Private Equity Market Environment: Spring 2004

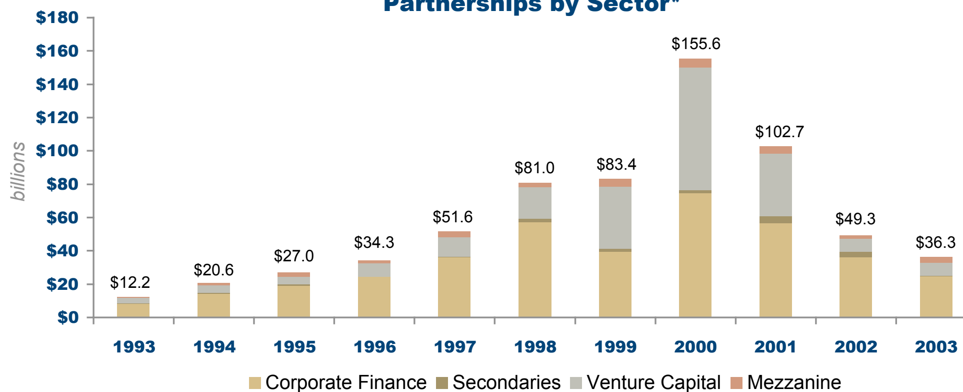
Fundraising Overview

2004 Will See a Significant Increase in Fundraising for Private Equity Partnerships in the U.S. and Europe

As expected, 2003 was the worst year for private equity fundraising since 1996. As reflected in Chart 1, though there has been weakness in all private equity sub-sectors in the U.S. in the last three years, the most dramatic changes have been in venture capital fundraising. Driven by the Internet bubble and its subsequent collapse, venture capital commitments form a sharp spike, peaking in 2000, and then falling dramatically.

What is not readily evident from these numbers is the strong increase in fundraising activity over the last six months. As we forecasted in the fall of 2003, the combination of an improved investment environment and increasing room in investor allocations, due in part to a strong public stock market, has resulted in a current surge of investor interest. For Probitas ourselves, three of our recent funds being placed – Alta BioPharma III, Alta California Partners IV, and KPS Special Situations II – closed substantially above target in the first quarter of the year. Our forecast is that 2003 will be the trough in the current fundraising cycle, with 2004 being a more dynamic, though still competitive, fundraising year.

Chart 1: Commitments to U.S. Private Equity Partnerships by Sector*



*Excludes fund-of-funds and other types of private equity financings
Source: The Private Equity Analyst, 2004

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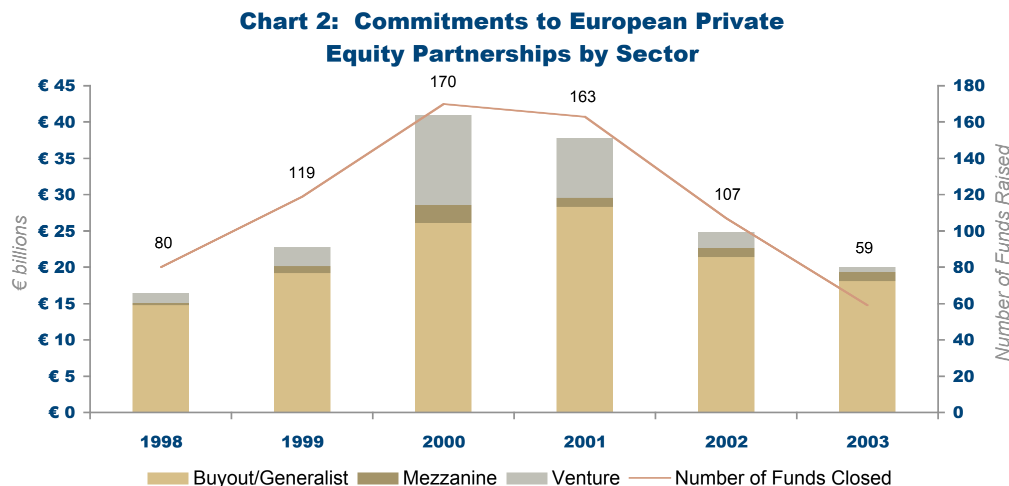


Source: Initiative Europe, 2004

As detailed in Chart 2, the overall fundraising totals in Europe remain strong, with much less fall-off than in the U.S. market. As in the U.S., a significant portion of the volatility in the fundraising market has been driven by venture capital, though venture capital has never been as important a factor in the European market as it is in the U.S. In addition, deal flow in the buyout market in Europe has been strong, with a number of very large investments completed in the last two years.

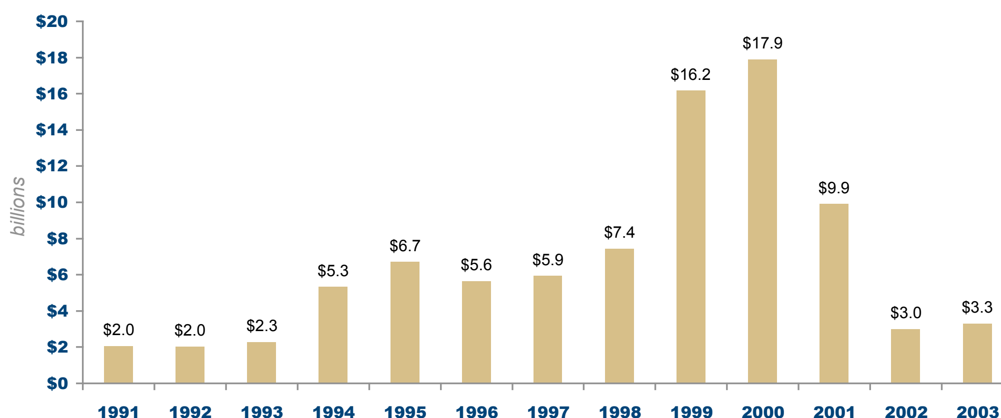
Of note, over the last few years more U.S. investors have been focusing attention on European funds. Though there has always been an interest in large, name brand, pan-European vehicles, the difference now is that more investors are also reviewing middle market and country specific funds.

The Asian Fundraising Market Is Back on the Radar Screen

Though not evident from the numbers in the fundraising graph in Chart 3, the last six months have also seen an increase in interest in Asian funds. Though total fundraising for Asian-focused funds is still significantly below the U.S. and Europe, it is the most developed of the emerging private equity markets.

Though details on sub-sector fundraising in Asia are not readily available, it should be noted that the fundraising dynamics in Asia have been quite different from those in the U.S. and Europe. The Asian economic crisis that started in 1997, coupled with ongoing weakness in the Japanese economy, created an active market in distressed assets – and a surge in private equity funds addressing the sector. At the same time, those conditions acted to undermine interest in the buyout and growth capital funds that had predominated in Asia to that point. A fuller discussion of Asian market trends follows in a separate section below.

Chart 3: Commitments to Asian Private Equity Partnerships



Source: AVCJ, 2004

Though Fundraising Will Increase in 2004, the Environment Is Still Very Competitive

With the difficult fundraising market over the last couple of years, many general partners delayed coming to market for as long as possible. As a result, a large number of funds are either in the market or are coming to market soon. Many long-time investors in private equity are being deluged by "re-ups" – funds being raised by general partners with whom they already have relationships. This makes it more difficult for newer groups to attract the attention of LPs.

One cannot assume, however, that all of these re-ups will be easily done. Limited partners who were burned badly in the recent downturn are now much more focused on doing intense due diligence and are making investments on a much more selective basis. A number of large investors are also looking to narrow their roster of core general partner relationships to limit administrative burdens. As a result, a few well-known large pan-European general partners – such as Doughty Hanson and Industri Kapital – have had difficulty reaching their fundraising targets as investors consider which funds to continue supporting.

Areas of Investor Interest

Information Technology Focused Venture Funds Are in Vogue Again – But the Era of Billion Dollar Early Stage Venture Funds as the Norm Is Over

In our Fall overview, we noted the first stirrings of investor interest in IT VC in almost two years. Those modest stirrings have turned into a flood of interest in the last six months, with investors actively pursuing IT opportunities and over 50% of the IT-focused venture funds in the U.S. planning to return to market this year.

In addition, nearly all of the Israel-based VC funds are returning to market this year. Besides enduring a difficult technology environment, these groups have been suffering from the fallout from the tense political environment in Israel and the Middle East, but expect increased investor interest, especially in Europe.

Some selected IT venture funds expected to be in the market soon are listed in Table 1.

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Table 1: Selected IT Venture Funds Thought Coming to Market

Fund Name	Expected Size	HQ
Accel IX	$700,000,000	Palo Alto
Alta Berkeley VI	$250,000,000	London
Artiman Ventures II	$250,000,000	Palo Alto
Austin Ventures IX	$750,000,000	Austin
Clearstone Venture Partners III	$200,000,000	Santa Monica
Coneybeer/Francis/Mohan Vehicle	$175,000,000	Palo Alto
Gemini Israel Fund IV	$250,000,000	Tel Aviv
Granite Ventures III	$200,000,000	San Francisco
Greylock XII	$500,000,000	San Mateo
Interwest Partners IX	$400,000,000	Menlo Park
IVP Fund XI	$250,000,000	Menlo Park
Lightspeed Venture Partners VII	$500,000,000	Menlo Park
Mayfield XII	$500,000,000	Menlo Park
Oak Investment Partners XI	$1,250,000,000	Palo Alto
Pacific Technology Partners II	$300,000,000	Taipei
Sevin Rosin Fund IX	$400,000,000	Austin
Storm Ventures II	$250,000,000	Palo Alto
Tamir Fishman Ventures III	$225,000,000	Tel Aviv
US Venture Partners IX	$500,000,000	Menlo Park
Worldview V	$500,000,000	Palo Alto

With all this activity, it is important to note the following:

- ***Top-tier venture funds that have returned to market have dramatically cut fund size as expected, thus access to these funds will be increasingly difficult***. In January of 2003, Sequoia capped its latest fund at about 60% the size of its previous vehicle. Since then, a number of other top-tier venture capital funds, including Kleiner Perkins, NEA, Battery and Charles River, have returned to market with much smaller funds. These cuts in fund size have not been driven by lack of investor demand, but rather by a return of discipline and focus by general partners on the size of fund that they are comfortable investing over a "normal" investment period. As these established funds shrink dramatically in size, access has become more difficult, especially for investors without established top-tier general partner relationships or those subject to Freedom of Information Act ("FOIA") disclosures. Charles River, for example, refused to grant access to its latest fund to any public sector fund that could be subject to FOIA, whether or not they had disclosed return information in the past.

- ***Though access to quality venture funds is becoming more difficult, investors are still focused on due diligence***. Though for a very few funds like Sequoia where due diligence is composed of saying "yes" when asked if you want to invest, intensive due diligence is a renewed focus of investors. The tumbling values of IT venture investments in the aftermath of the Internet bubble, the downsizing of capital commitments, and the general partner turnover at a number of funds have caught investors' attention – and adequate due diligence is seen as the best way to manage those future risks.

Investors Are Still Interested in Middle Market Buyout Funds and Are Increasingly Interested in Smaller Funds in this Sector

As the large buyout space has become more and more competitive, investors have turned to middle market buyout funds in search of better returns. By operating in a less efficient market not driven entirely by auctions, and by targeting the purchase of smaller firms that are not usually operating on a "best practices" basis, middle market buyout firms are seen as being more likely to add value to portfolio companies, even in difficult investing environments. Table 2 provides historical return data for U.S. buyout funds sorted by fund size and lends support to this thesis, as smaller funds are generating higher returns.

Table 2: Performance Analysis of U.S. Buyout Funds by Size*

	Fund Size		
	$100m - $500mn	$501m - $1,000mn	$1,001mn+
# of Funds	211	76	96
3 Year IRR	-3.1%	-6.3%	-0.6%
5 Year IRR	3.8%	2.9%	1.7%
10 year IRR	8.5%	9.5%	6.6%
15 year IRR	13.3%	13.1%	6.9%
20 year IRR	18.9%	16.8%	7.2%

**Historical Returns through December 31, 2003 (Pooled Net IRR)*
Source: Thomson Financial/Venture Economics/NVCA

In Europe, increased focus on middle market investing has led to increased interest in country or region specific funds – such as CDC Enterprises in France, ECI in the United Kingdom, Quadriga in Germany, or Polaris in Denmark – as most pan-European funds have reached the size where it is difficult for them to do true middle market transactions. Many of the middle market companies that are targets of these funds are locally based, though they often sell their products or services throughout Europe. However, cultural affinity between a company owner or management team and a locally based general partner often provides an advantage in both sourcing transactions and in developing a relationship that can be crucial to winning a limited auction where price is not the only criterion in a sale.

Table 3 provides a summary of selected U.S. and European middle market funds:

Table 3: Selected Middle Market Funds Thought Coming to Market

Fund Name	Expected Size	HQ
Arlington Capital Partners II	$600,000,000	Washington, D.C.
Aurora Equity Partners III	$900,000,000	Los Angeles
Brantley Partners V	$250,000,000	Cleveland
Century Park Capital Partners II	$250,000,000	Los Angeles
CDC Enterprises III	€ 700,000,000	Paris
Concert Capital	$200,000,000	San Francisco
ECI Partners 8	£275,000,000	London
Electra European Fund II	€ 1,200,000,000	London
Genstar Capital Partners IV	$300,000,000	San Francisco
Gilde Buy-Out Fund III	€ 700,000,000	Amsterdam
Littlejohn Fund III	$800,000,000	Greenwich
Palamon Capital Partners II	€ 750,000,000	London
Parthenon Capital III	$900,000,000	Boston
Polaris Equity II	€ 200,000,000	Copenhagen
Quadriga III	€ 750,000,000	Frankfurt
Segulah III	1,000,000,000 kr	Stockholm
Triton II	€ 750,000,000	Frankfurt
WestView I	$150,000,000	Boston
Windward Capital III	$500,000,000	New York

Given the Difficulty of Accessing Top-Tier Venture Managers of the 1990s, Experienced Investors Are Beginning to Focus on Emerging Groups Likely to Become the Next Generation of Top-Tier Managers

Given the access problems to venture capital funds noted above, certain investors are focusing attention on Emerging or "Next Generation" Managers. These programs focus on newly forming groups that have the potential to be the top-tier managers of the next decade. Importantly, most of these emerging manager programs seek individual general partners with strong personal track records that are forming new funds – "first time funds, not first time investors." These funds have the benefit of being free of legacy problems and the distraction such problems pose in many existing portfolios at established funds. These funds are, of course, challenging to identify in advance.

Interest in Funds Focused on Asia Is Beginning to Increase, Driven by Recent Liquidity Events

With the exception of distressed funds, Asia has been relatively quiet in fundraising over the last few years. Recently, the IPOs of a number of large Chinese companies on U.S. stock exchanges, the local IPO of Shinsei Bank in Japan after a major restructuring led by western private equity investors, and continued high tech outsourcing to China and India have caught investors' attention.

Though interest is increasing, many investors remain skeptical. Few investors have been able to generate significant profits investing in Asian private equity funds in the past (with the exception of funds focused on distressed assets), though many argue that the market has now developed to the point where private equity has reached positive inflexion.

A few selected funds from various Asian strategies and geographies are listed in Table 4.

Table 4: Selected Asian Venture Funds Thought Coming to Market

Fund Name	Expected Size	HQ
AIG Asian Opportunity Fund III	$750,000,000	Hong Kong
Artiman Ventures II	$300,000,000	Palo Alto
Avenue Asia Fund III	$500,000,000	Hong Kong
Baring Private Equity Asia II	$350,000,000	Hong Kong
Chengwei Ventures	$150,000,000	Shanghai
ChrysCapital	$125,000,000	Bangalore
Crimson Investment Fund III	$350,000,000	Hong Kong
CVC Asia Pacific II	$1,000,000,000	Hong Kong
Granite Global Ventures	$160,000,000	Menlo Park
Jafco Asian Technology Fund II	$125,000,000	Hong Kong
Jafco Bio-Fund	$170,000,000	Tokyo
Jafco Venture Capital Fund	$470,000,000	Tokyo
Newbridge Asia III	$1,000,000,000	San Francisco
Pacific Technology Partners II	$300,000,000	Taipei
Unison Fund II	¥50,000,000,000	Tokyo
Yangtze Special Opportunites Fund	$500,000,000	Beijing

Hard Asset Investments – Such as Real Estate, Timber and Energy – Are Still Attracting Investor Interest

Especially after the turmoil of the last few years, a number of investors are looking at hard asset investments as a part of their alternative portfolios. These investments generally provide a degree of current income, downside protection through the security of the asset, and an inflation hedge.

The return profiles and market dynamics of each of these individual types of investments do differ, however. Strategies in energy range from funds focused on oil field royalties or power plant purchases generating fairly stable current income, to private equity strategies geared toward operating company investments. Real estate strategies are broadly split between core programs looking to purchase stable cash flowing properties and opportunistic vehicles looking to turn around troubled assets or otherwise add value, seeking significant capital gains as well interim income. Timber investments run the gamut from programs investing widely in different types of timber in multiple locations across the world to more focused opportunities investing in particular types of timber in specific geographies – for example, soft-wood in the southeastern U.S.

Unlike private equity investing, many of these opportunities can be structured as separate accounts instead of partnerships, and are targeted at larger, sophisticated investors.

More Pension Plans Are Actively Looking at Hedge Funds – Both Directly and Through Multi-Manager Funds

Hedge funds have long been an investment vehicle for family offices, endowments, and foundations. More recently, pension plans have begun to invest in hedge funds as part of their search for strong risk-adjusted returns coupled with downside protection. As a first step in pursuing the strategy, many of these investors are looking for Multi-Manager Funds to provide them diversification and experienced fund management while reviewing the asset class in depth.

The Secondary Market

Increased Interest Drives a Narrowing of Spreads – But Variability of Bids Requires Thorough Market Understanding

From mid-2001 through mid-2003, discounts to Net Asset Value (NAV) – the value of private equity positions reported by General Partners to Limited Partners – on secondary transactions widened dramatically. Last Fall, we identified the beginning of a significant shift in the dynamics of the market when we noted, "The last few months have seen several new primary investors entering the secondary market. These investors are willing to pay up for strategic reasons – in order to gain access to, or to strengthen relationships with, pre-identified general partners." This increase in the breadth and depth of the secondary buying universe has been one of the major drivers that has caused spreads to rapidly contract during the last year, with discounts on diverse, mature buyout portfolios shrinking from the 40%-50% range to the 5%-25% range. Venture capital spreads have also contracted, but continue to demonstrate significant variability based not only on the quality and reputation of the fund manager or portfolio under consideration, but also on the motivations of the prospective purchaser.

While many secondary purchasers continue to price their bids based solely on projected returns, others are incorporating strategic motivations, such as access to future funds, into their bids. Given the increasing importance of primary investors in the secondary market, ***there is no "correct" price; rather, only a winning bid***. It is more important than ever for sellers of secondary positions to strategically navigate the universe of prospective buyers to identify that highest bid.

An arbitrage opportunity currently exists in the market between NAV and "True Value." Many potential sellers are motivated and compensated on the basis of the comparative value between the sale price achieved and the fund's reported NAV or carrying value. However, most buyers evaluate opportunities in the secondary market based on their view of the underlying assets being sold. Thus, both parties to a transaction can benefit when sellers are able to sell at prices that approach or even exceed NAV, achieving their strategic goals, while buyers can purchase at prices that represent discounts to what they consider the intrinsic value - thus achieving their financial goals. This unique situation exists largely because of the lag between reported values and market values that can occur simultaneously during periods of rapidly improving underlying company values. If interest rates spike or the public markets begin to stabilize or recede, reported values could rapidly normalize and spreads may again widen.

Active Portfolio Management

The evolution of the private equity secondary market, from a niche sub-category in which the majority of sellers were distressed to a robust and far more balanced process, reflects the continued maturation of the overall private equity industry. Active portfolio management is one of the hallmarks of a developed market, and while it remains highly improbable that limited partnership interests will ever trade via a truly liquid exchange, sophisticated investors have begun to capitalize on the benefits of both buying and selling in the secondary market.

As discussed above, the punitive discounts that previously characterized secondary transactions are far less prevalent in today's market, allowing potential sellers to evaluate the benefits of rebalancing their private equity allocations or selectively achieving liquidity. Thus, an increasing number of stable, long-term investors find themselves improving administration and portfolio performance by actively managing their private equity investments.

Table 5: Benefits of Puchasing Funds on the Secondary Market	
• Partial mitigation of the J-curve effect	• Eliminate early year management fees
• Shorter timeframe for ultimate liquidity	• Ability to evaluate assets held in a portfolio
• Increased vintage and strategic diversification	• Opportunity to capitalize on unique market or fund-specific insights

Return Disclosure

Charles River's Recent Fundraising Took Investors' Fears of Venture Capital Access to a New Level and Has Begun to Trigger an Interesting Response

Over the past two years, institutional limited partners subject to Freedom of Information Act ("FOIA") disclosures struggled to deal with the competing demands of transparency and confidentiality. By revealing too much information, institutional investors risk jeopardizing relationships with general partners - and being denied access to future funds of general partners who prefer to maintain a higher level of confidentiality. So far in 2004, a number of significant events have occurred:

- ***Charles River, which dramatically cut the size of its latest fund, denied access to its latest fund to all investors it deemed possibly subject to FOIA, whether or not they had disclosed returns in the past.*** With many of the large venture capital general partners of the late 1990s dramatically cutting fund sizes on their latest efforts, access to top-tier venture capital funds has become more difficult. Even more than Sequoia's actions last year, Charles River's decision made it clear that for many general partners the potential for FOIA disclosure would be a key determinant in the allocation process.

- ***The State of Colorado passed a law that forbids the state's treasurer and public pension funds from disclosing any information regarding the value of a private equity investment.*** The measure was specifically meant to provide Colorado pension plans such as CoPERA a competitive advantage in accessing and maintaining positions in funds. Michigan also just passed a law amending their public records act to allow public universities and colleges to keep return information confidential and other states are considering similar measures.

- ***Certain investors subject to FOIA are asking GPs to limit return information that they are provided, so that in turn they are not obliged to disclose it.*** This technique has not been totally tested as yet – and is not as clear a safe-harbor as the law passed in Colorado. In addition, it flips the entire notion of transparency on its head. As the result of FOIA, some limited partners seek to receive less information in order to maintain access to funds.

Business Development Company IPOs

Apollo's Business Development Company IPO at the Beginning of April Has Attracted a Number of Other General Partners to the Structure

Though discussed by some as a potential wide-spread replacement for private equity partnerships, legal and operating restrictions mean that Business Development Companies ("BDCs") are effectively focused on mezzanine investing – a niche within the private equity market. If all the groups that have filed for BDC IPOs in April of 2004 successfully raise funds at their target levels, over $5 billion in new capital will be targeted at the sector – an amount well in excess of the $3.6 billion raised for U.S. private equity mezzanine funds in all of 2003. The result could be a dramatic impact on return expectations for both BDCs and mezzanine funds.

An in depth review of the current status of BDCs can be found on Probitas' Web site at http://www.probitaspartners.com/overview/index.html.