ALPINE INVESTORS

Private Equity 101

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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**:

CLEO	BENECO	HealthPlus Management Services	McKissock
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!

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)

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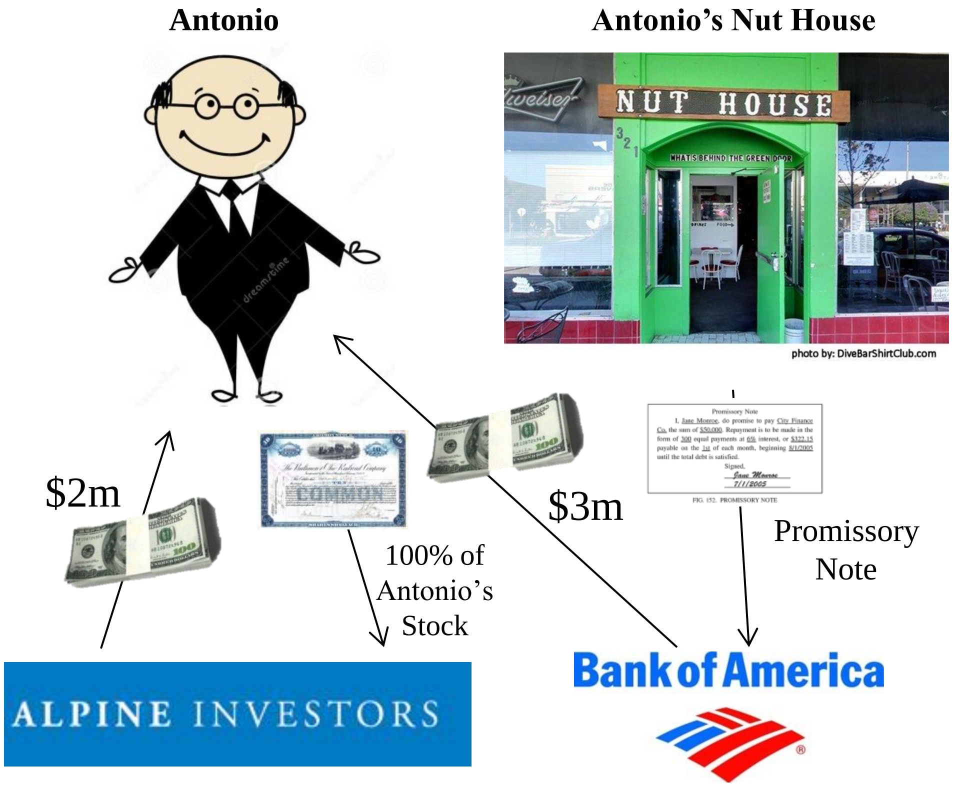
Explain and Simplify Private Equity Investing

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 it's 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



Impact of Leverage

- **Deal Structure:**

Alpine Equity	$2.0m	$3.0m	$4.0m	$0.0m
Debt	$3.0m	$3.0m	$3.0m	$3.0m
Enterprise Value	**$5.0m**	**$6.0m**	**$7.0m**	**$3.0m**
Alpine Return*	0%	50%	100%	-100%

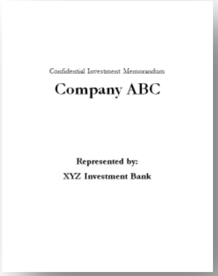
- What is Alpine's return if the next year, Alpine sells the company for $6.0m, 20% higher than it's entry price? (ignore interest/dividends)
- What is Alpine's return if the next year, Alpine sells the company for $7.0m, 40% higher than it's entry price? (ignore interest/dividends)
- What is Alpine's 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

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. Private equity group reviews CIM
6. Management call
7. Deal champion presents to committee
8. Bid or pass?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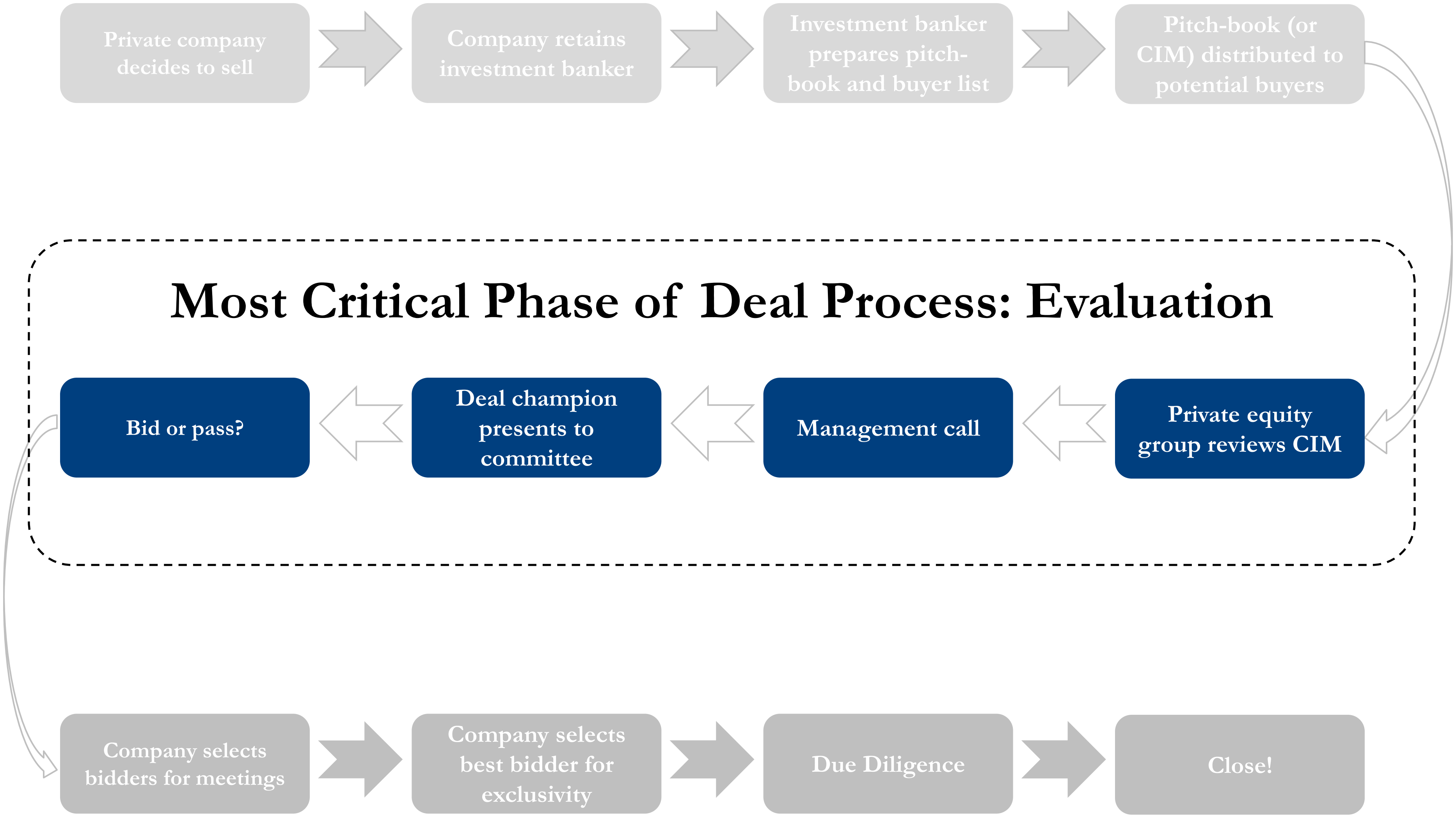
9. Company selects bidders for meetings
10. Company selects best bidder for exclusivity
11. Due Diligence
12. Close!


Private company decides to sell
Company retains investment banker
Investment banker prepares pitch-book and buyer list
Pitch-book (or CIM) distributed to potential buyers
Most Critical Phase of Deal Process: Evaluation
Private equity group reviews CIM
Management call
Deal champion presents to committee
Bid or pass?
Company selects bidders for meetings
Company selects best bidder for exclusivity
Due Diligence
Close!

Your Job in Deal Evaluation:

Become an expert at valuing the underlying asset

Underlying Value is a Function Of:

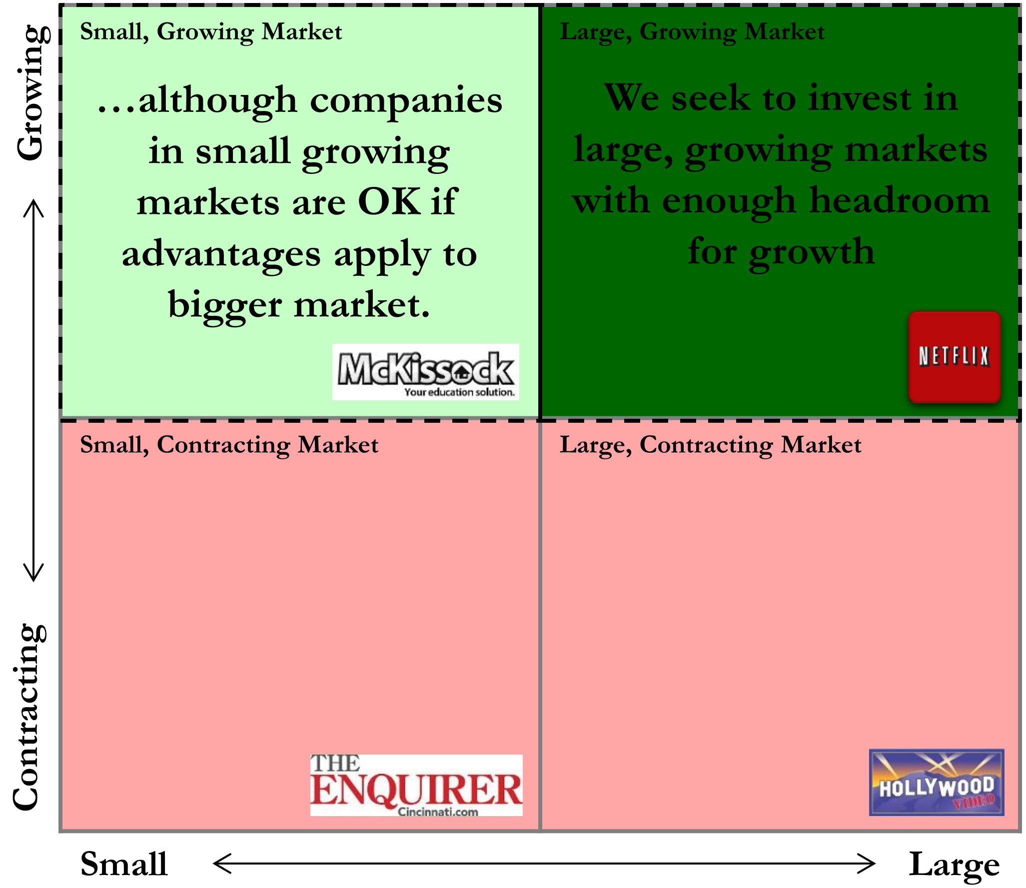
- Market
- Company and Competitive Position
- Management
- Valuation
- Structure

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."

Market | Company and Competitive Position | Management | Valuation | Structure



Market	Company and Competitive Position	Management	Valuation	Structure

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?

Market | Company and Competitive Position | Management | Valuation | Structure

Antonio's Market

Criteria?	+ / -	Commentary
Market Growth?	O	Stanford enrollment proxy for market growth
Big Market?	-	Est. $125mm market (student pop x food/bev spend); very localized business
Risks Endogenous?	+	No regulatory risk. Success within Antonio's control; HOWEVER, low barriers to entry
Can small biz compete?	+	Restaurant / bar market fragmented

Market	**Company and Competitive Position**	Management	Valuation	Structure

What is different or unique today?

Why is this sustainable?

Why will Company ABC win over long-term?

Market | **Company and Competitive Position** | Management | Valuation | Structure

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

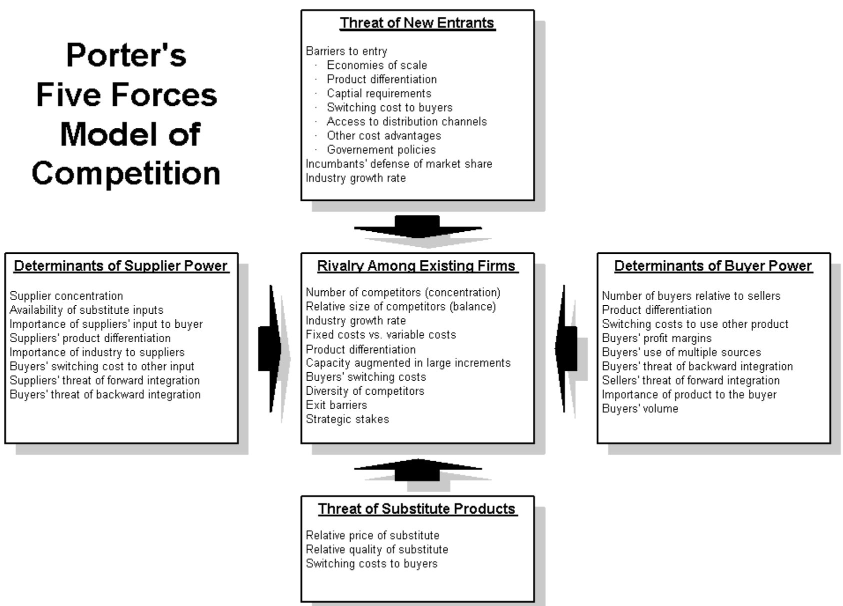
Market | **Company and Competitive Position** | Management | Valuation | Structure

Sources of Competitive Advantage:

- Switching costs (brand, hassle, technology) — SAP *vs.* SPORT CHALET
- Local economies of scale — Walmart *vs.* Kmart
- Supply barriers (access to key resources, vendor exclusivity) — Chesapeake Energy *vs.* General Mills
- Cost or Process (management, efficiency, culture) — Southwest Airlines *vs.* American Airlines

Market	**Company and Competitive Position**	Management	Valuation	Structure

That all sounds great… but how do I assess a company's competitive position?



SWOT Analysis

Strength (S)	Weakness (W)
A distinctive competence?	No clear strategic direction
Well-thought-of by stakeholders?	Obsolete facilities?
An acknowledged academic leader?	Weak image?
Well conceived operational strategies?	Falling behind in R&D?
Location advantages?	Too narrow ranges of courses offered?
Insulated from competitive pressures?	Lack of managerial depth and talent?
Proprietary technology?	Missing any essential skills or competencies?
Adequate financial resources?	Poor track record?
Access to economies of scale?	Plagued with internal operating problems?
Cost advantages?	Vulnerable to competitive pressures?
Product innovation abilities?	Competitive disadvantages?
Proven Management?	Below-average marketing skills?
Other?	Unable to finance needed changes in strategy?
	Other?
Opportunities (O)	**Threats (T)**
Serve additional customer groups?	Likely entry of new competitors?
Enter new market or segments?	Growing of substitute courses?
Expand courses to meet broader range of customer needs?	Slower student growth?
Diversify into related courses or services?	Adverse government polices?
Add complementary courses or services?	Growing competitive pressures?
Vertical integration?	Vulnerability to recession and business cycle?
Ability to move to better strategic group?	Growing bargaining power of customers or suppliers?
Complacency among other institutions?	Changing stakeholder needs and tastes?
Faster market growth	Adverse demographic changes?
Other?	Other?

Market | **Company and Competitive Position** | Management | Valuation | Structure

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?

Market | **Company and Competitive Position** | Management | Valuation | Structure

Antonio's Competitive Position

Criteria?	+ / -	Commentary
Switching Costs?	+	Brand loyalty; benefit from network effects
Local Economies of Scale?	-	Single store; no real scale today
Supply Barriers?	-	Access to all the same product as other bars
Cost or Process?	+	Cost advantage in rent control

Market | Company and Competitive Position | **Management** | Valuation | Structure

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

Market	Company and Competitive Position	**Management**	Valuation	Structure

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.

Deal Evaluation Simplified

Market | Company and Competitive Position | **Management** | Valuation | Structure

Market	Company and Competitive Position	Management	**Valuation**	Structure

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

Market | Company and Competitive Position | Management | **Valuation** | Structure

How do we determine valuation we're willing to pay?

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

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

PUBLIC COMPS

PRIVATE COMPS

BANKER GUIDANCE

Market | Company and Competitive Position | Management | **Valuation** | Structure

How do we determine valuation we're willing to pay?

	2010	2011	2012	2013	2014	2015	CAGR
Revenue	50,000	55,000	60,500	66,550	73,205	80,526	**10%**
Operating Expenses	35,000	39,050	43,560	48,582	54,172	60,394	
EBITDA	**15,000**	**15,950**	**16,940**	**17,969**	**19,033**	**20,131**	6.1%
Margin	*30.0%*	*29.0%*	*28.0%*	*27.0%*	*26.0%*	*25.0%*	
Interest		4,950	4,432	3,851	3,202	2,481	
D&A		2,000	2,000	2,000	2,000	2,000	
Earnings before Taxes		9,000	10,508	12,118	13,832	15,651	
Taxes		3,600	4,203	4,847	5,533	6,260	
Net Income		5,400	6,305	7,271	8,299	9,390	
Cash Flow to Debt		7,400	8,305	9,271	10,299	11,390	
Debt Schedule (Total)							
BOP		60,000	52,600	44,295	35,024	24,726	
Payments		7,400	8,305	9,271	10,299	11,390	
EOP	60,000	52,600	44,295	35,024	24,726	13,335	
Common Equity Distributions		0	0	0	0	0	
Exit Enterprise Value						161,051	
Minus: Debt						13,335	
Plus: Cash						0	
Equity Value						147,716	
Investor Cash Flows	**(44,000)**	**0**	**0**	**0**	**0**	**104,831**	

IRR	**21%**
ROIC	**3.0x**

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

Market	Company and Competitive Position	Management	Valuation	**Structure**

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

- Market
- Company and Competitive Position
- Management
- Valuation
- Structure

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 (eg. multiple method)

Deal Evaluation Simplified

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

	At Purchase		Exit Scenario #1: No growth, pay down debt	Exit Scenario #2: No growth, multiple growth	Exit Scenario #3: Earnings growth multiple growth
Earnings	1,000,000	Exit in Year 5 under these scenarios ➔	1,000,000	1,000,000	1,500,000
Multiple	5.0x		5.0x	7.0x	7.0x
Enterprise Value	**$5,000,000**		**$5,000,000**	**$7,000,000**	**$10,500,000**
Less: Debt	$3,000,000		$0	$0	$0
Plus: Cash	$0		$1,000,000	$1,000,000	$1,500,000
Equity Value	**$2,000,000**		**$6,000,000**	**$8,000,000**	**$12,000,000**

Return on capital		
3.0x	**4.0x**	**6.0x**

How Private Equity Deals Happen

Private company decides to sell → Company retains investment banker → Investment banker prepares pitch-book and buyer list → Pitch-book (or CIM) distributed to potential buyers

Case Competition!

Private equity group reviews CIM → Management call → Deal champion presents to committee → Bid or pass?

Company selects bidders for meetings → Company selects best bidder for exclusivity → Due Diligence → Close!

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

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.

<u>Timeline</u>

-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

Our Rubric

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