alpha generation.[3]

Outlook: The private equity market has seen significant growth over the past decade, fueled by strong private equity and public equity market returns, low interest rates and favorable credit conditions. Exits from buyouts exceeded $450 billion in 2014, a new record, resulting in a strong year for fundraising, according to a report from Bain & Co.[4] However, a "superabundance" of capital could create challenges in the years ahead, with higher asset prices, increasing competition to access top funds and longer holding periods for companies, Bain found. An emphasis on lower- and middle-market managers who often operate under the radar can mitigate these risks. There will always be a universe of companies with untapped potential that could benefit from better management and financial and operational improvements. Managers who are able to identify and transform undervalued companies should be well-equipped to find opportunities throughout the economic cycle.

REFERENCES

Page 1 left chart: SCS Private Equity represents the median EV/EBITDA multiple for deals completed by buyout managers in SCS funds as of 3/31/15. US Private Equity represents the median EV/EBITDA multiple for buyouts as of 12/31/14 presented in PitchBook's US PE Breakdown 4Q 2015 report. S&P 500 represents the V/EBITDA multiple for the S&P 500 as of 9/30/15.. Page 1 right chart from Ernst & Young, "Returning to Safer Ground: How do private equity investors create value? A study of 2013 North American Exits."

[1] *"Patient Capital, Private Opportunity: The Benefits and Challenges of Illiquid Opportunities," Blackstone Group. Oct. 1, 2014.*
[2] *"Returning to Safer Ground: How do private equity investors create value?" A study of 2013 North American exits.*
[3] *Golding Capital Partners and HEC Paris, Private Equity Study: Finding Alpha 2.0. A study by Prof. Oliver Gottschalg (HEC) and Golding Capital Partners on the Relative Performance of Private Equity. Frankfurt, Nov. 7, 2011.*
[4] *Global Private Equity Report, Bain & Co.*

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