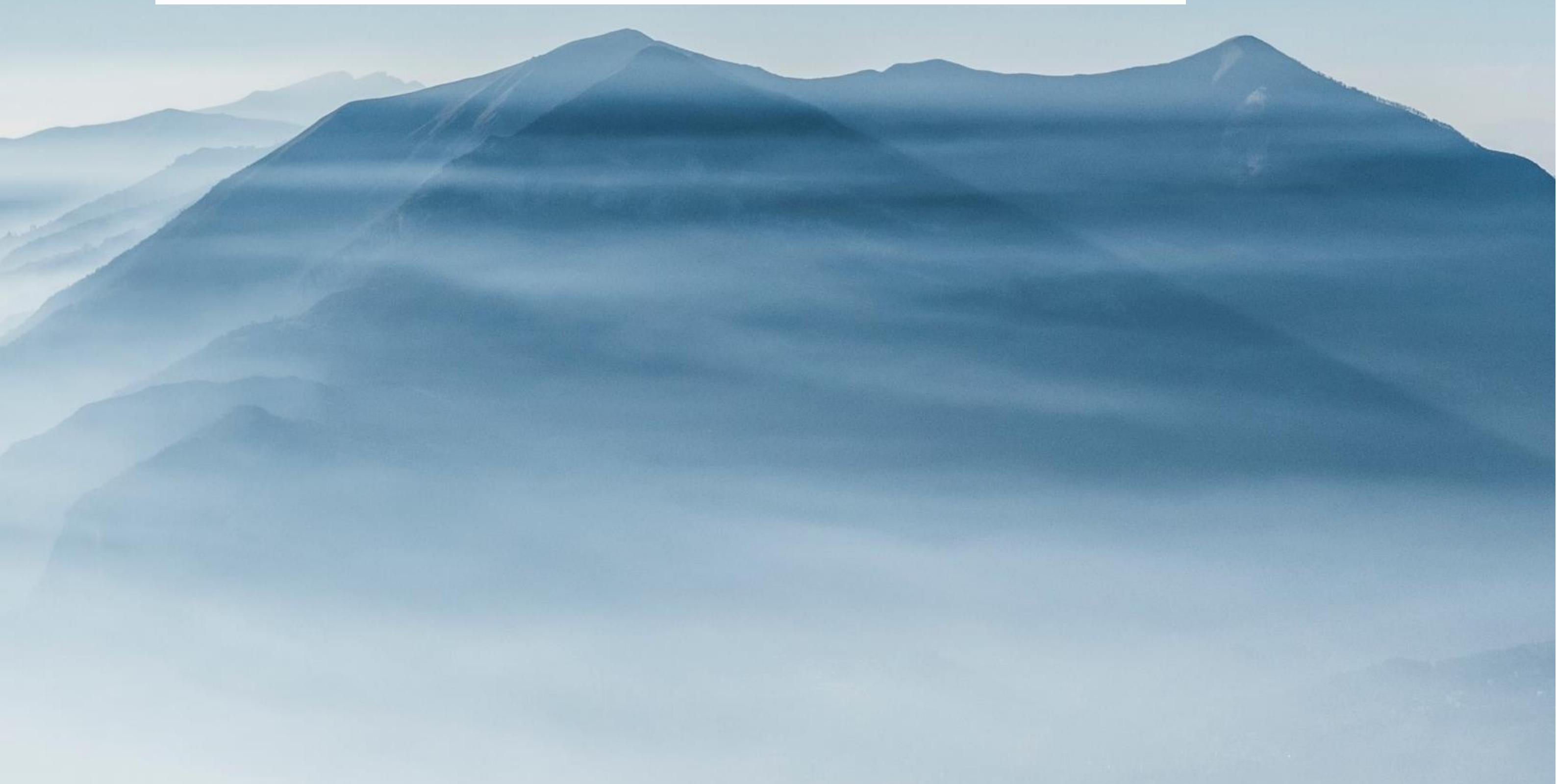
INVESTMENT LETTER

NOVEMBER 2021



In the wake of the 2008 crisis, the fundamentals of the Private Equity (PE) model were put into question. Leveraging companies at the highest possible gear was no longer enough. Financial engineering was over. A new set of skills, based on operational improvement, were paramount.

From then onwards, we have seen almost every single major player create their own value creation teams. These, supposedly, would ensure superior returns going forward without the need of leverage.

However, more than a decade into this model, we have evidence to believe the strategy failed in Latin America. More importantly, here we make the bold claim that this approach was also not successful globally.

Let's get to it.

1 Our first step in assessing the impact of operational prowess in global PE returns was to look at data.

Our recent addition to the team, Humberto, a PhD, and our data-scientist, dug into academic literature and papers on the subject. However, we were only able to find a few articles stemming from more peripheric investment destinations. There was nothing of high quality focused on the US market, for example.

The impact of operational capabilities of PE players on internal rate of returns (IRRs) is something so relevant that the fact that there are no academic papers on the subject is something that should not go unnoticed. Our hunch is that data is either impossible to collect or managers are not that willing to share.

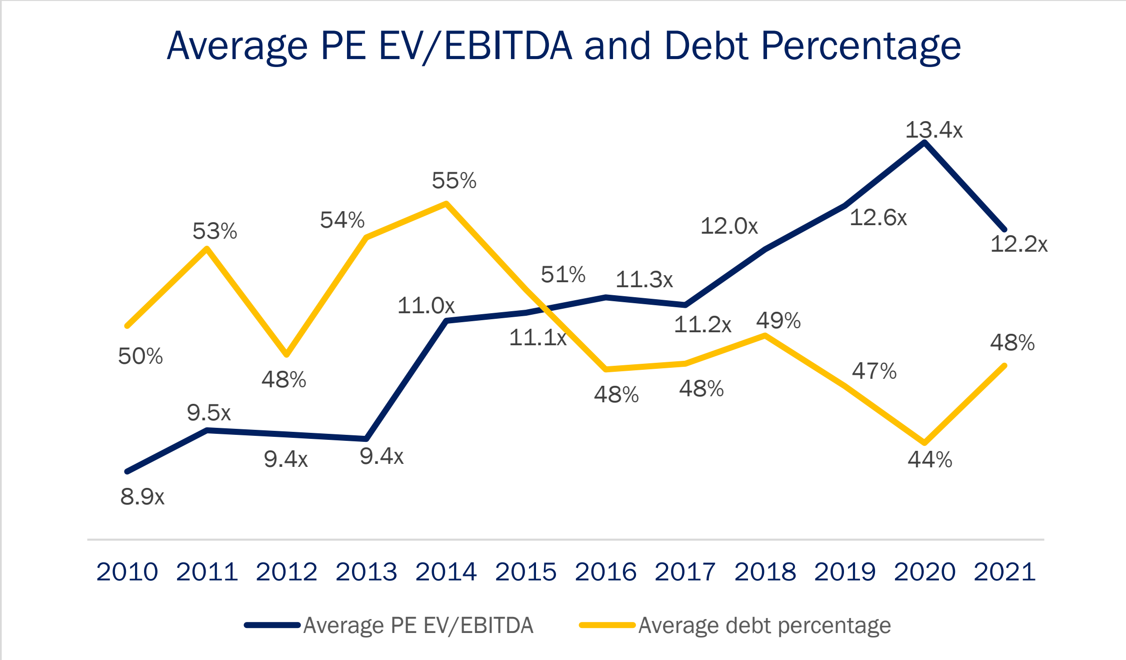
The papers we found indicate that roughly only 20% of total returns were due to operational capabilities. The remaining came from good asset selection (20%), leverage (35%) and price arbitrage (25%). Returns derived from operational capabilities are not meaningless, but far from being a defining characteristic of overall PE returns. Prowess in asset selection, financial engineering and correct market timing are still more powerful tools within the GP toolkit. [1]

Looking from another angle, Bain published a paper in 2020 revealing that 71% of deals underdeliver on the original business plan. Average margins were 3.3% below deal model forecast.

How have returns been healthy if operationally, companies are not delivering?

Another way of looking at the issue is to compare average PE returns for the last decade with the steady multiple increase that assets amassed over the same period. According to Cambridge Associates, buyouts posted a median return of circa 11% in the last decade. Concomitantly, asset price multiples increased from about 8.9x in 2010 to 12.2x in 2021[2]. Leverage ratios have roughly stayed the same at approximately 50%.

[1] Ann-Kristin Achleitner, Reiner Braun and Nico Engel. 2011. Value creation and pricing in buyouts: Empirical evidence from Europe and North America. *Review of Financial Economics,* v.20, n. 4.
Shourun Guo, Edith S. Hotchkiss and Weihong Song. 2011. Do buyouts (still) create value? The Journal of Finance, v.66, n.2.
Ernst & Young. 2014. Taking Stock. How do private equity investors create value? A study of 2013 European Exits.
Benjamin Puche, Reiner Braun and Ann-Kristin Achleitner. 2015. International Evidence on Value Creation in Private Equity Transactions. *Journal of Applied Corporate Finance*, v. 27, n.4.
Mikael Kallio. 2019. Does value creation skill exist in private equity? A deal-level analysis of private equity value creation mechanisms and their persistence in Europe. Master's dissertation thesis.
[2] PitchBook. US Market Insights Q3 2021.



Consider a simple IRR calculation with the following assumptions:

- EBITDA growth of 10% p.a. resulting from 2% inflation + 3% GDP growth + 5% additional company growth and whatever operational efficiency achieved.
- Entry price of 8.9x, which was the average entry price in 2010.
- Leverage of 50%, also the average in 2010. Interest rate of 5%.
- EBITDA cash conversion of 50% (meaning how much of EBITDA becomes cash to lower debt). This ratio is not that meaningful for this exercise.
- Holding period of 5 years, the average holding period for the vintage.
- Exit EBITDA multiple of 11.1x which again is the average multiple for that year.

	Year 0	Year 1	Year 2	Year 3	Year 4	Year 5
EBITDA	100	110	121	133	146	161
EBITDA cash conversion		55	61	67	73	81
Debt	445	412	372	324	267	200
Enterprise Value	890					1,788
Investor Cash Flow	-445	0	0	0	0	1,588

The gross of fees IRR is 29%, while net of fees IRR is circa 24%, if we use the standard 2 and 20 fee structure (without hurdle) for transaction fees. Quite an impressive outcome for a deal in which the manager just delivered 5% p.a. growth in EBITDA with the remaining value stemming from passively following the market trend!

This exercise becomes even more interesting when we compare the results with Cambridge Associates' net of fees median return of 16.9%. Using the same simplified model, managers achieved only 5% EBITDA growth, which roughly equates to GDP + Inflation. Therefore, on average, managers have not achieved any additional EBITDA growth over the past decade.

Almost all global buyout returns (on aggregate) stem from passively waiting for asset prices to increase due to Quantitative Easing! The effort exerted into creating operational improvement teams, value creation initiatives, 100-day plans, etc. seems to have been in vain.

In order to try to explain this phenomenon, we turn to Latin America, a region we are more familiar with and have more granular data on.

We used our database to assess the capacity of GPs to bring in exceptional teams to lead their portfolio companies.

CEOs were divided into two categories: professional CEOs (Agents) and owner CEOs (Principals). In the owner category, we included CEOs that either have a substantial number of shares in the company or are seen by GPs as owners. Take the example of search funds. Searchers have a small stake in the company, but given their role in finding the asset, assembling the investor base, and managing the company, they are considered as owners and not as fluid, easily replaceable managers.

Looking at historical data in Latam, deals executed from the early 90s up to mid-2010s, we filtered for the outliers (deals that have generated more than 5x returns – 14% of the deals). Within the outliers, we attributed the status of their CEOs as either Agents or Principals. The results were staggering:

	MOIC	IRR	Holding Period
Principals	17.7x	149.3%	4.7
Agents	6.1x	50.9%	6.0

Roughly 85% of the outliers had Principal CEOs. We deliberately excluded VC deals from the database for bias purposes.

Looking at Spectra's portfolio, we conducted a similar analysis. Out of our 399 portfolio companies, we removed early-stage VC companies, as they follow a different pattern, in addition to Secondary deals, Infra assets, Real assets and legal claims. This results in a sample of 133 companies. Out of those, 29 have an Agent CEO and 104 have a Principal CEO.

We then classified our Star Portfolio Companies, which are those either marked at >5x MOIC or >40% IRR, resulting in 22 Stars in the portfolio. Again, not surprisingly, 86% were managed by Principals and not Agents.

It looks like the core idea of a hands-on Private Equity manager seems to be at stake here. Hiring and actively managing management teams in portfolio companies, for some reason, appears not to be working out.

We asked around why this seems to be the case and from the answers received, we created the above-mentioned categories of Agents and Owners. CEOs as Agents seem to be more worried about their yearly bonus than their stock-options. They tweak budgets in favor of their bonuses, are not fully transparent regarding the root problems of their companies and so forth. More on this will be divulged in our next letter, where we will elaborate on the CEO as Agent vs CEO as Owner performance differentials.

It seems as the CEO as an Agent mindset focuses on the wrong goals, and indications are that it is very hard for a PE manager to overcome this behavior.

Does this mean that the buyout model is dead? Of course not. We are also not implying that every deal needs to be a minority investment deal either. Our claim here is that the model needs to be adjusted. A successful deal requires a greater degree of partnership and alignment between financial sponsors and management teams.

The deals we love are the ones in which the CEO-to-be is an active part of the search and diligence of the target company. The CEO-to-be must see the investment as an opportunity of a lifetime and commit a relevant part of their own net worth to the deal and be generously incentivized on the upside. The financial sponsor needs to see the CEO-to-be not as an easily replaceable asset but as part of the reason for investing into that company.

We have since tilted our model to favor more of these deals and we hope other GPs do the same.