DelCam Holdings, LLC

GENERATING ALPHA THROUGH IMPACT INVESTING

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TABLE OF CONTENTS

Introduction 2
Ethical investing is entrenched in long-term trends 3
Social and environmental impact improves financial returns .... 3 - 4
Dichotomy of real estate and operating company investments .... 4 - 5
Control positions as a strategic investment .... 5 - 6
What's next .... 6 - 7
A winning approach 8
Conclusion 9

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INTRODUCTION

The Tax Cuts and Jobs Act of 2017 created sweeping changes to the tax code substantially impacting both individuals and corporations. Major elements of the Act include increasing the standard deduction and family tax credits, limiting property and mortgage interest deductions, and several other changes that impact a large percentage of Americans. Other provisions favorably affect television and movie production companies while some lower the excise taxes for beer and wine producers and one removes the 7.5% ticket tax for private jet operators. Buried in the long list of revisions is language that created Opportunity Zones, which provide powerful tax advantages incentivizing private investment in historically low income and undercapitalized communities.

The thought that investors can meaningfully improve society while earning attractive investment returns is increasingly gaining traction. More and more professional asset managers are incorporating environmental, social and governance (ESG) considerations into their strategies, and public interest in ethical investing is a part of the zeitgeist. Several mainstream publications now track social investing trends, and the media enthusiastically depict large and small investors helping improve the world we live in through their choice of investments.

Beyond the hype, abundant data corroborates this trend. The number of fund managers who have signed the United Nations-sponsored Principles for Responsible Investment (PRI) grew to more than 2,000 in 2018 from 1,200 in 2013. The $82 trillion in assets managed by these signatories increased by 19% per year over the same period. According to Schroders' 2017 Global Investor Study of 22,000 investors, 78% said they focus more on sustainability now than they did five years ago.

ETHICAL INVESTING IS ENTRENCHED IN LONG-TERM TRENDS

The shift to sustainable portfolios and impact investing reflects growing public concern about global challenges such as climate change, pollution, deforestation, and importantly, social inequality. Investors, especially the millennial generation, are increasingly demanding that companies not only expose ethical issues linked to their investments, but actively incorporate ESG considerations into asset allocation decisions. It is telling that, according to Morgan Stanley's Institute for Sustainable Investing, Millennials are twice as likely as the overall population to buy products from sustainable companies. Over the next 30 years an estimated $30 trillion of wealth is expected to change hands from Baby Boomers to Millennials, making the potential spoils sufficiently lucrative for managers who embrace an impact investing philosophy.

Improved transparency and an ESG focus in company reporting are helping cultivate the ethical investing movement. More than 90% of the world's 250 largest companies published corporate social responsibility (CSR) or sustainability reports in 2018, which is up from just 45% in 2002. While the strides that have been taken are significant, more can be done. For example, consistent disclosures and uniform reporting metrics will enable companies and investors to more effectively measure and evaluate risks and those of suppliers and competitors.

SOCIAL AND ENVIRONMENTAL IMPACT IMPROVES FINANCIAL RETURNS

While pressure is growing on fund managers to pay greater attention to environmental and social issues, many have learned that following ESG policies typically leads to strong financial returns. For years, investors assumed a commitment to environmental, social and governance protocols meant accepting lower profits because companies incurred greater reporting, measurement, and compliance costs. However, a growing number of studies are disproving that theory. In 2015 a comprehensive review by the German investment fund, DWS Group and the University of Hamburg of more than 2,000 studies found that 63% showed a strong correlation between ESG performance and positive investment returns.

INVESTORS CAN PURSUE DIFFERENT INVESTMENT MODELS TO ACHIEVE THEIR ESG GOALS

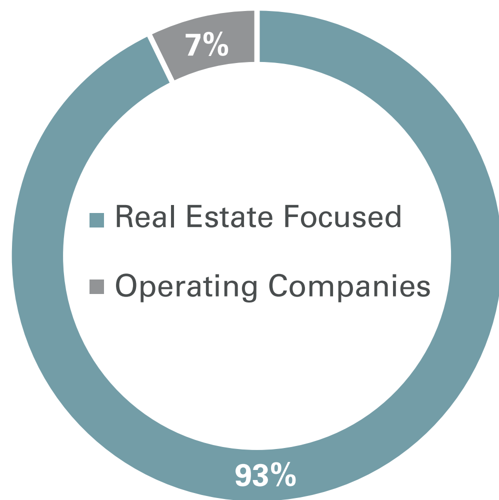
<table>
<tr><th></th><th colspan="2">Traditional Investor</th><th colspan="2">ESG risk mitigator</th><th colspan="2">ESG opportunity seeker</th><th colspan="2">Impact Investor</th></tr>
<tr><td>Source of Value</td><td colspan="3">Financial Only</td><td colspan="3">Financial first; ESG considered</td><td>Both financial and ESG</td><td>Social and environmental primarily</td></tr>
<tr><td>Sourcing approach to ESG assets</td><td colspan="2">Passive</td><td colspan="2">Focus on screening of noncompliant assets/sectors</td><td colspan="2">Seek assets in sectors with positive ESG impact</td><td colspan="2">Seek assets only with positive ESG impact</td></tr>
<tr><td>Investment approach</td><td colspan="5">No specific investment fund</td><td>Thematic fund</td><td colspan="2">Dedicated impact fund</td></tr>
<tr><td>ESG involvement during ownership</td><td colspan="2">None</td><td colspan="3">Focus on risks and divest certain assets/sectors</td><td>Push for impact</td><td colspan="2">Actively involved, such as capability building</td></tr>
<tr><td>ESG impact measurement</td><td colspan="2">None</td><td colspan="2">Limited: usually includes KPIs focused on risks</td><td>Track some ESG KPIs</td><td colspan="3">Have tailored performance indicators to measure ESG impact in addition to financial returns</td></tr>
</table>

Source: Bain Capital

The measurement timeline is not yet sufficient to state definitively that ESG-governed private equity deals can consistently generate returns that match investors' expectations, but there are several promising signs. According to research conducted by Bain Capital, a sample of 450 private equity exits conducted over the past five years exhibited median multiples on invested capital of 3.4x for deals with social and environmental impact, compared with 2.5x for all other transactions in the sample. The ESG holdings also experienced relatively lower variability in returns. These findings are an important signal for a market that has been and will continue to be driven by economic profitability.

DICHOTOMY OF REAL ESTATE AND OPERATING COMPANY INVESTMENTS

One of the more common ESG and impact focused investments of 2019 has been the emergence of Qualified Opportunity Zone Funds. This government sponsored program is intended to stimulate private investment in historically undercapitalized communities. While the bulk of Opportunity Zone investment has been allocated to real estate projects, we believe that investing in operating businesses is more in line with the spirit and intent of the Opportunity Zone program. Acquiring run down properties and rehabbing them or buying vacant parcels of land for development undoubtedly create temporary jobs in construction, project management, and possibly demolition. However, it is unlikely that many permanent career opportunities will manifest directly from real estate developments.



Breakdown of Opportunity Zone Funds by Investment Focus

Alternatively, investments in operating businesses offer the potential for sustainable job creation. As with real estate acquisitions, purchases of operating businesses must be accompanied by subsequent investment in the form of "substantial improvements" equal to at least 70% of the tangible value of the acquired asset. Injecting this additional capital into a going concern business likely comes in the form of capital expenditures for new equipment, expansion of the physical plant, or enhancement of the property or building structure. New equipment will require new employees for operation, a larger facility will accommodate additional workers, and building enhancements will make the factory a safer and more efficient working environment. Because the substantial improvement expenditure is mandated to remain compliant with the program and to preserve the tax benefits, the financial sponsors are required to comply with all parameters of the program and post-acquisition capital investment cannot be avoided.

Job creation has a multiplier effect that permeates communities. Data from the Economic Policy Institute indicates that for 100 new construction jobs only 226 indirect jobs are created as a result. Significantly, for each 100 new manufacturing jobs 744 peripheral jobs are produced and for every 100 new entertainment or management positions, 379 and 400 de novo jobs come into existence, respectively. Increased employment rates are paralleled by increased municipal tax revenue. A larger tax base facilitates increased expenditure for social programs, educational improvements, a bigger budget for emergency services, and a host of other public services that rely on tax revenues.

Industry	Direct Jobs	Suppller Jobs	Induced Jobs	Total Indirect Jobs
Agriculture, forest, fishing, and hunting	100	93.6	134.8	228.5
Mining	100	224	166	390
Utilities	100	515.4	442.2	957.7
Construction	**100**	**88**	**138.1**	**226.1**
Durable manufacturing	**100**	**289.1**	**454.9**	**744.1**
Nondurable manufacturing	100	184.8	329.5	514.3
Wholesale trade	100	107.3	128	235.3
Retail trade	100	46.7	75.4	122.1
Transportation and warehousing	100	112.8	163.3	276
Information	100	252	321.1	573.1
Finance and insurance	100	149.7	214.7	364.4
Real estate and rental leasing	100	396.6	483.1	879.7
Professional, scientific, and technical services	100	142.1	276.2	418.3
Management of companies	**100**	**144.4**	**255.4**	**399.9**
Administrative services and waste management	100	45.5	89.1	134.5
Educational services	100	63.8	129.9	193.7
Health care and social assistance	100	69.4	136.2	205.6
Arts, entertainment, and recreation	**100**	**123.3**	**255.2**	**378.5**
Accommodation and food services	100	53.8	104.7	161.2
Other services (except public administration)	100	70.7	139.6	210.3

Source: Economic Policy Institute and Bureau of Labor Statistics

With each new job comes a new salary and often accompanying health insurance benefits. Permanent employment is understood to have a halo effect that contributes to increased home ownership, which leads to community pride. Research conducted by the National Association of Realtors reports that home ownership increases civic participation, lowers crime rates and improves children's academic performance. Further, while 30% of renters relocate from year to year only 5.2% of homeowners move residences each year which contributes to stable neighborhoods with higher levels of community involvement and even improved voter participation rates.

CONTROL POSITIONS AS A STRATEGIC INVESTMENT

In addition to the social benefits attributable to investing in operating companies there is significant economic profit potential that corresponds to private equity investing. Few asset classes have matched the investment performance of private equity over an investment horizon of 10 or 15 years. According to data provided by Cambridge Associates, the US private equity index returned 15.4% (net of fees, expenses and carried interest) per year for the 10-year period through March 2019. Although real estate projects can yield relatively attractive rates of return over short periods of time, for example when a property is "flipped" more often, real estate returns are measured with single digit cap rates over intermediate periods of time. It is similarly instructive to note that due to the Opportunity Zone requirement to remain invested in a qualified fund for ten years, extracting double-digit returns from property over an investment horizon of that duration is unlikely.

Private equity as an investment strategy is ideally suited when, in order to realize a value-creation opportunity, buyers take outright ownership and control of each target acquisition. Such an opportunity most often arises when a business has not been aggressively managed and has been underperforming for some time. It can also be found with businesses that are undervalued because their potential is not readily apparent. In those cases, once the changes necessary to achieve the uplift in value have been made it makes sense for the owner to sell the business and move on to new opportunities.

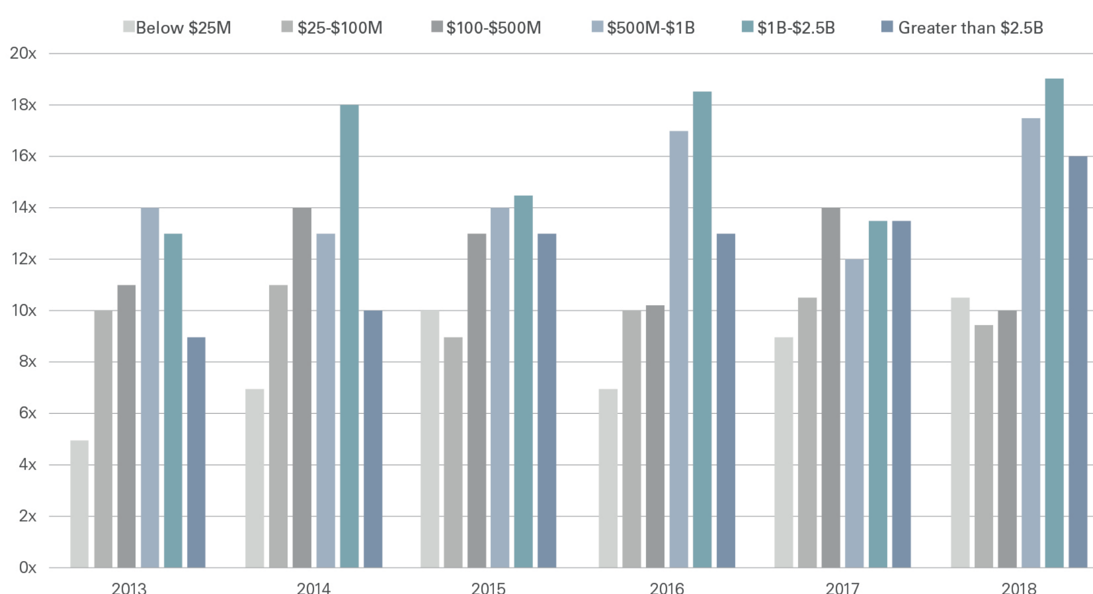
Over the past several years private equity has demonstrated that the asset class has produced steadier, more reliable returns than public equities. After a period of heavy stock market volatility around the world, private equity funds have continued to outperform public equity markets in all major regions, over both short and long investment horizons.

Recent history has seen wild public equity valuation swings. In 2016, European stock markets tumbled on the news of the Brexit vote. Asian stock markets declined dramatically due to a correction of China's stock market. In 2017, markets advanced as a synchronized global economic expansion resulted in gains worldwide. In 2018, European public market performance was anemic, while Asia was weighed down by trade tensions and continued slow growth in China. Domestically, a torrid, multiyear bull run came to an abrupt halt at the end of 2018 as a host of concerns spooked investors. Private equity, meanwhile, kept outperforming.

Looking ahead to the likelihood of future capital market volatility, investors remain focused on the relative outperformance of private equity as an asset class. In a recent global survey by Preqin, 90% of respondents said that their private equity holdings met or exceeded their expectations over the past year. 83% said that their confidence in fund performance was unchanged or had increased. Through economic thick and thin, private equity has delivered remarkably stable returns.

WHAT'S NEXT

SMALLER COMPANIES CONSISTENTLY TRADE FOR LOWER MULTIPLES THAN LARGER ONES



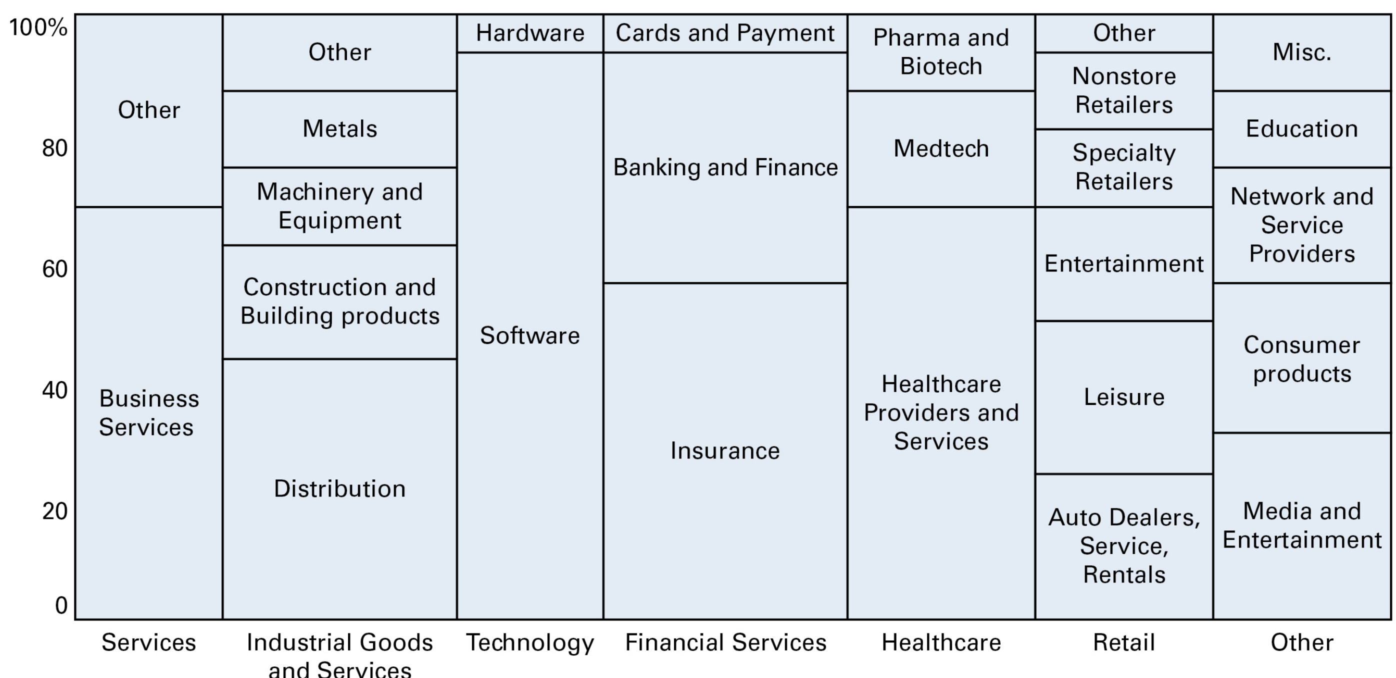
Source: PitchBook Data, Inc.

Buy-and-build strategies have been around as long as private equity, yet they are experiencing a renaissance today. The reason is straightforward: buy-and-build offers a clear path to value at a time when deal multiples are elevated, and managers are under heavy pressure to find strategies that are not reliant on traditional tailwinds like falling interest rates or stable GDP growth. Buying a strong platform company and building value around it through well-executed add-ons can generate impressive returns over the life of the fund.

We define buy-and-build as an explicit strategy for building value by using a well-positioned platform company to make several sequential add-on acquisitions of complementary companies. 15 years ago, one in five add-on deals was at least the fourth acquisition by a single platform company. Today that ratio is closer to one in three, and 10% of the time the add-on was at least the tenth acquisition. Buy-and-build strategies are showing up across a wide range of industries. The deals are also growing as larger funds are now targeting increasingly bigger platform companies.

Buy-and-build strategies are also popular because they offer a powerful solution to soaring deal multiples. They offer managers a way to take advantage of the market's tendency to assign large companies higher valuations than smaller ones. Buy-and-build allows managers to justify the initial acquisition of a relatively expensive platform company by offering the opportunity to tuck in future smaller add-ons that can be acquired at lower multiples. This multiple arbitrage brings down the firm's average acquisition cost, while putting capital to work and building additional asset value through scale and scope. Simultaneously, serial acquisitions allow owners to create value by capturing a greater portion of the value chain and reducing costs or increasing revenues. The obvious point being to construct a powerful new business such that the whole is worth significantly more than the individual parts.

DISTRIBUTION OF PLATFORM COMPANIES BY SECTOR

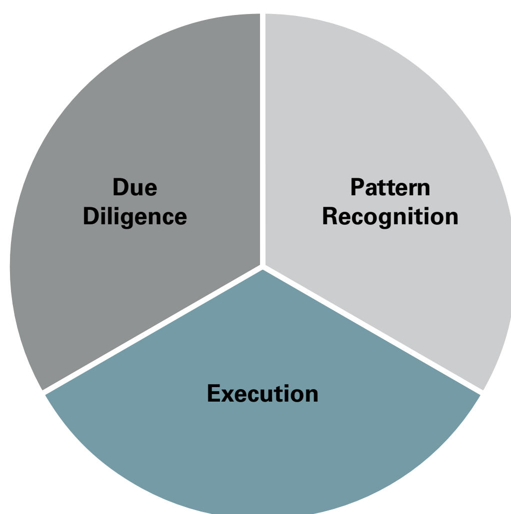


Source: Dealogic, Bain Capital

A WINNING APPROACH

Many attempts to create value through buy-and-build execution fail simply due to poor planning. Success involves assessing the dynamics of a specific sector and leveraging those insights to weave together the right set of complementary assets. The funds that succeed in creating buy-and-build value understand three critical elements:

Exhaustive and systematic due diligence is crucially important. To be effective, managers must have a holistic plan in place prior to completing the first acquisition. The best practitioners examine the entire opportunity from a 360-degree perspective, they don't simply assess the quality of the discrete assets in a vacuum. The manager must specifically understand how the strategy will create value in a given sector using a specific platform company to acquire well-defined types of add-ons. An exercise of this magnitude requires a solid understanding of the industry, it's drivers, and thoughtful projections on the future of the industry as a whole. Do sufficient acquisition targets exist, and are these companies stable enough to support future growth? Does the platform company have the requisite infrastructure to make acquisitions? What are the potential targets, and what value do they add to the portfolio? Reflective answers to questions like these are a critical prerequisite to analyzing the bona fide potential of a buy-and-build thesis.



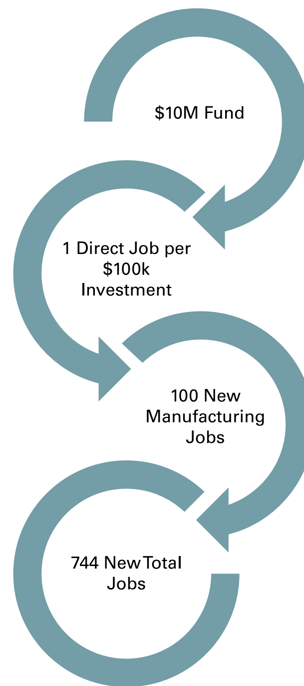
Three Pillars of Successful Private Equity Investing

Execution is as important as the acquisition. Excellent evaluation of target companies can lead managers to a well-defined implementation roadmap. High performing funds have a clear plan for what to buy, how to integrate it, and what roles fund managers and platform company leadership will play. The process begins with constructing a purpose-built leadership team. An invaluable second step is identifying challenges that can seriously derail timelines and impede operational performance (incompatible systems, personnel disputes, integration conflicts) and addressing them immediately. Various strategies can be successfully employed with the vital determination relying on whether the deal team or the portfolio company management is charged with driving critical decision making. However, given the execution time frame, the imperative is to have a clear attack plan at the outset and to accelerate acquisition activity during what can be an expedited investment period.

Pattern recognition and learning from experience is invaluable. Recognizing what does and does not work comes with time and experience. However, learning relies on a conscious effort to diagnose what led to successes in previous situations. This forensic analysis should include the choice of targets, as well as how decisions along each link of the investment value chain created or destroyed value. Outcomes improve only when leaders use insights from past decisions to make better choices moving forward. In an environment when competition is forcing managers to create value by any means necessary, a buy-and-build strategy is a compelling blueprint. The potential for value creation is inherent; capturing it requires sophisticated due diligence, a clear, rational playbook, and strong, disciplined leadership.

CONCLUSION:

Private equity investments have been shown to exhibit attractive return profiles complemented by low measures of volatility compared to traditional investments. When combined with the tax advantages of Qualified Opportunity Zone funds the investment result can be sufficiently compelling. Although Qualified Opportunity Zone funds that invest in operating companies have not seen nearly the level of investment as those that focus on real estate, they can offer significantly attractive returns and potentially represent an uncrowded corner of the capital markets. The impact element inherent in Opportunity Zone investments conveys the prospect of meaningful positive stimulus to undercapitalized communities. The confluence of these factors suggests that enacting a private equity strategy in a Qualified Opportunity Zone fund could be an appropriate investment for certain clients seeking superior, tax advantaged returns while satisfying an ESG objective.



Link Between Direct Investment and Job Creation

For inquiries regarding information on Opportunity Zones please contact Stephen Trotta
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