

PRIVATE EQUITY

PERFORMANCE IN A DELEVERAGING MARKET

The Global Credit Environment

The sub-prime residential housing crisis that began to reveal itself in 2007 through increased loan delinquencies marked the beginning of the current global credit crisis. This crisis has gone on a path of financial destruction that has targeted the entire international financial system. The interwoven strands of the world's financial markets, coupled with the growth of unregulated derivative financial products that trade on a global platform, resulted in a credit crisis that had an immediate and simultaneous impact throughout the capital markets and economies of the world. It led to the downfall of some of the once mighty global financial giants; firms that represented the mainstream financial infrastructure in our western society. Within a 30 day period of time Bear Stearns, Lehmann Brothers, Merrill Lynch, AIG, Freddie Mac, Fannie Mae, Wachovia, Indymac Bank and Washington Mutual all suffered a very harsh financial fate. Some institutions survived with radical government intervention while others were taken over by their rivals and others still were left to perish. The credit crisis tsunami even managed to arrive at the remote shores of Iceland causing their entire banking system to be nationalized.

This credit crisis has disrupted capital markets and exposed the vulnerability of countries and regions of the world that were once considered to be immune from such risks. There is no longer any doubt of the far-reaching and serious consequences that a sustained credit crisis poses to the global economy as that economy has evolved over the past two decades. World central banks have responded with coordinated rate cuts while they struggle to deal with the consequences of an interconnected global economy. Markets, sectors, industries, firms, investors and consumers alike will have to weather the unprecedented economic turmoil that lies ahead. We are now witnessing a global economy in decline.

The Private Equity Market

The impact of the credit crisis on private markets has truly been a tale of two markets and a story of size. That is to say, there is an adequately functioning private equity market for transactions of small and medium size that are typically found in the small-middle private equity submarket. Small-middle market sponsors and surviving lenders have grown more cautious in the current credit and recessionary environment. They are elongating their due diligence and underwriting processes as well as tightening deal terms. Importantly, the supply of equity and debt to this submarket is currently and selectively available for solid deals. In contrast to the small-middle market, there is a dysfunctional private equity market for transactions of large-mega size, a segment of the market that captured global attention in the past three to four years.

When attempting to assess the future behavior of an asset class after a market adjustment it is natural to look back in time to comparable market movements and form a perspective based upon historical comparisons. The challenge in comparing the 2008 market adjustment to history with respect to private equity is that there are few comparable economic or time periods when private equity was a viable asset class. This lack of data makes it difficult to draw conclusions about performance. We have 2001, 1987, 1982, and 1975 as comparable periods for economic downturns. However, as an asset class, private equity was not established until 1982. Therefore, the only comparable economies and time frames that are relevant and allow the observation of private equity's performance are 2001 and 1987. Following both of these previous economic downturns, private equity asset class returns were among the best performing in the three decades of available data. The exception was venture capital post the 2001 bubble.

In 1987 and 2001, the recovery period for the markets was on average 13 months. These recessions were short and there was little or no systemic damage to the financial infrastructure. In 2008, the financial infrastructure broke down not only in the U.S., but the rest of the western world. This is unprecedented. Therefore, there is no historical marker to reference how private equity will perform because we are operating in uncharted waters. However, we do know that the time it is going to take for all of the capital markets and the underlying economies to recover will not be measured in months, but in years.

In the absence of sufficient historical data, the only way that we can try to predict the future performance of this asset class is to judge it on the fundamentals of what makes it successful. In doing so, we must again accept the definition of private equity as being a spectrum of investment opportunity that ranges from early stage venture capital to the large cap private equity buy-out market. In between are multiple stages of venture capital, mezzanine, special situations and various stages of the buy-out market based upon size or market cap of the transaction. There is no question that mezzanine and distressed debt thrive in a period of time when credit is withdrawn and access to capital is difficult or non-existent. Therefore we can conclude that these two sectors will perform well in this credit crisis driven market correction. We must now determine how the other main sectors of private equity will perform over the next two to three years.

Venture Capital

The U.S. economy continues to generate and develop new companies each year based upon the ideas and dreams of generation after generation of young entrepreneurs. The venture capital sector of this asset class has never run out of ideas and new company opportunities to finance. Some of these companies make products to run other companies more efficiently while others create wholesale changes in how we communicate, research, transfer data and extend life expectancy. No market cycle, regardless of its magnitude, is going to change the development of these products and companies. Robert Litan of the Brookings Institute and the Kaufman Foundation finds that about 500,000 Americans start new companies each year and that 10-15% of all American working adults participate in some form of entrepreneurial activity.

The infrastructure to finance these ideas and nurture the development of the products has been formally in place for three decades. Therefore, capital is continuously provided to the venture funds and the system continues to operate below the efficient capital market turmoil. Venture companies are not dependant upon credit markets and since they do not trade publicly, valuations are only significant when the companies are in need of financing. Most of that financing is done by other venture capital firms and strategic buyers, not commercial banks. Today even these sources of capital are scarce. Most venture capital firms learned from the 2001 bubble to maintain follow-on financing capital in their fund so that they minimize the need to seek external capital during periods of time such as today. The other learning experience from 2001 was to only finance businesses that have a clear value added strategy and that have the potential to grow to substantive companies or become attractive acquisitions. While some venture capital firms still see opportunities to create companies that will grow to at least \$1 billion in market value, others have adjusted their investing strategies to be able to generate high returns on modest \$100 million exits.

The fundamentals of the venture capital market have not changed in this credit market crisis because their existence is not dependent upon leverage or public market financing. In addition the cycles for start-up companies from initial investment to final exit are much longer than economic cycles, so many venture-backed companies would not be expecting to access the public markets until well after the end of this recession. Therefore, the anticipated impact on venture capital backed companies will be a slowdown in sales of portfolio companies to strategic buyers and any public offerings are at least a year away. We conclude that top-quartile venture capital returns should remain in the historical expectation range of between 20%-22% throughout this volatile economic period, with distributions slowing significantly.

Small and Middle Market Buy-out

The principle difference between the middle market and large cap buy-out market is the value added by the general partner. The smaller market cap companies are often owned by second or third generation family members who want to grow their business and need to access capital and a partner to help them achieve their shared vision for the company. This requires the general partner to bring more than money to the business. The general partner must be prepared to spend time at the company, often filling the role of chairman and chief strategist while also helping to upgrade the accounting function to a financing operation. The original owner continues to oversee the company's day to day operations. The business plan is to acquire competitors and suppliers and significantly increase the value of the company by 2x or 3x its original size.

What makes this sector so dynamic is the number of operating companies within it. Approximately 84% of the working population of the United States work for companies which employ less than 500 people. No one knows the exact size of this market but it is estimated to be between 500,000 and one million investable companies in the United States. Frequently, the selling owner agrees to keep equity in the new company and in return does not want the success of the business to be dependent on leverage. This applies in many cases but not all.

The result is that these middle market companies are not highly leveraged, often no more than 25%-35%, and as a result they are not crippled by the changing credit markets. Therefore, the impact of today's lack of credit in the economy does not debilitate the portfolio companies. In fact, we have portfolio companies that have continued to access credit and some are negotiating portfolio company sales, even today.

These sectors of the private equity market are also experiencing a slowdown in distributions and access to capital. Strategic buyers will not return until the overall market improves. However, we believe that the fundamentals are sound in this sector and that top performing middle market investments will continue to achieve their historical return range of between 15%-20% throughout this time frame with return expectations at the lower end of this range.

Large Cap Buy-outs

Lenders have effectively closed their doors to the large end of the private equity market. Clear signs of this began in the second half of 2007 when busted deals such as Sallie Mae, Huntsman, Harman Int., ACS, Alliance Data and Penn National were reported. Some large deals were still getting done at that point in time but only after the deals were significantly restructured. Examples of these restructured deals included Clear Channel, First Data, Harrah's, Biomet, HD Supply and Thomson. By 2008, both the number and size of large-mega transactions had contracted significantly. Surviving lenders re-priced risk, rejected complex structures, required more equity from sponsors and reduced deal size. Deal flow in this segment of the private equity market relative to the recent past has come to a standstill in the second half of 2008. Oddly enough, capital raising for new funds in excess of \$5 billion still continues today. There are currently 25+ funds raising capital in anticipation of the resurrection of deal flow. It's reminiscent of the 1990s when the principle virtue needed to raise capital was to have a good story and a good story teller.

The large cap buy-out model only works with low-cost debt and a high debt-to-equity ratio. Surprisingly to some, the operating company's performance is not insulated from market corrections when credit is withheld. The current environment has destroyed the myth that the general partners of the large cap funds are better at managing a company than their public company counterparts. They are what we thought they were: financial architects who manage a capital structure built on leverage. Put very simply, the LBO model does not work without leverage. According to Capital IQ, of the 109 U.S. companies that have filed for bankruptcy this year, 67 were backed by buy-out funds. Until credit markets again offer the generous terms that were available in the middle of this decade, return expectations will be significantly reduced from their historic highs.

Data from Venture Economics shows that over the past three years, commitments to large cap funds increased by 145%, growing to \$161.8 billion in 2007. Most of this capital was committed by very large pension funds that financed future capital calls (commitments) with distributions from previous funds. However, distributions from these funds came to an abrupt halt in 2008. In addition, these pension and endowment funds have suffered large losses in their equity portfolios in 2008 placing significant strain on their ability to raise cash for benefit payments. This has caused the management of some pension funds to warn the general partners of the new vintage year funds that they may not have the capital to meet any future capital calls. So far, this appears to be acceptable to the general partners, since they have no measurable deal flow and could not finance a deal even if they were to have one in hand. However, this situation cannot remain harmonious for very long.

Given the change in cost and availability of credit, the returns of 30%+ have gone away for some time to come. We anticipate double digit negative returns from this sector of private equity for 2008, 2009 and possibly 2010. This will bring the average return for this large LBO market to 12-15% for this decade. This return is well within the historical return expectation for large cap buy-outs. Future returns from this sector will continue to be in the 12-15% range because the cost of capital will be more expensive (at least 300 basis points higher) when credit becomes available again, and the loan to value ratios will be closer to 40% than to the 90% that was common earlier in this decade.

Portfolio Opportunity

Since October the federal government has spent \$4 trillion to strengthen the balance sheets of the major U.S. financial institutions and stimulate the economy. The Federal Reserve has now become the 3rd largest commercial bank in the U.S. The Federal Reserve has also given over \$70 billion to the Swiss government to support UBS and it may have done the same with other foreign banks. The point is that U.S. commitments have risen to a level no one would have anticipated or thought of even six months ago. Money supply has increased significantly in this period as the Federal Reserve and Treasury have tried to monetize our way out of this recession.

Over time we expect inflation to result from this monetization and spending by the government in the U.S. and other developed countries. The increases in money supply numbers are so large one could only expect price increases of a substantial nature. By 2010 we could see a return of 1982 style double digit inflation. Regardless of its magnitude inflation is on the horizon. Therefore, an investor should look to the consequences of this event on their portfolio. Hard assets such as real estate should benefit, while highly leveraged transactions will be hurt.