

The Outlook for Private Equity: Third and Fourth Quarter 2009

November 2009

Table of Contents:

Introduction	1
The Global Outlook	1
Private Equity Outlook	3
Secondaries Update	6
Conclusion	7
Private Equity Trends at a Glance	8

Introduction

Is the private equity market back? This is one of the most widely posed and debated questions of the financial industry over the past few months. Given that there is scant evidence that the market is anywhere close to its fervor two years ago, this question is either too vague or premature to tackle in the current environment. Perhaps it would be more fitting to ask whether private equity has overcome the worst of its cyclical downturn? Global economies are recovering and financial markets are stabilizing so it's not unforeseen that private equity should also be reaching an inflection point in its cycle.

In this report, we provide supporting evidence that the private equity industry has bottomed out, and is showing some early signs of a rebound. We begin by reviewing the improved prospects for economic growth around the world. Most countries have officially come out of recession and forward-looking economic indicators suggest continuing expansion. Next, we examine the private equity industry in detail and the various metrics signaling the market is approaching renewed growth prospects after many quarters of dislocation. Lastly, we discuss the past performance of the secondaries market and the outlook for the remainder of the year, as well as 2010.

The Global Outlook: World Economy on the Mend

Longer-term economic trends are increasingly important for private equity investors since, unlike traditional stock and bond investors, they can ignore short-term quarterly results. As a result, economic fundamentals underpinning our assumptions for the global trajectory are important drivers of the health of the private equity industry, as well as revealing market and industry opportunities. Institutional investors are increasingly enamored with international private equity that can help diversify their portfolios geographically. A recent survey by the Emerging Markets Private Equity Association found that about 74% of limited partners (LPs) plan to increase their commitments to emerging markets over the next three to five years.

After a sharp retrenchment in global output, the world economy is stabilizing. Of the 20 leading economic indicators tracked worldwide, 15 are signaling expansion. Since the recession hit in late 2008, real GDP has begun to recover globally, led by a strong rebound in the Asia Pacific region and milder than previously experienced declines in the US and Europe. The manufacturing sector and industrial production are recovering first. Massive inventory liquidations during 2008 and 2009 have set the stage for a significant rebound in global output and trade activity.

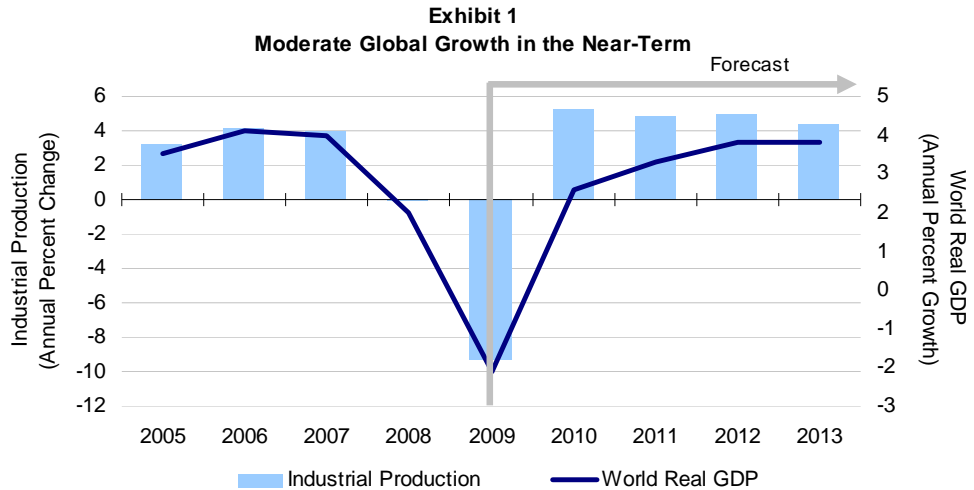
Financial markets are also recovering and the appetite for risk has returned. Credit remains tight, however. Even though the banking sector did not fall off a cliff, it remains fragile and a number of financial institutions continue to face mounting levels of non-performing loans. According to the October 2009 IMF World Outlook report, US banks have recognized more than half of their projected losses from impaired assets through 2010. By contrast, their analysis suggests that in Europe, banks are less advanced in their recognition of impaired assets, mainly reflecting differences in their economic cycles across the broad regions.

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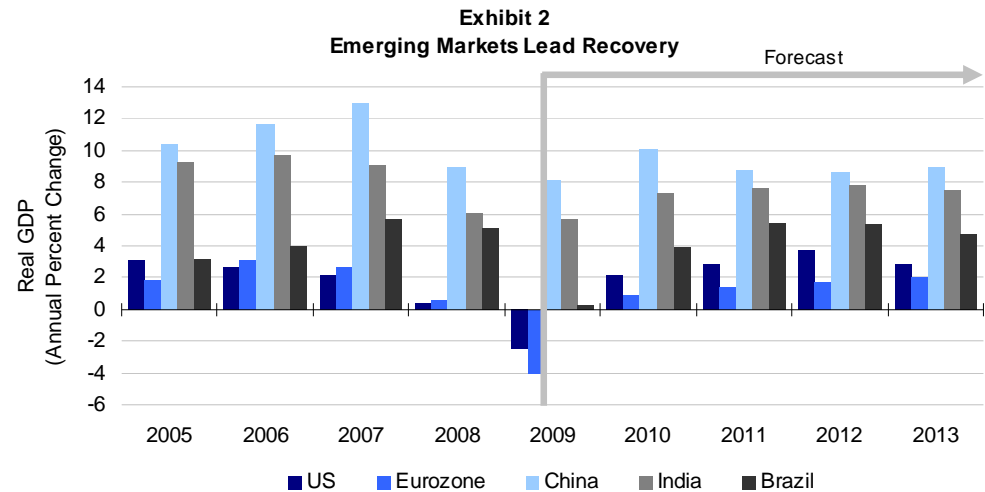


Source: Global Insight and RREEF Research

World real GDP is expected to advance by a muted 2.5% in 2010 after having contracted at a 2.2% rate this year. Growth should accelerate to 3.4% in 2011, assuming that banks are able to repair their balance sheets and begin to provide much needed credit to households and corporations. If history is any guide, recoveries that follow financial crises and recoveries that occur during periods of broad de-leveraging are often weaker than traditional boom-bust recessions.

Across regions, there exist wide disparities in performance. Asia's emerging markets are leading the recovery while Europe and Japan will lag overall world growth. The US will be an average performer until 2011 when growth is expected to pick up broadly across a wider number of sectors. Regional highlights are presented below.

- Emerging Markets:** Asia's emerging markets are leading global growth with a V-shaped recovery, having benefited from highly aggressive monetary and fiscal stimulus policies and a rebound in intra-regional trade. China will lead the pack driven by a boom in investment activity. India's economy will also remain on a fast track despite the decline in agricultural output. Brazil is also now officially out of recession. Private consumption has been stimulated by government fiscal policy whereas investment spending remains flat.
- Eurozone:** Recently released economic data suggests that the Eurozone economy expanded in third quarter 2009. Stronger growth in Germany and France has offset continued declines in Spain, the Netherlands and, to a lesser extent, Italy. The cash-for-clunkers program has supported greater consumer spending in some of the region's leading economies. Longer-term growth prospects for the region are less buoyant, however. The region continues to face serious financial sector problems and tight credit conditions. The euro is appreciating and the labor markets are inflexible.
- US:** The US economy is likely to post positive growth in the second half of 2009, however, the job market will continue to struggle. The massive inventory correction is supporting a technical recovery in manufacturing output and industrial production. The housing market is closer to stabilization than that witnessed in the European economies. Headwinds facing consumers and businesses will prevent a stronger recovery in the near-term.



Source: Global Insight and RREEF Research

Private Equity Outlook

The private equity market appears to have finally approached its cyclical nadir in the second half of 2009. Despite a slew of mixed signals and premature prognostications that the market has either died, been reborn or is heading towards a great resurgence, most relevant time series indicators illustrate an apparent trough. Amongst eight key private equity metrics—LBO deal volume, M&A deal volume, VC investments, valuations, IPO exits, private returns, listed market performance and fundraising—there are four discernable stages of activity. These include bottoming out, stabilizing, early recovery and positive upswing. These stages are defined by recent performance on a relative basis, not an absolute one.

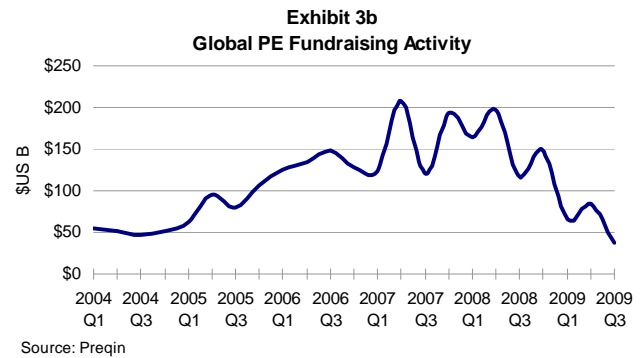
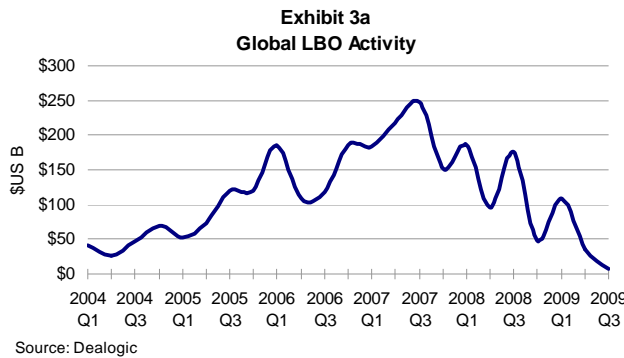
Much like the movement of a pendulum, the private equity industry has been undulating between periods of high activity/strong performance and low activity/weak returns. If one were to trace oscillation of the industry during the current cycle, the midpoint is likely to coincide with the collapse of Lehman Brothers over a year ago. Since then, the market has fallen to its lowest level in six years in terms of transaction volume, fundraising and performance. The private equity industry is on the road to recovery but will be characterized by smaller deals, more conservative capital structures and longer holding periods—a significant change from the 2006 and 2007 boom period. The improvement of global macroeconomic variables will eventually lend itself to a recovery in the private equity sector.

Bottoming Out

LBO activity has been on a steady decline during the past year. In third quarter 2009, only \$8.2 billion of buyouts were completed globally, conditions unseen since 1993 (Exhibit 3a). The sector has hit a wall in terms of debt financing. In order to service a single deal, more banks are needed to amass a lower amount of leverage (as compared to the boom period) over a longer timeframe. The deals that are being completed are distinguished by more conservative capital structures, pricing discipline and an emphasis on risk management. Once the debt market improves and exit opportunities resurface (trade sales, secondary buyouts and IPOs), the outlook for LBOs should rally and deal activity will pick-up.

Private equity fundraising has also been suffering from the market downturn. Although many investors have expressed an interest in holding their allocations to the asset class steady, capital raising statistics prove otherwise. The third quarter was one of the worst quarters for fundraising since 2003 (Exhibit 3b). A number of funds were abandoned or put on hold and those that did survive took an average of 18 months to close. Part of the reason for the slowdown in fundraising is that the market still has approximately \$1 trillion of dry powder to

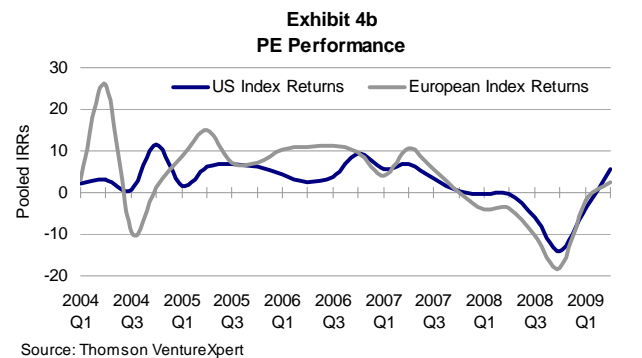
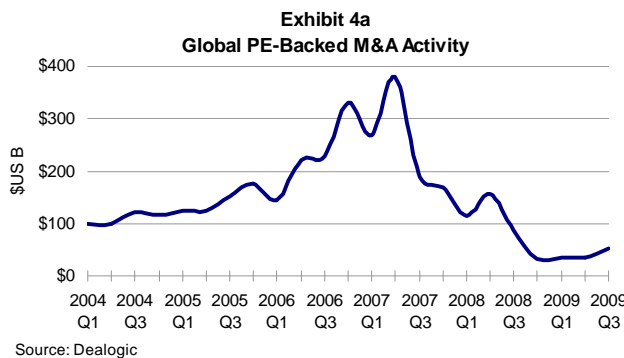
work through. Investors are hesitant to commit new capital to funds when existing commitments have yet to be put to work. Additionally, LPs are scrutinizing fund terms and are willing to pass on opportunities that do not correspond to their needs.



Stabilizing

Similar to the circumstances plaguing the buyout market, announced private equity-backed M&A deals have plummeted. According to Dealogic, global M&A totaled \$1.67 trillion year to date as of September 30. This represents a 35% decrease from the previous year. Of that total, private equity groups represented \$123 billion in acquisitions which amounted to a 66% decrease since the same period in 2008 (Exhibit 4a). Financing is still a key constraint for the sector but conditions are showing slight improvement on a quarterly basis this year since fourth quarter 2008 when the market approached its low. New multibillion dollar deals are being announced again, including the sale of AB InBev's central and eastern European assets to CVC Capital Partners for \$3.0 billion (October 2009), CD&R's recapitalization of Johnson Diversity valued at \$2.6 billion (October 2009), Blackstone's \$2.3 billion acquisition of Busch Entertainment Corp (October 2009) and CVC Capital Partners' \$3.0 billion acquisition of National Express Group (July 2009).

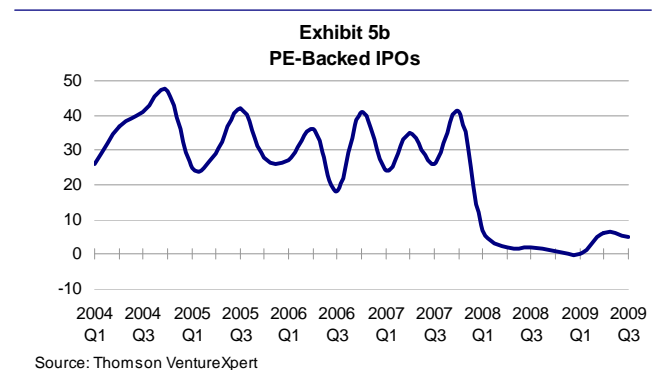
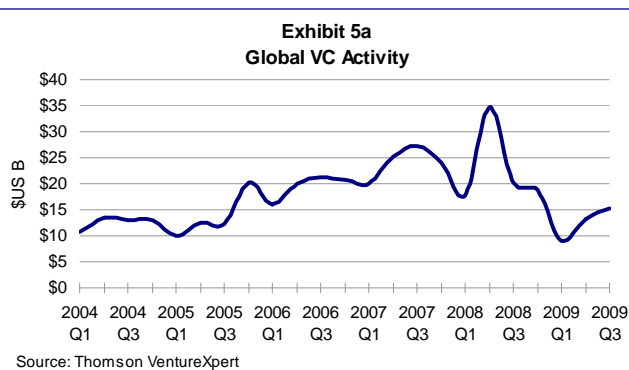
Private equity performance is beginning to show signs of improvement after crossing into negative territory in first quarter 2008 (Exhibit 4b). Second quarter 2009 returns in both Europe and the US have edged upwards and indicate a trend towards improving performance and stabilization. On an encouraging note, private equity valuations tend to follow public equity markets which are up 33.9% (S&P 500), 35.9% (FTSE) and 38.9% (Nasdaq) between March 31, 2009 and September 30, 2009. With mark-to-market rules in effect, the rise in the stock market should lead to an increase in private equity valuations which, in turn, should result in a boost to returns. Portfolio valuations will likely improve through the second half of 2009 although realizing exits may be difficult.



Early Recovery

Of late, venture capital has suffered from the grimmest outlook vis-à-vis the rest of the private equity industry. Although the sector is 10 years removed from its halcyon days, investment in cleantech, renewables, healthcare and technology has been driving investment activity. Overall 2009 deal volume will be less than the previous year, however, since the sector bottomed-out in first quarter 2009, the outlook has been warily improving. During the second and third quarter of this year, there were \$13.4 billion and \$15.4 billion worth of deals completed, respectively (Exhibit 5a). VC focus has shifted to later stage companies over early seed investments and the pick-up in IPO activity should prove beneficial for this set of portfolio companies. Nonetheless, the sector is most at risk for slipping performance and should be monitored closely.

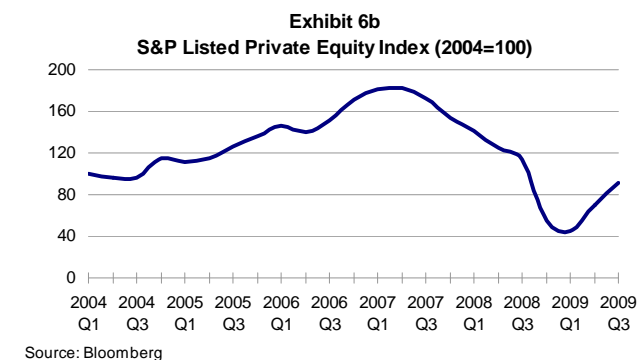
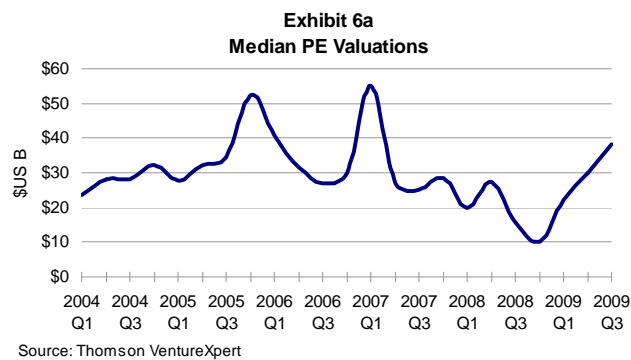
As mentioned, the private-equity backed IPO market has come back to life after having no offerings in the beginning of this year. Between second quarter 2008 and first quarter 2009, only five private-equity backed IPOs were recorded (Exhibit 5b). By comparison, 19 private-equity backed IPOs have occurred through the end of October this year. Not only is the overall IPO market experiencing a “boomlet” but private equity-sponsored offerings have been outperforming the broader stock market indices. According to Thomson VentureXpert, private equity IPOs have achieved a year-to-date return (as of September 30) of 69.2% while the S&P, Nasdaq and Dow have achieved returns of 17.0%, 34.6% and 10.7%, respectively. Assuming a continuing recovery in global economies, debt and equity markets, the number of IPOs entering the market should continue to strengthen in the next year.



Positive Upswing

Of all the private equity indicators that have shown the strongest rebound, valuations are on top. FAS 157 contributed to reduced valuations in 2008 and early 2009 but has since been partially responsible for driving up valuations over the last three quarters (Exhibit 6a). With the public equity market starting to intensify and the mark-to-market valuations situation improving, the return profile for private equity investments should begin to improve.

The often overlooked segment of the broader private equity market, listed private equity funds, has also shown a positive upswing in light of improving market conditions. Currently, investors in listed funds are able to take advantage of the spread between stock price and the increasing underlying value of the assets. Furthermore, the recovery in the broader equity markets, coupled with increased awareness of the listed market, has been contributing to the run-up in the share prices. As measured by the S&P Listed Private Equity Index, the market reached its most recent low point in February 2009. Since then, the index has shown a 150% increase in value as of September 30 (Exhibit 6b). A survey by LPEQ indicates that there will be sustained interest in the listed market by European investors, especially if discounts to NAV still persist.



Secondaries Update

Just as the overall private equity market has experienced a pendulum shift, the secondaries market is also undergoing a directional change. In the latter half of 2008 and first quarter 2009, the secondaries market was characterized by panicked selling by distressed investors. The denominator effect, potential capital calls, and lack of visibility and uncertainty in the underlying private equity market took a toll on a number of investors who needed immediate liquidity. This period was then followed by the second and third quarters of 2009 which marked a lull in the market. The expected influx of deal activity that was to follow large portfolio write-downs failed to materialize. Buyers and sellers reached a pricing stalemate and distressed sellers achieved a new-found optimism due to reduced denominator effect pressures, a lack of capital calls and rising public equity markets. During this period, the only market segment that remained buoyant for sellers was that of unfunded positions sold to non-traditional secondary buyers. Traditional secondary buyers wanted to buy mostly funded positions in high quality assets at large discounts to NAV and sellers, no longer facing an immediate pressure to liquidate, decided to hold.

This leads us to present-day—fourth quarter 2009—where the secondaries market should begin to thrive again due to a confluence of factors. First, improving global economies coupled with increased visibility for private equity portfolio companies and updated valuations have resulted in increased secondary pricing. Cogent Partners witnessed pricing bottoming out in first quarter 2009 but has since seen improvement. With the pricing situation improving, the secondary market is showing early signs of picking up again and should continue to do so in 2010. Second, deal volume will likely be driven by a combination of increasing capital calls and anemic distributions. Investors who find themselves cash-strapped or looking to rebalance their portfolios will, once again, tap into the secondary market as a source of liquidity. Should unexpected market dislocations or stock market corrections also take place, that will further fuel the market. Lastly, the selling of large unfunded commitments—a trend which began in 2009—is expected to continue in 2010 but is only likely to receive the attention of non-traditional secondary buyers. Non-traditional secondaries buyers are willing to consider immature stakes in order to supplement and diversify their existing portfolio of primary investments.

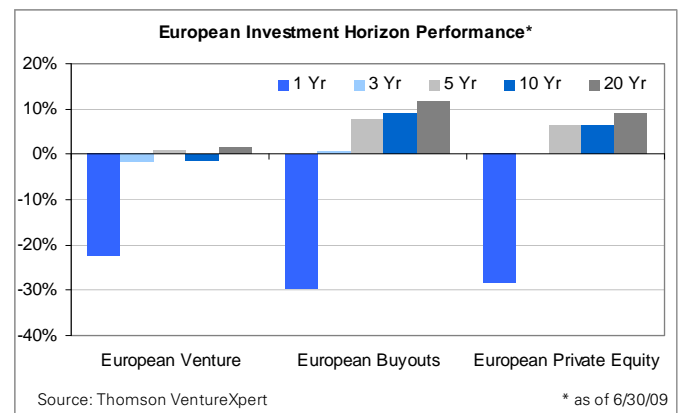
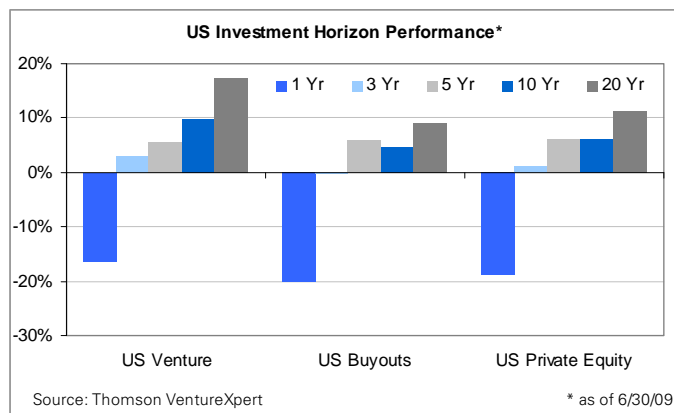
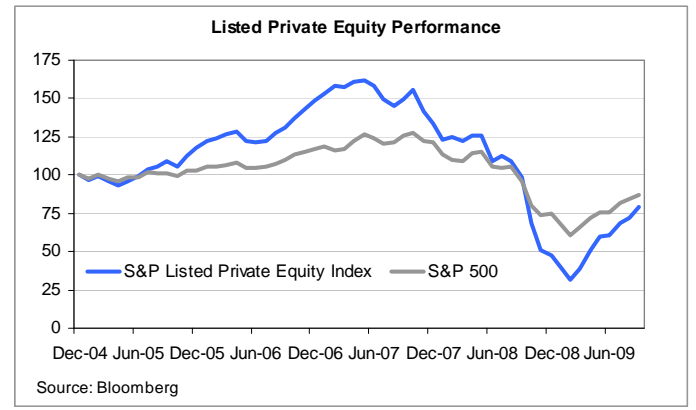
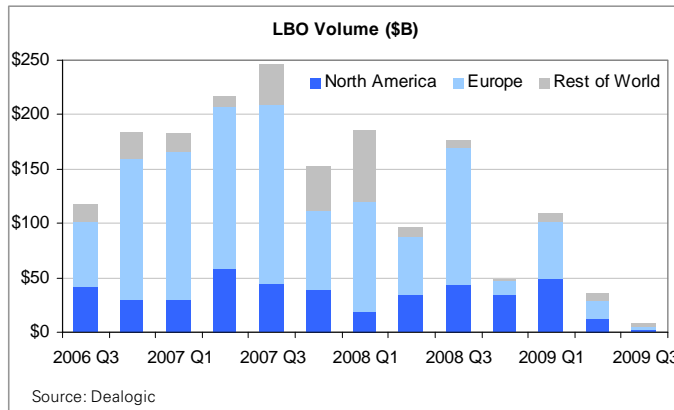
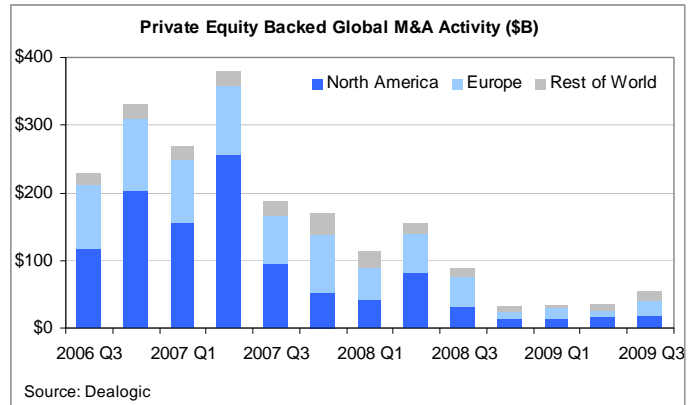
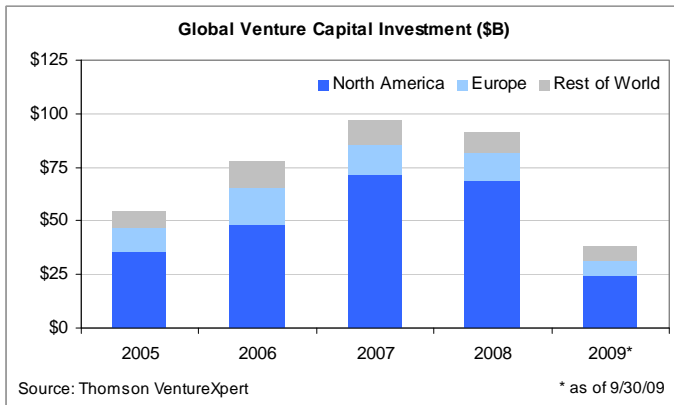
Looking ahead, secondary market sales are likely to pick-up as high net worth/family offices, foundations, endowments and banks seek to actively manage their private equity portfolios. By the end of 2009, RREEF estimates secondary transaction volume will likely fall between \$15 billion and \$20 billion. This is much less than the anticipated \$50 billion of activity forecast by UBS in the beginning of the year. Nevertheless, the market is gaining much-needed traction after a prolonged lull.

Conclusion

In the two years since the onset of the economic and financial crisis, global markets are finally heading toward a period of recovery and stabilization. Although there is an overarching risk that the convalescence of the market may be short-lived and that a W-shaped recovery could be on the horizon, there is compelling evidence that the worst is behind us. The key recovery fundamentals for the private equity market—economic growth, available financing, corporate earnings and market confidence— are beginning to take hold. This will provide the momentum to keep the private equity market on a cyclical upswing.

For secondaries, the outlook is slowly improving. Although 2009 transaction activity fell well short of industry expectations, the market appetite for this slice of the market is increasing. Inasmuch as the growth of the private equity industry follows the growth of the overall economy, the trajectory of the secondary market should mirror that of the primary market.

Private Equity Trends at a Glance



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