Venture Capital and Private Equity
The Past, Present and Future

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Finance Department
Overview

- The Private Equity Industry has been characterized by boom/bust cycles. Both venture capital and private equity have been impacted by the current economic environment with many predicting the industry will go through a significant transition or even contraction.

- This webcast will review the origins of the industry, highlight the current industry trends and issues, and discuss what the future may hold for the industry.

- The assessment framework will explore the four main activities of private equity professionals: fundraising, investing/deploying capital, managing the portfolio, and exits/harvesting the investment.
The Private Equity Asset Class

- Private Equity is investing in or acquiring the securities of non-public companies. Private Equity firms can be broken down into two main categories (excluding fund of funds):
  - Venture Capital Firms (Private, Corporate & SBIC)
    - Seed Stage, Early Stage, Later Stage, & Growth Capital
  - Private Equity Firms
    - Leveraged Buyouts, Management Buyouts, Mezzanine Capital, PIPEs, Merchant Banks, BDCs & Distressed Investments
- Venture firms invest in young or emerging companies and may take a minority interest while LBO firms invest in mature firms and typically take a majority control.
- According to NVCA, from 1970-2008, venture capital backed firms have accounted for 12.1 million jobs and $2.9 trillion in revenues.
Origins of the U.S. Private Equity Market

IN THE BEGINNING……..

➢ Merchant Banks in London and Paris provided acquisition capital and minority investments in private firms going back to the 1850s in Europe. These firms also financed many of the U.S. railroads.

➢ In 1901, J. P. Morgan acquired the Carnegie Steel Company from Andrew Carnegie & Henry Phipps for $480 million in the first US buyout. In 1907, Phipps created the Bessemer Trust, a family office, to invest $50M in private companies.

➢ The Glass Steagall Act of 1933 and other US government regulations prohibited merchant banking in the US. Investment banks were primarily confined to placement of debt and equity securities and M&A advisory roles.

➢ Before WWII, venture capital investments were called development capital provided by primarily angel investors.
Family Offices Transition to Institutional VC

- During the industrial revolution until after World War II, private equity was the domain of wealthy families
  - The Vanderbilts & JH Whitney
  - Laurence Rockefeller (Rockefeller Brothers Foundation) – helped finance the creation of Easter Airlines and Douglas Aircraft
  - The Warburgs (Became Warburg Pincus doing both LBOs/VC)
  - Belmont Towbin (Unterberg Towbin)
  - Payson & Trask

- Ralph E. Flanders, President of the Federal Reserve Bank of Boston, is credited with the idea of Venture Capital.

- 1946: American Research and Development Corporation (ARD) – founded by General Georges Doriot, former Professor & Dean of HBS and considered the father of VC, along with Karl Compton, former president of MIT
  1. Raised $7.4 million from 1946 to 1951
  2. First closed-end public investment company
  3. The 1957 investment of $70K in DEC and sold for $37M at the 1968 IPO – a 500x return (100% IRR).
VC Industry Expansion

- **1958 - passage of the Small Business Investment Act**
  - The SBA licensed SBICs and MESBICs to provide long-term capital to small, growth-oriented entrepreneurial businesses in the US. Private capital was levered up to 4:1 with federal funds.

- During the 1960s and 1970s, venture capital focused on emerging technologies in electronic, medical and data-processing and became almost synonymous with technology firms. Venture capital remains concentrated near the intellectual and technology centers for these industries – namely Silicon Valley, Boston, Research Triangle, and Southern California.
  - The first venture backed start-up was Fairchild Semiconductor in 1959 by Venrock Associates founded by Lawrence Rockefeller.
  - Palo Alto & Sand Hill Road in Menlo Park began with the founding of Kleiner Perkins and Sequoia Capital in 1972 and leveraged the intellectual capital at Stanford and Berkley.
  - Texas was a late entrant, but with notable success stories with Sevin Rosen in Dallas (1980) and Austin Ventures in Austin (1984).
VC Industry Expansion

- Late 1970s and early 1980s: Important regulatory and tax changes caused an acceleration of capital into the private equity markets:
  - Change in interpretation of ERISA “prudent man” provision which allowed pension funds to increase their investment in alternative asset classes
  - The maximum capital gains tax rate reduced from 49.5% to 20% from 1978 to 1981 (15% today) making risky investments more attractive.
  - The high corporate tax rates encouraged the use of leverage to reduce taxes
    - Big surge in LBO shops starting in 1984 with Michael Milken’s advent of the junk bond market

- In 1978, VCs raised a record $750 million and the number of firms increased.
  - TA Associates, Apax Partners, NEA, and Sevin Rosen all started during this year.
  - During the 1980s, notable VC investments include: Apple Computer, Compaq, FedEx, Genentech, Tandem Computer, Electronic Arts
The first LBO may have been in 1955 when McLean Industries purchased Pan-Atlantic Steamship with $42 million in debt.

During 1960s, using public companies as investment vehicles became popular:

- Warren Buffett – Berkshire Hathaway
  - While called a stock market investor, Buffett used Berkshire, a textile company, to make acquisitions and investment in insurance companies and branded product companies. While he did not use a lot of debt or hostile takeovers, his consolidation technique was similar to private equity firms.

- Victor Posner – DWG Corporation
  - Posner is often credited with coining the term leveraged buyout or LBO.
  - In 1969 launched a hostile takeover of Sharon Steel Company which took Chapter 11 in 1987.

Management buyouts came into existence in the late 1970s and early 1980s.

- An early transaction was management’s buyout of Harley-Davidson from AMF in 1981
Growth of the LBO Market

- As Bear Stearns bankers, Kohlberg, Kravis and Roberts' first significant acquisition was in 1964 with the purchase of Orkin Exterminating Company using significant leverage to complete the transaction.

- In 1976, Kohlberg, Kravis and Roberts left Bear Stearns and in 1978 raised $30 million in their first fund. KKR was formed to acquire family-owned businesses with succession issues.

- In 1974, Thomas H. Lee in Boston formed one of the earliest independent PE firms to focus on leverage buyouts of mature companies rather than venture capital investment in growth companies.
  - To date, THL has raised $22 billion and invested in over 100 companies with an aggregate purchase price of $125 billion.

- Between 1979-1989, over 2,000 LBOs were done.
Boom/Bust Cycles

- There have been periods, like the golden years of the 1980s, where both VC and Buyout firms both performed well due to favorable regulatory, tax, economic and industry considerations.

- There have been other periods, like currently, where both VC and Buyout firms have both suffered due to the economic uncertainty, tight credit, limited exit opportunities and a tough fundraising environment.

- However, since institutional investors allocate limited funds to this asset class, VC and PE firm’s performance often run counter cyclical to each other. **VCs dominated the 1990s and LBO shops dominated the 2000s.**
Golden Years

The decade of the 1978-1988 is often referred to as the “Golden Age” of PE.

- The 1980s saw VC successes like Apple, Cisco, Genentech & FedEx. While software and the internet fueled huge successes in the mid to late 1990s (Netscape, Amazon, Juniper), Venture Capital would peak in 2001 with the internet bubble bust. By 2003, VC industry was less than half its 2001 peak size.

- Private Equity was thought to have peaked in 1989 with the KKR $31 billion acquisition of RJR Nabisco— a record that stood for 17 years. Black Monday (10/87), the collapse of the S&L Industry and the junk bond market, the bankruptcy of Drexel and indictment of Michael Milken left many saying the LBO market was dead.

- A LBO mini-boom began in 1992 with TH Lee’s acquisition of Snapple (IPO and sale to Quaker only 2 years later for $900M gain) and TPG’s acquisition of Continental Airlines (seen as a savior). However, VC returns dominated in the late 1990s and LBO shops could not compete until the internet bubble burst in 2001.

- Beginning in 2003-2007, LBOs surged with 13 of the 15 largest LBOs in history, including the $45 billion TXU transaction. This boom period collapsed with the mortgage and banking crisis in 2007.
## Venture Capital

<table>
<thead>
<tr>
<th>Cycle</th>
<th>Fundraising Environment</th>
<th>Investing Environment</th>
<th>Operating Environment</th>
<th>Harvesting (Exit) Environment</th>
<th>Industry Drivers</th>
</tr>
</thead>
<tbody>
<tr>
<td>1979-1988</td>
<td>Boom</td>
<td></td>
<td></td>
<td></td>
<td>Apple, Cisco, FedEx</td>
</tr>
<tr>
<td>1992-1996</td>
<td>Boom</td>
<td></td>
<td></td>
<td></td>
<td>Bull market</td>
</tr>
<tr>
<td>1996-2000</td>
<td>Boom</td>
<td></td>
<td></td>
<td></td>
<td>Internet – AOL, Ebay, Amazon</td>
</tr>
<tr>
<td>2000-2003</td>
<td>Bust</td>
<td></td>
<td></td>
<td></td>
<td>Internet &amp; Telcom bust</td>
</tr>
<tr>
<td>2003-2007</td>
<td>Mediocre</td>
<td></td>
<td></td>
<td></td>
<td>Web 2.0, Google, Salesforce</td>
</tr>
</tbody>
</table>
# LBO Market

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<tbody>
<tr>
<td><strong>Cycle</strong></td>
<td>Boom</td>
<td>Bust</td>
<td>Boom</td>
<td>Mediocre</td>
<td>Bust</td>
<td>Boom</td>
</tr>
<tr>
<td><strong>Fundraising Environment</strong></td>
<td>★</td>
<td>✗</td>
<td>★</td>
<td>✗</td>
<td>✗</td>
<td>★</td>
</tr>
<tr>
<td><strong>Investing Environment</strong></td>
<td>★</td>
<td>★</td>
<td>★</td>
<td>★</td>
<td>★</td>
<td>★</td>
</tr>
<tr>
<td><strong>Operating Environment</strong></td>
<td>★</td>
<td>✗</td>
<td>★</td>
<td>★</td>
<td>✗</td>
<td>★</td>
</tr>
<tr>
<td><strong>Harvesting (Exit) Environment</strong></td>
<td>★</td>
<td>✗</td>
<td>★</td>
<td>★</td>
<td>✗</td>
<td>★</td>
</tr>
<tr>
<td><strong>Industry Drivers</strong></td>
<td>Junk Bond, Corporate Raiders, KKR/RJR</td>
<td>Black Monday, S&amp;L, Drexel BK</td>
<td>TPG/CO, THL/SNAP</td>
<td>Competing with VCs</td>
<td>Internet &amp; Telcom bust, BK Worldcom</td>
<td>13 of 15 largest LBOs, SOX</td>
</tr>
</tbody>
</table>
### Private Equity Returns As of 9/30/09

<table>
<thead>
<tr>
<th>Fund Type</th>
<th>1yr</th>
<th>5 yr</th>
<th>10 yr</th>
<th>20 yr</th>
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<tbody>
<tr>
<td>Early VC</td>
<td>8%</td>
<td>-1%</td>
<td>40%</td>
<td>21%</td>
</tr>
<tr>
<td>Balanced VC</td>
<td>25%</td>
<td>6%</td>
<td>18%</td>
<td>14%</td>
</tr>
<tr>
<td>Later VC</td>
<td>24%</td>
<td>5%</td>
<td>10%</td>
<td>14%</td>
</tr>
<tr>
<td>&gt; All VC</td>
<td>18%</td>
<td>3%</td>
<td>21%</td>
<td>16%</td>
</tr>
<tr>
<td>Buyouts</td>
<td>22%</td>
<td>11%</td>
<td>9%</td>
<td>13%</td>
</tr>
<tr>
<td>All PE</td>
<td>21%</td>
<td>9%</td>
<td>11%</td>
<td>14%</td>
</tr>
<tr>
<td>S&amp;P 500</td>
<td>10%</td>
<td>4%</td>
<td>7%</td>
<td>8%</td>
</tr>
<tr>
<td>NASDAQ</td>
<td>4%</td>
<td>6%</td>
<td>7%</td>
<td>9%</td>
</tr>
</tbody>
</table>

But this chart can be deceiving. The 5-year is the disturbing column. Much of the VC returns in the 10-yr. column were all in 1999-2000 before the internet bubble collapse. The 21% for all VC 10-yr. average has decreased from 33.9% in June 2008 as good years are dropped. The 1-year numbers are unrealized gains.

*Source: Thomson Financial/National Venture Capital Association*
VC Returns

- With few exits (IPOs and M&A) and lower valuations, the median IRR for venture funds has since 2000 has been poor, affecting VC firms in raising additional capital.
  - The Denominator Effect
  - Poor Returns for the Asset Class

<table>
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</tr>
</thead>
<tbody>
<tr>
<td>Median IRR</td>
<td>35.9%</td>
<td>-0.8%</td>
<td>-7.1%</td>
<td>0.6%</td>
<td>-0.9%</td>
<td>3.9%</td>
<td>8.4%</td>
<td>-1.3%</td>
<td>-2.7%</td>
<td>-12.6%</td>
</tr>
<tr>
<td>% Called</td>
<td>100%</td>
<td>100%</td>
<td>100%</td>
<td>97%</td>
<td>97%</td>
<td>94%</td>
<td>94%</td>
<td>87%</td>
<td>69%</td>
<td>54%</td>
</tr>
<tr>
<td>% Dist.</td>
<td>193%</td>
<td>77%</td>
<td>46%</td>
<td>50%</td>
<td>38%</td>
<td>41.2%</td>
<td>24%</td>
<td>13.5%</td>
<td>6.0%</td>
<td>0.0%</td>
</tr>
</tbody>
</table>

Source: Preqin

VCs have called 30.4% of their 2007 vintage funds and 9.8% of their 2008 vintage funds. (about $25-$30 Billion each year). Neither year has made any distributions yet and the 2007 funds are valued at 86% while the 2008 funds are valued at 83% of their original invested capital.
Current PE Status

- Global PE Funds under management at the end of 2008 was $2.5 trillion with $1 Trillion available for investing and $1.5 trillion in unrealized portfolio value.

Largest PE firms at end of 2008 were (PEI Media):
- TPG ($50 Billion)
- Goldman Sachs Capital Partners
- Carlyle Group ($87 billion)
- KKR ($50 billion)
- Apollo Global Management ($51 B)
- Bain Capital ($65 billion)
- CVC Capital Partners
- The Blackstone Group ($96 Billion including $25 billion dry powder)
- Warburg Pincus
- Apax Partners ($35 Billion)

Large VC Firms:
- New Enterprise Associates ($6 B)
- Sequoia Capital
- Benchmark Capital ($2.3 Billion)
- Bessemer Ventures ($2.5 Billion)
- Oak Investment Partners ($8.4 B)
- Kleiner Perkins
- Charles River ($2.1 billion)
- Sevin Rosen ($1.6 Billion)
- Austin Ventures ($3.9 Billion)
- Draper Fisher ($5.5 Billion)
- Insight Ventures ($3.2 Billion)
- TA Associates ($10 Billion)
<table>
<thead>
<tr>
<th>Cycle</th>
<th>2008-Present</th>
<th>Issues</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fundraising Environment</td>
<td>Bust</td>
<td>Few funds being raised. LP denominator problem. Smaller funds may not have dry power to support portfolio companies. Cram downs. Secondary market.</td>
</tr>
<tr>
<td>Investing Environment</td>
<td></td>
<td>Low valuations, but entrepreneurs may bootstrap. Capital efficiency and path to profitability are priorities. Fewer early stage deals getting done but Angels picking up slack. Down rounds on portfolio companies.</td>
</tr>
<tr>
<td>Operating Environment</td>
<td></td>
<td>Lower costs (labor, rent, IT costs) but hard to get revenue growth in recessionary environment.</td>
</tr>
<tr>
<td>Harvesting (Exit) Environment</td>
<td></td>
<td>Closed IPO market and credit crunch killed off the M&amp;A market. Both seem to have improved slightly in Q4, 2009 but will remain anemic in 2010.</td>
</tr>
<tr>
<td>Industry Drivers</td>
<td>Cleantech Medical Device, Web 2.0</td>
<td>VCs are internally focused. Working to stretch capital, support portfolio companies and are worried about fundraising and exits. Much more selective on new funding.</td>
</tr>
</tbody>
</table>
Current VC Status

- There were 7,497 venture capitalists at approximately 798 venture capital firms in the United States in 2008.

- These firms managed approximately $195 billion – down from $275 billion in 2006.

- In the third quarter of 2009, only 17 new funds closed with an aggregate $1.54 billion, the lowest level in the last 15 years. Through 3 quarters, the industry has raised $8.87 billion, not even close to the $28.6 billion raised for all of 2008.

- The number of deals and size of deals has dropped slightly, but the tendency is toward follow-on and later stage investments.
Industry Consolidation

**Smaller Ventures**

As some venture-capital firms form smaller funds and manage less capital, the number of venture firms has declined.

<table>
<thead>
<tr>
<th>Number of venture-capital firms*</th>
<th>Capital managed</th>
</tr>
</thead>
<tbody>
<tr>
<td>1,200</td>
<td>$300 billion</td>
</tr>
</tbody>
</table>

*Active venture-capital firms that have raised funds in the last eight years

Source: National Venture Capital Association
VC Fundraising

U.S. VC Fund-Raising Through 3rd Quarter
Number of VC Funds & Total Amount Raised in First Nine Months

Amount Raised ($B)

2006  111  $22.5
2007  141  $24.9
2008  141  $18.9
2009  83  $8.0

Number of VC Funds

Source: Dow Jones Private Equity Analyst
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Number and Amount of Deals

Venture Capital Investment Drops in Q3
Deal Flow & Equity into Venture-Backed Companies

<table>
<thead>
<tr>
<th>Quarter</th>
<th>Amount Invested ($B)</th>
<th>Number of Deals</th>
</tr>
</thead>
<tbody>
<tr>
<td>4Q07</td>
<td>$8.34</td>
<td>746</td>
</tr>
<tr>
<td>1Q08</td>
<td>$8.56</td>
<td>750</td>
</tr>
<tr>
<td>2Q08</td>
<td>$8.35</td>
<td>737</td>
</tr>
<tr>
<td>3Q08</td>
<td>$8.17</td>
<td>663</td>
</tr>
<tr>
<td>4Q08</td>
<td>$6.09</td>
<td>619</td>
</tr>
<tr>
<td>1Q09</td>
<td>$4.08</td>
<td>497</td>
</tr>
<tr>
<td>2Q09</td>
<td>$5.42</td>
<td>595</td>
</tr>
<tr>
<td>3Q09</td>
<td>$5.09</td>
<td>616</td>
</tr>
</tbody>
</table>

Source: Dow Jones VentureSource

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2009 Median Deal Size

Median Deal Size Flat In 2009

Median Amount of Venture Capital Invested Per Financing Round

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U.S. Angel Investment Statistics

- In 2008, Angels invested $19.2 billion (down 26.2%) in 55,480 companies (2.9% decrease).
  - 260,500 active angel investors (unchanged)
  - 330 angel groups
- In the first half of 2009, total investments were $9.1 billion (down 27% from first half of 2008). However, 24,500 companies received funding, a 6% increase.
  - Average deal size declined 31% reflecting angels committing fewer dollars and lower valuations.

**Sectors analysis**

<table>
<thead>
<tr>
<th></th>
<th>Healthcare/Biotech</th>
<th>Software</th>
<th>Electronics</th>
<th>Industrial/Energy</th>
<th>Retail</th>
<th>Media</th>
<th>Telecom</th>
</tr>
</thead>
<tbody>
<tr>
<td>2008</td>
<td>27%</td>
<td>13%</td>
<td>n/a</td>
<td>8%</td>
<td>12%</td>
<td>7%</td>
<td>n/a</td>
</tr>
<tr>
<td>Q1,2 2009</td>
<td>28%</td>
<td>14%</td>
<td>14%</td>
<td>13%</td>
<td>8%</td>
<td></td>
<td>5%</td>
</tr>
</tbody>
</table>

Source: Center For Venture Research
## Current LBO Environment

<table>
<thead>
<tr>
<th>2008-Present</th>
<th>Issues</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Cycle</strong></td>
<td>Bust</td>
</tr>
<tr>
<td><strong>Fundraising Environment</strong></td>
<td>Denominator effect. Investment overhang from record fundraising years in 2006-2007. $1 Trillion dry powder.</td>
</tr>
<tr>
<td><strong>Investing Environment</strong></td>
<td>Low valuations but no debt market to leverage. More equity in deals. Low TTM EBITDA and lower multiples. Seller’s reluctant to sell. Competing with Strategic Investors.</td>
</tr>
<tr>
<td><strong>Operating Environment</strong></td>
<td>Restructuring debt, recapitalizations. Credit crisis limits access to debt but debt cost, while higher due to crisis, is still relatively cheap by historical standards. Lower operating costs but low revenue growth due to recession</td>
</tr>
<tr>
<td><strong>Harvesting (Exit) Environment</strong></td>
<td>Low valuations. Buyers can’t access debt and stock prices are too low to exchange. Poor IPO market. Strategic buyers with cash &amp; looking for growth.</td>
</tr>
<tr>
<td><strong>Industry Drivers</strong></td>
<td>More focus on Middle Market. Growth in the secondaries and distressed debt markets. Lots of capital overhang to deploy. $300B in debt to refinance over next 2 years. Credit markets still tight but some increase in M&amp;A in Q4.</td>
</tr>
</tbody>
</table>

**Economy, Banking crisis, government regulation**
Conditions for a Robust M&A Market

2006-2007 – Perfect Conditions

2008-2009 - Perfect Storm

Willing Sellers

Hot Market

Willing Buyers

Cheap & Available Capital
### Total U.S. Private Equity Fund-Raising

**Funds & Total Amount Raised by Industry in First Nine Months of 2009 & 2008**

<table>
<thead>
<tr>
<th></th>
<th>3Q’2009</th>
<th></th>
<th>3Q’2008</th>
<th></th>
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<tbody>
<tr>
<td></td>
<td>No. of Funds</td>
<td>Amounts (MM)</td>
<td>No. of Funds</td>
<td>Amounts (MM)</td>
</tr>
<tr>
<td><strong>Buyout/Corporate Finance</strong></td>
<td>121</td>
<td>$49,385</td>
<td>126</td>
<td>$140,748</td>
</tr>
<tr>
<td><strong>Mezzanine</strong></td>
<td>11</td>
<td>$1,374</td>
<td>11</td>
<td>$24,763</td>
</tr>
<tr>
<td><strong>Venture Capital</strong></td>
<td>83</td>
<td>$8,002</td>
<td>141</td>
<td>$18,938</td>
</tr>
<tr>
<td><strong>Funds of Funds</strong></td>
<td>29</td>
<td>$6,868</td>
<td>27</td>
<td>$7,962</td>
</tr>
<tr>
<td><strong>Secondary &amp; Other</strong></td>
<td>21</td>
<td>$14,285</td>
<td>10</td>
<td>$2,579</td>
</tr>
<tr>
<td><strong>TOTAL</strong></td>
<td>265</td>
<td>$79,914</td>
<td>315</td>
<td>$194,990</td>
</tr>
</tbody>
</table>

Source: Dow Jones Private Equity Analyst
PE Fundraising

U.S. Fund-Raising In First Nine Months
Total Amount Raised by PE Firms in First Nine Months of the Year

Source: Dow Jones Private Equity Analyst
Valuation Trends

U.S. Middle-Market Median EV/EBITDA

Source: WY Campbell
M&A Trends

Mergers & Acquisitions Continue Decline
M&A Transactions and Amount Paid, 3Q06-2Q09

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Source: Dow Jones VentureSource
The Future of VC & Buyout

Fundraising

- Q4, 2008 and 2009 were miserable for both VC and Buyout/Mezzanine. Distressed Investment had some success.
  - Endowments and Pension Funds saddled with denominator effect
  - Lack of exits to fund new investments limit funds available
  - General aversion to risk – no more “covenant lite” loans
  - Limited Partners in stronger negotiating position on partnerships
  - Regulation of Placement Agents

- Venture Capital - After 1999 and 2000 vintage funds drop off, the 10-year performance of this asset class will be negative due to the internet bust and the current downturn. If you take out the returns of Kleiner and Sequoia or take out a couple of homeruns like Google, Salesforce or Skype, it gets even uglier. Longer holding periods, lower valuations and limited exit opportunities have killed returns

- LBO Firms – The credit and banking crisis has led to tighter credit standards and more regulatory oversight. Going forward, more equity and less leverage will be required – returns from operating efficiencies rather than financial engineering. Competing with strategic buyers.
The Future of VC and Buyout

Investing Environment

- Interestingly, it is a buyer’s/investor’s market. Valuations are low, the number of firms competing for deals is less and thus the investing opportunities should be great. Down rounds are dilutive.
  - For VCs, entrepreneurs may just bootstrap or go with angels.
  - For LBO firms, sellers may just wait until their TTM EBITDA improves and/or valuation multiples go higher.
- Venture Capital – The buzz word is “capital efficiency”. Since fundraising and exits are so tough, VCs are trying to maintain dry powder for portfolio companies to avoid getting cramped down. Many have moved to later stage and growth capital. Being more selective has stimulated angel networks and firms like Capital Factory and Ycombinator.
- LBO Firms - The credit freeze and banking crisis significantly reduced the number of leverage buyout sponsors and mezz funds. Mega-buyouts may slow but middle market activity may improve as baby boomers look to sell their firms. Lots of capital to deploy from 2007-08 fundraising (In U.S. $500 Billion).
The Future of Private Equity

Operating Environment

- The Good – Lower costs. A larger, cheaper labor pool and renters market have reduced operating costs. Lower IT costs (hardware, SaaS, the cloud). Hard to cut cost to prosperity.
- The Bad – Poor growth. The recession has made both it difficult to get consumer and business customers to write a check. Unemployment likely to remain high and GDP growth anemic.
- Venture Capital – Since most VC-backed firms do not use leverage, credit crisis has had less impact. However, the economy has affected both B2B and B2C companies with reduced spending. Companies with that can prove ability to lower customer costs are doing best.
- Private Equity – More dependant on the capital markets and thus much more time spent on recapitalization, de-leveraging and meeting debt covenants. Growth and EBITDA margins of portfolio firms reduced by recession thus lowering valuations. $300 Billion of LBO debt needs to find a home over next two years. Sponsors can buy exiting debt at discounts.
The Future of Private Equity

Harvesting Environment

- The recent IPO and M&A markets are showing some signs of life in Q4, 2009 should improve somewhat in 2010.
- Low valuations make it a buyer’s market and thus VC and PE firms are holding investments longer waiting for a more opportune time to exit.
- The cost of going public and market cap required to justify public status costs (SOX) will make IPO exits slow. M&A will continue to be the primary exit vehicle.
- Government deficits and prospects for tax hikes (including LTCG) may provide a catalyst for sellers.
- Both VC and Buyouts will probably have to settle for singles and doubles instead of home runs – accepting less risk and lower returns.
- Chrysler/Cerberus, Aleris/TPG, Linen n Things/Apollo and Tribune/Zell have already gone bankrupt – wiping out $8 billion in invested equity. With $300-$400 Billion senior debt coming due, more could follow. Dilution with debt for equity or swaps of higher price bonds to pay off senior debt may be the future.
Major Issues Facing Industry

- Succession planning as industry pioneers exit.
- Innovation if VCs move to later stage investing.
- If LPs fund larger firms, must make larger average investments and thus exits must be larger and this is problematic with average IPO raises at $25 million.
- If LPs fund smaller firms, then smaller investments can be made and thus exits can be smaller, but management fees become an issue.

- Exits - Firms must focus on their portfolio and exits

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VC Exits

Liquidity Drops 57% in Q2 v. Year Ago
Total Amount Raised by VC-Backed Companies via M&As and IPOs

Source: Dow Jones VentureSource
IPO Market

IPO Market Still Very Anemic
Number of IPOs & Total Amount Raised, 2001 - 1H09

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Source: Dow Jones VentureSource
The Future of VC

NVCA Venture View 2010 predicts:

- Industry contraction – fewer firms (as much as 30%) but not fewer companies funded.
- Gradual increases in investment levels and exit transactions but the asset class will continue to shrink over the next 5 years.
- More dollars into portfolio companies and less enthusiasm for early stage investing
- Optimism in clean technology, internet, media and software sectors
- Growth equity, later stage investing, PIPEs and overseas opportunities, especially in China and India.
- Mild improvement in the IPO market (recent success of Solar Winds (up 76% from IPO), Fortinet and OpenTable – both up 35%)
- Fewer firms raising capital and small funds for those who do. Fewer LPs in each fund and higher percentage of foreign capital.
- Few first-time funds will be raised (Andreessen Horowitz LLC $300M) as LPs invest in seasoned top-tier firms.

Source: NVCA
Future of PE

- $300 billion of LBO debt matures over the next two years.
- Over $1 Trillion of capital on sidelines. Investment Bankers need fees from M&A or IPOs.
- More equity and less leverage on deals. Fewer Mega-buyout and more middle-market deals.
- Huge opportunities from Baby Boomers retiring and selling their middle-market companies.
- Less financial engineering and more value creation from operating improvements.
- Regulatory issues including disclosure requirements, Long-term capital gains rates and taxation of carried interest.
- In the short-run, the debt markets will require more up-front fees, interest rate floors and pre-payment penalties as well as strong covenants on loans.
Leverage of Middle Market LBO Transactions (<$50MM EBITDA)

Source: WY Campbell
LBO Equity Contributions

Average LBO Equity Contribution

Rollover Equity – Yellow
Private Equity Contribution - Green

Source: WY Campbell
Summary

- The private equity industry has survived other bust cycles and will survive this downturn. Innovation and creativity have not stopped. Capital will find good ideas.

- The PE industry is maturing and must adapt like other industries including succession planning, adapting to new markets, finding innovative ways to fund investment, create value and produce exit strategies.

- The industry may contract in the number of firms and the amount of capital, but that is not necessarily a bad trend. Too many firms and too much capital lead to asset bubbles.

- Funds managers will need to adapt – expanding their pools of limited partners, being more capital efficient, operating under stricter partnership rules & investing outside their backyards.
Summary

- VCs and governments must find a way to reward risk taking and stimulate early stage investment or else innovation will be stunted. Public/Private/University partnerships should be explored.

- Businesses and the capital markets do not like uncertainty and governments must find ways to provide stability and increase employment without over-regulating.

- Government deficits must be addressed before it starts competing with businesses for capital, creating inflationary pressures or rising interest rates. Controlling government spending, not raising taxes.

- Government policy can accelerate or delay the recovery of the private equity market.
Suggested Readings

- **A Vision for Venture Capital: Realizing the Promise of Global Venture Capital and Private Equity** (Winthrop Group) by Peter Brooke and Daniel Penrice

- **Creative Capital: Georges Doriot and the Birth of Venture Capital** by Spencer Ante

Sources for this Presentation include:

- **PwC MoneyTree** - [https://www.pwcmoneytree.com/MTPublic/ns/index.jsp](https://www.pwcmoneytree.com/MTPublic/ns/index.jsp)
- **NVCA** - [http://www.nvca.org/](http://www.nvca.org/)
- **Preqin** - [http://www.preqin.com/](http://www.preqin.com/)
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