EUROPEAN INVESTMENT FUND

THE PRIVATE EQUITY MARKET IN EUROPE.

RISE OF A NEW CYCLE OR TAIL OF THE RECESSION?

Anastasia Di Carlo

Working Paper 2010/003
EIF Research & Market Analysis

Author

Anastasia Di Carlo is Risk Management Officer for Private Equity in EIF's Risk Management and Monitoring Division.

Contact: a.dicarlo@eif.org
Tel.: +352 42 66 88 266

Editor

Helmut Kraemer-Eis, EIF Research & Market Analysis

Contact:
European Investment Fund
96, Blvd Konrad Adenauer, L-2968 Luxembourg
Tel.: +352 42 66 88 394
Fax: +352 42 66 88 280
www.eif.org

Luxembourg, February 2010

Abstract

This paper presents a general overview of the European Private Equity (PE) market as of September 2009, based on industry activity data published by the European Venture Capital Association (EVCA) in November 2009 and the latest performance data published by Thomson Reuters Venture Xpert as of June 2009. The financial system and public equity markets seem to have now stabilised and a slow recovery is expected in 2010. However, the main characteristic of the current global recession is uncertainty, and it is still too early to confirm a turnaround. Private Equity is a cyclical industry and the findings of the analysis show that a floor has probably been reached. However, the medium-term performance outlook remains uncertain. Therefore, funds are looking towards governments and institutional investors for support due to the increased challenging fundraising environment.

The paper is organised as follows: a brief introduction on the global macroeconomic outlook and the responses to the financial crisis is followed by an overview of the main trends currently observed in the Private Equity market. The analysis focuses on two major dimensions: activity figures (fundraising, investments and divestments) and performance figures (rolling investment horizon). Finally, some recommendations conclude the paper.

A Private Equity glossary according to EVCA definitions is attached to this paper in Annex 3.

Table of contents

Executive Summary

This paper provides – starting from the general economic environment - an overview of the European Private Equity market in 2009. Private Equity-specific terminology is explained in Annex 2.

A generalised global recession occurred in 2009. However, the financial system and public equity markets seem to have now stabilised and a slow recovery is expected in 2010. Within Europe, eastern European countries were the most affected by the crisis with a slowdown in GDP growth of - 6%, vs. the - 4.2% of the EU-15. Economic growth is only expected to get back to its 2% trend rate in 2012-2013.

Since March 2009, stock markets have recovered about 35%-40% of the 2008 losses, stock market volatilities and business confidence indexes are back to their historical average. Nevertheless, the main characteristic of the current global recession is uncertainty, and it is still too early to confirm a turnaround at this time. All the three major dimensions of the Private Equity activity are still on a significant downward trend. Compared to the same period in 2008, Q1-Q3 2009 fundraising is down by - 86%, investments by - 63% and divestments by - 42%.

In the first half of 2009, further negative developments have materialised, with the 10-year rolling investment horizon performance for all Private Equity funds decreasing by -3.1% from +9.3% at the end of 2008 to +6.2% in June 2009. During the same period, the buyouts 3-year rolling investment horizon performance decreased more (- 7.7%) than the Venture Capital one (-1.6%).

Private Equity performances in the long term remain attractive: looking at the 20-year investment horizon performance, the buyout segment continues to deliver a performance, adequate for the risk taken, above 11%, contrary to Venture Capital, with less than 2%. However, no major difference in performance over the 2002-2007 period is observable between US and EU Venture Capital markets. Private Equity is a cyclical industry and a floor has probably been reached. The medium-term performance outlook nonetheless remains uncertain. The crisis is also a source of opportunity in Private Equity as valuations are decreasing and acquisitions can be completed at more favourable prices. Historically, recession vintage years have provided the opportunity for outsized returns in Private Equity.

1. Global economic outlook

The global economy has experienced its most severe downturn since the Second World War, following an unparalleled phase of expansion. According to the latest Economist Intelligence Unit (EIU) forecasts as of December 2009, all major developed economies have seen sharp GDP declines in 2009 and growth is expected to be rather slow in 2010. In the EU 27 in the third quarter of 2009, the first quarter-on-quarter expansion in GDP since January-March 2008 was observed, suggesting that recovery is now under way. However, this recovery is expected to be gradual given the magnitude of the shock that the economy has suffered. Only in the final two years of the forecast period (2013-14) economic growth will likely return close to its trend rate of around 2% (EIU 2009, p. 24).

Many developing economies have also seen negative growth in 2009, although China and India were notable exceptions. Worldwide economic data generally confirms that activity started to pick up during summer months of 2009 and an upswing is currently underway in a number of key economies. Like most economists, we remain conservative in predictions regarding a recovery; there are common trends in the analysis of the economic outlook for the near future:

- The current strong bounce back of some economic indicators is likely to be short-lived - the worst of the recession may be behind us and the growth momentum is positive, but conditions persist which indicate that the pace of the recovery is going to be very modest. Medium-term recovery from the sharp downturn is expected to be slow and the upswing might transform into sub-trend growth.
- The pace of recovery across different parts of the world is going to vary significantly, i.e. recovery in some Central and Eastern European countries (CEECs) will take longer to materialize.

The reasons for this uncertainty are multifaceted, some of them are:

- The Financial sector health not yet restored.
- Shortage of financing for firms (and i.e. SMEs): deterioration of availability of bank loans and other financing forms.
- Increase in business insolvencies (high elasticity of insolvencies to growth).
- Rising unemployment, unlikely to peak before mid-2010 (with negative impact on consumer demand).
- Reduction of stabilising public interventions and fiscal stimuli.

Hence, forecasts for recovery in most Western developed economies are far more cautious. Based on the EIU country forecasts as of December 2009, it is expected that the US economy, after declining by 2.4% in 2009, will return to positive growth of 2.5% in 2010, before softening in 2011 as fiscal and monetary stimulus ends. Average growth in 2012-13 is expected to be well below the level in recent years (EIU 2009, p. 23-25).

Despite the fact that the current financial and economic crisis originated in the US, the EU economy is expected to suffer more, because of its high export dependence. EIU country forecasts show that the EU GDP declined by 4.2% in 2009 before recovering only gradually, to achieve average growth of 1.5% over 2011-13. Indeed, the EU economy has experienced an unprecedented contraction, from which it will take multiple years to recover. In April-June 2009, the EU 27-member bloc registered its fifth consecutive quarter-on-quarter contraction in GDP. As a result, European economic output was more than 5% below its all-time peak, recorded in the first quarter of 2008. Only in the final two years of the forecast period (2012-13) the economic growth is expected to return close to its 2% trend rate (EIU 2009, p. 24).

Table 1: Real GDP Growth (in %)

Area	2008	2009 (f)	2010 (f)	2011 (f)	2012 (f)	2013 (f)
World	1.7	-2.5	2.5	2.4	2.8	3
US	0.4	-2.3	2.5	1.3	1.9	2.2
EU 27	0.8	-4.2	0.7	1.3	1.7	1.9
EU 15	0.5	-4.2	0.7	1.2	1.5	1.8
Eastern Europe*	4.7	-6	2.1	3.6	4.4	4.3

*The Balkan states of Bulgaria, Croatia, Romania and Serbia and the eight new EU members in East Central Europe and the Baltics.

Source: EIU, EU forecasts as of December 2009.

The Global Financial Stability Map, published by the IMF in its Global Financial Stability Report (GFSR 2009, p. 17), illustrates the situation of the stability of the Global Financial Markets as of October 2009 and its evolution since October 2007 (see Figure 1). The stability is assessed by an estimation of the key financial risks (macroeconomic risk, emerging market risk, market & liquidity risk and credit risk) and the two dimensions that assess the general market conditions (monetary & financial conditions and risk appetite).[1]

Financial stability has improved significantly in the past six months, compared to the levels of April 2009. Reflecting the decline of systemic risks, all indicators like macroeconomic, market and

[1] For details on the methodology please see: Appendix 1.1 of the "Global Financial Stability Report", IMF (October 2009), p.44.

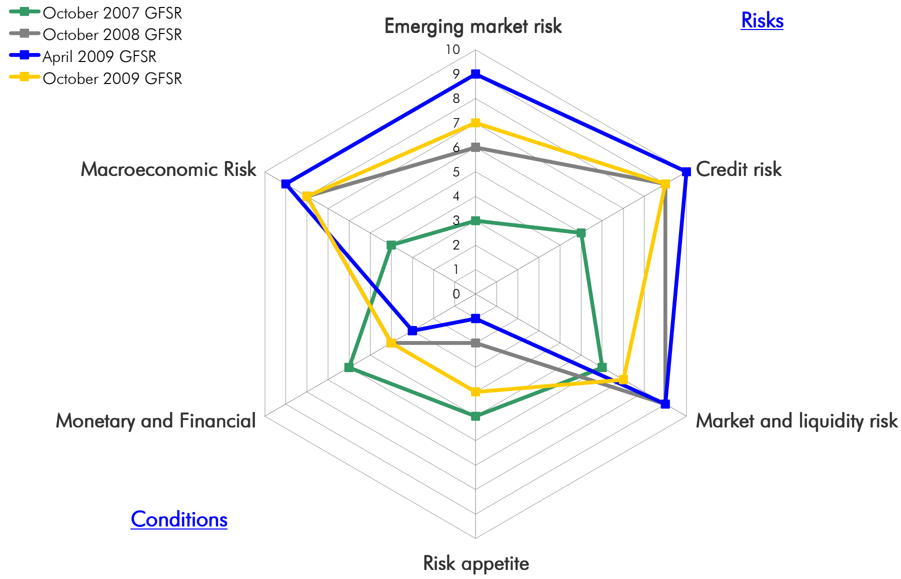
liquidity risks, and credit risk have been reduced. However, the risk of reversal remains significant and indicators of financial stress remain elevated at the core of the financial system and in some market segments.

According to the latest IMF Global Financial Stability Report published in October 2009 confidence in the financial system is going to be restored by clarity over future regulatory reforms needed to address systemic risks. In addition, the global policy response should help to mitigate crisis risks. However, the recent reduction of tail risks should not induce authorities to lessen their efforts to create a more robust financial system.

As highlighted in the IMF report, a holistic, understandable approach needs to be formulated where the priority should be to reform the regulatory environment so that the probability of a recurrence of a systemic crisis is significantly reduced. This includes not only defining the extent to which capital, provisions, and liquidity buffers are to rise, but also how market discipline is to be re-established following extensive public sector support of systemic institutions in many countries. Proposals that will go toward removing pro-cyclicality in the financial system and increasing buffers against losses and liquidity dislocations are already devised.

However, efforts still need to be made to conceive capital penalties, insurance premiums, supervisory and resolution regimes, and competition policies to ensure that no institution is believed to be "too big to fail." Crucial to reform the system is the timely definition of criteria to identify systemically important institutions and markets. Once identified, some form of surcharge or disincentive for marginal contributions to systemic risk will need to be formulated and applied (GFSR 2009).

Figure 1: IMF Global Financial Stability Map[2]

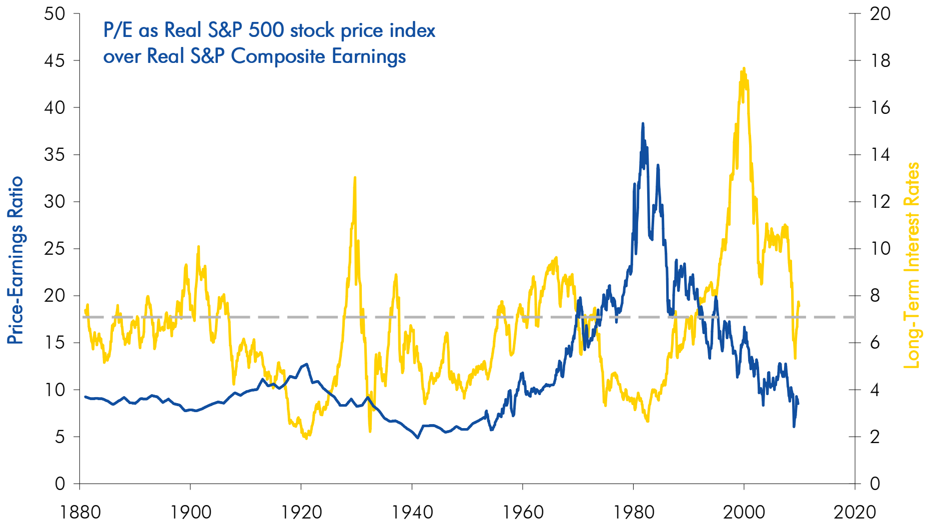


Source: IMF (2007, 2008, 2009)

As illustrated in Figure 2, the recent evolution in the Price/Earning ("P/E") ratio has reached again levels slightly above its historical average. This suggests that, based on this simplified measure, even after the crisis and compared to previous crisis, valuations in the public equity markets are somehow overpriced. One explanation could be the extensive actions put in place by Central Banks to face the crisis as illustrated by the exceptional low levels of long term interest rates, coupled with quantitative easing.

[2] Closer to the centre signifies lower risk or worse conditions.

Figure 2: Real P/E ratio-LT interest rates



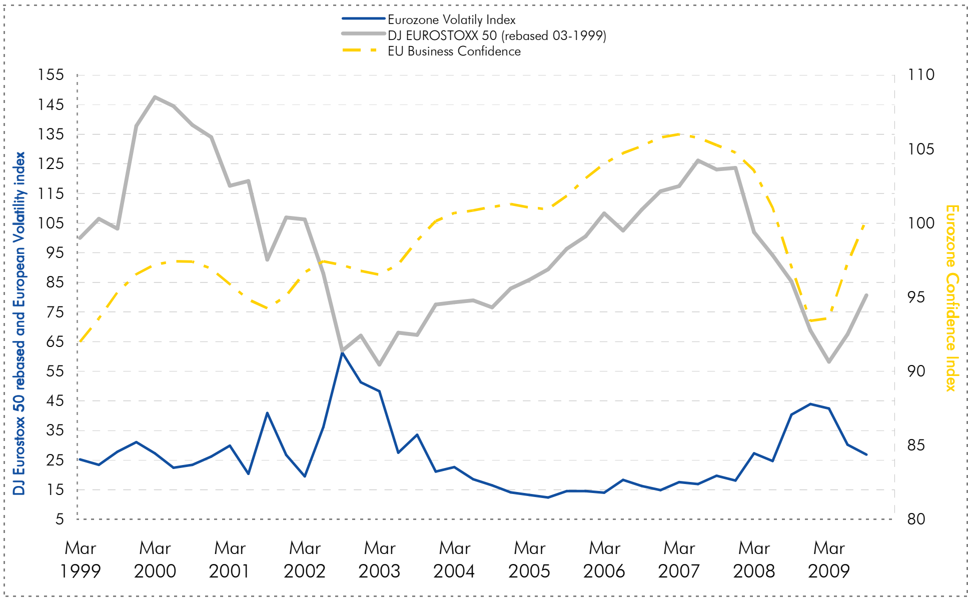
Source: http://www.econ.yale.edu/~shiller/data.htm. Last data as of November 2009.

The latest trend of public market indices has been rather positive since its lowest level in March 2009, (see Figure 3). Indeed, stock markets have recovered about 35%-40% of the 2008 losses and stock market volatilities and confidence indexes are back close to their historical average (see Figure 4). However, the short and mid-term outlook is still uncertain.

Figure 3: MSCI EU Small Caps index

Source: Bloomberg. Morgan Stanley Capital International (MSCI); Base 100: Jan 2008.

Figure 4: DJ EUROSTOXX 50 and Euro zone Volatility index vs. EU Business Confidence index



Source: Bloomberg.

2. European Private Equity Market Outlook

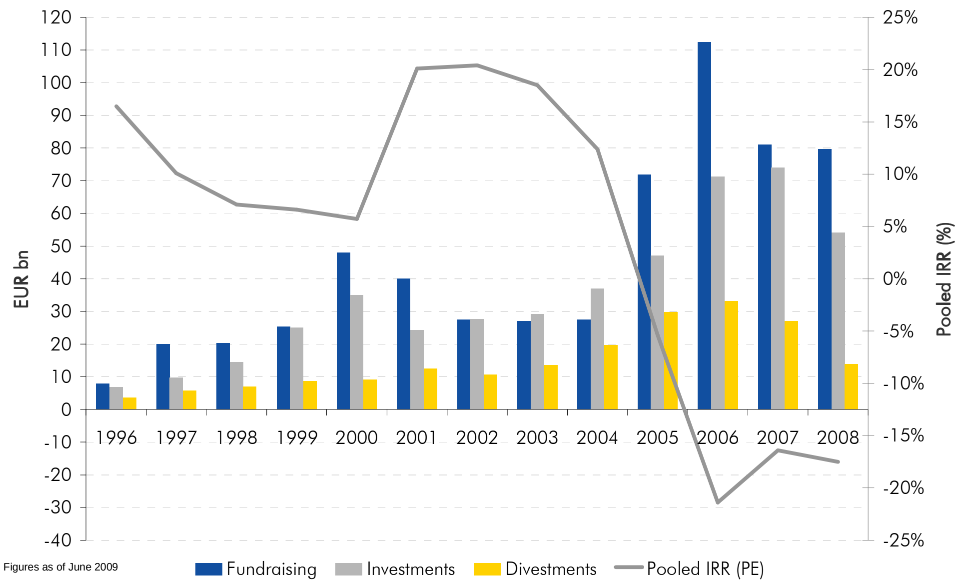
The macroeconomic environment described above entailed major challenges for the European Private Equity market. After a general introduction on the overall industry outlook, two main dimensions of analysis of the Private Equity market are presented: activity figures (i.e. fundraising, investments and divestments) and performance figures (rolling investment horizon performance).

The financial crisis made the European PE market more challenging in 2008. Faced with these difficult times, portfolio companies were forced to rely even more on PE backing (given that access to debt was either expensive or impossible) for either capital expenditures or operational needs. Many early-stage companies in particular – with no positive cash flows or hardly breaking even – could not have survived without the continuous support of their current venture capital investors. For more mature companies, servicing debt became more challenging, as it became harder to preserve covenants in a bear market. Given these circumstances it is expected that follow-on investments will increase and holding periods will become longer across segments in the coming years. According to the latest EVCA Yearbook 2009, buyout deals realized at the peak of the market (2005-2007) at high entry prices will be harder to exit at a profit, given the current deflated exit valuations (EVCA 2009). However, PE is typically a long-term investment strategy; hence the industry does not witness redemption calls or the pressure to exit companies in the down cycle.

In terms of new investment opportunities, it is possible to observe a more crowded space in the small and medium size segment and in growth capital. This is mainly driven by buyout funds scaling down deal sizes and stepping in earlier with their investment rounds, but it is also triggered by more growth funds being present in the market. Therefore, the focus will be even more on operational improvements and growth, in addition to restructuring and turnaround. While the PE industry has continued to receive the support of investors, as reflected by sustained fundraising levels in 2008, servicing commitments in 2009 has become problematic due to the broader difficult market conditions. The divestment window slowed down considerably in 2008 – even trade sales reduced due to the uncertainty of valuations – and this decrease in exits has a direct impact on fundraising, where showing a good track record of realizations is essential.

Write-offs started to increase in 2008 and continued in 2009; fundraising has been challenging in 2009 and is expected to remain difficult in 2010. Additionally, sales to secondary funds of funds are expected to increase. In terms of new entrants and restructurings of management companies, the market was dynamic in 2008, boosted by the lure of high returns for funds raised and invested during recession times for new entrants (as proven by performance track records, see also Figure 5), and the sale of some captive PE funds by banks in their quest for liquidity.

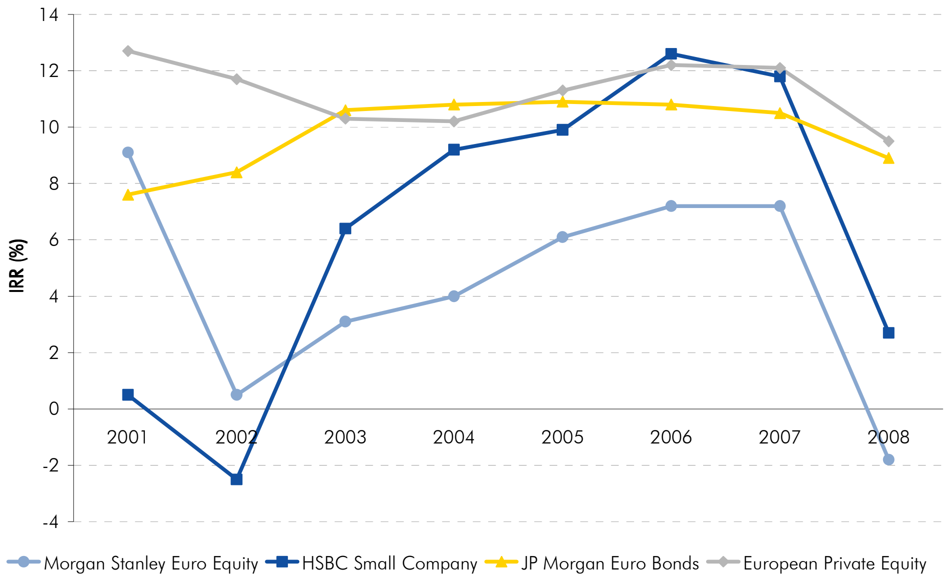
Figure 5: PE Performance by Vintage year (pooled IRR %) vs. PE activity by year (EUR bn)



Source: EVCA Yearbook (2009), Thomson Reuters VentureXpert as of September 2009.

The PE market has proven in the past to provide the best vintage years in recession times; in addition, it is also true that PE beats main public market indices as illustrated in Figure 6, where the European Private Equity index has been constructed taking all PE stages annualised net pooled IRRs since inception until December 2008, on the basis of a methodology proposed by J Coller and published by A Long and C Nickles[3].

Figure 6: Public market indices vs. EU Private Equity



Source: Thomson Reuters/EVCA Performance Benchmarks 2008 European PE.

Furthermore, recent statistics presented by Unquote Q3 2009 Barometer (Unquote Private Equity Barometer 2009, p.2.) show signs of a shift in sentiment in PE investment activity, with deal numbers increasing by 11% quarter-on-quarter from 232 deals to 257 in Q3, emphasizing how conditions in the banking sector are steadying and how the availability of financing for buyout transactions has improved.

However, these are only preliminary figures and one should not forget how far the market has fallen and therefore how far it has to come back.

[3] Comparators are Internal Rates of Return (IRR). IRRs for public market indices are calculated by investing the equivalent cash flows that were invested in private equity into the public market index. Then an equivalent IRR is calculated for each index. Calculations based on methodology proposed by J Coller and published by A Long and C Nickles.

The main messages of the various latest quarterly reports received from the VC funds in EIF's portfolios, are similar-sounding. The current trends in the PE market at General and Limited Partner levels in Europe can be summarized as follows:

- Uncertainty due to ongoing crisis.
- Still closed exit environment with no IPO and very limited M&A activity.
- Development of "exit-ready" strategies.
- Increased focus on operational efficiency.
- Execution of synergistic add-ons at portfolio companies level at favourable prices.
- Lack of leverage for new deals.
- Increased difficulty to service commitments from the LPs.
- Uncertainty about the impact of valuations.

3. Private Equity Activity figures (EVCA based on Perep Analytics)

The impact of the financial crisis was felt by the European PE industry on a number of fronts, primarily:

- Considerable decrease in capital markets and bank contributions to PE.
- Significant decrease in investments (-27%), driven mainly by the drop in buyouts.
- Dramatic reduction of exit opportunities, with the total amount divested at cost sliced to half and the number of exits reduced by one-fifth.

Fundraising

Despite the financial crisis, until the end of 2008 fundraising levels were sustained. This trend may be partially explained by the awareness that recession years are usually linked to the highest returns in the PE market and that the PE market continued to outperform, on average, the public equity market. Indeed, compared to the EUR 81bn raised in 2007, the fundraising activity in 2008 was slightly reduced by – 2.5% to EUR 79bn. However, the anticipated dramatic plunge in the fundraising activity finally materialized in the first three quarters of 2009 with a -86% reduction compared to the same period in 2008 (see figure 8). One reason is the strong level of activity in previous years (2005 to 2008), but the main driver is the crisis. Capital commitments from capital markets and banks considerably dried up, both halving their commitments of previous years. The time from launch to closing has increased with some funds facing great difficulties in reaching a minimum viable fund size. On the other hand, due to liquidity issues, LPs' commitments are not anymore a guarantee of the capacity to meet capital calls on time.

Investments

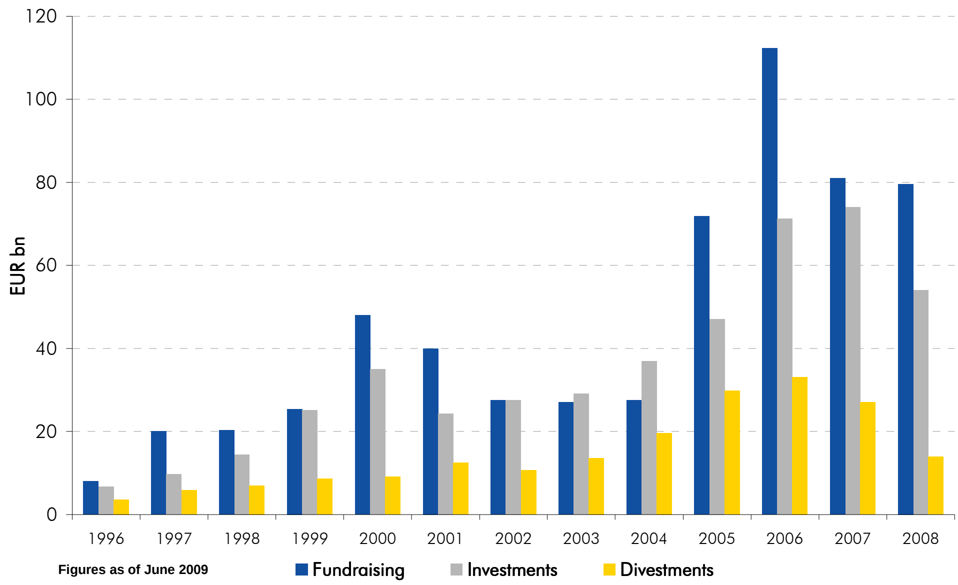
PE firms based in Europe in 2008 invested a total amount of EUR 54.1bn, down by - 27% compared to 2007. Nonetheless, it was still the third-best investment year for the European industry (after 2007 and 2006). The decrease in amount invested was mainly driven by buyouts, with a EUR 20bn drop. In particular, the upper end of the buyout segment was most hit by the crisis, with only 17 mega-buyout companies and 19 large companies financed. On the contrary, activity in the growth financing intensified, with EUR 3bn more financing put into the segment, especially by buyout funds looking to expand their investment scope. Finally, the venture segment received EUR 1bn less than in 2007, due to the reduced average deal size of later-stage venture deals.

In Q1 2009, investments fell by - 42% in value and by - 12% in terms of companies financed compared to Q4 2008 and the situation did not improve in the following two quarters of 2009. The decrease in value was still driven by a steep drop in buyout investment, which more than halved in Q1 2009. Venture investments fell by - 39%, while growth capital proved more resilient, down by only 14%. The situation for rescue and turnaround investment instead has been rather positive as expected, reflecting the changed market environment.

Divestments

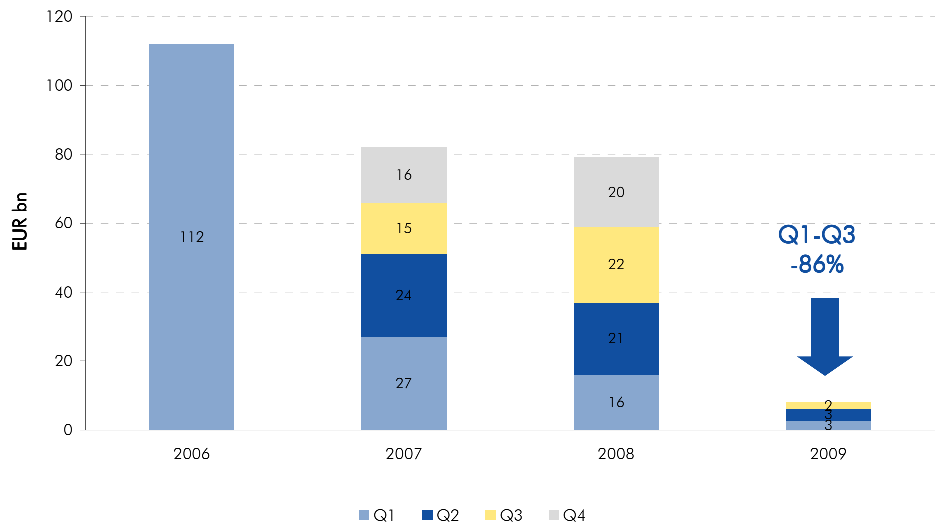
In 2008, PE firms based in Europe exited 2,059 companies, with a total amount divested at cost of EUR 13.9bn. This was close to the 2003 level but down - 50% compared to 2007, driven by a - 34% drop in the average amount divested at cost. In particular, trade sales were the main exit route, both by amount and by number of companies divested (38% and 23% respectively) followed by secondary sales (27% by amount). The proportion of companies written-off increased from 7.9% in 2007 to 12.5% in 2008. In Q1 2009 the divestment activity fell by 19% compared to Q4 2008 and further worsened in Q2 2009 with an additional -55% vs. Q1 2009. However, figures in Q3 2009 slightly began to improve after four quarters of downtrend. Figure 7 below gives the historical evolution of the European PE activity by amount (EUR bn) since 1996; the figures 8, 9 and 10 give the evolution of the European PE activity by amount (EUR bn) by quarter since 2006.

Figure 7: Yearly evolution of European PE activity by amount (EUR bn)



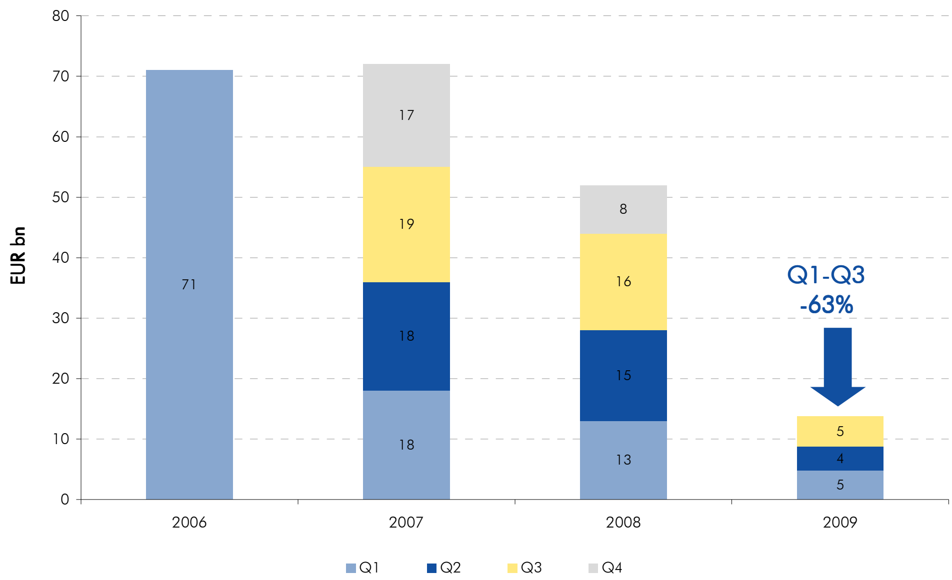
Source: EVCA Yearbook (2009).

Figure 8: EU PE quarterly fundraising activity by amount (EUR bn)



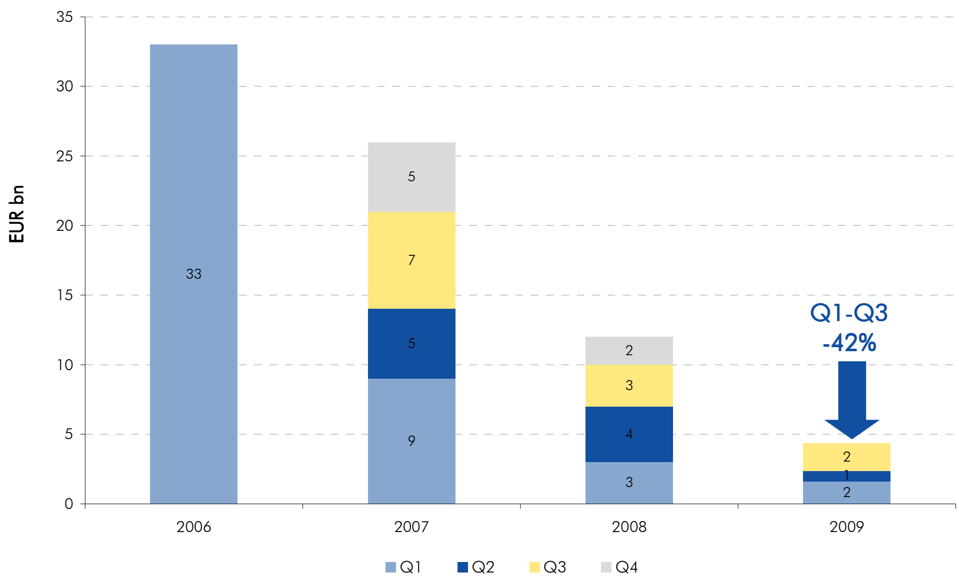
Source: EVCA Quarterly Activity Indicator, Perep Analytics November 2009.

Figure 9: EU PE quarterly investment activity by amount (EUR bn)



Source: EVCA Quarterly Activity Indicator, Perep Analytics November 2009.

Figure 10: EU PE quarterly divestment activity by amount (EUR bn)



Source: EVCA Quarterly Activity Indicator, Perep Analytics November 2009.

A recent study published by Deloitte and EVCA suggests that many Venture Capitalists are remarkably optimistic about their future funds and intend to keep the same level or even higher level of investment (Deloitte and EVCA 2009, see Annex 1 for more details). The main trends that emerged from the survey are summarised below:

- Maintain the current strategy, however a significant percentage of fund managers are shifting the focus to later-stage and existing portfolio companies.

- Maintain the same strategy when it comes to industry sector.

- Believe that the next fund will be either larger than the existing one or approximately the same size.

- Fund managers willing to drift/shift their strategy, e.g. favouring the cleantech sector.

4 Performance figures (VentureXpert, Thomson Reuters database)

Although still attractive, PE performances at the end of 2008, and even more in H1 2009, further diminished, with the 10-year investment horizon returns for all PE funds decreasing by -3.1% from +9.3% at the end of 2008 to +6.2% in H1 2009. Table 2 gives the European 3, 10 and 20-year horizon IRRs evolution by stage focuses since June 2008.

The decrease in performances was more important for the buyout segment than for the VC one. In particular, in the short term, the mega buyout segment was the most impacted by the crisis and triggered the drop in the overall buyout sector. However, in the long term, buyout returns remain attractive: indeed, looking at the 20-year investment horizon return, the buyout segment continues to deliver a performance adequate for the risk taken of above 11%, contrary to VC, with less than 2%.

Since the crisis, EU and US PE markets have followed the same downward trend. Performances further deteriorated in both countries and the gap in figures in June 2009 seems to converge towards the lowest level since 1996. EU continues to outperform the US market with regards to the buyout segment although with a reduced gap of +4.4% (vs. +6.5% in 2008). In contrast, the EU VC segment continues to significantly underperform the US (-11.2%). However, aggregate pooled IRRs over the 2002-2007 period show no material difference in performance in the two regions. Figure 11 gives the historical IRRs evolution of the EU and US buyout and VC 10-year horizon IRR since 1996 and Figure 12 shows a comparison of VC Performance between EU and US by vintage year.

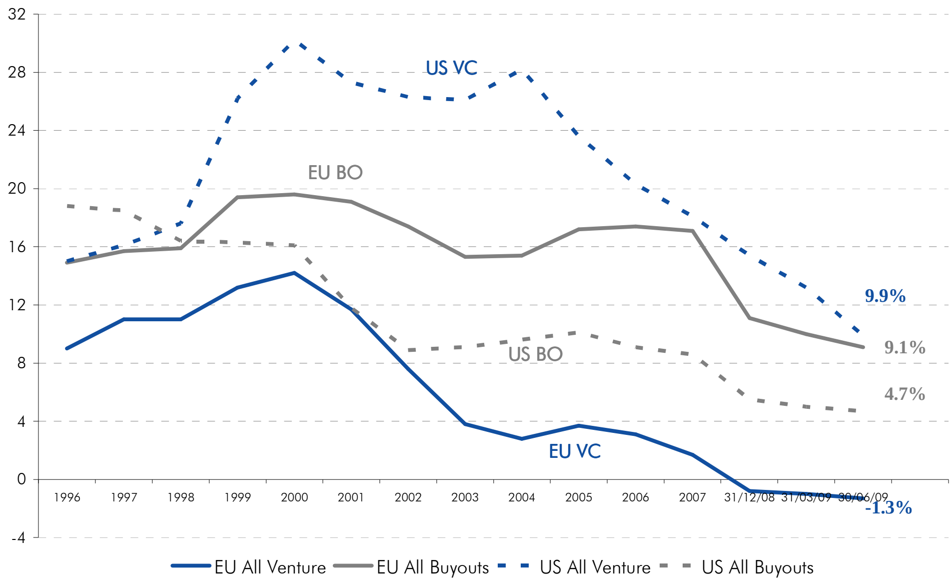
Table 2: Investment benchmarks: PE performance – Horizon IRRs (in %)

	3-Year			10-Year			20-Year		
Stage	**Jun-09**	**Dec-08**	**Jun-08**	**Jun-09**	**Dec-08**	**Jun-08**	**Jun-09**	**Dec-08**	**Jun-08**
Early Stage	-3.3	-1.7	-0.2	-3.1	-2.4	-2.5	-1.3	-1.1	-1.1
Balanced	0.3	1.0	6.8	-0.1	0.3	2.7	2.4	4.6	4.4
Development	-0.3	-0.4	2.8	1.1	2.2	2.9	6.6	6.8	7.3
All Venture	**-1.6**	**0.0**	**3.5**	**-1.3**	**0.4**	**1.0**	**1.6**	**3.1**	**3.7**
Small Buyouts	7.3	5.3	9.1	8.8	9.5	10.0	12.5	12.3	12.8
Medium Buyouts	6.2	9.3	14.6	10.3	18.5	20.7	14.4	16.7	17.7
Large Buyouts	6.4	7.5	14.3	13.0	18.9	18.2	18.7	19.2	20.1
Mega Buyouts	-2.0	0.1	18.5	8.0	8.8	14.7	8.0	8.7	14.7
All Buyouts	**0.8**	**8.5**	**16.2**	**9.1**	**13.3**	**15.0**	11.8	**14.1**	**15.6**
All Private Equity	**0.0**	6.3	12.7	**6.2**	9.3	10.5	**9.0**	10.4	11.5

Source: VentureXpert, Thomson Reuters database[4].

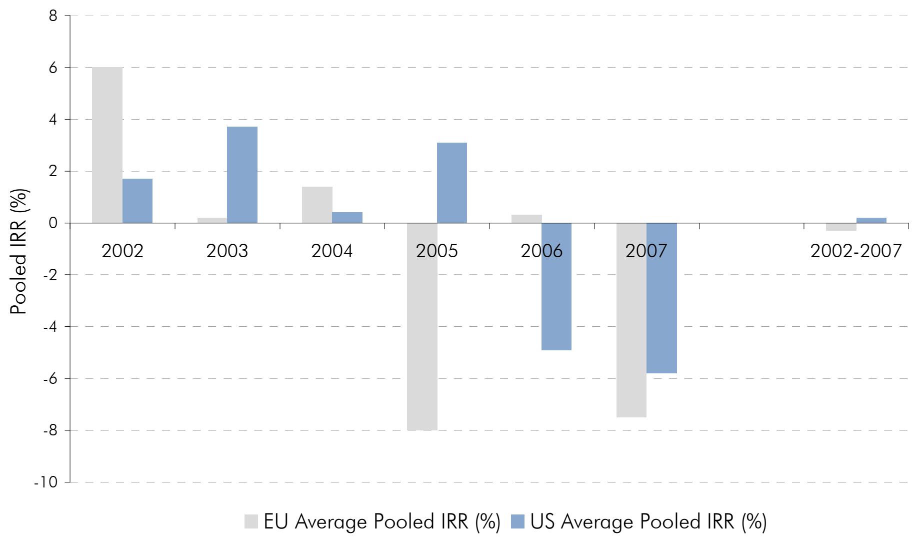
[4] Data are continuously updated and might therefore be subject to change.

Figure 11: European PE Performance-10-year horizon IRR (in %)



Source: VentureXpert Thomson Reuters database.

Figure 12: EU vs. US VC Performance by vintage year (average pooled IRR in %)



Source: Thomson Reuters VentureXpert (data as of 30-06-09).

4. Conclusion

Many PE funds are facing difficult times in reaching fundraising targets, leading to closing delays and smaller fund sizes.

As the fundraising challenge drags on and the traditional investor base – commercial banks, investment banks, corporate operating funds, insurance companies and public pension funds – is unwilling to take the risks on these equity investments, funds are looking towards governments and institutional investors for support. According to market participants, fundraising is more difficult than it was even in the post internet bubble period.

Although the financial system and public equity markets seem to have now stabilised and a slow recovery is expected in 2010, the main characteristic of the current global recession is uncertainty, and it is still too early to confirm a turnaround at this time.

At this juncture, EIF plays a paramount role in stabilising the European PE market, being EIB Group's specialist provider of Integrated Finance to SMEs across the EU, EFTA and Accession Countries. The EIF's catalytic role in attracting further investors in European PE funds is deployed through a full spectrum of financing solutions for selected intermediaries aimed at the pursuit of Community Objectives.

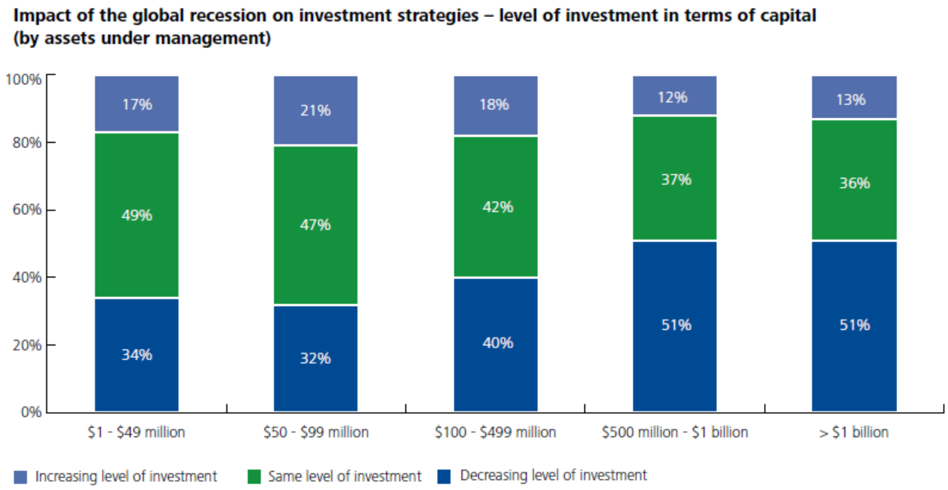
Annex 1: Summary of Deloitte/EVCA study

Deloitte and EVCA have conducted a survey with venture capitalists (VCs) in the Americas, Asia Pacific (AP), Europe and Israel concerning their expectations (Deloitte and EVCA 2009a and 2009b). There were 725 responses from general partners (GPs) of venture capital firms with assets under management ranging from less than USD 100m to greater than USD 1bn. 44 percent of the respondents were from the United States, 21 percent from European countries (excluding the UK), 16 percent from Asia Pacific countries, 10 percent from the Americas (excluding the U.S.), 7 percent from the UK, and 2 percent from Israel. We briefly summarize the results of the survey:

Level of investment

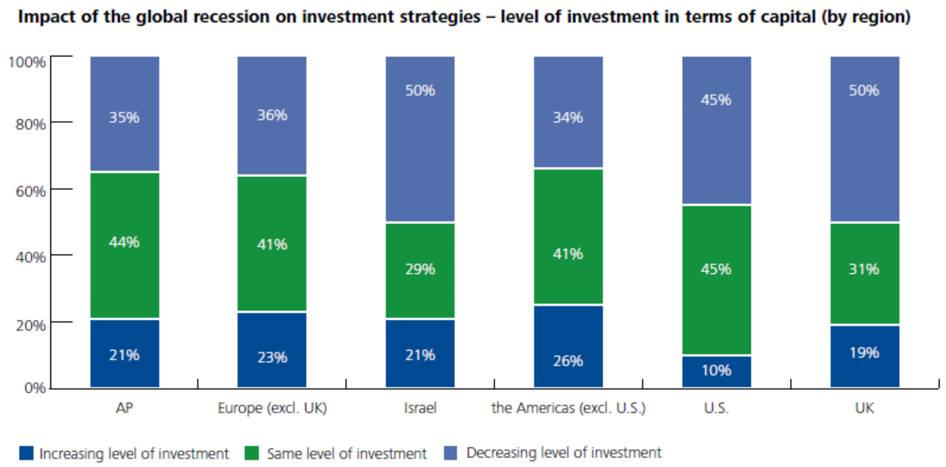
More than half of the GPs want to keep the same level or higher level of investment.

Figure: Impact of recession on Investment Strategies (1/8)



Source: Deloitte and EVCA (2009)

Figure: Impact of recession on Investment Strategies (2/8)



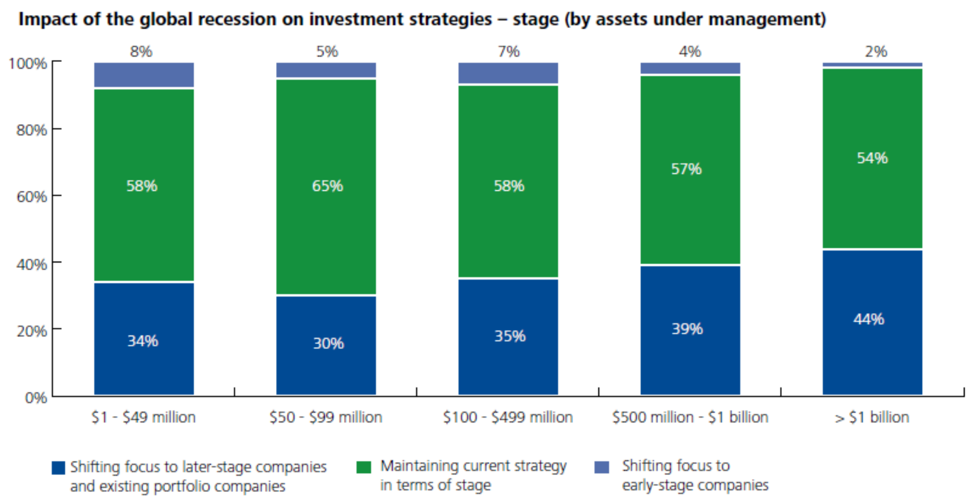
Source: Deloitte and EVCA (2009)

Stages

VCs are re-evaluating the stage in which they're investing. Very few are shifting to early-stage investing. Instead, about half are maintaining their current strategy and a significant percentage are shifting their focus to later-stage and existing portfolio companies. No doubt this is due to both the strain on the capital markets and the fact that it is now taking longer for companies to be acquired and rare for them to go public. Investing in later-stage companies shortens the VC's gestation period and allows them to exit sooner.

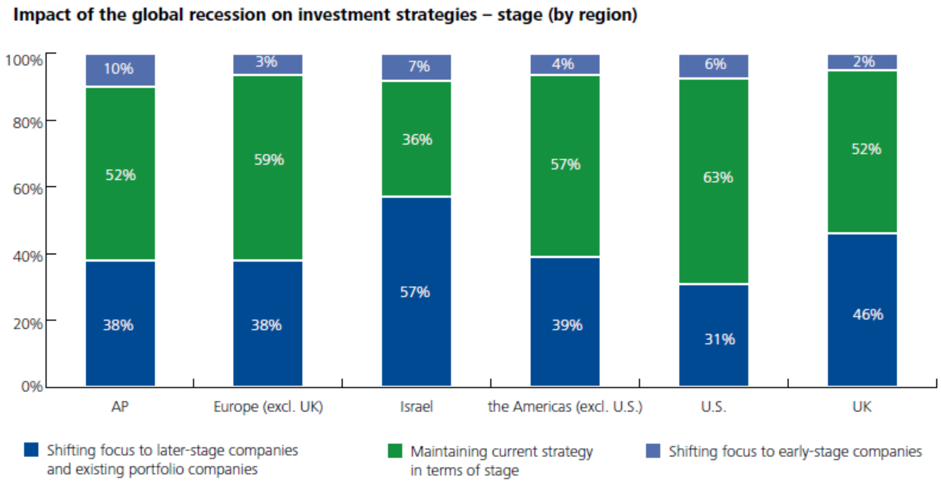
"In this environment, it pays to be either a very early-stage investor or a very late-stage investor," said Steve Fredrick, general partner of Grotech Ventures. "The classic Series B round, where a business is still finding its legs and remaining capital requirements are at best an estimate, carries more risk given higher burn rates and the climate's uncertainty around future financings. So, we're seeing reduced investment levels as firms either invest smaller sums in very early-stage companies, or invest traditional sums in fewer and much later-stage companies. The middle ground has been largely vacated."

Figure: Impact of recession on Investment Strategies (3/8)



Source: Deloitte and EVCA (2009)

Figure: Impact of recession on Investment Strategies (4/8)

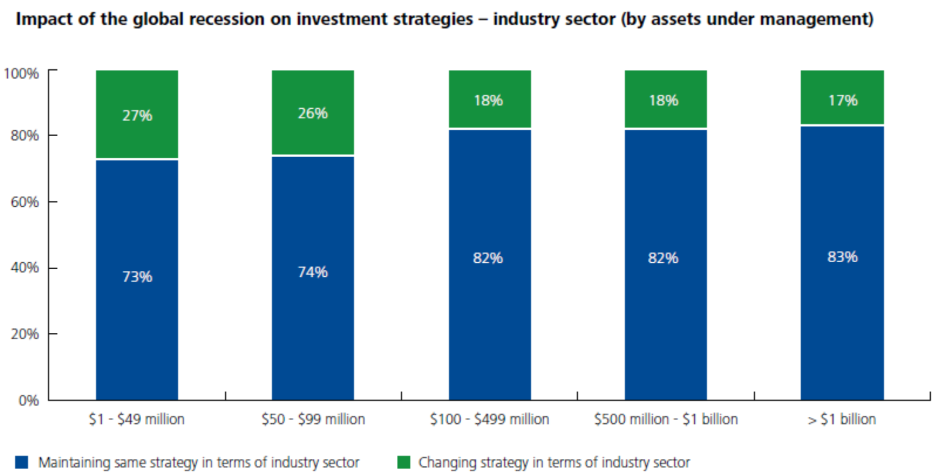


Source: Deloitte and EVCA (2009)

Industry sector

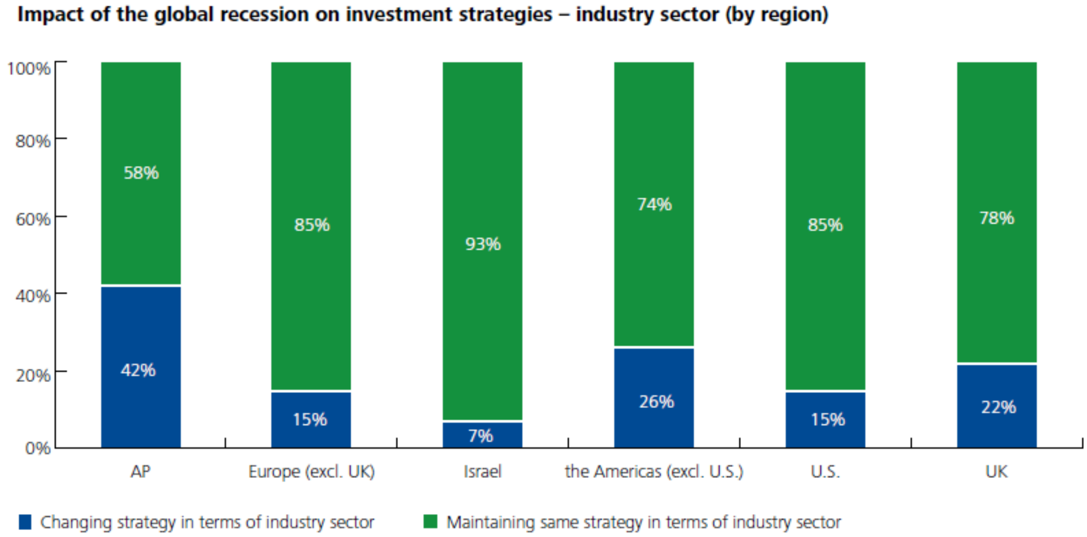
The vast majority of GPs are maintaining the same strategy when it comes to industry sector. At least seven out of 10 VCs - and the percentage increases with the size of the firm -plan to maintain the same strategy in terms of industry sector.

Figure: Impact of recession on Investment Strategies (5/8)



Source: Deloitte and EVCA (2009)

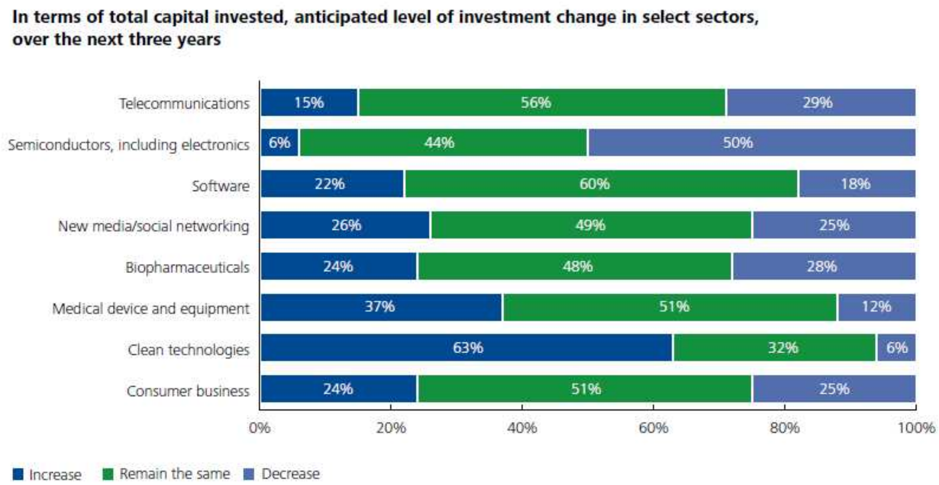
Figure: Impact of recession on Investment Strategies (6/8)



Source: Deloitte and EVCA (2009)

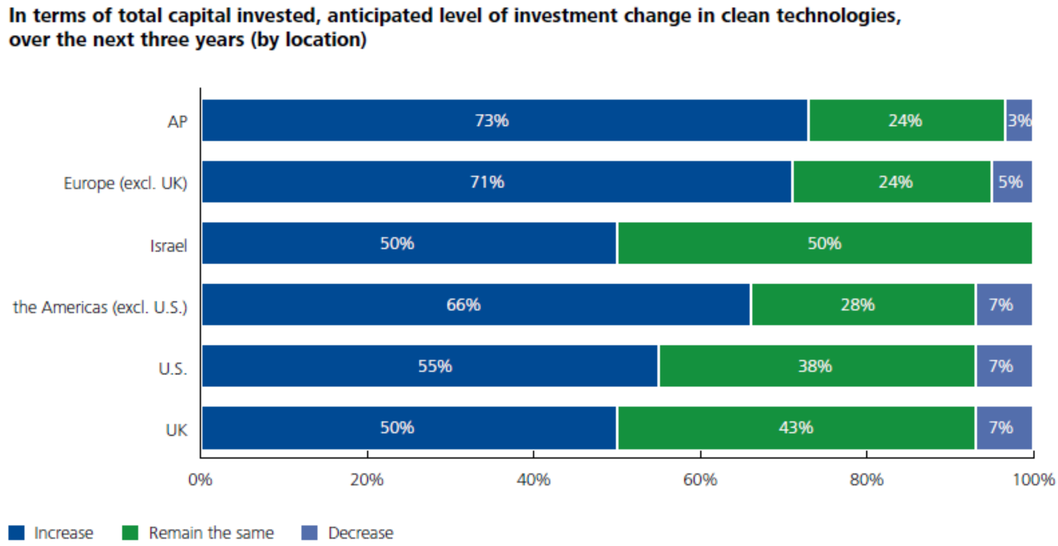
For the ones with changing strategies, the cleantech sector is one of the favourites:

Figure: Impact of recession on Investment Strategies (7/8)



Source: Deloitte and EVCA (2009)

Figure: Impact of recession on Investment Strategies (8/8)

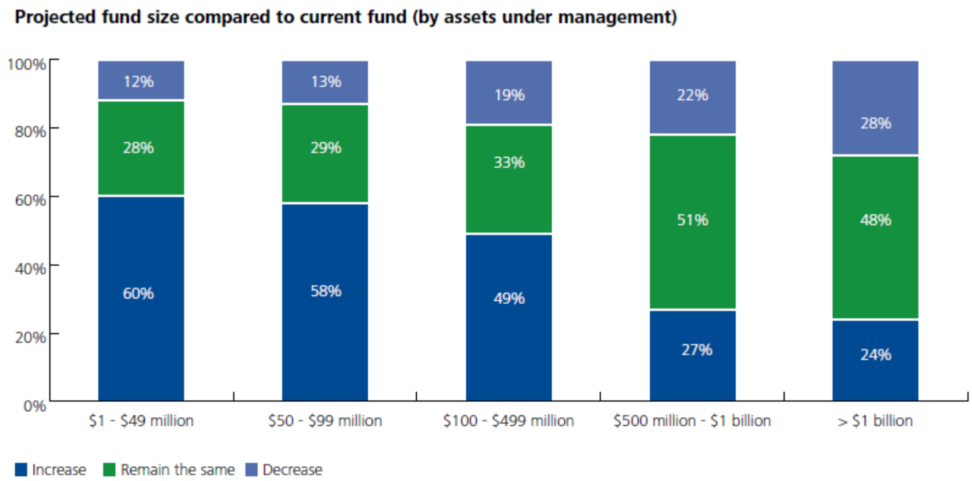


Source: Deloitte and EVCA (2009)

Fund size

Despite the fact that the world is struggling with a recession, VCs are remarkably optimistic about their future funds. Most VCs believe that their next fund will be either larger than their existing fund or will be approximately the same size.

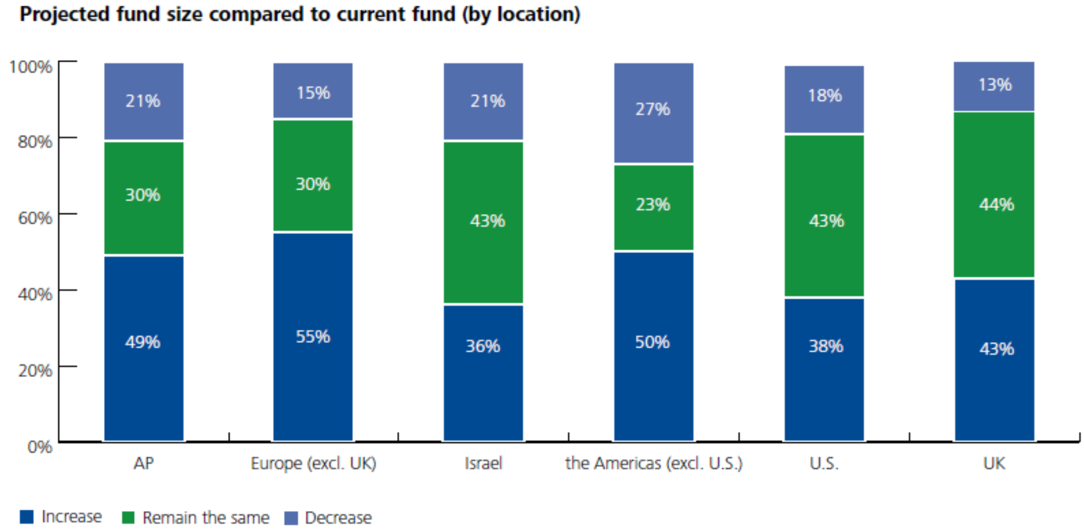
Figure: Projected fund size compared to current fund



Source: Deloitte and EVCA (2009)

From a regional perspective: Very little decrease in fund size is projected across the board. And, those projecting increases or stasis range from the Americas (excluding the U.S.) at 73 percent to the UK at 87 percent. The region anticipating the greatest increase in their next fund is Europe (excluding the UK) at 55 percent. Similar optimistic are the respondents from Asia/Pacific; less optimistic are the replies from the US (38%) and Israel (36%).

Figure: Projected fund size compared to current fund

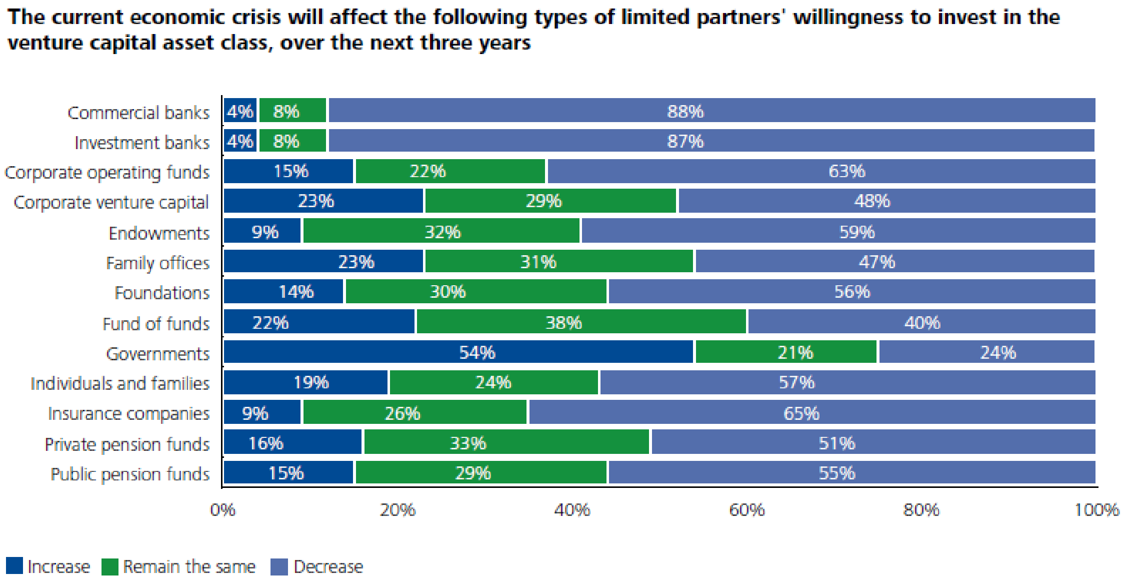


Source: Deloitte and EVCA (2009)

Deloitte asked venture capitalists how the current economic crisis will affect the various types of limited partners' willingness to invest over the next three years, and while they plan to increase the size of their funds and level of investing, they nevertheless see their traditional investor base - commercial banks, investment banks, corporate operating funds, insurance companies and public pension funds - to be drying up.

Among all respondents, 88 percent see commercial bank investors' willingness to invest in venture capital over the next three years decreasing. Another 87 percent were just as pessimistic over investment banks. 60% were pessimistic about corporate operating funds, insurance companies, corporate venture capital, and endowments decreasing as limited partners. Intriguingly, venture capitalists are looking to governments as their financial partners. More than half of VCs see an increase in governments as willing investment partners with another fourth looking at an increase by family offices.

Figure: Impact of economic crisis on LPs



Source: Deloitte and EVCA (2009)

Annex 2: Acronyms

- **CEE:** Central and Eastern Europe
- **EC:** European Commission
- **EIB:** European Investment Bank
- **EU:** European Union
- **GP:** General Partner
- **GS:** Guarantees & Securitisation
- **IFC:** International Finance Corportation
- **IFI:** International Financial Institution
- **IMF:** International Monetary Fund
- **IRR:** Internal Rate of Return
- **LMM:** Lower Mid Market
- **LP:** Limited Partner
- **PE:** Private Equity
- **P/E ratio:** Price/Earnings ratio
- **RCM:** Risk Capital Mandate
- **SMEs:** Small and medium sized enterprises
- **VC:** Venture Capital
- **VCs:** Venture Capitalists

Annex 3: PE Glossary (EVCA)

- **Alternative Investments/assets**

  Investments covering amongst others private equity and venture capital, hedge funds, real estate, infrastructure, commodities, or collateralised debt obligations (CDOs).

- **Asset Allocation**

  A fund manager's allocation of his investment portfolio into various asset classes (eg stocks, bonds, private equity).

- **Asset Class**

  A category of investment, which is defined by the main characteristics of risk liquidity and return.

- **Average IRR**

  The arithmetic mean of the internal rates of return (IRRs). See Internal rate of return (IRR).

- **Balanced Fund**

  Venture capital funds focused on both early stage and development with no particular concentration on either.

- **Benchmark**

  A previously agreed upon point of reference or milestone at which venture capital investors will determine whether or not to contribute additional funds to an investee company.

- **Buy-and-build strategy**

  Active, organic growth of portfolio companies through add-on acquisitions.

- **Buyout**

  A buyout is a transaction financed by a mix of debt and equity, in which a business, a business unit or a company is acquired with the help of a financial investor from the current shareholders (the vendor). See management buyout (MBO), management buyin (MBI), institutional buyout (IBO), leveraged buyout (LBO).

- **Buyout fund**

  Funds whose strategy is to acquire other businesses; this may also include mezzanine debt funds which provide (generally subordinated) debt to facilitate financing buyouts, frequently alongside a right to some of the equity upside.

- **Capital weighted average IRR**

  The average IRR weighted by fund size.

- Captive Fund

  A fund in which the main shareholder of the management company contributes most of the capital, ie where parent organisation allocates money to a captive fund from its own internal sources and reinvests realised capital gains into the fund.

- Carried interest

  A share of the profit accruing to an investment fund management company or individual members of the fund management team, as a compensation for the own capital invested and their risk taken. Carried interest (typically up to 20% of the profits of the fund) becomes payable once the limited partners have achieved repayment of their original investment in the fund plus a defined hurdle rate.

- Closing

  A closing is reached when a certain amount of money has been committed to a private equity fund. Several intermediary closings can occur before the final closing of a fund is reached.

- Co-lead investor

  Investor who has contributed a similar share with the lead investor in a private equity joint venture or syndicated deal.

- Commitment

  A limited partner's obligation to provide a certain amount of capital to a private equity fund when the general partner asks for capital.

- Deal flow

  The number of investment opportunities available to a private equity house.

- Development fund

  Venture capital funds focused on investing in later stage companies in need of expansion capital.

- Disbursement

  (US) The flow of investment funds from private equity funds into portfolio companies.

- Distribution

  The amount disbursed to the limited partners in a private equity fund.

- Distribution to-paid-in capital (D/PI)

  A measure of the cumulative distributions returned to the limited partners as a proportion of the cumulative paid-in capital. DPI is net of fees and carried interest.

- Divestment

  See exit.

- **Distribution to-paid-in (DPI)**

  The DPI measures the cumulative distributions returned to investors (Limited Partners) as a proportion of the cumulative paid-in capital. DPI is net of fees and carried interest. This is also often called the "cash-on-cash return". This is a relative measure of the fund's "realized" return on investment.

- **Drawdown**

  When investors commit themselves to back a private equity fund, all the funding may not be needed at once. Some is used as drawn down later. The amount that is drawn down is defined as contributed capital.

- **Due Diligence**

  For private equity professionals, due diligence can apply either narrowly to the process of verifying the data presented in a business plan/sales memorandum, or broadly to complete the investigation and analytical process that precedes a commitment to invest. The purpose is to determine the attractiveness, risks and issues regarding a transaction with a potential investee company. Due diligence should enable fund managers to realise an effective decision process and optimise the deal terms.

- **Early stage**

  Seed and start-up stages of a business.

- **Early stage fund**

  Venture capital funds focused on investing in companies in the early part of their lives.

- **Exit**

  Liquidation of holdings by a private equity fund. Among the various methods of exiting an investment are: trade sale; sale by public offering (including IPO); write-offs; repayment of preference shares/loans; sale to another venture capitalist; sale to a financial institution.

- **Exit strategy**

  A private equity house or venture capitalist's plan to end an investment, liquidate holdings and achieve maximum return.

- **Expansion capital**

  Also called development capital. Financing provided for the growth and expansion of a company, which may or may not break even or trade profitably. Capital may be used to: finance increased production capacity; market or product development; provide additional working capital.

- **Financial secondaries**

  A secondary deal involving a funds' portfolio of companies that are relatively mature (five to seven years old), with some exits already realized, but not all capital drawn down. The main interest for the buyer is to negotiate a potential discount on the fund portfolio.

- **Follow-on investment**

  An additional investment in a portfolio company which has already received funding from a private equity firm.

- **Fund**

  A private equity investment fund is a vehicle for enabling pooled investment by a number of investors in equity and equity-related securities of companies (investee companies). These are generally private companies whose shares are not quoted on any stock exchange. The fund can take the form either of a company or of an unincorporated arrangement such as a limited partnership.See limited partnership.

- **Fund age**

  The age of a fund (in years) from its first drawdown to the time an IRR is calculated.

- **Fund focus**

  The strategy of specialisation by stage of investment, sector of investment, geographical concentration. This is the opposite of a generalist fund, which does not focus on any specific geographical area, sector or stage of business.

- **Fund of Funds**

  A fund that takes equity positions in other funds. A fund of fund that primarily invests in new funds is a Primary or Primaries fund of funds. One that focuses on investing in existing funds is referred to as a Secondary fund of funds.

- **Fund size**

  The total amount of capital committed by the limited and general partners of a fund.

- **Fundraising**

  The process in which venture capitalists themselves raise money to create an investment fund. These funds are raised from private, corporate or institutional investors, who make commitments to the fund which will be invested by the general partner.

- **General Partner**

  A partner in a private equity management company who has unlimited personal liability for the debts and obligations of the limited partnership and the right to participate in its management.

- **General Partner's commitment**

  Fund managers typically invest their personal capital right alongside their investors capital, which often works to instil a higher level of confidence in the fund. The limited partners look for a meaningful general partner investment of 1% to 3% of the fund.

- **Generalist fund**

  Funds with either a stated focus of investing in all stages of private equity investment, or funds with a broad area of investment activity.

- **Hands-on**

  A private equity investment in which the venture capitalist adds value by contributing capital, management advice and involvement.

- **Holding period**

  The length of time an investment remains in a portfolio. Can also mean the length of time an investment must be held in order to qualify for Capital Gains Tax benefits.

- **Horizon internal rate of return**

  An indication of performance trends within an industry sector. Horizon IRR uses the beginning net asset values as an initial cash outflow and net asset values at the period end as the terminal cash flow. Through these values plus/minus any net interim cash flows, it calculates IRRs for the defined time period.

- **Horizon IRR**

  The Horizon IRR allows for an indication of performance trends in the industry. It uses the fund's net asset value at the beginning of the period as an initial cash outflow and the Residual Value at the end of the period as the terminal cash flow. The IRR is calculated using those values plus any cash actually received into or paid by the fund from or to investors in the defined time period (i.e. horizon).

- **Hurdle rate**

  A return ceiling that a private equity fund management company needs to return to the fund's investors in additionto the repayment of their initial commitment, before fund managers become entitled to carried interestpaymentsfrom the fund.

- **Inception**

  The starting point at which IRR calculations for a fund are calculated; the vintage year or date of first capital drawdown.

- **Institutional investor**

  An organization such as a bank, investment company, mutual fund, insurance company, pension fund or endowment fund, which professionally invest, substantial assets in international capital markets.

- **Internal rate of return (IRR)**

  The IRR is the interim net return earned by investors (Limited Partners), from the fund from inception to a stated date. The IRR is calculated as an annualised effective compounded rate of return using monthly cash flows to and from investors, together with the Residual Value as a terminal cash flow to investors. The IRR is therefore net, i.e. after deduction of all fees and carried interest. In cases of captive or semi-captive investment vehicles without fees or carried interest, the IRR is adjusted to created a synthetic net return using assumed fees and carried interest.

- **IPO (Initial public offering)**

  The sale or distribution of a company's shares to the public for the first time. An IPO of the investee company's shares is one the ways in which a private equity fund can exit from an investment.

- **Later stage**

  Expansion, replacement capital and buyout stages of investment.

- **Leverage buyout (LBO)**

  A buyout in which the NewCo's capital structure incorporates a particularly high level of debt, much of which is normally secured against the company's assets.

- **Limited Partnership**

  The legal structure used by most venture and private equity funds. The partnership is usually a fixed-life investment vehicle, and consists of a general partner (the management firm, which has unlimited liability) and limited partners (the investors, who have limited liability and are not involved with the day-to-day operations). The general partner receives a management fee and a percentage of the profits. The limited partners receive income, capital gains, and tax benefits. The general partner (management firm) manages the partnership using policy laid down in a Partnership Agreement. The agreement also covers, terms, fees, structures and other items agreed between the limited partners and the general partner.

- **Management fees**

  Fee received by a private equity fund management company from its limited partners, to cover the fund's overhead costs, allowing for the proper management of the company. This annual management charge is equal to a certain percentage of the investors' commitments to the fund.

- **Mezzanine finance**

  Loan finance that is halfway between equity and secured debt, either unsecured or with junior access to security. Typically, some of the return on the instrument is deferred in the form of rolled-up payment-in-kind (PIK) interest and/or an equity kicker. A mezzanine fund is a fund focusing on mezzanine financing.

- **Multiples or relative valuation**

  This estimates the value of an asset by looking at the pricing of "comparable" assets relative to a variable such as earnings, cash flows, book value or sales.

- **P/E ratio**

  Price/earnings ratio – the market price of a company's ordinary share divided by earnings per share for the most recent year.

- **Paid-in-capital**

  The amount of committed capital an investor has actually transferred to a fund. Also known as the cumulative takedown amount.

- **Pooled IRR**

  The IRR obtained by taking cash flows from inception together with the Residual Value for each fund and aggregating them into a pool as if they were a single fund. This is superior to either the average, which can be skewed by large returns on relatively small investments, or the capital weighted IRR which weights each IRR by capital committed. This latter measure would be accurate only if all investments were made at once at the beginning of the funds life.

- **Portfolio at cost**

  The portfolio at cost is the sum of all private equity and venture capital investments (held at cost) that have been made until the end of the measurement period and that have not yet been exited.

- **Portfolio company**

  The company or entity into which a private equity fund invests directly.

- **Pre seed stage**

  The investment stage before a company is at the seed level. Pre-seed investments are mainly linked to universities and to the financing of research projects, with the aim of building a commercial company around it later on.

- **Preferred return**

  Either (i) the set rate of return that the investors must receive before the general partners can begin sharing in any distributions, or (ii) the level that the fund's net asset value must reach before the general partners can begin sharing in any distributions.

- **Present value**

  Present value is found by dividing the future payoff by a discount factor which incorporates the interest forgone for not receiving this payoff at the present time.

- **Private Equity**

  Private equity provides equity capital to enterprises not quoted on a stock market. Private equity can be used to develop new products and technologies (also called venture capital), to expand working capital, to make acquisitions, or to strengthen a company’s balance sheet. It can also resolve ownership and management issues. A succession in family-owned companies, or the buyout and buyin of a business by experienced managers may be achieved by using private equity funding.

- **Private Equity Fund**

  A private equity investment fund is a vehicle for enabling pooled investment by a number of investors in equity and equity-related securities of companies. These are generally private companies whose shares are not quoted on a stock exchange. The fund can take the form of either a company or an unincorporated arrangement such as a Limited Partnership.

- **Quartile**

  The IRR which lies a quarter from the bottom (lower quartile point) or top (upper quartile point) of the table ranking the individual fund IRRs.

- **Realisation ratios**

  Benchmark measurements of investment performance which complement IRR. Realisation ratios are distributions to paid-in capital (D/PI), residual value to paid-in capital (RV/PI) and total value to paid-in (TV/PI). These are measures of returns to invested capital. These measures do not take the time value of money into account.

- **Realised multiple**

  The ratio of total gain(/loss) to cost of realised investments.

- **Recapitalisation**

  Change in a company's capital structure. For example, a company may want to issue bonds to replace its preferred stock in order to save on taxes. Re-capitalisation can be an alternative exit strategy for venture capitalists and leveraged buyout sponsors.

- **Replacement capital**

  Purchase of existing shares in a company from another private equity investment organisation or from another shareholder or shareholders.

- **Rescue or turnaround**

  Financing made available to an existing business which has experienced trading difficulties, with a view to re-establishing prosperity.

- **Residual value to paid-in capital (RV/PI)**

  A realisation ratio which is a measure of how much of a limited partner's capital is still tied up in the equity of the fund, relative to the cumulative paid-in capital. RV/PI is net of fees and carried interest.

- **Rounds**

  Stages of financing of a company. A first round of financing is the initial raising of outside capital. Successive rounds may attract different types of investors as companies mature.

- **RVPI (Residual value to paid-in)**

  The RVPI measures the value of the investors' (Limited Partner's) interest held within the fund, relative to the cumulative paid-in capital. RVPI is net of fees and carried interest. This is a measure of the fund's "unrealized" return on investment.

- **S&P 500**

  A market-value weighted index of the 500 largest stocks in the US markets maintained by Standard & Poor Corporation. Generally considered to be a benchmark of the overall US stock market.

- **Secondary investment**

  An investment where a fund buys either, a portfolio of direct investments of an existing private equity fund or limited partner's positions in these funds.

- **Seed stage**

  Financing provided to research, assess and develop an initial concept before a business has reached the start-up phase.

- **SME**

  According to the European Commission definition, "Small and medium-sized enterprises (SMEs) are those businesses which employ fewer than 250 persons and which have an annual turnover not exceeding EUR 50 million, and/or an annual balance sheet total not exceeding EUR 43 million".

- **Start-up**

  Companies that are in the process of being set up or may have been in business for a short time, but have not sold their product commercially.

- **Syndication**

  A group of venture capitalists jointly investing in an investee company.

- **Target company**

  The company that the offeror is considering investing in. In the context of a public-to-private dealthis company will be the listed company that an offeror is considering investing in with the objective of bringing the company back into private ownership.

- **Top Quarter**

  Comprises funds with an IRR equal to or above the upper quartile point.

- **Total value to paid-in (TV/PI)**

  A realisation ratio which is the sum of distributions to paid-in capital (D/PI) and residual value to paid-in capital (RV/PI). TV/PI is net of fees and carried interest.

- **Track record**

  A private equity management house's experience, history and past performance.

- **Trade sale**

  The sale of company shares to industrial investors.

- **TVPI-Total value to paid-in**

  TVPI is the sum of the DPI and the RVPI.TVPI is net of fees and carried interest.

- **Upper Quartile**

  The point at which 25% of all returns in a group are greater and 75% are lower.

- Venture Capital

  Professional equity co-invested with the entrepreneur to fund an early-stage (seed and start-up) or expansion venture. Offsetting the high risk the investor takes is the expectation of higher than average return on the investment. Venture capital is a subset of private equity.

- Venture Capitalist

  The manager of private equity fund who has responsibility for the management of the fund's investment in a particular portfolio company. In the hands-on approach (the general model for private equity investment), the venture capitalist brings in not only moneys as equity capital (ie without security/charge on assets), but also extremely valuable domain knowledge, business contacts, brand-equity, strategic advice, etc.

- Vintage year

  The year of fund formation and first drawdown of capital.

- Volatility

  The volatility of a stock describes the extent of its variance over time.

- Write-off

  The write-down of a portfolio company's value to zero. The value of the investment is eliminated and the return to investors is zero or negative.

References

- BIS, Bank for international settlements (2009). 79th Annual Report 2008/2009; June 2009.
- Deloitte and EVCA (2009a). Global trends in venture capital. 2009 Global Report; June 2009.
- Bullard, J., Neely, C. J., and Wheelock D. (September/October 2009). "Systemic risks and the financial crisis: a primer". Federal Reserve Bank of St. Louis Review, 91 (5, Part 1), pp.403-417.
- Caruana, J. (2009). "The international policy response to the financial crisis: making the macro prudential approach operational". Panel remarks, Jackson Hole; 21-22 August 2009.
- Deloitte and EVCA (2009a). Global trends in venture capital. 2009 Global Report; June 2009
- Deloitte and EVCA (2009b). Press Release. Global economic downturn driving evolution of venture capital industry, according to study by Deloitte and the European Private Equity & Venture Capital Association; Brussels, 10.06.2009.
- EVCA based on Perep Analytics (2009a). Quarterly Activity Indicators, Q2 2009; August 2009.
- EVCA based on Perep Analytics (2009b). Quarterly Activity Indicators, Q3 2009; November 2009.
- EVCA and Thomson Reuters (2009). Performance Benchmarks 2008 European Private Equity, 2009.
- EVCA based on Perep Analytics (2008). Pan-European Private Equity and Venture Capital Activity Report; June 2008.
- EVCA based on Perep Analytics (2009). Pan-European Private Equity and Venture Capital Activity Report; June 2009.
- IMF (2007). Global Financial Stability Report; October 2007.
- IMF (2008). Global Financial Stability Report; October 2008.
- IMF (2009). Global Financial Stability Report; October 2009.
- Orlowski, L.T., (2008). "Stages of the 2007/2008 Global Financial Crisis: is there a wondering asset price bubble?" Economics e-journals, Discussion paper No. 43; 2008.
- The Economist Intelligence Unit (2009). Country Forecasts, European Union; December 2009.
- Unquote (2009a). Private Equity Barometer, Q2 2009 data; September 2009.
- Unquote (2009b). Private Equity Barometer, Q3 2009 preliminary data; December 2009.
- www.bloomberg.com
- www.econ.yale.edu/~shiller/data.htm
- vx.thomsonib.com/NASApp/VxComponent/VXMain.jsp

About …

… the European Investment Fund

The European Investment Fund (EIF) is the European body specialised in small and medium sized enterprise (SME) risk financing. The EIF is part of the European Investment Bank group and has a unique combination of public and private shareholders. It is owned by the EIB (62%), the European Union - through the European Commission (29%) and a number (30 from 17 countries) of public and private financial institutions (9%).

The EIF supports high growth innovative SMEs by means of equity (Venture Capital and Private Equity) and guarantees instruments through a diverse array of financial institutions using either its own funds, or those available through mandates given by the EIB (the Risk Capital Mandate or RCM), the EU (the Competitiveness and Innovation Framework Programme or CIP), Member States or other third parties. Complementing the EIB product offering, the EIF plays a crucial role throughout the value chain of enterprise creation, from the early stages of intellectual property development and licensing to mid and later stage SMEs. By the end of June 2009, EIF had invested in more than 300 VC and growth funds with net commitments of over EUR 3.7bn. At the same date, the EIF net guarantee portfolio amounted to over EUR 13bn in some 200 operations.

The EIF fosters EU objectives in support of innovation, research and regional development, entrepreneurship, growth, and job creation.

… EIF's Research & Market Analysis

Research & Market Analysis (RMA) supports EIF's strategic decision-making, product development and mandate management processes through applied research and market analyses. RMA works as internal advisor, participates in international fora and maintains liaison with many organisations and institutions.

… this Working Paper series

EIF Working Papers are designed to make selected topics and studies in relation to EIF's business available to a wider readership. Working Papers were edited by EIF's Research & Market Analysis and are typically authored or co-authored by EIF staff. These Papers are usually only available in English and distributed only in electronic form (PDF).

EIF Working Papers

2009/001	Microfinance in Europe – A market overview. November 2009.
2009/002	Financing Technology Transfer. December 2009.
2010/003	Private Equity Market in Europe – Rise of a new cycle or tail of the recession?