Association for Enterprise Growth

White Paper

Why is private equity increasingly interested in smaller private companies?

Table of Contents

Overview 2

Section 1: Brief History of Private Equity 3
Section 2: Development of the smaller company investment thesis 4
Section 3: How Private Equity values smaller companies 4
Section 4: The Value Creation Blueprint 5
Section 5: How to optimize your company's value 6

Conclusion 7

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For most owners, the subject of private equity conjures up visions of teams of MBAs financially engineering a distant portfolio company from ivory towers somewhere in the chaos of New York City. Well, 20 years ago, you'd be right. However, today the landscape has changed dramatically. For owners of smaller companies, private equity has finally arrived - en masse. So, the question is why - why has private equity "discovered" smaller private companies and, more importantly, what does this mean to you?

This white paper is not intended to extoll the virtues of private equity but rather to provide owners of smaller companies a foundation to understand the role of private equity in helping you grow enterprise value, and achieve your company and personal objectives.

You might ask -- how does private equity help me grow enterprise value? In short, because private equity is the most reliable financial partner for smaller companies. No, it's not a typo. Said differently, private equity is a far more reliable source of capital than your local bank or potential strategic investor. This is true because, unlike your local bank or potential strategic investor, private equity is in the business of investing, which in aggregate, creates a deep market for owners of closely held businesses. By creating this market, private equity distinguishes the "average" from the "excellent" business and, in so doing, provides the blueprint to enterprise value creation.

So, by creating a market-based blueprint to smaller company value creation, private equity helps you grow the value of your company. Indeed, following this blueprint can mean the difference between whether your company is worth 1 times revenue or 3 times revenue. Imagine what that means to you personally.

Let's get to the blueprint. It starts with an understanding of the market.

Section 1: Brief History of Private Equity
Section 2: Development of the smaller company investment thesis
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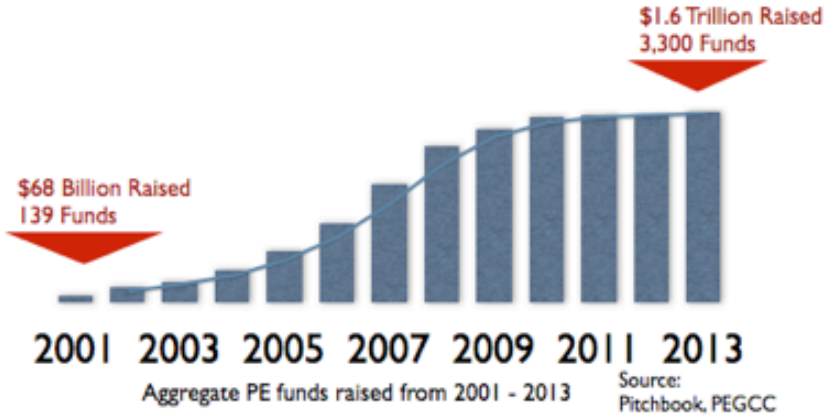
BRIEF HISTORY OF PRIVATE EQUITY

The private equity asset class has grown tremendously since its inception in the 1980s. In the last 14 years alone, private equity assets have grown from $68 billion to $1.6 trillion today with over 3,300 U.S. private equity firms owning over 11,000 companies with 7.5 million employees. At the end of 2013, the industry had approximately $486 billion of capital available to invest.

1

Private equity raises capital from investors to invest in or purchase companies they believe will achieve a superior return on investment.



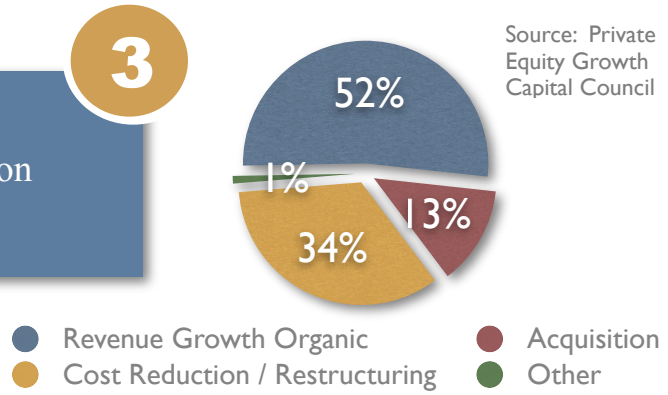
2

Broadening of Private Equity Investment Strategies

1980s	1990s	2000s
Large Company LBO	Growth Equity Middle Market LBO Venture Distressed	Small Company LBO Mezzanine Debt Leveraged Dividend Minority Equity Investment Fundless Sponsor Class High Growth / Low Growth

3

Today, private equity focuses primarily on fundamental improvements to drive return on investment.



Source: Private Equity Growth Capital Council

DEVELOPMENT OF THE SMALLER COMPANY INVESTMENT THESIS

Ten years ago, private equity largely ignored smaller companies. Said differently, a company with $23 million in revenue and $3.5 million in free cash flow annually would have very few options to sell or raise capital outside of a strategic investor or a local investment group arranged through a business broker. Today, the same company would attract hundreds of private equity groups competing for the opportunity to purchase or invest. In fact, today there are well over 1,000 private equity and family office groups specifically targeting smaller companies in the U.S.

Why has private equity finally "discovered" smaller companies? The short answer is superior return on investment compared to alternatives. How does private equity achieve a superior return on investment in smaller companies? The answer is private equity managers are experts at growing enterprise value. They believe (and have shown) that 3-7 years following their purchase or investment, they will likely double or triple the value of the company through fundamental improvements.

There are two important take aways: 1. Private equity has created a deep, reliable market for smaller companies, and; 2. Private equity's investment thesis relies on a value creation blueprint.

HOW PRIVATE EQUITY VALUES PRIVATE COMPANIES

The standard valuation multiple equation used in the private equity industry is:

Enterprise Value / Trailing Twelve Month Adjusted EBITDA

1. *Enterprise Value* is defined as equity plus funded debt minus excess cash beyond working capital.
2. *Adjusted Trailing Twelve Month EBITDA* is defined as the most recently completed 12 month period of earnings before interest, taxes, depreciation and amortization adjusting out or in extraordinary expenses, normalized salaries and the like.

Beyond the equation, the more common rule of thumb is smaller companies are generally valued between 3 and 7 times trailing twelve month pre-tax profit. The important number is not pre-tax profit but rather what the multiplier is between 3 and 7 times. It's fairly straightforward that the value of your company will rise if you increase your pre-tax profit. The real question is by how much. Let's say you increase pre-tax profit by $200,000 this year, will the value of your company increase by $600,000 (3X) or $1,400,000 (7X)? That is the question. And, as you may have guessed, this is the foundation of the private equity value creation blueprint -- how to turn a 3X company into a 7X company.

THE VALUE CREATION BLUEPRINT

Within 3 months of investing in a company, private equity will typically engage a 3rd party consulting specialist to systematically analyze the 18 value drivers below to evaluate how best to grow enterprise value. The process will typically identify 5 or fewer initiatives possessing the highest return on investment.

Growing value efficiently means knowing on which driver to focus. For example, lowering customer concentration could add more to your enterprise value than continued revenue growth at historical customer mix. Or, supplementing senior management to lower key manager dependency may contribute more to enterprise value than margin growth.

On average, private companies can increase its value by 33% through the value enhancement initiatives identified through the 18 value driver discovery process. In fact, studies show the top 5 value drivers alone often account for almost half of the missing value.

The critical point is the value driver analysis will be rigorous and comprehensive, supported by specific return on investment and executed to conclusion. With empirically-based identification of value gaps and disciplined execution of strategies targeted to close those gaps, private equity is able to consistently improve the valuation multiple of portfolio companies and, in so doing, achieve above-market return on invested capital.

HOW TO OPTIMIZE YOUR COMPANY'S VALUE

As you may have already concluded, it's not easy to execute the value creation blueprint especially because it needs to be customized to your unique company and personal factors. So, how to get started? Like private equity, you would benefit by engaging a 3rd party consulting specialist to lead a rigorous and comprehensive analysis to identify the most important contributors to your company's enterprise value. In conjunction with this step, you should also consider beginning the process of creating a board of advisors (formal or informal) to assist you in executing the highest return on investment initiatives identified in the value creation blueprint. To that end, we have put together a separate resource entitled *Building the Right Advisory Board* discussing the value of and critical planning steps to creating an effective advisory board. With these two steps, you'll be well on your way.

CONCLUSION

Private equity is providing great value to owners of smaller private companies by creating a market-based blueprint to enterprise value creation. It has never been clearer how to grow the value of your company to meet your business and personal objectives. Those who act will reap the rewards.

Association for Enterprise Growth

About the Association For Enterprise Growth:

The Association For Enterprise Growth is a non-profit organization dedicated to the educating business owners about the unique interconnected and interdependent issues impacting the value of their business and personal wealth.

The organization is structured regionally into councils of approximately 30 independent professionals each with proficiency and experience in a wide range of financial, legal and management disciples. These professionals operate as a cohesive group of specialists providing collaborative diagnostics, advice, planning and solutions to address complex growth, management and financial challenges to individual business owners.