New & Newsworthy

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Why Now is The Time to Invest in Private Equity

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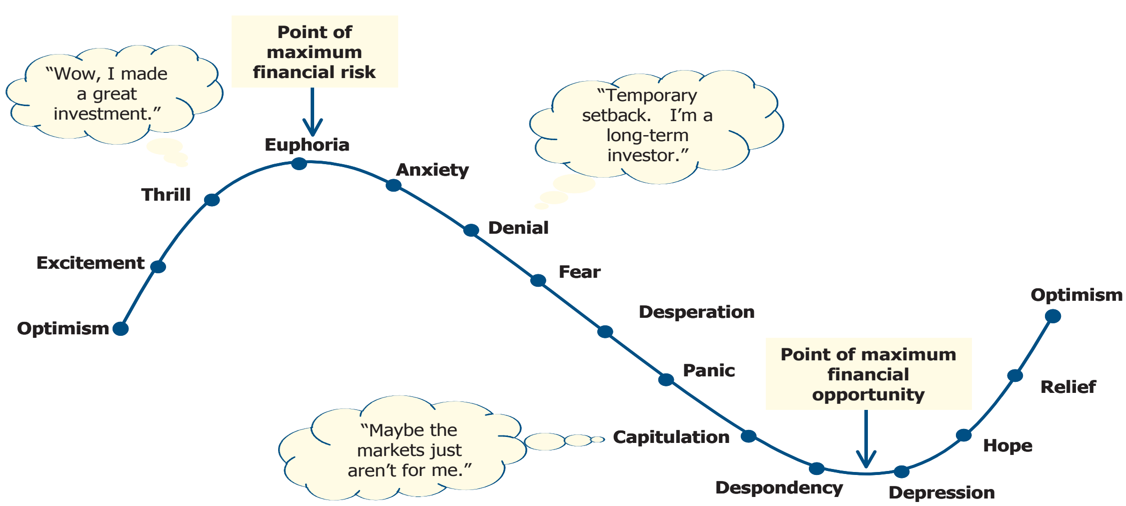
The Perfect Storm

The past three years have been the "perfect storm" for investors: speculative market valuations, over-investment in technology, dot.com hype, corporate accounting fraud, 9/11, overcapacity leading to weakened pricing power, hints of deflation, hostilities in Iraq and ominous threats from North Korea. Although few of these specific issues could be easily foreseen, when put in perspective, they are merely representative of the intense variations that typically emerge in every market cycle since each cycle is built around unforeseen events. What should not be surprising is the fact that prudent portfolio diversification and the necessity to focus on the long term, regardless of how turbulent or discouraging the present may be, is the soundest way to weather a market cycle.

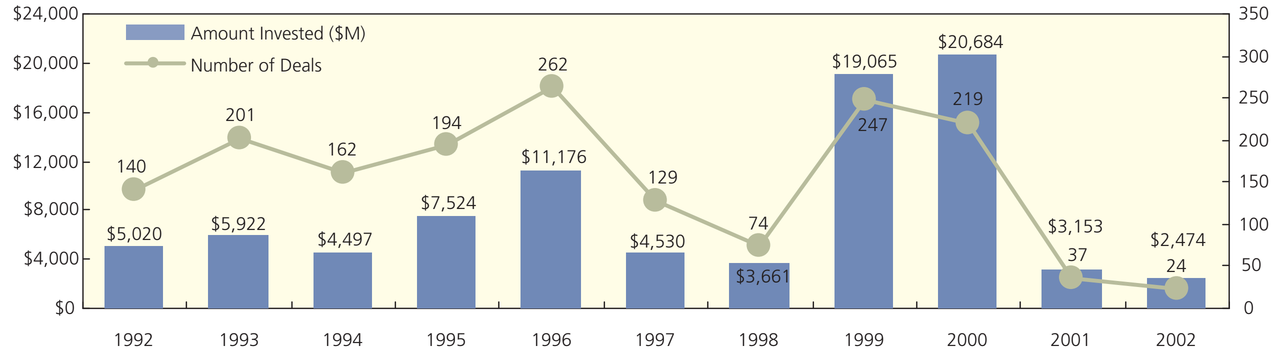
The Wave of Market Emotions

History has shown that exceptional investment opportunities often occur when conditions appear to be bleak and emotions are at their lowest. Companies such as Apple, Dell, Microsoft, Oracle, Starbucks and Sun Microsystems were all launched during lean periods for private equity investing. Investors must be aware of the emotional side of markets and understand the inverse relationship between subjective emotions and objective investment opportunity. The point of maximum financial opportunity is often found at the nadir of the cycle situated



Source: AIM Funds

Exhibit 1
Historical Venture-Backed IPO Activity



Source: Venture Economics

between despondency and depression. Given the current investment environment, it appears that we may well be approaching a point of maximum opportunity.

Why Invest in Private Equity Now?

There are several factors in the current market environment that make investing in private equity attractive:

- valuations are down
- venture capitalists have time to perform proper due diligence on new investments
- the cost of office space, equipment and seasoned executives (required to start a company) have dropped dramatically compared to three or four years ago
- over-leveraged corporations are more willing to shed non-core assets, which provides buyout firms with fewer strategic acquirers competing for deals
- although the M&A and IPO markets are currently quiet, the historical cyclicality of the venture-backed IPO market is an indication that recovery is possible once a number of uncertainties are resolved (Exhibit 1).

Market Pulse

The key drivers of private equity returns are the same as any other investment: buy in at a low price and achieve a high valuation through a public offering or strategic sale when ready to exit.

Deal Activity and Liquidity

Venture Deals are Getting Done: U.S. venture capital firms invested a total of $20.3 billion in 2,088 deals during 2002.[1] Although this represents a significant decline from 2001 ($37.7 billion in 3,226 deals), the year was the fourth best ever in the venture industry's history.

Buyout Activity has Accelerated: The buyout segment of the private equity industry experienced a surge of activity in the second half of 2002, as a $19 billion fourth quarter increased total deal volume for the year to $42 billion—almost double the amount done in 2001.[2] Several trends helped propel last year's activity, but the primary driver was corporate divestitures which provided public companies with much needed cash.

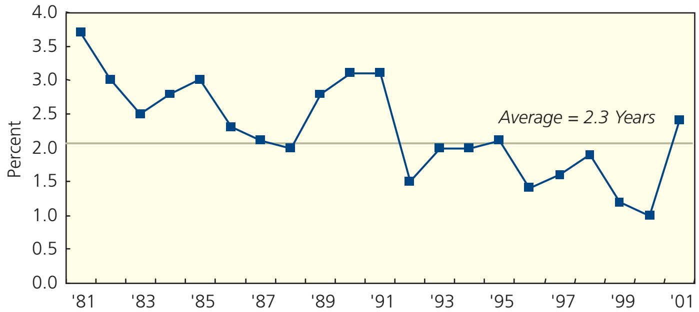
IPO Clarity: Although obtaining liquidity through an IPO continues to be challenging, investment bankers are finally "getting it" relative to what investors are looking for in a new stock offering. Only start-up companies with rock solid products and realistic business plans are likely to attract investor attention.[3]

Exhibit 2

Putting Venture Capital Overhang into Perspective

Reserve Ratio: 1981-2001

Ratio of Overhang to the pace of Investment



Source: Venture Capital Journal December 2002

Additionally, a recent *Red Herring* article noted that investment bankers have established unofficial targets of potential IPO candidates with $40 million in revenues, 30 percent annual growth rate, several million dollars of available cash, a diverse customer base and signs of near-term profitability.

Declining Valuations

Venture Deals are Getting Done at Lower Valuations: The average valuation for venture-backed companies was $36.9 million in fourth quarter 2002, a decrease of more than 30 percent from the $52.3 million in the same period of 2001.[4]

Buyout Deals Multiples have Declined: Since their peak during 1997 to 1999, prices for buyout deals have come down through 2002. Average trailing EBITDA multiples for all industries declined from 7.4x in 1999 to 5.9x in 2002. Several factors have been instrumental in the reduction. These include seller attitude, the quality of companies and their degree of cyclicality, the recession, and the debt markets. As we move forward, these factors should stabilize and perhaps even strengthen multiples.[5]

Increase in Technology Spending

IT Spending Expected to Increase: A number of research firms are calling for an Information Technology (IT) recovery in 2003. Both IDC and Gartner Group predict an approximate six percent growth in IT spending this year—up from two percent in 2002.[6] The increase in demand is related to updating existing infrastructure. Areas that could spur the IT recovery next year include security and wireless infrastructure.

Private Equity Overhang in Perspective

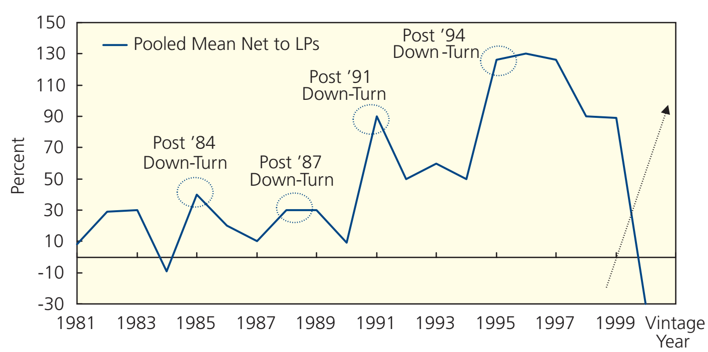
An important issue in private equity today is whether the industry has too much uninvested capital under management, commonly known as "overhang." According to a recent article in the *Venture Capital Journal*, some industry experts estimate that the current amount of overhang is in the range of $45 to $100 billion.[7] Many investors are concerned about the impact this overhang will have on a General Partner's ability to effectively put money to work and the influence on future returns. More specifically, an excess of capital may lead to unwarranted competition for new deals, which in turn may result in overvaluation of deals.

It is important to view the overhang issue from the proper perspective and dimension. Considering the absolute dollar amount of uninvested capital strictly from a supply side, does not adequately address the issue. To properly assess its significance it is necessary to measure the "ratio" of the overhang (or supply of capital) to the pace of investment

Exhibit 3

Uncertain Environments Present Challenges and Opportunities

Historically, VC Funds in years of negative NASDAQ returns showed record returns overall.



Source: Draper, Fisher & Jurvetson

(the demand for capital), which has been referred to as the Reserve Ratio. It expresses, in years, the amount of capital reserved for future investment.

Exhibit 2 gives this ratio some historic perspective. Over the past 20 years, the average Reserve Ratio has been 2.3 years, with a high of 3.7 years in 1981. The ratio for 2001-2002 of 2.4 years is actually more in line with historic standards, and should not be cause for alarm.

The *Venture Capital Journal* article indicated that market conditions today resemble the 1987-1991 period when the United States suffered a market crash, war and recession. The Reserve Ratio was slightly above 3.1 years in 1990. Over the succeeding years, investment rates outpaced capital contribution rates, bringing the Ratio down to approximately 2.0 years by 1994. As the overall public market improved, exits were achieved and the performance for venture funds formed in the late 1980s and early 1990s averaged 19.7%.

Now Is The Time To Invest

As long-term private equity investors, we believe that now is a sound time to invest. A rational investor must recognize that feelings of discouragement can actually mask a point of maximum opportunity (Exhibit 3). Concern about overhang in private equity is exaggerated, as the current Reserve Ratio appears to be in line with historic norms.

The drivers of private equity returns favor entry into this asset class: valuations are low, and projections of a resumption of technology spending are getting stronger. Liquidity options, although maybe not available today, could be available several years from now when maturing companies are ready for exit opportunities. From our vantage point, the private equity industry appears to be well-positioned on a risk/reward basis, particularly when compared to other asset classes. It would not surprise us to look back several years from now and understand that the current moment was actually one of the better periods in which to have been an investor in the asset class.

Endnotes:

1. *"Venture Wire Releases 2002 Venture Capital Investment Totals,"* Venture Wire, January 6, 2003, Editor.
2. Editor, Private Equity Week Wire (Buyouts Newsletter), January 7, 2003.
3. Millard, Elizabeth, *"Who's Getting Funded in High-Tech?"* E-Commerce Times, September 9, 2002.
4. Money Tree Survey 4th Quarter, 2002, Pricewaterhouse Coopers.
5. Green, Leslie, *"Annual Multiples Survey,"* Buyouts, April 9, 2003.
6. Maguire, James, (NewsFactor Networks), *"Study: IT Spending to Rest-For Now,"* CRM Daily, February 26, 2003. Regan, Keith, *"Is an IT Budget Boost on the Horizon?"* E-Commerce Times, December 18, 2002.
7. Dignan, Phillip and David Link (Appian Venture Partners), *"Putting the Venture Capital Overhang into Perspective,"* Venture Capital Journal (Venture Economics), December 1, 2002.

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