

Hands-On Operational Improvement Key to Creating Alpha in the Middle Market¹

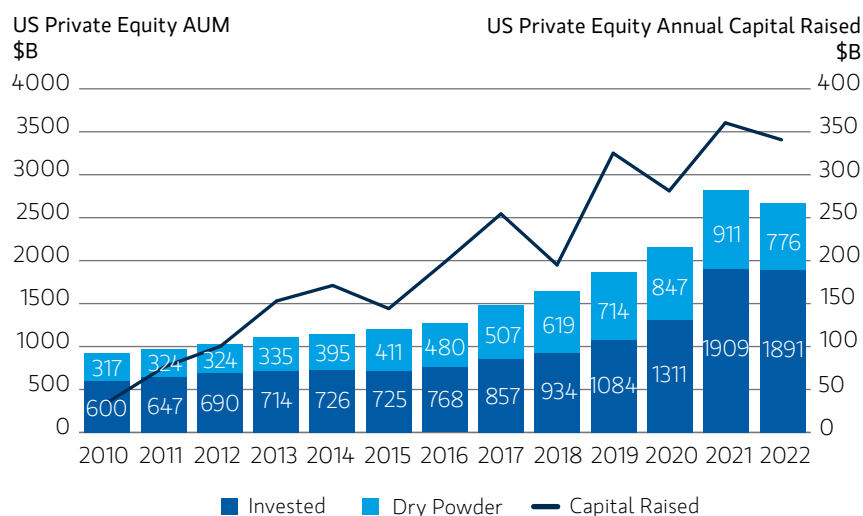
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Differentiation is critical in a dynamic private equity landscape

The middle-market private equity landscape has evolved significantly in the past decade. Investable dry powder has set new records each year from 2010 to 2021² and the sponsor universe has seen a significant volume of new entrants. An increasing number of investors, a larger pool of capital that needs to be deployed, and a fixed supply of top-quality companies have combined to drive up asset values, and in turn placed an ever-greater importance on the ability to drive true alpha.

DISPLAY 1 Fundraising and Dry Powder

Annual Fundraising and Total Private Equity AUM Have Increased Significantly Since 2010



Source: Pitchbook 2022 Annual US Private Equity Report

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² Source: Pitchbook. See Display 1 "Fundraising and Dry Powder".

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KEY TAKEAWAYS

- 'Buy and Hold' is no longer a viable strategy in the current macro environment.
- Hands-on portfolio operations is critical to drive profitability and equity value creation.
- Approaches to portfolio operations vary widely – successful implementation is key to returns.
- Alignment and integration of investment and operating teams is key throughout the investment lifecycle.
- A deep and broad team of operating resources is key to driving real change in the portfolio.
- Potential success is contingent upon a proven and repeatable process and playbook.

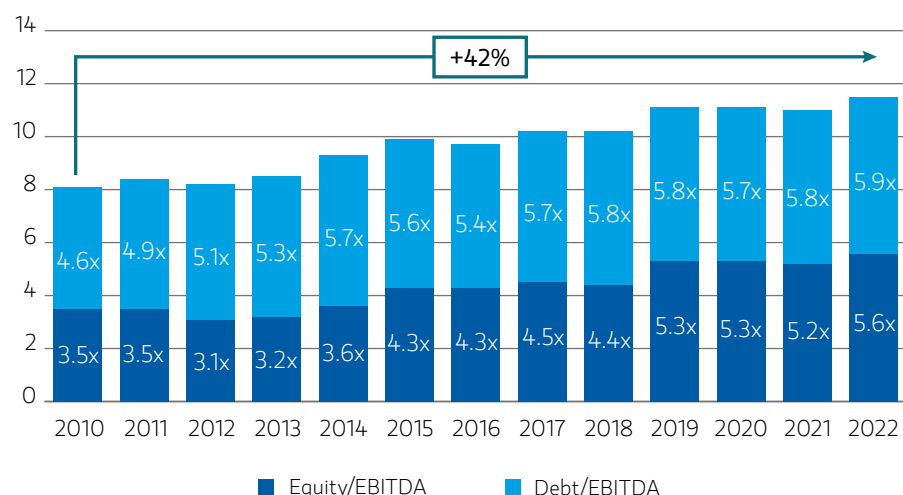
“Equity value in the middle market is built by backing great teams and deploying a proven operational playbook to build great businesses.”

As sponsors enter a dealmaking chapter defined by generally lower levels of leverage, higher borrowing costs, and potentially slowing underlying economic growth, a hands-on approach to operational value creation becomes even more important. If a rising macroeconomic tide combined with financial engineering can no longer be counted upon to lift all boats, hands-on operational value creation will be key to driving sustainable revenue and EBITDA growth, and thus differentiated investment outcomes.

DISPLAY 2

Buyout Multiples and Leverage

Private Equity Valuations and Average Leverage Levels Have Increased Steadily Over the Last Decade



Source: Pitchbook 2022 Annual US Private Equity Report

Delivering top-quartile private equity returns in the face of a changing market backdrop requires a differentiated approach to investing and portfolio management. As asset values have increased, the ability to achieve potential success through a simple buy-and-hold strategy has largely gone away. Instead, a hands-on approach to portfolio operations and value creation has become critical to generating value in portfolio companies. A successful approach to portfolio operations requires engagement starting with thesis

development and diligence, ramps up with the development and execution of the value creation plan during the first 12-24 months, and then continues over the full investment period to support management and create equity value.

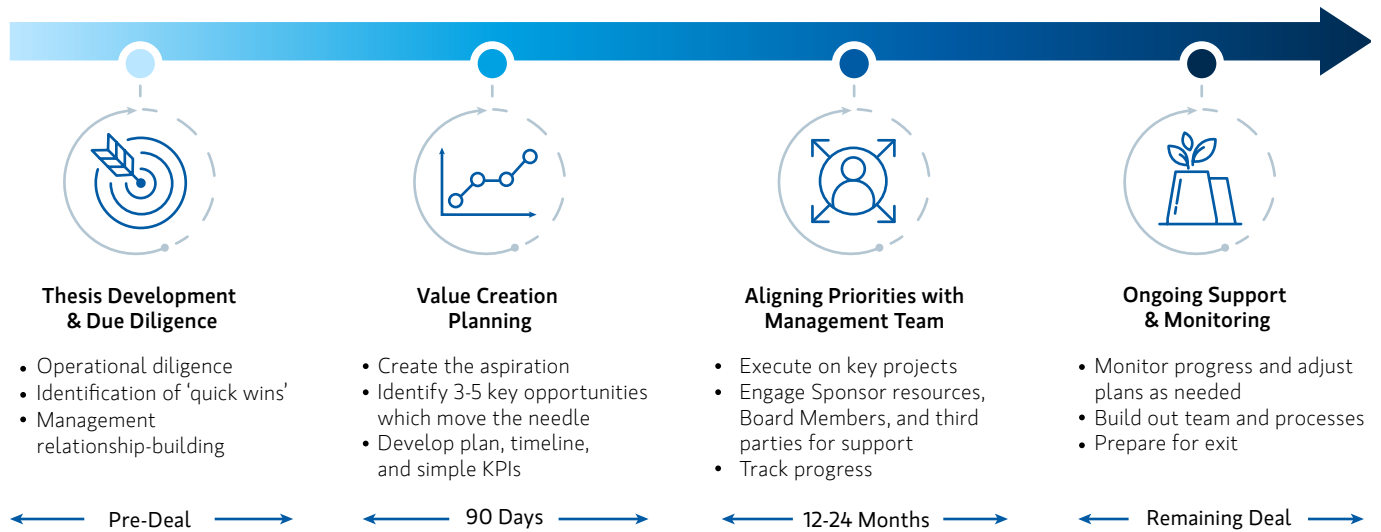
A focused portfolio operations strategy has become particularly important given the macroeconomic backdrop of the last several years – specifically the significant market disruptions during and after COVID-19, and the subsequent period of elevated inflation, interest rates, and general volatility.

Operational expertise is required to drive top-line growth, profitability, and equity value creation

If hands-on operational value creation is key to driving portfolio company potential success, sponsors must define what a robust portfolio operations approach looks like, and how it drives day-to-day behavior within the private equity firm and within the portfolio companies. Looking across the sponsor landscape, successful operating platforms are fully integrated and engaged across all four stages of a typical private equity investment lifecycle.

THEESIS DEVELOPMENT & DILIGENCE

To be truly effective, portfolio operations professionals need to be involved in evaluating a prospective investment from the beginning. Partnership between investing and operating professionals brings diverse perspectives to the evaluation of an investment and allows for the identification and execution of quick win opportunities shortly after close. Engaging early also allows private equity operations teams to build strong trust-based relationships with management, which are critical to establish credibility from the beginning. Successfully delivering

DISPLAY 3**Operational Lifecycle of a Private Equity Deal***Portfolio Operations Team Plays a Key Role Throughout the Deal*

operational value creation often requires management teams to embrace significant change, which is only possible when the Sponsor and management team have a truly collaborative relationship and are aligned on the same goals.

VALUE CREATION PLANNING

The first 90 days are key in a new private equity investment. It's during this period when relationships with the management team are solidified, goals are identified, and the strategic plan is developed. An effective operations team will lead the planning process and will move beyond a formulaic 90-day checklist. A differentiated value creation plan creates the aspiration for an investment, identifies a series of initiatives that are rooted in quantitative analysis and prioritized based on impact, and closely measures progress using data throughout the investment.

ALIGNING PRIORITIES

Once the plan is developed and the sponsor and management team are aligned on priorities, a hands-on approach to operational value

creation is necessary to translate the plan into action during the first 12-24 months, which are critical to the potential success of any private equity investment. The specific drivers of value creation will vary by investment, but there are several common themes across the middle-market landscape. Operating professionals who can be on the ground with management teams and bring practical expertise around revenue growth, strategic pricing, cost reduction, M&A integration, and how to build a best-in-class management team through talent development and recruitment can drive repeatable value creation, and become a key source of alpha in a competitive marketplace.

ONGOING SUPPORT & MONITORING

The focus of a portfolio operations team will naturally change throughout the lifecycle of an investment. After the plan is developed and implemented during the first 12-24 months, there is a shift in focus towards ongoing monitoring and support of the company. During this phase, key responsibilities include closely tracking the results

of the value creation plan and making adjustments as needed, identifying needs within the organization, bringing the right resources to the table, and otherwise working with the management team to continue scaling the business.

Success in operational value creation requires an aligned culture, strong team, and repeatable playbook

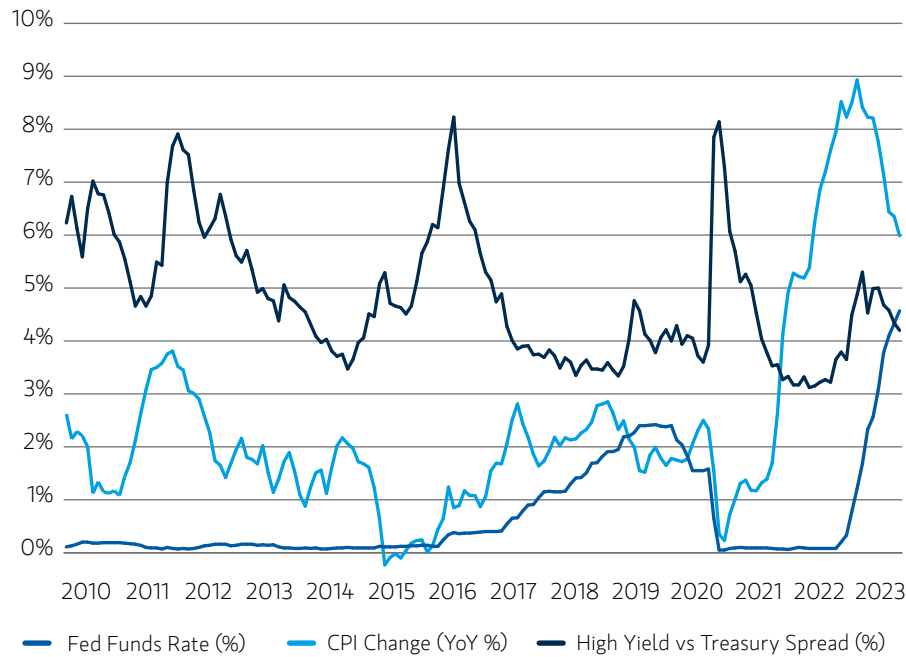
Delivering repeatable value creation through hands-on portfolio operations requires real investment from the sponsor. The most effective operations teams are fully resourced with the people needed to support a private equity portfolio of 10-20 companies at any given time, as well as the capabilities needed to identify and execute on multiple value creation levers.

Best-in-class operating platforms have built out deep teams, ranging from senior operating partners to mid-level and junior professionals focused on day-to-day support and execution.

DISPLAY 4

Macroeconomic Environment

Significant Reset in Interest Rate and Inflationary Environment Starting in 2020 vs. Prior Decade

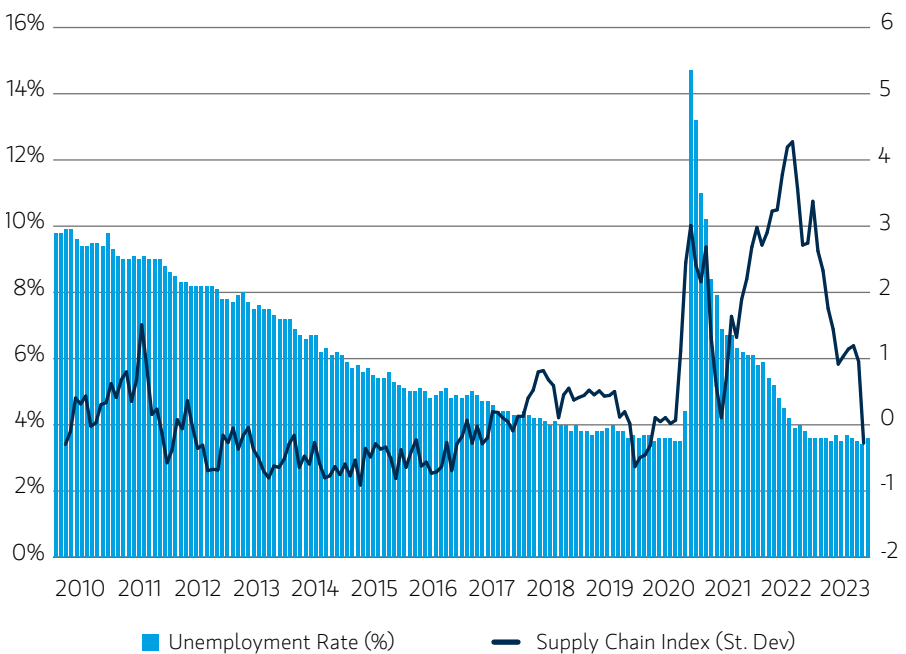


Source: St. Louis Federal Reserve

DISPLAY 5

Macroeconomic Environment

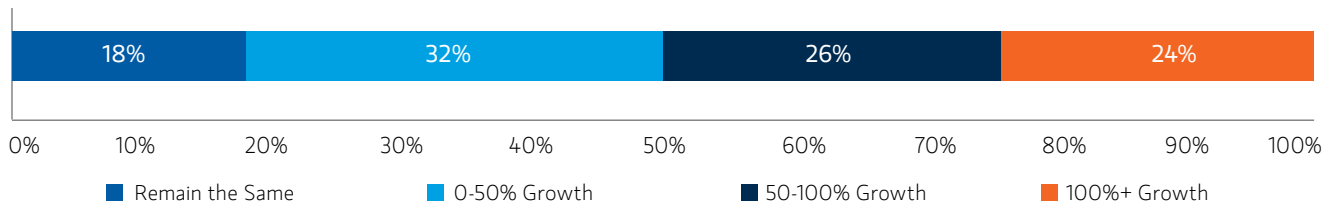
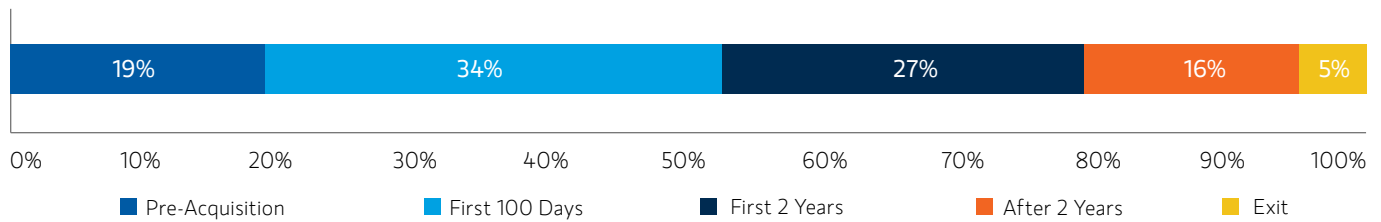
Unemployment and Supply Chain Environments Have Been Significantly Disrupted



Source: St. Louis Federal Reserve (FRED); New York Federal Reserve

Many sponsors have built some level of operating partner support over the last 10 years. However, these professionals are often external consultants or are deployed on a deal-by-deal basis. While this can be effective in some scenarios, there are real structural advantages to a model where operating partners are fully integrated with the investing team and are full members of the investment committee and carried interest pool. An integrated model ensures that operating professionals are involved with the full investment lifecycle as described earlier and that incentives are fully aligned around the long-term success of the full portfolio, avoiding potential deal-by-deal misalignment.

As operational value creation has become a bigger focus and a driver of alpha over the last five-plus years, best-in-class sponsors have invested further to build capabilities beyond a team of senior operating partners. Given the ambitious growth and transformation agendas that are common in middle-market private equity investments, leading sponsors have built depth below the operating partner level, with the goal of ensuring that each portfolio company has a dedicated mid-level professional who is solely focused on supporting the management team to drive equity value. The best portfolio operations teams today are composed of a full range of professionals across seniority levels and backgrounds, utilizing a proven and repeatable playbook that they have developed over years of experience.

DISPLAY 6**Private Equity Operations Team Resourcing***Private Equity Operations Team Headcount Growth Plans Over the Next Two Years, % of Survey Respondents***Private Equity Operations Team Time Allocation***Private Equity Operations Team Time Allocation by Deal, % of Survey Respondents*

Source: Alvarez & Marsal PE Operating Partner Survey, 2022

Conclusion

Middle market private equity offers numerous opportunities for value creation through organic growth, accretive acquisitions, margin expansion, and business building. The pool of investable companies is wide and deep, including family- and founder-owned businesses that frequently offer opportunities to drive professionalization, scale, and sophistication. Equity value in the middle market is built by backing great teams and deploying a proven operational playbook to build great businesses.

A successful approach to operational value creation has been key to driving great outcomes over the last decade and has become increasingly important as market participants adjust to the current environment of higher interest rates and inflation, lower levels of financial leverage, and potentially slowing macroeconomic growth. While many private equity investors today claim to have some level of operational capability and value-add, a truly differentiated approach is defined by several factors. Specifically, a focused strategy, a fully integrated team of professionals, a defined value creation planning process, and a proven playbook can come together to deliver outsized returns for sponsors that have invested to build these capabilities.

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