

PRIVATE MARKETS *Trends*

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Private Equity Fundraising

Private equity fundraising in the first quarter of 2004 started at a faster pace than last year. The first quarter run rate is more than double last year's both in number of partnerships and capital commitments. However, 2003 likely represents the trough of post-Bubble fundraising, so 2004 may not be large in absolute terms.

There is strong demand for high quality partnerships as many new limited partners have entered the asset class over the past few years. This has created a sizeable "limited partner overhang" when combined with longstanding private equity investors continuing to make sizable investments. The substantial rise in public market valuations since March 2003 greatly increased the size of private equity allocation targets in absolute dollars.

While plan sponsor demand has increased significantly, the supply of established, high-quality private equity managers has been insufficient. Most groups presently seeking to raise funds are new, less-tenured managers that do not represent material commitments in institutional portfolios. Next year (2005) is expected to be the beginning of a very active fundraising period when many established managers that raised capital during the Bubble will be returning to market.

The first quarter venture capital figures are especially robust considering that most groups approached the market with significantly reduced fund sizes from the 1999 to 2000 time-frame. A majority of the commitments went quickly (and quietly) to a few well-tenured firms.

Funds Closed January 1 through March 31, 2004

Strategy	# of Funds	\$ Amt (mm)	%
Venture Capital	20	2,922	30%
Acquisition/Buyouts	9	2,476	26%
Subordinated Debt	3	827	9%
Distressed Debt	0	0	0%
Other	4	576	6%
Fund-of-funds	8	2,808	29%
Totals	44	9,609	100%

Source: *The Private Equity Analyst and Buyouts*

In the buyout sector, there is a notable lack of billion-dollar funds, with a large number of more modestly sized funds seeking capital to invest in mid- and small-market portfolio companies.

Private Equity Market Environment

The rate of investment by private equity funds in companies is proceeding at a very healthy pace. According to *Buyouts* newsletter, there were 117 buyout transactions in the first quarter with disclosed valuations of \$15.5 billion. The number of transactions is similar to last year's first quarter, but about \$4.5 billion less in total value.

The venture capital investment rate is steady and healthy according to *VentureOne*, with \$5.1 billion being invested in 465 deals in the first quarter—up about \$1 billion from a year ago. Late-stage venture investments absorbed almost half the capital. Healthcare continued a strong showing, representing about 36% of dollars invested.

Positive economic trends are driving valuation increases, both for new investments in companies and in client portfolios. *VentureOne* reports that median prices for new venture capital rounds have been increasing for three quarters, with the first quarter 2004 median price of \$13.7 million being \$1.6 million higher than the fourth quarter of 2003.

Improved company earnings and easy credit are also nudging up prices in the buyouts sector. Callan is seeing higher valuations being reflected in client portfolios as well. Even portfolios that began right before the Bubble (1998 and thereafter) are showing break-even to slightly positive returns.

Distributions to investors, while not strong, are also increasing. A recent phenomenon in the buyout sector is high yield recapitalization, or "recaps." The high yield market has been very accommodative to new issuance at low rates and at low credit quality. Many buyout portfolio companies have floated relatively large high yield issues that replace a portion of the more restrictive bank financing and still have capital left over to pay a special dividend to investors. The general partners view recaps favorably because capital is returned to investors (boosting IRR) while full ownership in the companies is retained. Investors always appreciate distributions; however, recaps are not generally considered true realization events, as aging company investments are releveraged and still need to be exited profitably.

While the merger and acquisition markets are becoming more active, strategic buyers have not yet returned in force. As buyout firms seek exits in a market with limited natural buyers, the industry is seeing an increase in company sales from one buyout firm to another. While this has happened

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periodically in the past, the increase is causing some discussion among investors because, theoretically, the first buyout owner should have maximized the efficiency and prospects for the company. These transactions will be watched closely, especially where limited partners are investors in both funds and the company is essentially cross-traded within the portfolio. The return of strategic acquirers is anticipated in the near future, both as a positive for general partners looking to exit investments, and as an issue because competition will increase for new acquisitions.

As reflected in recent returns (see next section), capital markets in general, and private equity specifically, are becoming more liquid. Underlying portfolio company investments, benefiting from the economic recovery, are beginning to grow and become more profitable. Barring any exogenous shocks, the sentiment in the private equity industry is quite positive, especially looking forward to 2005.

Private Equity Returns

Venture Economics recently published its annual update of private equity returns (see table). Returns rebounded considerably during the year. The one-year return for the broad Private Equity Performance Database swung from -11.0% the previous year to a positive 18.3% for calendar 2003. These are pooled returns representing a capitalization-weighted return of all the funds in the database. Plan sponsors with professionally managed investment programs should achieve better results. We have incorporated some public stock index comparisons. Although the public and private return calculations differ in methodology, over longer time periods the return figures from the two calculations should converge, making the comparison reasonable.

Private Equity Performance as of December 31, 2003

Strategy	1Yr	3Yrs	5Yrs	10Yrs	20Yrs
Venture Capital	-8.1	-18.9	22.8	25.4	15.5
Buyouts	24.1	-2.1	2.2	7.8	12.4
Mezzanine	5.7	1.1	5.6	7.3	9.6
All Private Equity	18.3	-7.0	6.8	12.7	13.6
<i>Public Markets</i>					
S&P 500	28.7	-4.1	-0.6	11.1	13.0
Russell 2000	47.3	6.3	7.1	9.5	10.2

Source: *Thompson Venture Economics/NVCA*

Note: Private equity return calculations are internal rates of returns (IRR); public return calculations are time-weighted.

At this point, long-term returns (10 and 20 years) between public and private returns are compressing. Because private returns tend to lag public stock trends (as seen in the one- to five-year figures), the return premium spread for private equity can be reasonably expected to widen again.

Business Development Companies

In early April, Apollo Advisors raised \$930 million in a public offering of a Business Development Company (BDC) that will focus on mezzanine debt investing. BDCs are publicly traded, closed-end, registered investment companies regulated by the SEC. There are at least two other well-known BDCs in existence, Allied Capital and American Capital Strategies. The Apollo offering has given rise to at least 10 other registrations for similar vehicles by

prominent private equity general partners, and a fair amount of controversy and discussion.

The controversy has to do with fees. The terms of the new BDCs call for a 2% management fee on total assets (equity and debt) and a 20% performance fee on income and gains. A BDC can double its size with debt. After the terms were vetted, two investment banks, Goldman Sachs and Morgan Stanley, stated that they would not participate in offerings, but others are lining up. BDCs are also causing discussion about the fate of institutional mezzanine funds. The BDCs, if formed, will be competing for much of the same opportunity set as traditional mezzanine providers (with some restrictions), but may be managed with a presumption of a lower cost of capital. Further developments merit watching.

Real Estate Capital Surplus

Real estate continued to be in high demand during the first quarter of 2004. Capital flooded into the markets and drove performance. Both the public and private real estate sectors continued to see interest, particularly in stable, well-leased "Core" strategies.

Institutional investors in Core open-end commingled funds earned returns similar to the NCREIF Total Property Index which produced 2.56% for the quarter and 9.72% for the trailing 12 months. Both the income and appreciation components of return have been consistently positive in every quarter for the past year generating 7.84% income and 1.77% appreciation returns. The strong demand combined with a low interest rate environment put upward pressure on property prices, even though fundamentals such as low lease rates and high vacancy rates were poor. Investors continued to use low-cost debt, creating a competitive buying environment especially for properties with Core characteristics.

The public real estate markets experienced record-level fund flows of more than \$3 billion to real estate investment trust (REIT) mutual funds by institutional and retail investors. These investors were rewarded with 12.56% returns for the quarter and 52.57% for the trailing 12-month period. Additionally, closed-end real estate securities funds raised approximately \$2 billion for the three-month period compared to \$4.5 billion raised all of last year. The abundant capital inflows to the public sector drove REIT share prices above their underlying Net Asset Value.

Retail outpaced all other sectors for the quarter. In the public markets (NAREIT), Retail returned 18.87%. In the private markets (NCREIF), Retail advanced 3.00% for the quarter. The sector continued to see high tenant demand and rising asking rents from the previous year.

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