Introduction to Private Equity Overview

CEO Forum – May 2016
Introduction and Contact Information

• Career Background
  – KLH Capital, Partner
  – Recovery Holdings, CFO
  – Founders IB, Associate

• Mobile, AL native

• BS, University of Alabama

• Covenant Life Church

• Married with three daughters (6, 4, and 2 yrs)

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Established Firm Focused On Small Businesses

- 130+ Transactions
- Private Capital Base
- 30 Year Track Record
- Licensed SBIC
- Management Led Transactions
- Small Business Focus
- Partnership Approach
- Tampa, FL
The Goal for Today Is To Understand...

1. Introduction to Private Equity

2. When to Consider Private Equity

3. How Private Equity Values Businesses

4. Top 5 Mistakes that Affect an Owner’s Exit
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What is Private Equity?

- Investors and funds that make investments into private companies (not publicly traded)

- Capital for private equity is raised from high net worth and institutional investors

- Money can be used to accomplish a myriad of goals and objectives in the context of a deal
Fund Structure Is Typically Consistent…

**Limited Partners (Investors)**
(Pension funds, insurance companies, high net worth individuals, family offices, endowments, etc.)

**Private Equity Fund**

- Investment
- Investment
- Investment
…But Each Firm Has Targeted Criteria…

Maturity of the Company

- Startup
- Stable/Mature

Operational Involvement

- Hands on
- Hands off

Size Investments

- $0
- $1bln+

Industries of Interest

- Old economy
- New economy
...For Example, At KLH We Invest In

<table>
<thead>
<tr>
<th>Company Maturity</th>
<th>Mature, growing businesses with a history of profitability that need capital for growth, expansion, working capital, or buyouts</th>
</tr>
</thead>
<tbody>
<tr>
<td>Company Size</td>
<td>Revenue of $10.0 to $100.0 million with EBITDA of $2.0+ million</td>
</tr>
<tr>
<td>Management</td>
<td>Desire to assume meaningful ownership stakes</td>
</tr>
</tbody>
</table>
| Targeted Sectors | - Niche manufacturing  
                  | - Value added distribution                                       |
|                  | - Specialty services                                             |
| Geography        | Nationwide                                                        |
WE'D LIKE TO BUY THE CIRCUS
BUT WE WANT TO BRING
IN OUR OWN PEOPLE
But Actual Reality Is Much Different

Non-recourse Capital

Energy & Excitement

Growth

Improved Reporting

Relationships

Experienced Advice
Core Tenets of a Partnership with KLH

- Management has control of day-to-day operations
- Management has meaningful equity in the business
- Management has an experienced financial partner to help grow the business
- Management has no personal guarantees or risk to personal assets

Post-Closing Ownership

Management Ownership
20% - 40%

KLH Ownership
60% - 80%

Primary Goal = Equity Growth

~4-7 years

Equity Value

Equity Value

Big Idea of the PE Partnership
A Partner to Focus on Achieving Success and Health

Strategic Planning
- Operating Plans
- Budgets
- Board Meetings
- Strategy Sessions

Leadership Development
- C Level Talent
- Middle Management
- Succession Planning
- Executive Coaching

Infrastructure Investment
- IT/ERP systems
- Audit and Taxes
- Insurance
- Real Estate

Add-On Acquisitions
- Analysis & Planning
- Sourcing
- Underwriting
- Closing
- Integration

While keeping your business moving forward
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Why Do I Own a Business?

Lifestyle

OR?

Investment

OR?
Understanding Your Goals & Objectives Is the First Step

Key Questions To Answer

- Who owns the company?
- Who runs the company and is creating the most value?
- Where is the company heading?
- Where do I want to be in 5 years?
- What is my exit strategy?
<table>
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<tr>
<th>Common Problems Solved by Private Equity</th>
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<tbody>
<tr>
<td><strong>Growth &amp; Diversification</strong></td>
</tr>
<tr>
<td>Business owner wants to diversify personal assets and bring in capital to help him grow</td>
</tr>
<tr>
<td><strong>Retirement</strong></td>
</tr>
<tr>
<td>Business owner wants to retire in 5 – 10 years, wants to maximize the value of his business over that time frame</td>
</tr>
<tr>
<td><strong>Shareholder Buyout</strong></td>
</tr>
<tr>
<td>Business owner needs to buyout minority partner and bring in capital to help him grow</td>
</tr>
<tr>
<td><strong>Family Transfer</strong></td>
</tr>
<tr>
<td>Patriarch of the family company wants to retire, but doesn’t trust 2nd generation to run the company with all his net worth on the line</td>
</tr>
<tr>
<td><strong>Management Buyout</strong></td>
</tr>
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<td>Inactive business owner wants to sell the company to his management team</td>
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</tbody>
</table>
Fundamental M&A Transaction Options

**Most**

- **Outright Sale**
  - Sell 100% of equity

**Recapitalization**
- Sell large % of equity

**Status Quo**
- No Exit Plan

**Least**

- Private Equity Options

**Control**

Liquidity
Recapitalization As a Phased Exit Plan

Big Idea: Client sells a portion of his or her ownership now at FMV, brings on partner to help grow the business and setup for 2nd “bite at the apple” in 4 – 7 years
“I needed to protect the asset I had spent 35 years building to ensure continuity for my employees and give financial certainty to my family.” – Hal Kersey, CEO
Outright Sale to Family or Management

**Big Idea:** Client sells the company to the Management team or someone else in his or her family to facilitate a liquidity event at a fair market value
Case Study: Atchafalaya Measurement

“We didn’t have family members to loan us the money and the local bank would cover just a portion of what the company was actually worth” – Nick Trahan, President
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Finance Theory Says That Value Is...

\[ NPV = -Principal + \sum_{i=1}^{n} \frac{payment_i}{(1 + rate)^i} \]
...But The Real World Values EBITDA

EBITDA × Multiple = Valuation

Earnings before interest, taxes, depreciation & amortization
Multiple Determined As Function of Risk

- High
- PEG’s Risk
- Low
- High
How Do We Evaluate Risk?

- Industry & End Markets
- Competition & Suppliers
- Customers
- Management & Financials

Cash Flow Sustainability
## Calibrating Risk

<table>
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<tr>
<th>Customers</th>
<th>4.0x – 6.0x</th>
<th>6.0x+</th>
</tr>
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<tr>
<td>- Top 3 customers &gt; 90% of revenue</td>
<td>- Top 10 customers &lt; 50% of revenue</td>
<td>- No customer more than 5% of revenue</td>
</tr>
<tr>
<td>- Lumpy / project revenue</td>
<td>- Mix of one-time and recurring revenue</td>
<td>- Small, recurring purchases</td>
</tr>
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<th>Industry &amp; End Markets</th>
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<td>- Small market size that is shrinking</td>
<td>- Low market growth</td>
<td>- Large market; growing rapidly</td>
</tr>
<tr>
<td>- Boom or bust</td>
<td>- Cyclical business; correlated to GDP</td>
<td>- Steady business; grew through the recession</td>
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- Customers
- Industry & End Markets
## Calibrating Risk

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<th>Management &amp; Financials</th>
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<td><strong>&lt; 4.0x</strong></td>
<td><strong>&lt; 4.0x</strong></td>
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<tr>
<td>Easy for new competitors to spring up and copy what you are doing</td>
<td>Little to no accounting systems</td>
</tr>
<tr>
<td>Top 3 suppliers &gt; 90% of purchases</td>
<td>No professional accounting staff</td>
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<tr>
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<tr>
<td>New entrants would require significant investment to compete</td>
<td>Limited information systems</td>
</tr>
<tr>
<td>Top 10 supplier &lt; 50% of purchases</td>
<td>Controller on staff</td>
</tr>
<tr>
<td><strong>6.0x+</strong></td>
<td><strong>6.0x+</strong></td>
</tr>
<tr>
<td>Significant capabilities that would be hard to recreate</td>
<td>Sophisticated information systems</td>
</tr>
<tr>
<td>No supplier more than 5% of purchases</td>
<td>Full time CPA or CFO on staff</td>
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Lack of Financial Veracity

ve·rac·i·ty [vuh-ras-i-tee]
conformity to truth or fact; accuracy; correctness or accuracy

A very high percentage of small business owners neglect their financial accounting systems. At the very least, this creates a situation where the owner does not have the right tools to measure and run his business. At the worst, this lack of proper financial management can cost millions of dollars of lost valuation when the business is sold.
Many small businesses “settle” for whatever person happens to pick up a task, or whatever person is the best of the worst to answer a craigslist ad. Often desire to save money is what makes the hiring decision.

• Why is your sister-in-law the controller of the company when she has no understanding of GAAP accounting?

• I know your head of sales has been with you since day 1, but you know he is struggling to grow sales.

• “Boudreaux drinks a little, but he knows the operations side of this company better than anyone.” And we all know Boudreaux drinks a LOT.
“Our company is organized as an S corporation. Oh, and we have a leasing entity for the employees, a separate LLC for the real estate, an S corporation for the commissions paid to the sales team, and we license the patents from a partnership. Some of those entities are December 31 year end, and some are March 30.”
Lack of Delegation

For many small businesses, the business owner is the business.

• Can you go on vacation for a week and only call the office 30 minutes each day?

• Can you go to Asia for two weeks and manage the company only via email on your smart phone? 30 minutes in the morning and 30 minutes at night?

Not having the right talent to delegate to holds back growth and profitability. It leads to personal stress, health problems and unhappiness.
• Deals only get done when buyers and sellers agree on a valuation for the business

• Most business owners think the value of their business is what they need to “retire”

• The multiple Thibodeaux got for his business is not what Boudreaux should expect
**Established Firm**

- Tampa, FL based team
- 9 full time professionals, 4 active partners
- Manage $300mm in assets
- Currently investing out of $135mm SBIC fund
- Eight committed funds over 30+ years
- 130+ successfully closed transactions

**Targeted Strategy**

- Equity investors
- History of profitability
- Revenues between $10 and $100mm
- EBITDA of $2mm+
- Management teams with large equity stakes
- Strong growth potential

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