Private Equity 101

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Alpine Investors

Background

*Alpine Investors is a private equity firm focused on making investments in middle market privately held companies*

- **Core Values:** Unwavering Character, Persistence, Continuous Improvement, Performance, Intellectual Honesty, and Balanced Lives

- **Funds under Management:** $900m of committed capital since inception (Fund V - $400m)

- **Industries of Interest:** i) Software, ii) Internet and iii) Business Services

- **Target Deal Size:** $5 – 15mm EBITDA

- **Value-Added Investment Partner:** We take an active role in our portfolio companies including: i) key hiring, ii) strategic planning, iii) add-ons (sourcing and transaction) and iv) other operational projects

- **Long Term Orientation:** We expect to grow businesses over a 5-10 year period

- **Example Portfolio Companies:**
  - B2B Communication Software
  - Benefit Administration Provider
  - Physician Practice Management
  - Online Continuing Education Provider
Goals of tonight:

1. Explain/simplify private equity investing

2. Discuss the process by which new deals are evaluated

3. Prep you for the Alpine PE Case Competition!
Goals of Tonight’s Discussion

**What we won’t cover tonight**

1. Financial modeling training

2. Public equities

3. Comparative Analysis of the Hoover Tower (285 ft) and Campanile Tower (307 ft)
1. Speak up if something doesn’t make sense

2. Question / challenge / debate openly (although we’ll need to be conscious of time)
ALPINE INVESTORS

Explain and Simplify
Private Equity Investing
What is a Leveraged Buyout?

**Antonio’s Leveraged Buyout**

- Antonio’s generates **$1 million** per year of **profit** and its owner is looking to **sell the company for $5 million**

- Alpine Investors thinks that it can grow Antonio’s and decides to buy it using a combination of debt and equity

- Alpine arranges a $3 million loan from a bank and puts in $2 million of its own money to buyout Antonio’s

- In exchange, Alpine receives 100% ownership of Antonio’s and Bank of America receives a secured promise from Antonio’s to pay its debt and interest
What is Alpine’s return if the next year, Alpine sells the company for $6.0m, 20% higher than it’s entry price? (ignore interest/dividends)

What is Alpine’s return if the next year, Alpine sells the company for $7.0m, 40% higher than it’s entry price? (ignore interest/dividends)

What is Alpine’s return if the next year, Alpine sells the company for $3.0m, 40% lower than it’s entry price? (ignore interest/dividends)

*=Return ignores impact of interest or dividends

### Impact of Leverage

**Deal Structure:**

<table>
<thead>
<tr>
<th></th>
<th>Alpine Equity</th>
<th>Debt</th>
<th>Enterprise Value</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>$2.0m</td>
<td>$3.0m</td>
<td>$5.0m</td>
</tr>
<tr>
<td></td>
<td>$3.0m</td>
<td>$3.0m</td>
<td>$6.0m</td>
</tr>
<tr>
<td></td>
<td>$4.0m</td>
<td>$3.0m</td>
<td>$7.0m</td>
</tr>
<tr>
<td></td>
<td>$0.0m</td>
<td>$3.0m</td>
<td>$3.0m</td>
</tr>
</tbody>
</table>

Alpine Return*:

- 0%
- 50%
- 100%
- -100%
The process by which new deals are evaluated
How Private Equity Deals Happen

1. Private company decides to sell
2. Company retains investment banker
3. Investment banker prepares pitch-book and buyer list
4. Pitch-book (or CIM) distributed to potential buyers
5. Deal champion presents to committee
6. Management call
7. Private equity group reviews CIM
8. Bid or pass?
9. Company selects bidders for meetings
10. Company selects best bidder for exclusivity
11. Due Diligence
12. Close!
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Most Critical Phase of Deal Process: Evaluation
Your Job in Deal Evaluation:

Become an expert at valuing the underlying asset

Underlying Value is a Function Of:

- Market
- Company and Competitive Position
- Management
- Valuation
- Structure
Tony Hsieh, Founder of Zappos, on Business Strategy:

“Table selection is the most important decision you can make in poker... and in business. Choose a table where you know you can win.”
Deal Evaluation Simplified

Market

Small, Growing Market

Company and Competitive Position

Growing

Small, Contracting Market

Management

Valuation

Structure

Small, Growing Market

...although companies in small growing markets are OK if advantages apply to bigger market.

Large, Growing Market

We seek to invest in large, growing markets with enough headroom for growth

Small, Contracting Market

Large, Contracting Market

Small

Large
Growth and certainty over long-term determine success

- Market growth – ride a rising tide

- Big market – size of your canvas

- Look for endogenous factors (eg. execution), not exogenous (eg. commodity prices)

- Small business can be competitive and build barriers

- Can we reasonably know what industry will look like in 5 years?
### Antonio’s Market

<table>
<thead>
<tr>
<th>Criteria</th>
<th>+ / -</th>
<th>Commentary</th>
</tr>
</thead>
<tbody>
<tr>
<td>Market Growth?</td>
<td>O</td>
<td>Stanford enrollment proxy for market growth</td>
</tr>
<tr>
<td>Big Market?</td>
<td>-</td>
<td>Est. $125mm market (student pop x food/bev spend); very localized business</td>
</tr>
<tr>
<td>Risks Endogenous?</td>
<td>+</td>
<td>No regulatory risk. Success within Antonio’s control; HOWEVER, low barriers to entry</td>
</tr>
<tr>
<td>Can small biz compete?</td>
<td>+</td>
<td>Restaurant / bar market fragmented</td>
</tr>
</tbody>
</table>
What is different or unique today?

Why is this sustainable?

Why will Company ABC win over long-term?
Buffet says look foremost for **durable competitive advantage**:

"The key to investing is not assessing how much an industry is going to affect society, or how much it will grow, but rather determining the competitive advantage of any given company and, above all, the durability of that advantage. The products or services that have wide, sustainable moats around them are the ones that deliver rewards to investors."

~Warren Buffett, Fortune Magazine, 1999

[http://www.youtube.com/watch?v=OnI64XuR4uI](http://www.youtube.com/watch?v=OnI64XuR4uI)
Sources of Competitive Advantage:

- Switching costs (brand, hassle, technology)
- Local economies of scale
- Supply barriers (access to key resources, vendor exclusivity)
- Cost or Process (management, efficiency, culture)
That all sounds great... but how do I assess a company’s competitive position?

**Porter’s Five Forces Model of Competition**

<table>
<thead>
<tr>
<th>Threat of New Entrants</th>
<th>Determinants of Supplier Power</th>
<th>Rivalry Among Existing Firms</th>
<th>Determinants of Buyer Power</th>
<th>Threat of Substitute Products</th>
</tr>
</thead>
<tbody>
<tr>
<td>Barriers to entry</td>
<td>Supplier concentration</td>
<td>Number of competitors</td>
<td>Number of buyers relative</td>
<td>Relative price of substitutes</td>
</tr>
<tr>
<td>- Economies of scale</td>
<td>Availability of substitute</td>
<td>- Relative size of</td>
<td>to others</td>
<td>Relative quality of</td>
</tr>
<tr>
<td>- Product differentiation</td>
<td>inputs</td>
<td>competitors (balance)</td>
<td>Product differentiation</td>
<td>substitute</td>
</tr>
<tr>
<td>- Capital requirements</td>
<td>Suppliers’ product differentiation</td>
<td>- Fixed costs vs. variable costs</td>
<td>Buyers’ switching costs</td>
<td></td>
</tr>
<tr>
<td>- Switching costs to buyers</td>
<td>- Product differentiation</td>
<td>- Capacity augmented in</td>
<td>Industry growth rate</td>
<td></td>
</tr>
<tr>
<td>- Access to distribution channels</td>
<td>- Industry growth rate</td>
<td>large increments</td>
<td>Exit barriers</td>
<td></td>
</tr>
<tr>
<td>- Other cost advantages</td>
<td>Suppliers’ switching costs</td>
<td>- Buyers’ threat of</td>
<td>Strategic stakes</td>
<td></td>
</tr>
<tr>
<td>- Government policies</td>
<td>Diversity of competitors</td>
<td>backward integration</td>
<td></td>
<td></td>
</tr>
<tr>
<td>- Inherent’s defense of market share</td>
<td>Exit barriers</td>
<td>- Importance of product to the buyer</td>
<td></td>
<td></td>
</tr>
<tr>
<td>- Industry growth rate</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>- Suppliers’ product differentiation</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**SWOT Analysis**

<table>
<thead>
<tr>
<th>Strength (S)</th>
<th>Weakness (W)</th>
</tr>
</thead>
<tbody>
<tr>
<td>A distinctive competence?</td>
<td>No clear strategic direction</td>
</tr>
<tr>
<td>Well-thought-of by stakeholders?</td>
<td>Obsolete facilities?</td>
</tr>
<tr>
<td>An acknowledged academic leader?</td>
<td>Weak image?</td>
</tr>
<tr>
<td>Well conceived operational strategies?</td>
<td>Falling behind in R&amp;D?</td>
</tr>
<tr>
<td>Location advantages?</td>
<td>Too narrow ranges of courses offered?</td>
</tr>
<tr>
<td>Insulated from competitive pressures?</td>
<td>Lack of managerial depth and talent</td>
</tr>
<tr>
<td>Proprietary technology?</td>
<td>Missing any essential skills or competencies?</td>
</tr>
<tr>
<td>Adequate financial resources?</td>
<td>Poor track record?</td>
</tr>
<tr>
<td>Access to economies of scale?</td>
<td>Plagued with internal operating problems?</td>
</tr>
<tr>
<td>Cost advantages?</td>
<td>Vulnerable to competitive pressures?</td>
</tr>
<tr>
<td>Product innovation abilities?</td>
<td>Competitive disadvantages?</td>
</tr>
<tr>
<td>Proven Management?</td>
<td>Below-average marketing skills?</td>
</tr>
<tr>
<td>Other?</td>
<td>Unable to finance needed changes in strategy?</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Opportunities (O)</th>
<th>Threats (T)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Serve additional customer groups?</td>
<td>Likely entry of new competitors?</td>
</tr>
<tr>
<td>Enter new market or segments?</td>
<td>Growing of substitute courses?</td>
</tr>
<tr>
<td>Expand courses to meet broader range of customer needs?</td>
<td>Slower student growth?</td>
</tr>
<tr>
<td>Diversify into related courses or services?</td>
<td>Adverse government polices?</td>
</tr>
<tr>
<td>Add complementary courses or services?</td>
<td>Growing competitive pressures?</td>
</tr>
<tr>
<td>Vertical integration?</td>
<td>Vulnerability to recession and business cycle?</td>
</tr>
<tr>
<td>Ability to move to better strategic group?</td>
<td>Growing bargaining power of customers or suppliers?</td>
</tr>
<tr>
<td>Complacency among other institutions?</td>
<td>Changing stakeholder needs and tastes?</td>
</tr>
<tr>
<td>Faster market growth</td>
<td>Adverse demographic changes?</td>
</tr>
<tr>
<td>Other?</td>
<td>Other?</td>
</tr>
</tbody>
</table>
That all sounds great… but how do I assess a company’s competitive position?

Look at the Company’s Data!!!

**REVENUE**
If revenue is growing, why?
Why are customers choosing them?

**PRICING**
How is pricing trending?
Is company able to command more or less for products?

**COSTS / MARGINS**
How are gross margins trending?
How do gross margins compare to comps?
### Antonio’s Competitive Position

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<tr>
<th>Criteria</th>
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<th>Commentary</th>
</tr>
</thead>
<tbody>
<tr>
<td>Switching Costs?</td>
<td>+</td>
<td>Brand loyalty; benefit from network effects</td>
</tr>
<tr>
<td>Local Economies of Scale?</td>
<td>-</td>
<td>Single store; no real scale today</td>
</tr>
<tr>
<td>Supply Barriers?</td>
<td>-</td>
<td>Access to all the same product as other bars</td>
</tr>
<tr>
<td>Cost or Process?</td>
<td>+</td>
<td>Cost advantage in rent control</td>
</tr>
</tbody>
</table>
Q: The single most highly correlated factor with investment success for Alpine?

*A: Quality of the CEO.*

Steve Schwarzman & David Bonderman (Blackstone):

“After exhaustively studying our databases of dozens of deals across twenty years, we concluded that the keys to success in private equity are:

1) Buying Right
2) Having an ‘A’ Team
3) Selling Right
An A+ Management Team is Key

- Track record of success – have they done what you’re asking them to do?

- Alignment of incentives – make money together

- Surround themselves with smart people – hire people better than themselves

- Passion for their business – you can “feel it”…

  …although keep it tempered.
Return model must meet 3 criteria:

- Low chance of principal loss (solvable via valuation and structure)
- 3x return on capital in base case (70% probability; conservative assumptions)
- 5x in reasonably attainable case
### How do we determine valuation we’re willing to pay?

**Step #1 – Understand where the market is pricing similar deals**

<table>
<thead>
<tr>
<th>Ticker</th>
<th>TEV/LTM</th>
<th>EV/LTM</th>
<th>EV/NTM</th>
<th>Sales</th>
<th>EBITDA</th>
<th>TEV/LTM</th>
<th>EV/LTM</th>
<th>EV/NTM</th>
<th>Sales</th>
<th>EBITDA</th>
</tr>
</thead>
<tbody>
<tr>
<td>Apollo Group Inc.</td>
<td>APOL</td>
<td>0.41</td>
<td>2.09</td>
<td>0.37</td>
<td>1.75</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Career Education Corp.</td>
<td>CECO</td>
<td>NM</td>
<td>NM</td>
<td>NM</td>
<td>NM</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Corinthian Colleges Inc.</td>
<td>COCO</td>
<td>0.19</td>
<td>2.73</td>
<td>0.19</td>
<td>2.73</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>DeVry, Inc.</td>
<td>DV</td>
<td>0.97</td>
<td>5.60</td>
<td>0.97</td>
<td>5.60</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>ITT Corporation</td>
<td>ITT</td>
<td>1.23</td>
<td>8.82</td>
<td>1.28</td>
<td>9.55</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>SmartPros Ltd.</td>
<td>SPRO</td>
<td>0.26</td>
<td>14.64</td>
<td>0.27</td>
<td>NM</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Strayer Education Inc.</td>
<td>STRA</td>
<td>0.90</td>
<td>4.12</td>
<td>0.86</td>
<td>3.51</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Universal Technical Institute, Inc.</td>
<td>UTI</td>
<td>0.54</td>
<td>8.14</td>
<td>0.51</td>
<td>6.12</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Capella Education Co.</td>
<td>CPLA</td>
<td>1.39</td>
<td>8.72</td>
<td>1.37</td>
<td>8.10</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>SmartPros Ltd.</td>
<td>SPRO</td>
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<td>NM</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Intuit Inc.</td>
<td>INTU</td>
<td>4.38</td>
<td>12.47</td>
<td>4.38</td>
<td>12.47</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>LivePerson Inc.</td>
<td>LPSN</td>
<td>2.66</td>
<td>35.68</td>
<td>2.84</td>
<td>23.55</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>K12, Inc.</td>
<td>LERN</td>
<td>0.66</td>
<td>6.91</td>
<td>0.66</td>
<td>6.91</td>
<td></td>
<td></td>
<td></td>
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</tr>
</tbody>
</table>

**PUBLIC COMPS**

**PRIVATE COMPS**

**BANKER GUIDANCE**
How do we determine valuation we’re willing to pay?

Step #2 – Based on conservative company growth assumptions and your estimate of valuation that will win, can we hit required returns of:

3X RETURN ON CAPITAL
Balance benefit of leverage with ability for company to invest

- Remember equity vs. debt?

- Don’t handcuff company with debt – manage business for growth, not repayment of debt

- Minimize risk of principal loss through preference
These things feed your model:

How to generate returns in private equity:

- Paying down leverage: Paying down debt increases value of equity – remember the Antonio’s example?
- Multiple growth: All else constant, selling a business at a higher multiple than you bought it for increases equity value.
- Earnings growth: Businesses are valued based on earnings potential (e.g., multiple method).
**Deal Evaluation Simplified**

**Paying down leverage**

Paying down debt increases value of equity – remember the Antonio’s example?

<table>
<thead>
<tr>
<th>At Purchase</th>
<th>Exit in Year 5 under these scenarios</th>
</tr>
</thead>
<tbody>
<tr>
<td>Earnings</td>
<td>1,000,000</td>
</tr>
<tr>
<td>Multiple</td>
<td>5.0x</td>
</tr>
<tr>
<td>Enterprise Value</td>
<td>$5,000,000</td>
</tr>
<tr>
<td>Less: Debt</td>
<td>$3,000,000</td>
</tr>
<tr>
<td>Plus: Cash</td>
<td>$0</td>
</tr>
<tr>
<td>Equity Value</td>
<td>$2,000,000</td>
</tr>
</tbody>
</table>

**Multiple growth**

All else constant, selling a business at a higher multiple than you bought it for increases equity value

<table>
<thead>
<tr>
<th>Exit Scenario #1: No growth, pay down debt</th>
<th>Exit Scenario #2: No growth, multiple growth</th>
<th>Exit Scenario #3: Earnings growth multiple growth</th>
</tr>
</thead>
<tbody>
<tr>
<td>Earnings</td>
<td>1,000,000</td>
<td>1,000,000</td>
</tr>
<tr>
<td>Multiple</td>
<td>5.0x</td>
<td>7.0x</td>
</tr>
<tr>
<td>Enterprise Value</td>
<td>$5,000,000</td>
<td>$7,000,000</td>
</tr>
<tr>
<td>Less: Debt</td>
<td>$0</td>
<td>$0</td>
</tr>
<tr>
<td>Plus: Cash</td>
<td>$1,000,000</td>
<td>$1,000,000</td>
</tr>
<tr>
<td>Equity Value</td>
<td>$6,000,000</td>
<td>$8,000,000</td>
</tr>
</tbody>
</table>

**Return on capital**

3.0x 4.0x 6.0x
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1. Private company decides to sell
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Case Competition!
Alpine Internship Program and Analyst Position

Now Hiring!

Internship Program: Summer Internship Program in San Francisco

Full-Time Analyst: Full-time investment analyst role open to undergraduates

To Apply: Go to the Cardinal Careers site and submit your resume

Our Promises to Our Interns and Analysts

We will invest in your training and development

We will put you into roles that align with your greatest strengths and interests

You will be involved in projects that will push and stretch you

You will be given all of the responsibility that you’re able to handle

You will be proud to have worked with us

You will be better for having worked with us
Alpine Case Competition

Register by Thursday!

**Teams:** 2-4 members per team, 1 Deal Champion

**Registration:** Deal Champions register your teammates’ names and emails as well as your team name by **Thursday October 16th at 11:59pm**. A registration link will be sent to every attendee of tonight’s event.

**Timeline**
- Thursday 10/16 11:59pm – Registration Due
- Friday 10/17 – Confidential Memoranda released
- Mon 10/27 – Wed 10/29 – Management calls
- Friday 10/31 11:59pm – Pitch presentation submission due to investment committee
- Wednesday 11/5 – Finalists announced and feedback provided to finalist teams
- Tuesday 11/11 – Final presentations to investment committee
Priority 1: Business and Market Analysis
1. High Quality Business
2. A+ Management
3. Growing Market with High Barriers

Priority 2: Valuation and Structure
1. Valuation
2. Deal structure

*Focus your energy on evaluating the company and market as we will prioritize that in our review of the submissions. Valuation and deal structure matter, but they take a backseat to business analysis*