

Private Markets Trends



SPRING 2009

PRIVATE EQUITY FUNDRAISING

Fundraising in the first quarter of 2009 was meager with only \$13.8 billion in new commitments and 47 funds being raised. By comparison, the prior quarter yielded \$42.8 billion in commitments, and the first quarter of 2008 had \$52 billion. Unless the remaining three quarters accelerate substantially, the annualized forecast for 2009 stands at only 188 funds and \$56 billion of commitments, a mere 20% of 2008's total. As clients complete their 2009 private equity portfolio financial modeling, the result is much lower commitment budgets. In some instances, the model's output must be overridden by informed human judgment to keep a semblance of dollar-cost-averaging in this vintage year.

Funds Closed January 1 through March 31, 2009

Strategy	# of Funds	Amount (\$ mm)	%
Venture Capital	18	1,849	13%
Acquisition/Buyouts	18	10,501	76%
Subordinated Debt	3	461	3%
Distressed Debt	3	451	3%
Other	3	499	4%
Fund-of-Funds	2	132	1%
Totals	47	13,893	100%

Source: *The Private Equity Analyst and Buyouts.*

According to Dow Jones, only three funds raised more than \$1 billion during the quarter. Hellman & Friedman quickly raised \$6 billion, which accounted for almost half the quarter's total. Blackstone added \$2.9 billion toward its \$15 billion target and First Reserve added \$1 billion. Venture capital maintained a double-digit market share, albeit with a substantial drop in dollar amount from the \$5

billion raised in the fourth quarter of 2008. All other direct partnership strategies received about equal commitments. Fund-of-funds vehicles received the least amount of new commitments of the strategy types, likely due to a slow-down of new investors entering the asset class.

PRIVATE EQUITY MARKET ENVIRONMENT

Buyouts

The investment pace by funds into companies continued to decline in the first quarter of 2009, adding to the precipitous drop in the fourth quarter of last year. According to *Buyouts* newsletter, buyout-sponsored U.S. acquisitions with announced values totaled only \$5 billion of announced volume during the quarter, with 120 total transactions closed. The number of transactions declined 15% from the fourth quarter of 2008 and 52% from a year ago. As measured by announced value, the fall off was more dramatic with a 30% decline from the prior quarter and a 92% drop year-over-year. Over half the purchases were add-on acquisitions to existing portfolio companies versus new portfolio holdings, which is unusual. General partners appear to be focusing their attention on existing portfolios, rather than initiating completely new endeavors.

IN THIS ISSUE

[PRIVATE EQUITY FUNDRAISING](#)

[PRIVATE EQUITY MARKET ENVIRONMENT](#)

[SECONDARY AND DISTRESSED UPDATE](#)

[PRIVATE EQUITY RETURNS](#)

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.

Buyouts reports that the largest deal closed during the quarter was the \$1.3 billion purchase of IndyMac Bancorp by J.C. Flowers and other investors, including Michael Dell. The second largest closing dropped to \$640 million, and was an add-on acquisition of natural gas assets to Continental Energy Systems by Lindsay Goldberg. As an indication of the dearth of new investment volume in the pipeline, the 10 largest announced, but not closed, deals start at \$1.5 billion and quickly drop to \$20 million in total value.

Exit activity was slim during the quarter. Investors are bracing for a long liquidity drought. *Buyouts* reports that no buyout-backed companies went public. Only 38 buyout-backed M&A exits occurred, nine of which announced values totaling \$28.4 billion. One company, Alltel, represented \$28.1 billion of the announced total.

Venture Capital

Company investments by venture capital partnerships also fell significantly during the first quarter. Thomson Reuters/MoneyTree reports that \$3.0 billion was invested in 549 rounds of financing—the lowest level since 1997. By comparison, the fourth quarter of 2008 produced \$5.7 billion in 866 investments. The largest investment during the quarter was the \$50 million funding for Anacor Pharmaceuticals by a syndicate of five firms, including Aberdare, Care and Venrock.

The \$3 billion invested by venture funds during the quarter is double the amount of new commitments raised, so the supply/demand dynamic remains in check. By industry, Information Technology com-

panies received 46% of the first quarter's funding, Health Care 32%, and Other 22% (e.g., Consumer, Energy, and Financials). By stage of investment, early-stage rounds received 28% of funding (including 6% start-up), later-stage 27%, and expansion-stage 44%.

There were no venture capital-backed IPOs in the fourth quarter, making it two quarters in a row. Since the 2000 timeframe, there has been a growing concern about the long lack of a robust exit market for venture capital investments. The new capital market freeze will cause extended holding periods for portfolios and further increase the number of private later-stage portfolio companies seeking exits. Venture-backed merger activity totaled 56 transactions, of which 13 had announced values totaling \$645.3 million.

Credit and Valuation Impasses

There are a host of recessionary issues affecting the private equity market. The lack of available debt capital is a key problem impeding buyout funds from closing new investments (and exiting current holdings). The securitization market is not expected to return anytime soon.

The fact that most banks—large and small—continue to tighten the availability of loans has been well covered in the press. Most lenders are trying to shore up their balance sheets in order to absorb future expected losses on their existing portfolios. While a relatively modest number of mid- and small-sized transactions are securing loans at about four-times cash flow, buyout activity—both

investment and divestment—is not expected to recover until new credit issuance begins in earnest.

The other major factor affecting loan availability and transaction volume is the uncertainty of companies' future earnings. Without earnings visibility, pricing transactions is especially problematic. Even M&A by strategic buyers has slowed due to financial performance and valuation uncertainty. A final hurdle is seller expectations. The earnings uncertainty and lack of credit make it difficult to meet sellers' price desires. Sellers with high quality assets who do not have to sell will wait for better times.

SECONDARY AND DISTRESSED UPDATE

There was an expectation that secondary market volume would pick up after the year-end FAS 157 numbers were finalized, but that has not been the case. The factors described above affecting the primary market transaction volume also apply to secondaries. It is now becoming evident that market clearing prices, in large volumes, will only occur when there is visibility: 1) that company earnings have bottomed, and 2) on exit timing, which will require the return of some sustainable capital market liquidity.

There is a steady but moderate amount of secondary sales closing, mostly from truly stressed or distressed sellers. Commonly cited examples are smaller sales by endowments and high-net-worth investors, and some very large portfolios from

sources like the Lehman estate and AIG. The secondary market has not become the free lunch investors were hoping for, although returns should still be attractive after pricing solidifies.

The distressed debt market is experiencing similar issues. The early entrants who expected a 2002-like recession are sitting on large unrealized losses. Managers invested their funds quickly when the market started falling, not realizing that debt prices would fall significantly below usual historical lows. Since the severity of the recession turned out to be more 1929-like and prolonged, most investors are now sitting on their hands. The corporate default rate has been ticking up very slowly, and the majority of expected defaults will take some time to arrive.

PRIVATE EQUITY RETURNS

Fourth-quarter numbers (the performance numbers lag one quarter), as represented by the Thomson VentureXpert Private Equity Performance Database (formerly Venture Economics), have been published. As expected, returns dropped precipitously during the fourth quarter. The fourth quarter 2008 return for All Private Equity was -15.9%. By comparison to public markets, the S&P 500 returned -21.9% and the Russell 3000 -22.8%. By strategy for the quarter, All Venture declined 14.8%, All Buyouts fell 15.9%, and Mezzanine dropped 2.6%.

The new FAS 157 "mark-to-market" methodology for valuing unrealized portfolio holdings accelerated write-downs, and returns were negative across all of the sub-categories that VentureXpert tracks.

PRIVATE EQUITY RETURNS | continued

Mega-buyouts, as expected, had the largest return decline in the fourth quarter of 16.5%, primarily due to the greater applicability of public market comparables in their pricing.

Although the FAS 157 valuations caused dramatic declines in returns, there is still smoothing built into the numbers, so we expect returns to continue to decline in subsequent quarters. There was a large dispersion in the size of write-downs taken by individual funds in the fourth quarter. Mega- and large-funds declines averaged about 20%, small and mid-market funds averaged a 10% decline, and venture capital mark-downs were

Private Equity Performance Database Pooled Horizon IRRs Through December 31, 2008

Strategy	1-Yr	3-Yr	5-Yr	10-Yr	20-Yr
All Venture	(20.9)	4.2	6.4	15.5	17.0
All Buyouts	(23.9)	2.2	8.4	5.9	9.8
Mezzanine	6.6	3.5	4.2	4.8	7.5
All Private Equity	(23.6)	3.4	7.9	7.9	11.9
S&P 500	(37.0)	(8.4)	(2.2)	(1.4)	8.4

Source: Venture Economics. Private equity returns are net of fees.

similar to small buyouts. Callan has heard from managers that many companies were still performing strongly through year-end, but that revenue and earning declines started in the first quarter of 2009, which will be reflected in future quarters.

DID YOU KNOW?

Callan has developed a well-defined process for our clients to successfully implement and maintain private equity allocations. Similar to first exposures with other asset classes, we provide education, create guidelines, develop portfolio structures, and conduct searches for highly qualified managers for separate accounts or commingled vehicles for smaller investments. Callan then assists in monitoring the managers and assessing performance via annual portfolio planning sessions and quarterly performance measurement reporting. Investment programs are designed for ease of execution and ongoing administration.

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