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U.S. MARKET COMMENTARY

Still Nursing the U.S. Private Equity Overhang Hangover

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Despite a meaningful reduction in the overhang for large private equity funds, it remains too large to be absorbed by anything other than a replay of the easy credit–powered 2005–08 exit environment; mid-market funds are still a more attractive option.

A little over a year ago, we posited that the capital overhang in the U.S. private equity industry, while significant, was mainly confined to larger funds, and that smaller funds seemed better positioned due to both a less significant overhang and a better transaction pace. This remains broadly true today, although there are some additional wrinkles to the story—e.g., many funds have looming deadlines to get cash invested, some mega funds are coming back to market, the exit environment has recovered (at least for the moment), and the overhang for mega funds has shrunk a bit. Still, we continue to believe smaller funds (broadly speaking, less than $1 billion) are more attractive, in aggregate, than larger funds.

The Song Remains the Same

U.S. private equity funds raised a total of $915 billion from 2005 to 2010, of which we estimate about half had been called as of December 31, leaving a $376 billion overhang net of fees (Exhibit 1). As was the case last year, the overhang is composed mainly of funds with more than $1 billion in commitments—42% is in funds of more than $5 billion, and 43% in funds between $1 billion and $5 billion.

Not surprisingly, more than 60% of the overhang is still concentrated in the 2007 and 2008 vintages—the top two fund-raising years ever—with the two vintages only about 46% and 34% called, respectively. This leaves roughly $236 billion for investment after assumed fees, or nearly four-and-a-half times *total* 2010 commitments ($53.3 billion). For perspective, consider that during the five years leading into the 1991 industry downturn, private equity funds raised a *record* $20 billion—the equivalent of one mega fund circa 2007. Perhaps more pertinently, it is worth asking to what degree 2004–08 data should be considered an outlier—particularly given the impact of the global credit bubble—as opposed to representative of the new norm to which the environment will eventually return.

The bottom line is that the overhang[1] is a good deal smaller than shown in our previous report ($445 billion), mainly because funds greater than $5 billion made investments in 2010 but raised little or no money; according to our estimates, all vintage year fund raising ($53.3 billion) was for funds smaller than $5 billion. This may well change in 2011, as several mega funds are either fund raising or actively considering it.

Back to the Races?

We modeled two scenarios, similar to analysis we did last year, to get a sense of how the overhang will influence the market. First, we assumed investment activity would be similar to the 2005–10 pace, and the average equity contribution 35%; second, we used 2009–10 activity levels and equity

[1] In comparison to last year's report, we dropped the 2004 vintage year and included 2010 in order to capture only funds with active investment periods.

contribution of 45% (Exhibit 2).[2] Not surprisingly, the first set of assumptions showed average time to invest for each fund size category to be within a typical investment period (approximately three to six years), while the second set showed a much bleaker picture.

In simple terms, these represent "good" and "bad" scenarios based on recent data, although as mentioned above, 2004–08 data may not provide a realistic baseline; if activity did fall back to pre-2004 levels, this would clearly result in a large number of funds never getting fully invested. Further, given that we included 2009–10 data in both sets so as not to make the "good" scenario unrealistic, the difference in deal activity is perhaps less dramatic than might be expected.

One area to watch is the number and size of "mega" deals, loosely defined as more than $1 billion. The number of such deals plummeted in 2008 and 2009, but rebounded in 2010, though both the number of deals and average deal size remain well below their 2006–07 peaks (Exhibit 3). As any sustained upturn in this market segment—by number or size or both—could cut the overhang sharply, we are keenly attuned to future developments; sustained traction in mega deals would temper our concerns about that overhang, at least in the short term.[3]

Indeed, as we said last year: "The question, of course, is whether the 2008 [environment] is simply another wave in the ongoing ebb and flow of credit (and we should thus expect another upturn within the next ten years or so), or represents a more substantive downturn that heralds a fundamental change in the global economy (i.e., is the credit crisis cyclical or structural?)."

Given that the exit environment has recovered faster than just about anyone expected (Exhibit 4), it is tempting to conclude that late 2008–09 was the anomaly. However, much of the recovery in financial assets—including both credit and equity markets—is due to extraordinarily aggressive actions by the government and Federal Reserve, which makes it difficult, if not impossible, to draw any firm conclusions. As one money manager recently quipped to us, "It's like your kid is sick, but he feels better because you've got him hopped up on drugs. You won't know if he's really recovered until they wear off."

In sum, while the overhang has shrunk over the past year, it remains quite large, and given that the improvement in investment pace is due in large part to monetary and fiscal largesse, it seems unlikely such favorable conditions will persist should fiscal policy continue to tighten and central banks move in the direction of normalizing monetary policy, as is widely expected. Recent economic data, meanwhile, have been decidedly mixed, raising additional uncertainty.

On the Bright Side

The good news for investors is that thanks to the overhang, many investments made in 2006, 2007, and 2008 vintage funds will offer exposure to current opportunities. Thus, investors that either refrained from making new commitments or scaled back their commitment pace in 2008–09 (i.e., the vast majority) should not worry about being "out of the market" during what appears to have been a great buying period. As the overhang is put to work, such investors will continue to get exposure to different market cycles, *even without making additional commitments to new funds*, although

[2] For context, historical equity contributions have ranged from 26.7% (1997) to 45.7% (2009), while investment activity has ranged from 105 deals (1995) to 1,097 (2006) across all fund sizes.

[3] Clearly, such deals still need healthy exit markets for longer-term success, but a continued rebound in large deals would help alleviate the current pressure from the overhang in investment markets.

obviously this will eventually come to an end. This dynamic also complicates manager evaluation, as performance will be bifurcated between the portion of a given fund invested at peak multiples around the top of the market, and that invested at lower prices following the credit crisis.

As noted, the exit environment has also improved dramatically since 2009, with mergers & acquisitions (M&As) and initial public offerings (IPOs) both picking up, and the former close to peak levels. These bottom-up observations were borne out by year-end data: according to Dealogic, private equity–backed M&A transactions in 2010 totaled $94.4 billion, almost two times the dollar volume delivered in 2009 and the fifth highest year on record going back to 1995. As a percentage of the overall market, 2010 came in at 10.4% of total dollar volume, just above the historical average of 9.0% since 1996. Leveraged recapitalizations, in which a manager levers or re-levers a portfolio company and receives a cash dividend, are another form of liquidity not counted as an official "exit," and have also been rising.

Private equity–backed IPOs also had their best year since 2007—with 58 IPOs raising an aggregate $11.0 billion—and accounted for 34% of U.S. IPOs by number and 25% by value, well above their post-1994 averages of 13% and 15%, respectively. First quarter 2011 IPOs, meanwhile, eclipsed the 2010 full-year total in terms of value, with ten IPOs raising $11.2 billion, including the three largest private equity–backed offerings on record—Nielsen ($1.6 billion), Kinder Morgan ($2.9 billion), and HCA Holdings Inc. ($3.8 billion). One caveat: while in the past IPOs were often true "exit" events where funds realized gains, today most companies are using proceeds to pay down debt or for general corporate purposes. In such situations, funds need to sell their ownership stakes—which are often substantial relative to trading volume—after the IPO.

Finally, easy credit–fueled issuance of leveraged loans and high-yield debt continues to be the wind beneath private equity's wings, particularly for larger deals/funds. U.S. leveraged loan issuance for 2010 was $510.0 billion, 85% more than 2009, while high-yield debt issuance—much of which was used to refinance existing debt—was a record $217.5 billion, with fourth quarter issuance a record $66.5 billion. The upside for investors is that as much of the "wall of maturities" has been refinanced, managers have begun to redirect capital to fund distributions, although this may be short-lived as the wall begins to climb anew in 2012–13.

It's Not Over 'Til It's Over

Still, the facts regarding distributions are sobering: the most recent vintage year to return more than 1 times cost to limited partnerships was 2002, and every year since 2003 has delivered distributions of less than 0.5 times cost. Indeed, of the 2005–10 vintage years within our current overhang timeframe, the 2005 vintage year has done the "best," with a 0.22 times pooled mean distribution to paid-in capital multiple, and 0.19 times median distribution. Much of this, of course, is the result of many levered private equity–backed companies losing a year or more on their business plans due to the credit crisis; the takeaway is that the wait for realizations will likely be longer than planned, and results less than anticipated.

Manager selection and access, meanwhile, remain important considerations (Exhibit 5). While dispersion has historically been less than that of venture capital funds, which often thrive or die based on one investment (e.g., Facebook, Google), private equity manager returns have been significantly more varied than those of long-only public equity managers, which makes sense given the fractured nature of the asset class. Further, many private equity portfolios now contain marquee Internet investments that could sharply boost returns. Given the parlous state of the economy and financial markets, as well as issues with the overhang, we expect the best managers to continue to distinguish themselves through better deal sourcing and due diligence and post-investment value add, while less talented managers struggle.

Conclusion

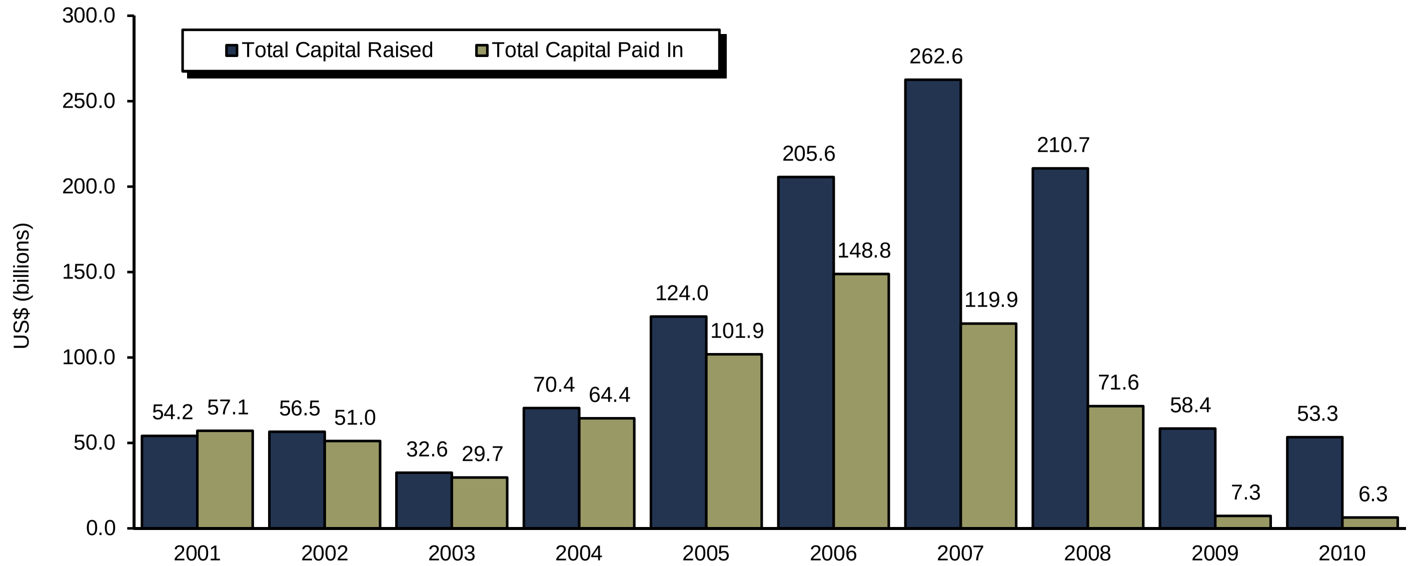
While there will always be a private equity overhang due to the nature of the asset class—investors commit capital in advance of a series of transactions made over what is typically a multiyear period, resulting in a portfolio of investments—the current overhang remains too large to be absorbed by anything but a replay of the easy credit–powered 2005–08 exit environment. That said, the bulk of the problem remains in large funds of more than $1 billion; smaller funds have less of an overhang and generally better exit prospects, although as noted, exit markets have been supported by the extraordinary levels of monetary and fiscal stimulus, and thus remain vulnerable to their reversal, particularly given heightened valuations in certain market segments (e.g., small caps).

One bright spot is that most investors in existing private equity funds will get exposure to the current, lower-priced environment regardless of whether they re-upped in 2008–09, although obviously this will vary by strategy and fund. We continue to believe private equity offers investors a legitimate investment option, but recommend investors set a high bar for allocating money to this illiquid asset class; as always, manager selection and access remain critical considerations. ■

Exhibit 1

U.S. Private Equity Estimated Capital Overhang

As of December 31, 2010

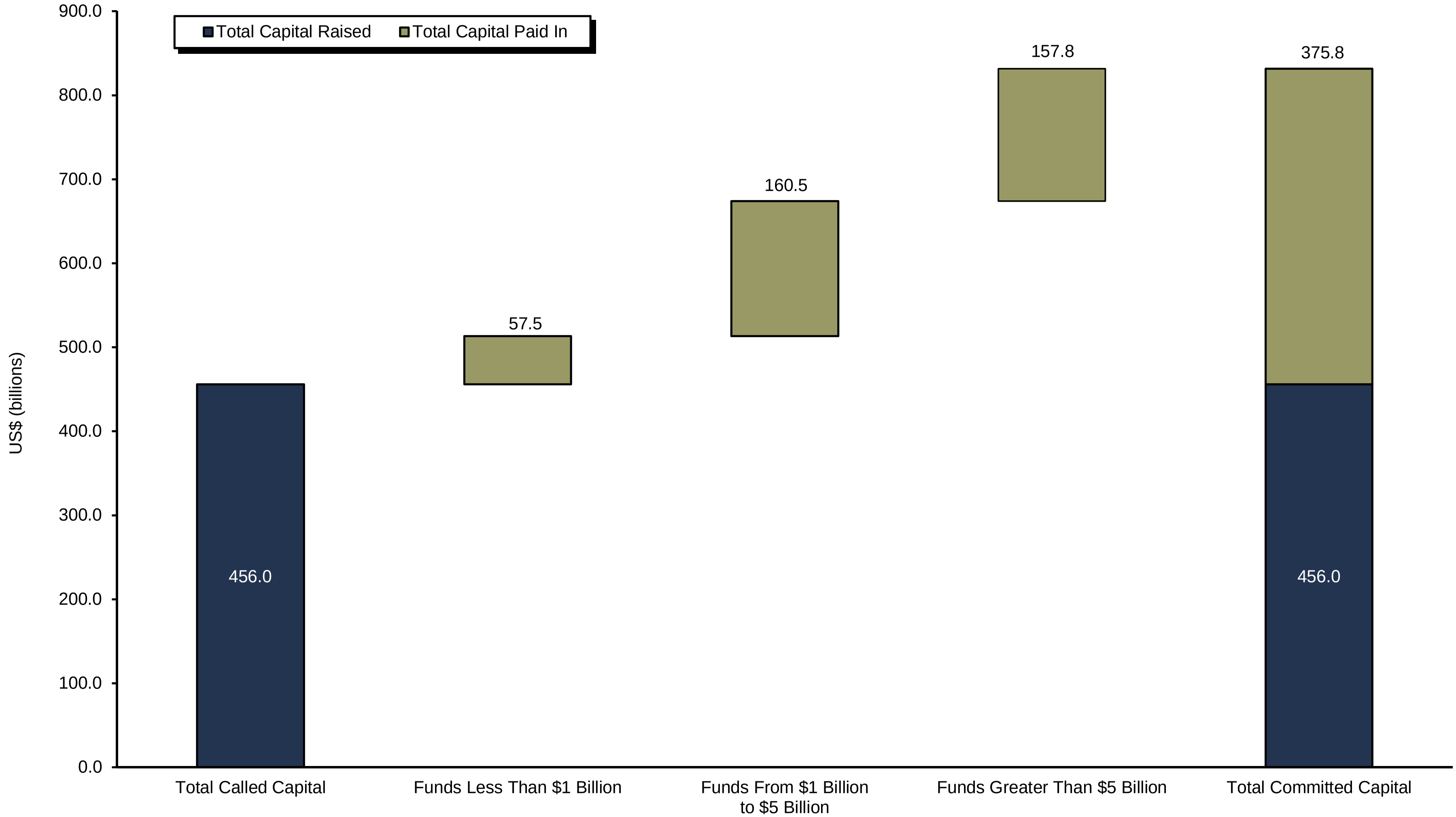


	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2005–10 Cumulative
Capital Commitments (US$)	54.2	56.5	32.6	70.4	124.0	205.6	262.6	210.7	58.4	53.3	914.6
% Paid In	*105%*	*90%*	*91%*	*91%*	*82%*	*72%*	*46%*	*34%*	*13%*	*12%*	
Estimated Paid-In Capital (US$)[1]	57.1	51.0	29.7	64.4	101.9	148.8	119.9	71.6	7.3	6.3	456.0
Capital Uncalled (US$)	-2.9	5.5	2.9	6.0	22.1	56.8	142.7	139.1	51.1	47.0	458.6
Remaining Fees (US$)[2]	0.0	0.8	1.0	3.2	7.4	15.4	23.6	22.1	7.0	7.2	82.8
Total Uninvested (2005–10)											**375.8**

Exhibit 1 (continued)

U.S. Private Equity Estimated Capital Overhang

2005–10



Sources: Cambridge Associates LLC Non-Marketable Alternative Assets Database and Dow Jones & Company, Inc.
[1] Estimate based on the percent paid in by funds tracked by Cambridge Associates LLC in each vintage year.
[2] Assumes a 1.5% management fee based on committed capital over ten years and assumes no recycling (re-investment) of capital.

Exhibit 2

Hypothetical Number of Years to Invest Existing Commitments of Private Equity Firms

As of April 30, 2011

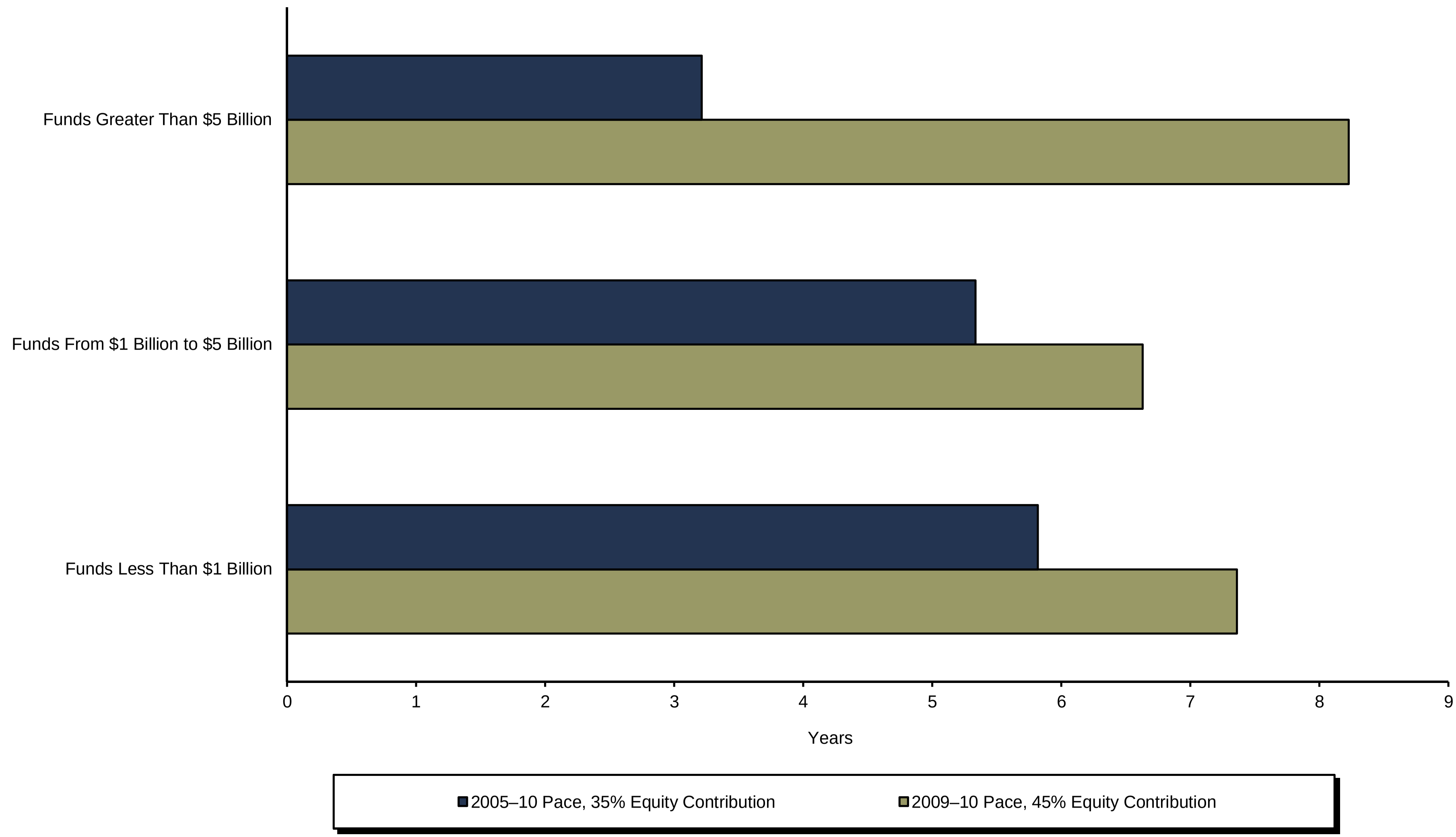


Exhibit 2 (continued)

Hypothetical Number of Years to Invest Existing Commitments of Private Equity Firms
Assumptions

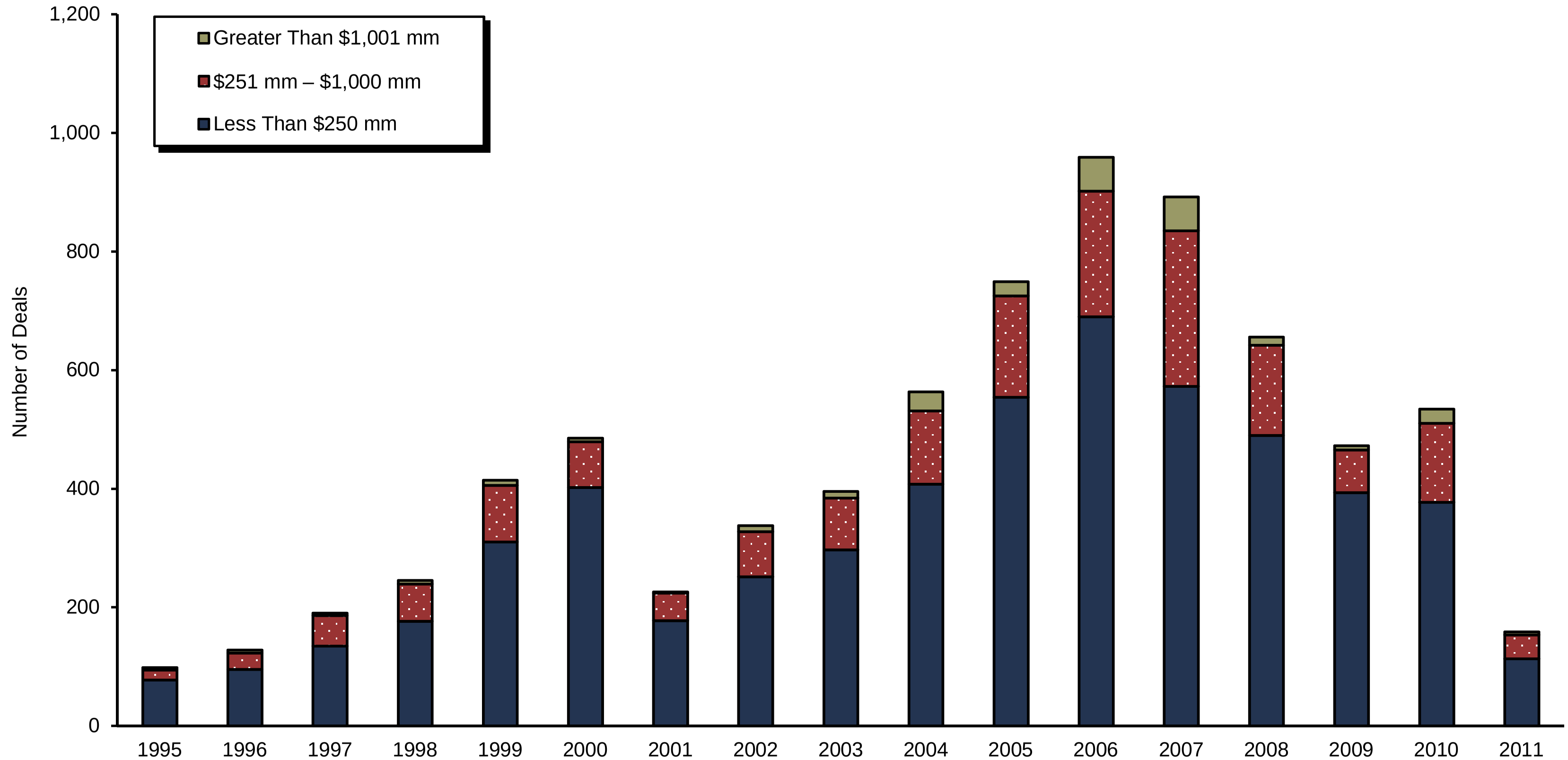
	Fund Size		
	Greater Than $5 bn	**$1 bn – $5 bn**	**Less Than $1 bn**
Transactions per Period			
2009–10	16	103	386
2005–10	31	167	513
Average Deal Size (US$ millions)			
2009–10	$2,750	$525	$45
2005–10	$4,600	$515	$55
Equity Contribution			
2009–10	45%		
2005–10	35%		
Annual Equity Investment (US$ millions)			
2009–10	$19,181	$24,216	$7,806
2005–10	$49,105	$30,094	$9,877
Estimated Overhang (US$ millions)	$157,805	$160,544	$57,459
Estmated Years to Invest			
2009–10	8.23	6.63	7.36
2005–10	3.21	5.33	5.82

Sources: Cambridge Associates LLC Non-Marketable Alternative Assets Database, Dealogic, and Dow Jones & Company, Inc.
Note: Dealogic updates its database on a regular basis, therefore historical data may change.

Exhibit 3

Announced Financially Sponsored Mergers & Acquisitions by Deal Size

1995–2011



Average Deal Size

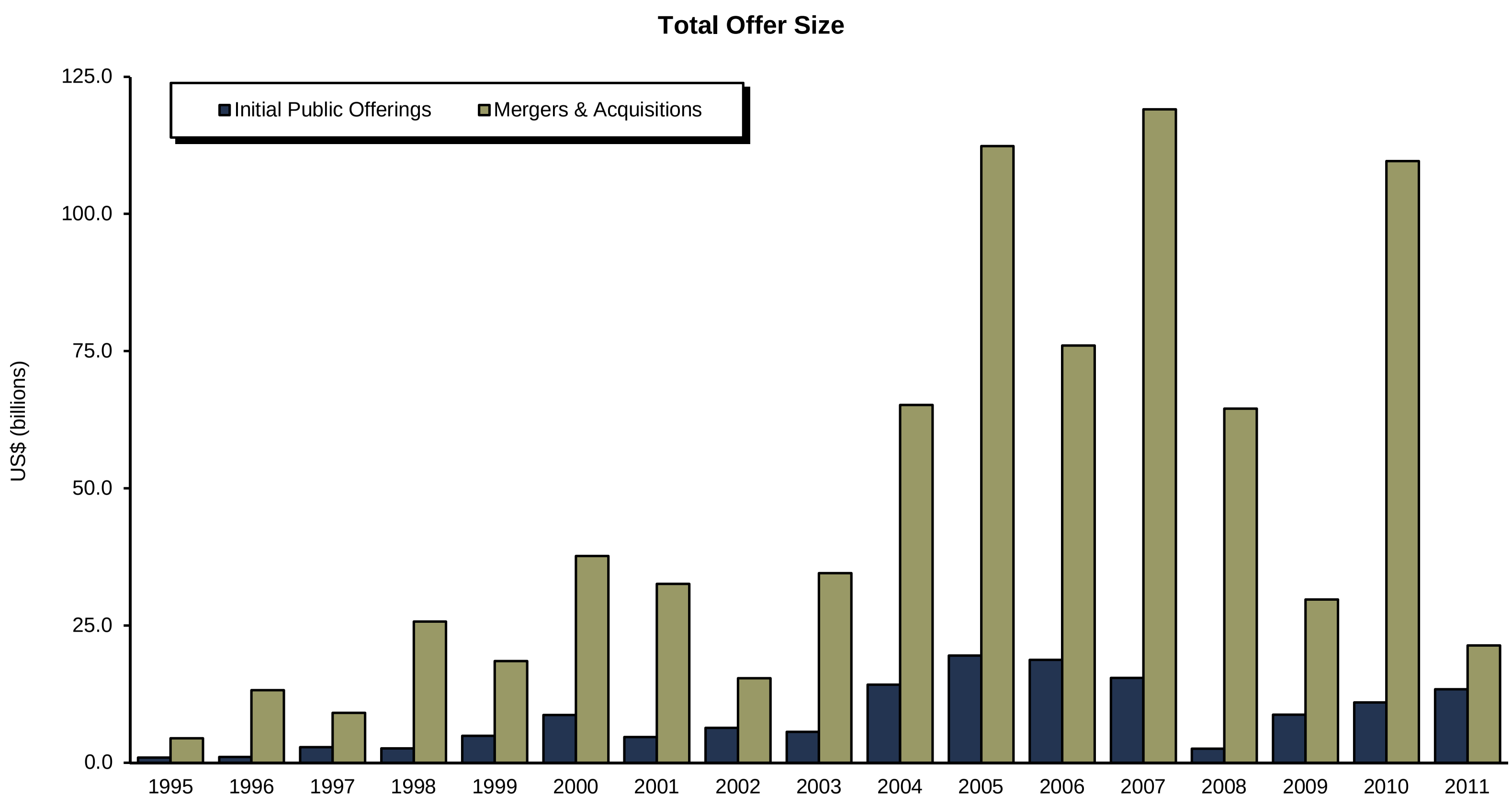
	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Greater Than $1,001 mm	2,046	1,274	1,530	1,468	1,768	1,643	1,744	2,190	1,907	1,921	3,215	6,086	5,468	2,099	4,126	2,231	3,711
$251 mm – $1,000 mm	561	451	515	490	521	444	498	488	490	473	516	522	527	464	459	565	680
Less Than $250 mm	95	94	82	71	74	58	58	52	66	68	60	47	61	46	35	56	42

Sources: Cambridge Associates LLC Non-Marketable Alternative Assets Database and Dealogic.
Note: Data for 2011 are as of April 30.

Exhibit 4

Dollar Value of Private Equity–Backed Initial Public Offerings and Mergers & Acquisitions

January 1, 1995 – April 30, 2011



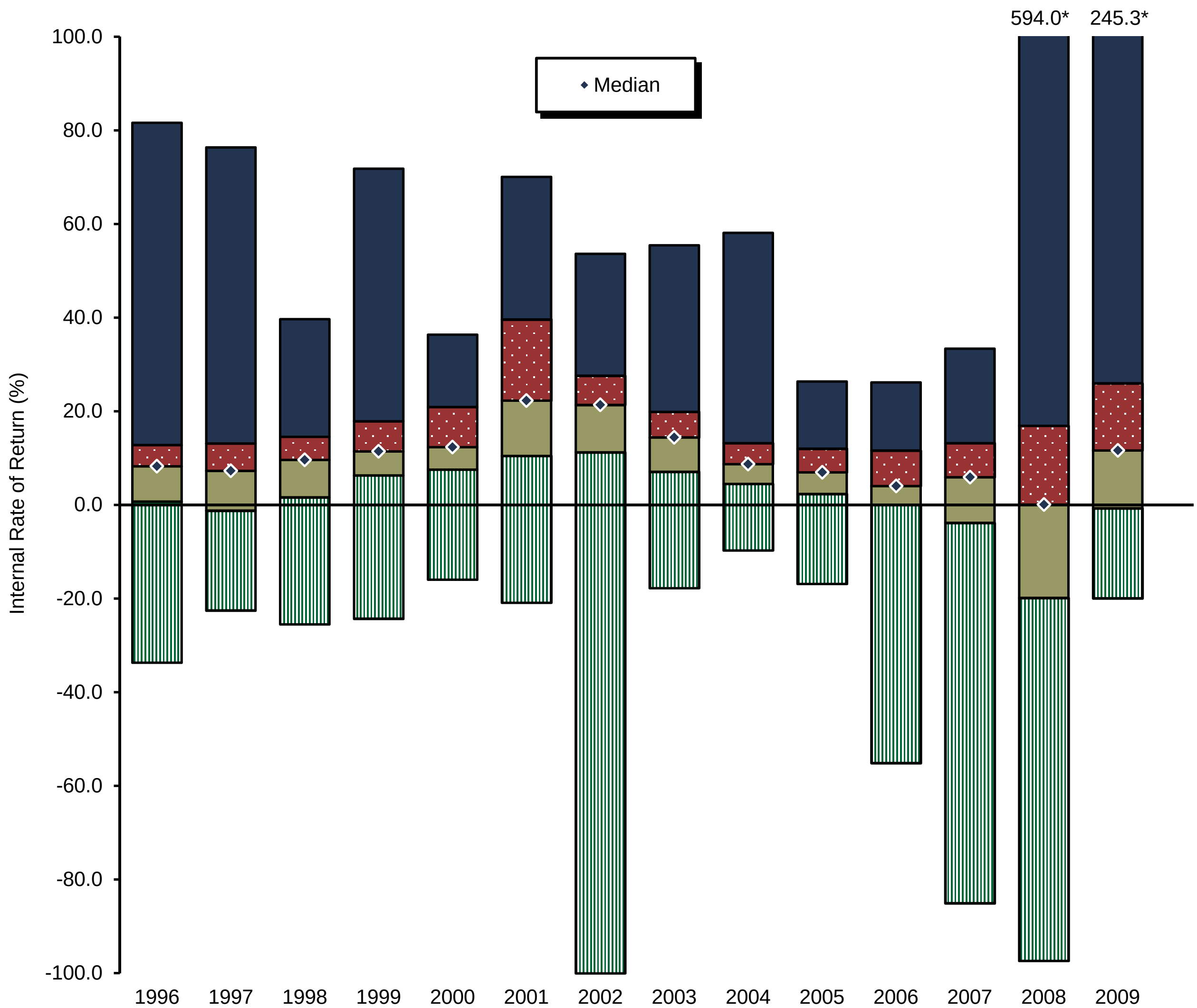
	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Private Equity–Backed Initial Public Offerings	1.0	1.0	2.9	2.6	4.9	8.7	4.7	6.4	5.6	14.2	19.5	18.7	15.4	2.6	8.8	11.0	13.4
Mergers & Acquisitions of PE-Backed Companies	4.5	13.2	9.1	25.7	18.5	37.7	32.6	15.4	34.5	65.2	112.4	76.0	119.0	64.5	29.7	109.6	21.4

Source: Dealogic.
Note: Dealogic updates its database on a regular basis, therefore historical data may change.

Exhibit 5

Internal Rates of Return (%) Net to Limited Partners of U.S. Private Equity Funds by Quartiles

Vintage Years 1996–2009 • As of December 31, 2009 • U.S. Dollar



	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
High	81.6	76.4	39.6	71.8	36.4	70.0	53.6	55.4	58.1	26.3	26.2	33.4	594.0	245.3
Upper Quartile	12.8	13.1	14.6	17.9	20.9	39.6	27.6	19.9	13.2	12.0	11.6	13.2	16.9	25.9
Median	8.3	7.3	9.7	11.5	12.4	22.3	21.4	14.4	8.7	7.0	4.0	5.9	0.1	11.7
Lower Quartile	0.7	-1.2	1.6	6.3	7.6	10.5	11.2	7.1	4.5	2.3	0.0	-3.9	-19.8	-0.7
Low	-33.7	-22.5	-25.5	-24.3	-16.0	-20.9	-100.0	-17.8	-9.7	-14.5	-55.1	-85.1	-97.3	-19.9
Number of Funds	38	51	52	55	72	22	32	34	62	78	72	70	54	14

Source: Cambridge Associates LLC Non-Marketable Alternative Assets Database.
Notes: Based on data compiled from 713 U.S. private equity funds, including fully liquidated partnerships, formed between 1996 and 2009. Internal rates of return are net of fees, expenses, and carried interest. Vintage year funds formed since 2007 are too young to have produced meaningful returns. Analysis and comparison of partnership returns to benchmark statistics may be irrelevant.
* The x-axis has been capped for scaling purposes.
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