APOLLON

Research Paper

Our Approach to Private Markets

Philosophy and Implementation
February 2022

Dedicated allocations to private markets have continued to increase among investors and, for some, have been a key contributor to outperformance by institutions and individuals. The long-term benefits may go beyond just returns of the asset class. Investing in private markets may permit investors to access a broader and more fragmented opportunity set generally not investable by public markets managers.

Philosophy – Three Key Tenets

With demand from institutional investors growing, the amount of money invested in private equity and the number of private equity funds continue to rise. As competition among firms to identify investment opportunities and create value intensifies, we believe that private equity firms guided by the following three key tenets are poised to outperform their peers:

1. Appropriately sized funds to effectively invest in the most attractive segment of the market
2. Acute focus on areas of expertise and strength
3. Alignment across the fund manager, its investors and underlying portfolio companies

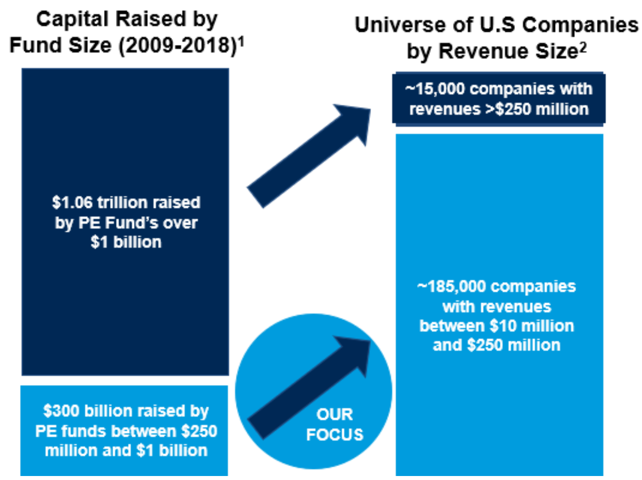
Raise the right amount

Pitchbook recently reported that nearly half of all PE capital poured into vehicles with $5 billion or more in the last few years and in 2021, mega funds raised $143.4 billion across just 13 vehicles.[1]

Despite the attention and enormous amount of dollars raised at the larger end of the market, we believe the most compelling opportunities are in the lower-middle market and middle market, a segment which we have observed has historically outperformed.

[1] Pitchbook 2021 Annual US PE Breakdown

The lower-middle market, typically defined as private equity funds raising between $250 million and $1 billion, coincides with the largest segment of private companies and the highest degree of sector fragmentation. Funds this size usually target companies with revenues between $10 million and $250 million and enterprise values of up to $100 million. This segment accounts for approximately 93 percent of the investable private companies. However, it only attracted 23 percent of the dollars raised between 2009 and 2018.



[1]Capital raised statistics are from Pitchbook article "1Q_2019_US_PE_Breakdown"
[2]NAICS, September 2019

Companies this size tend to be less institutional and historically have not been well served by investment banks, which leads to inefficient sale processes and lower entry multiples. The abundance of small businesses is met with attractive downstream demand, especially today, as billions of dollars from private equity firms and strategic buyers search for healthy, growing companies. The fragility of businesses associated with these firms, however, created wide dispersion among top and bottom quartile performers, emphasizing manager selection and the need to find firms with the specialized skills to create value.

Focus on what you do best

With more than 185,000 companies comprising the lower middle-market, focus is paramount. We believe that private equity managers whose specialized expertise prioritizes operational focus can effectively source transactions to create value. Areas of focus may vary, but most often they are demonstrated in the following ways.

Sector Focus	Structural Expertise	Thesis Driven
• Industrials	• Distress/turnaround	• White paper research
• Consumer	• Bankruptcy	• Thematic
• Software/Technology	• Corporate carve-outs	• ESG/Impact
• Healthcare	• Take-privates	

Sector specialists focus on industries that require specific technical skills. Oftentimes, these industry-specific firms possess decades of operating and investing experience within their dedicated sector. That experience may have benefits, including:

- Sourcing
- Performance improvement
- Earnings growth
- Exit optionality

Industry specialization is not the only way for private equity investors to differentiate themselves. Some firms focus on specific transaction types or situations. These firms may be generalist by sector; however, they wield the structuring expertise to navigate complex transactions. Regardless, if it is a corporate carve-out, take-private or turnaround investment, the inherent complexity of these transactions requires a highly specialized skill set and experience.

The final focus is thesis-driven idea generation. The themes can be a specific subsector, business model, geography or macroeconomic trend. Taking a thematic approach, private equity firms narrow their focus on a specific type of company, thereby strengthening sourcing channels as well as deploying operational skills that create value.

Align investors, funds and company management

Alignment comes in different shapes. First, *is the fund aligned with its investors?* A fund typically aligns itself with investors economically through either terms or the team's investment into the fund. Investor-friendly terms, such as a preferred return (hurdle rate) or a reasonable carried interest waterfall, demonstrate a commitment to creating value for Limited Partners (LPs).

By committing a significant portion of their personal net worth to a fund, private equity firms demonstrate they are "eating their own cooking" by aligning themselves personally with the performance of the fund. Economic alignment is especially prevalent where economics are driven more by performance-based fees rather than management fees. Economic alignment strengthens the bond between LPs and General Partners (GPs).

In addition to aligning with their LPs, it is also important for private equity funds to align themselves with the founders and management teams at the companies they invest in.

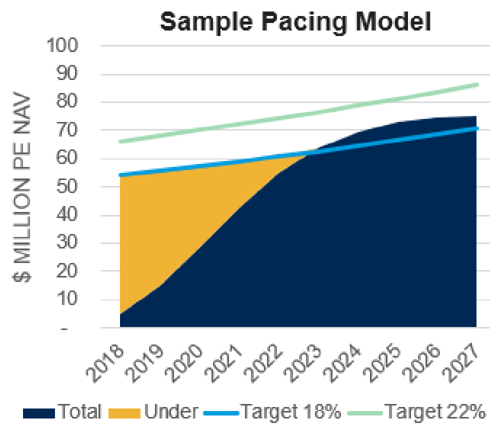
Successful funds incentivize their management teams with substantive equity ownership or the option to obtain it. By tying company performance to compensation, management teams are in-step with their private equity owners. This bond can be strengthened on the first day if a founder or seller reinvests a significant amount of the sale proceeds into the company. If the management team is well-aligned with its private equity owner and the private equity firm is aligned with its LPs, all parties are incentivized to succeed.

Implementation – Intentionality and Planning

One of the hurdles many investors face is the practical implementation of private markets given the unique investment structure. Most institutional-level private markets funds are closed-end, meaning they have a pre-determined life with liquidity that is almost entirely driven by the manager. In all, a private equity fund can last for more than 12 years. The cash flow dynamics between the investment period, when capital is called from investors, and the harvest period, when capital is returned to investors, creates what is known as the "j-curve." The j-curve is characterized by negative returns in the early years with capital being called, management fees being charged and new investments marked at cost. In the harvest period, as the fund matures, investments are realized or held at updated values and the return metrics normalize. Each fund's curve will look slightly different as a result of when managers identify companies they want to purchase and when they later realize holdings.

The cash flow dynamic of the structure creates a challenge for portfolio implementation, which is compounded by delayed reporting and valuations that move quarterly rather than daily with the rest of the portfolio.

How do investors seek to maintain allocations when there is so much that cannot be controlled? The best offense is having a well-planned, programmatic approach. By creating a pacing model accompanied with a thoughtful plan, investors can deploy capital in a way that will achieve longer-term consistency between contributions (capital calls) and distributions (fund exits).



For illustrative purposes only. Pacing model assumes a $300 million total portfolio with no existing allocation to PE. Portfolio hits target allocation range of 20-22% in 2023 by making annual new commitments of $20 million.

Setting a plan and framework regarding how to commit capital enables investors to achieve long-term strategic allocations to private markets. While cash flow modeling can help establish a plan, frequent revisiting is vital to ensure targets will be efficiently attained as it can take between four and seven years to achieve the desired allocation.

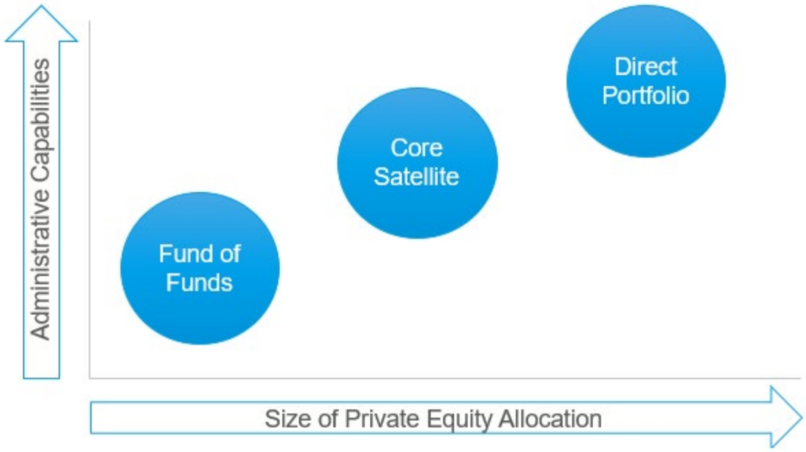
The length of time required to reach a target allocation is due to the need for vintage year diversification. The risk of overloading any particular year will have a material impact on the long-term outcome of the private markets portfolio as well as your broader portfolio. In all likelihood, the ownership period will last for a full market cycle and continuing to invest across that market cycle is important to long-term outcomes.

Diversification by strategy type and sector is also critical. Traditional buyout, growth equity, venture capital and distressed or special situations funds will perform differently throughout the market cycle. By investing in quality funds in each area, investors will likely realize better risk-adjusted performance across market cycles while still generating significant alpha.

For many clients, the preferred method for access is to create a diversified portfolio of direct fund investments, but ultimately it depends on client size and administrative capabilities. Direct investments into funds allow investors to take a targeted approach to a select group of managers and have complete discretion over how the underlying portfolio is organized. More importantly, this approach encourages investors to create the level of diversification described above. While this requires a meaningful commitment to the asset class, it is not solely for the largest subset of investors.

A fund-of-funds approach can also be utilized in order to gain diversification by managers and sectors. This approach is better suited for smaller-sized clients or those that do not have the administrative capabilities to manage subscription documents, legal documents, capital calls and ongoing accounting. This comes with an extra layer of fees, which can lower overall returns, but it can be effective in balancing complexity.

A core-satellite approach is a combination of direct investments and investments in fund-of-funds, which can create a desirable level of diversification within private markets while maintaining the characteristics that boost this asset class toward creating alpha over long time horizons.



Formula for Long-Term Success

Private-market investors must evaluate several factors to determine the right investment opportunities for their portfolio. From the vast opportunity set within private equity, Apollon focuses on the segment of the market that we believe gives our clients the best formula for long-term success. We assert that well-aligned, smaller funds with a specialization are critical elements in this formula. In doing so, we take a differentiated approach to sourcing – one that is proactive and outwardly driven through our extensive network of LPs, GPs and intermediaries.

Finally, we build customized client portfolios with bespoke pacing models to suit the individual needs and goals of all clients. Through attentive planning and a thoughtfully driven approach, investors can achieve a private markets allocation that can add meaningful return and diversification from other asset classes.

For more information, please reach out to any of the professionals at Apollon.

YOU SHOULD BE AWARE OF AND CAREFULLY CONSIDER THE FOLLOWING POINTS BEFORE DETERMINING WHETHER ALTERNATIVE INVESTMENTS ARE APPROPRIATE FOR YOU.

You should understand that an alternative investment strategy is subject to a number of risks and is not suitable for all investors. Alternative investments are generally classified as an investment other than a traditional stock, bond, mutual fund or exchange traded fund. Investing in alternative investments is only intended for experienced and sophisticated investors who are willing to bear the high economic risk associated with such an investment. By themselves, alternative investments do not constitute a balanced investment program.

Please read any prospectus and summary prospectus carefully before you invest or send money.

You should carefully review and consider potential risks before investing, including carefully review all advisory disclosure documents, private offering memoranda, prospectuses, or other offering materials provided by us and any separate manager or third-party service provider of an alternative investment. Alternative investment offering documents are not reviewed or approved by federal or state regulators.

Specific Alternative Investment Risks:

Alternative investments, including hedge funds, private equity funds, real estate private equity funds and venture capital funds: (1) involve a high degree of risk, (2) often engage in leveraging and other speculative investment practices that may increase the risk of investment loss, (3) can be highly illiquid with extended lock up periods where assets may not be sold, (4) may lack a secondary market to purchase shares that investors care to redeem, (5) are not required to provide periodic pricing or valuation information to investors, (6) may involve complex tax structures and delays in distributing important tax information, (7) are not subject to the same regulatory requirements as mutual funds, (8) often charge high fees which may offset any trading profits, and (9) in many cases execute investments which are not transparent and are known only to the investment manager. The performance of alternative investments, including hedge funds and other alternative funds, can be volatile. An investor could lose all or a substantial amount of his or her investment. Often, hedge fund or other alternative investment account managers have total trading authority over their funds or accounts. The use of a single advisor applying generally similar trading programs could mean lack of diversification and, consequently, higher risk. There is often no secondary market for an investor's interest in alternative investments, including hedge funds and managed futures, and none is expected to develop. There may be restrictions on transferring interests in any alternative investment. Alternative investment products, including hedge funds and other alternatives may even execute some portion of their trades on non-U.S. exchanges. Investing in foreign markets may entail risks that differ from those associated with investments in U.S. markets. You should understand that past performance is not necessarily indicative of future results and that income from alternative investments may fluctuate and that the investment's price or value may rise or fall. Accordingly, you may realize less than the amount you invested.

Additional alterative investment risk disclosures can be found in Apollon's ADV Part 2A, https://adviserinfo.sec.gov/firm/summary/291902.