

RCP Advisors

Q2 | 2017

State of the Middle Market:
Insights Into The High Valuation Environment



Important Notice



The information contained in this presentation (this “Presentation”) is highly confidential and has been prepared by RCP Advisors (together with its affiliates, “RCP”) for informational purposes only and is not to be reproduced or distributed to anyone other than the person to whom this was delivered. This Presentation does not constitute an offer to sell or buy any security or other financial instrument or to participate in any trading strategy in any jurisdiction. The information set forth herein does not purport to be complete. No interests in any fund or other investment opportunity are offered hereby. An offer to sell or solicitation of an offer to buy interests in any fund will be made solely through definitive offering documents, identified as such, in respect of the relevant fund. Such documents contain additional information about the investment objectives, terms, and conditions of an investment in the applicable fund and contain risk disclosures that are important to any investment decision. This Presentation reflects the opinions of certain individuals at RCP and are not necessarily reflective of the view of RCP. Any conclusions contained herein are speculative in nature and are not intended to predict the future of any specific investment strategy. Note: All references to fund metrics and performance contained in this Presentation are qualified in their entireties by reference to the important notes and disclosures contained in the Appendix attached hereto. The explanatory notes and methodology contained in these notes should be carefully reviewed in full.

Past performance is not indicative of future performance and there can be no assurance that any returns described herein or comparable returns will be achieved. All figures are presented in U.S. Dollars.

Alternative investments can be highly illiquid, are speculative and not suitable for all investors. Investing in alternative investments is only intended for experienced and sophisticated investors who are willing to bear the high economic risks associated with such an investment. Investors should carefully review and consider potential risks before investing. Individual funds will have specific risks related to their investment programs that will vary from fund to fund.

Targets and/or projections are only estimates of future results based upon assumptions made at the time the projections are developed. There can be no assurance that the projected results are correct or will be obtained, and actual results may vary significantly from the projections.

Terms used herein such as top-tier, high caliber, high profile and top-quartile are based on RCP Advisors’ qualitative assessment of a manager’s team, strategy and track record (to the extent one exists). The words “expects,” “intends,” “anticipates,” “believes,” “estimates,” “may,” “might,” “will,” “would,” “project,” and “predict,” and analogous expressions are intended to identify forward-looking statements and are not guarantees of future performance or results. Any forward-looking statements inherently are subject to a variety of risks and uncertainties that could cause actual results or events to differ materially from those results or events predicted or anticipated by these statements, including any results described herein. Accordingly, investors should not rely on these statements.

Certain information contained herein has been obtained from published and non-published sources prepared by other parties, which in certain cases have not been updated through the date hereof. While such information is believed to be reliable for the purposes used herein, none of RCP, any of its officers, employees, partners, shareholders or affiliates assume any responsibility for the accuracy of such information, and such information has not been independently verified. The performance information provided herein was not prepared, reviewed or approved by the underlying funds or their general partners.

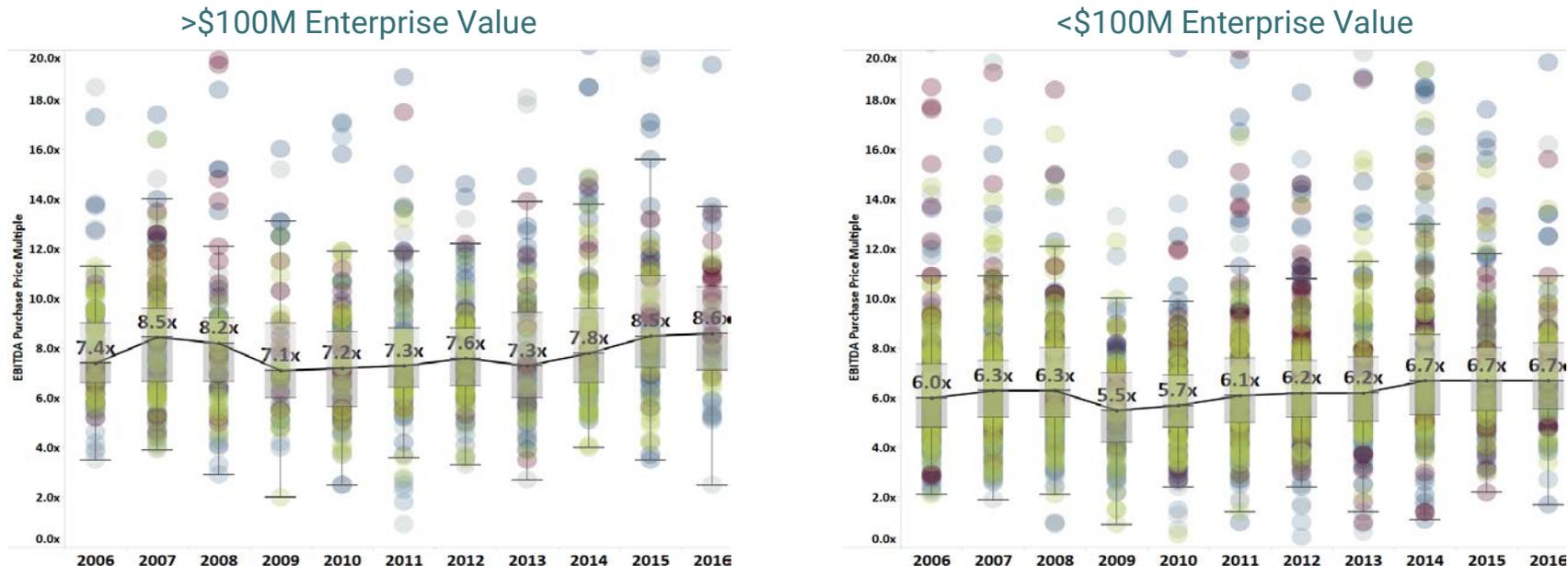
This Presentation and the statements and information contained herein are made as of June 16, 2017, unless stated otherwise herein. The delivery of this Presentation shall not, under any circumstances, create an implication that the information contained herein is correct as of any time subsequent to the date hereof.

This document is not intended, and should not be construed, as marketing materials for the purposes of the Directive 2011/61/EU on alternative investment fund managers (“AIFMD”) in any member states (each, a “relevant member state”) of the European Economic Area (“EEA”) that has implemented AIFMD.



Purchase Price Multiples (by Deal Size)

Valuation Environment Remains Elevated



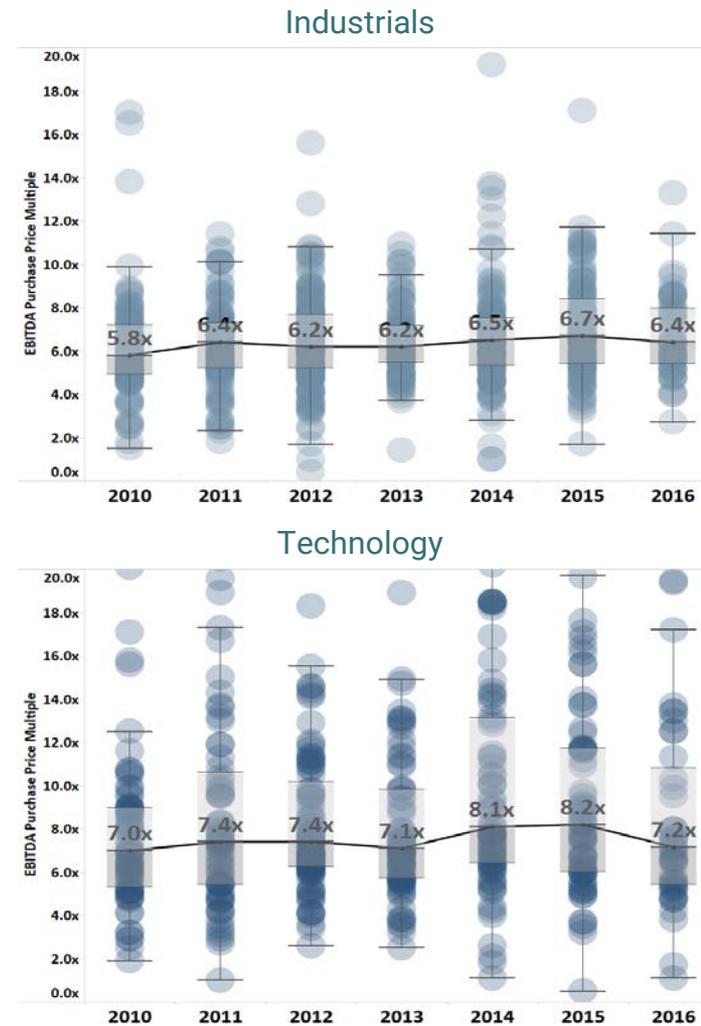
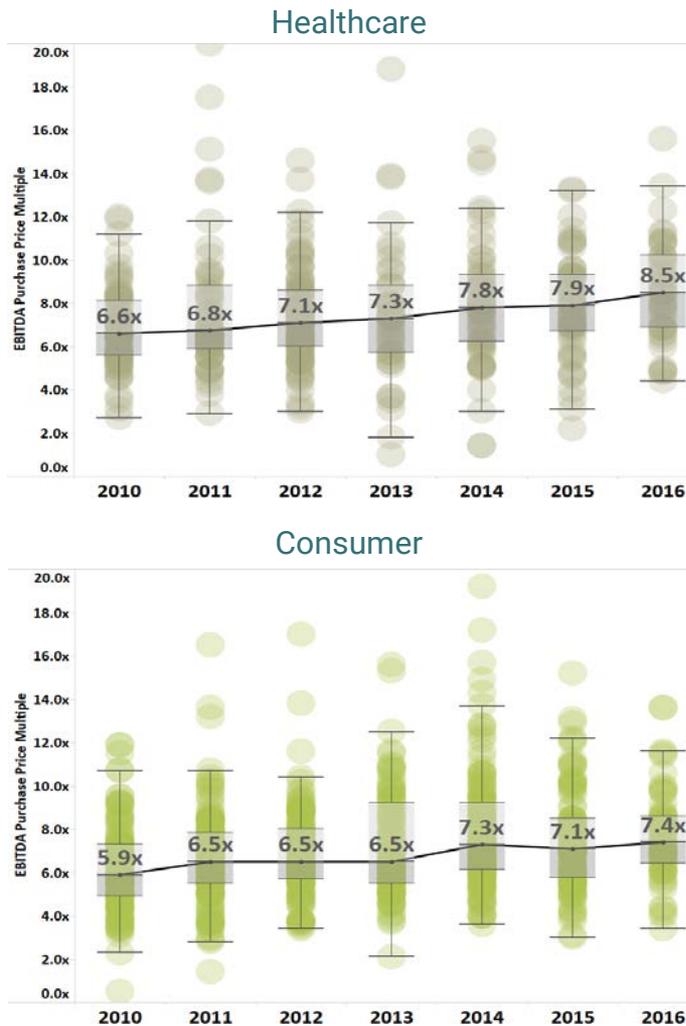
- » Entry valuations remain at pre-recession highs throughout the market
- » Recent run-up in entry valuations of smaller deals (<\$100M initial Enterprise Value) has been more muted than larger deals (>\$100M initial Enterprise Value)
 - Entry valuations for larger companies continue to increase year over year and have surpassed previous peak of 8.5x reached in 2007
 - Entry valuations for smaller companies have not increased since peak of 6.7x in 2014, but remain higher than previous peak of 6.3x reached in 2007 and 2008

Source: RCP Database.



Purchase Price Multiples (by Sector)

Various Levels of Deviation From General Upward Trend Within Sectors



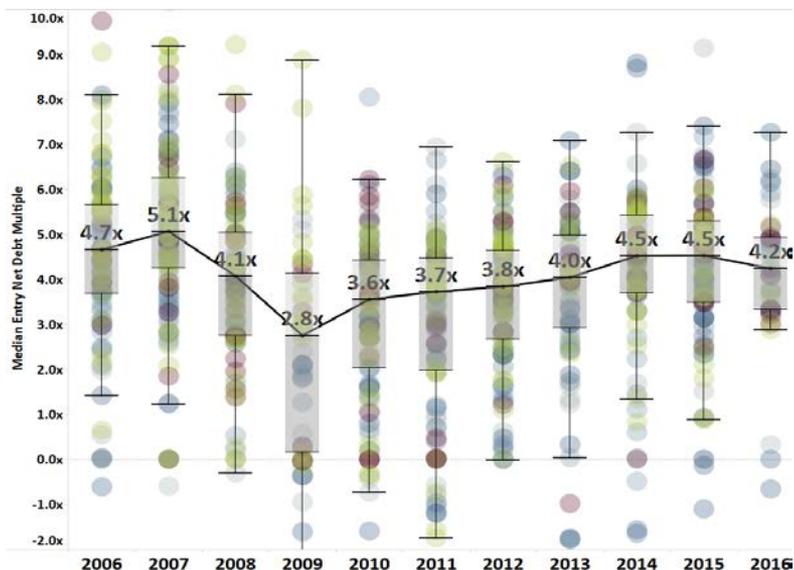
Source: RCP Database.



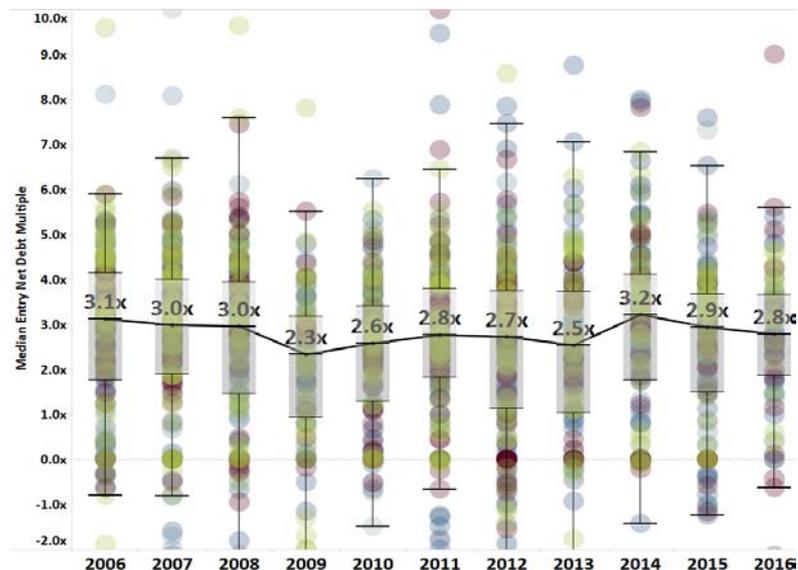
Net Debt Multiples (by Deal Size)

Recent Stability, Slight Decline in Leverage Multiples

>\$100M Enterprise Value



<\$100M Enterprise Value



- » The last three years have been characterized by relatively stable leverage multiples with slight declines since 2014 highs
- » Leverage levels in larger deals have been more volatile
 - Significant difference (2.3 turns) between pre-recession highs (5.1x in 2007) and post-recession lows (2.8x in 2009)
 - Notably, current median net debt multiples are meaningfully below pre-recession levels
- » Leverage levels in smaller deals have exhibited more long-term stability
 - Less than a turn of difference between pre-recession highs (3.0x in 2007) and post-recession lows (2.3x in 2009)
 - Ultimately, current median net debt multiples are only slightly below pre-recession levels

Source: RCP Database.

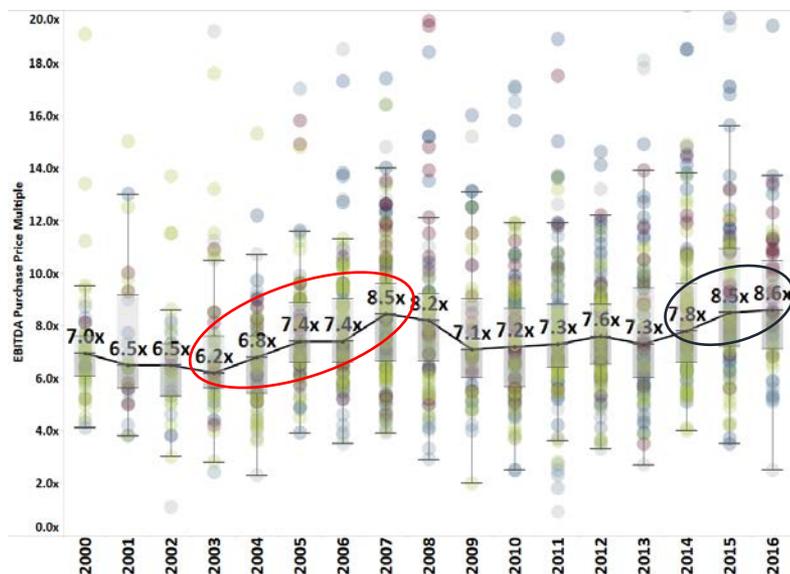


Valuations and Leverage: Transactions >\$100M EV

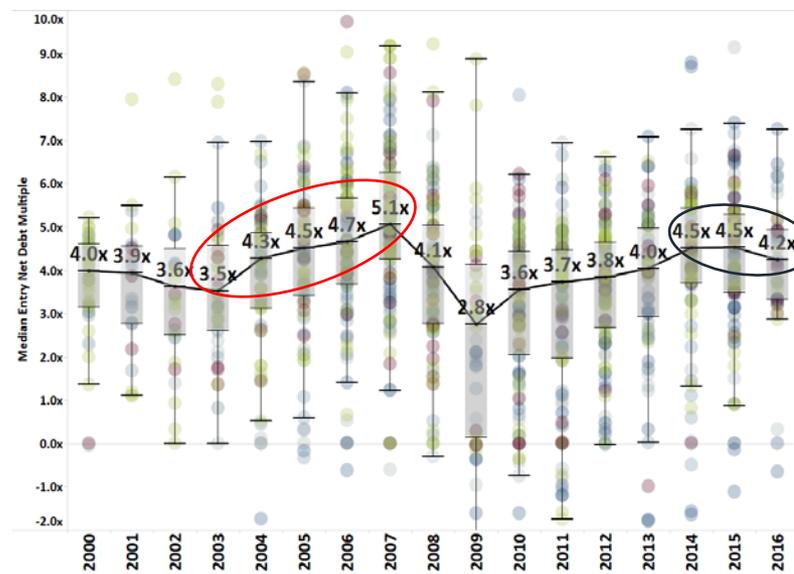


Simultaneous Run Up in 2003 – 2007 in Larger Deals

Purchase Price Multiples



Net Debt Multiples



- » Period leading up to the GFC (2003 – 2007):
 - Purchase multiples increased by 2.3 turns and net debt multiples increased by 1.6 turns
 - Increased borrowing likely a large contributor to pre-recession high valuation environment
- » Today's environment (2014 – 2016):
 - Purchase multiples have increased by 0.8 turns and net debt multiples have decreased by 0.3 turns
 - Previously observed positive relationship between valuations and net debt levels is not sustained

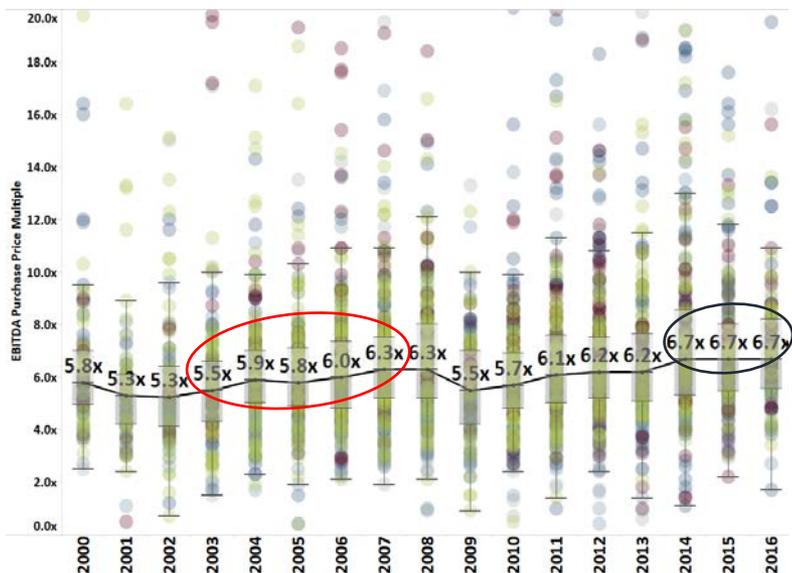


Valuations and Leverage: Transactions <\$100M EV

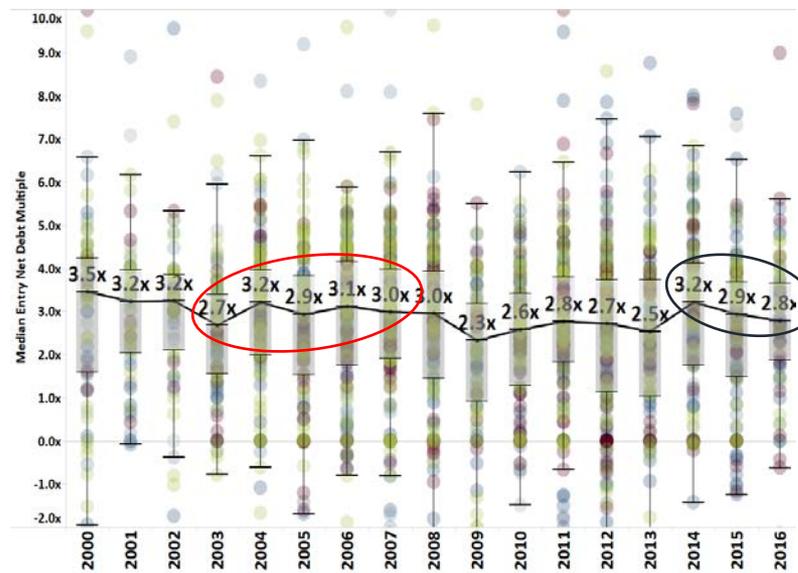


More Long-Term Stability in Smaller Deals

Purchase Price Multiples



Net Debt Multiples



- » Period leading up to the GFC (2003 – 2007):
 - Purchase multiples increased by 0.7 turns and net debt multiples increased by 0.3 turns
 - More muted valuation increases seem only slightly connected with increased leverage levels
- » Today’s environment (2014 – 2016):
 - Purchase multiples have remained flat while leverage has decreased by 0.4 turns
 - Leverage does not seem to be an underlying driver of valuation environment

Source: RCP Database.



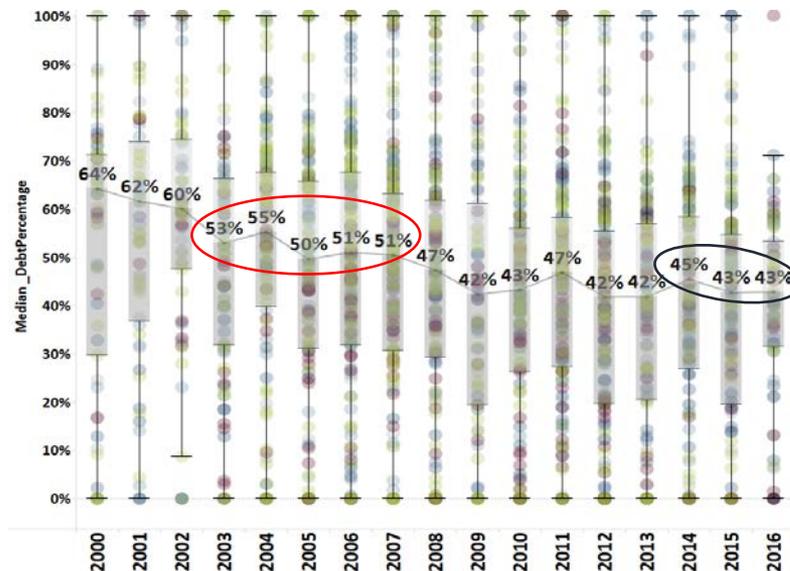
% of Debt in Transactions (by Deal Size)

More Conservative Use of Leverage in Today's Market

>\$100M Enterprise Value



<\$100M Enterprise Value

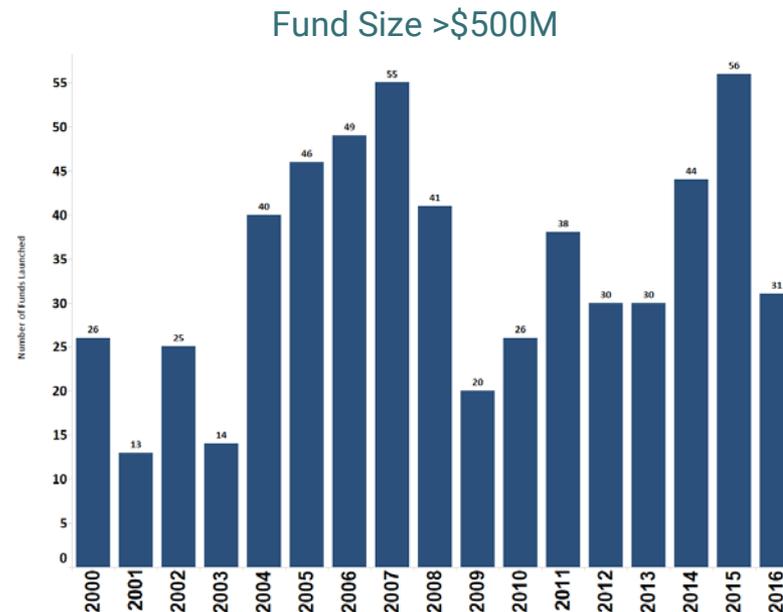
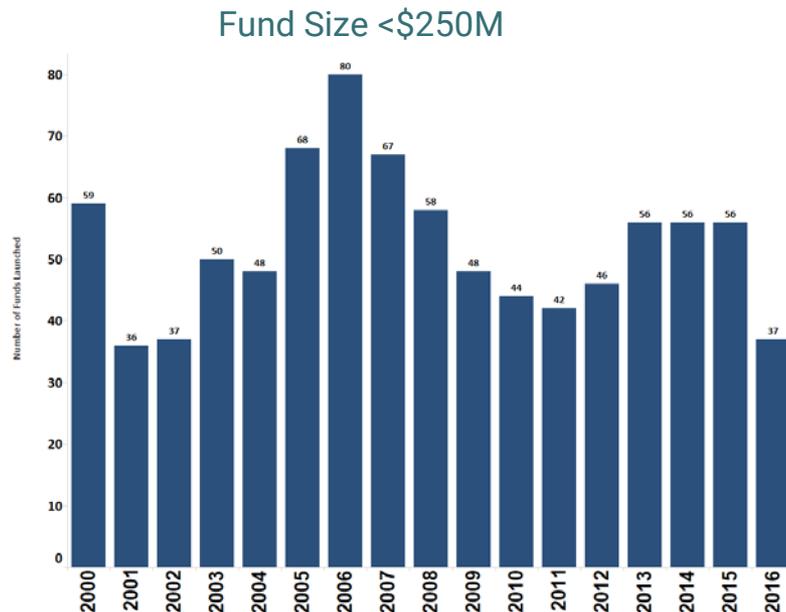


- » Across all deal sizes, percentage of debt in transactions has trended down since GFC
- » Both larger and smaller have decreased use of leverage measured as a % of enterprise value by ~900 bps
- » Continued trend of smaller deals utilizing a lower % of debt than larger deals



What's Driving the Current Shifts?

Significant Number of Private Equity Funds Raised Recently (despite 2016 drop)



Funds are arranged by initial launch date of the fund vehicle rather than more common convention of close date or vintage. Statistics above reflect both open funds (assume to raise target size in summation of dollars raised) and closed funds (final commitment amounts).

- » Despite drop in funds launched in 2016, fundraising environment remains robust; however, unlike pre-GFC environment, many LPs are concerned that pace of deployment is lower than expected
- » Abundance of private equity capital available and mounting pressures to put capital to work are likely more of a contributor to current valuation environment given debt levels have remained flat to down (especially larger funds – likely to invest in deals >\$100M in EV – which have recovered to pre-recession volumes)
- » Other factors to consider include: changing attitudes of lenders, proliferation of growth equity (lower leverage) and buy-and-build strategies (initial over-equitization in anticipation of add-ons), and generally higher levels of risk aversion

Source: RCP Database.



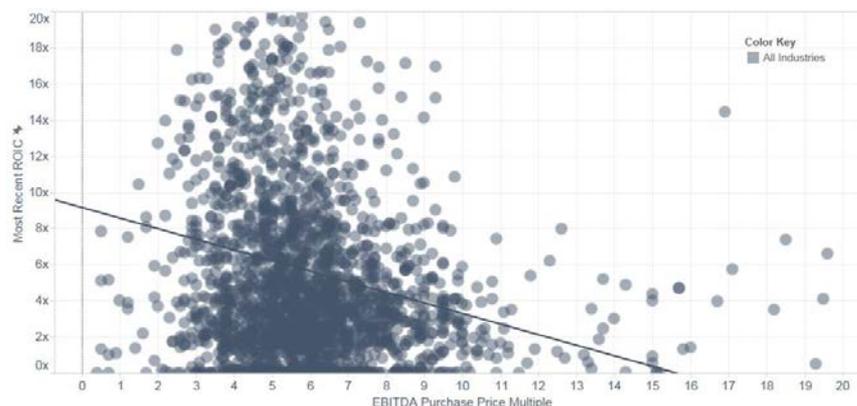
Final Thoughts



Understanding and Navigating the Current Environment

- » Valuation environment remains elevated
 - Market has shifted away from highly leveraged deals
 - Likely driven more by availability of equity rather than leverage, **especially at larger deal sizes**
- » Sub-segments of market remain relatively more insulated than others
 - Smaller transactions
 - Certain industries (e.g., Industrials vs. Healthcare)

-
- » Silver Lining: purchase prices alone do not dictate ability to generate returns (see Exhibit 1)
 - Inverse relationship between purchase multiple and ROIC is apparent
 - However, low strength of association implies purchase price alone does not determine likelihood of success as measured by ROIC
 - Within this environment, there are still avenues to generate strong returns



Gross ROIC as explained by initial Purchase Price Multiple. Includes all fully realized transactions with available data transacted from 1985 – Present.



Appendix



Notes on the Data



- » RCP collected information from PE Firms, third party data providers (e.g., Preqin, etc.), and public data sources for inclusion in the dataset. RCP's strategy is focused primarily on North American lower-middle market buyouts, so a majority of managers analyzed operate in this segment of the market
- » In total, RCP tracks information on more than 1,200 fund managers, as of June 1, 2017. Manager strategies include Buyout, Growth, Buyout & Growth, Distressed, and Multi-Strategy; Mezzanine and other credit strategies are largely excluded from analysis, but can be added if relevant. Venture, Real Estate, and other unrelated strategies are completely excluded. Fund strategy classifications are determined based on internal RCP assessment
- » The dataset contains Gross ROIC information for more than 13,000 deals that are either fully realized or unrealized and recently valued (based on valuation dates following "Cut Off Date", a user-controlled input, usually defaulted to exclude unrealized valuations >2 years old)
- » Gross ROIC are controlled for outliers that can meaningfully skew average calculations. Any instance of an ROIC >50x is replaced with a value of 50x ROIC to account for the outsized return without removing the data point.
- » Deals analyzed range from enterprise values of less than \$1M to greater than \$20B with an average of ~\$145M and companies are assigned various levels of industry classification based on those provided by S&P Global Market Intelligence
- » The dataset contains more than 1,500 funds with Vintage Years¹ from 1969 – present with vehicle maturities² ranging from 1 – 40 years for which relevant deal valuations are available
- » Fund sizes of these managers range from less than \$50M to \$2B with an average fund size of ~\$500M. Unless explicitly noted, attributed fund track records and 'pledge funds' (capital raised on a deal-by-deal basis) are excluded.
- » Both sector specialist and industry agnostic strategies are included. Data set includes managers that invest in Consumer, Healthcare, Business Services, Technology, and Industrials sectors (among others), or any combination of the aforementioned.
- » Because analysis is often disaggregated by manager maturity, manager strategy, company sector, etc., certain analyses may be performed on smaller sample sizes and may be biased by one or several data points.
- » Past performance is not an indication of future performance, provides no guarantee for the future, and is not constant over time

1. In this Presentation, RCP defines "Vintage Year" as the year in which a fund first draws capital, or, if unavailable, date of final close.

2. In this Presentation, "vehicle maturity" refers to the difference, in years, between the valuation dates of deals and fund's Vintage Year.



Important Disclosures and Notes



This Presentation is based on analysis of financial information available or provided to RCP Advisors (together with its affiliates, "RCP") by third parties. RCP has not independently verified any such information provided or available to RCP. Performance information provided herein was not prepared, reviewed or approved by the underlying funds or their general partners. Information obtained from third parties is believed to be reliable, but no representation, warranty or undertaking, express or implied, is given as to the accuracy or completeness of such information. Projected market and financial information, analyses and conclusions contained herein are based on the information described above and on RCP's judgment, and should not be construed as definitive forecasts or guarantees of future performance or results. The information, data, analyses, and opinions presented herein do not constitute investment advice, are provided solely for informational purposes and therefore are not an offer to buy or sell a security. Please note that references to specific securities or other investment options within this Report should not be considered an offer (as defined by the Securities and Exchange Act) to purchase or sell that specific investment. The performance data shown represents past performance. **Past performance does not guarantee future results.**

Description of Performance Measurement Methodology

Gross ROIC: Represents the return on invested capital for an individual deal. Gross ROIC is calculated by dividing the sum of distributions and unrealized NAV as of the most recent available valuation date by invested capital. Gross performance returns do not reflect management fees, carried interest, and expenses. Actual returns will be reduced by management fees and other expenses that will be incurred in the management of a fund. Actual account performance will vary depending on each fund's applicable fee schedule.

GFC: Great Financial Crisis.

Exhibits detailing data for portfolio companies are grouped by year of the fund's initial investment in a company, as opposed to vintage year. Returns are gross returns.

Biases within the Report for consideration include:

- Survivorship bias:
 - Information flow will be biased towards managers successful enough to raise subsequent funds; given updated return information is primarily gathered during fundraising diligence, data reflects deals transacted by relatively more successful managers
 - Inclusion of realized deals may positively skew results as poorer performing investments often remain 'unrealized' for longer periods despite eventual likelihood of being ultimately written off
- Availability bias: Due to RCP's lower middle market focus, more data is available on smaller companies vs. larger

RCP Database: Provides private fund and investment-level performance data drawn from fundraising and diligence documents produced by general partners and publicly available information, as well as quarterly unaudited and audited annual financial statements produced by RCP's underlying fund managers. As of June 1, 2017, RCP's database contains information on more than 1,200 fund managers and more than 2,500 funds. These documents are provided to RCP by the fund managers themselves. Full discussion on the database appears on "Notes on the Data".

Copyright © 2017 by RCP Advisors ("RCP"). All rights reserved.

This Presentation may not be displayed, reproduced, distributed, transmitted, or used to create derivative works in any form, in whole or in portion, by any means, without written permission from RCP. Copying of this publication is a violation of US and global copyright laws (e.g., 17 U.S.C. 101 et seq.). Violators of this copyright may be subject to liability for substantial monetary damages. The information and material published in this Presentation is nontransferable. Therefore, recipients may not disclose any information or material derived from this Presentation to third parties, or use information or material from this Presentation, without prior written authorization of RCP. This Presentation is provided for informational purposes only. The information presented herein is not intended to be investment advice. Any references to specific investments are for illustrative purposes only. The information herein does not constitute a personal recommendation or take into account the particular investment objectives, financial situations, or needs of individual clients. This research is not an offer to sell or the solicitation of an offer to buy any security in any jurisdiction. Some of the data contained herein or on which the research is based is current public information that RCP considers reliable, but RCP does not represent it as accurate or complete, and it should not be relied on as such. Nothing contained in this report should be construed as the provision of tax or legal advice. **Past performance is not indicative of future performance.**



Copyright Notice



Any information or opinions provided in this Presentation are as of the date of the Presentation, and RCP is under no obligation to update the information or communicate that any updates have been made. Information contained herein may have been provided by third parties, including investment firms providing information on returns and assets under management, and may not have been independently verified. Information obtained from third parties is believed to be reliable, but no representation, warranty or undertaking, express or implied, is given as to the accuracy or completeness of such information. Performance information provided herein was not prepared, reviewed or approved by the underlying funds or their general partners.

RCP Advisors 3, LLC, a Delaware limited liability company headquartered in Chicago with a satellite office in Newport Beach, California, is an investment adviser registered with the U.S. Securities and Exchange Commission.*

*Registration with the U.S. Securities and Exchange Commission as an investment adviser does not imply a certain level of skill or training.