North Sky
CAPITAL

First Quarter 2011

MARKET UPDATE

North Sky Capital 2011 Private Equity Predictions

In Q4 2009, we made several predictions for 2010, many of which cut across commonly-held views at that time. This quarter, we thought we would again squint into the distance, but this time with a twist. Here are five things that **won't** happen in 2011.

1. ***VCs will continue to take a conservative approach to evaluating the prospects (or lack thereof) of new investment opportunities, despite the euphoria caused by Facebook, Zynga, Groupon, Twitter and others in 2010.***
   - Unlikely. History tends to repeat itself. We anticipate seeing a combination of undisciplined VCs, hedge funds, strategic investors and angels in search of the next multi-billion dollar company. These investors may deploy capital based on a desire to appear trendy, a need to prove their ability to access "hot" companies and emotion rather than thoughtful analysis. This at least would partially explain the recent explosion of billion-dollar valuations for new financing rounds in the last 12 months (Facebook = $50 billion, Groupon = $15 billion, Zynga = $10 billion, Twitter = $8-10 billion). [1] This will lead to many over-priced "pre-IPO" rounds.
   - We do believe there are some disciplined managers that will avoid this pitfall.
2. ***Distressed funds will outperform.***
   - Nope. Spreads of corporate to junk bonds have tightened to historic lows. This makes it very challenging for distressed funds to put capital to work. We have seen a steady flow of distributions from our underlying distressed funds as they sell into the over-exuberant debt market. It is a seller's market; not a buyer's market. Distressed managers will have a hard time deploying capital while also meeting their return targets if these conditions continue.
3. ***Discounts on secondary private equity fund sales will widen and investors in secondary funds of funds will jump for joy.***
   - Uh-uh. Given the run-up in the public market, sellers are much less stressed as their "denominator effects" wane. While there may be some opportunistic selling like CalPERS's recent $800 million sale of mega buyout funds, we expect the tens of billions of dollars waiting to be deployed by secondary managers will drive prices back toward reported Net Asset Value (or even slightly above that for strong portfolios).
   - In fact, a recent study showed pricing for buyout funds reached 90% of NAV in the 2H 2010, compared to 86% in 1H 2010. [2] The trend continues upward, based on first-hand observations—pricing for a certain well-known fund is reaching 98% of NAV. Maybe it is time to sell those secondary funds on the secondary market and redeploy capital into higher returning categories.
4. ***Venture capital will see record fundraising and new fund formation.***
   - We haven't seen this little interest from investors in the venture capital asset class since the period following the bursting of the dot com bubble. VC fundraising dropped in 2010 by over $4 billion from 2009—the fourth straight year of falling interest in the sector.[3] Given the uncertainty caused by the passage of the 2010 health care bill and an FDA that views safety as its one and only goal, there is very little interest in healthcare VC funds. Given meager average returns over the

last decade for tech firms, especially early stage tech firms, the fundraising trail will be arduous.

- Mark Heesen, President of the NVCA, recently said, "Given current conditions, a limited number of venture firms will be able to successfully raise new funds in 2011 and many of these will be smaller than previous funds raised."[3] We agree.
- Many venture capitalists are quietly looking for their next professional opportunities as it becomes obvious their firms will not be able to raise new funds. While groups like Kleiner Perkins can still raise a fund by snapping their fingers, most firms will struggle this year to get to a first closing.

5. ***Distributions will remain at an anemic pace.***
   - Distributions will actually rise for the following reasons:
     - Strategic acquirers are sitting on hoards of cash. Non-financial companies in the S&P 500 have nearly $800 billion in cash on their balance sheets.[4] The M&A bankers are very happy as the strategics have money to spend and are seeking to grow through acquisition.
     - Buyout funds are reaching the ends of their investment periods and still have plenty of committed capital to put to work. According to Cambridge Associates, the overhang in the U.S. is in excess of $400 billion.[5]
     - Like venture firms over the last few years, many buyout firms were unable to raise new funds due to lack of demand for illiquid assets after the credit crisis. There will be a large number of venture and buyout firms vying for the attention of investors this year—as many as 1,800 this year by our count! Venture and buyout firms know they need to show exits from past funds if they hope to be well positioned to raise new funds. Increasingly, exit strategies will include sponsor-to-sponsor deals. In fact, we have seen a large uptick in the number of sponsor-to-sponsor deals over the last several quarters. We expect this to continue throughout 2011.
     - The IPO window is pretty much open. Venture and buyout firms are taking advantage of this and getting liquidity for their LPs.
     - The average holding period for private equity companies has been elongated by the recession, adding to the pressure for firms to shop their portfolio companies now.

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[1] Wall Street Journal and New York Times
[2] Cogent Partners
[3] NVCA
[4] Capital IQ
[5] Cambridge Associates

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