Big PE at the Peak. Rise of the AIP's.

Where do returns go from here?

Alan Braverman
Managing Partner

Milestone Active Management, LLC
116 Village Blvd, Suite 200 • Princeton, NJ 08550

Industry Research Paper

Milestone Active Management, LLC is a family office investor in private equity focused on actively managing investments in the lower and mid markets. All opinions are those of Milestone Active Management, LLC.

Alan Braverman is the managing partner of Milestone Active Management, LLC and has been a #1 ranked Wall Street Journal and Institutional Investor ranked analyst for Credit Suisse, Deutsche Bank Securities and Bank of America Securities. He has also served in leadership positions in major operating companies including serving as president at a publicly traded division of General Electric (NYSE: GE; Nasdaq: NBCI).

Private Equity Outlook

The Fall of Big PE; Rise of the "AIP's"

Private Equity (PE) has long provided institutional investors—mostly pension funds and retirement plans—with great returns and diversification. But the industry has changed and its not such an "alternative" investment anymore, at least in terms of Big PE...which is now 22% of the size of the S&P. We believe that Big PE is at or near its peak and that forward returns will fall. We also believe that a new alternative PE strategy will rise for select investors—the AIP.

Our Thesis:

(i) PE is principally Big funds that invest in Big deals (Big PE);

(ii) Big PE returns will fall as a result of many factors, including their own historic success, and

(iii) Aggregating Investment Platforms (AIP's) will emerge to exploit the new reality of PE—our coined name for a class of PE constructs designed to take advantage of today's market

AIPs: our newly established PE strategy for Family Office & Small Institutional (FOSI) investors. AIPs:

1) **Aggregate** like-minded FOSI investors on a platform to gain scale and diversification;

2) Are **managed** by a team far deeper and more focused in operations and growth than most PE funds;

3) **Encourage & leverage FOSI** industry **operating expertise** for deal vetting & ongoing operations

4) **Tactical Strategy centers on operating growth** vs financial engineering as with most Big PE;

5) **Target lower to mid-market PE** where less competition, lower price multiples, and 30X greater volume of potential targets exist

AIPs take advantage of the new reality in PE, delivering far better risk-adjusted returns for FOSI's

EXHIBIT 1 AIP's versus Big PE - Apples and Oranges

Attribute	AIPs	Big PE
Platform Sponsor Management	**Operationally experienced and focused oversight:** including taking on managerial roles	**Typically board level oversight:** directing CEO and CFO to execute Big PE strategies.
Investor Involvement	**Key to strategy:** leverage of deep FOSI industry experience in vetting and operations	**None:** Investors as LP's only
Investment Size Target	Small to Medium Sized Deals	Big Deals
Pressure on Purchase Price Multiples	Medium to Medium +	High to Very High
Volume of Potential Targets	**Significant:** over 10% of all US companies	**Low:** Less than 1/3 of 1% of all US companies
Leverage Sought	Medium	High
Value Add Strategy	**Operationally and growth focused:** organic growth is the priority; tactics include expanding operations, hiring and upgrading talent	**Financial engineering focused:** where growth is not the priority, tactics include layoffs, spin offs, cost cutting, reducing R&D
Investment Risk	**Low to Medium:** lowerpurchase prices, lower leverage and core strategy of growth is less dependent on economic cycles or interest rates	**Medium to Very High:** Paying peak purchase price multiples, assuming peak debt multiples, dependent on high leverage and an active IPO market.

Thesis Support:

1) **Big PE is at the Peak of its cycle**. Its bigger, more concentrated and more risky than ever.

2) **Why Big PE is set for a fall.** Too much money chasing too few deals & too much easy debt.

3) **A slow motion car crash.** Why investors aren't headed for the door. Yet.

1. Big PE is at the Peak of its cycle.

It's bigger, more concentrated and more risky than ever.

- **PE assets (AUM) exploded** to $2.4 Trillion, an increase of 42% or $700 Billion since 2010[1]. The entire S&P 500, by contrast is $10.6 Trillion[2] (PE is 22.6% of S&P).
- **Concentration is increasing**[3]. Big PE holds > 80% of industry assets, and concentrates on a select few strategies that put big money to work quickly. Top five firms equal 13% of industry AUM (Exhibit 2).
- **PE dry powder is at a record level**: $1.2 Trillion[4], or just under 50% of all PE AUM.
- **Deals are bigger than ever.** M&A activity in 2015 is on pace to hit $3.7 Trillion[5], a record second only to 2007, the peak year of the last Private Equity bubble. In fact, up through 4/9/15 there were more deals over $10 Billion[6] than has ever been recorded.
- Fund size is bigger than ever. See Exhibit 2
  - Data from Bain[7] suggests that deal size is up 30% over the past three years alone.

From Bain and Company Global Private Equity Report 2014:

"Although the number of buyout funds that closed last year increased only slightly to 168 (compared with about 140 each year since 2009), the amount of capital raised jumped 89% year over year to $191 billion as money flowed disproportionately to bigger funds"....

"...nine mega-funds closed in 2013, attracting more than $5 billion each and accounting for 48% of the total capital raised by buyout funds. Among them was the largest buyout fund raised since the financial crisis..."

EXHIBIT 2

Vintage Era	Small	Mid-Market	Large	Mega
1992-1996	< $200 MM	$201 MM - $500 MM	> $501 MM	N/A
1997-2004	< $300 MM	$301 MM - $750 MM	$751 MM - $2 Billion	> $2 Billion
2005-2013	< $500 MM	$501 MM - $1.5 Billion	$1.6 MM - $4.5 Billion	> $4.5 Billion

Source: Prequin Ltd./ www.prequin.com; http://www.usinflationcalculator.com/Prequin definitions of fund size over time.

Concentration among leading Alternative Investment Firms

Film	Market Share	AUM* ($ Billions)
Blackstone	4.1%	$ 266
Carlyle	3.0%	$ 189
Apollo	2.5%	$ 161
Bridgewater Assoc.	2.0%	$ 150
JP Morgan Asset Management	1.4%	$ 91
Top 5 Firms	**13.0%**	**$ 857**

Alternative Investment Funds rank and value, IBIS World, Private Equity report 2014

2. Why Big PE is set for a fall.

Too much money chasing too few deals, plus too much easy debt

- **Purchase multiples are way up;** above those at the peak of the last LBO bubble in 2008[8], a full turn higher than last year (2014 vs 2013)
- **Debt is way up;** above the LBO bubble peak in 2008[9] (Exhibit 3),
- **Too Few Targets.** Exhibit 4 displays the narrow target pool of Big PE versus AIP strategy target pool
- **Pressure to put out money** before investment periods expire[10]—or else funds must return unvested capital—which is also driving increased fund life—now at 13 years[11]. Risk rises with longer hold periods
- **Lack of Growth Focus.** Many Big PE strategies center on financial engineering (ie Kraft deal), not growth. But cost cutting, layoffs and spin offs can only go so far and run out of steam after a few years... and then what?
- **Big PE is more vulnerable to Interest rate swings.** With high leverage and high purchase price multiples, expected interest rate increases (as soon as 3Q15[12]) will have the most impact on Big PE.

EXHIBIT 3 Median EBITDA Multiples for Buyouts

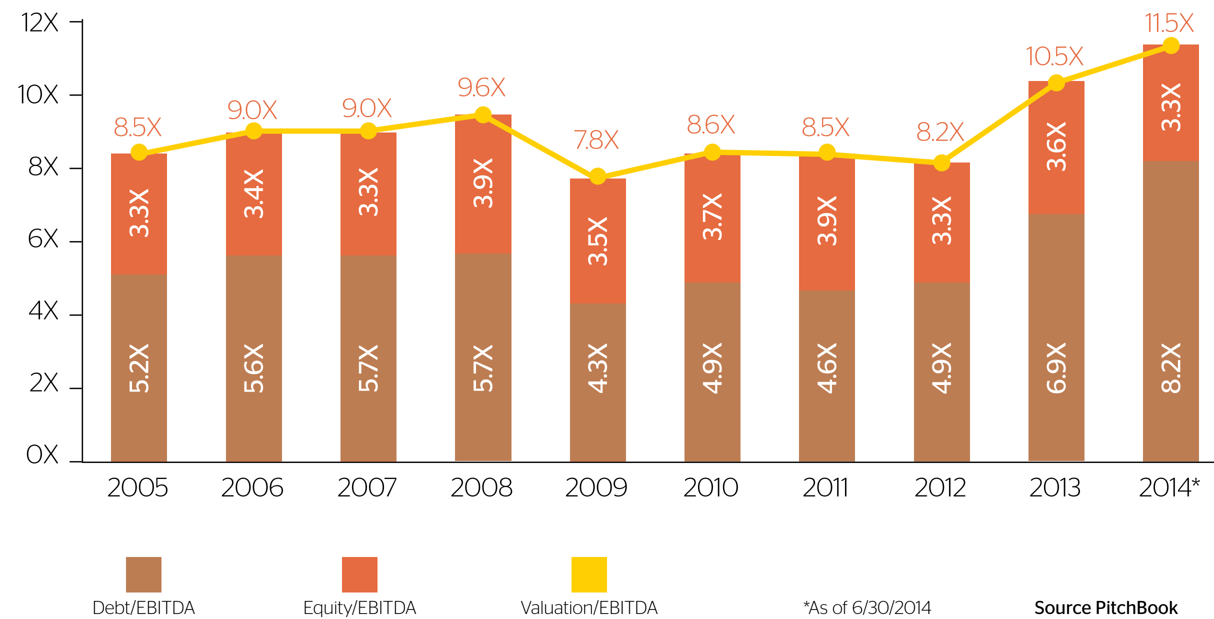

EXHIBIT 4 Big PE Has Few Targets

Big PE targets Big companies. The total number of Big PE potential targets is small, less than 1/3 of 1% of all US companies according to Government data[13], versus over 10% for AIP strategies—a 30 X difference in terms of number of potential targets.

Said one long-term investor Bain interviewed last fall, "You have to kiss a lot of frogs at the smaller end of the market to get the commitment size you want. In the end, it may be just too much work.[15]"

3. A slow motion car crash.

Why investors aren't headed for the door. Yet.

a. **Recent returns are strong**—Blackstone just paid out its largest ever quarterly dividend[14]. With LP's getting great returns today from yesterday's PE investments, they are less concerned about the tomorrow's market. But that's really **looking in the rear view mirror for future returns**.

b. **Big Intuitions dominate Big PE** and are pressured to keep investing; Big PE is the easy call.

i. With an aging population, Big Institutions' retirement-dominated coffers are full

ii. Flight to Big PE: there is an assumption among large institutions that bigger is safer

iii. Bigger is easier: To invest in smaller PE, Big Investors have to write more, smaller checks, making it harder for them to manage a greater number of investments...

c. **Human nature is long on inertia and short memory.** *"If it aint broke don't fix it".* People don't run for the exits when they smell smoke...they wait until the fire is right in front of them. Of course, by then its too late.

d. **Slow motion car crash**—A speeding car hitting the wall and bursting into flames is impossible to miss. Death by a thousand cuts is harder to notice.

AIPs are designed to take advantage of the new reality in PE and deliver far better risk adjusted returns for FOSI investors than Big PE in today's market environment

Rise of the AIPs

AIP's—our coined name for Aggregating Investment Platforms (AIP's) will execute a highly differentiated strategy & should yield superior risk-adjusted returns for select investors

a. **Target market:** mid to lower mid-market has lower price multiples and better target supply/demand dynamics

b. **Scale:** Aggregating small institutions and family offices can replicate Big scale

c. **Active Management:** to grow operations and add value the old fashioned way. Revenue growth not reliant on financial engineering or simply cost cutting.

With our cautionary Thesis for Big PE, why consider **any** PE strategy?

- **PE is still a strong strategy.** Big PE is at its Peak, and as a sub-strategy of overall PE is "overbought".
- **AIPs are a completely different animal.** In today's Peak Big PE jungle, AIPs are simply better suited to thrive. PE remains a solid investment strategy (Figure 5, 6). Let's not confuse Big PE investing with other PE strategies.

EXHIBIT 5 Pension Fund Investment Return by Asset Class *10 year annualized returns*

Asset Class	Return
Public Equity	5.8%
Fixed Income	6.6%
Real Estate	6.7%
Private Equity	10.0%

Source: Private Equity Growth Capital Counsel; as of June 2012 Returns are net of management fees and carry

EXHIBIT 6 Alternative Asset Investment Returns: 1997-2011 *Research from 2,465 pension funds over 15 year period*

Asset Class	Return
Hedge Funds	7.1%
Real Assets	9.5%
Private Equity	11.9%

Source: Defined Contribution Institutional Investment Association, Forbes 2013. Returns are net of management fees and carry

Anatomy of an AIP

AIPs are animals designed to thrive in this new, changed market environment. Some key distinctions:

EXHIBIT 7 Anatomy of an AIP

Attribute	AIPs
Platform Management	• Operationally experienced & focused on enhancing growth • Sponsors will have had experience running a company or division • Not just board level involvement. "Roll up your sleeves" oversight
Investor Involvement – *"not such a limited partner"*	• Designed to lever deep operational experience of Family Offices in multiple verticals • Platform actively seeks out industry domain experts in vetting process and operations • Relationship between Sponsor and investor more of a partnership vs quarterly update • Investors may be a material provider of proprietary dealflow; co-investment rights • Strategy delivers deeper indsutry and operational experience across multiple sectors
Investment Size Target	• EBITDA of between $4MM to $50MM • TEV of between $25MM to $500MM
Dealflow of Potential Targets	• Unlike big PE which relies heavily on brokers, dealflow will rely more on direct & FOSI channels
Leverage Sought	• Debt to equity ratio will be far more conservative than typical Big PE
Value Add	• Operational professionalization is key • Growth focus will be both on active management for organic growth as well as bolt ons
Investment Risk	• Being closer to the steering wheel (operations), we can better manage unexpected bumps in the road • By reducing risk with lower purchase multiples, less debt and more active management, operating management has more freedom to pursue growth strategies

Nothing is without risk. Some of the pros and con's of AIP's

EXHIBIT 8 Select Pros and Cons

–	CON: More time and effort to deploy the same investment dollars
+	PRO: Superior risk/reward vs. Big PE: lower multiples and debt, targets are 30X as abundant
+	PRO: Differentiated Skills: Operational and growth focused
+	PRO: Investors are partners, not just LP's — and can add value
–	CON: Platforms will begin emerging; investors need to seek them out

Who will lead AIP sponsors or platforms?

Winning strategies will include:

- **First Movers**. Like any paradigm shift, first movers will have an advantage that, once attained, could last for decades. Note the current position of PE's early movers—like Bain, Blackstone.
- **Core investors.** Leaders will have assembled or have access to a core set of Family Office or Small Institutional investors sufficient to establish scale for an AIP platform.
- **Family Offices** with historic operational experience could aggregate like-minded families, each with different industry experience thus assembling professional teams to establish their own platforms.

AIP Platforms could emerge by combination or evolution.

1) Seasoned team of financial and operating managers to lead the platform

2) Forward thinking FOSI's:

- Multi-family offices like GenSpring and WE Family Offices, or
- Private client practices of firms like Goldman Sachs, Morgan Stanley, UBS or Credit Suisse

Why should platforms evolve or combine?

1) **Satisfy customer demand.** Family office and small institutional clients are aggressively seeking ways to make **direct investments** and **co-investments** consistent with AIP platform strategies

2) **Customer retention.** If these groups don't do it—someone else will—and will take their clients as a result

3) **New fees:** Investment banks and family offices can earn new, significant revenue streams by aggressively establishing market-leading AIP platforms. Big PE is a great business, on average delivering 40% net profit margins[16] at the GP level — AIPs could deliver these same GP level results to those that lead the way.

Past returns for PE have been strong, besting the major indices over the longer time frames and adding diversification due to their limited market correlation.

EXHIBIT 9 U.S. Private Equity and Venture Capital Index Returns (%) *Periods ending September 30, 2013*

	Quarter	YTD	1 Year	3 Years	5 Years	10 Years	15 Years	20 Years	25 Years
USPE	5.1	13.3	17.2	15.7	11	14.2	12	13.5	13.4
USVC	6.5	14	15.1	14.4	7.5	8.6	26.1	30	20.2
Other Indices									
DJIA	2.1	17.6	15.6	14.9	9.9	7.7	6.9	10	11
NASDAQ Composite*	10.8	24.9	21	16.8	12.5	7.8	5.5	8.3	9.5
Russell 2000 Composite	10.2	27.7	30.1	18.3	11.2	9.6	8.9	9	9.8
S&P 500	5.2	19.8	19.3	16.3	10	7.6	5.3	8.8	10

Sources: Cambridge Associates LLC, Dow Jones & Company, Inc., Frank Russell Company, Standard and Poor's, and Thomson Reuters Datastream.

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References

[1] IbisWorld, 2014; Alan Braverman analysis

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[11] Wall Street Journal, 3/31/15

[12] Goldman Sachs expects the Fed to begin increasing rates starting September 2015, Goldman Sachs, 4/16/15

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[14] Wall Street Journal, 4/17/15

[15] Bain Global Private Equity Report 2014

[16] IBISWorld, "Private Equity...in the US Report, 2014"