



## CAMBRIDGE ASSOCIATES LLC

### **Cambridge Associates Private Equity and Venture Capital Market Commentary for Quarter Ending December 31, 2006**

During the quarter ending December 31, 2006, the Cambridge Associates LLC U.S. Venture Capital Index<sup>®</sup> rose 9.3%, by far its best quarterly performance since the third quarter of 2000, bringing the benchmark's return for calendar year 2006 to 17.6%. The index's strong showing in 2006 marked its third consecutive year of positive performance and helped it continue to recover from the extended period of losses precipitated by the mid-2000 collapse of the technology sector.

The venture capital funds formed between 1999 and 2001 had the biggest impact on the benchmark's return in 2006 because during the year they represented at least two thirds of the index's value. The year 2000 funds were not the best performers during either the fourth quarter or the year, but they were the most active. In the fourth quarter of 2006 alone, the general partners of the year 2000 funds called and distributed \$927 million and \$1.1 billion, respectively. During the year, the same funds drew down and distributed nearly identical amounts of money to their Limited Partners, approximately \$4.2 billion. Nearly a quarter of the dollars invested in 2006 by the funds launched in 2000 went into new companies, and the balance funded follow-on rounds of financing for existing ones. Such activity could bode well for investors, particularly if enough of the existing fund investments are exited profitably.

The benchmark's large increase in 2006 reflects the widespread success enjoyed by venture-backed health care, technology, and communications companies through initial public offerings (IPOs) and mergers and acquisitions (M&A). The last quarter of 2006 was a busy one as some of the year's largest transactions, for example Google's purchase of YouTube, were closed while the IPO market had its best quarter of the year with 18 companies going public. Unrealized gains from increased portfolio company valuations in the index's largest sectors, communications, health care, and technology, led to speculation that the new fair value measurement methodology, defined by the Financial Accounting Standards Board (FASB) #157 also boosted the quarter's return. However, the immediate effect of the valuation rules changes appears to have been small for 2006 performance, particularly given that most fund managers had not adopted fully compliant valuation policies as of December 2006. Valuations, especially for mature companies within the venture benchmark, are expected to be adjusted over the next 12-to-18 months as managers comply with the new fair value standards.

Overall, health care companies performed the best during the fourth quarter and were the steadiest throughout the year and medical devices, pharmaceuticals and health care services companies at all stages, continue to interest venture investors. Communications and technology companies dominated the funds started between 1998 and 2000, while health care investments represented the largest sector in the funds raised in 2001, 2002 and 2003, as of the end of 2006. As the 2004 funds develop and become fully invested, it appears that the cycle has turned and that communications companies once again attracted the most attention. Issues expected to influence venture investing over the near term include demographics, such as the aging population in the United States and elsewhere, environmental concerns and the growing demand for energy worldwide. The politics involved with global warming already play a role in venture investing, particularly in California where "clean," or environmentally friendly, energy and technology companies are being funded.

As shown in the table below, in the 10- and 15-year periods ending December 31, 2006, the venture capital index produced double-digit returns. While the table includes only one negative return, -0.9% for the seven-year period, that and the lackluster 1.5% return for the five-year period reflect the fallout from the late 1990s investment environment, once described by Alan Greenspan as “irrational exuberance.” Some worry that today’s market is again overheating with too much money chasing too few deals since venture capital fund sizes are on the rise and investment activity is reaching levels not seen since the bubble era. Today’s market, in contrast to its early stage, technology and telecommunications focused counterpart of a decade ago, encompasses a wide selection of strategies, diversified by industry, stage, and regional focus, which could help prevent history from being repeated.

Cambridge Associates derives its venture capital benchmarks from the financial information contained in its proprietary database of venture capital funds; as of December 31, 2006, the database comprised 1,160 venture funds started between 1981 and 2006 and 27,471 transactions with a value of roughly \$76 billion. By way of comparison, in December 1996 the benchmark index included 447 funds and 9,027 transactions whose value was nearly \$24 billion

<b>U.S. Venture Capital Index Returns (%)</b>							
<b>As of December 31, 2006</b>							
<b>Periods Ending December 31, 2006</b>							
<b>4th</b>	<b>1</b>	<b>3</b>	<b>5</b>	<b>7</b>	<b>10</b>	<b>15</b>	
<b>Qtr.</b>	<b>Year</b>	<b>Years</b>	<b>Years</b>	<b>Years</b>	<b>Years</b>	<b>Years</b>	<b>Years</b>
<b>2006</b>	<b>Year</b>	<b>Years</b>	<b>Years</b>	<b>Years</b>	<b>Years</b>	<b>Years</b>	<b>Years</b>
U.S. Venture Capital	9.3	17.6	13.6	1.5	-0.9	37.9	29.8

Source: Cambridge Associates LLC U.S. Venture Capital Index<sup>®</sup>

During the quarter ending December 31, 2006, the Cambridge Associates LLC U.S. Private Equity Index<sup>®</sup> climbed 10.5%, bringing the benchmark’s 2006 return to 25.8%, the fourth successive year it gained 23% or more. Each group of funds formed in the years between 1997 and 2005 represented at least 5% of the index throughout 2006, but roughly half of the benchmark’s value resided in the funds raised in 2000, 2001, and 2004. For the fourth quarter and the year, the 2003 funds earned the industry’s best returns through exits in the manufacturing sector and the rising valuations of consumer companies, particularly food producers and restaurants.

Private equity fund managers maintained a feverish investment pace throughout 2006, with many large public companies and utilities being taken private. In 2006, the 2004 and 2005 funds drew down the largest amount of capital, \$15 billion and \$18 billion, respectively. The 1999 and 2000 funds distributed the most, \$11 billion and \$17 billion, respectively.

In 2006, the general partners of year 2000 funds, much like their venture capital counterparts from the same year, were actively investing in new companies, calling nearly \$6 billion from limited partners. About 70% of the capital drawn down was earmarked for new investments in communications and consumer companies. The private equity industry has grown so large over the past few years that billion dollar deals are considered to be in the mid-market capitalization range, \$10 billion and higher “mega funds” are raised with ease, and few companies, public or private, remain beyond the reach of the private equity funds.

It appears that FASB’s new fair value standard began impacting the private equity index’s return in 2006, likely a result of the large number of companies held in private equity funds that either were previously publicly traded or have a number of comparable, public market competitors. Increases within some of the largest sectors in the index, including consumer, financial services and communications, as well as shifts within smaller sectors, such as energy and technology, seem to reflect the beginning of the move towards marking companies to market where possible as opposed to holding them at cost. Now that they will be tied more closely to the public market, private company valuations are likely to fluctuate more than in the past, particularly through the end of 2008 as managers adjust portfolio company valuations to comply with the new fair value standards.

As noted in the table below, the private equity index returned 25.8% for the one- and three-year periods ending December 31, 2006, 10% higher than the index’s longer-term performance. Recent private equity returns have been fueled by readily available credit, a wide open M&A environment, and record investor interest. The future environment might not be as friendly to private equity investors due to the financial troubles facing some sub-prime lenders and the recent increase in pension fund activism, which could have negative consequences for buyout funds.

Cambridge Associates derives its private equity benchmarks from the financial information contained in its proprietary database of private equity funds; as of December 31, 2006, the database comprised 630 buyout, expansion, restructuring, special situation, sector specialized, and mezzanine funds. Among them there were 8,005 transactions with a value of roughly \$224 billion; ten years ago, the index contained 196 private equity funds and 1,590 transactions whose value was \$25 billion.

<b>U.S. Private Equity Index Returns (%)</b>							
<b>As of December 31, 2006</b>							
<b>Periods Ending December 31, 2006</b>							
<b>4th Qtr.</b>	<b>1</b>	<b>3</b>	<b>5</b>	<b>7</b>	<b>10</b>	<b>15</b>	
<b><u>2006</u></b>	<b><u>Year</u></b>	<b><u>Years</u></b>	<b><u>Years</u></b>	<b><u>Years</u></b>	<b><u>Years</u></b>	<b><u>Years</u></b>	<b><u>Years</u></b>
U.S. Private Equity	10.5	25.8	25.8	17.6	10.8	13.8	15.3

Source: Cambridge Associates LLC U.S. Private Equity Index®

Cambridge Associates LLC's proprietary databases provide independent statistics to the institutional investment industry. The Cambridge Associates LLC U.S. Venture Capital Index is based on returns data compiled on funds representing over 80% of the total dollars raised by U.S. venture capital partnerships formed between 1981 and 2006. Similarly, the Cambridge Associates LLC U.S. Private Equity Index<sup>®</sup> is based on returns data compiled on funds representing over 70% of the total dollars raised by U.S. leveraged buyout, subordinated debt, and special situation partnerships formed between 1986 and 2006. 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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