PRIVATE EQUITY

Private Equity Investing: Assessing Business Quality

The first step of any private equity investment—deciding where to invest—might seem obvious, but it's not easy to execute.

Strong private equity returns, after all, stem from a complex choreography that includes finding great businesses, acquiring them for value and driving operational improvement prior to exit.

A key part of screening potential investments, then, is assessing the business quality of a particular company. Our experience tells us that great companies consistently produce cash flows that are durable and stable over the long term.

While countless factors contribute to business quality, we have found that six specific attributes come together (and overlap) to mark a good or great company, regardless of sector or geographic location.

Once we have screened companies for these attributes, we take an opportunistic approach to find situations where we might be able to acquire such high-quality businesses for value. We also look for opportunities where taking on an active operational role would likely enhance the performance and cash flows of the businesses.

Here, we take a closer look at these six attributes, including the importance of each, and share the questions we ask ourselves in determining whether a business is one we might want to own.

Attributes of a Great Business

1. Essential products or services
2. High barriers to entry
3. Market-leading positions
4. Stable cash flows
5. Durable competitive advantages
6. Large-scale operating leverage

The Six Attributes of a Great Business

When we describe the quality of a business, we are summarizing a wide range of characteristics that determine its long-term chances of success.

As part of our underwriting, we perform a thorough analysis of company-specific financial and operating performance, as well as a detailed review of industry structure and competitive market dynamics. This allows us to assess trends in and drivers of operating performance. We also evaluate the magnitude and sustainability of a company's competitive advantages, as well as the risks related to any possible changes in a company's product, service or value proposition. We then translate that into our assessment of long-term cash flows and value creation potential. This comprehensive bottom-up analysis allows us to build conviction in the businesses we seek to invest in—high-quality businesses in sectors we know well and where we have a competitive or informational advantage—and supports our objective of creating value through our hold period.

Target Sectors

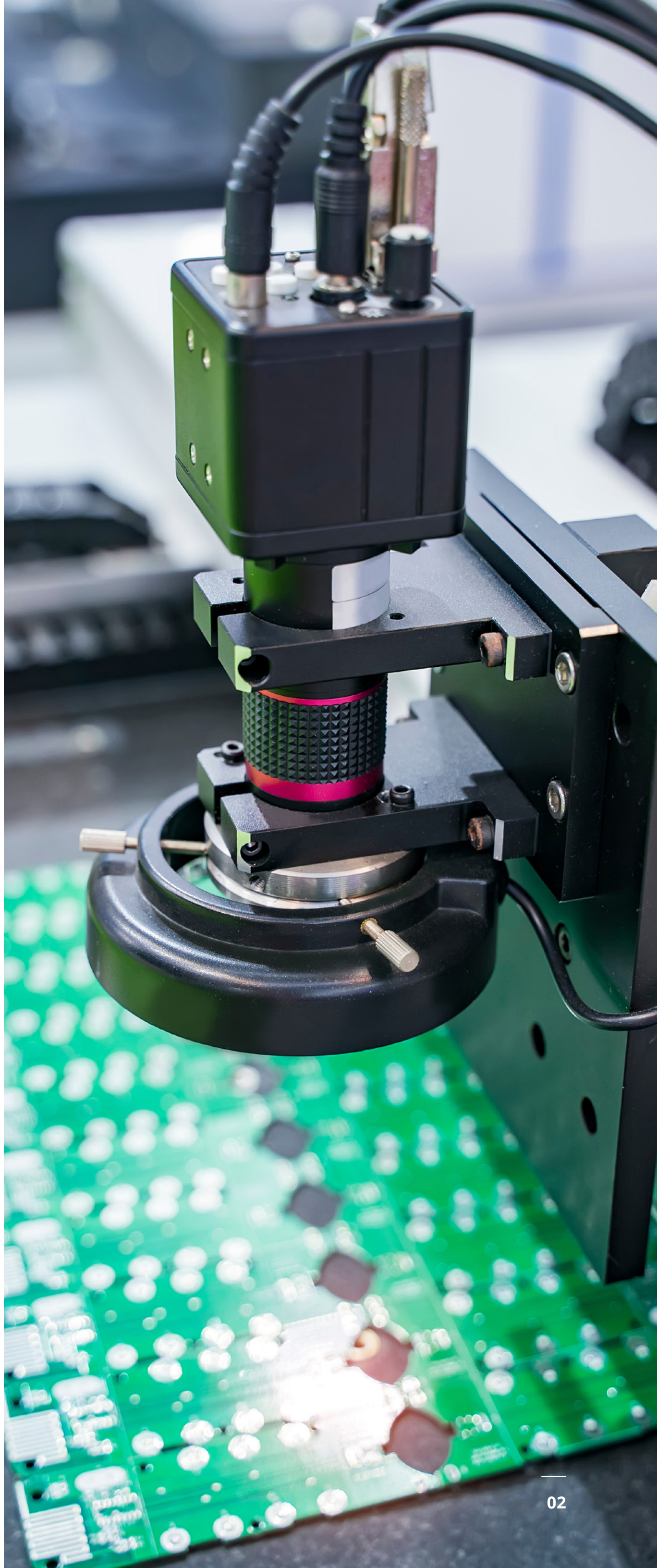
Industrials

Infrastructure Services

Business Services

Healthcare

Technology Services



ONE

Essential Products and Services

Companies that provide essential products or services are vital to the functioning of a market or industry—making them resilient through various macroeconomic conditions.

Such mission-criticality is typically derived from the dynamics of the competitive landscape and position in the value chain. Often, the product or service may be a small component of the customer's overall cost structure, making factors other than price most relevant.

The Key Questions

When evaluating a business's products and services, we seek to determine its value proposition over time and the risk of product or service substitution.

Key questions we ask include:

- **Why does a particular business need to exist?**
- **How has the core product and value proposition changed over the past decade?**
- **Where does the product or service fit into a customer's value chain?**
- **What will the industry look like in 10 years? 20 years?**

TWO

High Barriers to Entry

Barriers to entry are important because they mean that an asset or business cannot be easily replaced, and the risk of substitution is low.

The Key Questions

When identifying a company's barriers to entry, we evaluate factors like replacement cost, operating efficiencies from scale, brand value, logistical advantages and customer switching costs.

Key questions we ask include:

- **How expensive and challenging would it be to replicate the business or erode its competitive position?**
- **What are the barriers to entry that prevent existing competitors and/or new entrants from adding capacity to the industry?**
- **How does our investment basis (valuation) compare with fundamental metrics such as the replacement cost of capacity?**

THREE

Market-Leading Positions

Companies with high market shares tend to enjoy key advantages that make them attractive to us.

These can include substantial cost and service advantages—from, for example, the benefits of large-scale manufacturing or the reach of large distribution or service networks—that translate into pricing power and margin realization. For market laggards, however, the opposite tends to be true. These businesses are often underinvested and losing market share to competitors' expansions.

The Key Questions

When evaluating market position, we look at factors including market share on both an absolute and relative basis, cost position, service and quality, economies of scale, and the magnitude and sustainability of advantages and disadvantages. Key questions we ask include:

- **What are the attributes of a company that define it or its products/services relative to its peers?**
- **How concentrated or fragmented is the industry and what are the competitive implications?**
- **What is the relevant competitive environment—regional or international? How has the industry structure changed over time? What is our level of confidence in how the industry will look in 10 years?**
- **What are the company's returns on capital compared with those of its peers?**

FOUR

Stable Cash Flows

The ability to generate stable, unlevered cash flows across market conditions is critical—and the biggest factor contributing to business quality.

We want to invest in businesses where we have conviction in the durability of free cash flow and our ability to control the outcome through operational improvements, acquisitions or capital structuring. Durable, stable businesses are easier to finance and sell in all market conditions. This makes investment returns less dependent on correctly timing an economic or commodity cycle.

The Key Questions

When evaluating cash flows, we look at factors such as pricing and volume, demand drivers and growth, operating costs, capital expenditures required to maintain the business, operating leverage, contractual commitments and cyclicality, and margins. These factors ultimately determine the cash generation potential of a business, which is a factor we weight highly in our assessment of business quality and return potential.

Key questions we ask include:

- **What is the return on capital, and is it sustainable?**
- **Is there an opportunity for organic growth? And how much ongoing investment would be required?**
- **What is the price elasticity of the customer base? What are the pricing trends on contract renewals? How easily can a company pass through changes in input costs?**
- **Does the company retain cost and efficiency improvements, or are these passed through to customers over time?**
- **Are there substantial restructuring costs, extraordinary items or noncash accruals each year?**
- **What maintenance-related capital expenditure would be required?**

FIVE

Durable Competitive Advantages

Businesses that have durable competitive advantages have defensible market positions that should strengthen over time with a low risk of substitution.

This drives value creation because the best businesses have competitive edges that allow them to generate high returns on capital and maintain or expand industry-leading market positions.

The Key Questions

- **Is the industry likely to experience long-term secular demand growth? What are the underlying market dynamics?**
- **Has the business created value through organic growth and/or acquisitions?**
- **Does management execute on a repeatable business-integration and value-creation playbook?**
- **Can the business increase cash flow with minimal additional capital expenditures? And if capital is required, are the returns attractive?**
- **Is the company able to increase margins over time?**

SIX

Large-Scale Operating Leverage

We seek to acquire businesses with large-scale operating leverage so that the operational improvements we make will have a meaningful impact on cash flows and, ultimately, on the value we can realize upon exit.

The Key Questions

When evaluating a company's operations, we review factors such as customer, channel and supplier concentration, points of failure, capital intensity and return on invested capital, labor productivity and efficiency of operations.

Key questions we ask include:

- **How much work (and risk) is required to generate margin? Is the cash flow margin reasonable?**
- **Does the overall business quality and scale allow us to attract high-quality management?**
- **Does the company need to invest substantial growth capital to increase revenue and EBITDA? What is the historical and projected return on invested capital on these incremental investments? Is the risk/return sufficient?**

NEXT STEPS:

Assessing Value and Operational Improvement Potential

In evaluating potential investments, we understand what makes a business “great” and filter transactions accordingly, taking into account whether we can buy for value and deploy an operations-oriented approach to enhance returns during our ownership period. Our business quality assessment is not a composite score—a deficiency in any one of these areas can mean that an investment may not be worth pursuing.

Yet, critically, a great business does not always translate into an attractive investment. Paying a high multiple and applying leverage can turn a low-risk business into a high-risk investment; or it may generate good—but not target—private equity returns.

It's important to remember that it is the combination of three factors—quality, value, and the ability to drive operational improvements—that makes an opportunity an attractive investment. As experienced long-term owners and operators of businesses, our operational approach is a key tenet of our strategy. It not only allows us to identify great businesses—those with durable, predictable free cash flows, driven by an entrenched competitive position—but also enables us to make them even better.

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