APRIL 2020

AN ALTERNATIVE TO ALTERNATIVES
PRIVATE EQUITY

Private Equity ("PE") has garnered increased attention and momentum over the past decade; and while there are substantial risks, it brings with it the possibility to provide enhanced returns and greater portfolio diversification for investors with a long-term investment horizon.

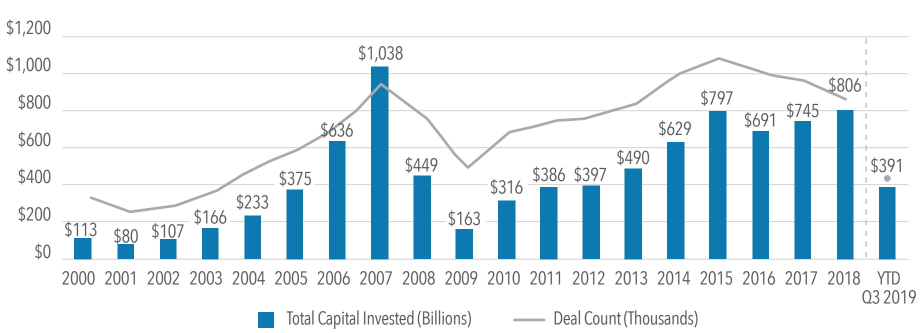
Private Equity—an asset class and investment style focused on investing directly in private companies, or that engage in buyouts of public companies—was once limited to institutions, pension funds and family offices. Today, we are seeing trends that the industry is slowly evolving to include mainstream investors that meet specified income and net worth qualifications.

INSIDE

STATE OF THE MARKET

Global PE activity was strong in 2018, recording the largest number of PE-backed buyout transactions and the second highest buyout volume level experienced over the past decade.[1] 2019 PE volumes had another strong year as well—benefiting from the resilient leveraged buyout activity sustained through a combination of low interest rates, economic growth, supportive credit markets and cash-like marketable securities (see Figure 1). These conditions have led to a highly competitive investment environment, resulting in the continued increase of valuation multiples.

FIGURE 1: GLOBAL PE INVESTMENT ACTIVITY

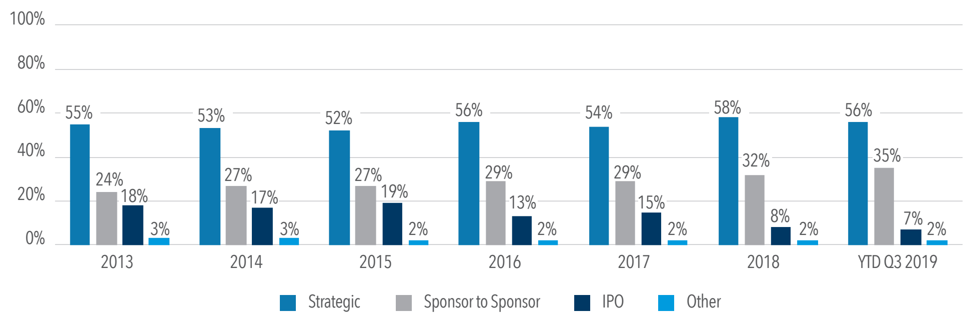


Source: PitchBook. Data as of September 30, 2019; excludes venture capital.

1. Private Equity Market Outlook, Neuberger Berman, January 2020

Private equity returns have been attractive as well. Between 2014 and 2018, the industry garnered the highest five-year exit return total on record at $2 trillion—and PE firms seem on track to produce similarly high exit levels in 2019. Furthermore, over the past eight years, distributions paid to investors from cash realizations have consistently exceeded contributions to fund new investments. Median PE investment holding periods have contracted and now average 4.5 years, down from a peak of approximately six years in 2014. Strong corporate balance sheets are driving robust interest from strategic investors for M&A, and sales to these strategic buyers account for the greatest proportion of exits. Sponsor-to-sponsor exits turned in their third strongest year for the industry in 2018 at $1.2 billion (behind 2007 and 2017). Meanwhile, the value of IPOs has dropped since the second half of 2018 amid continued market uncertainty and higher volatility—a trend we expect will continue (see Figure 2).[2]

FIGURE 2: PE EXITS BREAKDOWN



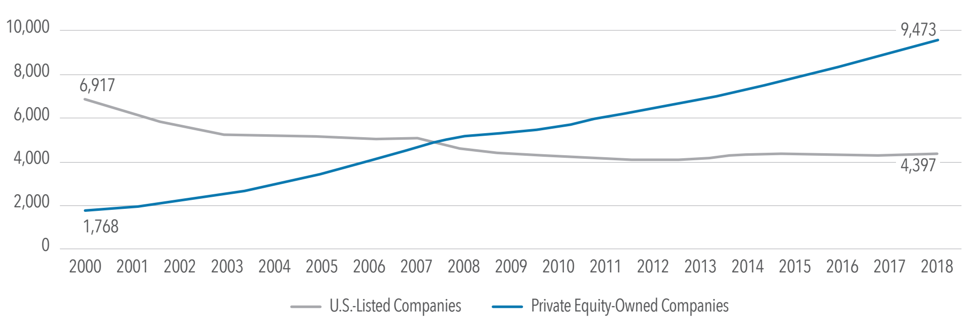
Source: Preqin Buyout Deals Analyst.

POLITICAL SPOTLIGHT ON PRIVATE EQUITY: A SHIFT FROM PUBLIC TO PRIVATE

During the last global financial crisis, U.S. PE-owned firms and their publicly-listed counterparts were roughly equal in number. Fast forward to 2020 and the universe of privately-owned firms has grown to twice that of public companies (see Figure 3). Capital markets are shifting from public to private, which decreases the number of investment options for individual investors. More capital is flowing into private equity as institutions and wealthy individuals search for greater returns with less volatility.

In financial terms, the PE market is a fraction of the size of public stock markets, comprising a mere net asset value of just 3% of the value of global stock markets.[3] However, this is twice as high as levels observed 10 years ago, and PE markets are anticipated to continue growing at a faster rate than public equity markets. A large part of this is expected to be attributed to the further growth of the industry through regulatory changes that could enable retail investors increased access.

FIGURE 3: U.S.-LISTED COMPANIES VS. PRIVATE EQUITY-OWNED COMPANIES



Source: PitchBook and World Bank.

2. Private Equity Market Outlook, Neuberger Berman, January 2020
3. Private Equity Market Outlook, Neuberger Berman, January 2020

Left unchanged, retail investors may reap the unintended consequences to their portfolios if companies' view PE as being more advantageous for a businesses' operating structure. The lack of opportunity for individual investors to diversify their portfolios has put many at risk of over-allocating into a single asset class or missing out on the growth of new technology.

Uber is an example of this trend, where a highly successful company chose to remain private for years. When Uber eventually went public, it was one of the highest valued IPO's in history, with a company valuation of $82.4 billion at $44.00 per share.[4] Post IPO, Uber stock has fluctuated, staying mostly in the mid-$30 range, meaning retail investors have been unable to capture the immense company growth that private equity firms did prior to its IPO.

Historically, stringent investment qualifications have limited individual investors access to PE. It's widely understood that institutional investors and ultra-high net worth individuals have had the means to invest in private equity opportunities. With insight and guidance from financial advisors, we believe individual investors should be given access to this ever-expanding investment class.

ATTRACTIVE ASSET CLASS RETURNS: DESPITE NEW CHALLENGES

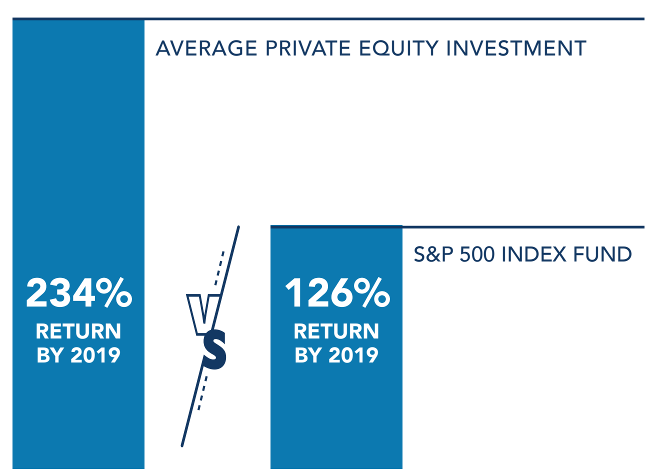
Over the past 20 years, private equity has outperformed public equity. During that time, the average private equity investment would have returned 234% in 2019, while a comparable investment in the S&P 500 Index Fund would have returned 126%.[5]

Over the past 20 years, private equity has outperformed public equity.

—CAMBRIDGE & ASSOCIATES

PRIVATE EQUITY VS. S&P 500 INDEX RETURNS

20-YEAR RETURNS (AS OF SEPTEMBER 30, 2019)



As an investment class, PE typically provides investors with information prior to an investment that can be critical to making an informed investment decision. These investments can also provide increased opportunity for active ownership and broader exit positioning/timing options. Furthermore, we believe the structural advantages in PE, relative to the public markets, will continue to attract savvy investors in search of higher-yielding investment alternatives.

4. https://www.theguardian.com/business/2019/may/09/uber-value-wall-street-ipo-friday
5. US Private Equity Index and Selected Benchmark Statistics, Cambridge & Associates, September 30, 2019.

BALANCING **THE RISKS OF PRIVATE EQUITY**

As with any new investment or asset class, it is important to weigh the risks and potential rewards prior to making any investment. Private equity has historically been reserved for institutional or savvy investors who have the ability to analyze an exorbitant amount of data in order to make an informed investment decision. Some of the risks investors must take into consideration include:

- Lack of liquidity
- Limited information about the issuer or manager
- Limited financial reporting
- Capital risk
- Funding risk

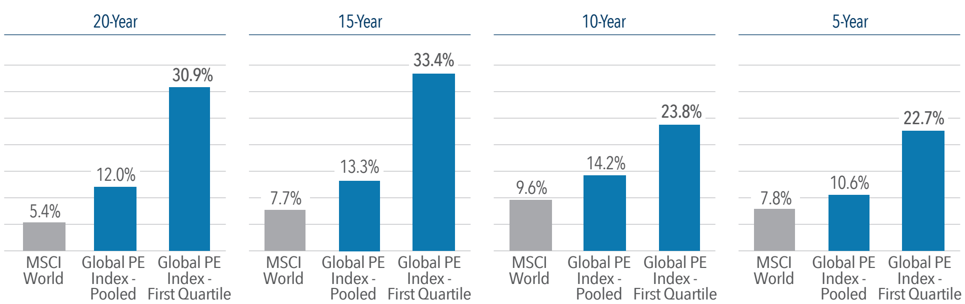
Private equity investments are often illiquid and carry substantial risks and should only be considered for sophisticated investors who can withstand the loss of their entire investment.

GROWING DEMAND & INCREASING ALLOCATIONS: **PRIVATE EQUITY AS A PORTFOLIO INVESTMENT**

Since the late 1990s, investor capital has entered the private markets at record rates. PE has been one of the best-performing asset classes across a variety of time periods and has delivered meaningfully stronger returns than the public markets over a 5-, 10-, 15- and 20-year investment time horizon (see Figure 4).

> “There is more openness to alternatives than ever before. The root cause of this being uneven performance, which has given investors leverage to push their managers for more engagement.”
>
> —PENSION, EUROPE, UNDER U.S. $2B

FIGURE 4: PERFORMANCE OF GLOBAL PE VS. PUBLIC MARKETS



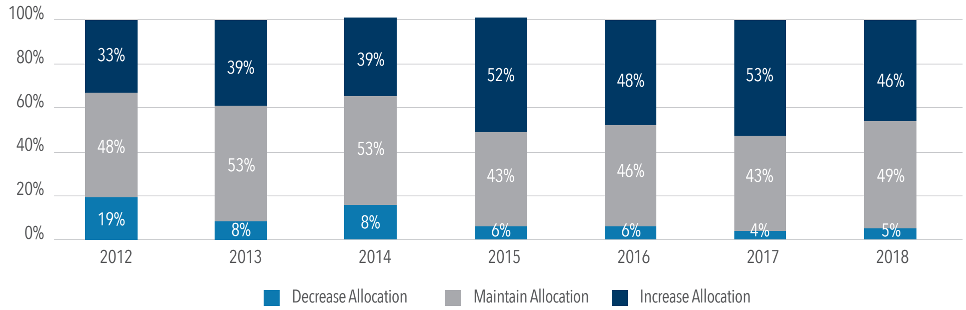
Source: Cambridge Associates (CA). Represents pooled horizon IRR and first-quartile return for the Global All PE Index from CA as of June 2019, which is the latest data available. The benchmark performance is presented for illustrative purposes only to show general trends in the market for the relevant periods shown. The investment objectives and strategies of the benchmarks may be different than investment objectives and strategies of a particular private fund, and may have different risk and reward profiles. A variety of factors may cause this comparison to be an inaccurate benchmark for any particular type of fund and the benchmarks do not necessarily represent the actual investment strategy of a fund. It should not be assumed that any correlations to the benchmark based on historical returns would persist in the future. The Cambridge Associates Index is not transparent and cannot be independently verified because Cambridge Associates does not identify the funds in the index. Because Cambridge Associates recalculates the index each time a new fund is added, the historical performance of the Cambridge Associates Index is not fixed and will differ over time from the data presented in the chart. Funds included in the Cambridge Associates U.S. Private Equity Index report their performance are voluntary, are unidentified and unaudited and therefore the index may reflect a bias towards funds with track records of success. The returns reflect a combination of fees including carried interest and data sets change and therefore cannot be replicated. “The Internal Rate of Return (IRR) is a metric used in capital budgeting to estimate the profitability of potential investments. IRR is a discount rate that makes the net present value (NPV) of all cash flows from a particular project equal to zero. To calculate IRR, one would solve for the discount rate when the NPV is set to zero. The MSCI World Index is a broad global equity index that represents large and mid-cap equity performance across all 23 developed markets countries. It covers approximately 85% of the free float-adjusted market capitalization in each country. **Past performance is no guarantee of future results.** Indexes are unmanaged and not available for direct investment.

While economists believe the PE markets will continue to generate attractive returns and a generally robust illiquidity premium over its public counterparts, a number of cyclical and structural factors—including the general macroeconomic environment, increased competition, maturation of the industry, and accelerating pace of technological change, among others—will likely result in more compressed returns in absolute terms in the future relative to historical levels.[6]

Furthermore, despite the general sentiment that we have entered the latter stages of the market cycle, surveys continue to show that, over the long-term, an overwhelming majority of institutional investors intend to either maintain or increase their allocations to PE (see Figure 5).

6. Private Equity Market Outlook, Neuberger Berman, January 2020

FIGURE 5: INVESTORS' ALLOCATION INTENTIONS TOWARD PE



Source: Preqin surveys, November 2012–2018.

To counteract the cyclical and structural factors that are presenting themselves in the economy, experts have identified seven ways PE firms are evolving.[7]

1	FIRMS SPECIALIZE IN SECTORS TO COMPETE – Specialization means more knowledgeable professionals may be better equipped to make operational changes. This is common among, smaller PE firms; however, it is also common for larger generalist firms to create sector verticals that achieve similar "specialist" results.
2	PORTFOLIO COMPANIES NEED OPERATIONAL EXPERTISE – Investors are now telling general partners to show them how they are affecting change through operational expertise.
3	FUNDLESS SPONSORS & OTHER ALTERNATIVES MODELS CHALLENGE PE Over the last decade, firms doing deals without dedicated private equity funds or through non-traditional methods have proliferated.
4	FAMILY OFFICES INVEST DIRECTLY – About 80% of family offices now have at least one full-time employee sourcing and evaluating direct investments, according to an annual survey by the Family Office Exchange.
5	PE FIRMS SELL MINORITY STAKES – This often occurs cyclically at the top of the market or as it becomes harder for firms to raise funds and grow their businesses. Some may look to buy private equity firms, which can enable them to create new specializations or lines of business.
6	MID-MARKET FUNDS OFFER MORE PRODUCTS – These can include a wide array of products such as large- and mid-market funds, geographically targeted funds, sector-focused funds, private debt funds and real estate funds.
7	CO-INVESTMENTS BECOME IMPORTANT – According to the Probitas Partners survey, interest in co-investments is strong with 55% of respondents having either an active internal or outsourced co-investment program.

7. https://www.themiddlemarket.com/news/special-report-on-private-equity-7-ways-pe-firms-are-evolving

SECTOR-FOCUSED **PRIVATE INVESTMENT FUNDS**

Sector-focused funds, which are defined as funds with managers that invest more than 70% of capital into a specified sector, have historically been at the head of the class and use industry expertise to avoid pitfalls.[8] For example, between 2001 and 2010, sector-focused investments in the consumer, financial services, health care and technology sectors outperformed generalists on a number of scales (see Figure 6).[9]

FIGURE 6: SECTOR-FOCUSED VS. GENERALISTS INVESTMENT PERFORMANCE

	Consumer Focused	Financial Services Focused	Healthcare Focused	Technology Focused
Sector Specialists				
MoIC	2.3x	2.1x	2.2x	2.3x
IRR	21.3%	23.3%	25.1%	23.5%
Generalists				
MoIC	1.9x	1.7x	2.0x	2.0x
IRR	17.9%	13.9%	17.3%	19.8%

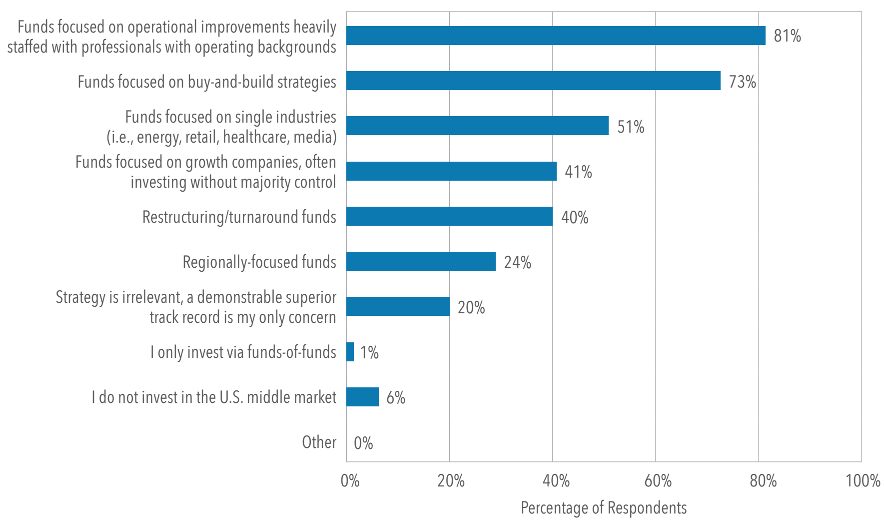
Source: https://finance.yahoo.com/news/sector-focused-private-equity-funds-150113497.html
Notes: Data represent realized and unrealized investments within the Cambridge Associates US Buyout and Growth Equity Benchmark initiated between 2001 and 2010. To focus in on actual sector-specific investment performance versus fund-level performance, each underlying portfolio investment within the Cambridge Associates US Buyout and Growth Equity benchmark was assigned a sector classification based on Standard & Poor's Global Industry Classification Standards (GICS). Investments within the four studied sectors represented approximately 60% of the benchmark's total invested capital during this time period –consumer (19%), technology (18%), health care (12%), and financial services (11%). MoICs (Multiple on Invested Capital) and IRRs are based on the aggregate performance of investments categorized as sector specialist or generalist. All performance is gross of fees and expenses.

"This outperformance comes from intimate knowledge of an industry—in an increasingly competitive private equity environment, a manager's ability to demonstrate deep expertise in a focused field is a key differentiator."

—ANDREA AUERBACH,
MD and Global Head of Private Investment Research, Cambridge Associates

According to a Probitas Partners survey, 51% of respondents acknowledged that funds focused on single industries are the most appealing in the middle market, an increase of 14% over last year.[10] The survey further identified that investors are focused on fund managers that drive operational improvements and buy-and-build strategies (see Figure 7).

FIGURE 7: PRIVATE EQUITY INSTITUTIONAL INVESTOR TRENDS SURVEY



Source: Probitas Partners Private Equity Institutional Investor Trends 2017 Survey.

8. www.cambridgeassociates.com/research/declaring-a-major-sector-focused-private-investment-funds/
9. https://finance.yahoo.com/news/sector-focused-private-equity-funds-150113497.html
10. Probitas Partners Private Equity Institutional Investor Trends 2017 Survey

The survey's analysis concluded numerous competitive advantages that can lead to better pattern recognition with higher quality and increased volume of deal flow, including:

- Industry and operational knowledge
- Ability to develop resources, executives, board members, etc.
- Ability to align processes and general approach to company management and investment oversight
- Playbook for driving operational improvements
- Deal sourcing advantages

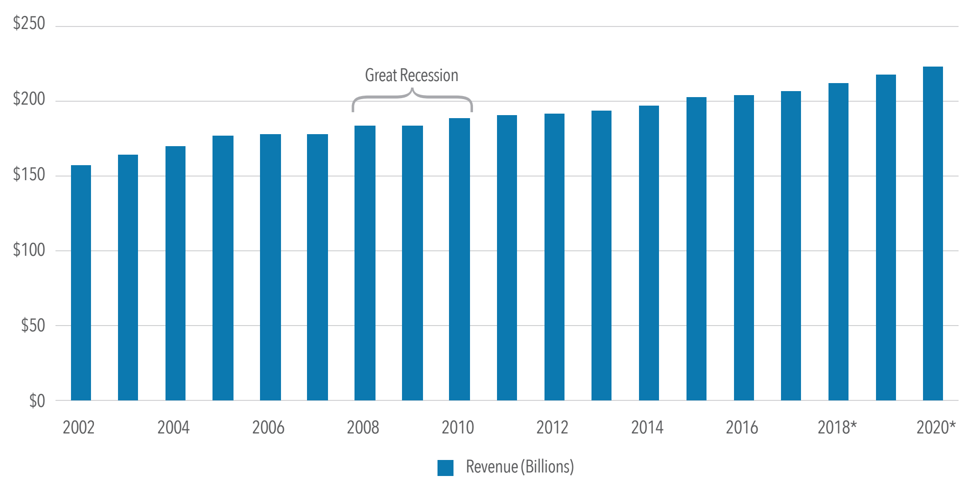
SECTOR FOCUS: **AN IN DEPTH LOOK AT QUICK-SERVICE RESTAURANTS**

Quick-Service Restaurants ("QSRs") represent a $500 billion industry and account for over 50% of restaurant sales nationwide.[11] Similar to other industries, today we are seeing a consolidation of restaurants across the country.

Economies of scale have driven brands to sell their companies or investment shares to larger multi-brand operators. This allows stakeholders to step back and hand off the legacy of the brand to experienced, well-capitalized operators. Investors can take advantage of greater food and beverage purchasing power which typically results in lower costs and increased profits. In addition, leveraging experienced staff for operations, marketing, purchasing and R & D allows a brand to reduce staff by spreading the experience across all of their brands.[12]

Historically, the QSR industry has enjoyed strong recurring revenue, with 84.8 million adults consuming fast food on a daily basis and 48% of a family's food budget being spent at fast food restaurants.[13] QSRs have also shown that they are the most recession resistant segment of the restaurant industry (see Figure 8).[14]

FIGURE 8: REVENUE OF QSR INDUSTRY IN THE UNITED STATES FROM 2002 TO 2020 (IN BILLIONS U.S. DOLLARS)[15]



Source: The NPD Group/Fall 2015 ReCount and GE Franchise Finance. IBIS World; Mazzone & Associates, Statista 2017.*Projected.

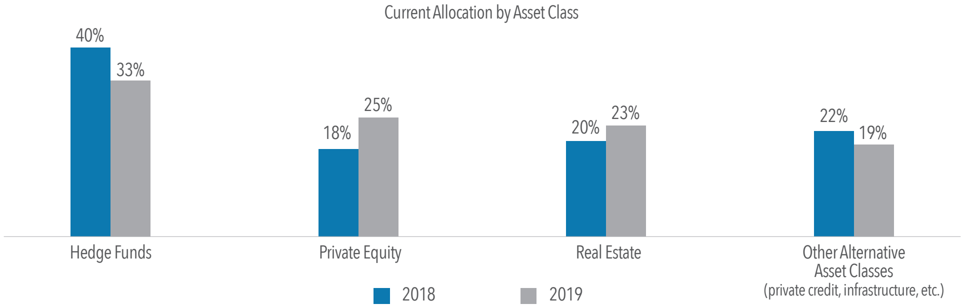
11. The NPD Group/Fall 2018 ReCount; GE Franchise Finance; Fast Food Industry Analysis 2019 - Cost & Trends
12. https://www.forbes.com/sites/darrentristano/2019/09/26/private-equity-investments-in-restaurants-continues-to-heat-up-as-jimmy-johns-sandwich-shop-is-being-sold-to-inspire-brands/#4d204b26e858
13. https://www.cnn.com/2018/10/03/health/fast-food-consumption-cdc-study/index.html; www.restaurant.org, Pocket Factbook, February 2017
14. Restaurant.org September 2016. Frequency of QSR Visits since Nov 2013. http://www.statista.com/statistics/294344/frequency-of-quickservice-restaurant-visits-us The NPD Group/Fall 2015
15. The NPD Group/Fall 2015 ReCount and GE Franchise Finance. IBIS World; Mazzone & Associates, Statista 2017

PRIVATE EQUITY **INVESTOR PROFILE**

There is growing demand for alternative investments in the retail marketplace today, as 91% of current private equity investors plan to maintain or increase their allocation in the asset class (see Figure 9).[16]

The leading investors, continue to be pension funds, insurance companies, sovereign wealth funds, asset managers, family offices and other institutional investors; however, in the future, we believe PE opportunities will open up and become more accessible to non-institutional investors, subject to the resolution of impeding regulatory hurdles.[17]

FIGURE 9: ALTERNATIVE INVESTOR INVESTMENT ALLOCATIONS



Source: 2019 Global Alternative Fund Survey, Ernst & Young.

SUMMARY

We maintain a positive outlook on PE given its unique structural advantages and compared to other asset classes. PE's long-term oriented nature encourages an investment and value creation approach that looks through and withstands the cycle.

However, current market conditions require an "extra cautious" discipline in portfolio construction and careful selection of investments. PE is an asset class renowned for being difficult to time, given fund structures and the capital deployment deferral over a multiyear period. A measured commitment pace and partnership with the industry's most experienced groups, with distinct sourcing networks, skilled professionals and deep resources, will remain paramount to successful investing in the asset class in the years ahead.

16. 2019 Global Alternative Fund Survey, Ernst & Young. https://www.ey.com/en_gl/wealth-asset-management/when-focusing-on-the-future-where-do-you-look
17. Private Equity Market Outlook, Neuberger Berman, January 2020

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