

PRIVATE MARKETS *Trends*

A PUBLICATION OF CALLAN ASSOCIATES INC.

Winter 2004-2005

Year in Review

There have been significant economic and capital markets changes during the last two years, especially 2004. The economy and business environment moved from relatively bearish/cautious to more optimistic in 2003, and from optimistic to strong during 2004. Corporate earnings are increasing, and employment concerns have faded. The federal budget deficit, U.S. trade gap and falling dollar have become the new discussion items. While the fed funds rate has been increasing, credit markets remain open with low interest rates, and the public equities market has been both liquid and appreciating. The economy and business environment have moved beyond recessionary influences.

Funds Closed January 1 through December 31, 2004

Strategy	# of Funds	\$ Amt (mm)	%
Venture Capital	115	14,870	17.5
Acquisition/Buyouts	90	46,217	54.5
Subordinated Debt	17	4,348	5.1
Distressed Debt	9	7,698	9.1
Other	15	5,594	6.6
Fund-of-funds	34	6,023	7.1
Totals	280	84,750	100.0

Source: *The Private Equity Analyst and Buyouts*

The past year saw major positive changes on all fronts in the private equity market, with the fourth quarter solidifying the marked turnaround. Fundraising increased for the first time in three years. Buyout investment activity set all-time records for new company investments, and venture capital investment activity was brisk. Company valuations are on the rise and institutions with established private equity portfolios saw large cash distributions during the year.

Looking Ahead

Looking to 2005, we expect continued moderate growth with favorable conditions in the U.S. and global economic and business environment. The private equity market is clearly entering a mid-cycle phase. Fundraising is officially booming. Pricing for corporate finance and venture capital transactions are increasing to historical mid-range levels. The capital markets are quite liquid, which foster both entry and exit for private equity investments, but also leads to more competition.

Regarding exits, the initial public offerings (IPO) market has been very active for good quality companies. The merger and acquisition (M&A) market is expected to be very robust throughout 2005. After a long hiatus, large companies (i.e., the Fortune 1000) are beginning to shift from cost-cutting and selling assets to initiating growth plans and making acquisitions. While somewhat nascent at this point, the return of strategic buyers should mean that long-held portfolio companies will finally find exits.

A large limited partner overhang of uncommitted capital has developed due to the slow partnership investment environment over the past several years and total fund valuation increases from good public markets performance. An echo-boom from the bubble era appears to be developing as the business cycle lengthens and prices paid for companies continue to rise. The key risk now is an overheating of the market.

Private Equity Fundraising

Well-established general partners began to return to the market to raise new funds during the second quarter of 2004. As seen in the table, a total of \$84.8 billion and 280 funds were raised in 2004—up from \$43.9 billion and 157 funds last year—ending a precipitous three-year decline. The fourth quarter was particularly strong, producing 54% of the year's capital commitments and 58% of the number of partnerships. Expectations are that 2005 will significantly exceed 2004.

Venture Capital

Venture capital commitments were about double 2003, at \$14.9 billion. As a percentage of the market, venture capital's 17.5% remained well below its historical average of about 30% of new dollar commitments. Most venture capital groups are raising much smaller funds—in the \$200 million to \$400 million range—so competition to participate in these funds is fierce. A number of larger plan sponsors are beginning to revisit the size of their strategic venture allocation targets as this reduction is being viewed as a potentially permanent shift.

According to VentureOne, venture capitalists invested \$4.5 billion in companies during the fourth quarter of 2004, with the year total being \$20.4 billion in 2,067 rounds of financing. The annual total represents a small increase from the \$18.2 billion invested last year. An investment rate of about \$20 billion has been steady for the past three years and has continually outpaced new commitments. According to the MoneyTree survey, the \$2 billion increase was due to more late-stage financing, as a large number of portfolio companies are maturing. Investment in earlier-stage companies remained steady. Information Technology (IT) companies received 55% of the new investment, Healthcare received 32% with other sectors such as Retail and Business Services accounting for 13%.

According to Thompson Financial, there were 249 IPOs in the U.S. during 2004, up from 73 last year. Of these, 67 were by venture-backed companies that raised a total of \$5 billion, up from 29 venture-backed offerings and \$2 billion in 2003. Healthcare sector companies put in an unusually strong showing, with 39 offerings (58%) accounting for 42% of the proceeds. While there were only 16 IT IPOs, the Google

continued on reverse



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offering of \$1.2 billion boosted IT's share of the proceeds. At year-end, there were 28 venture-backed companies in registration to go public, so 2005 is looking strong.

There were 376 venture-backed M&A transactions in 2004 valued at \$22.6 billion, up from 289 venture-backed M&A deals in 2003. The median value of the deals rose to \$40 million in 2004 from \$23 million in 2003.

Buyouts

Buyout fundraising about doubled in 2004 from 2003's trough. Ninety funds and \$46.2 billion in commitments were raised versus last year's 51 funds and \$22.1 billion. Funds across the size spectrum received strong interest.

The investment pace by buyout general partners in new portfolio companies set an all time record. The \$136.5 billion in buyouts with disclosed prices during 2004 was 45% higher than 2003's \$94 billion investment rate. *Buyouts* newsletter counted 773 individual deals during the year with only about half providing values.

Transaction multiples and prices continued moving up, particularly for larger companies, according to *Buyouts*. Average multiples for larger companies increased to 7.7x EBITDA for larger companies from 7.3x in 2003. Smaller companies remained in the 6.8x range.

Regarding exits, buyout-backed companies also found good reception in the public markets in 2004. There were 52 buyout-backed IPOs that raised \$10.3 billion in the public markets, up from only 17 buyout-backed companies raising \$3.4 billion in the equity market in 2003.

Obviously there is a lot of conviction and momentum in the buyouts arena. Corporate America is exhibiting revenue growth and predictable profitability. Debt capital for financing is cheap and easy to arrange. According to *Buyouts*, the debt multiples of leveraged transactions jumped from 5.2x operating cash flow (EBITDA) in 2003 to 6.0x or more in 2004. Now that prices have recovered to the mid-range of historical norms, sellers are willing to do business.

Other key trends that Callan is seeing in the buyouts market is growing interest in European funds. Returns have been strong from European funds throughout the U.S. downturn. Structural changes resulting from an integrating Eurozone and global competitive pressures are forcing restructuring and creating buying opportunities for financial purchasers. The coming year is expected to set an all time record for fundraising by European groups.

There have been a number of instances where hedge funds have entered the competition for buyouts. Whether this becomes a growing trend remains to be seen—the larger hedge funds are under increasing pressure to seek higher returns, but the illiquidity of buyout investments could be problematic for these open-ended vehicles.

Finally, the “leveraged recap” phenomenon that started in 2003 has continued, which involves releveraging portfolio companies in the high yield market and using the proceeds for cash distributions to investors without selling assets. This has the beneficial effect of “taking money off the table” and locking in early cash returns to investors, but introduces more risk into the portfolio and does not constitute a true exit.

Subordinated Debt

Subordinated debt funds raised \$4.3 billion of commitments and 17 new partnerships in 2004, up from \$3.6 billion in 2003. Most were

mid- to small-market-oriented, with the largest being the captive WCAS Capital Partners IV fund of about \$1.5 billion. Generally, there is a growing concern among investors about increased competition and lower pricing as the credit cycle advances and standards become more relaxed.

Distressed Debt

In 2004, \$7.7 billion and nine funds were raised pursuing various distressed and restructuring strategies. The U.S. high yield default rate for 2004 fell to 1.5% according to Fitch Ratings, down from 5% last year. The benign economic environment and ability of even poor-credit-quality companies to refinance has greatly reduced the investment opportunities in this market for the time being.

Real Estate

Private real estate produced strong returns again in 2004. As represented by the NCREIF Property Index, private real estate returned 4.66% for the quarter and 14.48% for the year. The income component was 7.46% for the year and appreciation was 6.67%. The fourth quarter income return was 1.77% with appreciation of 2.89%. Publicly-traded Real Estate Investment Trusts (REITs) closed out 2004 with a bang. The NAREIT Equity Index returned 15.23% for the fourth quarter and 31.58% for the year.

The retail sector continued to outperform all other real estate asset-type classifications, both public and private. The success of retail is being driven by strong consumer spending and higher rental income. The public sector, as measured by the Regional Mall slice of NAREIT, rose 7.62% for the fourth quarter, bringing the year-to-date return to an outsized 45.01%. The private retail sector, as measured by NCREIF, gained 7.83% for the quarter.

Given the sustained high returns of the past several years, real estate continued to attract massive capital flows. Many managers have investment queues for new investors. The demand was especially rewarding to owners and sellers of well-leased core assets, which created lofty appreciation gains. Capitalization rates reached historical lows in 2004 and are compressed to a point where many institutions have been forced to shelve new investments or lower cash-yield return expectations in policy guidelines.

Tenant demand remains positive and vacancy rates are showing improvement in all asset types as of year-end. With the nation's economy beginning to shift from a consumer-led expansion to a business-led expansion, the expectation is that business-driven property types, such as office and industrial, will benefit.

Did You Know...

Callan can act as an “extension of staff,” assisting with all aspects of private equity and real estate portfolio planning, implementation and monitoring. Examples would include state-of-the art policies and procedures, and portfolio structures; tactical plans for near term improvements; selection and monitoring of private equity and real estate managers; and evaluating performance. For private markets inquiries, contact your Callan Consultant, or Gary Robertson or Jamie Shen at 800.227.3288.