Briefing Note

PRIVATE EQUITY

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What's in store for Private Equity?

[The turmoil] showed again how measures of risk used by companies and regulators can be pro-cyclical, encouraging more risk taking at the top of the cycle and potentially exacerbating the downswing
– Sir John Gieve, Deputy Governor of the Bank of England, 17 January 2008.

It is hard to imagine a more volatile start to the year for financial markets. It remains to be seen whether we are now nursing the hangover from the tightening in the credit market or if further contraction is yet to come. This document follows on from our note in August 2007. For private equity, will the economic downturn and uncertain outlook mark an increasing aversion to risk or represent a great opportunity to invest, with even better buying opportunities expected in 2009? More than six months on from the first real impact of the "credit crisis", what can we say about deal activity and what is the likely impact for private equity investors in 2008?

Changes in Deal Terms and Financing Structures

- There is less debt available as a multiple of operating cashflow or as a percentage of the overall financing structure, and risk spreads have risen sharply.
- US underwriting backlog of loans and high-yield estimated at US$230 billion in January 2008[1]
- Dividend recapitalisations, which accounted for a significant part of early returns in recent years, are now not possible.
- Debt structures are simpler again, with mezzanine – the most expensive element – now filling a larger percentage of the overall bank package.
- So-called "covenant-lite" loans (where banks could usually only enforce debt rights if interest payments were not met) are being replaced with conventional covenants on leverage, interest coverage, capex, etc.

How have activity levels been affected?

Banks are more risk averse. It is clear now that banks underestimated their exposure to the credit risk in structured products and underpriced their liquidity back-up lines for such products. There still seems to be a lack of transparency about the extent of the banks' exposures to liquidity issues and the potential losses on their portfolios. This has increased risk premiums and the cost of capital for the active banks and consequently for those seeking loans. Some banks, meanwhile, have adopted a bunker mentality and are simply unwilling to participate in new lending until market uncertainty subsides.

Recent data suggest a dramatic tightening of bank lending – in terms of supply of credit extended, its pricing, and the lending standards attached – across the credit spectrum. This rationing is likely a combination of banks being less able to deploy capital as their balance sheets have dramatically contracted, as well as a reflection that they are less willing to do so, itself a reflection of a reassessment of risks given the current fundamentals in the credit market. Recent – and expected further – rate reductions by central banks will probably do little in the short term: the banks' problem is not access to funds, but the above-mentioned balance sheet uncertainty and lack of visibility regarding the riskiness of potential borrowers.

[1] Bloomberg, 24 January 2008

Mega buyouts have borne the brunt of the impact of the liquidity crunch on new deal activity. Smaller deals, by contrast, appear to be holding up better. Only two deals in the US$5bn-plus bracket were recorded globally in the fourth quarter of 2007, whereas the second quarter saw 18 such mega buyouts with a combined value of US$231 billion[2]. We expect the slow-down in the pace of transaction activity to be maintained during 2008, as the underwriting backlog washes through the system.

Overall deal pricing has returned to levels seen two to three years ago. Purchase price multiples for transactions above US$500m hit 9.9xs EBITDA in 2006[3] and some deals are believed to have been financed above these levels in 2007. It appears that we have returned to the region of the 8.4xs EBITDA level of enterprise value seen in 2006[2], but it is too early to tell whether this is sustainable.

Divergence in price expectations is another factor that will tend to hold back the pace of deals. Private equity bidders have already been forced to adjust their structures and return expectations to reflect higher borrowing costs and a more conservative lending environment. Potential vendors, however, are taking longer to adjust to these new realities.

Private equity bidders are likely to face more competition from both sovereign wealth funds and trade buyers than in the recent past. Corporate balance sheets are in better shape than in 2001, the last official US recession. On the flip side, companies in "softer" sectors could well look to divest non-core businesses to restore financial or liquidity ratios.

In the primary arena, it can be argued that all areas should benefit over the medium term as vendor expectations readjust and good buying opportunities emerge. Many private equity managers have been anticipating a downturn and have shifted their focus to more defensive sectors, such as healthcare, in anticipation of a downturn, while others have been targeting sectors where consolidation is likely to occur and buy-and-build strategies are possible.

Default rates remain low in relation to historical norms within buyout portfolios (presumably in part a function of covenant-lite lending practices) but also across the corporate sector as a whole. The coming phase, however, is likely to feature an increased pipeline of opportunities for distressed debt and turnaround specialists. Meanwhile, a number of established private equity managers are diversifying their offerings with interesting product extensions, focusing on segments including cleantech, infrastructure, growth capital and mezzanine.

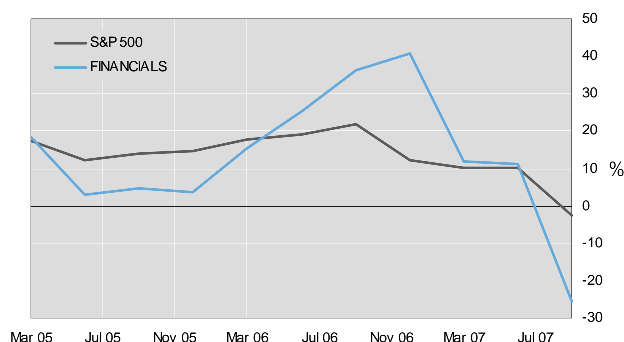
Has there been an impact on private equity valuations?

> *Wild swings in share prices have more to do with the "lemming-like" behaviour of institutional investors than with the aggregate returns of the company they own*
>
> *– Warren Buffett*

Private equity cannot be wholly decoupled from the public markets, since valuations and exit multiples are to a significant extent determined by sector P/E ratios. We would expect to see some write downs over the next few months in response to declines in public market earnings and valuations and as a consequence of the move to Fair Market Valuation, by which private equity managers value their investments (after an initial 12 month holding period) based on a comparison to public equity values.

[2] Dealogic
[3] S&P Q4 2007 LBO Review

Chart 1 : US Corporate Earnings (US$) – EPS Growth Rates, S&P 500



Data is historical and not indicative of future results. Indexes are unmanaged and cannot be invested in directly.
Source: Bank for International Settlements Quarterly Review Dec 2007[4]/Bloomberg

With the decline in equity values since the start of last year, fair market valuations will lead to a dip in short-term performance numbers. Given the lag in private equity valuations, it is too early to see an impact on the bulk of the portfolios but the slowdown has already affected some investments in those sectors that tend to be hit first in economic downturns: retail, media, and semi-conductors.

Meanwhile, on the exit front, we can expect to see a return to longer – in other words, more typical – holding periods for buyouts, in particular. Expect to see a more pronounced J-curve, which together with lower fair market valuations will bring returns down from the extraordinarily high levels we have seen in recent years. Nevertheless, private equity investing is about the long term and this downturn has been expected for some time, and our private equity managers have been tracking their portfolios very closely with greater attention to value building and longer hold periods.

Is Asia a different story?

> *Asia offers the greatest [capital flow] arbitrage opportunities worldwide during the demographic transition, since it is host to some of the biggest, oldest, and youngest economies worldwide*
>
> *– IMF Policy Discussion Paper, January 2008*

Suggestions that decoupling of the Asian markets from the US will be the global economic saviour in the near term appear to be receding although the consensus seems to be that Asian growth prospects, particularly for the colossal powerhouses of China and India, will remain relatively robust by comparison with the rest of the world.

While the global private equity investment pace slowed in the second half of 2007, primarily due to a slowdown in US and European buyout activity, capital deployed in the Asia Pacific market during the second half of 2007 kept pace with the first half of the year. Greater China, Australia & New Zealand (which were impacted in the second half by the credit crunch) and India were the most active markets for new investments, while the Japanese private equity market is showing signs of increased deal activity.

Our managers in Asia (with the exception of Australia), where leverage tends to be more modest, have not seen evidence of credit conditions affecting activity levels or underlying company performance. Asia, however, is not without its challenges and risks, including the dynamic regulatory environment, the potential consequences of a US-led slowdown on Asian exports and the plethora of new managers in the region which puts a high premium on selectivity. However, valuations in certain Asian markets, particularly in growth companies, have tended to be lower than in the more mature markets; in conjunction with continued economic growth, we expect this factor to contribute to strong long-term performance in our portfolios.

How about the venture market?

Activity in the US, the core venture market globally, was extremely robust throughout 2007, with total investments reaching US$29.4 billion, the highest annual figure since 2001[5]. 2007 was a strong year for venture exits: there were 86

[4] Full publication available free from Bank of International Settlements at www.bis.org
[5] PWC MoneyTree, Full-year 2007 US Report

IPOs in the US, half as many again as in 2006, and their combined value, at US$10.3 billion, was more than double the 2006 figure. The disclosed value of M&A sales of venture-backed companies in 2007 was US$25.4 billion, the highest level recorded since 2000[6]. However, the pace of realisations fell sharply in the final quarter of the year, which saw the fewest trade sales since Q1 1998.

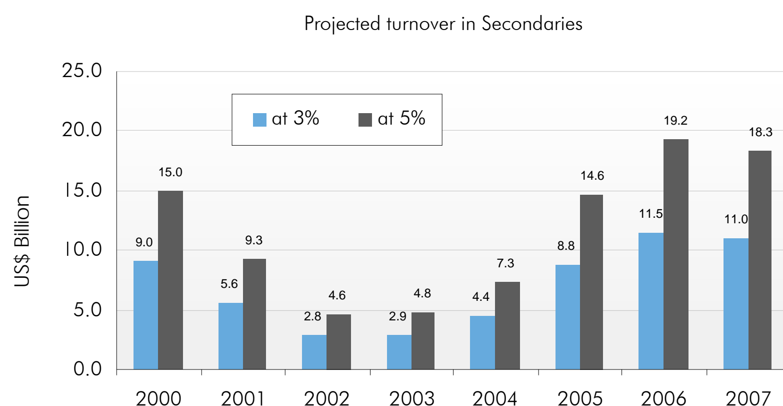
The number of new venture investments in Europe fell last year, but total capital invested increased to 4.6bn, the highest annual total since 2002 driven in part by growth in later-stage venture rounds[7]. These trends illustrate the increasingly focused approach of funds investing in European venture opportunities as they make fewer investments, but fund companies to compete on a global scale.

The venture segment is obviously not immune to the factors that are currently creating uncertainty about prospects for buyouts. However, the word from venture managers is that achieving proof of concept and then scaling businesses is now cheaper than ever before, since the necessary infrastructure to support technology investment is now in place. This, taken in conjunction with prevailing 'realistic' valuations, represents an attractive environment for venture investments and suggests that activity levels should hold up during the coming year. Fundraising in the US venture market may be an indicator of this, with the amount of venture funds raised in Q4 2007 outstripping each of the past five quarters and with the total for the full year, at US$34.7 billion, the highest since 2001[8].

Will the secondary market grow in these conditions?

Chart 2 : Scale of Secondary Market Opportunity

Global Private Equity Dollars Raised by Vintage Year (US$ billion)							
2000	2001	2002	2003	2004	2005	2006	2007[1]
301	186	93	97	147	292	384	366



Annualised estimate based on half-year figures
1 Source: Venture Economics, data retrieved 28 December 2008

We anticipate that secondary fund investing will continue to be robust as 2008 progresses. Financial sellers are returning as a significant source of opportunities, in response to regulatory and balance sheet pressures, while strategic sellers, the backbone of the market during the past couple of years, are also expected to continue to increase their secondary selling activity. This increased supply is expected to be matched with more competition from both secondary funds and from opportunistic financial acquirers, than was the case when the Basel II wave of secondaries first broke.

[6] Thomson Financial/national Venture Capital Association release 2 January 2008
[7] Dow Jones VentureSource, Q4 07 European Venture Capital Report
[8] Thomson Financial/National Venture Capital Association release, 14 January 2008

December 2007 valuations may not fully reflect the contraction in P/E multiples and secondary vendor expectations, for the most part, have therefore not adjusted to the lower bids being submitted by buyers. We expect that once these factors filter through more universally, secondary investment pace will accelerate towards the end of 2008 and into 2009. Successful investors in this phase of the market – as in any other – will be those who focus on the quality of the underlying assets in portfolios offered for sale.

What does all this imply for Private Equity Investors?

> *It is an immutable law in business that words are words, explanations are explanations, promises are promises but only performance is reality*
> *– Harold S. Geneen*

So, in the face of the credit crunch and a tougher economic environment, what should private equity investors consider doing? There are some time-honoured themes to remember about private equity: it is a long-term asset class which is not suitable for market timing and over the long term, private equity managers in the top two quartiles have outperformed public equities by a significant margin.

In the near term, you can prepare your investment committees for:

- Lower overall returns and a potential widening of the difference in performance between the best and the rest

Performance dispersion is typically very wide in private equity. Benign market conditions as experienced over the past few years, on the "rising tide that floats all boats" principle, may have served to dampen the variation in interim performance between the best and the rest in more recent vintages. This in turn will highlight once again the crucial importance of selectivity skills, and access to top-tier managers, for the investor in private equity.

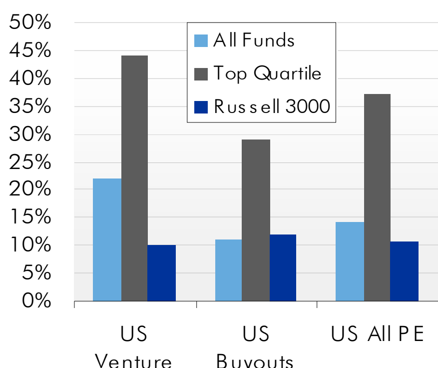
- Building tolerance into your private equity allocation

As overall pension values fall in line with equity values, your private equity allocation may rise even without any additional commitments. This happened in 2002 and 2003 and many investors' response was to withdraw from further private equity commitments only to find themselves underinvested and playing catch-up – with consequent vintage year skewing – in 2004 to 2007. This time around, however, private equity valuations can be expected to adjust more quickly, since the adoption of FAS 157 means that interim valuations will be more closely linked to current market pricing and conditions.

For the time being, there has been no decrease in the number of funds in the market as private equity managers raise new vehicles in anticipation of good buying opportunities. Over time, we expect that the mega funds in particular will have longer fund raising cycles and this will filter through to other areas. With many new investors to the asset class, we do not expect that demand will be curtailed to the same extent and, thus, there is likely still to be access issues relating to the best funds.

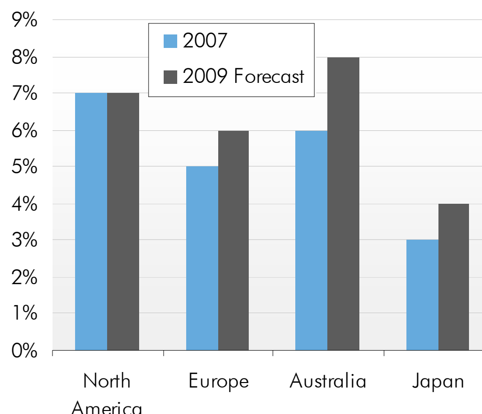
- Demand for private equity springs from its potential to outperform the public markets over the long term

Chart 3: Annualized 15-Year Returns
Net IRR to 31st December 2006



Calculated applying Pantheon portfolio cashflows.
For illustrative purposes only.
Source: Thomson Venture Economics; data captured August 2007; Bloomberg

Chart 4: Current and Forecast Strategic Allocations to Private Equity



Source: The 2007-2008 Russell Investments Survey on Alternative Investing

As illustrated in Chart 3, the best private equity managers have proven their ability to deliver a significant margin of outperformance. This is reflected in institutional appreciation of the asset class: a study sampling 180 public pension plans from Europe and North America revealed overwhelming satisfaction with private equity among this constituency, with 74% saying that private equity had met, and 24% that it had exceeded, their performance expectations over a ten-year period[9].

The 2007-2008 Russell Investments Survey of Alternative Investing indicates that demand for private equity should be sustained. Institutions generally forecast that their strategic allocations to private equity will continue to increase through 2009 (see Chart 4). The Russell Survey also confirmed that investors' return expectations for private equity are higher than for other alternatives such as hedge funds and real estate.

What is Pantheon's response to the changes in the market?

As a long-term investor over the last 25 years, Pantheon has invested through many cycles. The liquidity crunch will highlight the importance of both manager selection and of monitoring skills. We believe we have put together well diversified portfolios and selected managers with sustainable franchises, strong investment discipline and portfolio management skills. The depth and breadth of our team, together with the Advisory Board seats that we hold in the vast majority of the funds in which we invest, means that we are well placed to track our managers closely and monitor developments within portfolios. We shall be particularly watchful of early warning signals of any cause for concern; of manager actions in these scenarios and of any "strategy drift" in the slower investment cycle. While the scale and complexity of private equity has changed, every so often the market is subject to corrections which prompt a re-evaluation of core principles and values. Such periods offer rich opportunities for premium private equity managers which, as an agent of change, are well positioned to thrive in these times of change.

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[9] Private Equity Intelligence January 2008

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