Private Capital in the Wake of the Crisis

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Time of many questions

- Recovery in private equity deal volume...
  - More limited resurgence of debt financing.
- But residual unhappiness of limited partners:
  - Interest in “going it alone.”
  - Questions about explosion in secondary deal activity.
- And looming regulatory and tax uncertainties world-wide.

Suggests several possibilities

- Will outline four scenarios:
  - Recovery.
  - Back to the future.
  - The LPs' desertion.
  - A broken industry.

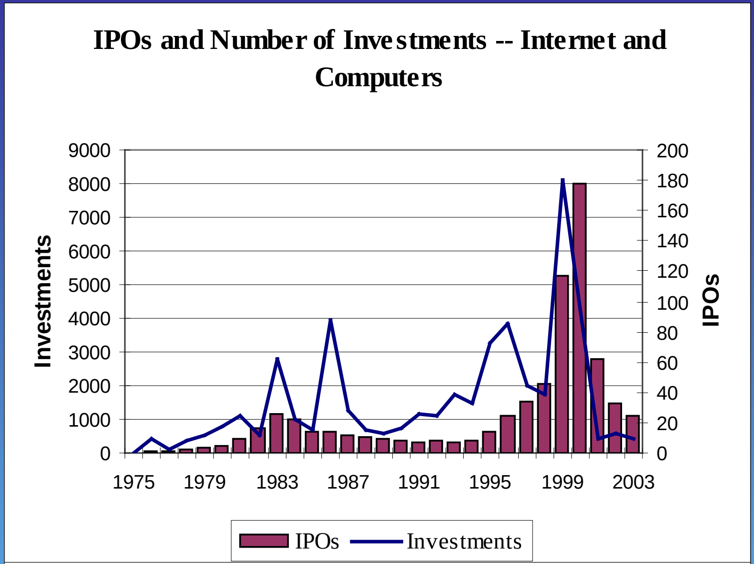
Four scenarios

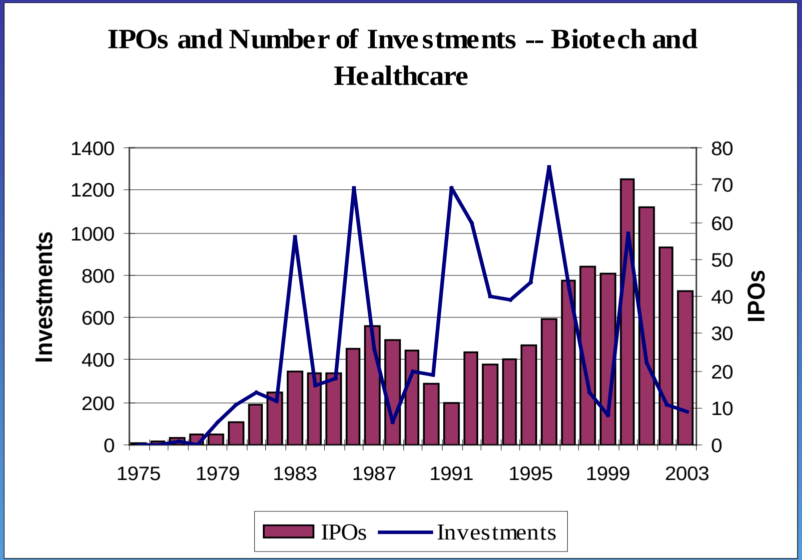
	Constant Investor Base	Turnover in Investor Base
"Fair" Returns	Recovery	Back to the Future
Disappointing Returns	A Broken Industry	The LPs' Desertion

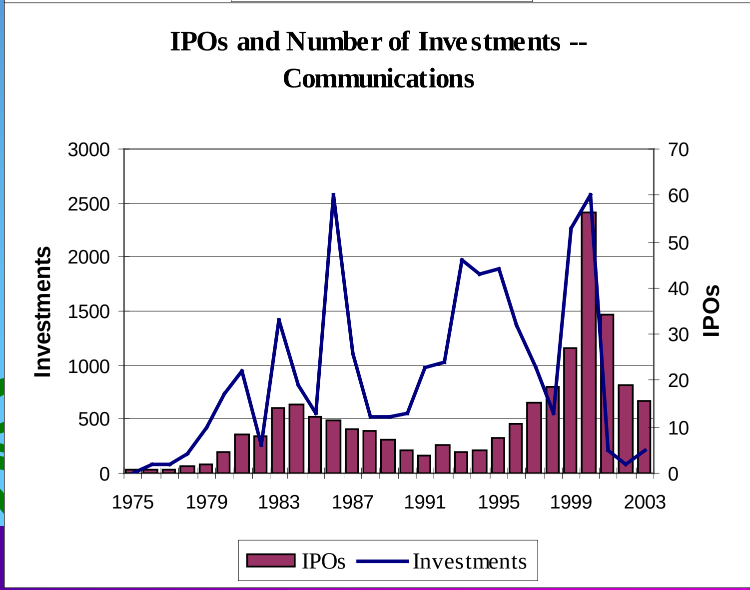
Scenario 1: Recovery

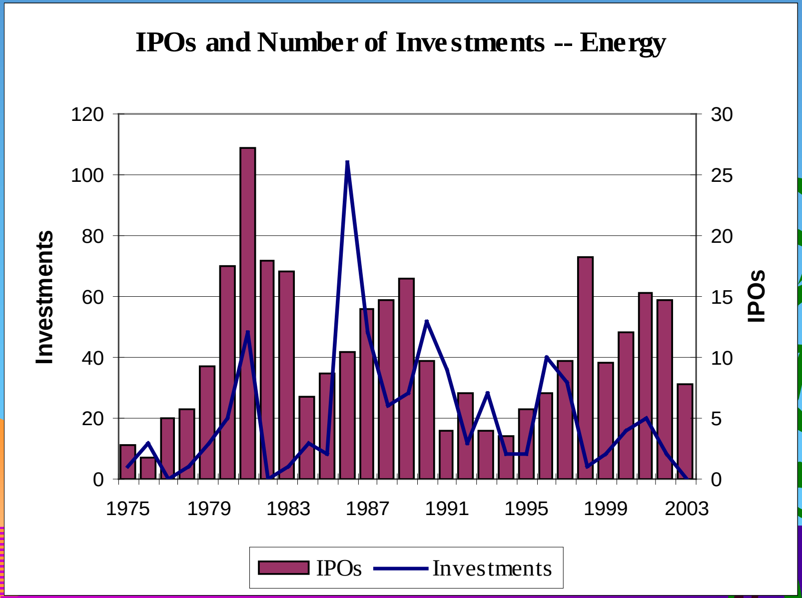
- VC and PE are inherently cyclical:
  - Too much investment during booms.
  - Too high-priced investments during booms.
- But there is a well-defined value proposition associated with these investments.
- While things may get out of balance in booms, steady state works well:
  - Classic process of recalibration going on right now.

IPOs and VC investments



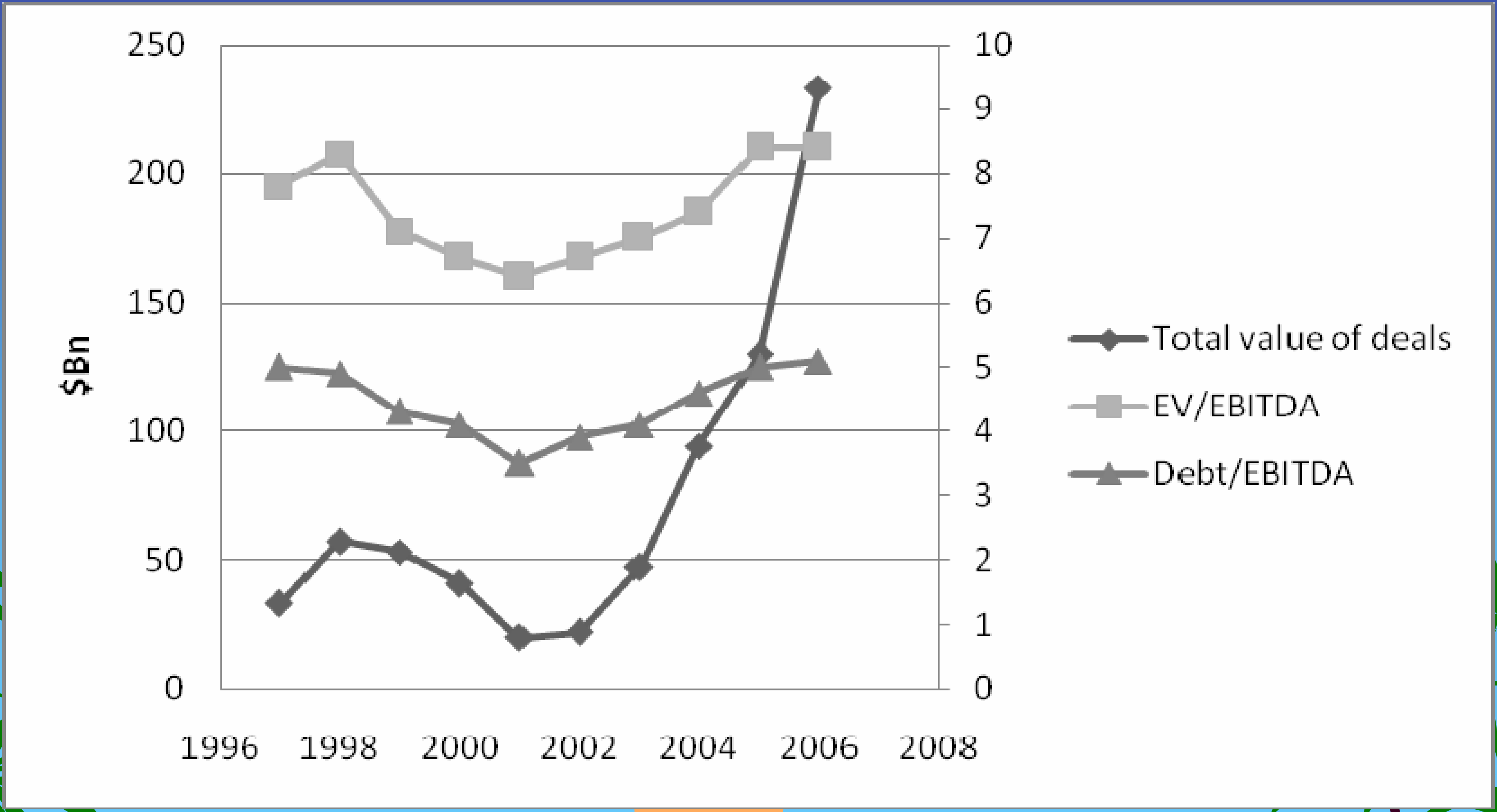






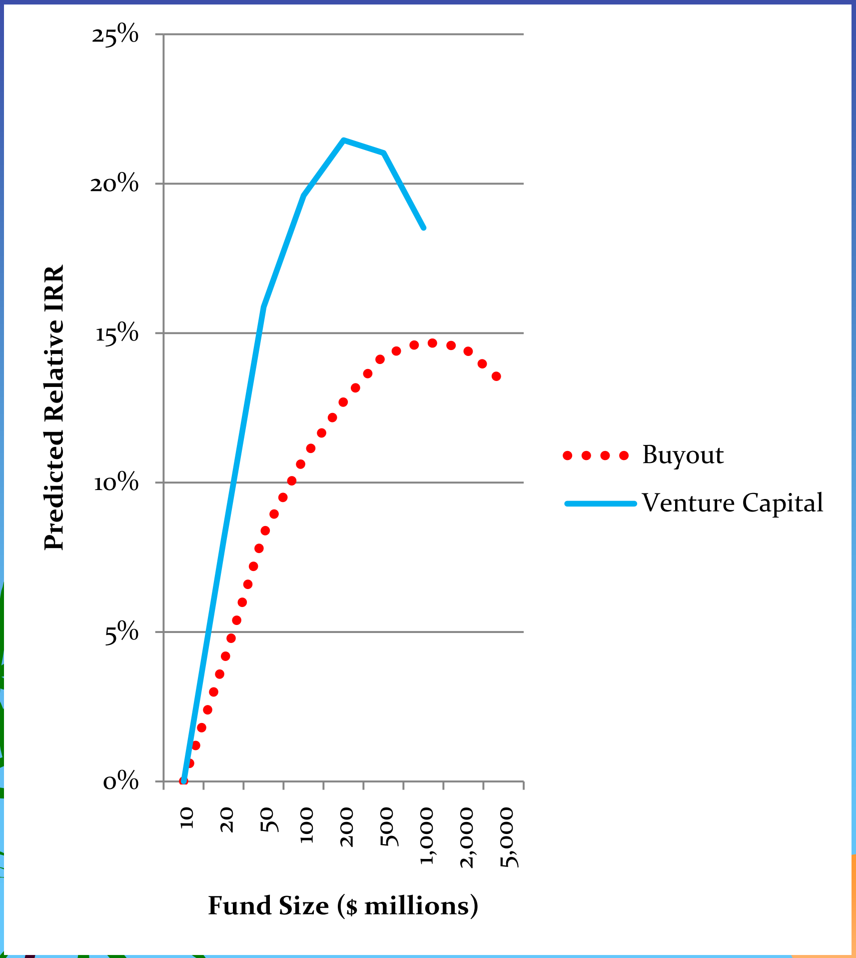
Source: Gompers, Kovner, Lerner and Scharfstein [2008].

Debt and LBO multiples over the cycle



Source: Axelson, Jenkinson, Stromberg, and Weisbach [2009].

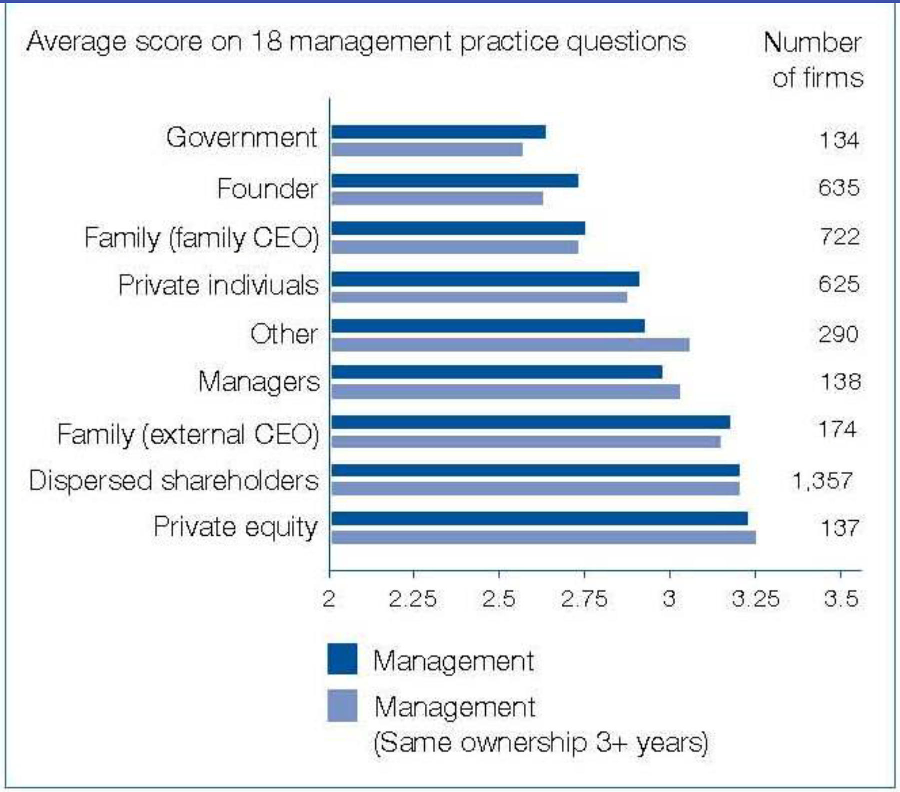
Also true at a fund level



- Funds do better as they get larger… to a point!
- Fund size is measured as capital committed at closing.
- Regression results control for vintage year effect, location, and fund category.

Source: Lerner, Leamon and Hardymon [2011]

Private equity and management practices



Note: Sample of 4,221 medium-sized manufacturing firms. The bottom bar chart only covers the 3,696 firms which have been in the same ownership for the last 3 years. The 'Other' category includes venture capital, joint ventures, charitable foundations and unknown ownership.

Source: Bloom, Sandun, and van Reenen [2009].

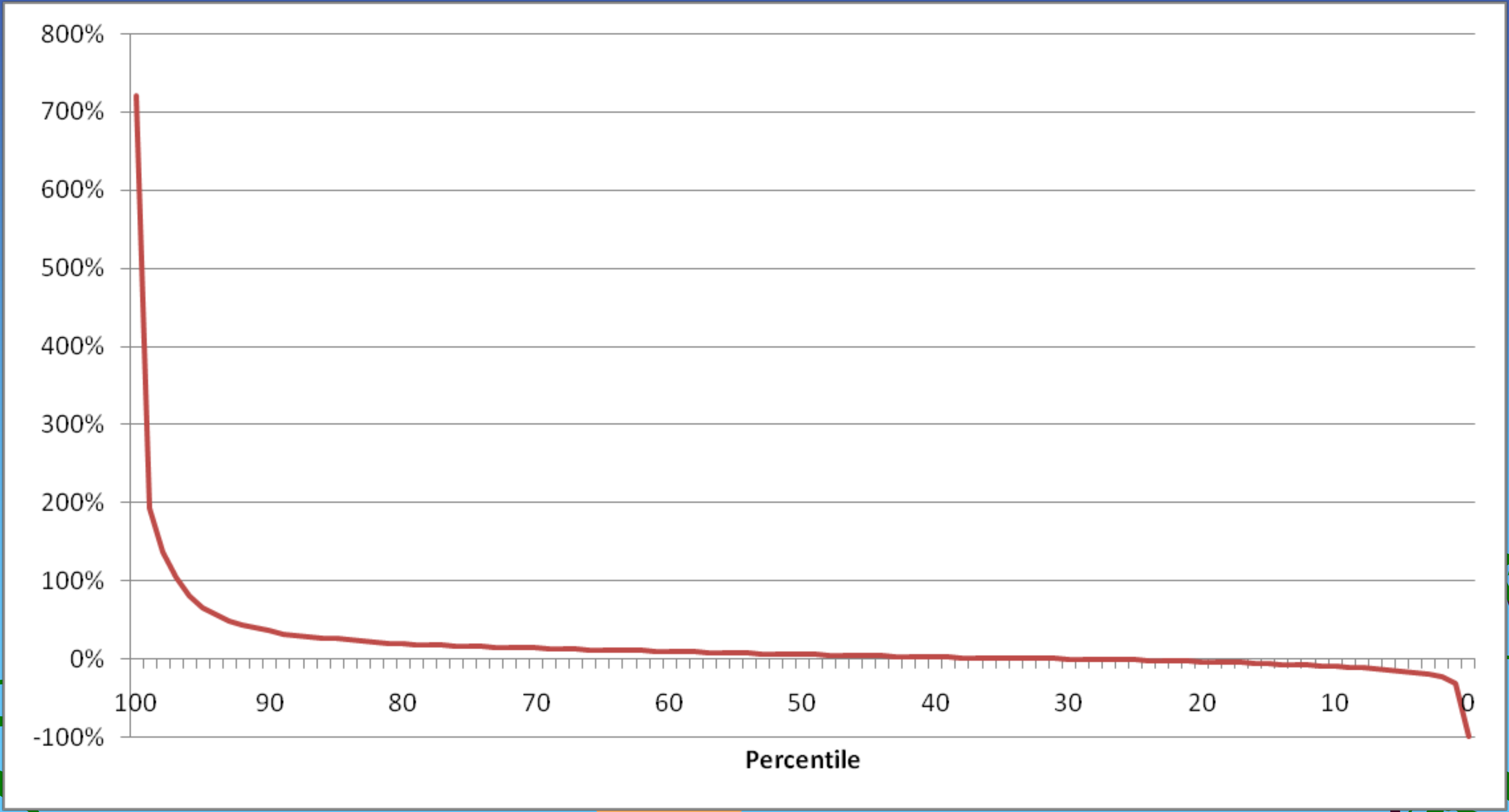
Implications

- Gradual recovery of returns reflecting fundamental value creation.
- Inflow of funds back into VC/PE market.
- Repeating boom/bust pattern that has characterized industry through 1950s.

Scenario 2: Back to the future

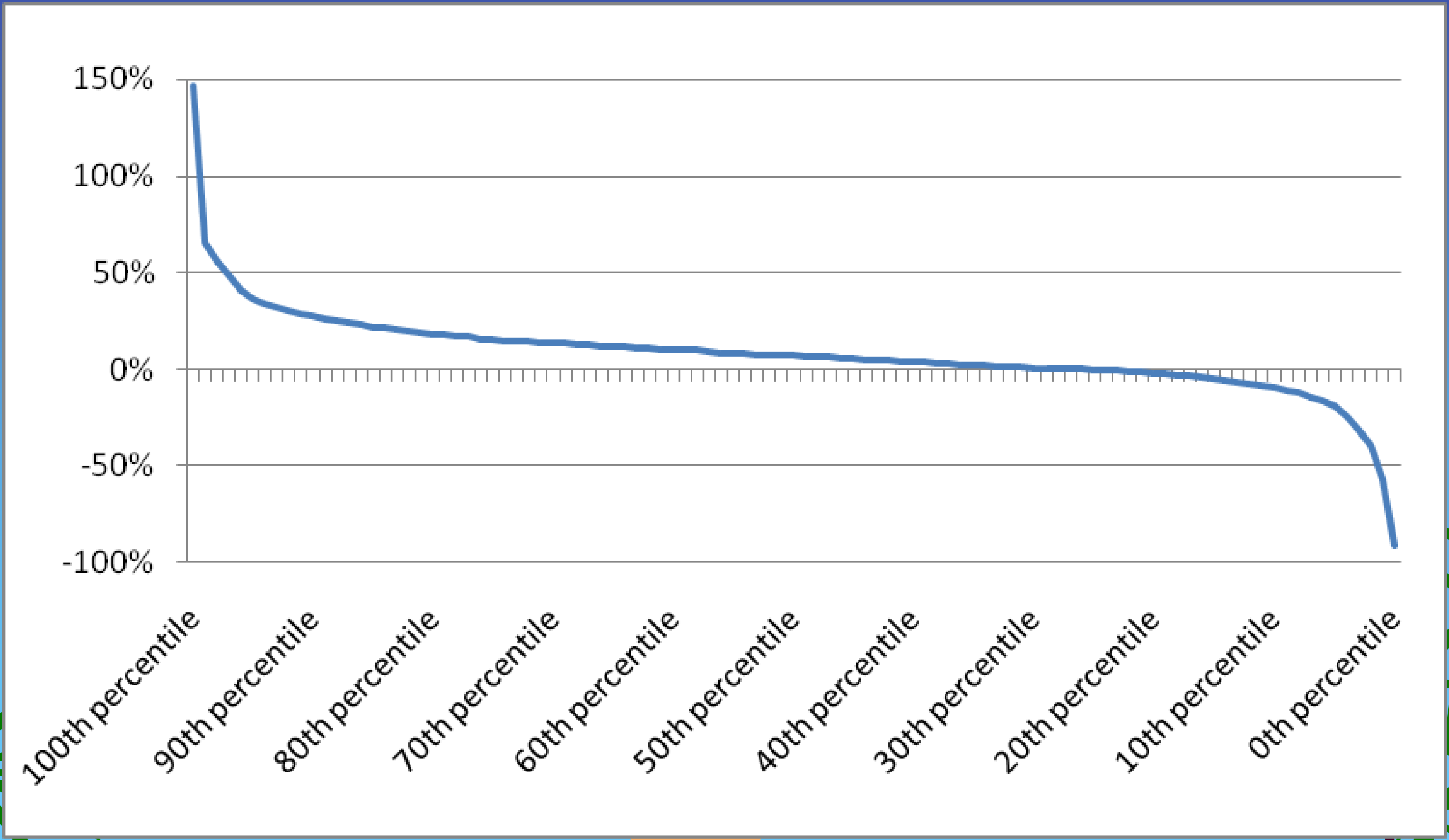
- Returns to limited partners are inherently “undemocratic.”
  - Skewness of returns:
    - Only a few funds are winners.
    - Trend seems to be intensifying.
  - Most investors have done poorly, and will gradually abandon programs.

Returns of U.S. venture funds



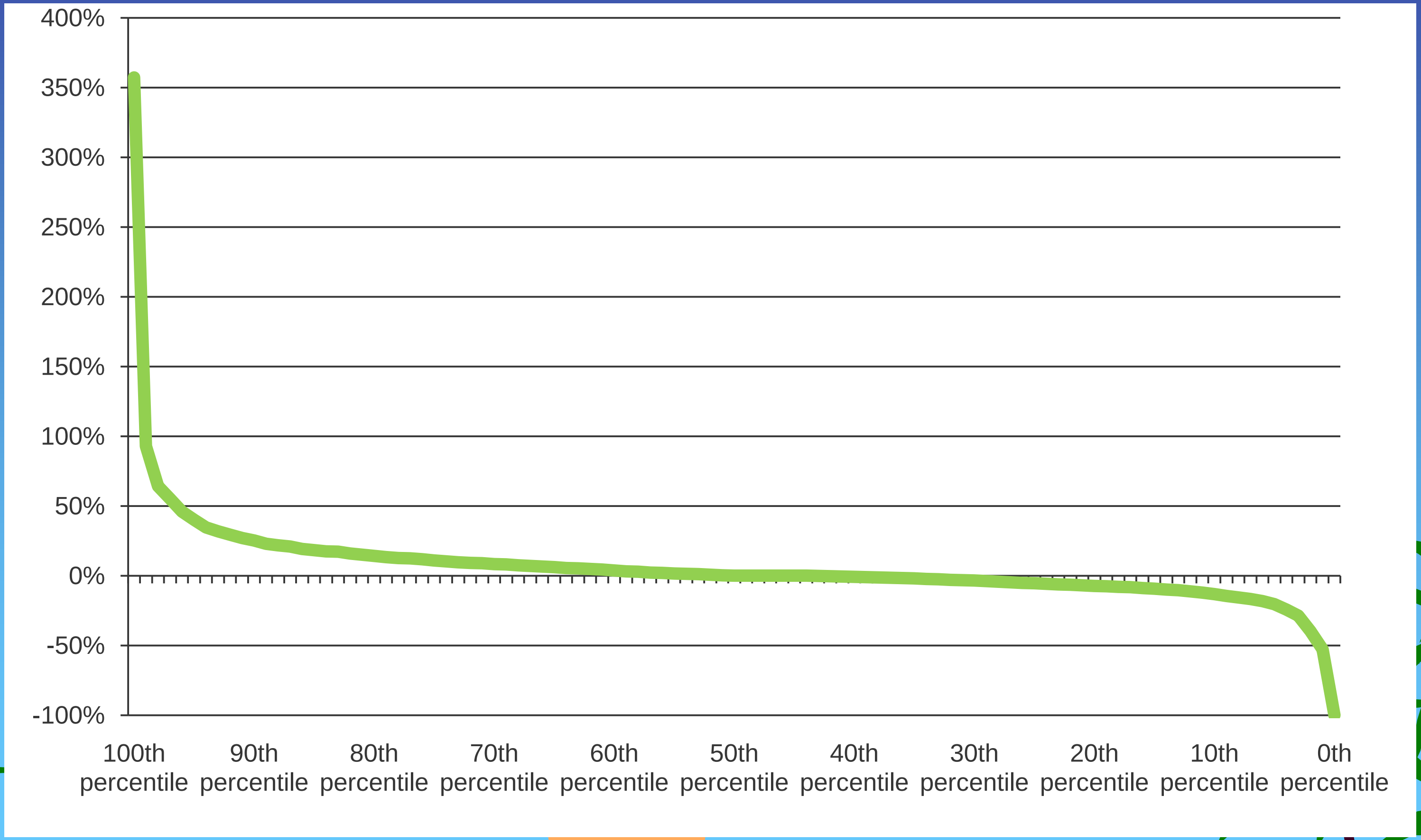
Returns from inception to 12/31/09.
Source: Authors' analysis of Thomson/Reuters data.

Returns of U.S. buyout funds



Returns from inception to 12/31/09.
Source: Authors' analysis of Thomson/Reuters data.

European private equity returns



Returns of 1227 funds from inception to 12/31/09. Source: Venture Economics.

Persistence of performance

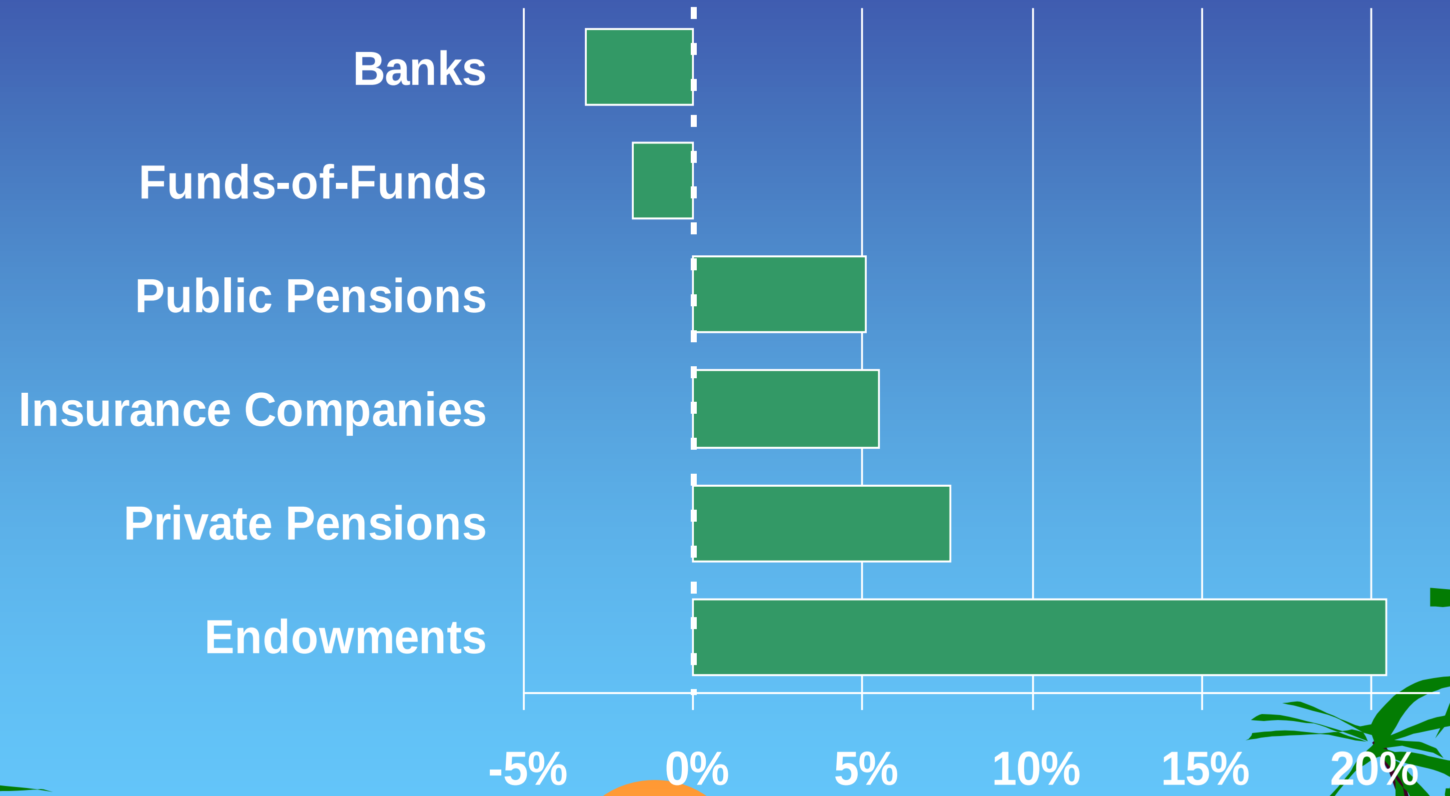
	Bottom	Medium	Top
Bottom Tercile	61%	22%	17%
Medium Tercile	25%	45%	30%
Top Tercile	27%	24%	48%

Source: Kaplan and Schoar [2005]

- High likelihood that the next funds of a given partnership stays in the same performance bracket

  ➔ Persistence.
- 1% boost in past performance → 0.77% boost in next fund's performance.

Performance by investor type, private equity funds between 1992 and 2001



Source: Lerner, Schoar and Wongsunwai [2007]

Implications

- Questioning of assumptions behind private equity in many investment committees.
  - Exit by many LPs who have:
    - Newer programs.
    - “Too large” or “too small” mandates.
- Limited number of LPs will remain, and will thrive.

Scenario 3: The LPs' desertion

- Poor returns may lead LPs to essentially abandon asset class:
  - Precedent of oil-and-gas partnerships, others.
- May conclude that inherently impossible to set right.

Fees have driven sharp wedge between net and gross returns

- Payments ***per partner per fund***, based on 240+ PE/VC partnerships ($MMs):

	VC	*LBO*
– Carried interest:	5.2	10.1
– Management fees	10.6	18.5
– Other fees:	1.3	4.1
– ***Total***	***17.1***	***32.7***

  - Metrick and Yasuda [2009]

An non-addressable issue?

- Failure to get traction partially reflected proponents and timing.
- But more fundamental challenges:
  - Fractured nature of LP community.
  - Competition between LPs to get into top funds.
  - Turnover within LPs.

Implications

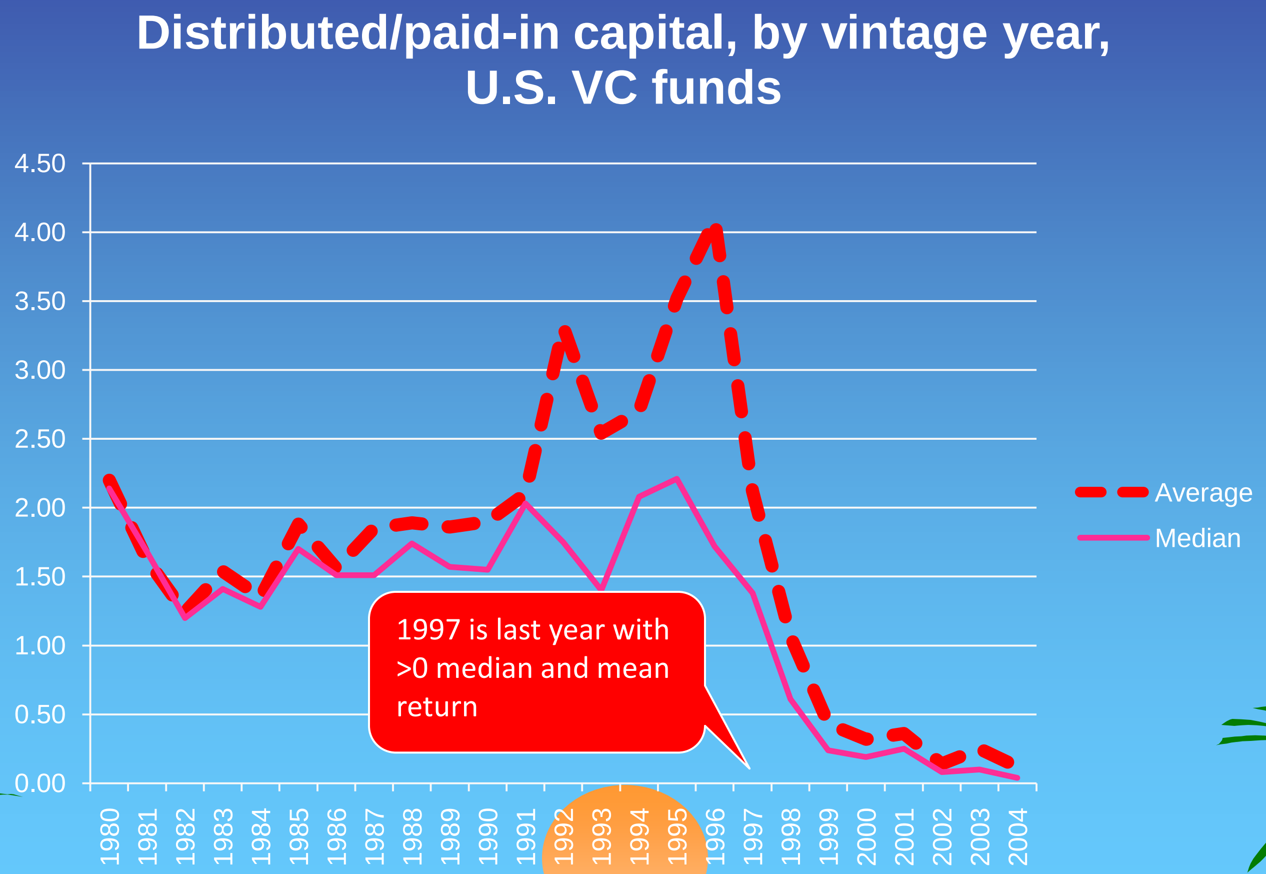
- Decreasing LP pool.
- Extensive exit by funds.
- Increasing reliance on non-institutionalized capital sources.


HELL NO, LEMMINGS WON'T GO!
KIM

Scenario 4: A broken industry

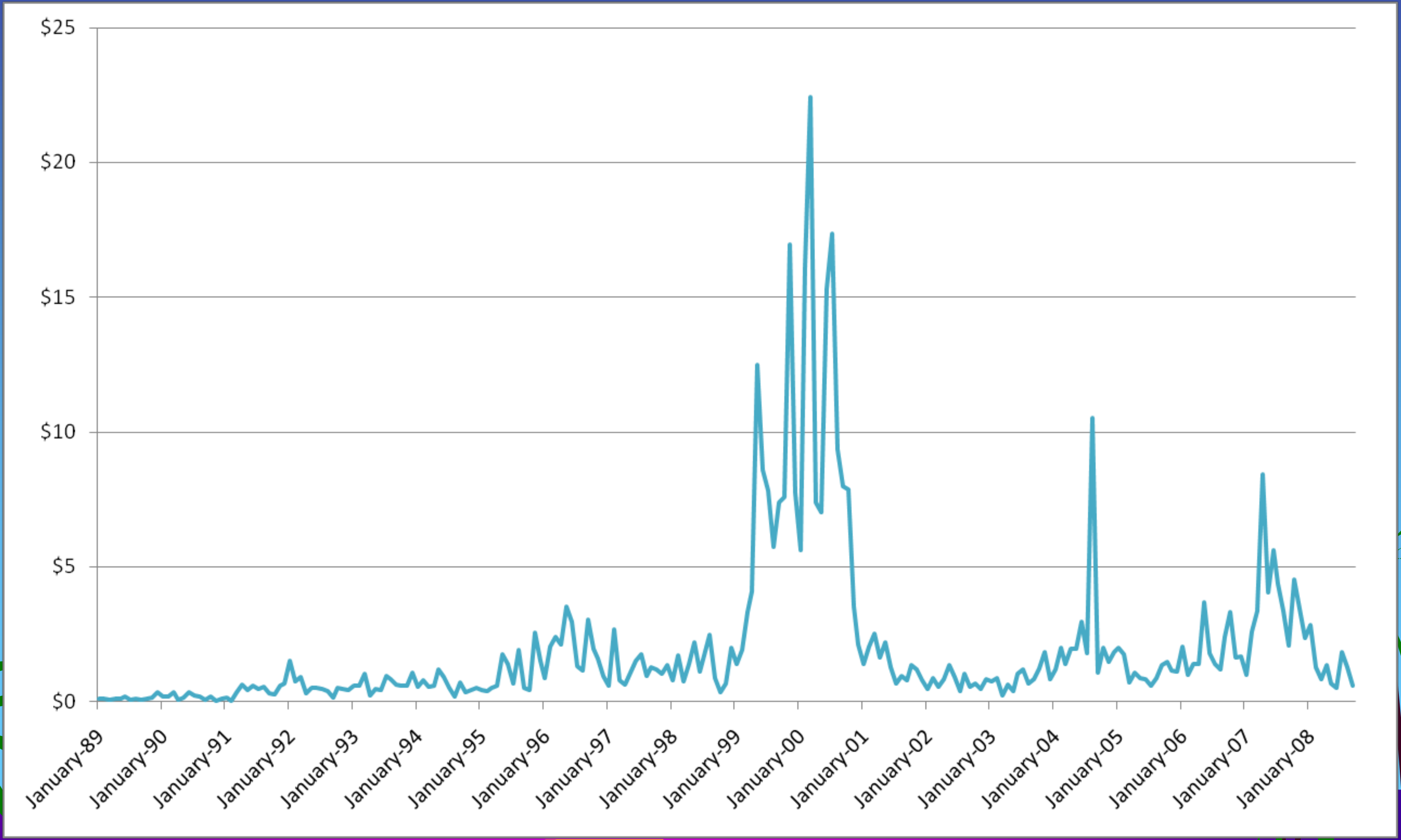
- Due to measurement issues and organization dynamics, PE groups may continue to raise funds.
- Even if returns are not there!
  - May continue for years or decades more…
    - Example of VC industry?!

Decade-plus disappointment in venture capital



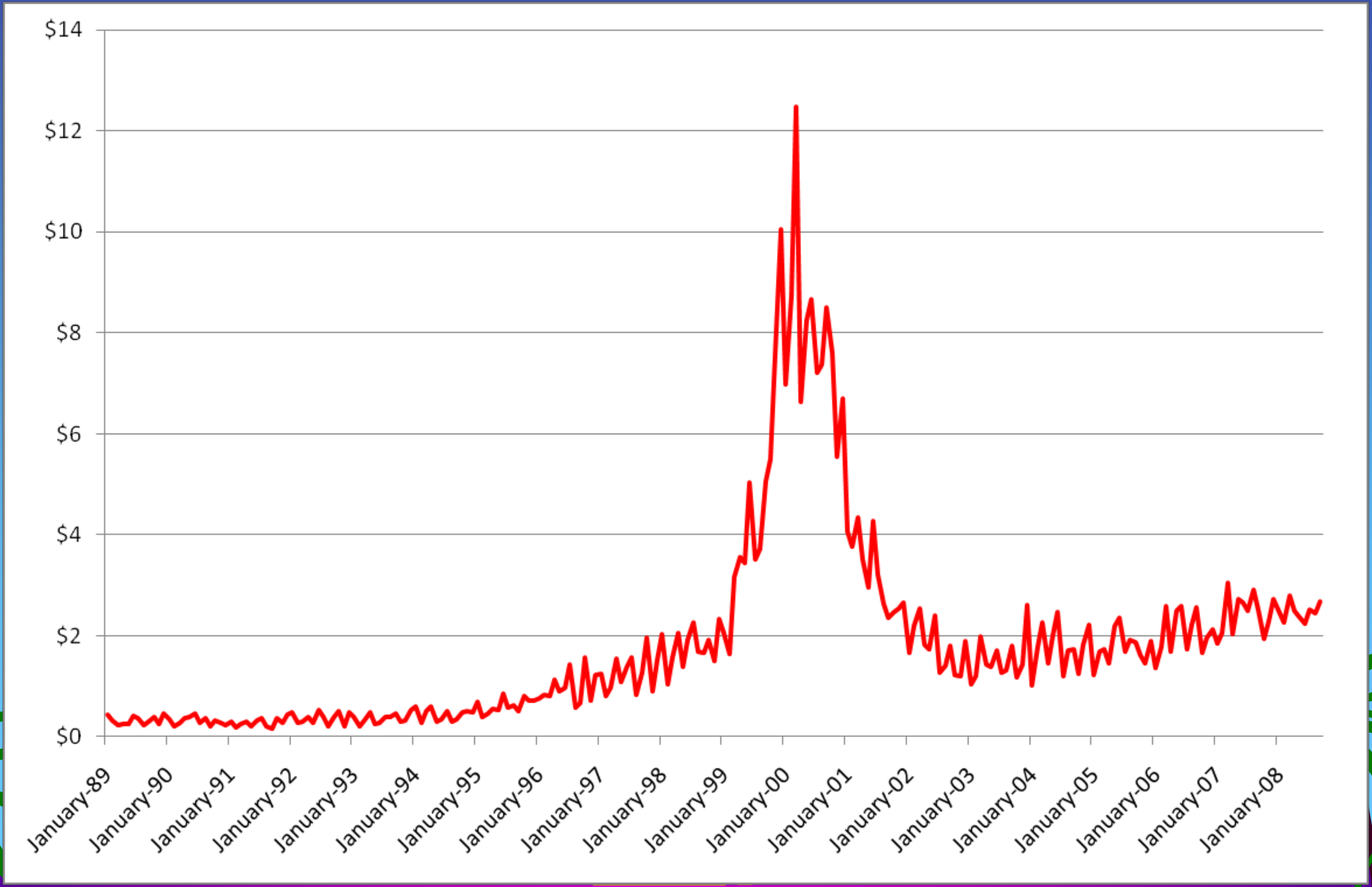
Source: Thomson/Reuters. Data as of 9/30/09.

Exits by venture funds ($B)



Source: Sand Hill Econometrics

Investments by venture funds ($B)



Source: Sand Hill Econometrics

Implications

- Reactions by LPs may be very slow.
  - Triumph of hope over experience?!
  - In many cases, may draw *wrong* conclusions:
    - E.g., shift to direct investments by sovereign funds.
- Suggests period of protracted disappointment.

Final thoughts

- Time to step back and think about where business is going.
- Can plausibly tell a variety of stories, with supporting evidence.
- All have elements of truth, but…
  - Believe some combination of first and second scenario is most plausible.
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