



A Rosy Vintage in Private Equity?

Opportunities in Venture Capital, Emerging Sectors and Distressed Investments; Headwinds for Mega-Sized LBOs

The outlook for private capital investments in 2010 is bifurcated. Although exits from older vintage years will continue to face challenges, new investments should fare better, since they will benefit from lower entry valuations and renewed growth as the economy recovers. The slow rebound may also provide particularly strong opportunities for investments in distressed securities and venture capital, which have historically tended to respond in contrarian ways to normal economic conditions. The continued deleveraging of balance sheets and difficulty with raising capital, however, should have a significant effect on private equity returns in both the short and long term.

Effects of the capital market downturn on private equity funds

The most significant negative consequences of the global financial crisis for existing private equity investments have been (1) the sharp tightening in access to capital, (2) the triggering of negative financial covenants and (3) the rise in defaulted loans. Obviously, numbers two and three were a driving cause of tightened lending and risk aversion. As a direct result of enormous fiscal and monetary stimulus, access to private capital financing has gradually improved since the March 2009 market trough. Growth in merger and acquisition (M&A) activity in the third and fourth quarters, along with the sharp turnaround in 2009 leveraged loan trading levels, confirms that banks and investors are more confident and looking to put capital to work. Banks have, in fact, demonstrated greater confidence in the long-term prospects of healthy corporations and well-positioned business models than the debt-laden consumer.

End of the excessive leverage era

Among private equity funds, investment returns in today's more restrained credit environment are going to be differentiated between managers who relied heavily on leverage and cheap credit alone to drive returns in the past, and those who have demonstrated a consistent ability to build businesses while using leverage prudently. Based on historical recessionary periods and the current favorable macroeconomic environment, 2010 - like 2009 - looks to be a strong vintage year (on average) for many funds putting capital to work. However, there will most likely be clear winners and losers based on the industries and strategies in which general partners invest. Sector selection, entry valuation and a strong track record of building and/or restructuring businesses will be essential for delivering attractive Internal Rates of Return (IRRs) to investors in the coming year.

Strategic entry points and sector selection

The technical and cyclical aspects of the various asset classes typically labeled as "private equity" are also important. In 2006, buying in at extraordinarily high LBO multiples was a poor strategy; today, avoiding asset classes that are trading at historically low multiples is likely to be a missed opportunity.

A continued, and perhaps widening, disparity between those winners and losers is likely in 2010 and beyond. From a top-down vantage point, venture capital, despite a trough in performance of early decade vintages, has historically been at its most attractive entry point during recessions. In contrast, a number of mega-cap leveraged buyout (LBO) managers continue to struggle despite the rise in overall M&A activity. Emerging markets appear to be better positioned for growth than developed markets and investors should continue

to find opportunities in the global initiatives around infrastructure expansion and clean technology. Finally, distressed security opportunities are likely to persist from continued weakness in many sectors of the U.S. and global economy.

A sustained sweet spot for distressed investing

The financial markets are well into the optimal investment phase of the distressed cycle. Although bankruptcies and defaults likely peaked in 2009, loan covenant violations will continue to rise. Many distressed managers have put a large portion of their capital to work, buying securities at fire sale prices. And because debt markets rebounded in 2009, many distressed investors have already seen positive returns.

It is likely, however, that substantial deterioration will occur in certain sectors and provide additional opportunities for distressed investors. Industries (and companies) come under pressure at different times. Many companies now in distress and in need of capital are in healthier industries. They may have sustained the initial downturn in the economy, but are now collapsing under the weight of their debt, presenting perfect opportunities for distressed buyers.

Given the historic magnitude of the current recessionary trough, distressed opportunities will likely be spread out over a longer period of time, benefiting investors who have significant capital-raising ability and expertise in managing companies through balance sheet crises. Financial services has clearly been at the top of the list for distressed sectors since the beginning of the credit crunch in late 2007. With housing still showing weakness, continued problems may still lie ahead for loans and mortgage securities. Corporate real estate, moreover, could also experience severe weakness in 2010, providing additional investment opportunities.

Since credit remains accessible only to well-financed companies and revenues have dropped as a result of lower consumer spending, liquidity and solvency crises are likely to drive more companies into bankruptcy. One such industry entering a period of potential balance sheet crisis with favorable long-term turnaround potential is the gaming sector, which has been squeezed by declining revenues and a heavy debt burden. Distressed investment managers who can identify quality businesses from this downturn and manage these companies successfully through restructuring may be able to generate substantial IRRs for their funds.

LBOs - opportunity at mid-market; trouble ahead for mega-sized deals

Global private equity activity sank to approximately \$190 billion in 2008, down 70 percent from 2007¹, as the global financial crisis crippled banks' ability and willingness to lend for buyout deals.

LBOs represented just 7% of total M&A volume - the lowest level since 2001 and far below the boom years of 2005-07, when industry leaders Carlyle Group, Blackstone Group and Kohlberg Kravis Roberts & Co. were systematically outbidding strategic acquirers. Buyout deals reached an all-time high of 20.5% of M&A volume in 2006.² As the global financial crisis peaked in early 2009, some of the deals constructed during 2005-07 increasingly appear to be mistakes, with high debt repayments crippling companies just as revenues shrink. Not surprisingly, the last 18 months have been punctuated by buyout firms trying to extract themselves from ill-conceived deals.

Perhaps the biggest issue for the coming year, however, is retaining support from limited partners. Not anticipating the pending dislocation, many LPs anticipated funding future commitments through distributions from existing investments. Unfortunately, distributions have slowed to a trickle over the past two years. Combined with the denominator effect of shrinking overall portfolio assets, the effect has weighed on overall pension fund allocations to private equity. In addition, early performance returns on funds raised during the bubble range from negative to barely positive. One question, then, is how many limited partners will continue to provide money to an illiquid asset class. Historically, in markets such as the one we're experiencing, they cut back at exactly the time they should be increasing their allocation in anticipation of a rebound.

Meanwhile, public appetite for investment in private equity has slumped. Shares of Blackstone are trading at around 40%³ of their June 2007 initial public offering price of \$31.⁴ That doesn't bode well for others aiming at the public market, such as Carlyle, KKR and Apollo Management.

1 Source: Thomson Reuters, March 2009

2 Source: Thomson Reuters, December 2009

3 Source: Bloomberg, L.P., December 31, 2009

4 Source: Thomson Reuters, December 2009

With the demand for leveraged loans dramatically reduced, potential deal sizes have dropped. Thus, it is unlikely investors will see double-digit, multi-billion-dollar deals coming back for quite awhile. More likely, larger market participants will focus on deals of less than \$5 billion dollar range once markets fully reopen, but even these deals will have augmented capital structures. Buyout firms will have to make equity investments of 30% to 50% in acquisitions to reach scale, altering the balance of debt to equity in a target company.

Entrepreneurship, valuation and attractive terms highlight opportunities for venture capital

Venture capital as an asset class is inherently cyclical. From an investment standpoint, it is more accurately described as countercyclical. During booming markets, access to capital is easy for entrepreneurs who have left their jobs to start a business in a hot sector. Think Silicon Valley, Silicon Alley, Silicon Prairie, etc. in 1999. That is not, however, an opportune time to be an early stage venture capital fund manager. Pre-money valuations are high and the likelihood of a bull market cycle lasting long enough for a successful exit of new investments is poor. It is no surprise, therefore, that the bubble vintages of 1999 and 2000 have produced negative returns to investors. A dearth of sizable exits in recent years and lackluster fund performance have led many investors to abandon the asset class.

Ironically, this decline in capital funding could be seen as a potential boon to the asset class. As the industry right-sizes, start up valuations will decline and capital can be deployed more prudently. Managers with the foresight to back successful startups will be rewarded when the market turns. Given the difficulty of raising capital, companies looking for startup funding or expansion capital are likely to be more flexible on terms.

Conclusion

Outlooks for 2010 among financial market predictions are as varied as they have been in decades. A 50+% decline in the equity markets followed dramatically by a 50+% increase from the March bottom has changed investor psychology from so-called normal years, when expectations stayed within a more modest range of possible outcomes. **For private equity funds, recessions represent historic opportunities.** Lower entry valuations have reduced entry prices while the asset class's long timeframe forces investors to be patient for price appreciation. Risks do remain, particularly with respect to a potentially slow recovery and limited access to credit. Not surprisingly, we come back to a core tenet of investor advice: seek out proven managers with operational as well as financial expertise.

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