

Private Markets Trends



WINTER 2009–2010

YEAR IN REVIEW

The public capital markets started to rebound in early March 2009 and GDP growth resumed in the second half of the year. However, the unemployment rate continued to rise throughout the year, albeit at a decreasing (but still substantial) pace. Although the Great Recession is officially over, the U.S. and other developed world economies are far from a state of good health. The public capital markets' price rebound and search for stabilization in 2009 benefited private equity returns, which turned positive in the second quarter. Nonetheless, illiquidity in the private equity market increased during the year as capital flows continued to slow across fundraising, new company investment, and company exits.

Private equity returns, as measured by the Thomson ONE Private Equity Database, continued a negative trend in the first quarter of 2009 (-3.6%) but rallied in the second (+5.7%) and third (+6.4%) quarters. The fourth quarter returns will not be released for several months, but are expected to be positive.

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LOOKING AHEAD

The private equity environment in 2010 is expected to be slow, but improving. The profitability outlook for companies is recovering as a result of cost cutting and excess inventory reductions, which help to stabilize valuations. However, until a recovery in employment gains momentum, the consumer-driven U.S. economy will not have strong fundamental growth.

Continued problem loan assets and the uncertainty surrounding potential new governmental regulation are continuing to affect financial institutions and their willingness to lend. While some credit markets have rebounded (e.g., high yield) and secondary bank loans are now trading around 90 cents on the dollar, the level of new credit issuance that is necessary to support an active private equity market is unlikely to return in 2010.

Price multiples for attractive, financeable companies, while not at distressed levels, are now sensible by historical measures. Additionally, current investments are being completed with conservative capitalizations and at trough earnings. General partners have also renewed their investment discipline and are exercising caution. When growth ensues and liquidity returns, it is likely that returns will be appealing for the relatively small number of investments being made currently and during the next few vintage years.

The *Private Markets Trends* is published quarterly by the Callan Investments Institute for professionals of the institutional investment community. The *Private Markets Trends* discusses the market environment, recent events, performance and other issues involving private equity.

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About the Callan Investments Institute

The Callan Investments Institute, established in 1980, is a source of continuing education for those in the institutional investment community. The Institute conducts conferences and workshops and provides published research, surveys and newsletters. The Institute strives to present the most timely and relevant research and education available so our clients and our associates stay abreast of important trends in the investments industry.

About Callan Associates

Founded in 1973, Callan Associates Inc. is one of the largest independently owned investment consulting firms in the country. Headquartered in San Francisco, Calif., the firm provides research, education, decision support and advice to a broad array of institutional investors through five distinct lines of business: Fund Sponsor Consulting, Independent Adviser Group, Institutional Consulting Group, Callan Investments Institute and the Trust Advisory Group. Callan employs more than 170 people and maintains four regional offices located in Denver, Chicago, Atlanta and Florham Park, N.J.

Callan is encouraging clients to maintain a backlog of private equity commitments, so that investable capital is available as activity increases and an upturn begins in earnest. Similarly, now is the best time in many years for plan sponsors without private equity programs to launch a new allocation.

PRIVATE EQUITY FUNDRAISING

As expected, 2009's fundraising total dropped precipitously from 2008. The \$95.9 billion of commitments in 2009 is only 36% of last year's total of \$267 billion, with 28 fewer funds being formed. This is the lowest fundraising total since 2003's \$70 billion. Mega-funds found few takers, as evidenced by the large drop in the year's dollar volume of commitments compared to only a 6% reduction in number of funds formed.

Funds Closed January 1 through December 31, 2009

Strategy	# of Funds	Amount (\$ mil)	%
Venture Capital	123	13,162	14%
Acquisition/Buyouts	104	39,552	41%
Subordinated Debt	20	3,262	3%
Distressed Debt	30	14,206	15%
Other	21	17,451	18%
Fund-of-funds	37	8,282	9%
Totals	335	95,915	100%

Source: *The Private Equity Analyst*.

In the fourth quarter, fundraising increased modestly with \$19.5 billion of commitments and 75 new funds formed. This represents a \$3.8 billion (17%) increase over the third quarter, with six additional funds. Similar to last year, the fourth quarter was not the largest, which is unusual as there is normally a rush to finish year-end business.

By strategy, the only category to increase compared to last year was "Other," which is almost entirely composed of secondary funds. Secondary

funds were a key theme for investors during 2009. While \$17 billion is not large in the context of the private equity marketplace, it was a record year for secondary fundraising. There is an estimated \$35 billion of undeployed secondary commitments seeking investment, which should approximate available supply based on historical transaction volumes. Distressed debt remained popular in 2009 receiving 15% of commitments, although the strategy is down from almost \$50 billion raised in both 2007 and 2008. Subordinated debt also experienced a large drop from the \$40 billion raised in 2008. Venture capital was down 55% from the \$29 billion and 204 funds raised in 2008, but the strategy maintained a double-digit market share of new capital raised.

In European fundraising, *The Private Equity Analyst* recorded \$30.4 billion in new commitments across 127 funds, down 75% from \$124 billion in 2008. Buyouts was the dominant strategy with \$20 billion in new commitments. The next largest categories were mezzanine and venture capital, raising \$3.4 billion each. The European private equity market is experiencing greater difficulties than the U.S. market due to higher pricing, a greater concentration in buyouts, and more leverage at the peak of the recent bubble.

Callan anticipates that fundraising will continue to be slow in 2010. Most well-established general partners have raised funds in recent years that are undeployed and will be invested slowly. Although many institutions are feeling better about their liquidity position after 2009's rally in public securities, there will be fewer tenured partnerships in which to invest. Commitment amounts and fund sizes will remain smaller given the still-cautious market environment.

MARKET ENVIRONMENT

Venture Capital

Venture capital fund commitments and fund sizes continued to contract during 2009, with most new funds collecting less than \$300 million during the year. Total venture capital commitments for 2008 declined \$8.4 billion from 2007's total. According to *The Private Equity Analyst*, the three funds that raised the most capital during the year were NEA XIII (\$1.2 billion), Norwest XI (\$1.2 billion), and Kosla III (\$800 million). A number of top-tier early stage funds did well with smaller targets. For example, Matrix IX and Charles River XIV quickly secured \$450 million and \$320 million, respectively.

Capital efficiency has become a theme for new venture capital investments due to the expectation of more modest exit multiples in the future. The U.S. IPO market for small companies—where the strongest venture returns have been made—now labors under structural impediments, such as Sarbanes-Oxley, imposed after the tech bubble. On a percentage basis, venture capital's share of total private equity commitments for the year increased to 15% in 2009 from 9% in 2008, primarily due to the severe decline in buyouts and other larger-cap strategies.

According to the National Venture Capital Association (NVCA), venture capitalists invested \$5.0 billion in 794 companies during the fourth quarter of 2009, and \$17.7 billion in 2,795 rounds of financing during the year. The fourth quarter represented a slight decline of \$83 million (2%) in dollar volume from the third quarter, but the number of investments increased by 105 rounds or 15%. The year's total dollar volume declined by

\$10.3 billion (37%) from last year and the number of investments for the year declined by 1,190 (30%) from 2008's total. Per the NVCA, 2009 had the lowest annual venture capital investment rate since 1997. Although company investments declined for the second straight year to a 12-year low, the investment rate still exceeded capital raised by \$4.5 billion. The continued wringing of capital from the strategy since the tech bubble should bode well for future returns.

The following two tables show the financing totals for the entire year by industry and stage. Overall, Information Technology-related sectors received 45% of the quarter's new capital, Health Care 35%, Business/Industrial 17%, and Consumer/Retail 3%. Health Care investments increased by 6% of overall dollars invested in 2009 compared to 2008, funded by declines of 3% in both Technology and Business/Industrial.

2009 Venture Investments by Industry

Industry (\$ mil)	# Rounds	\$ Invested	%
Technology	1,543	8,040	45%
Health Care	748	6,147	35%
Business/Industrial	365	2,923	17%
Consumer/Retail	112	534	3%
Other	27	36	0%
2009 Annual Totals	2,795	17,680	100%

Source: Thomson Reuters/NVCA.

By industry sub-sector, Biotechnology and Software received the largest dollar funding during the quarter with \$1.0 billion invested in 180 rounds of financing and \$959 million in 177 rounds, respectively.

2009 Venture Investments by Stage

Development Stage (\$ mil)	# Rounds	\$ Invested	%
Start-up/Seed	312	1,650	9%
Early-Stage	883	4,627	26%
Expansion	801	5,484	31%
Later-Stage	799	5,919	34%
2009 Annual Totals	2,795	17,680	100%

Source: Thomson Reuters/NVCA.

By maturity, expansion and later-stage investments garnered about 65% of capital investment in 1,600 rounds of financing in 2009. Start-up and earlier-stage companies received 35% of capital in 1,195 rounds. Earlier-stage investment increased by about 12% of dollars invested in 2008, indicating a significant tilt toward newer and start-up companies in 2009. During the fourth quarter, later-stage investments garnered about \$3.1 billion of capital investment (61%) in 426 rounds of financing, with earlier-stage receiving \$2.0 billion (39%) in 368 rounds.

Venture capital exit statistics for the past four years are seen in the table below. Liquidity in the venture capital industry in 2009 was essentially unchanged from an abysmal 2008. While the number and dollar volumes of IPO's increased in 2009, the number and disclosed dollar volume of M&A exits decreased by an offsetting amount.

Venture Capital Liquidity

Exit Type	2006	2007	2008	2009
Private Exits (\$ mil)				
Total Number of M&A Deals	375	378	348	262
# Deals w/ Disclosed Values	163	167	119	85
Total Disclosed M&A Value	18,910	29,312	13,677	12,255
Public Exits (\$ mil)				
Number of IPOs	57	86	6	13
Total Offer Amount	5,117	10,326	470	1,942

Source: Thomson Reuters/NVCA.

According to Thomson Reuters, 13 venture-backed companies raised a total of \$1.9 billion in the IPO market during 2009. While this is an increase from the six venture-backed IPOs and \$470 million raised in 2008, the public markets were illiquid compared to volumes several years ago. There were no venture capital-backed IPOs in the depths of the downturn in the fourth quarter of

2008 or the first quarter of 2009. The largest IPO of the year was A123 Systems, Inc., founded by North Bridge and Sequoia, raising \$380 million. The second largest was DigitalGlobe, Inc., offering \$279 million, founded by Alta Partners and Technology Venture Investors. The fourth quarter turned in a strong showing with five IPOs raising \$649 million.

Thomson Reuters recorded a total of 262 venture-backed M&A deals with 85 disclosing values of \$12.3 billion, a decline from 2009's 348 total deals, with 119 disclosing values totaling \$13.6 billion. Fourth quarter M&A activity totaled 67 deals with 36 announcing values totaling \$7.7 billion—more than half the year's total. The largest private sale with an announced value was Amazon.com's purchase of online shoe retailer Zappos.com for \$930 million. Early Zappos.com investors were Venture Frogs and Draper Richards, with Sequoia and Millennium Technology Ventures coming in on later rounds.

Buyouts

According to *The Private Equity Analyst* newsletter, buyout fundraising totaled \$20 billion for the year, with 57 funds being formed.¹ This represents a decrease of 79% from the \$97 billion and 98 funds formed in 2008. Hellman & Freidman VII was a standout, quickly raising its \$8.8 billion fund within the year. According to *The Private Equity Analyst*, the next largest corporate finance fund raised within the year was TA Associates XI, in the growth and expansion strategy, for \$4 billion. Only five other funds raised more than \$2 billion in 2009, as institutional investors scaled back on

¹ These figures are larger than the Acquisition/Buyouts category total in the Funds Closed table because they include Distressed Debt, which is broken out separately in the table.

their exposure to large and mega funds. Small and middle market funds were of the most interest in the buyouts strategy, likely given greater confidence in their ability to pursue and close smaller, lower-leveraged deals.

In 2009, the investment pace by buyout funds into companies fell precipitously both by dollar amount and number of transactions. The year produced a total of \$34.7 billion in buyout transactions that disclosed values, and a total of 530 investments. The announced dollar volume dropped 75% from the \$137 billion in 2008, which had 872 total transactions. For the fourth quarter, the investment pace by funds into companies fell by the number of deals, but increased by dollar amount compared to the third quarter. According to *Buyouts* newsletter, buyout-sponsored U.S. acquisitions with announced values totaled only \$20.2 billion during the fourth quarter, with total transactions closed numbering 98. The fourth quarter's dollar volume was a step up from the \$3.8 billion in the third quarter, but a drop from the previous quarter's 144 transactions.

Half the dollar volume in the fourth quarter was the \$11 billion purchase out of bankruptcy of the automotive parts company Delphi Corp., which was the largest transaction of the year. The year's second and third largest were the purchase of Busch Entertainment by Blackstone for \$2.7 billion, and Skype Technologies for \$2 billion by a consortium of four investors including Silver Lake, Index Ventures and Andreessen Horowitz. The Busch and Skype transactions also closed in the fourth quarter.

Buyout Transactions with over \$50 Million EBITDA

Yearly Average	2009	2008	2007
Purchase Price Multiple (x EBITDA)	7.9x	9.5x	9.8x
Senior Debt Multiple (x EBITDA)	3.2x	4.4x	5.6x%
Senior Debt % of Capital Structure	32.9%	37.1%	51.1%
Equity Contribution % of Capital Structure	46.5%	38.3%	30.3%

Source: Standard and Poors Leveraged Data and Commentary, *Buyouts*.

The above table shows Standard & Poor's statistics quantifying the changes in the buyout financing markets that have occurred during the downturn. The average price for large buyout transactions (those with over \$50 million of EBITDA) fell to 7.9x EBITDA in 2009 from 9.5x in 2008. The 7.9x figure is still considered pricey, especially compared to the low of 6.1x that was achieved during the prior trough that occurred in 2001. During the previous recession, average prices fell below 7.0x for three consecutive years. While prices have been stubbornly high, financing dynamics have shown significant changes. Senior debt availability has dropped from over one-half to only one-third of company purchase prices, and equity contributions have jumped to almost half the capital structure on average.

Buyout exit activity remained slow for the fourth quarter and the year, although the fourth quarter did pick up for buyout-backed IPOs. *Buyouts* reports 195 M&A exits occurring during 2009 with 51 announcing values totaling \$39 billion. The number of private exits was down from 252 last year, when the announced dollar volume was also \$39 billion. Most of the announced value was associated with the sale by TPG and Goldman Sachs of their holding in Alltel Corp. to Verizon Wireless for \$28.1 billion. There were only two other announced values that topped \$1 billion. One was Cerberus' exit of Chrysler via a sale to a consortium including the U.S. Treasury, Fiat SpA,

and the Canadian government for \$2.5 billion. The other was the sale of a manufacturing plant by Carlyle's Vought Aircraft to Boeing for \$1 billion. The fourth quarter had 21 of the 64 private exits with 13 announcing values totaling \$4.3 billion.

There were 20 buyout-backed IPOs in 2009 valued at \$6 billion, 17 of which were in the fourth quarter totaling \$4.9 billion. This is up from 2008 when only six buyout-backed companies went public and raised \$1.3 billion. The largest buyout-backed IPO in 2009 was the \$950 million offering by Cerberus owned Talecris Biotherapeutics. The second largest offering was Cobalt International Energy which raised \$851 million, owned by Carlyle, First Reserve, Goldman Sachs, and KERN Partners.

Subordinated Debt

Subordinated (mezzanine) debt fundraising totaled \$3.3 billion and 20 partnerships in 2009, down substantially from \$43.1 billion and 24 partnerships in 2008. The 2008 figures were an anomaly, dominated by two Goldman Sachs debt-related funds raising a combined \$30 billion. However, the 2009 figure is also low relative to 2007's \$8.9 billion total.

Most institutional investors placed their tactical credit bets over the last several years, so it is not surprising that mezzanine fundraising is trailing off. The availability of new credit has not improved significantly and for the deals getting done, unsecured debt terms are attractive for the lenders. As noted in the Buyouts strategy discussion, even with average 40%-plus equity contributions and 35% bank loan coverage, there is still, on average, more than a 20% capital gap to be closed in order to achieve the current company purchase prices.

Distressed Debt

Distressed debt and restructuring funds raised \$14.2 billion and formed 30 funds in 2009. This is a significant drop from the \$50 billion and 29 funds formed in 2008 and the \$48.2 billion in commitments in 2007. However, with 15% of the year's capital commitments, the strategy is well above its historical norm of about 5%.

According to Fitch Ratings, the U.S. high yield default rate ended 2009 at 13.7%, with a record \$118 billion in defaults during the year. The majority of the defaults occurred in the first half of the year, with defaults falling by 50% in the second half. According to *The Wall Street Journal*, the recessions of 1991 and 2002 produced peak default rates of 11.9% and 10.4%, respectively.

Concurrent with the high default rate during the year was a strong rally in the credit markets— notably bank loans and high yield. During the course of the year, bank loan indices rose from trading at 60% of par to 90% of par and have recently stabilized at that level. High yield indices returned in excess of 55% for the year. Many distressed funds that “caught the falling knife” in 2008 had recovered nicely by the end of 2009.

A lot of work was done in 2009 by buyout firms to extend maturities and renegotiate existing loan agreements. However, there remains an oft cited “wall of maturities” lurking in the 2014 timeframe. While the opportunity for rapid appreciation in the distressed debt strategy may be limited for a while, the credit markets are far from healthy and retiring or replacing all the outstanding loans that are expected to come due should continue to create profitable opportunities for many years to come.

PRIVATE EQUITY RETURNS

The Thomson ONE Private Equity Performance Database has released returns through the third quarter of 2009. The All Private Equity return was negative in the first quarter of 2009 (-3.6%), but rebounded in the second (+5.7%) and third (+6.4%) quarters. The fourth quarter is expected to be up as well. For the third quarter, all of the strategy types were positive, with All Venture advancing 2.6%, All Buyouts up 5.4%, and Mezzanine Debt the highest with 6.6%. As seen in the next table, the one-year returns continued to be negative, due entirely to the fourth quarter 2008 return of -15.9% for All Private Equity.

Private Equity Performance Database Pooled Horizon IRRs Through September 30, 2009

Strategy	1-Yr	3-Yr	5-Yr	10-Yr	20-Yr
All Venture	(10.8)	2.6	5.4	7.7	17.4
All Buyouts	(9.9)	0.1	6.4	4.8	9.1
Mezzanine	(11.7)	2.3	3.2	3.9	7.3
All Private Equity	(7.9)	1.7	6.6	5.9	11.4
S&P 500	(6.9)	(5.4)	1.0	(0.2)	8.0

Source: Thomson ONE. Private equity returns are net of fees.

While recent private equity quarterly returns were strong, they significantly lagged the rebound in the public equity markets, where the S&P 500 was up 16% in each of the second and third quarters. Because the write-downs were larger for public equity during the downturn (especially the fourth quarter of 2008), private equity only lags public equity by 1% for the last 12 months.

With FASB 157 “mark-to-market” taking effect in the fourth quarter of 2008, private equity has ceased to lag public equity price movements. However, private equity return volatility continues to be dampened from appraisal smoothing effects. Private equity bolstered total plan portfolios during the recent downturn, but now lags public equity returns early in a recovery.

It is very positive that private equity returns (and valuations) appear to have bottomed out and are on the mend. While no one invests in private equity for single-digit returns, the asset class has borne up well through the downturn, especially as a complement to public equity holdings. As seen in the table, private equity has provided downside volatility dampening at the total fund level in the near-term, while maintaining positive absolute returns and positive return premiums relative to public equity over longer timeframes.

Activity on all fronts should be slow but improving in 2010. Given that deal activity is bottoming, it is likely that the number of tenured general partners coming to market will also decrease because recently raised funds will be invested slowly as the economy and capital markets continue to struggle. The effects of the Great Recession are ultimately expected to create new buying opportunities at lower prices, with more conservative financial structures and stronger growth prospects.

DID YOU KNOW?

Callan’s Center for Investment Training (or “Callan College”) just scheduled its sole 2010 session focusing exclusively on Alternative Investments in San Francisco on June 2–3. The three-day intensive will address the most prevalent non-traditional investment strategies—private equity, real estate and hedge funds. The curriculum has also been expanded to cover newer strategies, including real assets and infrastructure. The course will define the strategies, explore benefits and issues, and address successful implementation of these increasingly important strategies. Please see our website www.callan.com for additional Alternative Investments “Callan College” curriculum and registration information.

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