

Fourth Quarter 2009

5 Private Equity Predictions for 2010

1. Secondary funds will disappoint investors

- Investing in secondary funds was all the rage in early 2009 – but the hype has far exceeded market reality. Given the big spread between buyers' and sellers' price expectations, the number of secondary transactions has been relatively small. Yet the management fee clocks on these funds keep ticking.
- And things recently got worse. As the equity and debt markets have rebounded, most potential sellers have been able to hang on to their private equity investments as their denominators improved (e.g. Stanford University). Others, like Harvard University, have smartly auctioned their private equity investments one-by-one to a throng of competing secondary buyers in order to maximize the value for each fund rather than selling them in a bundle to a single buyer at a steep discount, as typically had been done by sellers in the past. With estimates ranging from \$40-80 billion available for secondary purchases, we expect deep discounts to be few and far between in 2010.

2. Vintage 1999-2000 GPs will ask LPs for extensions (and more fees)

- The last ten years produced the dot.com bust AND the recent global financial crisis, resulting in 3-4 years of "lost time" for VC-backed companies, thus extending the time-to-exit and cash burn.
- Most 1999-2000 vintage funds are out of investment capital but many of their portfolios are still alive. As a result, we expect these GPs to seek additional time and capital to continue funding their remaining companies.
- Creative structures, such as annex funds and requests for sizable recycling provisions, will likely be suggested by many GPs. Any new investors added to these existing funds create conflicts of interest as value has to be re-allocated among the old and new investors. Some weary (and alert) LPs will suggest instead that the GPs step aside and hire investment bankers or liquidation professionals to sell the remaining companies over the next year or so. Other LPs will go with the flow and simply sign whatever amendments are sent to them.

3. FAS 157 will depress early-stage VC valuations

- Many early-stage VC-backed companies raised capital at relatively high valuations prior to the Lehman bankruptcy.
- In subsequent financings, many early-stage VCs have avoided down rounds by resorting to internal "bridge" investments, where the existing investor syndicate has more latitude to set the price and thus prop it up.
- FAS 157 will make it difficult for these VCs to avoid write-downs at yearend (or over the next few quarters) when their auditors begin to weigh in more aggressively regarding the progress of each company and the value that should properly be ascribed to each one given the tough economy and the valuations of comparable companies.

4. CleanTech VC dabblers will get burned

- Most tech-focused VCs have entered the CleanTech sector in search of the next lucrative investment theme.
- Not surprisingly, most of these VCs have arrived late to the party and have overpaid for companies, typically in follow-on rounds of companies that were originally found and financed by more experienced VCs. Witness the solar sector today. Solar is a tremendously big global market but can 100+ VC-backed solar companies all survive? We doubt it. We refer to these late-comers as dabblers and we expect their CleanTech portfolio companies will be forced to raise additional capital in 2010 at lower valuations than in previous rounds. This is not good news for their investors, who thought they could play the new CleanTech wave through traditional tech VC funds rather than through more experienced specialists.

5. Mezzanine will outperform

- In the recent boom, a vibrant second lien market emerged that provided cheap money to buyouts, largely displacing mezzanine financing in companies' capital structures. The second lien market was primarily driven by hedge funds who have since exited the business due to the economic downturn.
- Traditional bank financing is also less available today. The economic downturn has made banks extremely risk averse, resulting in low senior debt (leverage) multiples for even the most attractive transactions. We expect senior leverage multiples to remain low in 2010, meaning ultimately that less senior debt is available even for very strong companies.

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- Furthermore, anemic financial performance and escalating covenant hurdles will likely cause numerous companies to refinance their balance sheets in 2010. We expect the majority of these refinancings to occur at low senior leverage multiples (as mentioned above); therefore, mezzanine lenders will be well-positioned to bridge the gap with structures that provide high returns and relatively low risk.
- The stage therefore is set for mezzanine funds to not only resume their activities but play a more prominent role, with corresponding power to demand higher returns and better terms.

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Upcoming Events

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

- **January 12:** Strategic Investments Conference, Amsterdam Netherlands
- **January 20-21:** Clean-Tech Investor Summit 2010, Indian Wells, CA www.cleantechsummit.com
- **January 26:** Scott Barrington is speaking at the VerdeXchange's Green Marketplace Conference, Los Angeles www.verdexchange.org
- **January 25-26:** Made in American Conference, Las Vegas www.frallc.com/conference.aspx?ccode=b800
- **February 23:** Piper Jaffray Fifth Annual Clean Technology & Renewables Conference, New York www.piperjaffray.com/cleantech2010