The Triago Quarterly

March 2012

Dear Reader,

More than 1,800 funds want to raise roughly $750 billion from limited partners today. The fund number is a record; the amount isn't.

Reduced fundraising ambitions from an unprecedented number of funds underline the problems private equity faces. Dry powder and unrealized investments are at or near pinnacles. Why give GPs new money, LPs ask, when there is so much to be spent, and when, on average, fund managers have only returned a fifth of paid-in capital after six years? These questions are obliging some GPs to close and forcing re-examinations of investment structures. They are also putting GPs with new strategies in a flattering light, and helping to drive secondary market growth, as private equity players innovate in the search for liquidity and returns.

As always, we hope the information found here helps you make informed decisions.

Sincerely,

Antoine Dréan
Triago Founder and Chief Executive
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INSIDE

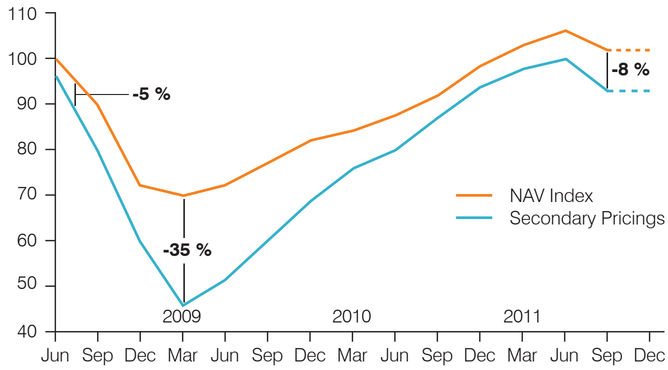
SNAPSHOT

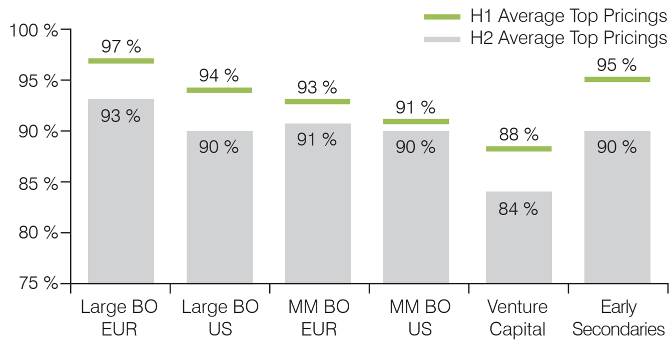
VC LEADS PRIVATE EQUITY RESILIENCE…

Net Asset Value Evolution

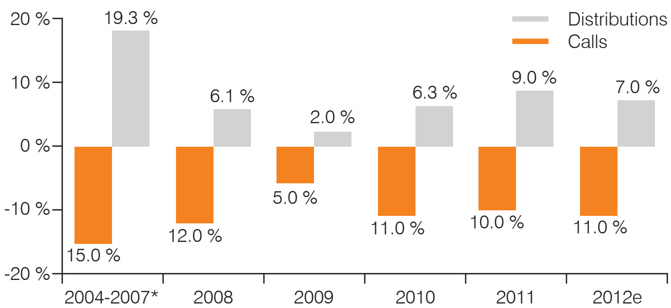
STRATEGY	FY 10	Q1 11	Q2 11	Q3 11	9M SEP 11
Large BO	+27.0 %	+3.4 %	+3.2 %	-4.7 %	+1.7 %
MMBO	+21.5 %	+3.0 %	+2.1 %	-3.0 %	+2.0 %
VC	+10.2 %	+6.5 %	+2.8 %	-2.0 %	+7.3 %
Special Sit.	+20.6 %	+3.7 %	+1.1 %	-6.1 %	+1.5 %
Energy	+15.9 %	- 1.3 %	- 1.7 %	- 2.5 %	- 5.4 %
Average	+20.2 %	+3.8 %	+2.9 %	-4.0 %	+2.5 %

…AS SECONDARY PRICES RAISE RECORD CASH…





…FOR INVESTORS BURDENED BY CALLS.



* Annual average

Source: Triago's proprietary data

Market Snapshot Analysis: Testing Times

Net asset values show resilience, deal multiples fall, but dry powder and unrealized investments still challenge investors, as secondaries raise record cash for stretched LPs.

Private equity funds registered a 4 percent drop in average net asset value between July and September, despite much larger declines for the listed comparables of private equity-owned companies. Europe's sovereign debt crisis sparked flight from global stock markets, but private equity portfolio companies were supported by a ninth consecutive quarter of strong cash flow growth, based on GP reports and rating agencies' leveraged loan issuer data. Initial GP reports for the fourth quarter indicate flat net asset value growth.

Average net asset value, up 2.5 percent in the first 9 months of 2011, is likely to increase modestly in coming quarters, given forecasts of a sluggish global economy and decreasing room to cut costs at lean portfolio companies. But one sector may prove to be a surprise: venture capital. The average net asset value for venture capital funds rose 7.3 percent from January through September, outperforming all other sectors. Venture capital portfolio companies have fewer stock market comparables than holdings in buyout and growth funds. But as numerous GP reports note, the key drivers behind VC's rise are rapidly falling technology costs and unprecedented revenue increases at consumer-focused internet start-ups.

Since tying the 2007 annual record of 9.7 times EBITDA in the third quarter, average private equity purchase price multiples have declined steadily, to 9.4 in the fourth quarter, and 8.7 for the three months through the end of February, according to Standard & Poor's Leveraged Commentary & Data. The decline can be attributed to leverage dearth and lower seller expectations as earnings growth forecasts have been cut, pressured by Europe's sovereign debt crisis.

Multiples may not spiral upwards, but the need to spend slightly more than half of today's $370 billion in buyout dry powder within 21 months should keep prices within lofty ranges. Also providing a floor for purchase price multiples is GP focus on growth companies and add-ons, where bright fundamentals and synergy opportunities come with higher price tags.

GPs now own an unprecedented 8,000 portfolio companies worldwide, held on average for a record five years. These investments generate yearly management fees, but mostly date from the '05-'08 credit bubble, with annual returns beneath the 8 percent threshold that would normally spark GP share in realized profit. Pressure is clearly growing for GPs to sell investments, even when they can't take a cut of profit. But the GP incentive to spend dry powder before investment periods end - when annual management fees on uncommitted capital expire - is likely to make 2012 the fifth cash-negative year in a row for investors.

Triago estimates capital distributed will be slightly less than two-thirds of capital called from LPs in 2012. Calls are seen climbing to 11 percent of committed capital in 2012 from 10 percent last year, as distributions drop to 7 percent from 9 percent. Relatively modest call and distribution levels should lead to record fund extension requests from GPs this year, amidst a difficult environment for buyout transactions that may ease considerably by year-end. Powered by LPs who received net cash in 2011 - essentially those less concentrated in credit bubble vintages -Triago expects global fundraising volume to rise 15 percent to $265 billion in 2012, after a two-year period when roughly $230 billion was raised annually.

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New LP cash for fundraising should also come from the booming secondary market. With nearly two-thirds of LPs regularly reporting themselves at or above their target allocations to private equity since late 2009, the secondary market is an increasingly important tool for freeing up capital for investment in new PE funds.

Secondary specialists and the secondary pockets of funds-of-funds held $44 billion in dry powder in January and are on pace to fundraise a record $26 billion this year. With the average top bid in the secondary market currently at a 9 percent discount to September net asset value, volume is likely to rise to $30 billion this year, surpassing 2011's $25 billion record.

Roundtable

Don't Trust Indexes

History does not make it obvious, but venture capital may be entering a new golden age for investment returns.

Venture capital looks like a lousy place to put your money. Over the last decade, VC has returned just 2.59 percent annually, according to Cambridge Associates' U.S. Venture Capital Index. That's considerably worse than the 11.55 percent annualized return over the same period for non-venture capital private equity funds. It's also bottom-of-the-heap versus gains on other assets, including large and small cap stocks, and government bonds.

Invited by Triago to discuss the relative appeal of venture capital, three prominent industry veterans - two LPs and a GP - say poor historical averages obscure the attraction of one of today's best investment opportunities. But their conversation makes it evident that venture capital requires patience, and even an extra smidgen of courage from investors.

TRIAGO: Based on indexes, venture capital returns have been subpar for more than a decade. Should limited partners regard such numbers as a reason not to invest in venture capital?

Peter Lawrence, Founding Partner of FLAG Capital Management: Like anything, you should really focus on the underlying drivers of returns. Should people have begun investing in 1998 based on the previous decade's remarkably strong venture capital index returns? Given subsequent performance, the answer would be no. It should be analysis of particular sectors in venture capital, and specific GPs, not indexes, that determine when and with whom you invest. Indexes lead people to the wrong funds at the wrong time. Today, they are preventing people from recognizing strong return drivers for venture capital.

Chris Douvos, Managing Director at Venture Investment Associates: In venture capital the disparity between highest and lowest performers is the most extreme of any broad investment category, including buyouts. A consistent, multi-cycle approach to venture capital investing makes the most sense. Investment programs focusing on managers who are value creation catalysts can generate fantastic returns, uncorrelated with indexes or with economic cycles. That is the promise of venture capital.

Norm Fogelsong, General Partner at Institutional Venture Partners: Investors should note cycles. They provide an indication of the scale of investment opportunity in venture capital at any given time. In the late 1990's this industry was absorbing a relatively healthy $15 billion to $20 billion per year. During the internet bubble, the investment community poured in $100 billion annually and people who shouldn't have been in this business became GPs and LPs. In 2000 there were 741 active venture capital GPs, and today there are 357. Annual capital flows are again in the $15 billion to $20 billion range. Those figures are a better indicator of the opportunity to make good returns today than lagging indexes.

TRIAGO: Venture capital investing involves occasional home-runs and lots of duds. How can LPs improve the venture capital risk/reward ratio?

CD: You should focus on GPs that are leveraging eco-systems. Some groups do this by building brands that attract a diverse range of entrepreneurs and investment opportunities. Others do it by being close to a network of entrepreneurs focused on exploiting a particular theme - say open source software - giving rise to a wide range of start-ups and investment opportunities.

PL: A classic buyout LP, or fund-of-funds manager, is looking at an extensive array of sectors, trying to identify the best managers in each area. But choosing the best managers in venture is different. At any particular point in time, venture returns are driven by a relatively small number of really great companies. So, investors should look for the best entrepreneurs and deploy capital with the GPs those entrepreneurs seek capital from.

NF: I'd add that one should look for venture firms where the partners have been together for at least 10 years. Choose the best teams and commit to investing in their next three funds - you can never tell exactly how any one fund is going to perform. Don't invest with a group that has come together for the first time, or with a manager who has great ideas but has never done venture capital before. In my book, there are no exceptions to these rules.

How are the qualities of good venture general partners materially different from those of top general partners in other sectors of private equity?

NF: Well, the earlier you pull the trigger in the investment process, the more qualitative judgment you need to supply. Good venture capitalists have a sense of mathematic probability, but they are obviously judging people and markets impossible to quantify in any precise way early on. By the time you get to the buyout stage, you've got up and running businesses and years of spreadsheets. At that point, there is a relatively greater premium than in earlier stages on GPs who can optimize the decimal points and reduce costs.

CD: What is amazing about investing in venture capital is seeing de novo company formation take place on nothing more than a cocktail napkin and then seeing some of those ideas move to commercial success. There are so many variables, so much skill, luck and patience that come into play in the process! I like to say that the best venture GPs can see around corners. What that means is that they know their space inside and out, magnetize entrepreneurs and build a position as the go-to-guy for the people with the best ideas.

PL: Well, there's always the line that "good GPs in venture capital are optimists, and good GPs in buyouts are cynics." It's not that cut and dried, but comparing venture capital specifically with buyout, it's clear that deep sector expertise is absolutely critical, even at what would pass for a generalist venture capital fund.

TRIAGO: People often speak of past golden ages in venture capital. Where would you situate venture capital's golden ages and how do the circumstances of those periods differ from today's environment?

NF: The first real golden age was in the U.S. in the early 1980s, when Reagan was elected, taxes were cut, and there was an unprecedented burst of entrepreneurship. Our firm made eight investments in 1980 and six of them went public within two years. Another golden age stretched from 1994 to 1999, covering the dawn of the internet's commercial feasibility. Many successful companies were created, and the dotcom bubble had not yet inflated. Today, I'd say we are in another golden age, despite one of the most challenging global economies we've seen. That's because of the unexpectedly rapid development of the internet in the last five years. With the right segment and the right entrepreneurs you can build a billion dollar company in less than five years today, something that was impossible half-a-dozen years ago.

CD: There are different types of golden ages: those when meaningful companies are built, ones where people make a lot of money, and others when significant sums are raised for investment. They are part of the same arc. Today, we are in a golden age of entrepreneurship, with a range of new technologies emerging, plus growing recognition and encouragement of entrepreneurship as a means of bootstrapping the world out of economic decline. The next stage could be a golden age of returns, which, in turn, will kick off record investment. The irony is that by the latter stage, widespread investment opportunity will be past.

Marc Tyler Nobleman

PL: I'd only emphasize that today's opportunities are exceptional. Not only is our computing speed doubling every couple of years, as it has since the invention of the integrated circuit in 1958, but everything we do that has anything to do with computing, including entertainment, is becoming vastly less expensive. Returning to your first question on index impact, now is a particularly good time for venture investors precisely because many others are looking backwards at the averages and saying "oh, that looks awful! I'm not putting my money in this business!"

CD: Regarding the relative lack of popularity of venture capital among LPs, and why investors have been so fickle despite its promise, it's worth noting that one of the challenges endemic to venture capital is that the investment-to-liquidity cycle remains longer than it is in most other areas of private equity. It is certainly longer than the attention spans of most investment committees.

> *"VC is half of the PE allocation at institutions with very long-term horizons. That seems about right to me."*
>
> **Chris Douvos, Venture Investment Associates**

TRIAGO: Critics also point out that getting access to the best GP teams is very difficult. How can this problem be overcome?

CD: Competition to get into the top funds is so acute that it's almost impossible for an LP without an existing relationship, or a special hook, to get access. A lot of people legitimately ask how do you play venture capital if you don't have access to the funds you want to invest with. Some look to funds-of-funds for access. Others invest time, effort and money putting people on the ground in different centers of entrepreneurship where they interact regularly with the best GPs, building relationships that lead to investments. My advice to any one investing directly into funds is "be creative." For me, internet blogging has been a great access strategy. It creates an intellectual peer relationship with top GPs that I would not otherwise have.

PL: I've got to agree. Even if you are a stalwart, experienced and well-connected limited partner in venture capital, you still struggle to get access. You've got to be constantly clever and resourceful.

NF: Granted, there are not always easy routes into top funds. Still, my recommendation to LPs on this point is to focus on developing relationships with GPs before they are fundraising. Identify the best GPs through conferences, industry literature, reputation and word of mouth, then call them and just say "I'll be in town on such and such a date and I'd like to drop by and talk to you for half-an-hour." Some pretty basic networking, outside of fundraising periods, is just not as common as it ought to be and that gives an advantage to LPs who take the time to do it.

TRIAGO: What would you identify as the most promising and the least promising areas of venture capital investment today?

PL: Information Technology has always been the best place to invest and I have no doubt that this continues to be the case. IT is anything that has to do with computing information, screen-based entertainment, and any business reliant on increased productivity through the use of technology. The least promising areas are defined by relatively high capital usage, relatively long periods between initial investment and commercialization and relatively high levels of regulation. If any one of those factors is at play, the investment is likely to be unattractive for venture capitalists. Both Bio-Tech and Energy are two areas that suffer from all three of these drawbacks across most geographies.

CD: I'm with Peter. We are seeing a highly positive re-architecting of IT. Bio-Tech has become cash consumptive to the point where booking capital gains seems as random as winning the lottery. And in Energy there are so many price-distorting variables in the form of subsidies that it's almost impossible to predict the performance of investments.

NF: I would put a finer point on the appeal of IT. I think the best areas are internet and digital media; enterprise IT; and mobile communications. All are rapidly evolving technologies and areas where there are large markets. If you put together a fantastic consumer-facing internet company, its potential market is measured in billions of dollars, as opposed to say a fantastic machine tool technology company, where the market may be worth just $50 million.

TRIAGO: What percentage of an LP's private equity portfolio can be prudently committed to venture capital?

PL: Variables like investor time frame, tolerance for illiquidity and cash flows into a portfolio obviously determine how much particular investors can commit. But I think it can make sense, everything being equal, to have 20 percent to 25 percent in venture capital.

NF: That sounds like a sensible range. I would add that for all but the very largest portfolios, if you get down to less than 3 percent, venture capital's ability to enhance private equity returns diminishes to a point where it is no longer worth the time and effort that must be put into it.

CD: Venture capital is the equivalent of the longest-dated, furthest out-of-the-money option you can buy for your portfolio, so for most people that puts a fairly low ceiling on how much of it they want. The role of private equity in a diversified portfolio is to enhance returns relative to what you would get from more liquid markets. Within private equity, venture capital is the most turbo-charged form of portfolio octane. Skillfully executed, it can be the best return enhancer of the lot. I would actually want to put as much of it into my portfolio as I could stomach. After all, courageous investing is about optimizing discomfort. I know some institutions with very long-term investment horizons where venture capital is half of their private equity allocation. That seems about right to me.

Private Equity Blog

A round-up of market issues and challenges for limited partners and general partners.

WAITING FOR DISTRIBUTED

Going back a bit, PE funds typically paid out more than 50 percent of LP investment after six years of existence, with every paid-in dollar usually returned by year ten. But the corollary of today's record number of unrealized investments is a lengthening cash wait. One-tenth of 2006 PE funds have paid back 50 percent of LP investment after six years, with the average fund returning just 19 percent. Meanwhile, 2005 funds have distributed only 42 percent of paid-in capital. Funds from 2004 and 2003 have monetized slightly more than two-thirds of paid-in capital, but within two years of standard fund-life expiration, the residual value locked in these vintages - counting appreciation - is 75 percent of LP investment. As fund-life deadlines near, record harvesting period extension requests should lengthen LPs' wait for checks, while record requests for investment period extensions, tied to massive dry powder, lengthen un-invested capital commitments.

The number of PE general partners considered active - those completing at least one fundraising in the past decade - shrank for the first time in 2011.

FIRST-TIME FUND APPEAL

When fundraising is difficult, first-time funds can do well. In the U.S., the world's largest fundraising market, a third of funds that successfully reached final close last year were new GP vehicles, according to Pitchbook. That ties the 2004 high-water mark for first-time fund market share and is up from 19 percent of final closings in 2010. The general partners of successful first-time funds are almost always long-time industry veterans with solid track records. Also, today's emerging teams tend to have specialist strategies, tapping into current LP desire for GPs with hard-to-replicate knowledge regardless of fund number.

GP ATTRITION IS HERE

Measured annually, the number of PE general partners considered active - those completing at least one fundraising in the past decade - shrank for the first time in 2011, even as freshly minted GPs took the place of a relatively large number of non-active GPs. Since the start of the financial crisis in 2009, at least 350 fund managers have moved to the non-active category, according to Preqin. That's 8 percent of the active GP population that existed when Lehman Brothers went bankrupt, and annualized represents a nearly four-fold increase over the 1 percent annual attrition rate in the decade through 2008. Watch for GP casualties to rise dramatically from 2015, as the poorly performing '05-'08 credit bubble vintages - representing 47 percent of existing funds by number - begin hitting ten-year anniversaries.

SIGNIFICANCE OF SEPARATE ACCOUNTS

"The comingled fund model is dead. Deal-by-deal structures are the future of private equity," a pension fund manager recently told us. His tongue may have been firmly planted in his check - objectively the statement is hyperbole. But separate accounts have clear appeal, whether they involve a diversified mega-GP providing one-stop-shopping for alternative asset classes, or an opt-out clause on specific investments offered by a smaller GP's pledge fund. They won't kill off the traditional commingled fund with its 2-and-20 compensation structure. But separate accounts are a key factor - along with LPs reducing overlapping GP relationships, and the relative lack of distributions from GPs - that are forcing fund managers to stand out from the crowd in unprecedented fashion.

GETTING CASH BACK

For LPs, who on average have contributed more in calls than they've received in distributions since 2008, secondary sales can be an attractive way to realize gains. Selling existing PE stakes generated an average 1.35 times paid-in capital in the five years to end 2011, according to Triago data. That represents cash received for secondary stakes, plus distributions from GPs made prior to the sale. It's difficult to generalize about a market where spreads between top and bottom bids can easily be 3,000 basis points, but on average the sweet spot for optimizing annual returns is in year seven of fund existence, where typical realized value post-secondary sale is 1.56 times paid-in capital.

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