Understanding private equity.
What is private equity?

A private equity investor is an individual or entity that invests capital into a private company (i.e. firms not traded on a public exchange) in exchange for equity interest in that business. In the US, there are approximately 18,000 publicly traded companies, and more than 300,000 privately held companies.

**WHO MIGHT SEEK A PRIVATE EQUITY INVESTOR AS A SOURCE OF CAPITAL?**

- Companies looking to fund a capital need that is beyond traditional bank financing
- Owners considering a partial or complete sale of their business
- Managers looking to buy a business
Private equity strategies.

Examples of private equity firms:

Most private equity investors will limit their investments to one or two of the following strategies:

- Angel investing
- Venture capital
- Leveraged buyouts (LBO)
- Growth capital
- Distressed investments
- Mezzanine capital
Sources of capital for PE funds.

THERE ARE TWO TYPES OF PRIVATE EQUITY FIRMS:

- Firms with a dedicated fund, with the majority of the capital sourced from institutional investors (i.e. pension funds, banks, endowments, etc.) and accredited investors (i.e. high net worth individual investors)
- Firms that raise capital from investors on a per-deal basis (pledge funds)

INVESTMENT DURATION AND RETURNS.

- Typical investment period is 3–10 years, after which capital is distributed to investors
- Rates of return are higher than public market returns, typically 15–30%, depending on the strategy

HISTORICAL S&P 500 RETURNS

Source: Standard & Poor’s LCD
Private equity fund structure.

PRIVATE EQUITY FIRM
Management Company  General Partner

LIMITED PARTNERS (Investors)
(Public pension funds, corporate pension funds, insurance companies, high net worth individuals, family offices, endowments, banks, foundations, funds-of-funds, etc.)

Fund Ownership

PRIVATE EQUITY FUND (Limited Partnership)

Fund’s Ownership of Portfolio Investments

INVESTMENT 1  INVESTMENT 2  INVESTMENT 3  Etc.
Private equity investment strategies.

- **Pre-Seed**
  - Pre-revenue/start-up
  - Building management team
  - Early stage product development
  - Significant market opportunity

- **Seed**
  - $500K-5MM in revenue
  - Management team near complete
  - Commercial acceptance
  - Significant market opportunity

- **Venture and Early Stage**
  - Profitable, with TTM revenue of $3MM+
  - Mature management team
  - Year-over-year revenue growth
  - Defensible market position

- **Growth and Expansion**
  - Revenue greater than $10MM
  - Mature management team
  - Growth strategy – organic or acquisition
  - Defensible market position

- **Buyout and Recapitalization**
  - Seed and Angel
  - Venture Capital

- **Private Equity (Growth and LBO)**
  - Mezzanine Funding
  - Distressed Investments
Partnering process.

**DISCOVERY PROCESS**
- Business plan and strategy
- Historical and pro forma finance projections
- Market opportunity and defensible position
- Resumes of senior management team
- Potential resources and capital need

**PRELIMINARY MEETINGS**
- Information requests
- Questions list
- Company visits
- Debt capacity assessment
- Data room preparations
- Supporting documents

**REVIEW OFFERS**
- Company due diligence
  - Management
  - Facility
  - Operations
  - Customer
  - Environmental
- Industry due diligence
- Financial due diligence
- Legal due diligence

**FUNDING**
- Review financial goals and expectations
- Review partnership roles and expectations
- Negotiate documents
- Board representation and compensation agreements
- Finalize capital structure (Sr., Mezz, PE)

**PARTNER**
- Develop plan for all parties to realize value from investment
- Build and grow partnership

1 - ? weeks
2 - 4 weeks
4 - 12 weeks
3 - 10 years

Total process from meeting to funding will typically take 6 months.
Understanding leveraged buyouts.

Leveraged buyouts (LBOs) include any acquisition by a private equity group that involves a mix of equity and leveraged finance (i.e. senior debt, mezzanine debt, etc.) to fund the capital required for the transaction. In the past, the debt portion of an LBO comprised 50-90% of the purchase price, but in today’s market, debt levels are typically less than 50%.

THE AMOUNT OF DEBT USED TO FINANCE A TRANSACTION VARIES ACCORDING TO:

- Market conditions
- Financial condition and history of the acquisition target
- Willingness of lenders to extend credit – both to the company being acquired and to the sponsoring private equity firm

Debt (interest and principal payments) will ultimately be repaid with the cash flows of the acquisition target. Due to the debt service burden placed on a company as a result of an LBO, such transactions are not always appropriate for cyclical companies with uneven cash flows.

BENEFITS OF A LEVERAGED FINANCING STRUCTURE:

- The private equity group only needs to provide a portion of the capital for the acquisition
- As long as the capital returned upon exit exceeds the invested equity plus the cost of the debt, the return for all investors can be significantly enhanced
Compelling LBO targets.

Many factors will determine how attractive a company is to a private equity group considering an LBO, and will also impact the willingness of banks and investors to provide financing.

- Quality of the management team
- Cash flow consistency
- Defensible market position
- Operational leverage for growth
- Feasibility of a solid exit strategy
- Stability during economic downturns
- Presence of larger, well-capitalized competitors
- History of successful LBOs in the industry
- Ability to generate returns greater than 25% (assuming an exit in 3–10 years)
- A purchase price in line with comparable companies and transactions
For the right company, an LBO can generate solid results with limited growth. This simple "financial engineering" strategy enticed many firms into leveraged buyouts in the 1990s.

### NO GROWTH SCENARIO

<table>
<thead>
<tr>
<th></th>
<th>Acquisition</th>
<th>Year 1</th>
<th>Year 2</th>
<th>Year 3</th>
<th>Year 4</th>
<th>Year 5/Exit</th>
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<tbody>
<tr>
<td><strong>Enterprise Valuation</strong></td>
<td></td>
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<tr>
<td>EBITDA</td>
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<td>Valuation Multiple</td>
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<td>5.0x</td>
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</table>

| **Equity Valuation**     |             |        |        |        |        |             |
| Implied Enterprise Value | $50         | $50    | $50    | $50    | $50    | $50         |
| Less: Debt               | ($30)       | ($24)  | ($18)  | ($12)  | ($6)   | $0          |
| Plus: Cash               | $0          | $0     | $0     | $0     | $0     | $0          |
| Implied Equity Value     | $20         | $26    | $32    | $38    | $44    | $50         |

### Returns Analysis

<table>
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<tr>
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<th>$20</th>
<th>$26</th>
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<th>$44</th>
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<td>Return on Investment (ROI)</td>
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<tr>
<td>Internal Rate of Return (IRR)</td>
<td>30.0%</td>
<td>26.5%</td>
<td>23.9%</td>
<td>21.8%</td>
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Generating value through growth.

Summer Street’s strategy is to generate value through real growth, not financial engineering.
Generating value through growth.

- ORGANIC GROWTH
  - Develop new products/services
  - Leverage new distribution channels
  - Expand geographic presence

- STRATEGIC ACQUISITIONS
  - Product/service overlap
  - Geographic expansion
  - Product/service extension

- OPERATIONAL IMPROVEMENTS
  - Improve IT systems
  - Enhance/augment management team
  - Implement lean manufacturing

- ALIGNMENT OF SHAREHOLDER INTERESTS
  - Equity held by senior executives
  - Profit sharing pool for management
  - Incentive-based bonus programs
Adding real growth to the equation increases returns dramatically for all shareholders. Greater earnings and improved operations make the company an attractive acquisition for a larger universe of prospective buyers.

### Value Creation Scenario

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<td>3.4x</td>
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<tr>
<td>Internal Rate of Return (IRR)</td>
<td>80.0%</td>
<td>61.2%</td>
<td>50.4%</td>
<td>43.2%</td>
<td>43.1%</td>
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Equity return comparison.

NO GROWTH SCENARIO

VALUE CREATION SCENARIO
In the years following the 2007 economic crisis, deal quantity has rebounded given the abundant access to both debt and equity capital. LBO volume hit a peak pre-crisis due to a mega deal trend.

Equity contributions in LBOs.

As the buy-out market continues to mature, private equity funds have to invest more equity in each transaction to remain competitive. This pressure on returns means more funds are adopting Summer Street’s strategy – generating real growth to drive great results.

Source: Houlihan Lokey, M&A Market Overview Q2 2015, Standard & Poor’s Q2 2015 Leveraged Buyout Review
About Summer Street Capital.

Summer Street Capital Partners, LLC is a Buffalo, NY based private equity firm with committed capital focused on investing in lower middle market companies. The firm invests alongside talented managers, bringing capital and resources to enable extraordinary growth. Summer Street’s investors include leading pension funds, insurance companies, and banking institutions.

- Founded: 1999
- Funds under management: over $450 million* (currently investing in our third fund)
- Investment type: Equity for growth and buyout transactions
- Investment preference:
  - **INVESTMENT AMOUNT:** minimum of $10 million
  - **REVENUES:** $20 – 150 million (10% + EBITDA)
  - **GEOGRAPHY:** US and Canada
  - **OWNERSHIP:** Control or minority positions

* as of 12/31/2015

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