Middle Market Private Equity & Stone Arch Capital

Ross School of Business

University of Michigan

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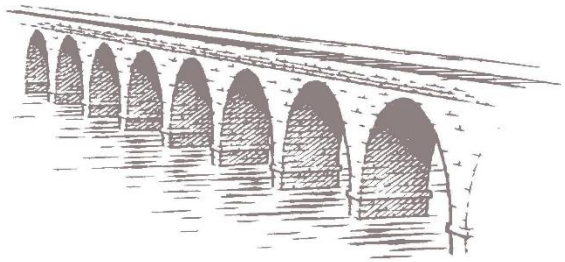


Agenda

I. Private Equity Investing

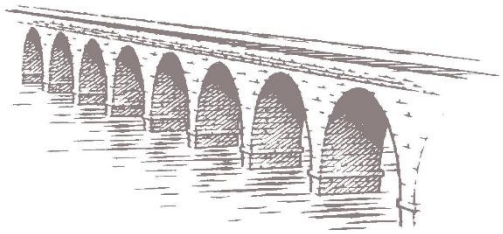
- What is Private Equity
- Private Equity Fundamentals
- State of the Private Equity

II. Stone Arch Capital

- Overview
- Investment Strategy
- Representative Investments

III. Questions & Answers

What is Private Equity



What is Private Equity

- Private Equity is a spectrum
- Private Equity encompasses everything from venture capital to large buy-out

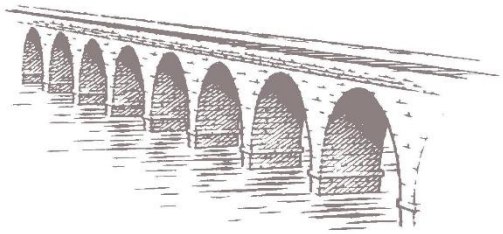
- Each point on the spectrum requires a different set of skills
  - Venture Capital - Disruptive ability/vision/scale
  - Growth Equity/Buy Out - Operational expertise/management talent
  - Large Buy-Out - Financial expertise/capital market experience
- Where you play depends on your skill set

Pros & Cons of the Private Equity Model

Pros	Cons
Active Investing	Macro Risks
Operational Control	Capital Market Risks
Ability to Manage Risk	Leverage (cuts both ways)
Ability to "Drive" Returns	Management Challenges
Ability to Control Liquidity	Accelerating Competition
Relatively Consistent Performance	Political Risk
Tax Preferred Status	Potential Loss of Tax Preferred Status

The ability to execute effectively the items on the "Pro" side of the chart and manage the "Cons" allows Private Equity to deliver extraordinary results

Private Equity Fundamentals



Fundamentals of Private Equity

- There are three basic fundamentals to the Private Equity Model
  1. Pay down debt
  2. Grow cash flow (EBITDA)
  3. Multiple arbitrage

- If you "buy right" and can do #1 you can generate solid 15-20% results
- If you "buy right" and can do #1 & #2 you can generate 20%+ results
- If you "buy right' and can do <u>all</u> 3 you can generate 25%+ results and often even significantly greater outcomes

Challenges to Realizing Such Fundamentals

- "Buying Right" and NOT Overpaying for Your Target
  - Excessive purchase price reduces multiple arbitrage opportunity upon exit
  - Excessive purchase price typically includes more debt. Logically additional debt and greater interest expense reduce your ability to pay down debt
  - Excessive purchase price reduces liquidity (greater debt service) and inhibits operational flexibility.
  - Excessive purchase impairs free cash flow and reduces funding to support organic growth and acquisition driven growth

Challenges to Realizing Such Fundamentals

- Growing EBITDA is REALLY hard work
  - Competition is a limiting factor
  - Management talent is not a given – often inconsistent
  - Cost reduction opportunities and operational/balance sheet improvements are often more difficult to realize and less plentiful than you think
  - Macro surprises are constant and unpredictable (f/x, tariffs, geo-political conflicts, recessions, coronavirus, etc.)

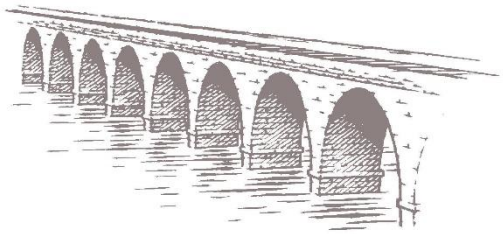
Challenges to Realizing Such Fundamentals

- Capital markets/financing options are variable and inconsistent
  - Interest rates can change quickly
  - Lenders turn conservative or aggressive based on numerous external influences
  - Poor lending and/or capital market environments can significantly hinder growth and extend hold periods
  - Liquidity in the martkets can dry up quickly

Key Elements of a Good Private Equity Investment Target

- Stable performance
- Strong free cash flow
- Moderate organic growth
- Strong management
- Ability to drive organic growth
- Simple/sound business model
- Healthy industry dynamics
- Competitive strength
- Robust acquisition pipeline
- Large universe of potential buyers

State of Private Equity



State of Private Equity

- **Pre Covid Environment**
  - Following the Great Recession (2010 -2019) extreme liquidity drove record levels of capital into all alternative asset classes, particularly Private Equity
  - Very little yield in debt/bond markets forced asset managers into equities and alternatives in search of yield
  - Equity markets rose to all time highs, pushing additional capital in alternative assets
  - Private Equity " Dry Powder" grew to over $1.6 trillion at year end 2019 vs. $840 billion only five years earlier (Source - Preqin)
  - Purchase price and transaction leverage multiples in 2019 were at all time highs
  - 2020 COVID hit and things materially changed – albeit unevenly and inconsistently.

State of Private Equity

- **Impact of Covid Pandemic on Private Equity 2020-2021**
  - After steep early declines, significant government fiscal and monetary intervention prevented large scale failures.
  - Strong economic rebound has lifted all boats
  - Labor shortages and logistical issues continue to hamper full recoveries to pre-pandemic levels
  - Debt is still cheap and very available driving a very robust M&A market
  - Institutional investors still pouring commitments into private equity as little return in fixed income and equity markets again at all time highs
  - Notwithstanding the forgoing, adversely impacted businesses will still experience a longer hold to recovery
  - However, businesses benefitting from government intervention and easy money policies are selling at a premium on upside performance (i.e. Infrastructure)

State of Private Equity

- **Specific Investment Considerations and Covid**
  - Significant reduction in new platform deal flow in 2020 rebounded strongly in 2021 (pent up demand)
  - Businesses typically net beneficiaries of COVID impact included: Essential/Infrastructure services, E-commerce, Hobbies/collectibles, Food and consumer basics, "At-Home" products/services
  - Those benefitting from COVID sold off inflated performance
  - Those adversely impacted generally still waiting for sale
  - Credit markets very cautious in 2020, have returned to aggressive leverage levels and terms in 2021 with support of Fed policies and government spending
  - Fear of tax code changes drove significant activity in 2021
  - Risk of over-paying still very high from an historical standpoint
  - Net effect – cheap debt and significant dry powder driving very robust market

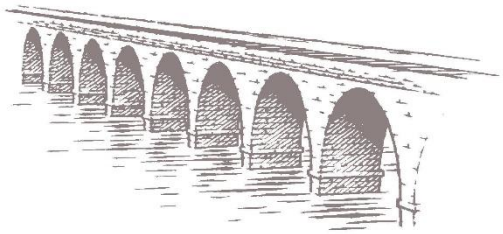
State of Private Equity

- **Specific Investment Considerations and Covid**
  - Smaller add-on acquisitions for established and performing platforms offer excellent opportunities to add value with diversity and scale
  - Industry sector performing and well understood
  - Quality management already in place
  - Current lenders up to speed on sector and business/management
  - Fewer buyers – non industry buyers less likely to show-up
  - Aggressive credit markets means plenty of liquidity to close on lower risk deals
  - Sellers willing to transact typically eager to diversify risk – become part of a larger enterprise/take money off the table
  - Results – bulk of investments done in 2020 were add-on acquisitions (significant value added). In 2021 aggressive platform acquisitions also driving add-on acquisitions to scale portfolio businesses

State of Private Equity

- **Specific Investment Considerations – Portfolio Operations**
- Companies adversely impacted by COVID took dramatic actions to address demand contraction and operating challenges
- Reduce fixed overhead (right size business)
- Pivot to focus on most profitable elements of business
- Leverage technology to increase efficiency and work remotely
- Management forced to find new and creative ways to drive sales, operate the business, manage the balance sheet and cut expenses to maximize liquidity
- Use dislocations in markets to top-grade management talent where possible
- In sum, significant work done to prepare businesses to be faster, leaner, more nimble and more profitable once COVID is over

Stone Arch Capital



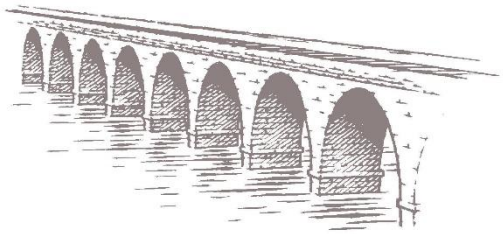
Stone Arch Capital Overview

- Minneapolis based private equity group formed in 2004 to make control equity investments primarily in private Midwest companies
  - 12 employees
  - Geographic concentration: Minnesota, Wisconsin, North Dakota, South Dakota, Nebraska, Indiana, Illinois, Kansas, Ohio, Iowa, Missouri and Michigan
  - $20 to $100 million deal size/minimum $5 million EBITDA
    - Ownership transitions
    - Control positions
  - Proprietary Sourcing
    - Evaluate over 400 opportunities per year
  - Disciplined pricing
    - Close 1-3 deals per year
    - Emphasis on free cash flow

Stone Arch Capital Overview

- Fund I - $90 million, Fund II - $175 million, Fund III - $205 million
- 43 investments to date
- Returns
  - Fund I: Gross – 3.8x cash on cash and 30% IRR; Net – 3.0x cash on cash and 22% IRR
    - Compare favorably to top quartile net returns of 14% as reported by Cambridge Associates for similar vintage funds
  - Expect strong returns with Funds II and III – still in process

Investment Strategy



Stone Arch Capital Investment Strategy

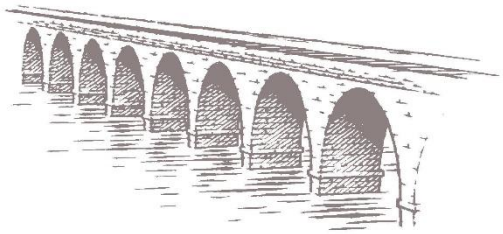
- Original focus on the Midwest geographic region
  - 20+% of U.S. economy in target area/5% of relevant PE capital
- Extensive calling/visiting effort able to drive deal flow
- Targeted lower middle market, private company transactions
  - Robust Target Environment
  - Estimated 80,000 companies(1) in target range and region ($15 million - $300 million in revenue)
- Evolution to "investment thesis" industry platform driven model in most recent fund to enhance deal flow, achieve platform scale and source additional non-auction opportunities
  - Willingness to go outside Midwest region for specific industry plays and add-on acquisitions
  - Followed demographic growth into areas like the Southeast and Gulf Coast
  - Need to achieve scale through add-ons an important driver of fund value

(1) Source: Info USA. Includes public and private companies that fit target revenue range.

Stone Arch Capital Investment Strategy

- Apply consistent, conservative deal criteria
  - Niche market leaders with high cash flow
  - Proven management teams/ willingness to roll equity
  - Stable, long-lasting industries - understandable
  - Utilize low levels of leverage
  - Target Gross IRR in the low 20%'s and Cash on Cash returns of 2.5
  - Repeat

Representative Investments



Representative Portfolio Companies

East Iowa Machine Company, LLC

Headquartered in Farley, IA, East Iowa Machine Company, LLC ("EIMCo" or the "Company") is a leading manufacturer of metal components and assembled products predominantly used in LED lighting, material handling, industrial, utility and food processing applications. EIMCo utilizes a full suite of manufacturing capabilities, including CNC plasma and flame cutting, CNC milling, turning, grinding, laser cutting, heat treating and robotic welding, to serve as a one-stop shop for its customers' product needs. The Company serves as a key supplier to a number of blue chip OEM customers located throughout the U.S.

Why Attractive?

- Industry-leading margin profile
- Stone Arch regional market position
- One-stop shop platform

Key Actions

- Expansion of executive team
- Diversified end market exposure
- Implemented more robust reporting and data utilization

Investment Results

SAC invested in EIMCo at a purchase price of $37.0mm. EIMCo generated steady performance during our ownership period growing from $6.5mm to $8.0mm in EBITDA. The Company was sold in 2020 and has returned ~3.0x it's invested capital and ~23% IRR including final receipt of all contingent consideration.

Representative Portfolio Companies

Ontario Drive & Gear, Ltd

Based in New Hamburg, Ontario (near Toronto), Ontario Drive & Gear Limited ("ODG") is a leading manufacturer of amphibious utility/all-terrain vehicles ("AUTVs") under the ARGO brand. The company sells on a worldwide basis through a broad network of distributors and dealers. ODG also provides precision-machined gears, couplings, and transmission components to third-party Original Equipment Manufacturers ("OEMs") in the heavy construction, material handling, forestry, and agriculture markets.

ODG
GEARS • TRANSMISSIONS • COUPLINGS
WORLD LEADER IN AMPHIBIOUS VEHICLES

Why Attractive?

- Worldwide market leader in manufacturing and marketing AUTV's
- Longstanding customer relationships
- Strong management team with proven track record

Key Actions

- Redesigned and refined distribution channel
- Enhanced marketing and management of new product launches
- Expanded sales team to better penetrate U.S. dealer networks

Investment Results

ODG enjoyed steady performance during our ownership, growing from $30.0 million to over $55.0 million in revenue, and from $7.8 million to $10.0 million in EBITDA. In August 2014, ODG was sold and SAC realized a gross multiple of 2.7 times the original investment amount.

Representative Portfolio Companies

Toy Investments, Inc.

Headquartered in Sumner, WA, Toy Investments, Inc., d/b/a Toysmith ("Toysmith" or the "Company") is a leading supplier and virtual manufacturer of impulse and novelty toy and gift products. The Company's product categories include outdoor adventure, science, active play, vehicles, dolls, light-up toys and role play, among others. Toysmith distributes products under owned company brands (e.g., Toysmith) and for 3rd party manufacturers (e.g., 4M and Spin Master). The Company sells to over 6,000 customers annually, including mass retailers, distributors, specialty retailers, museums, zoos, hospital gift shops, educational dealers and internet retailers primarily in North America with additional distribution capabilities throughout the world.

Why Attractive?

- Diverse customer and product portfolio
- Low retail price points creating consistent demand
- Market leader in the specialty channel
- Very stable business

Key Actions

- Expanded and upgraded the management team
- Implemented operational efficiencies and pricing strategies to increase margin
- Opened China office to enhance product development, sourcing and quality control efforts
- Grew sales in new market channels

Investment Results

SAC invested in Toysmith at a purchase price of $35.5mm. The Company has returned over 100% of invested capital to date. SAC still owns controlling (~70%) interest in Company. Having acquired the company at a very attractive price and due to the company's high free cash flow and unique position in the impulse toy and gift market, SAC believes there is an excellent chance for multiple arbitrage upon exit.

Representative Portfolio Companies

ICS Holding, LLC

ICS Holding, LLC ("ICS" or the "Company") is a holding company formed to make partnership investments in leading industrial electrical construction, installation, and maintenance businesses. The Company currently consists of four sister businesses Electrical and Instrumentation Unlimited, LLC ("EIU"), South Ark Electric, LLC ("SAE"), Funderburk Electrical Services ("FES") and Bright Future Electric ("BFE"). The company is headquartered in Lafayette, LA with 15 offices and approximately 1000 employees throughout the Gulf Coast and Southeast.

Why Attractive?

- Long standing senior leadership team
- Limited customer concentration
- Diversified end markets with proven ability to pivot
- High free cash flow conversion averaging >90% of EBITDA

Key Actions

- Consolidate corporate functions at ICS level to professionalize operations and achieve cost and revenue synergies (i.e., senior leadership, finance, safety, business development, human resources)
- Expand the Company's physical presence throughout targeted geographic markets both organically and vis acquisitions
- Diversify end markets and customer base and expand depth of labor pool via acquisitions

Investment Results

SAC has invested in the four ICS businesses at attractive purchase price multiples and believes there are numerous additional opportunities to add to the platform via acquisition and drive accelerated organic growth via synergies between the businesses. At scale (>$20MM EBITDA) and above, SAC believes there will be significant financial and strategic interest in the business and the potential for multiple arbitrage upon exit. The Company expects to realize such scale in the next two years.

Questions & Answers