# MESIROW FINANCIAL PRIVATE EQUITY
# CREDIT CRISIS IMPACT ON PRIVATE EQUITY

PRESENTED TO

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MAY 12, 2008

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# GOALS FOR THIS PRESENTATION

I. Present an overview of the various private equity strategies

II. Describe the events which led up to the current difficulties in the credit market

III. Explain how private equity investors are adapting to the new environment

IV. Provide expectations for private equity going forward

V. Offer recommendations for institutional investors

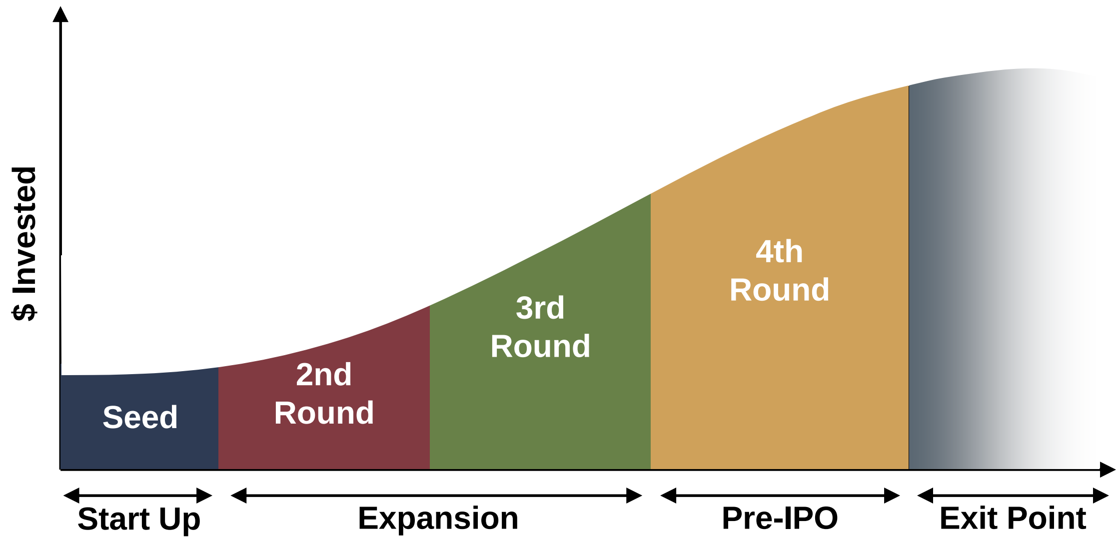
# PRIVATE EQUITY OVERVIEW

*Private equity is a privately negotiated investment, typically in a private company, ranging from early-stage technology start-ups to buyouts of established companies.*

**Private Equity**

| **Venture Capital** | **Leveraged Buyout** | **Special Situations** |
|---|---|---|
| Financing for startup and emerging growth companies, typically in the healthcare & information technology sectors | Equity sponsorship of leveraged buyouts and growth capital for mature, cash flow generating businesses | Subordinated / mezzanine debt, distressed debt, operational turnaround and industry-focused investments |

# VENTURE CAPITAL OVERVIEW




- Capital typically provided to earlier stage companies to finance growth.
- Most venture capital firms specialize on either early stage financing, where capital is generally used to develop a new product or technology, or later stage financing where capital is generally used for expansion of sales & marketing.
- Venture capitalist generally focused on companies in the information technology and life science sectors.  Cleantech has more recently become a significant area of focus.



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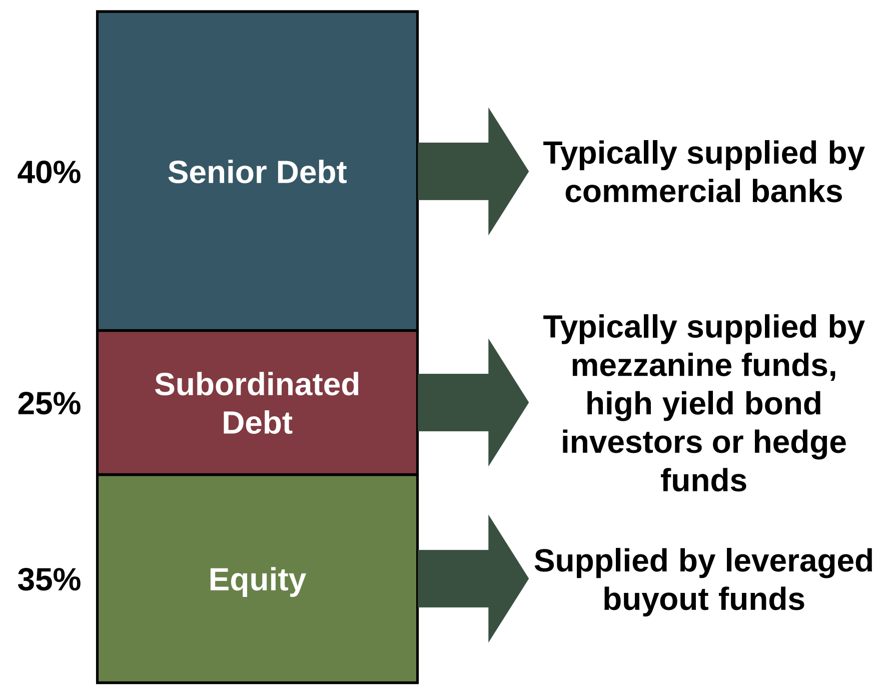
# LEVERAGED BUYOUT OVERVIEW

- Equity capital provided to facilitate the acquisition or recapitalization of a company.
- Target companies typically have predictable cash flows.
- A leveraged buyout fund leads the transaction and provides the equity capital, while mezzanine funds typically provide subordinated debt financing.
- Variations of the LBO strategy include buy-and builds, take privates, and growth buyouts.

**Post-LBO Balance Sheet**

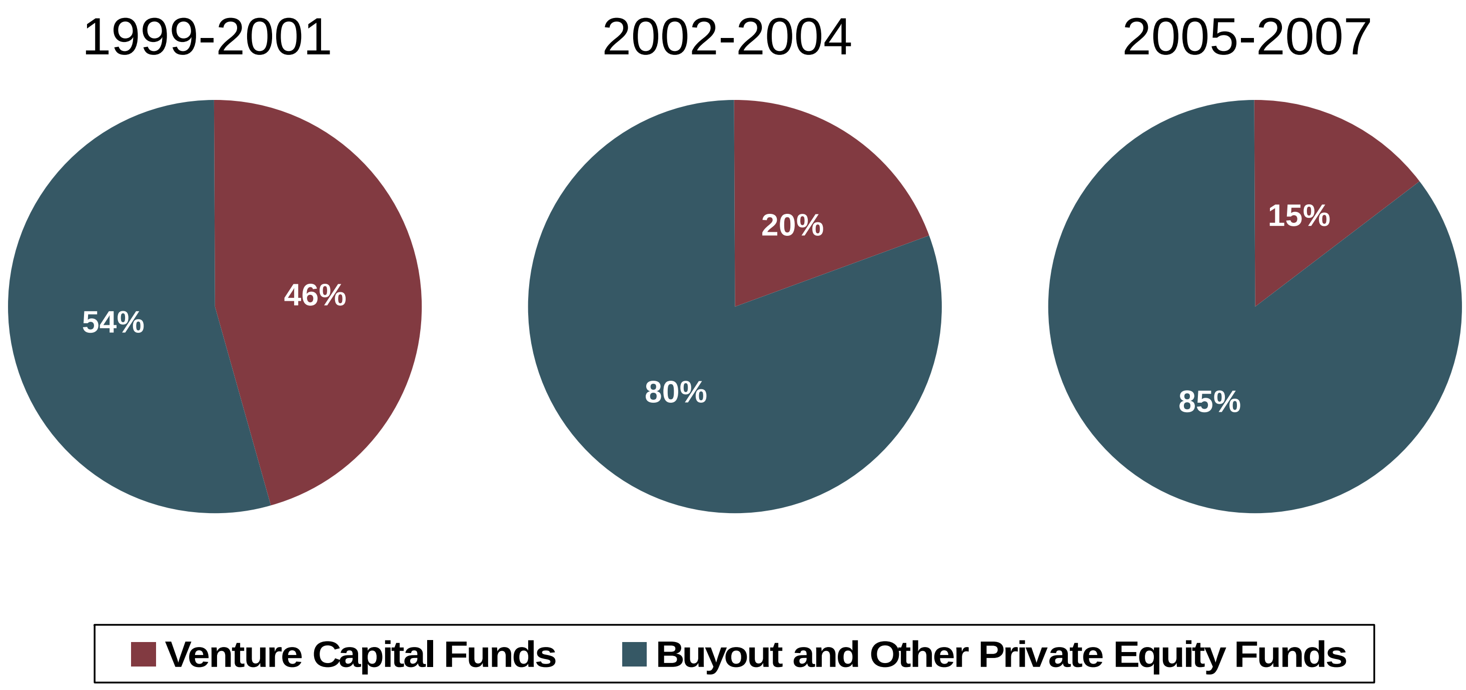


# SPECIAL SITUATIONS OVERVIEW

- **Mezzanine / Subordinated Debt**
  - A hybrid of debt and equity financing typically used to finance leveraged buyouts or expansion of existing companies. Mezzanine financing is debt capital that gives the lender the rights to convert to an ownership or equity interest in the company if the loan is not paid back in time and in full. It is generally subordinated to debt provided by senior lenders such as banks and venture capital companies.

- **Distressed Debt**
  - Distressed debt investors scour the market for undervalued debt securities of companies undergoing financial distress.  They purchase debt at deeply discounted prices and adopt various strategies to enhance the debt's value.

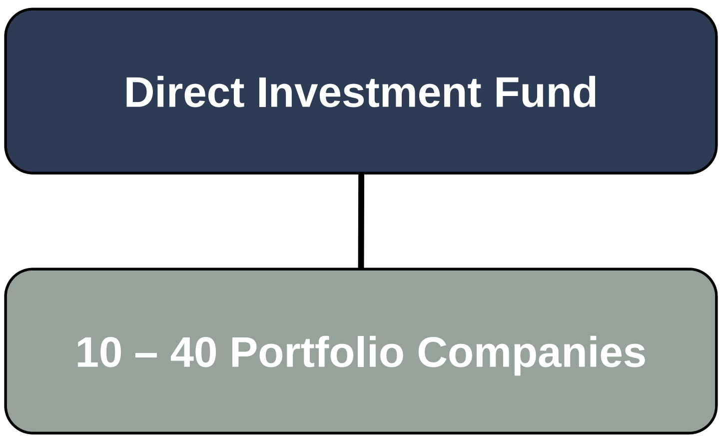
# MARKET SUB-ASSET CLASS ALLOCATIONS



# TYPES OF PRIVATE EQUITY FUNDS

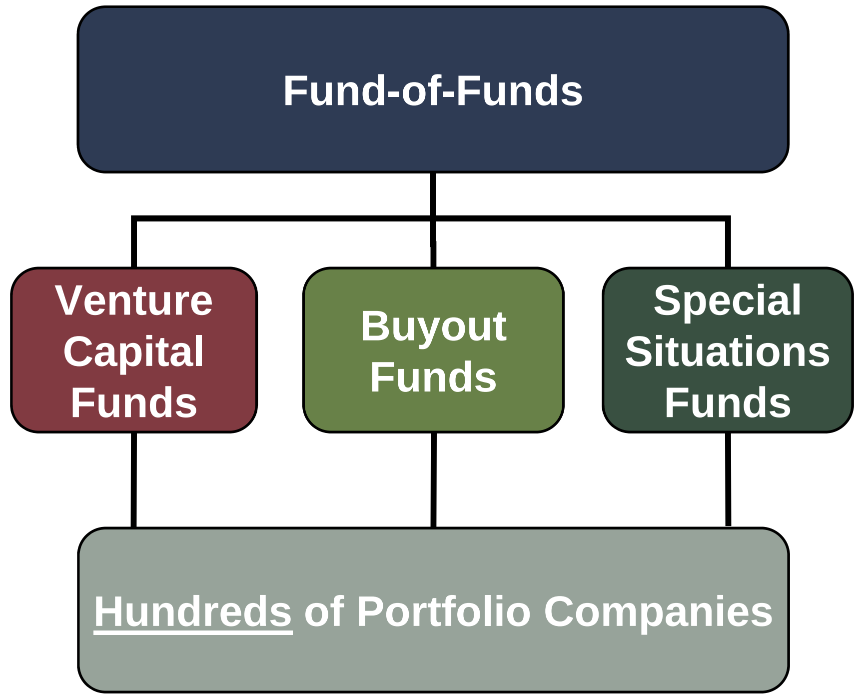
## Direct Investment Funds

A direct investment fund invests directly into underlying operating companies




## Fund-of-Funds

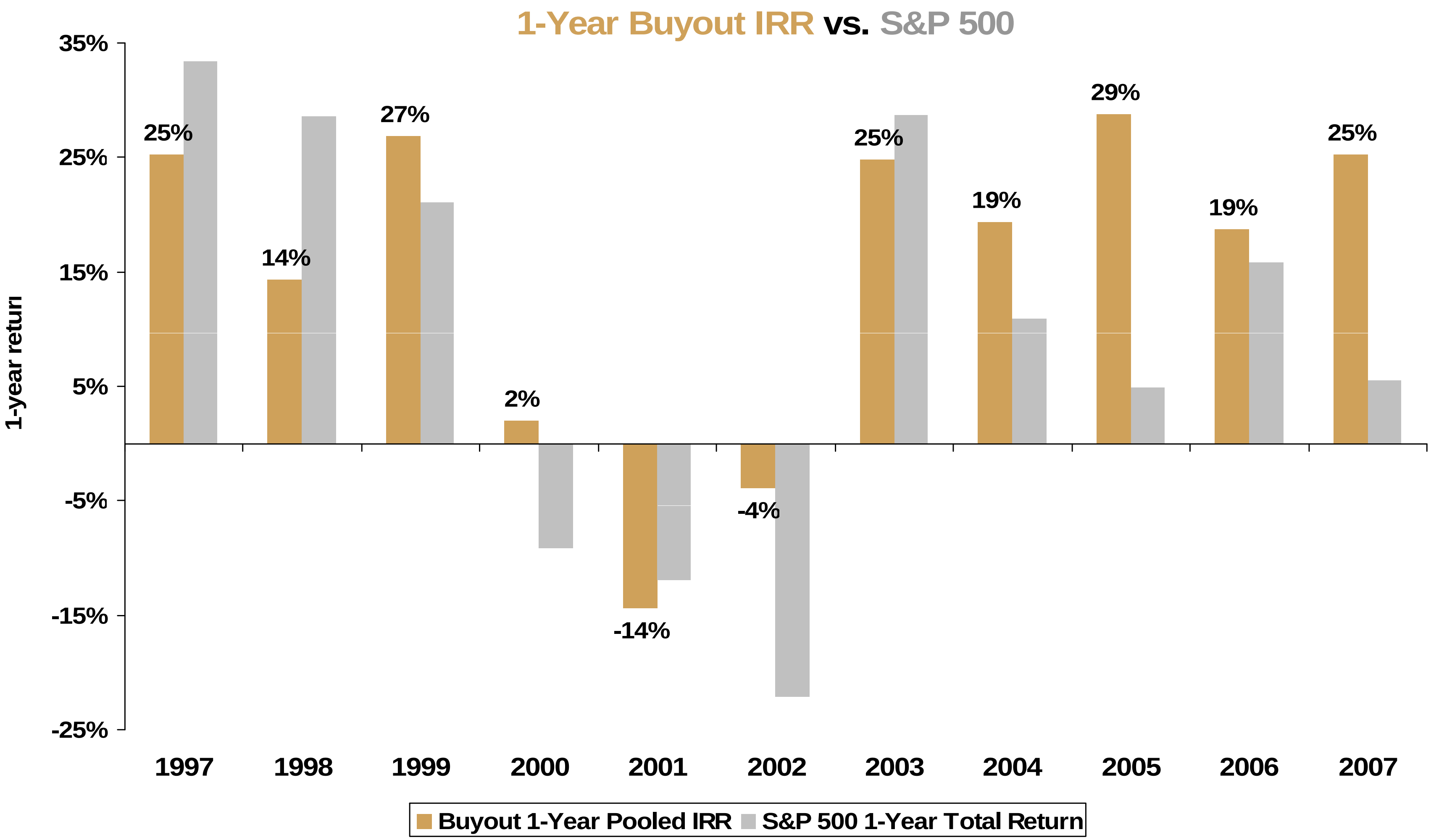
A fund-of-funds commits capital to a broad range of direct investment funds



# PRIVATE EQUITY FIRMS HAD VERY LIMITED DIRECT EXPOSURE TO SUBPRIME MORTGAGES AND RELATED STRUCTURED SECURITIES

- Buyout and venture capital firms are generally not in the business of buying debt securities, rather they invest in the equity of operating companies
- Some value-oriented private equity firms have recently made investments in the fallout of the subprime mortgage crisis; but these have been limited and presumably at attractive distressed valuations
  - Mortgage originators, bond insurance, equity infusions into banks, hung debt held by Wall Street
- However, the broader credit market disruption is creating unique challenges and opportunities for private equity investors

# GOLDEN AGE OF THE BUYOUT




Source: Thomson VentureXpert, May 2, 2008. Pooled net IRR for all U.S. buyouts.
Source: Standard & Poor's. 12-month total return for S&P 500.



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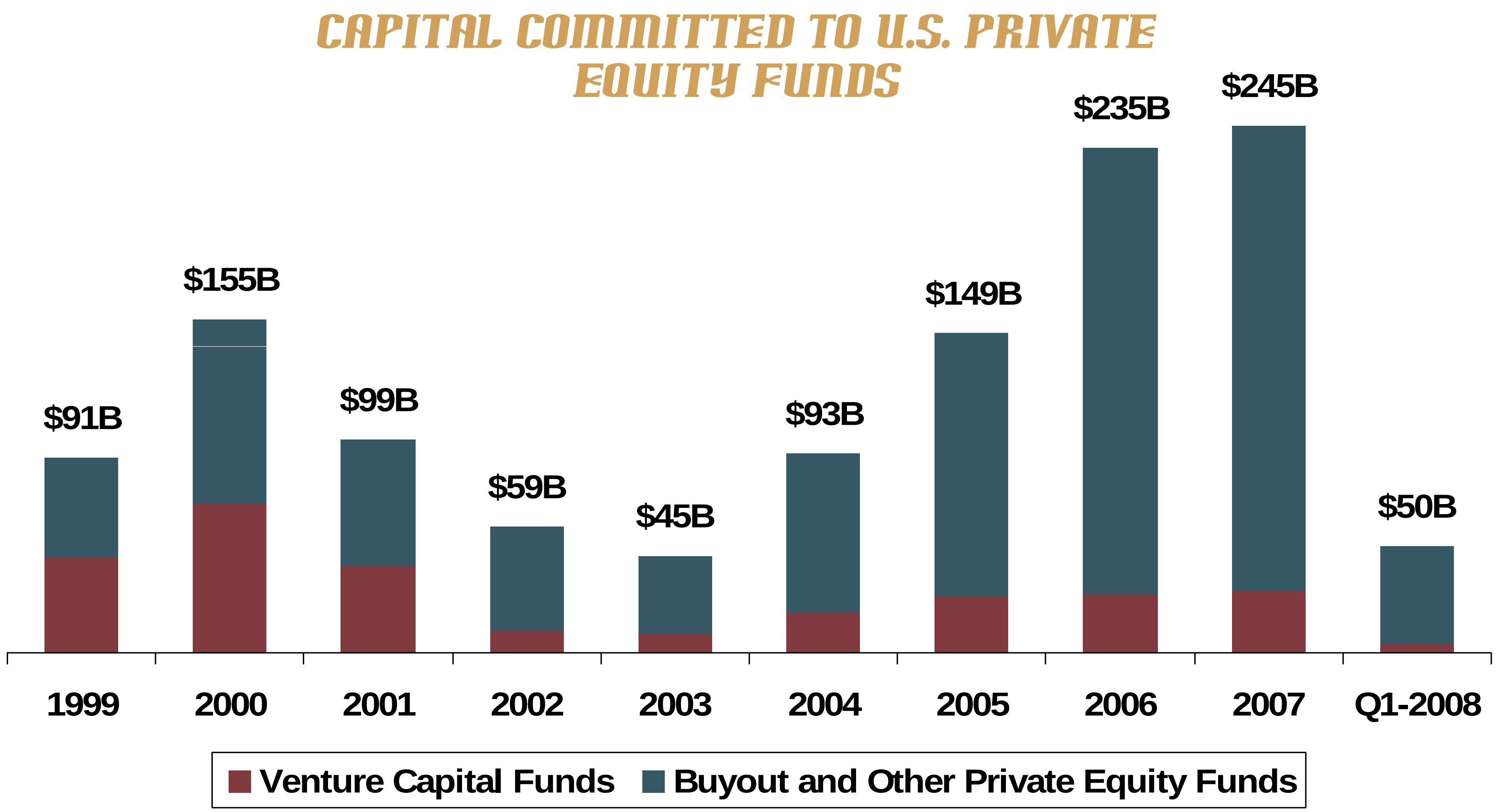
# BUYOUT FUNDRAISING SURGED TO RECORD HIGHS

- Fundraising during 2007:
  – 6 buyout funds raised LP commitments >$5 billion
  – 2 buyout funds raised LP commitments >$20 billion (Blackstone & Goldman Sachs)

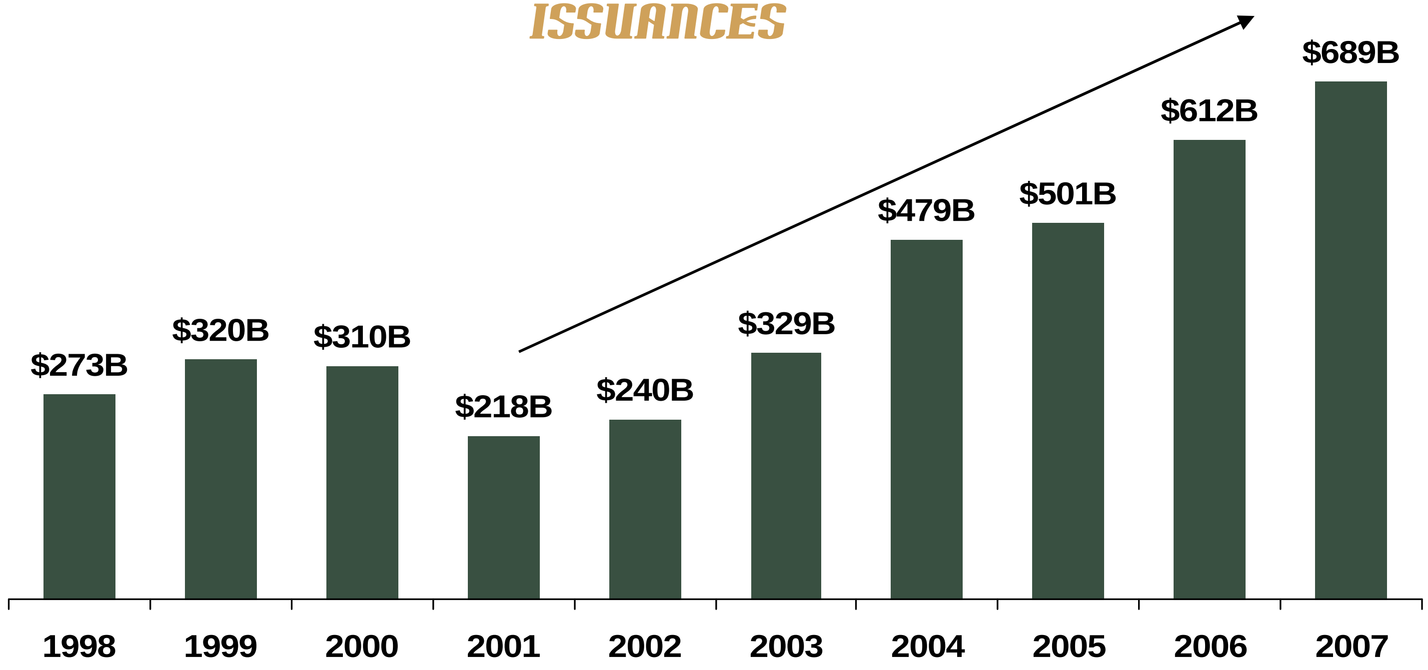



Source: Private Equity Analyst. U.S. funds only, excluding fund-of-funds.

# CREDIT MARKET EXPANSION FUELED THE BUYOUT BOOM

- Historic low interest rates in 2002-2004 led investors to reach for yield
- Rising investor demand for junk bonds as default rates moderated after 2002
- Structured finance expansion revolutionized the leverage loan market
  - CDO and CLO share of new loan volume rose from 10% in 1998 to 59% in 2007
- Loosening of structural terms ("covenant-lite", PIK toggles)

## LEVERAGED LOAN MARKET NEW ISSUANCES




Source: Credit Suisse. $US denominated non-investment grade bank debt. CLO/CDO data from JPMorgan.



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# LOOSE CREDIT MARKETS ENABLED EVER LARGER BUYOUT TRANSACTIONS

- Leveraged buyout volume hit a series of new records, led by an expansion in deal size
- Increasing market concentration:  20 deals accounted for ~80% of 2007 LBO volume

## TOP-10 LARGEST BUYOUTS EVER

| Target | Date | LBO Sponsor | Deal value, in billions |
|---|---|---|---|
| **BCE** | 2007 | Providence, MDP, OTPP | $46.8 |
| **TXU** | 2007 | KKR, TPG, Goldman | 44.4 |
| **Equity Office** | 2006 | Blackstone | 38.9 |
| **HCA** | 2006 | Bain, KKR, Merrill | 32.7 |
| **RJR Nabisco** | 1998 | KKR | 31.1 |
| **Harrah's** | 2006 | Apollo, TPG | 27.4 |
| **First Data** | 2007 | KKR | 27.0 |
| **Alltel** | 2007 | Goldman, TPG | 26.9 |
| **Hilton Hotels** | 2007 | Blackstone | 26.7 |
| **Clear Channel** | 2006 | Bain, TH Lee | 25.7 |

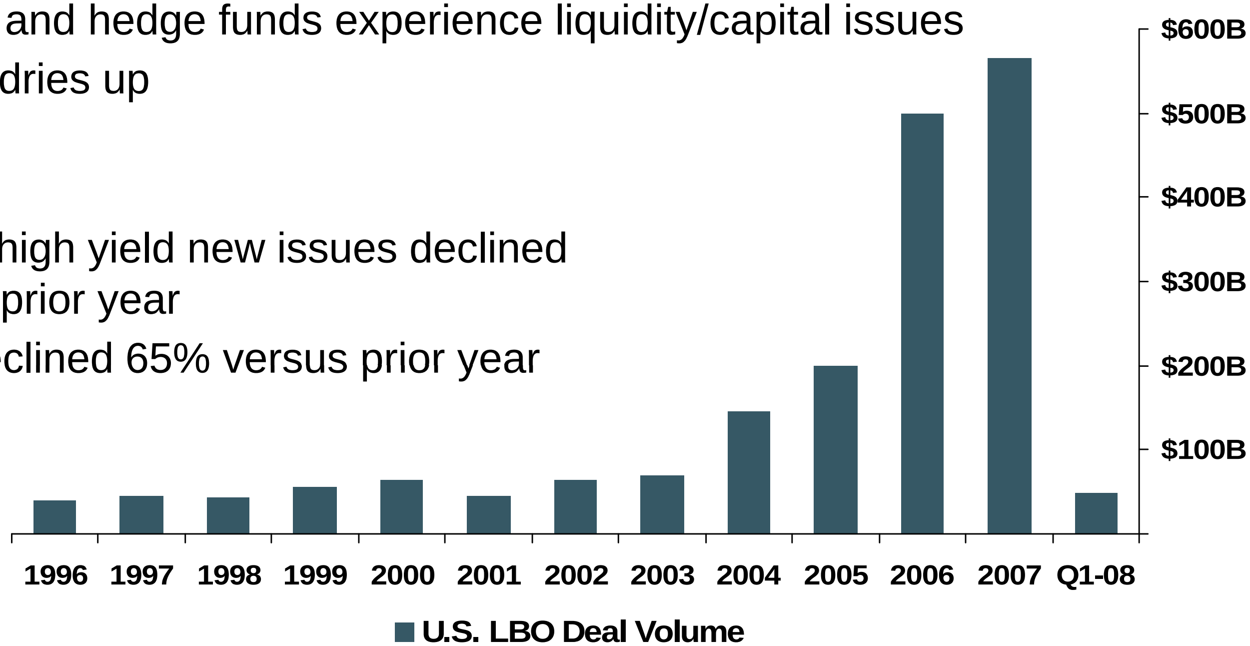
Source:  Buyouts January 2008 & Private Equity Analyst January 2008.

# JULY 2007: THE MUSIC STOPS. . .

- **June 2007:** Leveraged loan market peaks
  - $400 billion+ backlog of LBO-related loan and bond commitments
  - Loan sizes never previously digested by the junk markets
  - Spreads at all time lows and leverage levels at all-time highs

- **July 2007:** Sub-prime mortgage crisis triggers concerns in the broader credit market and a global repricing of risk
  - Demand for buyout-related debt evaporates
  - Macro fears: Recession, inflation, weak dollar, consumer weakness
  - Banks, brokers and hedge funds experience liquidity/capital issues
  - CLO formation dries up

- **Q1-2008:**
  - Bank debt and high yield new issues declined by 76% versus prior year
  - LBO volume declined 65% versus prior year




(1) Source: S&P LCD and Thomson Financial.



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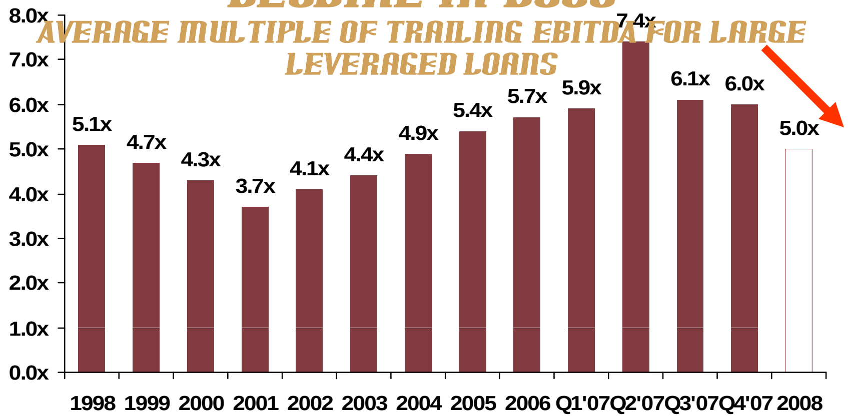
# LEVERAGE MULTIPLES AND PURCHASE PRICES ON THE DECLINE

## BUYOUT LEVERAGE MULTIPLES WILL DECLINE IN 2008

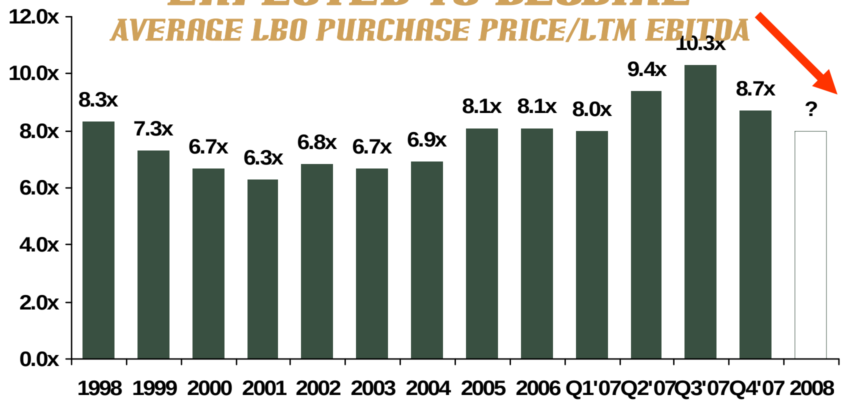
### AVERAGE MULTIPLE OF TRAILING EBITDA FOR LARGE LEVERAGED LOANS




- Underwriters have started writing new commitments, but credit markets effectively closed for very large deals
- LBO sponsors will need to contribute more equity (35-40%)
- Wider spreads; tighter covenants
- Higher quality companies with stable cash flows will get financing

## LBO PURCHASE PRICES EXPECTED TO DECLINE

### AVERAGE LBO PURCHASE PRICE/LTM EBITDA




- Repricing in private market mirrors sell-off in public markets
- Slowdown in activity as seller expectations lag market realities
- Much smaller deal sizes

Source: Leverage multiples (for LBOs $250M - $499M) and purchase price multiples from S&P LBO Review. Buyout deal volume from Thomson Financial Mergers & Acquisitions Review.

# RENEWED INTEREST IN CREDIT-DRIVEN PRIVATE EQUITY STRATEGIES

**Mezzanine / Subordinated debt:**

- LPs should benefit from pullback of competing financing sources
  - BDCs/Hedge funds: less liquidity for new loans, more scrutiny of public portfolios
  - Lower senior lending multiples should mean greater utilization of mezzanine
- Mezzanine pricing has improved:
  - Pre-credit crunch: low-teens IRRs
  - Post-credit crunch: high-teens IRRs
- Flight to quality?
  - Mezzanine fundraising has averaged ~7.5% of buyout capital raised
  - $9.2 billion of mezzanine raised in 2007 (2nd highest ever) = 4% of buyout capital
  - $22.3 billion of mezzanine raised in Q1-08
- Sponsored mezzanine activity will likely slow along with buyout activity

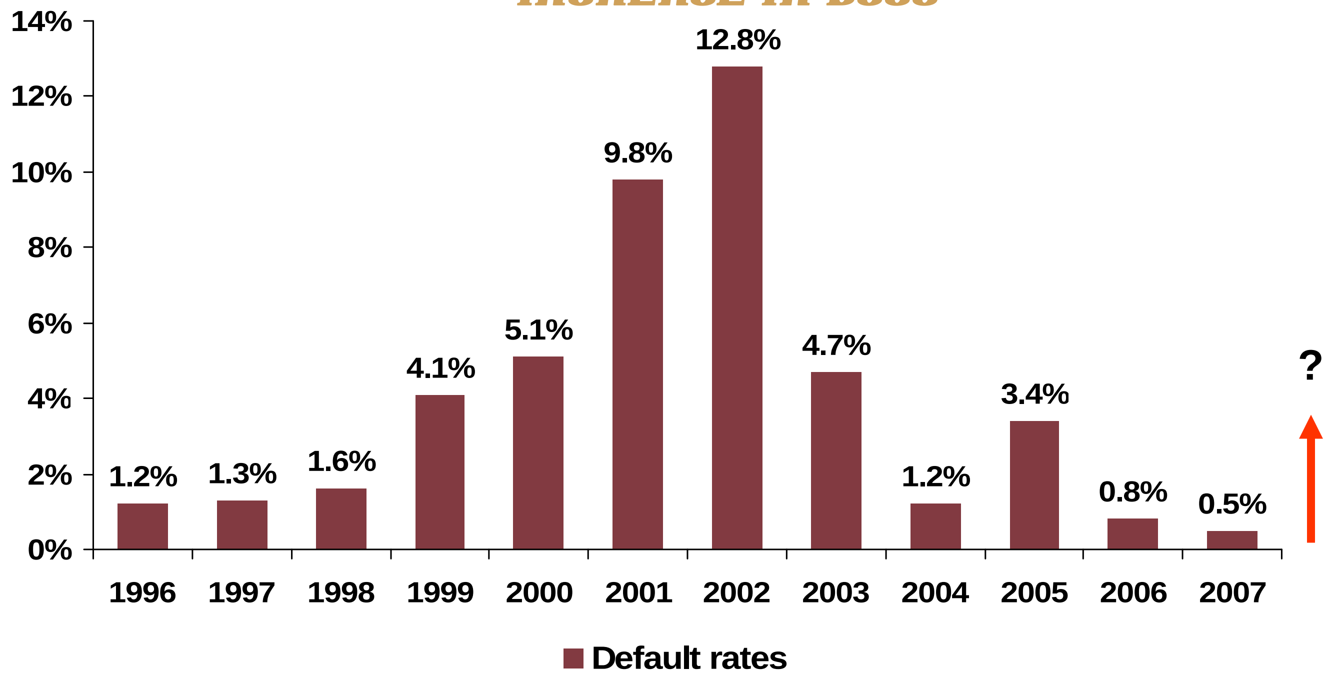
Source: Private Equity Analyst. Note that GS Mezzanine Partners V accounted for $20B of Q1-08 mezzanine fundraising.

# RENEWED INTEREST IN CREDIT-DRIVEN PRIVATE EQUITY STRATEGIES

**Distressed debt:**

- Long-anticipated increase in default rates will likely be realized in 2008
  - – Peak leverage multiples in 2006-2007
  - – Slowing economy
- Capital overhang for distressed debt investment strategies?

## DEFAULT RATES LIKELY TO INCREASE IN 2008




Source: Edward Altman, New York University.

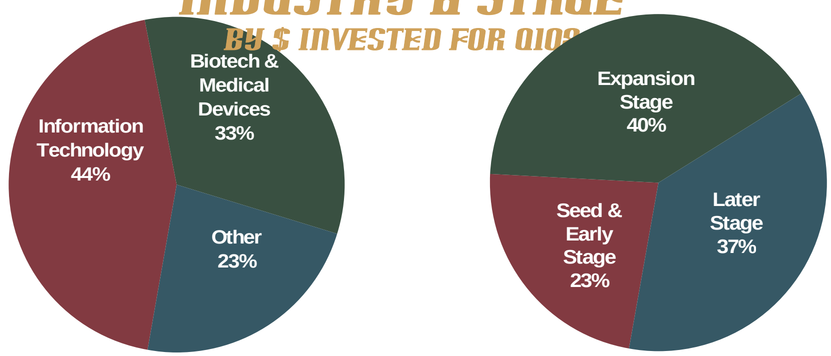
# VENTURE CAPITAL RELATIVELY WELL INSULATED FROM THE CREDIT CRISIS

- **Stable investment environment**
  - Normalized VC investment pace of $25-30B per year
  - Rational early stage valuations, but upward pressure on later-stage financings
  - Key areas of VC interest include software, IT services, biotech & medical devices
  - Growing interest in Clean technology /alternative energy
  - Growing interest in emerging markets, in particular China and India

- **Exit environment**
  - M&A provides primary path to liquidity
  - Valuations for M&A exits of VC-backed companies have nearly tripled since 2003
  - Average IPO valuations in 2007 similar to levels last seen in 2001
  - Market volatility during 1Q-2008 has temporarily closed IPO window for emerging technology companies
  - Experienced managers are budgeting for recessionary declines in IT spending

## VENTURE CAPITAL INVESTMENT BY INDUSTRY & STAGE

BY $ INVESTED FOR Q108




Source: PricewaterhouseCoopers, Q1-2008 MoneyTree Report.



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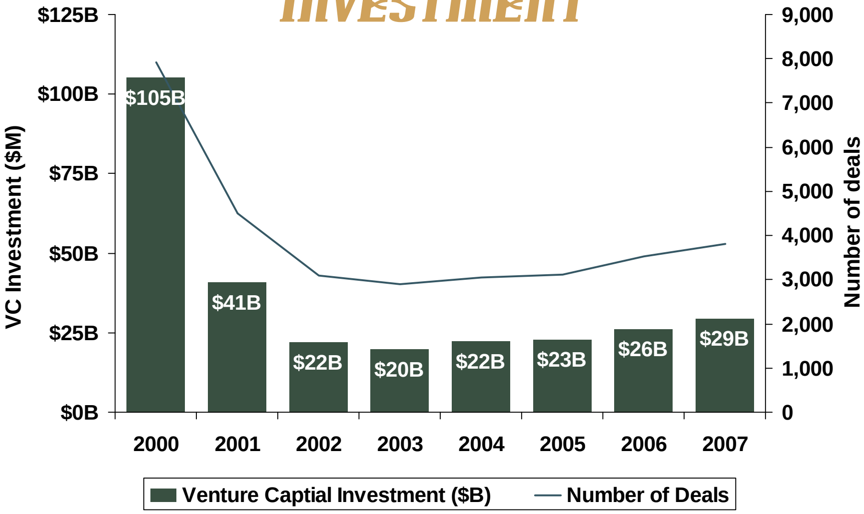
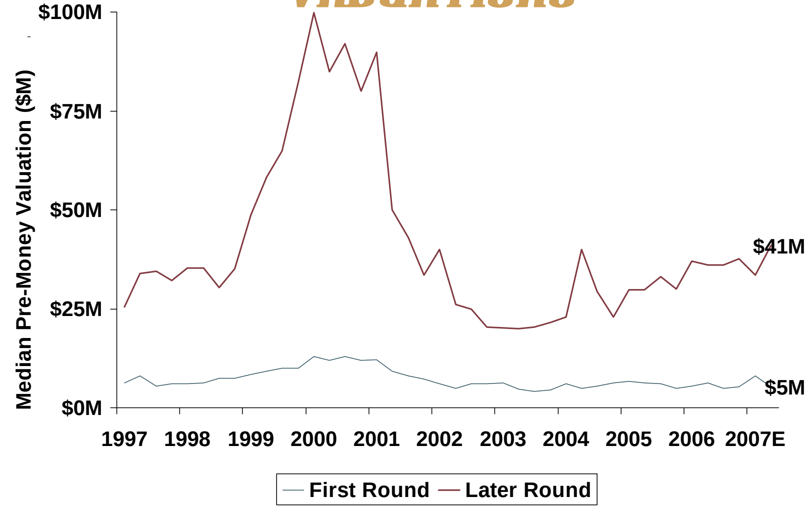
# FAVORABLE MARKET DYNAMICS FOR VENTURE CAPITAL INVESTMENT

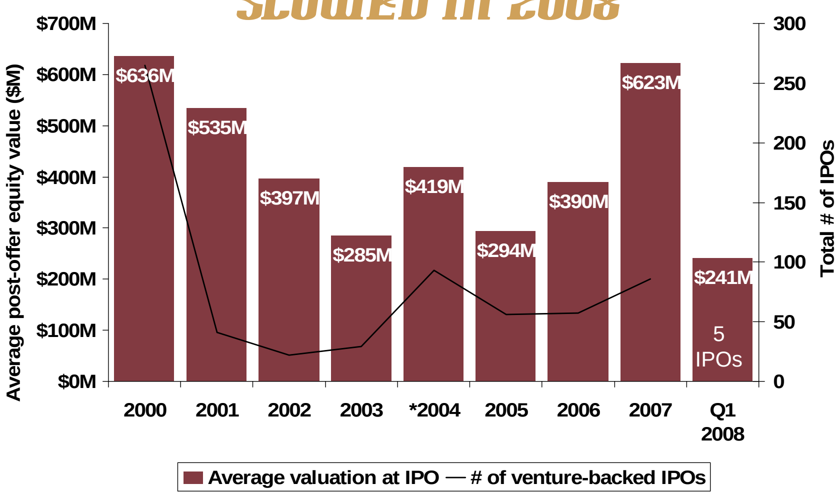
## SUSTAINABLE INCREASE IN VC INVESTMENT



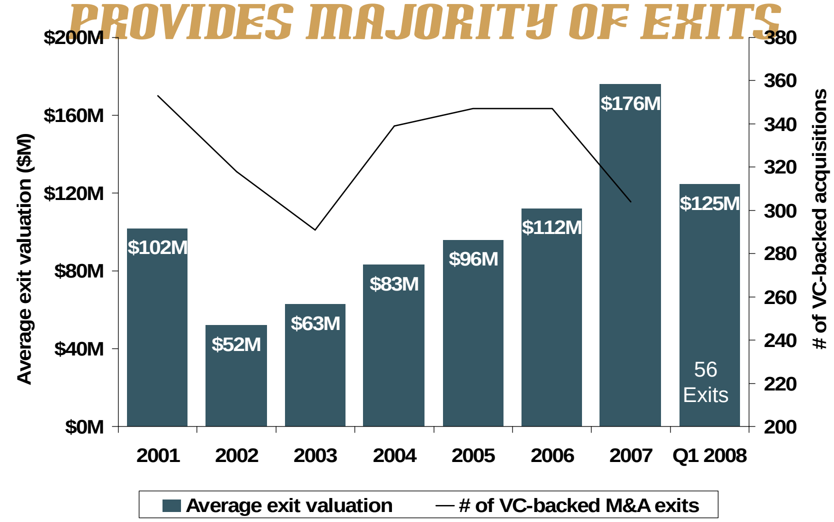

## STABLE EARLY-STAGE VALUATIONS




## VENTURE-BACKED IPO ACTIVITY SLOWED IN 2008




## VENTURE-BACKED M&A PROVIDES MAJORITY OF EXITS




Sources: VC investment data from PriceWaterhouseCoopers and NVCA through 4Q-2007; VC-backed IPO data from Thomson Financial through 12/31/07 (excludes 2004 IPO of Google); VC-backed M&A data from NVCA through 12/31/07 (only accounts for deals with disclosed values); VC valuation data from VentureOne through Q2-2007.



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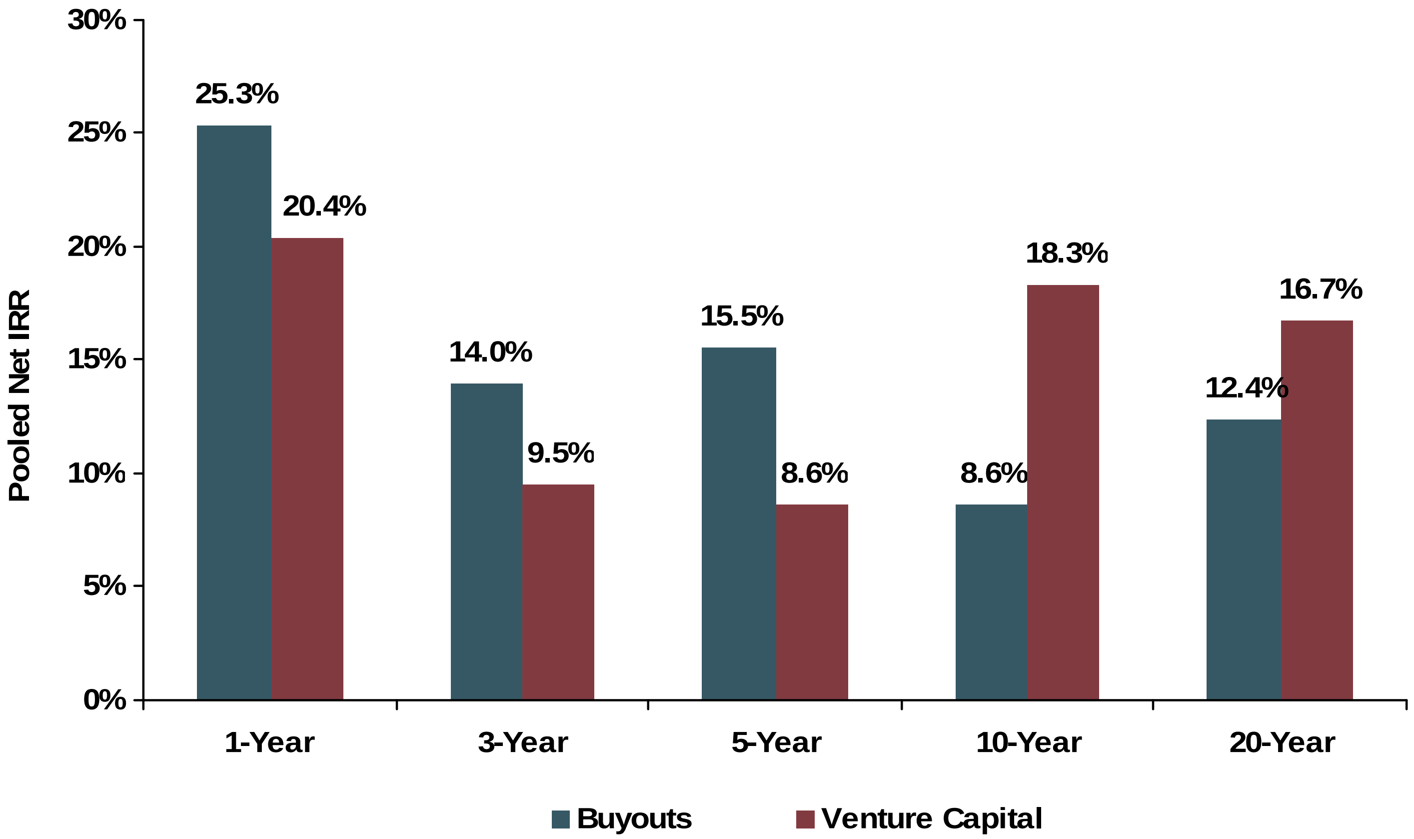
# STRONG RECENT PERFORMANCE ACROSS SUB-ASSET CLASSES

**Venture Economics pooled net IRRs as of December 31, 2007**




Source: Thomson Financial Venture Economics as of May 2008.



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# PRIVATE EQUITY RETURN EXPECTATIONS

## BUYOUT FUNDS WILL FEEL SHORT TERM IMPACT OF CREDIT MARKET DISRUPTION

- Long-term return expectations remain attractive for top-quartile private equity
  - 400-600 basis points over long-term S&P 500
- Unsustainably high buyout returns will return to earth
  - Recent vintage PE portfolios may experience modest write-downs as fair value is fully reflected
  - Increase in defaults, loss rates for buyout managers that utilized excessive leverage
  - Drawdown pace will slow; return to normalized pace of 20-25% per year
  - Longer holding periods expected; dividend recaps no longer an option
  - New buyout investments will feature lower risk capital structures
- First-quartile funds will continue to outperform median returns by a wide margin

| Pooled net IRRs as of December 31, 2007 | 1-Year | 3-Year | 5-Year | 10-Year | 15-Year |
|---|---|---|---|---|---|
| ***All U.S. Private Equity*** | 25.3% | 13.0% | 13.3% | 10.8% | 14.4% |
| ***First Quartile U.S. Private Equity*** | 28.7% | 16.0% | 16.9% | 17.0% | 20.2% |
| ***S&P 500*** | 5.5% | 8.6% | 12.8% | 5.9% | 10.5% |

Source: Thomson Financial Venture Economics as of May 2008. Total return for S&P 500, including reinvestment of dividends.

# RECOMMENDATIONS FOR INSTITUTIONAL INVESTORS

## DISCIPLINED PORTFOLIO CONSTRUCTION WILL MITIGATE EXPECTED VOLATILITY

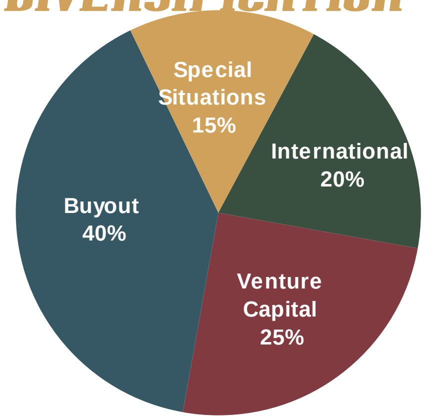
- **Diversification by vintage year**
  Commitments to private equity partnerships made over a three- to four-year period

- **Diversification by sub-asset class**
  Venture capital, buyout, mezzanine, restructuring/turnaround/distressed debt, special situations

- **Diversification by manager**
  Rigorous selection process to access top-tier private equity partnerships

- **Diversification by geography**
  The U.S. and Western Europe are most proven private equity markets

### RECOMMENDED SUB-ASSET CLASS DIVERSIFICATION



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# RECOMMENDATIONS FOR INSTITUTIONAL INVESTORS

## ATTRACTIVE PRIVATE EQUITY INVESTMENT OPPORTUNITIES IN THE WAKE OF THE CREDIT CRISIS

- **Venture capital:** Maintain allocation to top-tier U.S. VC managers
  - Relatively well-insulated from credit crisis
  - Very short list of oversubscribed VC firms will continue to dominate PE returns
- **Buyout:** Core portfolio of middle-market, with limited exposure to largest managers
  - Carefully assess quality of lending relationships, deal flow and ability to impact cash flow growth
- **Special situations:** Selective exposure to mezzanine, distressed debt, turnaround strategies
  - Control turnaround strategies attractive, provided manager has demonstrated operational capabilities
- **Experience matters!** Emerging private equity managers have under-performed

| Pooled net IRRs as of December 31, 2007 | 1-Year | 3-Year | 5-Year | 10-Year | 15-Year |
|---|---|---|---|---|---|
| ***First-time Funds*** | 8.8% | 5.6% | 8.2% | 5.6% | 8.3% |
| ***Follow-on Funds*** | 25.9% | 13.8% | 13.9% | 11.6% | 15.5% |

Source: Thomson Financial Venture Economics as of May 2008. Relative comparison likely exaggerated by survivorship bias.

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