North Sky CAPITAL

Fourth Quarter 2012

MARKET UPDATE

Super Storm Sandy

In the aftermath of Sandy, a number of "pundits" proclaimed the storm showed that federal and state governments need to invest heavily in building new infrastructure. While that might be true generally across the USA, we don't see the connection to Sandy unless they are arguing we should bury all of our power lines (which we believe would cost several hundred billion dollars and wasn't entirely effective anyway due to flooding). To the contrary, what Sandy showed us at North Sky Capital is that businesses and homes could *and should* have more robust power systems so they are less reliant on centralized systems and government. Modern society is absolutely dependent upon 24/7 access to electricity. But new options are becoming available that can displace our antiquated centralized power stations and aging electrical grid. Options for enhanced energy security available today include natural gas fuel cells, full-time or back-up generators (diesel, propane or natural gas), geothermal systems and small form-factor wind and solar systems paired with battery systems like those offered by Solar City (ticker: SCTY). However, one of the most cost-effective solutions today for distributed power is community solar systems. These systems enable residents (including apartment renters) to buy or rent one or more panels that are installed in a central location for ease of connectivity, metering and maintenance. The power produced can be used locally or sold back to the utility. The power also can be stored in utility-scale batteries in order to power the community 24/7 (at added cost, of course). We see community solar as a big investment trend for 2013 and beyond.

A community solar site in Northern Colorado. Picture courtesy of Clean Energy Collective.

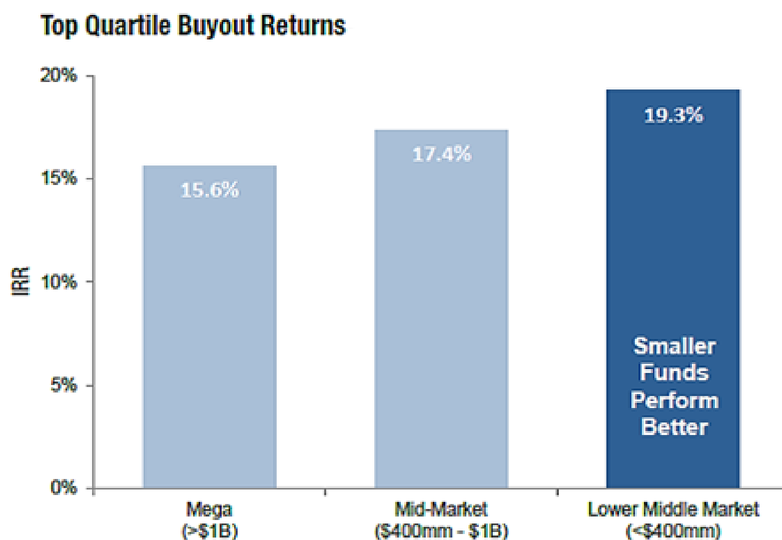
Lower Middle Market Buyouts

One of our primary areas of focus continues to be lower middle market buyouts ("LMMB"). We classify LMMB funds as ≤ $400mm in size, seeking to buy companies valued at $25-250mm (typically EBITDA of $3-20mm). We believe LMMB funds are well positioned to generate consistent and attractive returns for the following reasons:

- It is a less efficient market
  - Lower valuations
  - More time for in-depth due diligence
  - Opportunity to add value beyond financial engineering by:
    - Add-on acquisitions
    - "Professionalizing" companies (install modern IT systems, strengthen financial controls, enhance the management and marketing teams,

improve supply chain, reduce input costs through group purchasing with other portfolio companies, etc.)

- There is a huge universe of target companies to choose from at entry relative to the number of LMMB funds; and many potential buyers at exit (strategics and PE firms).
- There is an opportunity for "multiple expansion." Historically, companies that grow beyond $20mm of EBITDA appeal to a broader group of potential acquirers. These include strategics looking for new growth initiatives and mid-sized and large buyout funds. In this higher strata, the acquirers often are willing to value the company using a larger EBITDA valuation multiple. So, for example, they might pay 7x EBITDA when the LMMB fund only paid 5x when it originally bought the company.
- Finally, LMMB funds have produced strong historical returns (on an absolute basis and also relative to their bigger peers). We analyzed the entire data set from Thompson Reuters (666 buyout funds) and separated the funds into three sizes: less than $400mm, $400mm-$1B and greater than $1 billion. The chart below shows the average top quartile return for each segment.



Latest on the JOBS Act

A well-known VC told us recently he was looking forward to the new crowdfunding rules, whereby average folks can invest in venture deals. Crowdfunding will have its limits, including restricting capital raises to $1 million or less per company per year. It sounds great; but then we began to think about the potential unintended consequences. We predict you will see the following scenario play out in the not-too-distant-future: VC invests in a company, company ends up on shaky ground and needs more capital, VC refuses to put more money in but assists in crowdfunding efforts to raise $1million, company then goes out of business, crowdfunders sue VCs claiming failure to disclose material information (or something similar), media drags the venture capital industry through the mud leaving the entire venture capital industry tarnished yet again and perhaps additional stringent, costly regulation ensues.

Predictions for 2013

Speaking of predictions, here are a few more for 2013:

1. Taxes will go up.
2. The burden of federal regulations on individuals and business will increase.
3. Economic growth will continue to be saddled by the effects of (1) and (2).
4. Medical device companies will be hit hard next year because the 2.3% medical device company tax in ObamaCare is on gross sales, rather than profits. One

medical device company announced last week that the effect would be to push its corporate tax rate on net income from roughly 43% this year to 65% next year. The company, Uresill in Skokie, Illinois, is preemptively laying off more than 10% of its workforce and cutting its R&D budget to stay in business.

5. Several prominent VC funds will report steep declines in valuations of their social media companies as they are finally forced by auditors to mark to market based on public market comparables like Groupon and Zynga, among others. While FAS 157 / ASC 820 calls for quarterly valuation adjustment, many VCs have resisted throughout 2012. Auditors will force their hands at yearend.
6. VCs will focus too much on enterprise software, cloud computing, big data and mobile opportunities and focus too little on medical device, pharma and next generation healthcare. Overcrowding leads to poor returns. The few remaining healthcare VCs may have the advantage over their tech brethren.
7. Credit opportunity funds are currently in vogue, but many have had a hard time putting the money to work other than in junk bonds and other high-risk assets. Lackluster results will shift investors back into historically higher returning, but illiquid, asset classes like private equity.
8. Natural gas will continue to grow in market share as a fuel used to generate electricity, as well as to power our trucking fleets and other on and off-road vehicles. The shift to a cleaner fuel creates investment opportunities across the energy, water and transportation sectors.
9. LEDs will begin to take significant market share in the general purpose lighting sector.
10. Despite the Fiscal Cliff and other issues, the US will continue to be a safe haven for capital in 2013.

Quote of the Quarter

"At prices of $80-90 per barrel of oil and $5 per thousand cubic feet of natural gas, we essentially have an infinite supply of both thanks to technological innovation. All the people who were estimating recoverable reserves and telling us we were approaching the "end of oil"…were wrong. You can now ignore them."

– Anonymous U.S. oil and gas investor

This is a bold statement. Whether you agree or not, or even like it or not, it is thought-provoking from an investment standpoint.

Upcoming Events

We are regular speakers and attendees at key industry conferences. We hope to see you at these upcoming conferences:

February 10-12	**Made in America Summit**, Las Vegas www.frallc.com/events/mia/
April 16-17	**Good Jobs Green Jobs Conference**, Washington, D.C. www.greenjobsconference.org
May 1-2	**Ceres Conference**, San Francisco www.ceres.org
May 20-22	**US SIF Conference**, Chicago https://ussif.org/events/public_event_display.cfm?Event_ID=191

North Sky Capital Contacts

Scott Barrington
Managing Director and CEO
(612) 435-7170
sbarrington@northskycapital.com

Danny Zouber
Managing Director
(612) 435-7180
dzouber@northskycapital.com

Michael Pohlen
Managing Director
(612) 435-7190
mpohlen@northskycapital.com

Mark Austin
Managing Director
(612) 435-7160
maustin@northskycapital.com

Gretchen Postula
Head of Investor Relations
(612) 435-7177
gpostula@northskycapital.com

Denise Galvin
Chief Financial Officer
(612) 435-7166
dgalvin@northskycapital.com

© 2012 North Sky Capital

Information contained in this publication is based on data obtained from sources we deem to be reliable, however, it is not guaranteed as to accuracy and does not purport to be complete. Nothing contained in this publication is intended to be a recommendation of a specific security or company nor is any of the information contained herein intended to constitute an analysis of any company or security reasonably sufficient to form the basis for any investment decision.

These materials are not intended as an offer to sell, or the solicitation of an offer to purchase, any security. Any offering will be made only by means of a private placement memorandum or other appropriate materials (the "Offering Documents") that will contain detailed information about any investment to be offered; no sales will be made, and no commitments to enter into investments will be accepted, and no money is being solicited or will be accepted, until the Offering Documents are made available to prospective investors.