

Operational Improvement: The Key To Value Creation in Private Equity

July 2009

WHITE PAPER

Executive Summary

The financial crisis sweeping global markets is reshaping the landscape of private equity investing. While credit tightening has curtailed the availability of leverage and intensified competition for new deals, the economic recession has caused many companies already in the portfolios of private equity firms to underperform. These changes are prompting investors to revisit a long-held key tenet of value creation in private equity: operational improvement.

Although the ability to raise debt will remain an important component of private equity investing, the sharp decline of leverage in the global financial system has reduced private equity firms' ability to create value through financial engineering. By making it more difficult to acquire large companies, the credit contraction has also intensified competition for smaller deals and thus made it more difficult to find bargains. At the same time, a diminished supply of leverage has also limited opportunities for private equity "home-run" deals capable of offsetting underperforming investments.

As a result, private equity firms have become even more dependent on their ability to improve operational performance in every transaction to achieve their investment goals and generate attractive returns. Few firms, however, have proven themselves capable of achieving operational improvements in portfolio companies consistently over time.

In this paper, we discuss the anatomy of value-adding operational change. Specifically, we examine several approaches private equity firms use to deploy operational expertise to drive value in portfolio companies. We also examine the analytical framework used by some firms for assessing and prioritizing the many operational initiatives that could be undertaken within a newly acquired company. Included in that examination is a detailed look at how private equity firms assemble an attractive mix of operational improvement projects in their initial 100-day plans. We then explore one of the challenges faced by private equity firms attempting to implement operational enhancements in newly acquired companies: enacting change without alienating company management.

Finally, we demonstrate the real-world application of these concepts by presenting a case study that illustrates how a private equity buyer puts its operational skills into practice in order to help create value within a mid-sized portfolio company.



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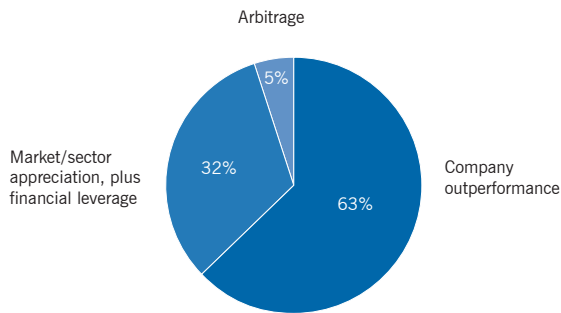
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Introduction

Even at the peak of the 2004-2007 credit boom, success in private equity transactions was usually a function of operational improvements and performance, not financial engineering. A 2005 McKinsey & Co. study of deals completed by 11 leading private equity firms (*Display 1*) revealed that “company outperformance” was the main driver of value in almost two-thirds of the transactions. “Market/sector appreciation plus financial leverage” was identified as the primary source of value creation in about one-third of the deals, with “multiple arbitrage” driving value creation in about 5%.

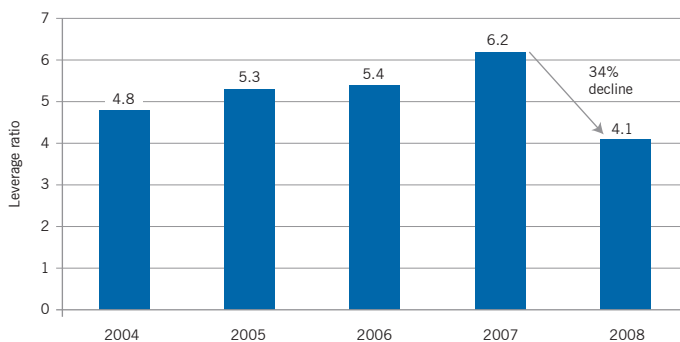
Display 1: “Company outperformance” has traditionally been the main driver of value creation in private equity



Source: The McKinsey Quarterly, 2005 Number 1. “Why Some PE Firms Do Better Than Others.”

The recent reduction of debt availability has tipped the scales of value creation even further in the direction of operating performance (*Display 2*). At the same time, operational expertise has emerged as a key competitive advantage for companies of all types as the difficult economic environment challenges them to react rapidly to market changes and increase efficiencies across their businesses.

Display 2: Leverage ratios in private equity deals have declined following the market correction



Source: S&P LCD data for large corporate LBOs (issuers with EBITDA > \$50M), Morgan Stanley

In this new environment, the ability to create an effective and repeatable process for improving the operations of portfolio companies can no longer be considered a luxury for private equity firms—it is a strategic imperative without which funds will likely struggle to consistently deliver superior performance over time to their investors.

Building a Performance Advantage: The Operating Partner Model

There is no single formula for creating an operational advantage in private equity. Competing firms target deals of all sizes, in a variety of industries, using many different investment strategies. As such, the most effective methods for planning and implementing operational changes in private equity portfolio companies will vary by investing strategy.

There is one requirement that does not change with deal size or investing strategy, however. Private equity firms looking to create a sustainable ability to improve the performance of portfolio companies must secure access to people who: a) understand the private equity process, strategy and execution, and b) have experience running companies (ideally, private equity-backed companies). One of the most effective methods of securing this type of talent is through the establishment of “Operating Partners.”

Operating Partners are individuals with experience as senior executives in the corporate world, consulting and/or private equity. These professionals adopt a hands-on role in the strategic planning and supervision of private equity portfolio companies. Operating as board members or consultants, they apply their industry knowledge and analytic skills to the most important issues facing a company from a high-level, strategic perspective. Because Operating Partners accumulate experience working with multiple portfolio companies, often in different industries, they bring a broader perspective than that of most portfolio company CEOs. Ideally, Operating Partners identify and apply best practices to drive results across industries and competitive environments.

This type of perspective represents an invaluable resource, since portfolio company CEOs are focused on day-to-day management and operational issues. Operating Partners bring to bear their own expertise and the capabilities of the private equity organization without disenfranchising the management team.

In fact, securing the buy-in and support of both management and the “rank-and-file” is a primary responsibility of Operating Partners. Although portfolio CEOs are experts in their industries and are intimately knowledgeable about the workings of their companies, they can be naïve about the intricacies and realities of private equity ownership. Compared to typical corporate executive situations, the private equity environment places a stronger emphasis on cash flow generation, and the timeframe for tackling important issues in a private equity transaction is greatly

compressed. Companies in a private equity portfolio answer to a broader set of stakeholders, including active Boards of Directors (usually the private equity partners and industry directors), banks, mezzanine funds, co-sponsors and limited partners.

Operating Partners must ensure that the company is taking the steps to meet the demands of the environment without damaging the firm's relationship with the CEO or the management team. Operating Partners with substantial industry experience are in an excellent position to form close and trusting relationships with CEOs and senior executives due to the credibility associated with their accomplishments, expertise and familiarity with the business issues facing the company. The successful Operating Partner defines with complete clarity the roles of everyone involved in the transaction, including management, the Operating Partner and the deal team.

Of course, the state of the business will go a long way in determining the precise nature of the relationship between the Operating Partner, the deal team and the CEO. If the company is not meeting its targets, if it has veered from the strategic plan, or if the management team has made careless mistakes, the Operating Partner will be forced to assume a more assertive role.

As a general rule, Operating Partners prefer to work with incumbent CEOs and their management teams due to two main reasons: a) showing trust in existing senior management tends to seep through the organization, enhancing morale and reducing nervousness among rank-and-file employees at the time of transition; and b) a lower level of disruption often translates into broader support from employees to operational-improvement initiatives. Rather than replacing management teams or imposing external decisions upon portfolio companies, the most successful Operating Partners engage CEOs and other senior managers to take ownership of operational initiatives.

However, there are exceptions to this general rule. Sometimes, the Operating Partner will retain the current senior management team, but change the incentive package so as to better align interests and facilitate the implementation of positive operational improvements. Other times, the Operating Partner will, upon thorough evaluation, realize that the current senior management team (or certain management members) is, in fact, part of the problem. In these instances, new managers are not only desired, but indeed a necessary, key source of change and value creation.

The Operating Partner model has a long history in private equity and the concept has evolved into several formats based on the needs of individual firms. At least three variations of the Operating Partner Model are currently in use:

1) *Elder Statesman*: Some private equity firms maintain relationships with retired executives with experience in the industries targeted by their strategies. These former senior executives help the fund manager find opportunities, vet

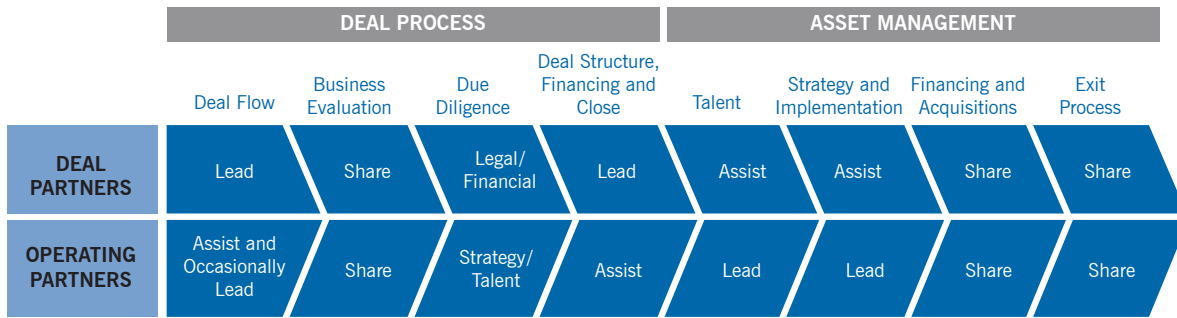
potential transactions and recruit management talent. In many cases, they are brought in as board members in portfolio companies to provide operational guidance. Generally these Operating Partners work as consultants to the private equity firm, and they often have the opportunity to participate in the economics of the individual transaction on which they are working. In another variation of this model, private equity firms will hire a talented retired executive to source deals in his or her former industry and then install the executive as CEO to run an acquired company for a set period of time. This model is often referred to as a "CEO in Waiting."

- 2) *In-House Consultant*: Other private equity firms maintain a staff of internal consultants who work closely with individual portfolio companies over a long period of time. These individuals usually have a background in consulting or deep experience in a specific function such as purchasing, IT, human resources or marketing. Although these Operating Partners are generally full-time employees of the private equity organization, they often do not have an ownership stake, are viewed as a separate pool of resources, and are usually brought into a transaction after the closing to work on specific issues. Operating Partners under this model work with a company for a few months or several years, providing analytic insight, strategic guidance and assistance in execution.
- 3) *Integrated Partner*: A third group of private equity managers employs a hybrid model that combines aspects of both approaches. They maintain an internal group of former industry executives—often with additional prior experience in consulting or private equity—who are asked to play a significant role in the private equity process from beginning to end.

The responsibilities of these Operating Partners include upstream activities such as identifying and vetting opportunities, and sitting on investment committees that review and approve firm investments (*Display 3*). Responsibilities also include downstream work providing hands-on support on both a strategic and execution basis. An Operating Partner working under this model will often assume the long-term role of an active chairman. In this capacity, he or she will interact with the CEO on a frequent basis (at least weekly), and will be "on site" regularly.

This level of activity represents a much higher level of engagement than would be common with traditional board members. The Integrated Operating Partners play a role in high-level or strategic decisions, and their deep involvement in transactions from the earliest stages gives them the opportunity to build strong relationships with company management teams that endure after the deal has closed.

Display 3: An integrated operating partner plays a key role in the deal activities workflow



One of the defining characteristics of the Integrated Operating Partner model is that these experienced individuals are partners in the private equity organization, receiving status and compensation on par with that of deal partners and full participation in the fund.

Two factors are most important in determining which of these models will work best for a given private equity firm: 1) the size of transaction targets, and 2) the level of influence or control typically acquired by the firm. Firms targeting relatively small investments often will not be able to afford the overhead costs associated with internal Operating Partners. At the same time, it would make the most sense for a private equity firm to invest in a strong staff of full-time Operating Partners if it aims to acquire ownership stakes large enough to give these individuals meaningful influence over senior management. Generally, private equity firms that maintain internal staffs of Operating Partners are those that obtain a controlling interest in portfolio companies, along with representation on the board.

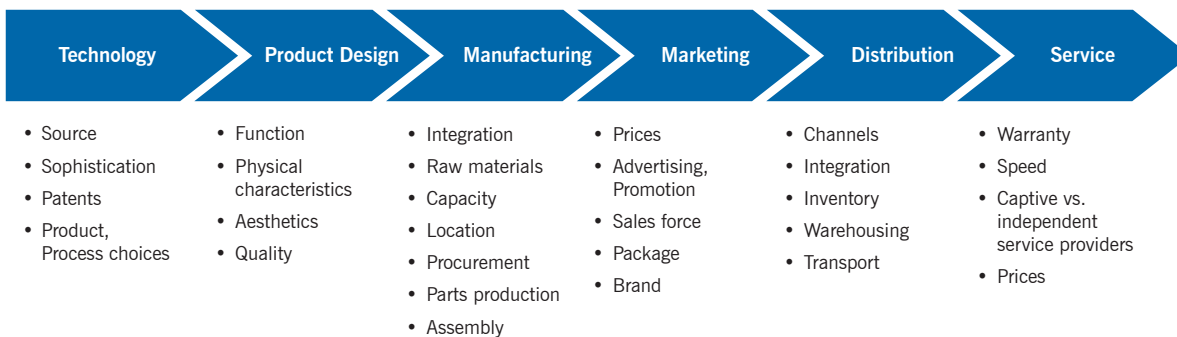
Integrated Operating Partners are most common among firms that target companies in the middle-market or larger. Private equity firms that invest in large multi-nationals and established middle-market businesses require a higher, or at least broader,

level of operational expertise than those that invest in smaller companies. Although operating a large company requires a different skill set than running more modest businesses, it is indeed size, as opposed to industry, that sets these two examples apart. The principles of sound operational management are largely transferrable across industries. While there are obvious advantages to having direct experience in the industry of an acquisition target, general experience in running a company and executing on private equity transactions will transcend industry categories.

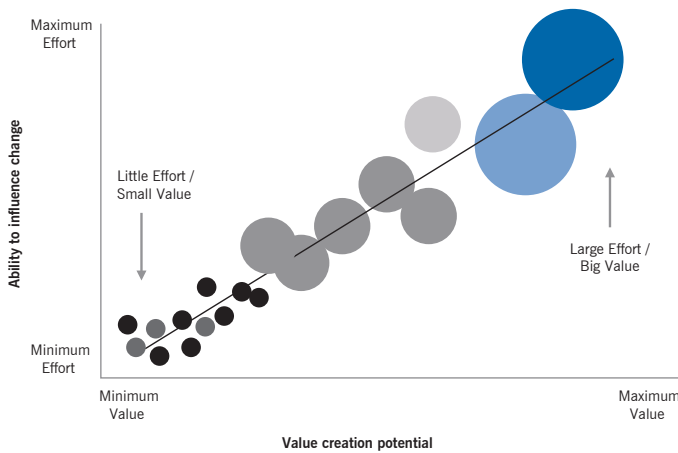
Assessing Opportunities for Improvement: Finding the “Sweet Spot” of Value Creation

Virtually every company presents new and motivated owners with a long list of potential operational improvements (*Display 4*). This is especially true for companies that get the attention of private equity buyers, which generally have challenges that helped put them in that position. In fact, private equity buyers are frequently faced with dozens of potential improvement opportunities upon completing a purchase. As a result, the trick to creating value through operational expertise is not identifying areas of the business to improve, but rather, sorting through a sometimes overwhelming number of potential opportunities to identify the right issues to act upon.

Display 4: Areas for potential operational improvement are plentiful...



... But selecting the right initiatives should weigh potential value creation against ability to influence change



For illustrative purposes only.

Source: Morgan Stanley

It is critical to pick the right projects to undertake in the early days of a transaction. Private equity firms are frequently under pressure to quickly improve cash flows to service debt associated with their acquisitions, and therefore have a limited window of time in which to enact operational changes. Moreover, portfolio companies range in their ability to effectively implement change, especially on more than just a few projects at a time.

Many private equity investors prepare for this situation in advance of a deal's closing by creating 100-day plans that detail the operational changes they will look to implement. These plans must be as specific as possible, especially when detailing how the private equity owner intends to transition the company's business from its state at acquisition to an enhanced state in the future. Traditionally, these plans highlight explicit goals, including traditional market share gains, growth and cost reductions; as well as goals more unique to private equity environments, such as EBIDTA, return on capital and debt paydown schedules. Operating Partners play an essential role in the success of these plans, both from helping set realistic, achievable targets to overseeing schedules and problem-solving to keep management on track.

It is often during the development of these plans that private equity firms begin to assemble a list of potential operational improvements, rank these projects in priority order, and pinpoint the handful of major projects they have the capacity to undertake.

Historically, many private equity firms have ranked the priority of potential operational improvements according to the amount of required investment capital. This simple criterion is often inadequate, as it fails to take into consideration both the non-monetary costs of management time and focus, as well as the potential rewards of freed-up cash flow and improved efficiency.

A more sophisticated approach compares the potential for value creation presented by each improvement with the level of difficulty, costs and time associated with the project and/or the private equity firm's ability to enact the desired change (*Display 4*). Analyzing every potential operational improvement according to these criteria will identify the projects that fall closest to the "sweet spot" of significant potential value creation for the required effort, as well as projects that will deliver lower amounts of added value, but might be completed quicker, with fewer resources and less effort.

A private equity firm's initial 100-day plan will ideally incorporate a mix of projects from across this spectrum, including no more than two or three high value/high difficulty projects and a manageable number of lower-value improvements that are more easily achieved.

Although private equity firms and their Operating Partners will inevitably devote the bulk of their attention to the high value/high difficulty projects that often determine the ultimate fate of the transaction, the inclusion of a limited number of low value/low difficulty project in the 100-day plan will deliver an important benefit in the form of relatively easy gains.

While these "easy" gains can rarely have much of a value impact on the company or the transaction as a whole, they often serve to energize company management and employees by instilling a sense of dynamism and momentum to the business. Oftentimes, the very act of creating the 100-day plan serves as a critical first step in establishing a strong, collaborative relationship among the management team, the private equity deal team and the Operating Partner.

But it is important to note that the job of the Operating Partner in ensuring the success of a deal is an ongoing commitment that goes beyond the 100-day plan. In fact, improving results in the first year after the deal is completed has been highly indicative of how well the investment is likely to fare in the long run. One reason: Firms that achieve such early success in operational improvements usually have also succeeded in permanently altering aspects of the company's culture. Although it is imperative that private equity firms preserve the core elements of corporate culture, it is equally essential that the Operating Partner and the CEO together ensure that internal culture is appropriate for both the immediate private equity environment and a competitive business environment over a long-term horizon. In particular, private equity firms will attempt to inject a sense of urgency to the business and accelerate the decision-making process, while also creating a more analytical and metric-based management framework that enhances accountability. These changes, which can contribute greatly to long-term performance, are often an outgrowth of the successful execution of the 100-day plan.

In summary, we believe that success is, in large part, a function of a) devoting resources and developing strong management relationships early in the deal; and b) making sure that there is continued follow-up, problem-solving and monitoring to ensure the consistency and durability of early accomplishments.

Case Study: Exploiting the Operational “Sweet Spot”

We present the following case study¹ to illustrate how the concepts discussed in this white paper are put into practice in an actual private equity transaction, and how a private equity firm’s ability to exploit the operational “sweet spot” can help create significant value for private equity investors/shareholders.

In December 2007, a majority stake in a US supermarket chain was acquired by a private equity firm as part of a corporate carve-out from the company’s prior owner, a large overseas corporation (*Display 5*).

Display 5: Case study highlights how exploring the operational “sweet spot” can enhance value creation

Case Study Snapshot

Company	Supermarket retailer
Industry	Retail & consumer
Region	North America
Ownership	Majority
Deal Type	Corporate carve-out
Transaction Date	December 2007

During the due diligence process, the deal team—working with an Operating Partner with significant experience in senior management positions at Procter & Gamble, PepsiCo and as the former CEO of three private equity-backed companies—identified what it thought could be a significant opportunity for value creation in the grocery chain: the company’s product and pricing strategy appeared to be flawed.

The prior owners had built the business by rolling up several mid-sized grocery retailers into a large entity with the scale to compete with major grocers, club stores and mass merchandisers in terms of purchasing power. By buying goods at prices similar to those paid by these competitors, the prior owners concluded that they could compete with these businesses on the basis of price. In keeping with that premise, they limited product assortment and adopted an “Everyday Low Price” strategy that had proven less than successful. Even though its purchasing costs were on par with those of other major retailers, the company could not match its competitors’ pricing and still maintain meaningful margins.

The revamping of the pricing strategy would be a costly and difficult enhancement with the potential to have a strong impact on revenues in the long run. But as the firm prepared to start running the business, the Operating Partner and the deal team looked for ways to balance this high difficulty/high return project with a series of quick accomplishments. Although these smaller projects would have only a marginal—yet positive—short-term impact on revenues, the team knew from past experience that these relatively minor successes would boost morale and keep management and company employees energized through what could be a challenging period of change. The firm’s 100-day plan incorporated projects from across the value/difficulty curve, including the following examples:

- *Quick Improvement: Adjusting the mix of products and pricing.* The firm quickly moved to add a large selection of locally manufactured products and locally grown produce to the retailer’s shelves—a move that was suggested by management and strongly supported by employees and customers. At the same time, the firm reduced prices on highly visible items that were grossly mispriced, including milk and deli meats. Deep discounts on holiday staples such as hams and turkeys were heavily promoted around Thanksgiving and Christmas. These changes resulted in an improved shopping experience for customers and an increase in sales compared to the same period in the prior year.
- *Quick Improvement: Outsourcing coffee sales to an industry-leading branded coffee retailer.* This move increased annual revenues by \$2.5 million while providing a “multiplier” effect on both staff (which was excited about more sales) and customers (who enjoyed the opportunity to savor better coffee while going about their grocery shopping). Although the incremental revenue generated by the move was modest in the context of the company’s almost \$2 billion in annual sales, the project galvanized management into action mode.
- *High Difficulty/High Reward: IT Upgrade.* The grocery chain’s IT system was a legacy from its previous corporate owner and inadequate for sophisticated inventory management and pricing techniques. The firm quickly concluded that installing a new IT system would be an integral step in exploiting one of the primary strategic opportunities it had identified: the flawed pricing model. The firm determined that installing a new IT system would cost almost \$25 million. It would also require months of work and hundreds of man-hours to design and implement.

A project of this nature and scope is normally undertaken by a senior management team once every 10 years. The Operating Partner working on the transaction, on the other hand, had been involved with three such projects in the prior five years across several companies. Based on this experience, the Operating Partner and management worked together

¹ For illustrative purposes only. The above case study is provided solely to illustrate the concepts discussed in the paper and is not intended to predict the performance of any investment.

to effectively scope the project and execute the bidding, monitoring progress and managing implementation. The teamwork proved invaluable as the company completed the IT upgrade on time and on budget. The installation of the new system allowed the company to adopt an advanced inventory management/pricing model that could dynamically adjust pricing in response to local conditions and competitors.

The adoption of the new pricing model has improved margins and is expected to be a key contributor to the overall success of the transaction. It also demonstrated the importance of operational experience in realizing potential value in private equity transactions. The expertise of the deal team and Operating Partner allowed the firm to identify the IT upgrade as falling within the “sweet spot” of operational value creation and to take it on as a top-priority project. At the same time, based on their past experience in corporate operations, the deal team members understood that such a disruptive project, undertaken so soon after a change in ownership, had the potential for disaster if management and the staff were not completely on board. The 100-day plan they created successfully avoided that scenario by incorporating a series of quick enhancements like the introduction of gourmet coffee that helped build trust and keep management and employees energized throughout the process.

The end result: Actual EBITDA beat the company budget by 12% in 2008, despite an economic environment that was much more challenging than expected. Meanwhile, the grocery chain has expanded its market share by more than 5 percentage points over the past 52-week period.

Conclusion

Even amid difficult economic conditions, there are ample opportunities for private equity firms with the skills to achieve operational improvements in companies they acquire.

Generating value through operational enhancement requires a combination of experience, expertise and process (*Display 6*). Operating Partners are used by many private equity firms to secure the first two of these ingredients. However, only a much smaller number of firms have created processes that allow them to identify and enact the right operational enhancements on a consistent and repeatable basis.

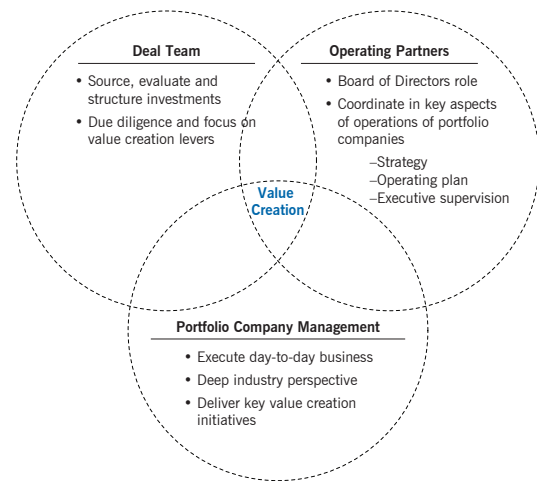
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Display 6: Generating value through operational enhancement requires experience, expertise and process



Source: Morgan Stanley

Among firms that have achieved this goal, the proper analytic framework serves as the foundation of their success. These firms have cultivated the ability to accurately determine the potential value creation and the level of difficulty associated with each possible operational improvement. They use the results of this analysis to pinpoint improvements that fall into the sweet spot of significant value creation.

Just as importantly, these results provide critical insights about how to best integrate individual operational enhancements into the firm’s overall strategy for the transaction. The ideal strategic plan will mix large-scale projects with initiatives that require less effort and create less in the way of overall transactional value, but nevertheless deliver important benefits such as strengthening the relationship between management and the firm or motivating employees. Given the new economic and financial environment, the ability to create and execute on such integrated operational improvement strategies is fast becoming private equity’s most important competitive advantage.

Morgan Stanley Investment Management Publications

Following are recent thought-leadership papers covering a range of investment issues:

How the Tight Credit Market Is Augmenting the Investment Opportunity for Private Debt Capital

May 2009—The dislocation in the credit markets has set the stage for a widening gap between the supply of, and demand for, capital. What solution could potentially fill this gap? This paper suggests that a combination of traditional and non-traditional sources of debt capital should emerge in response to this imbalance. Specifically, we believe that private credit capital targeting middle-market issuers is likely to be an important focus for investors.

Return Targets and Percentile Fans

May 2009—A portfolio's beta exposure has traditionally been a key factor influencing the prospects for reaching return targets. But how much beta does one need to increase one's chances of exceeding the risk-free rate over a one-year period? Conversely, how much beta risk is necessary to satisfy target returns in the long run? In this paper, we address these issues, and provide a compelling framework for understanding beta exposures.

Looking Beyond the Valley: Identifying Cross Asset-Class Opportunities

May 2009—The global economic crisis has taken a heavy toll on asset prices across the investment spectrum, including equities, credit and commodities, creating a number of distressed investment opportunities. Yet, many investors are still wondering how to best assess these opportunities, and how to rebalance their portfolios for optimal potential returns. This paper addresses these questions, and

lays out a comprehensive roadmap for investors to gauge the current opportunities and place them in the proper historical context.

Accessing Investment Opportunities in a Real Estate Recession

May 2009—We believe that the most severe economic crisis since World War II is creating the most compelling commercial real estate opportunities in a generation. In this paper, we examine the causes of the ongoing market correction, quantify the impact of the crisis to date, and compare the current real estate recession to past market downturns. Due to the unique combination of events that precipitated the current slowdown, investors could have the chance to purchase the debt and/or equity of real estate at what we view as historically attractive terms.

Incorporating Distressed Opportunities within a Strategic Asset Allocation Framework

April 2009—The recent dislocation experienced in capital markets appears likely to unveil a number of attractive investment opportunities. Yet we believe institutional investors should exercise caution when evaluating potential distressed opportunities. In particular, investors must consider how to identify distressed investments; assess the relative merits of different opportunities; and best incorporate these investments into a portfolio to improve its risk/return profiles without compromising current strategic asset allocations. This paper considers these issues and outlines a framework for evaluating and assessing the relative attractiveness of opportunities, and then efficiently adding select investments to existing portfolios.

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The information on these pages is intended solely for the purposes of informing managers and owners of operating companies of the potential benefits of the operating partner model described herein. Since the success of an operating company is dependent on numerous factors, including economic and market conditions, no assurances can be given that the approaches described herein will generate successful performance. Nothing contained herein constitutes an offer to sell or a solicitation of an offer to purchase any investments or securities of any investment vehicles.

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