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CAMBRIDGE ASSOCIATES LLC

EUROPEAN MARKET COMMENT

WESTERN EUROPEAN PRIVATE EQUITY: ATTRACTIVE BUT FOR HOW LONG?

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Western European Private Equity:
Attractive But For How Long?

As more and better data on the performance of European private equity has become available, it is increasingly apparent that investors have earned better returns in Europe than in the United States during the past decade. As a result, European fund raising is active and access issues are for the first time materialising for selected buyout funds. This raises several questions:

- Why have European private equity firms outperformed those in the United States?;
- Is the dispersion of returns also similar?; and
- Is this a temporary phenomenon or may we expect it to continue?

European and U.S. Private Equity Performance

Over the past ten years, European private equity has returned 14.9% compared to 9.9% for U.S. funds (see Table A). Western European private equity has also outperformed all other sectors and benchmarks over five and ten years, with the exception of U.S. venture capital and (perhaps) European venture capital (data for which are thin and of dubious integrity).

Is the Dispersion of European and U.S. Returns the Same?

If the mean returns of European private equity managers were slightly higher than those in the United States, but the dispersion of returns were less, investors who felt they could both identify and gain access to top-quartile fund managers might still prefer to invest in the United States, since the potential for exceptionally good returns might be greater. However, this is not the case: the dispersion of returns among European funds has been at least as great as that for U.S. funds, if not greater (see Tables B, C, and D).

Why has European Private Equity Done Better than U.S. Private Equity?

Private equity markets thrive on change and inefficiency because these conditions create opportunities for experienced managers to buy poorly managed assets or badly run businesses on the cheap, improve their productivity and management, and then sell them at sharply higher prices. Since the fund managers themselves may not be particularly well versed in the details of a given business, it also helps if they can motivate existing managers to enhance the quality of the business by offering them the prospect of material capital gain. It is no coincidence that the golden years of U.S. private equity investing coincided with a period of massive economic transition during the 1980s. By the mid-1990s, however, this transition was largely finished—the economy had become markedly more efficient, with far fewer poorly managed companies burdened with surplus assets and poor financial controls, while corporate managers were already highly incented by stock options to manage the business as effectively as possible.

Western Europe is another matter. Few managers have become wealthy through stock options, and salaries are on the whole significantly more modest than in the United States. Few management teams have been motivated to run their business for optimum efficiency, and many companies are operating for corporate or family objectives rather than peak performance and cash management. Surplus assets may well have been left to languish. Strategic thinking may well have been local and parochial, limited by country barriers and the lack of European or global perspective. The transition to greater efficiency has only recently gathered momentum, driven in part by the adoption of the single currency and in part by the steady withdrawal of EU member states from their historical involvement in many sectors of the economy. A tidal wave of rationalisation, restructuring, privatisation, and deconglomeration (see Table E) is sweeping across Europe, and is likely to continue for many years. This is meat and drink for private equity funds, who should find no shortage of opportunities to earn strong returns in the years ahead.

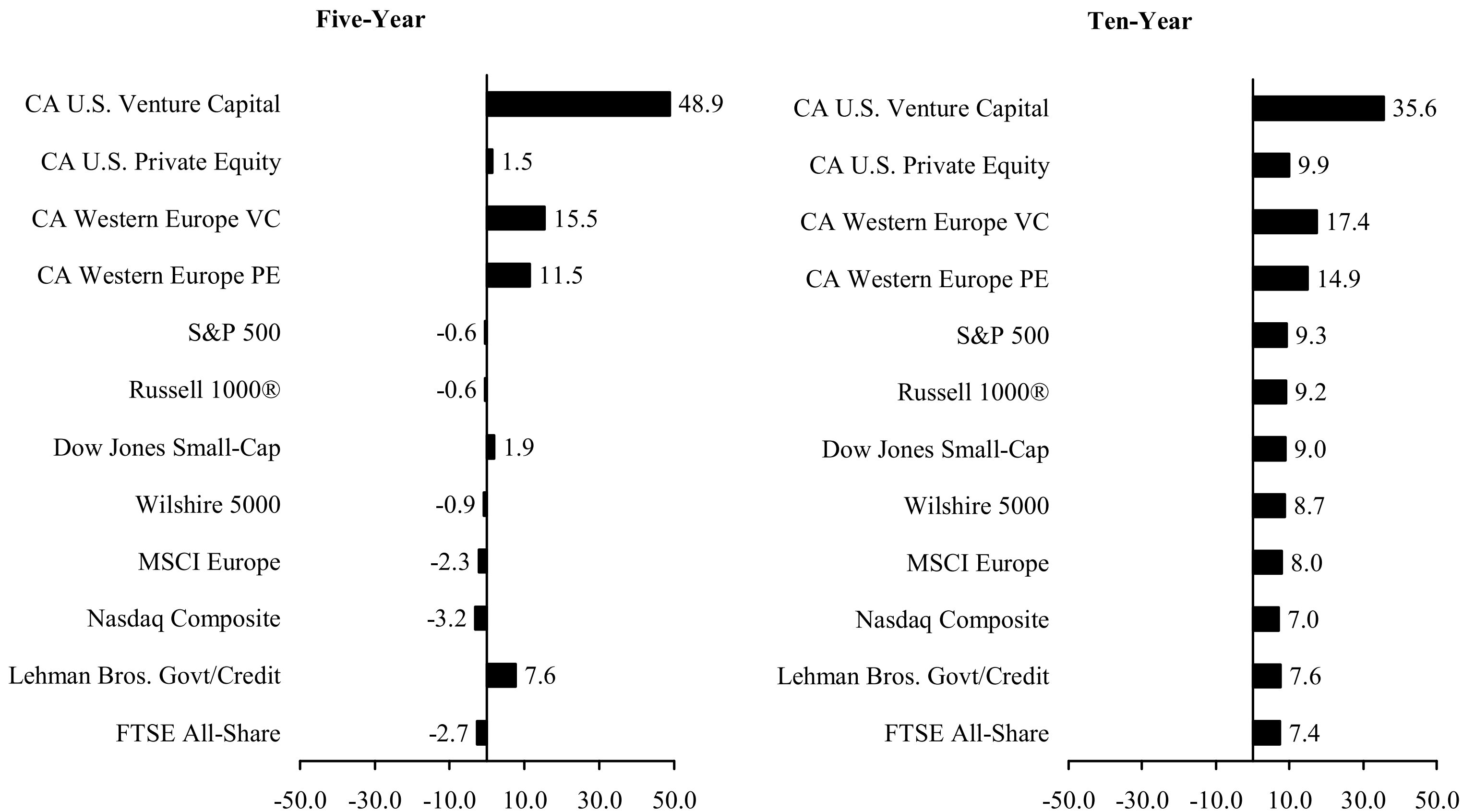
Is this a Temporary Phenomenon or may we Expect it to Continue?

We expect the gradual transformation of Europe's economies will take many years, continuing to provide private equity managers with significant opportunities to earn attractive rates of return. More specifically, we would expect the large buyout market to mature over the next few years as a result of increasing amounts of capital available and the consumption of low hanging fruit. However, although returns may be less than they have been, we regard the European opportunity set as sufficiently expansive to provide the best managers with plenty of fodder for years to come, both for large buyout managers and for those in the middle-market space, where operational skills and country-specific knowledge are often the keys to success.

Table A

COMPARATIVE AVERAGE ANNUAL COMPOUND RETURNS

1993-2002



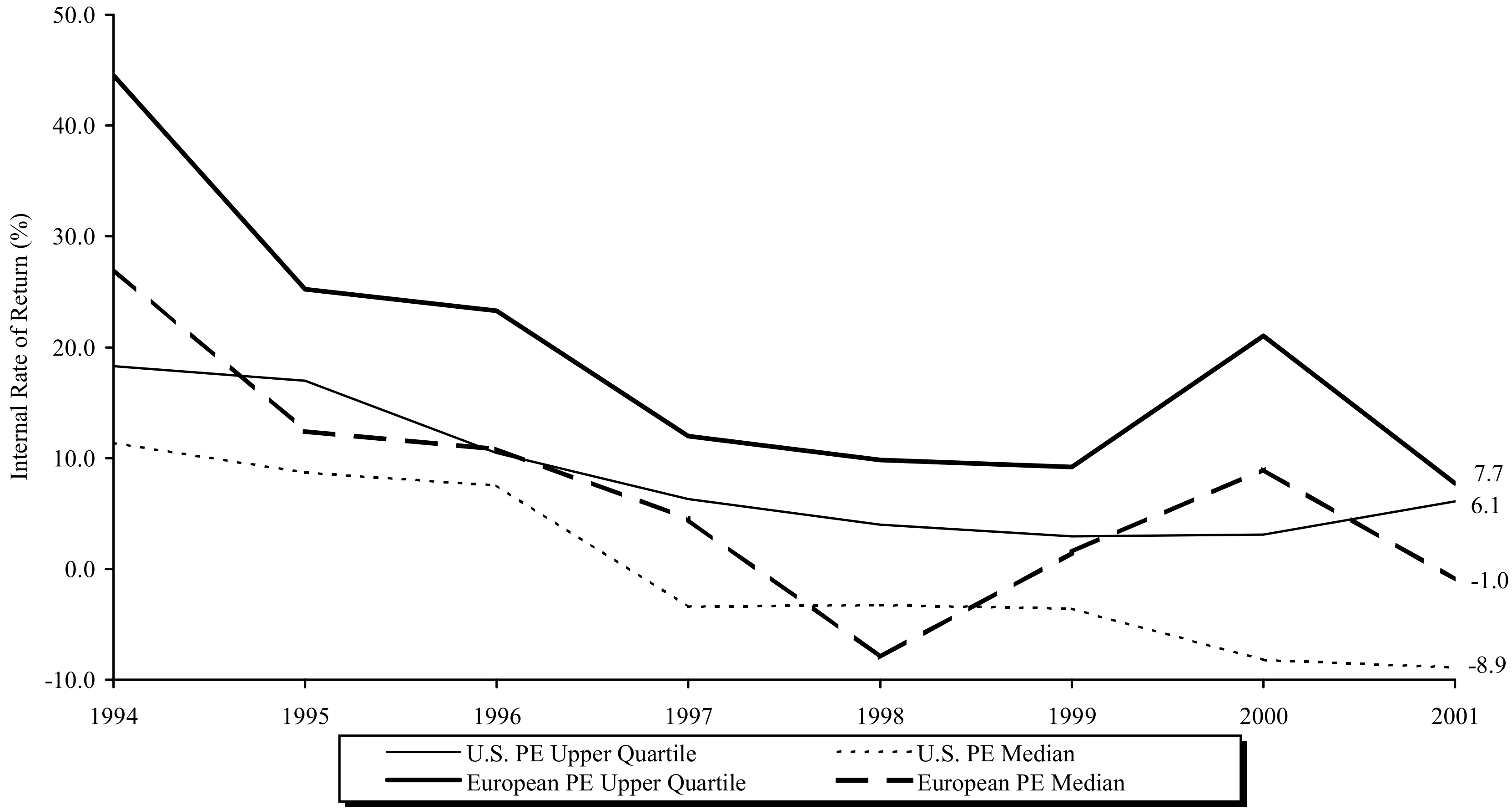
Sources: Cambridge Associates LLC Non-Marketable Alternative Assets Database, Dow Jones & Company, Inc., Lehman Brothers, Inc., Standard & Poor's, Thomson Datastream, *The Wall Street Journal,* and Wilshire Associates, Inc.

Note: All returns are shown in U.S. dollars.

Table B

DISPERSION OF U.S. AND EUROPEAN PRIVATE EQUITY RETURNS

1994-2001



Source: Cambridge Associates LLC Non-Marketable Alternative Assets Database.

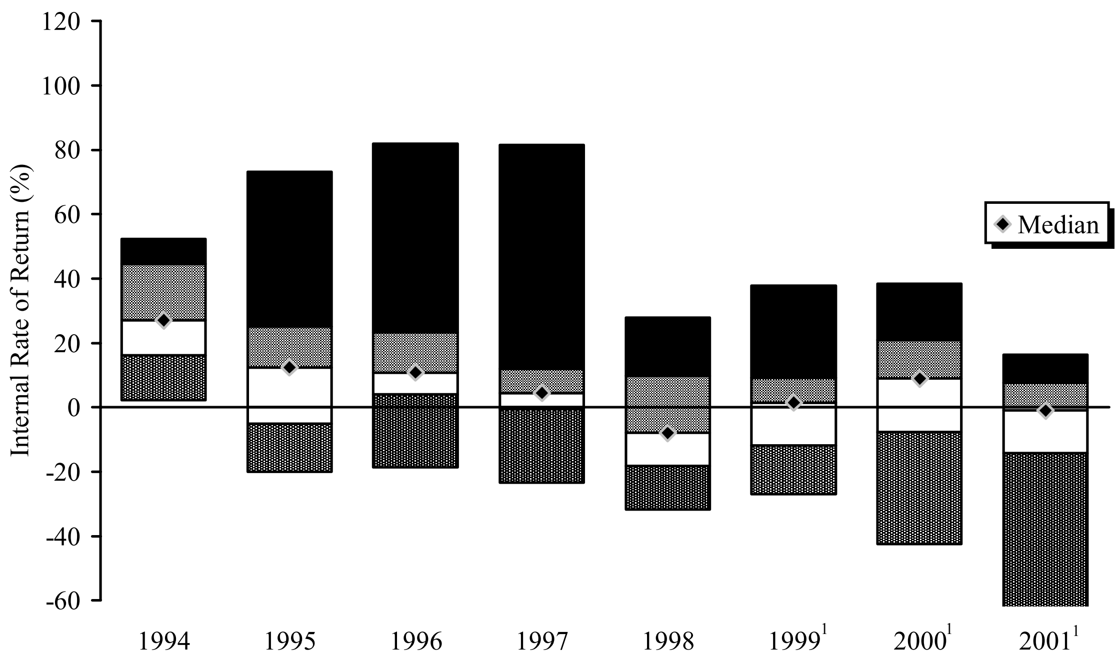
Table C

EUROPEAN PRIVATE EQUITY RETURNS

INTERNAL RATE OF RETURN (%) NET TO LIMITED PARTNERS OF WESTERN EUROPEAN PRIVATE EQUITY FIRMS BY QUARTILES

Vintage Years 1994-2001

As of 31 December 2002



	1994	1995	1996	1997	1998	1999[1]	2000[1]	2001[1]
High	52.2	73.1	82.0	81.5	27.8	37.8	38.4	22.0
Upper Quartile	44.5	25.2	23.3	12.0	9.8	9.2	21.0	7.7
Median	27.1	12.4	10.8	4.5	-8.0	1.5	9.0	-1.0
Lower Quartile	16.2	-5.2	4.0	-0.5	-10.3	-11.8	-7.8	-13.2
Low	2.2	-14.8	-18.6	-23.0	-13.4	-15.3	-34.7	-49.5
Number of Funds	9	6	12	16	9	18	11	10

Source: Cambridge Associates LLC Non-Marketable Alternative Assets Database.

Note: These internal rates of return have been compiled from 91Western European leveraged buyout, subordinated debt, and special situation funds with inceptions from 1994 through 2001 and are net of management fees, expenses, and carried interest.

[1] Most of these funds are too young to have produced meaningful returns. Analysis and comparison of partnership returns to these benchmark statistics may be irrelevant.

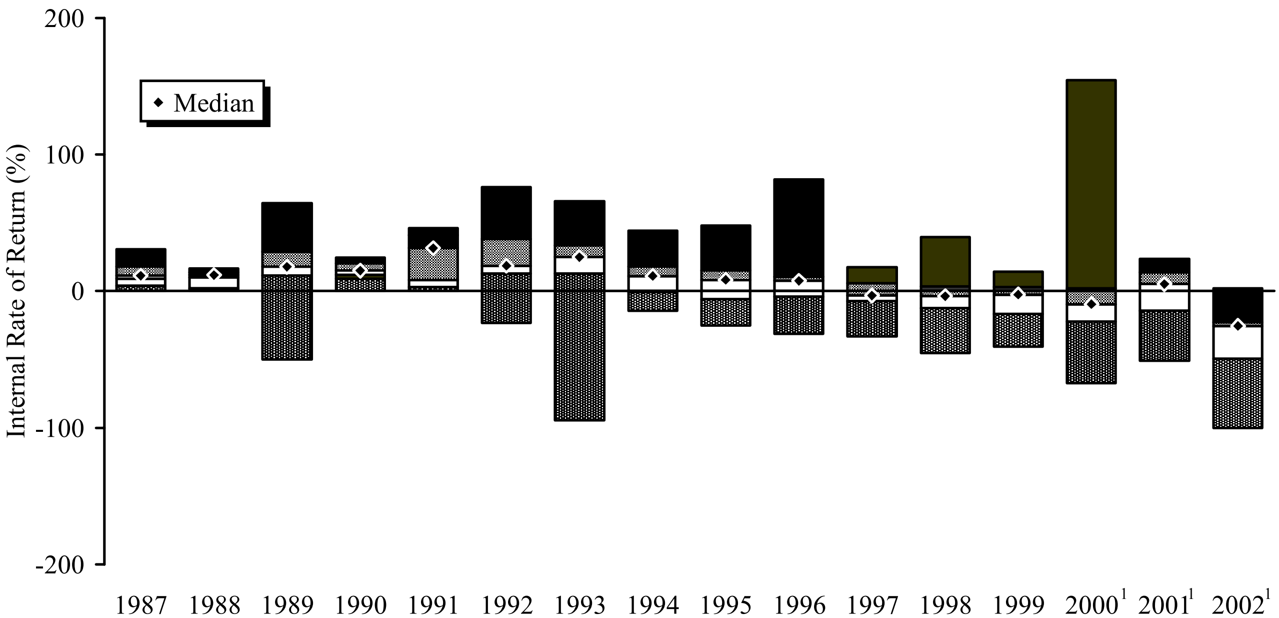
Table D

U.S. PRIVATE EQUITY RETURNS

INTERNAL RATES OF RETURN (%) NET TO LIMITED PARTNERS OF PRIVATE EQUITY FIRMS BY QUARTILES

Vintage Years 1987-2002

As of March 31, 2003



	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000[1]	2001[1]	2002[1]
High	30.5	16.4	64.3	24.3	46.1	76.3	66.0	44.1	48.1	81.7	17.6	39.5	14.2	154.4	23.6	2.0
Upper Quartile	18.0	13.8	28.9	20.4	41.0	38.2	33.6	18.2	15.1	10.5	5.9	3.5	3.1	2.1	13.5	-22.9
Median	11.2	11.8	17.9	15.1	31.5	18.5	24.9	11.0	8.2	7.5	-3.3	-3.8	-2.7	-9.5	5.2	-25.4
Lower Quartile	8.9	9.9	11.6	12.0	8.2	12.8	12.7	-0.8	-5.8	-4.1	-7.6	-12.4	-16.6	-22.3	-14.4	-49.2
Low	3.7	1.9	-49.8	8.9	3.0	-23.3	-94.7	-14.5	-25.1	-31.0	-33.2	-45.0	-40.3	-67.3	-51.0	-99.9
Number of Funds	13	15	18	10	8	16	27	20	29	31	42	52	34	54	13	14[2]

Source: Cambridge Associates LLC Non-Marketable Alternative Assets Database.

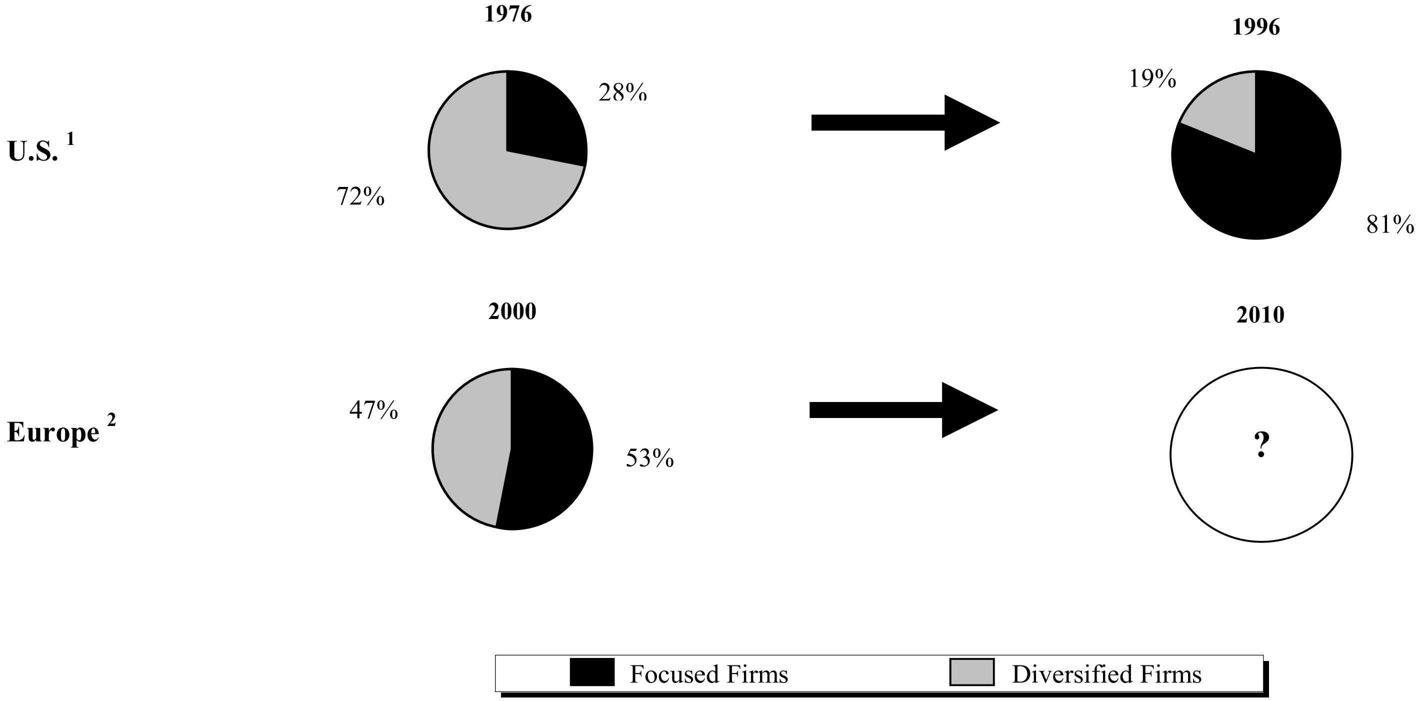
Note: These internal rates of return have been compiled from 396 U.S. leveraged buyout, subordinated debt, and special situation funds with inceptions from 1987 through 2002 and are net of management fees, expenses, and carried interest.

[1] Most of these funds are too young to have produced meaningful returns. Analysis and comparison of partnership returns to these benchmark statistics may be irrelevant.

[2] Represents only those funds formed in 2002 that began investing by March 31, 2003.

Table E

"DE-CONGLOMERATION"



Sources: [1]"Why Conglomerates Sell at a Discount," Henri Servaes, LBS.
[2]Schroder Salomon Smith Barney.

Notes: Firms are listed companies only. In 2000, around half of all Western European companies were conglomerates, most as private family businesses. This type of business structure is expected to be challenged from the lowering of barriers in the EEC. In comparison, the U.S. buyout market during the 1970s and 1980s enjoyed abundant opportunities by carving subsidiaries out of conglomerates, fueling the leveraged buyout market with commensurately good returns aided by high inflation and high levels of available leverage. By the mid-1990s, less than 20% of U.S. businesses remained in the conglomerate structure, which severely reduced the opportunity set for the larger buyout sector.