Private Equity Partners | market update

Third Quarter 2009

Your Private Equity Allocation—Increase, Decrease or Maintain It?

Last fall, a number of factors caused investors to panic in an almost unprecedented way. Fueled by such events as the collapse of Bear Stearns, the U.S. government's explicit takeover of Fannie & Freddie, Lehman Brothers' bankruptcy filing, AIG's bailout, distress in the auto industry and the House's rejection of the $700 billion TARP plan (causing the Dow to drop 778 points on 9/29), the credit markets locked up and the stock market began a dramatic decline.

Safety and liquidity became the only two things that mattered in those first few months. Many investors chose to accept a negative return in exchange for the safety and liquidity of Treasury Bills. In some cases, investors were told by their advisors to throw out the old playbook; that 100 percent cash was the new asset allocation. Talk of a financial Armageddon was ubiquitous. One quip that properly captured that sentiment was "put everything into gold, guns and canned goods." We can muster a laugh about that today, but clearly emotions were running high and the fear being felt was real.

As we now of course know, the decline in the S&P 500 bottomed on March 9 at 676.53, down 47 percent from the August 29 close. Today, the S&P 500 sits just above 1,000. Investors that panicked and sold near the bottom typically locked in losses and missed roughly a 50 percent rise in U.S. stock markets. Many lessons on diversification, correlations among asset classes and hedging strategies were learned from this horrific period. Another big lesson: don't change your allocation strategy in the midst of a panic.

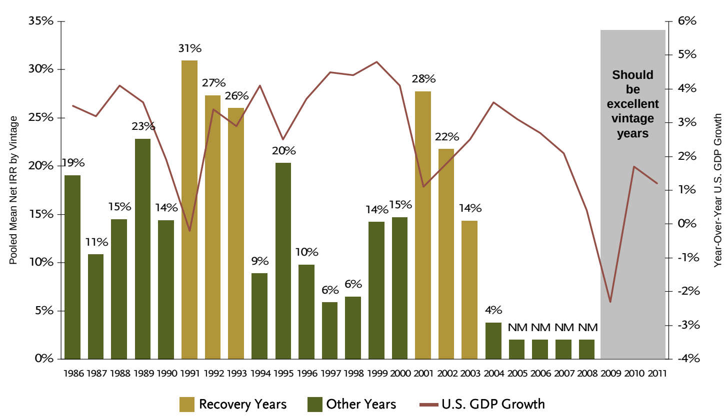
Now that capital markets appear to have stabilized, many investors are reviewing their allocation strategies and trying to apply some of the lessons learned since last September, as they should. As private equity managers, we thought this quarter's commentary should address the current opportunities within various private equity subsectors and related allocation issues.

Some of this is obvious, however to ensure investors' actions match their beliefs and long-term goals in times like these, it may require a little repetition (and perhaps even stating those beliefs out loud at your next investment committee meeting). Clearly, with money market funds paying a scant 1.5-2.0 percent, institutional investors must look elsewhere to achieve their investment goals and meet their spending commitments and actuarial assumptions (typically 5-9 percent). While some investors left their private equity allocation unfunded over the last tumultuous year or shifted a portion of the allocation to short-term opportunities within the sector (distressed or secondaries), we feel there is an opportunity now for investors to make new private equity allocations and should do so in earnest.

Why? The answer is in the adjacent graph, which for the time period reflected shows substantial returns follow recessions. This likely is because investing post-recession means you are buying at relatively low valuations due to entering the investment at a low point in an economic cycle and then selling at relatively high valuations at a higher point in the economic cycle. The objective of our managers is to grow each of their investments through active management and operating skills, rather than merely being the beneficiaries of good market timing, but it seems obvious to us that breaking from private equity during down times means missing the additional rocket fuel that post-recessionary economic expansion provides.

Post-Recession Years Have Provided Best Private Equity Vintages

Private Equity Returns by Vintage vs. U.S. GDP Growth



Sources: The Economist (GDP growth projections 2009-11); U.S. Department of Commerce (GDP data 1986-2008); Cambridge Associates LLC (U.S. Private Equity Benchmark Statistics as of March 31, 2009. Pooled mean net IRR to limited partners by vintage year. Based on data compiled from 768 U.S. private equity funds, including fully liquidated partnerships, formed between 1986 and 2008). Returns are net of fees, expenses and carried interest. Vintage year funds formed since 2005 are too young to have produced meaningful returns. Analysis and comparison of partnership returns to benchmark statistics may be irrelevant. Past performance is no indication of future performance or results.

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Where to Allocate Your Private Equity Dollars— A "Back to School" Overview

Buyouts:

Mega – Mega funds are investing in a very difficult environment today. First, they are burdened with ailing over-levered investments from 2006-2008 and these legacy problems reduce the resources available for new investments. Second, they are unable to obtain adequate debt financing to complete new large deals because there is no appetite for such deals in the syndication market, so they must move down market to find executable transactions. This will make the upper middle market space very, very competitive. Third, they are addicted to high management fees and, despite the difficult environment, could be incentivized to invest all their committed capital before the investment period expires to make the basis on which fees are calculated as big as possible. *Grade: D*

Middle market – Debt financing for middle market deals is hard to come by but less so than for large deals where the mega funds typically invest. To bridge the gap, middle market funds have needed to boost their equity contribution to each deal from 20-25 percent a few years ago to 35-50 percent (or higher) today. That change generally reduces the expected returns from this subsector. However, specialist funds may have an advantage over generalists, as specialists are more attuned to valuation changes in their areas of expertise and many of them were more active sellers than buyers as valuations marched toward their peak in recent years. This means specialists are less burdened with bad legacy investments and can focus on finding and securing great investments going forward. In addition, by definition, specialists are better equipped to add value post transaction and preserve value in economic downturns. *Specialist grade: B+; Generalist grade: C+*

Lower middle market – In our opinion, experienced lower middle market investors are in the best position to generate outsized buyout returns right now. Given the low leverage these funds typically use, surviving a tough economy is much easier when you have purchased a company for 6x EBITDA using 3x leverage than a typical 2007 mega deal purchased at 11x EBITDA using 7x leverage. So these firms may have fewer legacy issues than their bigger brethren. Further, debt for small deals historically has come from regional banks that have relationships with the target company or other specialized regional lenders. These regional sources have continued to lend and debt financing today is generally obtainable for most small deals. Anecdotally, we have seen very attractive deals getting done recently in this subsector. In addition, the universe of companies in the lower middle market is significantly larger than in the mid and large markets. In sum, a large number of potential targets, available debt, good valuations, some ability to source deals proprietarily and ability to negotiate favorable terms equals good hunting. *Grade: A*

Distressed:

Timing is everything in this subsector. Distressed managers tend to make great returns over brief periods of economic dislocation but then make lackluster returns in "normal times." So returns come in spurts and are hard to predict. Investments can also turn disastrous quickly if timing and assumptions are bad, as was the case for many distressed managers investing in 2H 2008 and early Q1 2009 who were counting on a shallower recession, a quicker recovery and avoiding bankruptcies. As the economy appears to have bottomed, we are seeing a much more attractive market for active, distressed-for-control managers who invest to turn companies around and build value over the course of a few years. However, distressed trading/passive-oriented managers are finding conditions more difficult as bond prices have rallied significantly (i.e., fewer fire sale situations where pricing quickly rebounds after the distressed manager buys in). In the current environment, we favor debt-for-control managers. There is still opportunity here, so this subsector deserves an allocation but not an overweighting. *Debt-for-control grade: B; Trader grade: C*

Mezzanine:

Recently mezz has been able to achieve equity-like returns, but we expect returns to moderate as soon as the big banks begin lending again. *Grade: B*

Infrastructure:

The lack of free flowing credit has created a void of capital in the infrastructure space. Any time there is a lack of capital, the return potential increases. Given the massive global stimulus, we see particular opportunity in CleanTech infrastructure such as wind farms, biomass, solar farms, etc. *Brownfield grade: B; Greenfield grade: A-; CleanTech grade: A*

Venture Capital:

Seed and early stage – Now is a great time for capital-efficient seed and early stage VCs. Innovative entrepreneurs are starved for capital (particularly at the seed stage) and VCs who are skilled at spotting the best investments are able to do so at low valuations and at reasonable terms. Given that the average holding period for these investments is now over 9 years, it is important to pick managers who understand the importance of investing in a syndicate of other capable and like-minded VCs who will support the company for the duration. *This holding period is also a big negative and keeps us from assigning a higher grade to this subsector.* Further, we would avoid early stage funds that are greater than $500 million in size because so many of them have struggled to return those big sums to their investors. We favor smaller funds because of their ability to pay back the entire fund with one or two successful investments. *Grade: B*

Late stage – We believe we are in the middle of a terrific vintage for late stage VC. There's a very large pool of high-quality VC-backed companies that were counting on the IPO window being open for them by now. In many cases, they are still burning through cash and will be forced to take another round of VC money before going public or selling out to an acquirer. Disciplined late stage VCs with strong pipelines of investment opportunities should do very well indeed, especially if the IPO window opens for them next year. *Grade: A*

Secondaries:

We wrote a cautionary report on the secondary market several months ago and our predictions only continue to come true (too much money chasing too few deals, very few deals getting done other than a handful of mega LBO fund deals and the buyers of those may have vastly overpaid—after all, what would you pay today for a portfolio of companies originally bought at 11x forward-looking EBITDA and burdened with 7x leverage … before the poor economy turned it into 10x leverage?). We are not so much patting ourselves on the back as we are continuing to sound the alarm that this is a vastly over-hyped subsector and that the advertised opportunity does not match reality. Please see our Q1 2009 commentary, Follow the Lemming. In addition to the points made there, we know that public pension plans and other non-traditional secondary buyers are now competing for the same deals as secondary funds of funds. Added competition further reduces returns expectations for this subsector. Further, we are not seeing big blocks of secondaries being sold to one buyer, as had been the case in the past where deep discounts had been granted to the buyer in exchange for the administrative ease of dealing with a single buyer. Instead, secondary partnership interests are being sold fund by fund in a sophisticated auction process to the highest bidder (e.g., the recent sales conducted by Harvard and Duke where each buyer paid up to gain access or increase its exposure to the one or two managers it highly desired). This forces secondary funds of funds to get "creative" and perhaps purchase things that might surprise their own investors like distressed debt and publicly traded closed-end vehicles that they perceive to be trading at a discount. Isn't that what you pay your hedge fund and distressed managers to do? Are you prepared to lose money on your secondary investment allocation? *Grade: D*

CleanTech:

We believe CleanTech will be the top growth sector over the next decade. That's a big statement, but we expect CleanTech innovation will fundamentally transform massive global industries like energy, transportation, construction, water and agriculture. Investment decisions in the sector center around the distinction between specialist and generalist managers. Many managers dabbling in the CleanTech market today as part of a broad technology investment strategy lack the deal flow pipeline necessary to identify the most promising CleanTech companies and the expertise to accelerate their growth. For managers with a specific focus on CleanTech, the potential for near- and long-term success is outstanding. *Early Stage CT grade: B; Late Stage CT grade: A; CT buyouts grade: B+ (and trending higher); CT infrastructure grade: A (see Infrastructure above)*

Conclusion

As private equity investors, we are finishing a decade with two "once in a lifetime" events: the burst of the dot com bubble early in the decade and the recent global financial crisis. Despite these shocks, history has shown the recovery years following a recession provide the best returns, meaning now is exactly the wrong time to pull back from private equity. In the current market, we favor managers in the following subsectors:

- lower middle market buyouts
- industry specialist buyouts
- distressed debt-for-control
- late stage VC
- cleantech specialists (not generalist VCs dabbling in cleantech)

Our funds of funds are designed to be nimble and target areas where we see the greatest opportunities in a manner that is consistent with the long-term nature of this asset class and a diversification strategy designed to mitigate risk. It should come as no surprise that these categories are precisely where we are allocating capital from our most recent fund, PEP IV.

Private Equity Partners IV Fundraising Update

Our LBO, Venture and CleanTech fund of funds offerings will remain open to investors through the end of 2009, as well as our late-stage CleanTech Co-investment fund. Investors may allocate their commitment to any combination of these four components. Please let us know if you have an interest in considering an investment in any of our funds and how we can help you in your due diligence processes. For additional information about PEP IV, please contact Gretchen Postula at 612 303-6331 or gretchen.s.postula@pjc.com.