



## CAMBRIDGE ASSOCIATES LLC

### Cambridge Associates LLC Private Equity and Venture Capital Market Commentary for Quarter Ending June 30, 2009

#### Overview

During the second quarter, private equity and venture capital seemed to weather the continuing recession better than in the recent past, as determined by the Cambridge Associates LLC benchmark indices of the two alternative asset classes. Despite the asset classes' improved performance, private equity and venture capital trailed the public markets in the quarter. Over the long term, however, both asset classes have outperformed the public markets.

The June 30<sup>th</sup> quarter marked the best quarter since the end of 2007 for the **Cambridge Associates LLC U.S. Private Equity Index**<sup>®</sup> and ended the streak of three consecutive negative quarters for the **Cambridge Associates LLC U.S. Venture Capital Index**<sup>®</sup>. While the difficult economy continued to challenge private equity and venture capital investors, the rebound in the public markets and the most active IPO market since the first quarter of 2008 helped maintain and in some cases increase valuations in both asset classes. A sustainable recovery for both asset classes will require a healthier economy and stable public markets.

The Cambridge Associates LLC U.S. Private Equity Index is based on returns data compiled for institutional quality funds that represent nearly two-thirds of the capital raised by private equity partnerships between 1986 and 2009. Based on that data, private equity's performance against indices tracking large- and small-capitalization public equities – the Dow Jones Industrial Average, the Russell 2000 Composite, and the S&P 500 – is shown below:

#### U.S. Private Equity Index Returns (%) for the Periods ending June 30, 2009

For the periods ending	Qtr.	Six Months	1 Year	3 Years	5 Years	10 Years	15 Years	20 Years
<b>June 30, 2009</b>	4.3	1.1	-20.6	0.9	9.9	7.7	11.1	11.4
<b>Other indices at June 30, 2009</b>								
<b>DJIA</b>	12.0	-2.0	-23.0	-6.3	-1.7	-0.4	8.1	9.0
<b>Russell 2000 Composite</b>	20.7	2.6	-25.0	-16.6	-1.7	-2.4	6.5	7.3
<b>S&amp;P 500</b>	15.9	3.2	-26.2	-8.2	-2.2	-2.2	6.9	7.8

Source: Cambridge Associates LLC

The Cambridge Associates LLC U.S. Venture Capital Index<sup>®</sup> is based on returns data compiled for institutional quality funds that represent more than three-fourths of the capital raised by venture capital partnerships between 1981 and 2009. Based on that data, venture capital's performance against indices tracking large- and small-capitalization public equities – the NASDAQ Composite, the Russell 2000 Composite, and the S&P 500 – is shown below:

## U.S. Venture Capital Index Returns (%) for the Periods ending June 30, 2009

For the periods ending	Qtr.	Six Months	1 Year	3 Years	5 Years	10 Years	15 Years	20 Years
<b>June 30, 2009</b>	0.2	-2.6	-17.1	1.3	5.7	14.3	36.3	22.7
<b>Other indices at June 30, 2009</b>								
<b>NASDAQ Composite</b>	20.1	16.4	-20.0	-5.5	-2.2	-3.7	6.6	7.5
<b>Russell 2000 Composite</b>	20.7	2.6	-25.0	-16.6	-1.7	-2.4	6.5	7.3
<b>S&amp;P 500</b>	15.9	3.2	-26.2	-8.2	-2.2	-2.2	6.9	7.8

Source: Cambridge Associates LLC

Note: Because the U.S. Private Equity and Venture Capital indices are capital weighted, the largest vintage years mainly drive the indices' performance.

In the sections below we provide details regarding the indices' performance. Highlights of the second quarter are:

- Other than during the six months and quarter ending June 30, 2009, the private equity and venture capital indices have handily outperformed the public markets.
- For private equity and venture, despite a slower investment pace, contributions continued to outpace distributions.
- Of the five vintage years representing at least 10% of the private equity index, the funds raised in 2007 performed best. Smaller vintage years, such as 1999 and 2001, produced higher returns but had less impact on the index due to their size.
- The top three industries by size in the private equity index—consumer, energy, and healthcare—all produced positive results. Similarly, public indices comprising companies in these three industries rebounded in the second quarter.
- Energy companies attracted the most capital from private equity managers in the index. Financial services and consumer rounded out the top three.
- Venture funds raised in 1999 outperformed all vintage years from 1998 to the present in the second quarter. A number of earlier vintage years earned higher returns than 1999, but they all accounted for less than 1% of the index.
- Healthcare, IT, and software companies, the top three components of the venture index, all earned positive returns in the second quarter. All three sectors performed better in the private equity index than in the venture capital one. In contrast, in the public markets, indices tracking small healthcare and technology companies rose more than their large market counterparts.
- Based on market value at June 30, 2009, public companies represented slightly more than 11% of the private equity index and approximately 10% of the venture one.

### Private Equity Performance Insights

During the second quarter of 2009, despite the recession, most public market indices were up for the first time since the end of 2007. Similarly, the Cambridge Associates LLC U.S. Private Equity Index had its best quarter since the middle of 2007, rising 4.3%. The benchmark's positive return was due in large part to increased valuations for companies in some of the industries hit hardest by the recession, such as retail, financial services, and energy. This quarter, the market-based valuation methodology was one factor helping the private equity index's results.

The index's performance in the second quarter was driven largely by its top five vintage years by size, 2006, 2005, 2004, 2000, and 2007, together 76% of the index's value. Quarterly returns for the top five vintages ranged from the 2000 funds' gain of 2.9% to the 2007 funds' rise of 5.8%. Increased valuations for energy investments led the largest vintage year, 2006, to a quarterly return of 3.1%. The 2005 funds' gain of 4.3% was due to written-up values for energy, financial services, consumer, healthcare, and software companies. Technology companies, the strongest performers for the vintage year 2004 funds, were the worst for the 2000 vintage, which instead earned its return through healthcare, retail, and media. The 2007 funds, the smallest of the top five vintages, saw values increase for their real estate, retail, and financial services investments.

*Seven of the Eight Key Sectors in the PE Index Earned Positive Returns for the Quarter, with Healthcare Outperforming All Other Industry Sectors in PE*

Of the eight sectors that together represent 90% of the index's value, seven earned positive returns in the second quarter; the exception, media, was down only about 0.3%. Each of the top three industries by size—consumer, energy, and healthcare—rose between 3.4% and 4.4%. Together the three sectors represented slightly more than half of benchmark's value, with healthcare performing the best and retail the worst. Retail, financial services, and healthcare collectively contributed the most to the index's return. For the second quarter in a row, industrials, which made up roughly 1.6% of the index's value, lost the most.

*More Capital was Called than in the Prior Quarter but There Was Essentially No Increase in Distributions*

In the second quarter, private equity managers called roughly \$7.4 billion from investors and returned about \$2.5 billion. Compared with the previous quarter, contributions rose by about \$1.1 billion and distributions were roughly equal. Investors in funds raised from 2004 through 2008 contributed more than 90% of the total capital fund managers called – at slightly more than \$2.0 billion, the 2006 funds called the most. The funds launched in 2000 distributed nearly \$734 million to investors, the most during the quarter, and roughly 30% of the total. During the first half of 2009, private equity fund managers invested at a much slower rate than in the previous few years. That said, energy, financial services, and retail companies attracted most of the capital invested.

*Recession Challenged Existing Portfolios and Exits were Limited while New Deals Required More Capital – Conditions that Together Perpetuated the Imbalance between Capital Contributions and Distributions*

Due to robust returns for public equities during the second quarter, the private equity index benefited from the “mark-to-market” valuation methodology for the first time since the policy was adopted. In the short time that the methodology has been in use, the private equity index has moved directionally in concert with the public markets but with less volatility. The benchmark did not drop as much as the public markets when they fell sharply in 2008 and early 2009 and its rebound was not as strong in the second quarter. In the index, valuations were affected most positively for companies in sectors that performed especially well in the public markets, particularly retail, financial services, healthcare, energy, and technology. Media appeared to be an exception as that industry did not fare well in the private equity index but excelled in the public markets.

For the private equity industry, macroeconomic forces, such as unemployment, tight credit markets, decreased consumer spending, and declining property values have challenged the viability of existing portfolio companies, particularly those that are highly levered. And, because credit has not been easily available, private equity fund managers have invested more equity into new deals than they had during

the previous few years. The combination of the need to invest more equity into new deals and the shortage of near-term exit opportunities has contributed to the trend of capital calls outpacing distributions.

Cambridge Associates derives its U.S. private equity benchmarks from the financial information contained in its proprietary database of private equity funds. As of June 30, 2009, the database comprised 787 U.S. buyouts, private equity, energy, growth equity, and mezzanine funds formed from 1986 to 2009, with a value of about \$296 billion. Ten years ago, as of June 30, 1999, the benchmark index included 304 funds whose collective value was nearly \$74 billion.

## **Venture Capital Performance Insights**

The amount of capital calls and distributions in the second quarter virtually mirrored that of the first quarter. As a result, if the second half of 2009 resembles the first half of the year, then both capital calls and distributions could hit levels not seen since 1998, when the venture industry was one-third of the size it is today. In the second quarter, for the first time in a year, more than one venture-backed company went public, while the number of mergers and acquisitions (M&A) was essentially equal to the quarter before.

According to the National Venture Capital Association, there were five initial public offerings (IPOs) and 64 M&A in the second quarter, most involving technology companies. The 13 deals in the second quarter whose values were released to the public were worth \$2.6 billion, comparing favorably with the first quarter's 14 deals that, as reported to the public, were worth \$657 million. The higher valuations for the announced deals in the second quarter were likely due, at least in part, to the up-tick in the public markets.

### *VC Index Sees First Gain Since Mid-2008; Funds from 1999 Vintage Topped All Others*

The Cambridge Associates LLC U.S. Venture Capital Index's 0.2% increase in the quarter ended June 30, 2009, was its first gain, albeit marginal, since the second quarter of 2008. Six vintage years, 1999 through 2001, and 2004 through 2006, accounted for nearly 80% of the index; in the second quarter, the funds raised in 1999 performed best, 3.5%, while the 2001 funds lost the most, 1.5%. The 1999 vintage's performance is largely attributable to increased valuations and realizations in IT and software, while the 2001 funds negative return was due largely to decreased valuations for software, IT, and hardware companies. The largest vintage year in the index, 2000, returned 0.5% for the quarter; bolstered by investments in hardware, healthcare, and software and hurt by electronics and media. The next three vintage years by size, 2004, 2005, and 2006, returned 0.8%, -1.3%, and 1.5%, respectively. The 2004 funds earned gains in healthcare, IT, and software and suffered losses in energy and electronics. For the 2005 funds, losses in energy, manufacturing, and media outweighed gains in healthcare, IT, and consumer companies. Virtually all of the 2006 funds' return was earned through healthcare investments.

As in previous periods, healthcare, information technology, and software represented nearly 75% of the venture index's value. Healthcare, up nearly 3.0% for the quarter, fared the best of the three, followed by software and then IT. All three had positive quarters. Across all sectors in the index, hardware earned the best return and manufacturing the worst.

*Capital Calls and Distributions Were Similar to Those in the Prior Quarter, with Most of the Distributions Flowing from Investments in Technology, Software, and Healthcare*

Capital calls and distributions from venture managers in the second quarter were close to the depressed levels hit in the first quarter. The benchmark's venture capital fund managers called \$2.7 billion from investors and returned about \$950 million, both figures represented only slight increases from the previous quarter. Collectively, the young funds from vintage years 2004 through 2008 plus the 2000 funds called \$2.5 billion (or roughly 92% of the capital called during the quarter). Two thirds, or \$630 million, of the quarter's distributions were made by three vintages, 1999, 2000, and 2006. Most of the capital distributed resulted from technology, software, and healthcare company investments.

*VCs Did Not Benefit as Much as PE from the Q2 Market Rally, and a Shortage of Profitable Exits Continued to be a Problem*

The second quarter proved to be a mixed bag for venture capital funds. While valuations for venture-backed companies benefited modestly from the rebound in the public markets, the difficult economic environment and a sluggish IPO market continued to challenge venture investors in general. The combination of the technology bust at the beginning of the decade and the current recession has caused venture returns to suffer since 2000. For example, as of June 2009, the ten-year return for the venture benchmark stood at 14.3% (shown in the table above) but the nine-year performance drops to -5.2%. Long-term performance, however, remained strong. The recent shortage of exit opportunities has forced many fund managers from "mature" vintages, such as year 2000, to own companies longer or in some scenarios, sell companies at lower than expected values. Long holding periods reduce internal rates of return because of the time value of money and increase the likelihood that interim private company valuations will be affected by the "mark-to-market" valuation methodology.

Cambridge Associates derives its U.S. venture capital benchmarks from the financial information contained in its proprietary database of venture capital funds. As of June 30, 2009, the database comprised 1,281 venture funds formed from 1981 through 2009 with a value of approximately \$85 billion. Ten years ago, as of June 30, 1999, the index included 628 funds whose collective value was slightly more than \$47 billion.

## **About Cambridge Associates and the Indices**

Founded in 1973, Cambridge Associates delivers investment consulting, independent research, and performance monitoring services to approximately 850 institutional investors and private clients worldwide.

Cambridge Associates LLC's proprietary databases provide independent statistics to the institutional investment industry and the National Venture Capital Association (NVCA). The Cambridge Associates LLC U.S. Venture Capital Index<sup>®</sup> is based on returns data compiled for more than three-fourths of institutional quality venture capital assets formed between 1981 and 2009. Similarly, the Cambridge Associates LLC U.S. Private Equity Index<sup>®</sup> is based on returns data compiled for nearly two-thirds of leveraged buyouts, subordinated debt, and special situations partnerships formed between 1986 and 2009. The pooled means represent the net end-to-end rates of return calculated on the aggregate of all cash flows and market values as reported to Cambridge Associates by the funds' general partners in their quarterly and annual audited financial reports. These returns are net of management fees, expenses, and performance fees that take the form of a carried interest.

Both the Cambridge Associates LLC U.S. Venture Capital Index<sup>®</sup> and the Cambridge Associates LLC U.S. Private Equity Index<sup>®</sup> are reported each week in *Barron's* Market Laboratory section. In addition, complete historical data can be found on Standard & Poor's Micropal products and on our website, [www.cambridgeassociates.com](http://www.cambridgeassociates.com).

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