MAKENA

LETTER TO INVESTORS

The Little Engines Who Can: Why Small-Cap Buyout Can Drive Investor Returns

JULY 2019

The beginning of 2019 marked the 10th year since the end of the Global Financial Crisis (GFC). Despite a few periods of enhanced volatility, equity markets in the United States and around the world have mostly continued their steady and prolonged march upward. While much of that increase has been driven by improved earnings, it has also been stimulated by lower interest rates and, consequently, higher multiples of earnings. Between 2009 and 2019, the forward PE multiple for the S&P 500 grew from 14.4x to 18.8x, an increase of 30%. The same goes for private markets; from 2009 to the end of 2018, the average purchase price multiple for a buyout in the United States grew from 7.7x EBITDA to 10.6x EBITDA, an increase of 38%. The increase in multiples has driven returns for all investors, but as we enter the 10th year of a bull market, the opportunity for further increases seems exhausted. In an effort to find value in the public or private markets, few, if any, pockets remain unexplored. Where should investors look for returns in private markets in the future? We believe small-cap buyout offers investors attractive entry valuations and strong prospects for growth, two necessary conditions for capturing excess investor returns.

Large-cap, brand name firms are widely seen as the access point to private equity. Large-cap buyout funds have produced strong trailing returns of late, driven by expanding multiples and strong public equity markets, which is the natural means of exit for most deals. Fund flows and capital raising further underscore investor enthusiasm, given nearly 80% of all capital raised in 2018 was allocated to larger funds.[1] While larger funds can provide steady returns, the Makena Private Equity team believes the greatest opportunity for alpha lies in small-cap buyout. Small businesses form the backbone of the U.S. and global economies and when these companies seek equity investment, they look to partner with high integrity individuals and firms, well-aligned organizations with existing networks and resources for driving growth. Since 2006, Makena Capital's Private Equity team has actively sourced and invested in managers that we believe can generate attractive returns through disciplined purchase prices, appropriate balance sheet optimization, active management, and careful exit timing. Currently, Makena has approximately $500 million invested with small-cap managers.

While we believe strongly in the importance of building and managing a diversified private equity portfolio, small-cap buyout continues to be an important area of focus. In the following pages, we discuss the advantages of small-cap buyout compared to mid- and large-cap. Our case includes three parts:

1. The attractive market dynamics of the small-cap buyout space.
2. The particular importance of manager selection in this market.
3. A case study demonstrating Makena's success in supporting small-cap buyout.

Clarifying the Upper Limit of "Small-Cap"

While practitioners may debate where to draw the line between small- and mid-cap, at Makena we believe the upper limit for small-cap should lie at a fund size around $500 million. Typically, funds of this size or smaller will focus on companies with $15–$100 million of revenues and $5–$30 million of EBITDA. These fund managers will seek to assemble a portfolio of 10–15 investments with an average equity investment of $15–$50 million. Because the barriers to entry in small-cap buyout are relatively low, with a large number of small funds, fundless sponsors, family offices, and others scouring the market for deals, the small-cap segment produces a wider range of outcomes, making manager selection paramount.

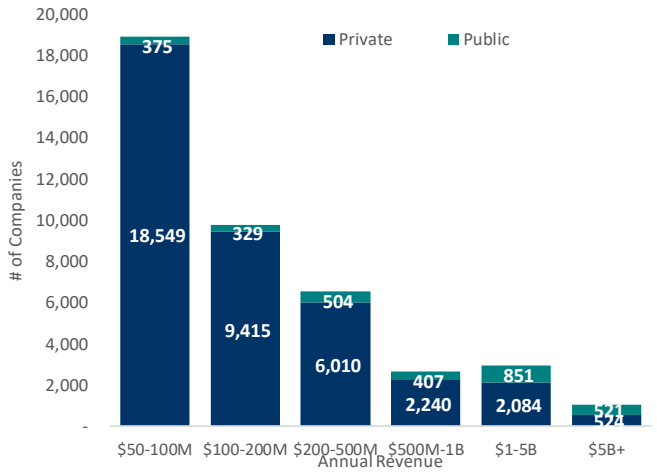
[1] Pitchbook, "Cumulative US Private Equity Fundraising."

The Three Advantages of Small-Cap over Mid- and Large-Cap

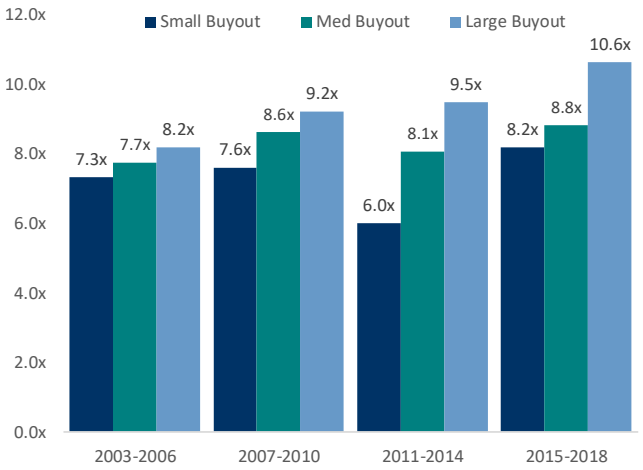
In this market segment, we believe the opportunity for experienced managers to generate outsized returns is attractive for several reasons: (1) small-cap buyout managers operate in a large and less efficient market; (2) small-cap funds possess more opportunity for value creation; and (3) small-cap managers typically enjoy more robust exit opportunities.

Advantage #1: Small-cap buyout managers operate in a large and less efficient market. The number of investable companies available to small-cap managers, on a global basis, is extremely large. In the United States alone, there are nearly 19,000 companies with revenues between $50–$100mm, and over 95% of these companies are privately held. The large universe of potential investments affords managers a wide array of possibilities as they seek attractive opportunities. Additionally, the significant pool of available companies can produce pricing inefficiencies at acquisition, by providing investors the opportunity to engage companies in bilateral negotiations often well in advance of an intermediated process. In the absence of intermediaries to inform pricing, investors can execute deals on a proprietary basis and, as a result, secure these deals at better prices. This larger buying opportunity enables experienced private equity investors to more effectively sift through actionable companies, separating the wheat from the chaff.

Private Equity Target Universe



Average EV/EBITDA at Acquisition



Source: Capital IQ; S&P LBO Review

Private small-cap companies have historically traded at discounts of 10–20% below those of their larger peers. We recognize that small businesses can carry certain idiosyncratic risks on a company-by-company basis, such as more concentrated customer bases, fewer product offerings, less experienced management teams and more constrained balance sheets. However, we believe asset managers building diversified portfolios should recognize that a broad-based portfolio of small companies should not be inherently riskier than a diversified portfolio of mid-cap or large-cap companies, and that these risks, while relevant to an individual company, also provide enormous opportunity for value creation for proven small-cap buyout managers.

Advantage #2: Small-cap funds possess greater opportunity for value creation. Small companies have more immediate room to grow revenues and earnings, frequently making their path to value creation (and ultimately return potential) much clearer than the path for larger companies. Put simply, it is much easier to double revenues of a $50 million business than those of a $500 million business. Because small companies are often undercapitalized, infusing more money allows a business to accelerate growth by attracting key executives to the

management team or board of directors, launching new products, or entering new markets. At the same time, managers can deploy strategies for improving operations, leveraging in-house expertise in digital marketing, forensic accounting, price harmonization, standardized procurement, and talent acquisition and retention. Because small-cap businesses have more room to grow, these strategies may produce a greater, more immediate impact than they would in the mid- and large-cap space. Once the buyout group establishes a strong management team, good corporate governance, and a flexible capital structure, these companies can often accelerate organic growth and pursue accretive add-on acquisitions.

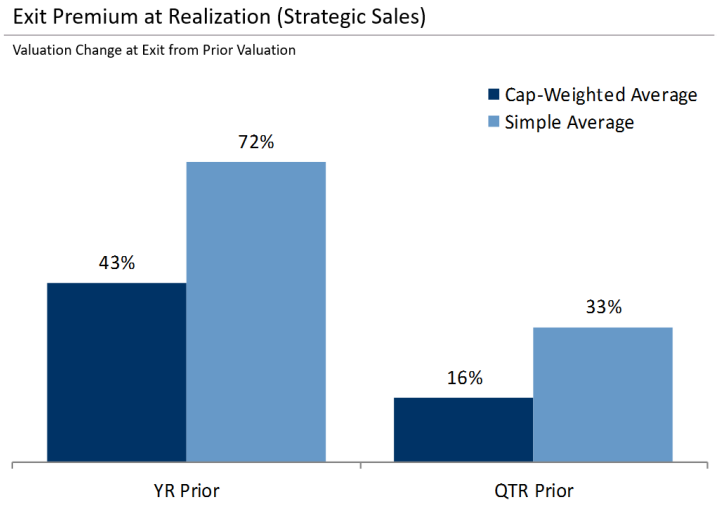
R2000 Outperforms S&P 500

		Trailing 1 Year	Trailing 5 Year	Trailing 10 Year	Trailing 20 Year
Revenue Growth	R2000	8.6%	5.6%	6.3%	4.3%
	S&P 500	6.6%	3.7%	5.0%	3.4%
	R2000 Outperformance	*2.0%*	*2.0%*	*1.3%*	*0.8%*
EBITDA Growth	R2000	12.6%	8.4%	6.1%	6.1%
	S&P 500	7.5%	3.8%	3.3%	4.0%
	R2000 Outperformance	*5.0%*	*4.6%*	*2.8%*	*2.0%*

Source: Bloomberg data as of 12/31/2018

Advantage #3: Small-cap managers typically enjoy more robust exit opportunities. Corporate and financial buyers engage in acute competition to acquire high-growth, well-managed businesses. As small-cap buyout managers implement value adding strategies, they transform companies into larger, more diversified, better-managed businesses, which makes them more attractive potential acquisitions for "up-market" purchasers, who are often willing to pay higher multiples than were paid at the time of the original transaction. Larger buyout managers also have considerable amounts of "dry powder" waiting to be invested. At the end of 2018, mid- and large-cap managers had approximately $433 billion of dry powder (~80% of cumulative dry powder) awaiting investment.[2] This competitive market dynamic, coupled with strong earnings growth over the holding period and multiple expansion at exit, can drive outsized returns for successful small-cap buyout managers. In contrast, for mid- and large-cap managers, the potential for further multiple expansion appears exhausted in the 10th year of the current bull market.

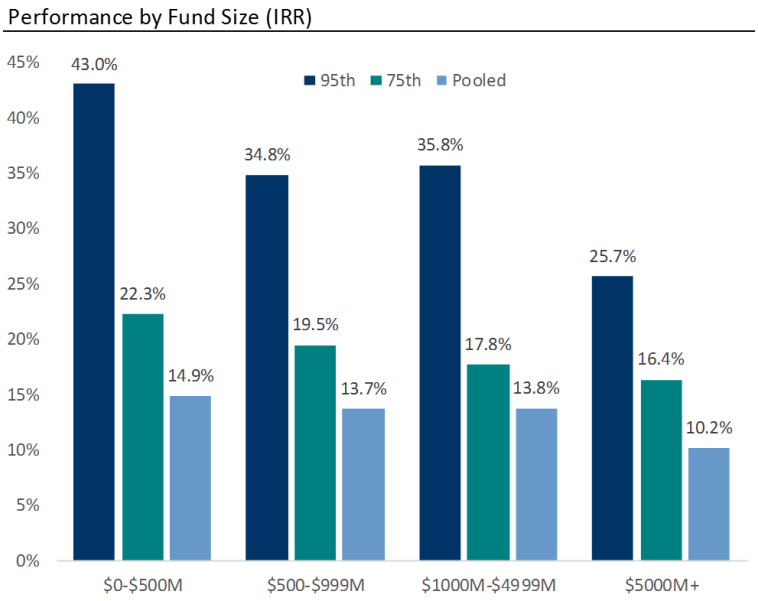
In Makena's Private Equity portfolio, this "step-up" in valuation at exit is material. For the past several years, we have tracked the average step-up in valuation at exit on fully realized transactions in our portfolio. This data set underscores the incremental value captured at exit, largely driven by multiple expansion. Since 2013 the average "step-up" in valuation at exit was 43% from the prior year (measured by cap-weighted) and nearly 72% (measured by simple average) from the year prior. The average step up in valuation from the prior quarter was 16% and 33%, respectively.[3]



[2] Pitchbook, "Cumulative US Private Equity Dry Powder."

[3] Based on largest 82% of total distributions between 01/01/2013 and 12/31/2018, step-up calculated for strategic sales where data was available.

The Importance of Manager Selection



Source: Burgiss Private IQ as of 12/31/2018

In March 2019, Makena's CIO Larry Kochard, published a piece on Makena's Six Investing Principles, where he discussed our core strength of manager selection and access. Regardless of the supportive dynamics for small-cap buyout managers, successfully navigating this market requires top-tier experience and expertise. Because managers within this segment display the largest spread between top-performing and average managers, it is critical to identify and access industry-leading fund managers. Maintaining a diversified portfolio of relationships across the spectrum of small-, medium- and large-cap buyout is imperative, because a major source of small-cap buyout manager talent often comes from mid-cap and, in some cases, large-cap investment firms. For example, Makena has backed several promising individuals and firms who have spun out of mid-cap and large-cap firms to consciously go down market and take advantage of small-cap buyout's favorable market dynamics. Performing Makena's necessary due diligence and accessing these investments was made possible given the relationships established with the individuals at their prior firms. Further, having invested in their prior firms, we had considerable time to develop and form deep relationships of trust and confidence in their investment acumen, work ethic, and personal character. We believe this level of due diligence is particularly important in the small-cap buyout space, where managers are generally earlier in their careers and have yet to develop an institutional following. Makena's experience in manager selection and access, and our proven ability to identify and seed the next generation of investment talent, inform our belief that we can successfully drive results.

Case Study: Foundation Investment Partners

In 2007, Makena was introduced to David Whittaker, the founding partner of Foundation Investments Partners ("FIP"). Whittaker started FIP in 2002 and had operated in the United Kingdom small-cap buyout space on a deal-by-deal basis as a "fundless sponsor" for several years. During that time, he had assembled a targeted portfolio of small-cap investments in privately held businesses including funeral homes and schools. From 2007 until 2014, the Makena Private Equity team maintained an active dialogue with FIP, frequently visiting with Whittaker and his team in London, and receiving updates on his investment portfolio.

In mid-2014, Makena formed a partnership with Whittaker which culminated in Makena investing £30 million in his £90 million inaugural fund, Foundation Investment Partners I ("FIP I"). The investment was predicated on our belief that Whittaker could acquire attractive businesses at attractive valuations, grow the businesses organically and through acquisitions, and exit those companies to buyers willing to pay a premium. While still early, FIP I has invested £65 million into five companies. Two of the companies, VTS Buying Services and Pro-Vets Group, have already been realized.

- *VTS Buying Services* – VTS is a leading purchasing platform in the veterinary sector. In November 2014, FIP I acquired a controlling stake in a platform to act as a small-scale consolidator. During the first half of 2015, Whittaker and his team completed several improvements to drive value at the company. As the company was preparing to embark on further acquisitions and value creation, VTS was approached by a strategic acquirer looking to buy the business. While VTS wasn't formally "for sale," the offer was sufficiently attractive to pursue the transaction, which occurred at a material step-up from the holding value.

- *Pro-Vets Group* – Pro-Vets is a leading veterinary group that owned and operated several regional clinics across the U.K. In May 2015, FIP I acquired four regional veterinary practices operating in the United Kingdom which together formed the initial acquisition platform. In 2016 and 2017, Whittaker and his team invested incremental equity to acquire an additional seven practices. During FIP's ownership, the company achieved significant consolidation and cost synergies, price harmonization across a broader base of business, and the addition of several higher value-added offerings like CT scanners. In July 2017, a larger consolidator, Independent Vetcare, made an unsolicited offer to acquire Pro-Vets at a valuation significantly higher than what FIP I paid. FIP sold the business and realized a considerable return.

Since our investment, Whittaker has pursued his strategy of investing in small-cap companies in the United Kingdom, growing them through organic and inorganic means and opportunistically selling them "up market." His success in growing these businesses has attracted the interest of larger consolidators, who have been willing to pay a premium multiple to acquire the assets. This virtuous cycle of success has led to exceptional absolute and relative performance for the investors in FIP I. Since our investment, FIP I has generated top decile performance among a cohort of International Buyout managers and over 2500bps of outperformance relative to the ACWI.

Conclusion

We believe investing in small-cap buyouts offers investors the opportunity for exceptional returns. Our experience suggests that manager selection and access remain keys to success. Even though the small-cap market possesses attributes not available to most mid-cap and large-cap managers, the range of outcomes is also much greater, making manager selection paramount. A proven and disciplined small-cap investor should be able to acquire promising companies at attractive rates, drive value creation and capture an exit premium at sale. Makena's edge remains reliant on a disciplined bottoms-up investment process that is focused on sourcing and partnering with top tier investment managers–an approach we will continue to pursue in the small-cap buyout space.

Sincerely,

The Partners of Makena Capital Management

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