

# Where to Next: A Framework for Resilience

PRIVATE CREDIT & EQUITY | AIP PRIVATE MARKETS TEAM | INVESTMENT INSIGHT | 2020

We believe the next decade is unlikely to mirror the last. We witnessed the second-longest bull run in history with the S&P 500 index rising more than 14% annually since March 2009 followed by one of the sharpest recessions on record due to the COVID-19 pandemic (as illustrated in *Display 1*). In our view, predicting the exact nature and timing of the current economic recovery post-COVID-19 is impossible but building a portfolio that seeks to withstand it is essential. We believe that this preparation requires applying a multidimensional investment methodology and discarding conventional wisdom in order to construct a portfolio to perform well in both economic downturns and subsequent periods of outperformance.

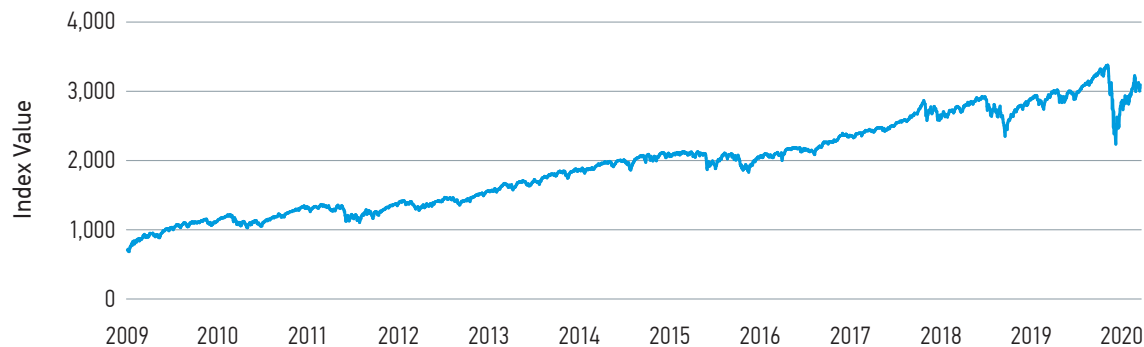
AUTHORS

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## DISPLAY 1

### S&P 500 Index Return

March 9, 2009 – June 30, 2020



<sup>1</sup> Source: Capital IQ - S&P500 Index, as of June 30, 2020. Past performance is not indicative of future results.

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While historically defensive sectors—such as utilities, healthcare, and consumer staples—have long been considered “safe” areas to invest and cyclical sectors have been perceived to have higher risk, we believe painting broad brush strokes about sectors and cyclical sectors is ineffective as a guideline for constructing a potentially resilient portfolio. Rather, we believe that deep evaluation of company fundamentals alongside a clear understanding of industry forces is critical to the success of creating a portfolio that seeks to withstand the next market downturn.

Since its inception in 2000, AIP Private Markets has collectively committed \$19.0 billion to over 850 private equity transactions.<sup>2</sup> Through this experience, we formed an investment philosophy that we believe helps enable us to endure challenging environments and to thrive in robust market conditions. Therefore, with a forward-looking lens, we developed a three-pronged framework for seeking to select potentially resilient companies with strong value creation prospects that entails the following:

### 1. Identifying efficiency producing businesses with exposure to stable end markets

One of the challenges to investing resiliently is to identify businesses that will grow in both benign and challenging market conditions. One such niche that we believe has this characteristic includes companies that provide a solution or service that lowers the overall costs for customers, and therefore improves margins. Such offerings can be the result of minor or major technological advances or services that better fit the current needs of customers;

often solving problems that did not exist 10-15 years ago. Businesses that focus on producing such efficiency can consistently do well through market cycles as they improve the profitability of their customers and are subsequently deemed essential, agnostic of where in the market cycle they are implemented.

For example, we invested in the largest private label oral care manufacturer in the United States. Since the global financial crisis, retailers have experienced declining footfall and in some cases declining revenues. In response, many retailers materially increased their promotion of private label brands which are typically cheaper for end consumers and could be 3x as profitable as branded goods.<sup>3</sup> As a consequence, consumption of private label brands has risen. The private label oral care manufacturer that we invested in is a significant player in this space and, in our opinion, is the chief beneficiary of this trend. As a result, this business has been able to grow even in a period where revenues for retailers are broadly under pressure.<sup>4</sup>

In a similar contrarian vein, we acquired a medical scribe company that serves medical providers including both hospitals and outpatient physicians. Our internal view is that healthcare providers will face both revenue and cost pressures going forward due to the U.S. government's desire to control overall healthcare spending and a continued shortage of both doctors and nurses. However, this company provides material efficiencies to these providers by solving issues related to the recently implemented electronic medical record systems (“EMR”). This business provides

qualified medical scribes that complete the EMR notes. This company has grown revenues organically at a rate of nearly 30%<sup>5</sup> and we believe that its growth can continue even in more challenging environments for medical providers due to the cost savings the company provides.<sup>6</sup>

### 2. Partnering with highly aligned and specialized investment partners

In our view, assessing resiliency involves dissecting the experience base of owner/operators and the payouts they receive from their compensation plans in both up and down markets. We seek to align ourselves with highly specialized private equity sponsors and management teams with proven track records of executing value creation plans and navigating operational challenges in the specific industry they invest in. We seek to achieve a strong alignment of interests with our partners by investing in businesses where the current sponsor/manager of the asset believes in its go-forward value creation potential and their compensation structure encourages both capital preservation and generation of strong returns for investors.

By way of illustration, we invested in one of the leading healthcare providers of respiratory products. The company operates in a highly fragmented subsector ripe for industry consolidation. The value creation thesis going forward was predicated upon pursuing a consolidation strategy. Such a buy-and-build strategy, in our view, requires an experienced team that can identify and execute add-ons successfully. In the case of this company, the management is led by a CEO with 27 years of experience in this particular healthcare niche who had already completed over 60 accretive tuck-ins since

<sup>2</sup> Source: AIP Private Markets Data, as of December 2019.

<sup>3</sup> Source: AIP Private Markets Data, as of December 2018.

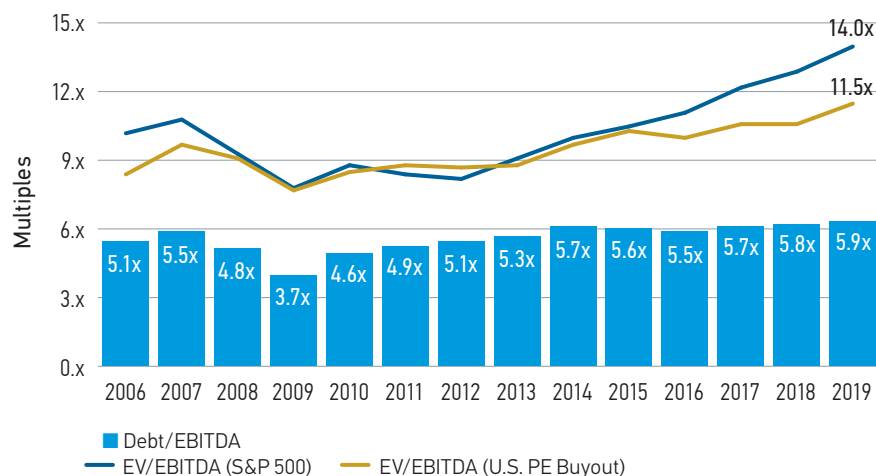
<sup>4</sup> Based on information provided by the underlying manager. There is no guarantee that the investment mentioned will perform well in the future. The above example is provided solely to demonstrate the views, opinions and type of analysis used by AIP in implementing its investment strategy.

<sup>5</sup> Annual compounded revenue growth rate since company's inception in 2000 to December 2018.

<sup>6</sup> Based on information provided by the underlying manager. There is no guarantee that the investment mentioned will perform well in the future. The above example is provided solely to demonstrate the views, opinions and type of analysis used by AIP in implementing its investment strategy.

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## DISPLAY 2 Leverage and Pricing Multiples<sup>7</sup>



2006. The private equity sponsor is purely focused on growth-oriented companies in the healthcare sector and brought deep and complementary experience in the segment to this investment. The sponsor, who was the current owner of the asset, believed in the trajectory of the asset and they agreed to roll all proceeds generated from the profit share during their prior ownership alongside us in this transaction and to make a meaningful additional commitment to the investment from their personal balance sheets. Through this alignment mechanism, we sought to ensure our partners were incentivized to both preserve capital and produce positive investment returns.<sup>8</sup>

As another example, we purchased a platform of franchise boutique fitness brands in 2018. The CEO has a

demonstrated track record of scaling fitness businesses, even through the global financial crisis. Confident in the value creation potential going forward, he rolled over his entire stake in the business to this transaction. Additionally, the option pool was increased for the management team and structured with performance hurdles. The private equity sponsor in this transaction is a highly regarded growth investor that has focused on the boutique fitness space over the last eleven years. This sponsor also made a considerable investment alongside us. This degree of alignment and experience is representative of what we seek in our partners to effectively manage businesses across economic cycles.<sup>9</sup>

### 3. Seeking value on the buy with businesses exhibiting high cash flow generation and conservative leverage

Investors architecting for resilience, we believe, are almost certainly concerned with the peak absolute pricing levels paid for assets in the current market, but many may forget that further fragility is added when we consider the impact of leverage. With average valuations hovering around 11.5x in the U.S. private equity market and 14x in the public equity market (as illustrated in *Display 2*), the environment continues to be challenging for investors seeking high quality companies at attractive prices. Nevertheless, we remain disciplined in seeking to purchase assets at discounts to fair market value and with strong relative value. The average entry multiple across the investments we closed in recent years is 11.2x EBITDA.<sup>10</sup>

We believe that the key to accessing value in frothy markets is to take a proactive approach to deal sourcing. Through our relationship-driven sourcing efforts, we seek to generate proprietary deal flow that allows us to invest in high quality companies at reasonable purchase prices.

However, in our view, an attractive purchase price provides only limited safeguards in a downturn if the company is over levered. Although current leverage multiples have surpassed pre-crisis levels, we maintain our focus on conservative capital structures. The average debt/EBITDA ratio for our investments made in recent years is 4.0x EBITDA<sup>11</sup> versus market leverage of 5.9x EBITDA.<sup>12</sup> In addition to leverage, we also assess a company's cash

<sup>7</sup> S&P LCD Leveraged Buyout Review, 4Q19. S&P Capital IQ. Past performance is not indicative of future results.

<sup>8</sup> Based on information provided by the underlying manager. There is no guarantee that the investment mentioned will perform well in the future. The above example is provided solely to demonstrate the views, opinions and type of analysis used by AIP in implementing its investment strategy.

<sup>9</sup> Based on information provided by the underlying manager. There is no guarantee that the investment mentioned will perform well in the future. The above example is provided solely to demonstrate the views, opinions and type of analysis used by AIP in implementing its investment strategy.

<sup>10</sup> Based on entry statistics of investments in Ashbridge Transformational Secondaries Fund I, as of December 2019. Note, this Ashbridge Fund is now closed to new investors.

<sup>11</sup> Based on entry statistics of investments in Ashbridge Transformational Secondaries Fund I, as of December 2019. Note, this Ashbridge Fund is now closed to new investors.

<sup>12</sup> S&P LCD Leveraged Buyout Review, 3Q19. S&P Capital IQ. Past performance is not indicative of future results.

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flow characteristics to seek to determine how stable, recurring, or sensitive they are to cyclical fluctuations. We seek to acquire highly cash flow generative businesses that continue to provide value to equity investors through downturns.

## Conclusion

There are many strategies to look at when seeking to build a resilient portfolio. Our experience has led us to develop a framework for selecting companies and constructing a portfolio that seeks to withstand changes in the economic cycle.

They should be well-capitalized, led by strong management teams, and fall within pockets of growth in less cyclical industries. We believe this guiding philosophy can enable a portfolio to perform well in both economic booms and recessions.

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