Global Exchange

Private Equity Insights

FIRST EDITION | Q3 2015

CURRENT QUARTER PERFORMANCE SUMMARY

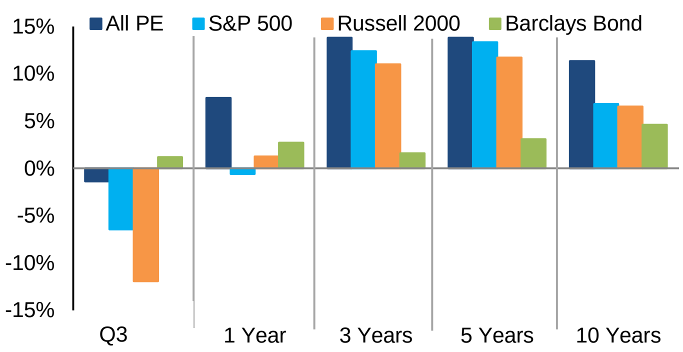
In the third quarter of 2015, the GX Private Equity Index dropped 1.37%, the first negative return after 12 quarters of uninterrupted gains.

With growing uncertainty about the global economy and a significant spike in public market volatility over the past six months, the private equity market appears to be taking a pause as well.

All three of the major private equity strategies—buyout, venture capital, and private debt—posted negative quarterly returns in Q3, with losses of 1.63%, 0.51%, and 1.27%, respectively. On a relative basis, venture capital outperformed other strategies, a trend that has continued since 2013.

Overall, 2015 was characterized by a sharp decrease in exit activity relative to 2013 and 2014, with the gap between distributions to investors and capital calls narrowing significantly.

Figure 1: Investment Horizon Returns (as of 30 Sep 2015)



Source: GX Private Equity Index, Datastream, Barclays Capital US Aggregate Bond Index.

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INDUSTRY BOOMS AND BUSTS

Insights from the Private Capital Research Institute

By Leslie Jeng and Josh Lerner

The most striking pattern in the GX Private Equity Index data for the third quarter of 2015 reflects the declining returns across all segments of private capital, which includes buyout, venture capital, and private debt. This observation is confirmed from more recent observations, such as the declining volume of initial public offerings—an important route for private capital investors to realize their investments—in the fourth quarter of 2015 and January 2016. According to Dealogic data presented in the Wall Street Journal, the monthly IPO volume dropped from a mean of $23 billion in the fourth quarter of 2015 to just over $5 billion.[1]

Thus, a natural question to pose is: Is this the beginning of a transition to a new cycle for private capital? Over the years, the industry has been characterized by a boom and bust cycle, where fundraising, returns, and investment activity all swing wildly. See Figures 2 and 3 on annual dollar amount of investments and number of investments, respectively, and Figure 4 on the number of funds by vintage year, as reported in the PCRI database.

While a definitive answer to this question is challenging, a paper by Axelson, Jenkinson, Stromberg, and Weisbach (2013)[2], which studies the financial structure of large buyouts over a 30-year period, sheds some light on the drivers of these cycles.

Continued on page 2.

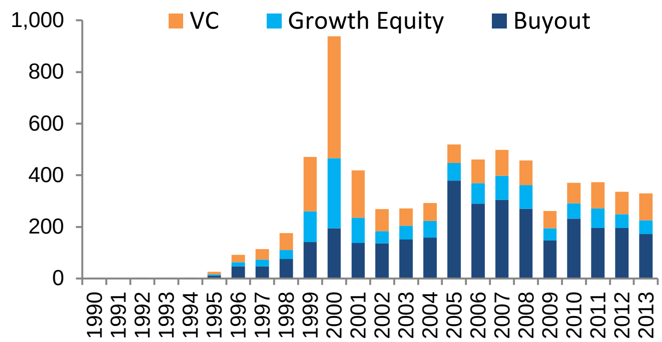
[1] *http://graphics.wsj.com/investment-banking-scorecard/*

[2] Axelson, Ulf, Tim Jenkinson, Per Strömberg, and Michael Weisbach, "Borrow Cheap, Buy High? The Determinants of Leverage and Pricing in Buyouts," Journal of Finance 68:6, December 2013, pp. 2223-2267 (Lead Article, Brattle Group Distinguished Paper Prize 2014).

INDUSTRY BOOMS AND BUSTS – CONTINUED FROM PAGE 1

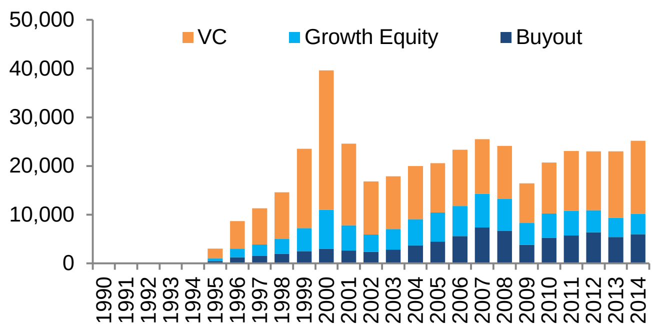
Axelson et. al suggest that the root cause of these cycles are debt markets: that economy-wide cost of borrowing constitutes the key driver in the quantity of debt in buyouts, the pricing of deals, and ultimately, the performance of funds. During periods when debt is readily available, the pricing of deals rises in lockstep with the amount of debt a deal can accommodate (see Figure 6). These high prices in turn lead to lower returns.

Figure 2: Amount Invested Over Time (USD Billions)



Source: PCRI.

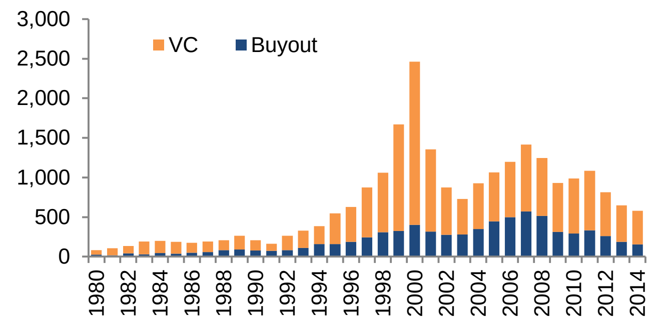
Figure 3: Number of Investments per Year



Source: PCRI.

Can this analysis, which provides a compelling view of the private equity cycles in the 1980s, 1990s, and the first decade of this century, explain today's patterns? Certainly, interest rates have been at an all-time low over the past seven years, since the Federal Reserve lowered and maintained the fed funds target rate at 0.5% at the end of 2008.[3] In the period ensuing since the financial crisis, we saw interest rates plummet, followed by an increase in the dollar amount of investments and number of investments (see Figures 2 and 3). As interest rates today begin to rise, we may see the type of retrenchment associated with earlier periods of rising rates, such as the early 1990s.

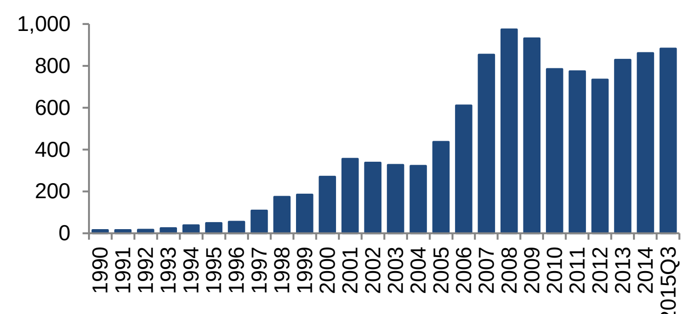
Figure 4: Number of Funds by Vintage Year



Source: PCRI.

Concurrently, certain aspects of the cycle are different today. For instance, the industry appears to have exerted more self-control in recent years, rather than plunging "all in" as during the so-called golden era leading up to the financial crisis. One illustration of this is the increasing amount of dry powder in the industry: that is, capital that has been committed but not yet deployed. See Figure 5 below for dry powder levels over the years.

Figure 5: Dry Powder over Time (USD Billions)

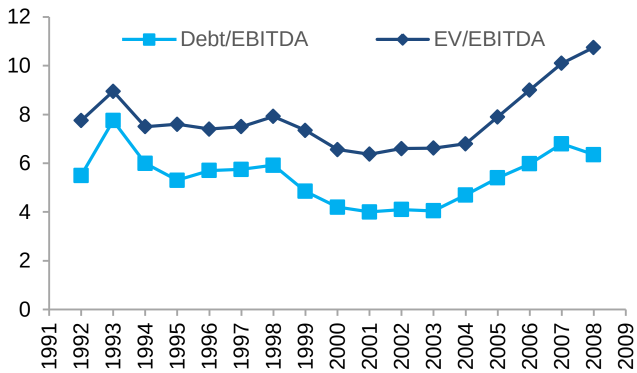


Source: GX Private Equity Index. Market aggregates are calculated based on 50% coverage.

[3] Appelbaum, Binyamin, and Karl Russell, "Why the Fed Raised Interest Rates," *The New York Times*, December 16, 2015.

It remains to be seen whether this self-control is sufficient to avoid the severe corrections seen in earlier downturns.

Figure 6: Leveraged Buyout Debt Levels and Valuation



Source: Axelson et. al (2014), Chart 2A.

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The Private Capital Research Institute is a not-for-profit 501(c)(3) corporation formed to further the understanding of private capital and its global economic impact through a commitment to the ongoing development of a comprehensive database of private capital fund and transaction-level activity supplied by industry participants. The PCRI, which grew out of a multi-year research initiative with the World Economic Forum, also sponsors policy forums.

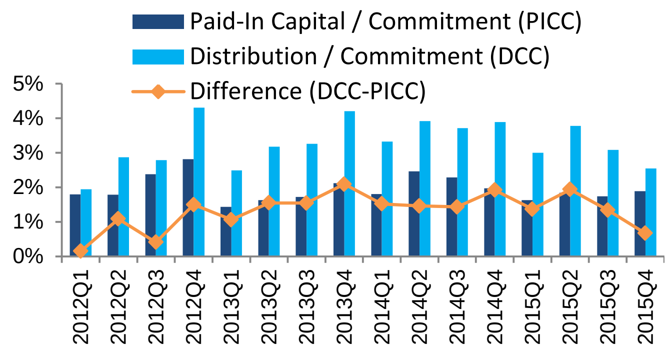
CURRENT QUARTER PERFORMANCE SUMMARY – CONTINUED FROM PAGE 1

In terms of geography, private equity funds in developed markets outperformed those in emerging markets. European-focused private equity funds recorded a positive return of 0.29% in the third quarter. Private equity in the US lost 1.43%, while emerging market private equity had a volatile quarter with performance dropping from 4.47% in Q2 to -3.13% in Q3 2015.

Cash Flow Activity

The past three years have been characterized by a higher level of exit volume relative to historical averages, with private equity fund managers returning capital to investors faster than they are calling it. This trend has not reversed yet, but by the end of 2015, the gap between capital calls (paid-in-capital) and distributions narrowed sharply. This is driven by both a reduction in exit activity and a slight increase in new investment—and therefore capital calls—relative to previous quarters.

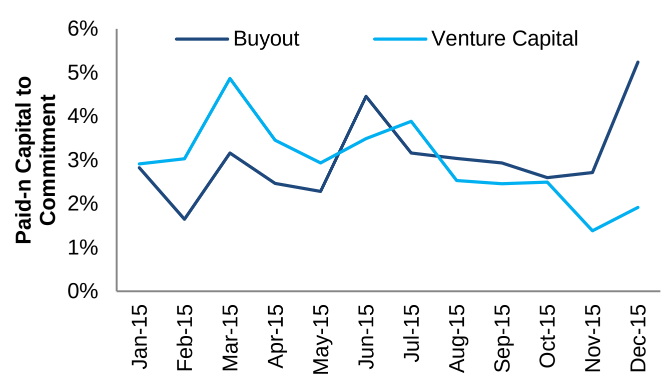
Figure 7: All Private Equity Monthly Cash Flow Activity Ratios



Source: State Street Global Exchange, as of Dec 2015.

At the same time, buyout managers started to actively make new investments in the fourth quarter. Compared with buyout funds, new investment activity of venture capital funds picked up at a slower pace.

Figure 8: Monthly New Investment Activity: Buyout vs. Venture Capital



Source: State Street Global Exchange, as of Dec 2015.

Valuations

With the recent turbulence in public markets, many private equity investors have expressed concerns about inflated valuations. Movements in the public markets can have both a direct and indirect effect on private equity valuations. First, private equity funds hold some publicly traded shares on their books for a period of time after those portfolio companies have conducted an initial public offering. Second, a decline in public markets impacts the expected earnings multiples of private companies which, in turn, influences their valuations.

In the recent quarter, plummeting valuations in the energy sector spilled over into private equity valuations through both of these channels. With energy indices down dramatically over the past couple of quarters, there has been a material impact on the performance of energy-heavy private equity funds. The IRR for non-energy buyout funds was 9.43% for the past year, whereas energy-focused buyouts lost 26.4%. The aggregate return for all buyout funds was 5.56%.

ABOUT THE GX PRIVATE EQUITY INDEX

Participants in private capital markets need a reliable source of information for performance and analytics. Given the non-public nature of the private equity industry, collecting comprehensive and unbiased data for investment analysis can be difficult. The GX Private Equity Index ("GXPEI") addresses the critical need for accurate and representative insight into private equity performance.

Derived from actual cash flow data of our Limited Partner clients who make commitments to private equity funds, GXPEI is based on one of the most detailed and accurate private equity data sets in the industry today. These cash flows, received as part of our custodial and administrative service offerings, are aggregated to produce quarterly Index results. Because the GXPEI does not depend on voluntary reporting of information, it is less exposed to biases common among other industry indexes. The end result is an index that reflects reliable, consistent and unbiased client data, and a product that provides analytical insight into an otherwise opaque asset class.

- Currently comprises more than 2,400 funds representing more than $2.2 trillion in capital commitments.
- Global daily cash-flow data back to 1980.
- The Index has generated quarterly results since Q3 2004.
- Published approximately 100 days after quarter-end.

Important Legal Information