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FINANCIAL SOLUTIONS

The Raintree Report Issue #7: Spring 2017

Insight Into Private Equity

Raintree had an eventful start to 2017 - we placed on Alberta Venture's Fast Growth 50 list and successfully hosted our second annual International Women's Day Women and Wealth Conference. It was a sold out event with Rachel Mielke (Hillberg & Berk), Teresa Spinelli (Italian Centre Shop) and Kendell & Justine Barber (Poppy Barley) as guest speakers. Finally, Raintree Wealth Management received its regulatory approval to act as a Portfolio Manager and Investment Fund Manager for our clients. We look forward to fully launching next quarter.

In this issue of the Raintree Report we will dive deeper into private equity funds. As the public equity markets continue to reach new highs, we continue to believe that there is a disconnect between public market valuations relative to what private equity firms buy companies for and where public companies are trading. Certainly investors are accepting a higher level of risk in exchange for potentially higher future returns. We have asked two of our private equity managers to provide some insights into their particular investment models to help our clients better understand their philosophies and strategies.

New Website and Email Addresses

Last week, Raintree Financial Solutions underwent a re-brand from raintreeEMD.com to raintreeFS.com. Our website can now be found at www.raintreeFS.com and your Private Wealth Advisor can be contacted using the same prefix as their existing email address but with @raintreeFS.com.

Investment Updates

Auctus Real Estate Trust

Auctus Real Estate Trust (Auctus) completed its final project and distributed the bulk of the remaining equity to investors. The management team was proud to steer the final project (of three) to a successful conclusion as economic and governmental headwinds made for a challenging final development project. Investors received their payment in March.

Solar Income Fund

An Advisory Committee, including two representatives from Raintree, was created in January to assist management in their evaluation of strategic alternatives. Investors should expect to hear more news relating to the decisions emanating from the strategic review during the coming three months. Raintree is prepared to do what we can to ensure that information is shared on a timely basis and to provide insight into recommendations provided to investors.

Going Long: Private Equity's Slow Response to a Proven Investment Thesis

Berkshire Hathaway's 50-year track record is incredible. With average annual returns of 21.6%, Berkshire beat the S&P 500 by 2-to-1.[1] Let's put that into perspective, if you had invested $100 with Berkshire 50 years ago, your investment would now be worth $1,765,000 .

When asked about his investment success in a recent interview with CNBC, Buffett simply said, "money is made by owning good companies for long periods of time".

Even though private equity firms are thought to be some of the best and brightest investors, most ignore the second component to Buffet's powerful investment model, holding for long periods of time. According to Preqin, a leading source of private equity data, the average investment hold period for private equity firms is only 5.5 years.[2]

So why don't private equity funds hold their good companies longer?

One of the main reasons private equity firms do not hold their investments longer relates to incentive structures. The ability to attract top talent to both private equity firms and their investee companies is made easier with the promise of rich bonuses linked to the near-term sale of the company. However, in a 20-year hold model, with no immediate exit to pay out big bonuses, the issue of attracting and retaining top talent can prove difficult.

Another obstacle with a long-term fund is the investment timelines of the underlying investors. Not all investors are endowments with a 50-year horizon. Making investors who require liquidity wait until the end of a 20-year fund to get their money back could sour the relationship between the fund and the investor, even if the fund is performing. Coming up with unique ways to offer liquidity becomes paramount to attracting investors that don't know for certain they have a long investment horizon.

1 http://fortune.com/2015/02/28/berkshire-after-50-years/
2 Latest value reported by Preqin effective 2015

An ability to demonstrate high returns to attract new investors also plays a major part of why funds aren't set up for long-term holds. It is a lot easier to post high internal rates of returns (IRR) when the holding period is only three years instead of 20. As the investment hold period increases, the chance of returning a top quartile result to your investors decreases. Investors all too often measure a fund simply by its IRR. Thus, managers prefer shorter horizons to attract new investors to their next fund. Top quartile returns are great, but unfortunately unless sustained over a long period, they do little to create true wealth.

Despite the list above, none of these obstacles are deal breakers. It simply requires a desire and some innovation for top-tier firms to step out from the traditional private equity model, and that is exactly what we are starting to see in the market.

Recent Market Trends

It has only been in the last two years that some of the major private equity firms have began to offer long-term funds. Carlyle Group, a ~$200 billion private equity firm based in Washington DC, has recently launched Carlyle Global Partners, a longer-term fund structured on a 20-year fund life. The firm has already raised nearly ~$4 billion and has deployed ~$1 billion of that among four companies in the last two years. New York based Blackstone Group, a formidable competitor to Carlyle, is also raising a long-term fund with current commitments totaling ~$5 billion. The fund, dubbed "Core", will also have a 20-year lifespan. Other major private equity groups now offering long-term funds include Apollo, Atlas and CVC Capital Partners.

Driving the creation of these funds is the appetite for long-term capital appreciation from the investors themselves, particularly given the low risk interest rate environment. Pension funds, sovereign wealth funds, and endowments are all looking for a greater return on their capital than current long-term products are providing.

Other factors driving the trend to longer-term private equity models is the general underperformance of the asset class itself, which continues to fall below the 20 % mark[3] , and the natural progression of private equity funds to diversify amongst their competitors which we have witnessed through business sector and geographic segregation of various firms already.

However, despite the trends, in 2016 investors committed $384 billion to private equity globally, with only ~5% of that being invested into funds that have an intended lifespan longer than 12 years [4]. Clearly, it is still a niche play.

Conclusion

Despite the success of Buffett's model, there are still only a handful of players in the private equity industry using a long-term approach and unfortunately for the average investor, there are even fewer options offering private equity level returns for long horizons other than Berkshire Hathaway itself.

Regimen Equity Partners was created based on Buffett's philosophy of long-term holds. Regimen is a 30-year fund life with no requirement to sell its underlying investments within that period. Our investors are given the opportunity to invest for the long-term alongside us (with earlier exit options) creating a unique vehicle we believe can generate true wealth.

Author Biography

Paul Shaw is the Vice President of Regimen Equity Partners, a long-term Private Equity fund based in Vancouver and funded by investors looking for sustainable private equity level returns over a longer period than traditional private equity models.

— Paul Shaw, CPA, CA, CBV | Vice President, Private Equity | Regimen Partners

3 In 2015, buyout funds generated an average internal rate of return of 17.1 percent, according to data from Preqin
4 Preqin

Four Pillars of Private Equity

Newlook Capital operates as a private equity firm sourcing acquisitions and deals in the lower mid-market. We target companies with an EBITDA (earnings before interest, tax, depreciation and amortization) of $1 to $5 million. Currently, our investment mandate is focused on businesses that provide a technical service, where that service is recurring or contracted in nature and the service provided assures code-compliance that is mandated by regulatory requirements within the industry. A good example from our current portfolio is Direct Elevator, an elevator contracting and maintenance company operating out of Ontario. Elevator maintenance and modernization service is driven by building and safety code that dictates a certain frequency of service and equipment updating ("modernization") within the industry.

As investors in the lower mid-market, we focus on and gauge our success based on four factors: the purchase price (multiple) and market timing, EBITDA growth, deleveraging, and multiple expansion. Let me expand on these four points.

The Purchase Price

Purchase price and market timing are the two main facets we use in negotiating deal structure. If we have exhausted the conversation and these terms aren't to our satisfaction, we move on to another deal. With that in mind, a negotiated price will always have input from both the vendor and the purchaser. Standard practice in the lower mid-market dictates that the sources of funds will generally be made up of three equal components: cash on close, some sort of vendor note (either with an earn out component or a subordinate note), and senior bank financing. We work to position the investment for success by negotiating the best payment terms in both types of financing, and by lengthening the term on the bank debt to allow each business more room to reinvest and pay out distributions to investors.

EBITDA Growth

The ability to increase EBITDA is largely dependent on management execution and market forces, although at the lower mid-market, we believe management tends to be more impactful than the prevailing market conditions. The two ways we look to increase EBITDA are by improving margins and increasing revenue growth. Newlook achieves this by cutting operating costs, spending marketing dollars effectively and making smart capital investments. While we believe picking a management team that is knowledgeable about the operating space and can execute is fundamental, we also believe in our ability to build our own plan to purposefully grow the EBITDA in partnership with the management on the ground.

Deleveraging

While historically leverage buyout funds typically used debt significantly to finance their transactions, our approach is more conservative in that we limit the use of leverage to 50% of the total acquisition cost. The use of leverage can change as a function of available credit and the type of revenue generated by the acquisition, and the terms will change on a deal-by-deal basis. However, one of our fundamental pillars is that the business itself not only has the ability to grow EBITDA, but that it also has the ability to generate actual cash flow to pay down principal of the debt utilized.

Multiple Expansion

The "multiple" of a transaction is the number of times EBITDA is paid for a business. Multiples usually range between 3 – 5 times EBITDA in the lower mid-market. Generating multiple expansion (the multiple we sell at, versus buy at) is a component of achieving the targeted rate of return that Newlook determines for each investment. This is done through a combination of operational expertise and market timing, and particularly, strong commitment to increasing recurring revenue lines. The operational expertise is important for improving the long-term growth forecasts of our portfolio companies, and is generally achieved through selecting a strong management team that shares our vision for the future of the company. The market timing is achieved through exiting investments at the most advantageous time, when higher purchase multiples are being offered in that industry. What carries the most weight in this fourth pillar however, is reclassifying or changing the characteristics of revenue streams to become recurring or contracted revenue. Adding new or growing existent recurring lines specifically, results in a higher valuation of the business as a whole.

Newlook Capital maintains a strong focus on the industrial services space, while continuing to develop and build strong investment strategies that provide both yield and growth. All of our funds and investment platforms are subject to our four pillars, and as a result we feel confident that our position as an issuer in the Private Capital Market and our value proposition offers investors both mitigated risk and the potential for strong returns.

Author Biography

Elroy Gust is President and Managing Partner for Newlook Capital. During the tenure of his 15 year career with Newlook, Elroy has been directly involved with real estate and private equity investments totalling in excess of $100 million.

— Elroy Gust | President and Managing Partner | Newlook Capital

Raintree in the Community

Raintree hosted our second annual Women and Wealth conference to celebrate International Women's Day on March 8th, 2017 at the DoubleTree by Hilton in Edmonton. This year the theme was "Celebrating Women's Entrepreneurship" and featured Rachel Mielke of Hillberg & Berk, Teresa Spinelli from the Italian Centre Shop and Kendall and Justine Barber from Poppy Barley as guest speakers. The event was a huge success with a sell out crowd of 250 guests and truly inspirational presentations from all of our guest speakers. This event is not-for-profit and we are proud to announce that we were able to donate $5,860 to local charity, Suit Yourself. To be kept up-to-date with information for our 2018 International Women's Day Conference, sign up to our mailing list here.

Behavioural Finance: Gambler's Fallacy

Gambler's fallacy is an erroneous or misleading assumption or prediction that an event/outcome might or might not happen based on a series of past events. For example, a coin is flipped 20 times with the "heads" side up. A gambler's fallacy assumes that the next flip must show "tails", where in fact, each flip is an independent event, unrelated to each other.

How To Avoid It?

When it comes to investing, decisions made based on irrelevant random events can cause devastating outcomes. Always keep in mind the importance of accurate, research-based information in analyzing any investment opportunity and do not get lost in biases that are based on misjudged probabilities of events occurring.

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