EUROPEAN
INVESTMENT
FUND

PRIVATE EQUITY MARKET OUTLOOK

Anastasia Di Carlo

Roger Kelly

Working Paper 2010/005
EIF Research & Market Analysis

Authors

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

Roger Kelly is a Research Officer in EIF's Research and Market Analysis team.

Contact: r.kelly@eif.org
Tel.: +352 42 66 88 396

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, May 2010

Abstract

This paper presents a general overview of the European Private Equity (PE) market based on industry activity for 2009 published by the European Venture Capital Association (EVCA) in March 2010 and the latest performance data published by Thomson Reuters as of December 2009.

The paper is organised in three different sections. An introduction on the global market outlook after the financial crisis is followed by an overview of the main trends currently observed in the European PE market. The analysis focuses on two major dimensions: activity figures (fundraising, investments and divestments) and performance figures (rolling investment horizon). Finally, some future perspectives for the industry conclude the paper.

A Private Equity glossary according to EVCA definitions is attached to this paper in Annex 2.

Table of contents

Executive Summary

Global Market Outlook

- Since the previous PE market outlook published in February 2010, there has been something of a pick up in the global macroeconomic outlook. However, it is becoming increasingly clear that the recovery is multi-speed, with a more rapid rebound in emerging economies, compensating relative sluggishness in Europe.
- The health of the global financial system has improved since the latest Global Financial Stability Report (GFSR) published by the International Monetary Fund (IMF) in October 2009. However, risks remain elevated due to the still-fragile nature of the recovery and the ongoing repair of banks' balance sheets.
- In contrast, due to a reduced ability of markets to sustain high leverage, sovereign credit risk premia have more recently widened across mature economies. The management of sovereign credit and financing risks therefore may carry important consequences for financial stability in the period ahead.

European Private Equity Market Outlook

- Private Equity's "golden age" of low interest rates, abundant leverage, mega-deal making and "effortless" returns is over, and will most likely not soon return.
- Economic uncertainty and debt markets' conditions constrained deal making.
- Many PE firms readjusted their investment focus favouring carve-outs, growth equity, acquisition finance, balance-sheet restructurings and distressed debt investments in line with the opportunities that originated during 2009 as a result of the crisis.
- During the crisis, fundraising declined across all major PE asset classes. However, since the end of 2009 it has started to improve, although it will probably remain weak across Europe in the short term.
- PE investments sank to a level not seen since the last downturn; all regions and industry sectors suffered. However, a new increase in the last quarter of 2009 can be observed.
- The downturn forced significant write downs in portfolio valuations, causing PE returns to decline sharply. However, since the second half of 2009, PE returns have started to improve again.
- Still, PE funds continued to outperform all major stock market indexes.

1. Global Market Outlook

Since the previous PE market outlook published in February 2010, there has been something of a pick up in global activity. In its March 2010 report, the Economist Intelligence Unit (EIU 2010) forecast that global GDP will grow by 2.8% at market exchange rates, a slight improvement on its previous forecast of 2.7%, with a slight slowdown to 2.4% foreseen for 2011. Forecasts from the IMF (IMF 2010a), OECD (OECD 2010), and ECB (ECB 2010) corroborate this view. However, it is becoming increasingly clear that the market is facing a multi-speed recovery, with the global picture being driven by a more rapid rebound in emerging economies, compensating relative sluggishness in Europe. GDP growth in the EU 15 is forecast to reach just 0.8% in 2010 and only slightly higher, 1.1%, in 2011. The global crisis had a particularly severe impact on Eastern Europe, which was hit harder than any other emerging-market region. From achieving GDP growth averaging over 5% in the 5 years to 2008, in 2009 the region saw its GDP contract –by 6.1%, more than at any time since the height of the transition recession in 1994. A relatively modest recovery is forecast for Eastern Europe, with the EIU forecasting growth of 2.6% in 2010, increasing to 3.8% in 2011. Fears exist that the crisis will have a longer-lasting impact on growth prospects, with most countries in the region still facing fundamental reform challenges. The EIU expects real GDP growth in the US to be in line with the global forecast, at around 2.8% in 2010 (compared with 2.5% previously), but with a slowdown to 1.6% in 2011 (1.4% previously).

There is a universal view that the growth that has been experienced in advanced countries in recent months has arisen principally due to the following factors:

- Accommodative macroeconomic policies - fiscal stimulus, and an expansionary monetary policy;
- Extraordinary measures adopted to restore the functioning of the banking system;
- A turnaround in the inventory cycle[1].

However, the above factors are temporary phenomena. Fiscal stimulus will have to be wound down soon in the face of a sharp increase in government indebtedness in order to prevent the risk of upsetting debt sustainability (see below). Despite inflation remaining relatively subdued, thanks to negative output gaps in most advanced countries, central banks are beginning to tighten

[1] The inventory cycle played a significant part in exacerbating the slowdown, as companies responded to the slowdown by slashing production and meeting demand by running down stocks, but recently has provided a strong boost for short term growth as companies increase production both to meet demand and to restore depleted inventories. For example, according to the EIU, restocking accounted for 3.8 percentage points of the 5.6% annualised growth in the US in Q4 2009.

monetary policy by withdrawing the extraordinary liquidity measures that had been injected. And support to growth from the inventory cycle will soon become less significant as stock levels return to pre-crisis levels.

Whether other sources of demand are sufficient to compensate, and prevent renewed weakness, remains to be seen. It is certainly true that recovery in emerging economies has resulted in increased demand in these countries in recent months, and there is some evidence that advanced countries are feeling the benefit of this growth through improving trade linkages. However, the scope for the private sectors in many advanced economies to step in and replace public demand is limited while household and financial sector balance sheets remain weak, which will continue to be the case for as long as credit growth remains sluggish and labour markets remain slack. As a consequence, the recovery is likely to be a slow process in advanced economies.

Rebalancing the global economy is critical for sustaining growth in the medium term. The enforced narrowing of imbalances witnessed during the crisis seems to be reversing. Within Europe, it is important that the group of debtor countries, including Spain, Portugal and Greece, bring down their external deficits, and the group of creditor countries such as Germany and the Netherlands boost domestic demand, to compensate for falling demand from the former group.

The IMF notes that expansionary fiscal policy has pushed fiscal deficits in advanced countries to around 9% of GDP, which, based on current policies, will push debt in excess of 100% of GDP by 2014, from 65% before the crisis. This issue is particularly acute in a number of southern European countries, and has contributed to a spike in sovereign risk premia. There is a risk that concerns about sovereign liquidity and solvency could result in a contagious sovereign debt crisis; the gravity of this risk can be evinced from the size of the rescue package provided to Greece by the IMF and the EU: this was equivalent to almost half the GDP of a country that accounts for less than 3% of Euro zone GDP.

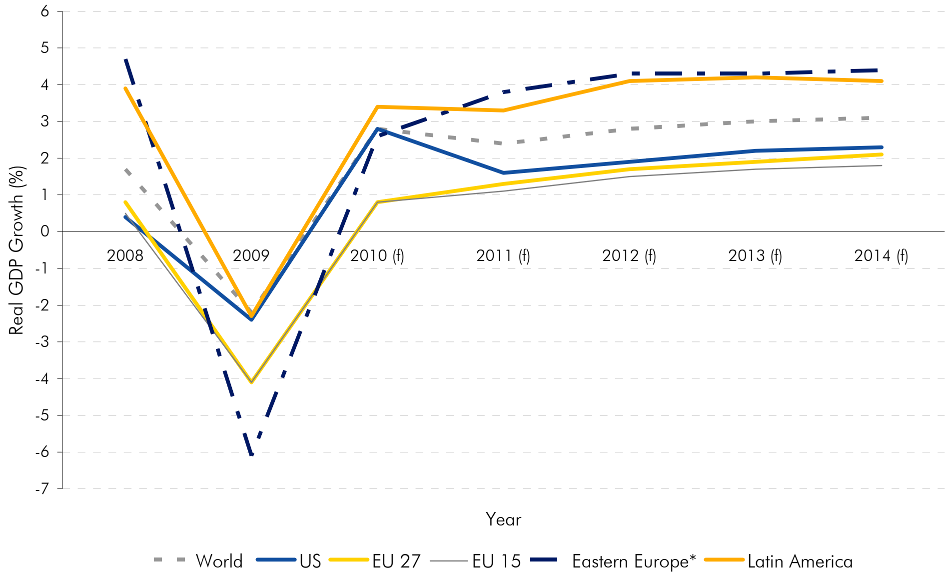
Although the Greek rescue package should address the country's liquidity issues, namely the imminent requirement to refinance a substantial proportion of the country's sovereign debt, it did not seem to have convinced investors, as witnessed by a sharp rise in yields on short term Greek bonds, and pressure on other Euro members such as Portugal and Ireland. This led to the introduction by the IMF and the EU of a more general EUR 750bn emergency rescue package comprising government-backed loan guarantees and a commitment to buy European sovereign bonds. The aim is to address financial market tensions arising due to concerns over public finances, in essence to ensure there is sufficient liquidity to defend the Euro against speculative attack. The condition that recipients pursue a strict IMF-monitored fiscal adjustment and structural reform programme should help address the solvency issue, although will clearly delay the recovery. Key to such a structural reform programme will be measures to address the underlying issue of competitiveness, which has diminished heavily in Southern European countries compared to other Euro zone countries, in particular Germany, due to rigidities in labour, product and service markets.

Table 1: Real GDP Growth (in %)

Area	2008	2009	2010 (f)	2011 (f)	2012 (f)	2013 (f)	2014 (f)
World	1.7	-2.2	2.8	2.4	2.8	3	3.1
US	0.4	-2.4	2.8	1.6	1.9	2.2	2.3
EU 27	0.8	-4.1	0.8	1.3	1.7	1.9	2.1
EU 15	0.5	-4.1	0.8	1.1	1.5	1.7	1.8
Eastern Europe*	4.7	-6.1	2.6	3.8	4.3	4.3	4.4
Latin America	3.9	-2.3	3.4	3.3	4.1	4.2	4.1

Source: EIU, EU forecasts as of March 2010.
*Bulgaria, Croatia, Romania, Serbia, the eight new EU members in East Central Europe and the Baltics, Russia, Kazakhstan, Ukraine, Azerbaijan.

Figure 1: Evolution of Real GDP Growth (in %) from 2008 to 2014 (f)



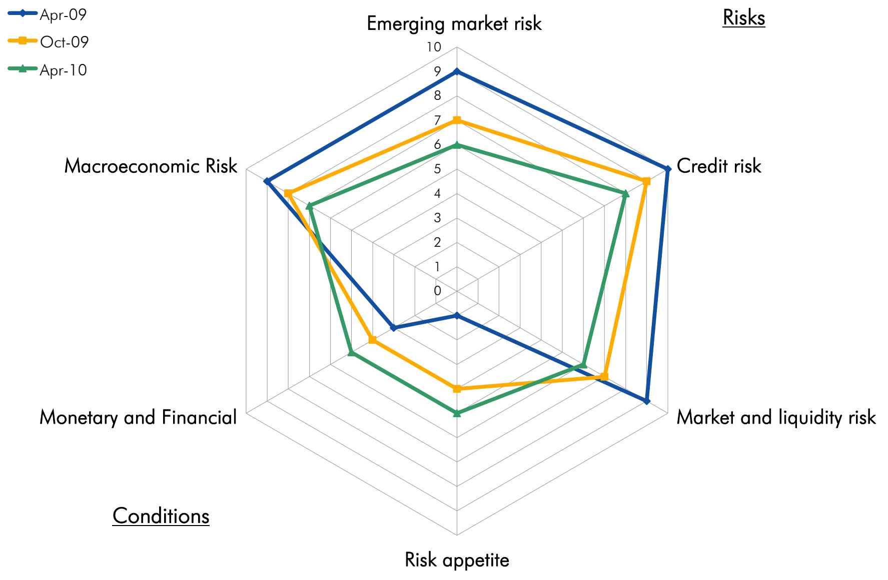
Source: EIU, EU forecasts as of March 2010.

The IMF Global Financial Stability Map (IMF 2010b) illustrates the situation of the stability of global financial markets as of April 2010 and its evolution since April 2009 (see Figure 2). 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).

The health of the global financial system has improved since the latest Global Financial Stability Report (GFSR) published in October 2009. However, risks remain elevated due to the still-fragile nature of the recovery and the ongoing repair of balance sheets. In particular, macroeconomic risk has progressively reduced as the economic recovery continues, thanks to policy stimulus and improvements in investor confidence. Still, the recovery is expected to be multi-speed and fragile, with many advanced economies recovering more slowly than emerging markets and currently facing structural challenges. The improving growth outlook has reduced dangers of deflation, while inflation expectations remain contained as output gaps remain large in many advanced economies.

In contrast, the need to address the consequences of the credit bubble has led to sharply higher sovereign risks. Due to a reduced ability of markets to sustain leverage, sovereign credit risk premia have more recently widened across mature economies. The management of sovereign credit and financing risks therefore carries important consequences for financial stability in the period ahead. Quantitative and credit-easing policies, extraordinary liquidity measures, and government guaranteed funding programs have helped improve the functioning of short-term money markets and allowed a tentative recovery in some securitization markets. As a result, monetary and financial conditions have eased further, as market-based indicators of financial conditions largely reversed the sharp tightening seen earlier in the crisis. This has been accompanied by a decline in market and liquidity risks as asset prices have continued to recover across various asset classes.

Figure 2: IMF Global Financial Stability Map[2]

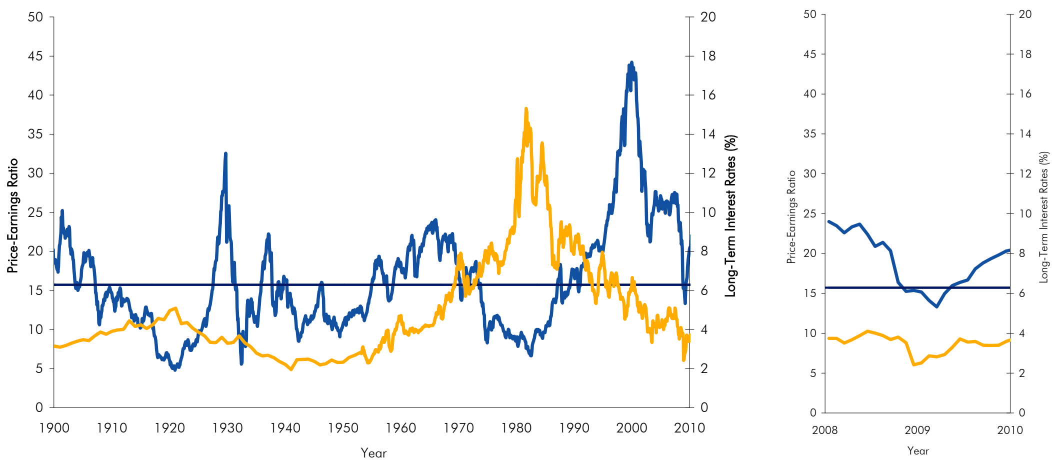


Source: IMF (2009 and 2010).

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

Figure 3 illustrates the historic and recent evolution in the price/earning ratio collected by Robert Shiller. This measure shows extreme overvaluation in 1929 and 2000, before great market crashes, and extreme under valuations at the beginning of long bull market periods as in 1932 and 1982. However, the recent evolution of the ratio since 2008 suggests that last year valuations in public equity markets were never nearly as undervalued as they have been at the previous great bear market lows. Therefore, it may be inferred that stocks remained somehow overpriced and never became as cheap as they had been expected during last year's crisis. Indeed, the ratio is again above its historical average. As already anticipated in the previous PE market outlook, this could be explained also by 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.

Figure 3: Real Price/Earning ratio-LT interest rates



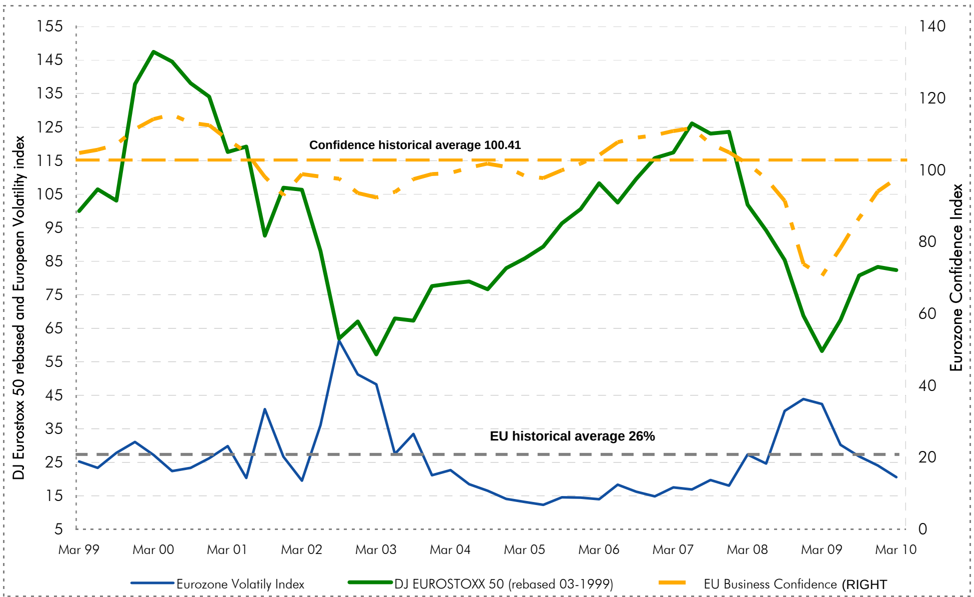
Source: http://www.econ.yale.edu/~shiller/data.htm. Last data as of April 2010.

The latest trend of public market indices has been positive since its lowest level in March 2009, (see Figure 4). Indeed, stock markets have continued to recover from 2008 losses and volatilities and confidence indexes are back to their historical average (see Figure 5). However, the outlook in the very short-term is still uncertain and it is difficult to draw conclusions on the future trend of the market.

Figure 4: MSCI EU Small Caps index

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

Figure 5: DJ EUROSTOXX 50 and Euro zone Volatility index vs. EU Confidence index



Source: Bloomberg.

2. European Private Equity Market Outlook

From the previous section, it is clear that the macroeconomic picture going forward is far from certain, and markets are likely to remain volatile for some time. This of course has had, and will continue to have, an impact on PE activity. In this section we will first take a retrospective view of activity and performance over 2009, and then provide some perspectives for the future months.

2.1 Market Activity

Fundraising

As foreseen by the EIF in a previous working paper (Di Carlo, 2010), the expected dramatic plunge in the fundraising activity finally materialized. According to EVCA, total funds raised in 2009 amounted to EUR 13bn, down 84% from 2008's figure of EUR 82bn (Figure 6). In fact, 2009's fundraising figure is equivalent to only approximately 75% of the two largest funds raised in 2008. Buyout funds were particularly hard hit by the dry up in commitments, with amounts raised declining by 86% and numbers of funds raised declining by 77%. As regards average fund size, this has fallen for buyout, growth and mezzanine funds that reached final closing last year, but this fall in the average is clearly driven by funds of more than EUR 1bn; if these are removed the average size is then in line with the one of funds closed in the previous two years. VC funds on the other hand did not witness the same plunge as the buyout segment, but they were already at very low levels of activity last year.

In terms of sources of capital, there has been a move away from pension funds, which provided around 28% of capital in 2008 and last year provided only 11%. This could be due to the well-documented denominator effect, in which pension funds (and certain other institutional investors) found their portfolios relatively overweight with PE as markets fell, and responded by cutting back their new commitments in 2009.

Banks, funds-of-funds and government agencies have all seen their relative shares of the total increase; indeed, in 2009 banks were the largest single category of providers of funds, providing 18.6% of the total. The countercyclical role played by government agencies is also apparent. The share of government agencies in the total funds raised in 2009 was 11%, and for VC it was 18%. This, in fact, amounts to 30% of the VC funds raised from identifiable sources (i.e. excluding funds raised from 'other' sources).

Investments

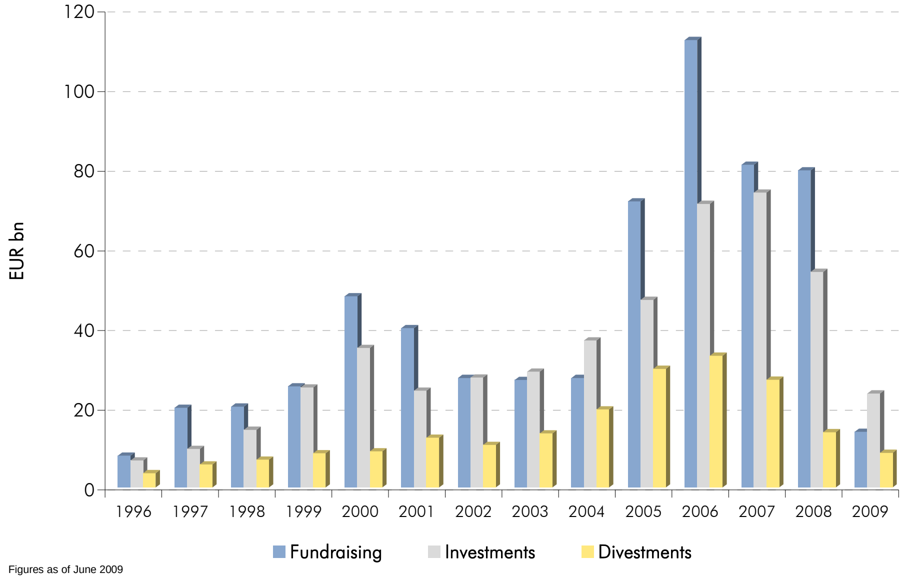
Preliminary statistics from EVCA (EVCA 2010) indicate that total investment activity in Europe during 2009 amounted to EUR 21bn, down 61% on 2008, and representing just 29% of investment activity by value in 2007 (Figure 6). Interestingly, the number of companies benefiting from PE financing declined by only 17% compared to 2007, corroborating the evidence that the decline has been driven by a sharp fall (24%) in large buyout investments, in terms of both size and number. This is not a PE-specific issue, in fact it is part of a more generalised trend; M&As by value were only around half what they were in 2008. The fall in large buyout investments has been offset by a 23% increase in the number of growth capital investments; venture capital deals remained relatively stable.

Another unsurprising yet significant trend according to the EVCA data has been the role of PE in rescuing distressed companies: although remaining a small proportion of the total, rescue/turnaround investments increased by over 150% in 2009 reflecting increased opportunities on the supply side. EVCA also reports a sharp increase in follow-on investments: approximately half of the 4,000 companies financed during 2009, both by number and amount, were follow-on investments aimed at sustaining active portfolio companies. Unsurprisingly, the amount of leverage used in investments remained low in 2009; this year was the first time that average equity contributions increased to in excess of 50%. This, in part, reflects the difficulty in obtaining finance, which not only limits leverage, but also has undoubtedly played a part in the change in the profile of investments away from large buyout, which tend to be the most highly leveraged transactions.

Divestments

Overall, divestments declined by 29% in 2009 compared to 2008 (Figure 6), although EVCA's quarterly statistics indicate that the exit market may have become more accommodating by Q4, with a notable rise in trade sales in this period. According to EVCA, M&A and IPO activity picked up moderately at the end of 2009 with a number of PE portfolio companies being prepared for an IPO. The most common form of exit in 2009 was by write-off, increasing from EUR 870m in 2008 to EUR 3.2bn in 2009, and amounted to 33% of exits. After write-offs, trade sales remained the most common exit route throughout the year. Secondary transactions, which had accounted for 28% of exits in 2008, only accounted for 9% in 2009; this decline is unsurprising as many funds have been starved of liquidity and were not in a position to undertake new investments, despite the inevitable need of some funds to liquidate investments.

Figure 6: Yearly evolution of European PE activity by amount (EUR bn)



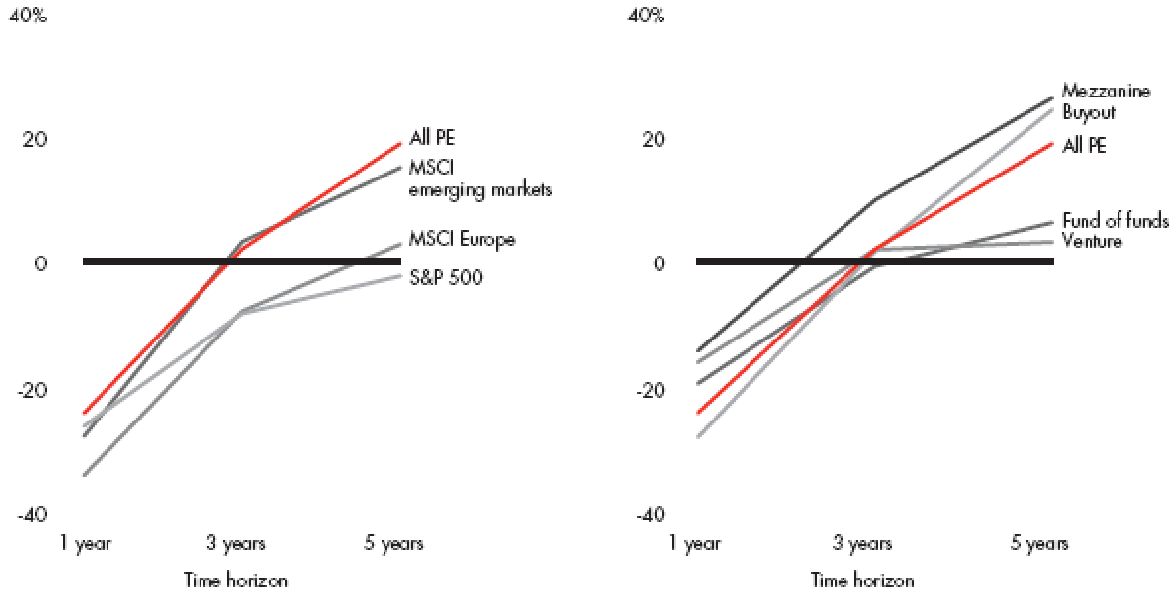
Source: EVCA (2009 and 2010).

2.2 Performance Figures

PE fund returns were severely affected by the downturn, as reported by the EIF (Di Carlo, 2010). By late 2008, the one-year returns on global PE funds were in steep decline and reached negative territory in early 2009. Funds of every type generated losses, in contrast to the previous recession, when mezzanine funds and real estate continued to show gains. Within the buyout fund category, small buyouts are the sub segment that better resisted the crisis. The 3-year horizon IRR for both the buyout and the VC segment further deteriorated from June to December 2009, falling from 0.1% to -3.9% for buyout and from -1.6% to -3.1% for venture. However, as observed in EIF portfolio, PE returns have started to improve since the second half of 2009.

As Figure 7 (from Bain (2010), and based on actual returns, not adjusted for risk or leverage) shows, despite the macroeconomic volatility witnessed in 2009, PE continued to outperform public stock market indices over all time horizons and, unlike many market comparators, had positive IRRs over the 3 and 5 year horizon. Clearly, as indicated by the figure, this overall trend conceals large differences between the performances of different types of fund; the performance differential between venture and buyout remains significant.

Figure 7: PE performance vs. public indices and performance by fund type (horizon pooled IRR to Q2 2009)



Source: Prequin, Bloomberg.

At this point it is important to bear in mind that PE is by definition an illiquid asset class, designed to be held until maturity. Therefore, quarterly valuations and one year IRRs are of little interest as a performance benchmark. It is more instructive to look at what is happening to IRRs over a medium and long term time horizon. Looking at the 10 year investment horizon return, the buyout sector remains attractive, delivering an IRR of 8.0%, far outperforming venture which reports a 10 year IRR of -1.8% (Table 2). Clearly, the latter is affected by the dot.com bust of 2001, the impact of which becomes clear, if one looks at the 5 year venture IRR of 0.7%.

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

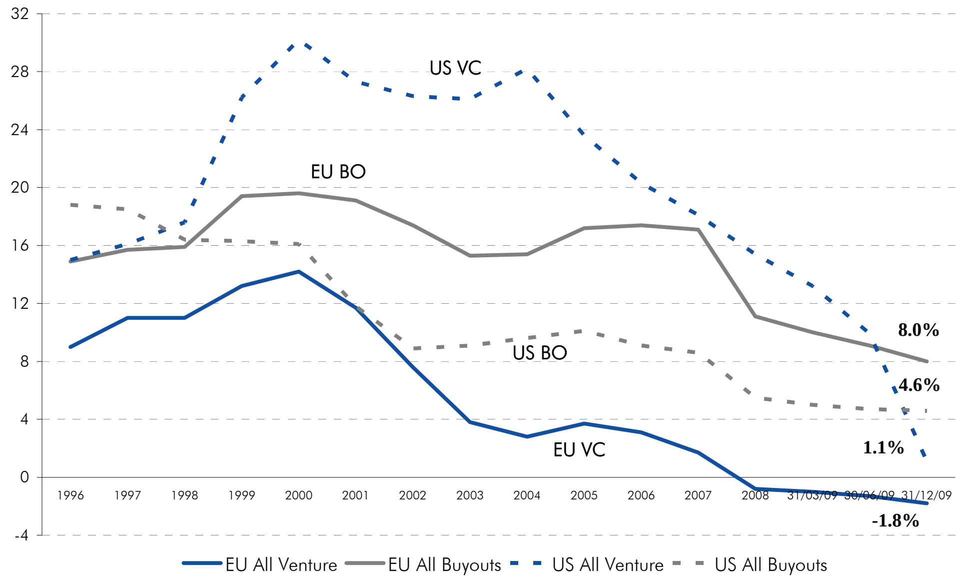
	3-Year			10-Year			20-Year		
Stage	Dec-09	Jun-09	Dec-08	Dec-09	Jun-09	Dec-08	Dec-09	Jun-09	Dec-08
Early Stage	-4.7	-3.4	-3.2	-3.5	-3.1	-2.8	-1.3	-1.3	-1.4
Balanced	-3.0	0.2	0.9	-1.4	-0.1	0.3	2.1	2.4	2.6
Development	0.7	-0.1	0.3	1.4	1.5	2.8	6.7	6.7	7.0
All Venture	-3.1	-1.6	-1.3	-1.8	-1.2	-0.7	1.6	1.7	1.9
Small Buyouts	4.1	8.1	9.3	8.0	9.1	10.4	12.6	12.7	12.8
Medium Buyouts	-2.7	3.8	8.5	6.5	9.5	14.5	12.2	14.1	15.0
Large Buyouts	-0.2	7.1	8.7	8.8	13.3	19.4	18.7	19.0	19.5
Mega Buyouts	-5.7	-2.8	0.2	8.1	7.5	8.8	8.4	7.6	8.7
All Buyouts	-3.9	0.1	3.2	8.0	8.9	11.1	11.4	11.6	12.4
All Private Equity	-3.9	-0.4	2.3	5.2	6.1	7.9	8.9	8.9	9.4

Source: ThomsonOne Reuters database[3].

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

The US VC market has not been immune to the effects of the crisis, as evidenced by the sudden plunge of the US VC returns (Figure 8), for which the 10 year IRR fell from 9.9% in June 2009 to 1.1% in December 2009. This decline is significantly steeper than the corresponding 0.5% decline experienced in the EU VC market. The EU continues to outperform the US market with regards to the buyout segment although with a progressively reduced gap of +3.4% (vs. +6.5% in 2008).

Figure 8: US and European PE Performance-10-year horizon IRR (in %)



Source: ThomsonOne Reuters database.

3. Future Perspectives

As we saw in the previous section, the uncertain macroeconomic environment in recent years meant that, in 2009, PE investors' focus was devoted to consolidating their existing portfolios. The number of investments made declined, but by significantly less than the decline in their total value, indicating a move towards the lower end of the market. Divestments have fallen, with an increasing proportion of exits being in the form of write-offs.

Fundraising has been hit, with some investors suffering from over-allocation to PE as noted above, and liquidity issues, but with European-focused buyout funds reportedly holding over USD 160bn of dry powder (Preqin 2010), this should not impede investment activity too much going forward. As regards performance, despite the difficulties experienced, PE remains a solid investment, outperforming other markets over the long-term.

As section 1 indicated, while the global economic situation appears to be improving, there is a lot of volatility in Europe as macroeconomic excesses of the past work their way through the system. This gives rise to the question of how this uncertain situation will be reflected in the recovery experienced by the industry. In its Global Private Equity Report 2010, Bain and Co. compare the impact of previous recessions and recoveries on the PE industry. They note that following the 2001 recession, the PE industry experienced a robust rebound, quickly coming back to life, while after the slump of the early 1990s PE markets suffered for years before returning to average market levels. It is unclear which of these paths the PE market will take at the present juncture; no two recessions are ever the same. What is certainly clear is that the destiny of the PE industry is intimately linked to developments in the macroeconomic environment (EIF 2010a) so until this is clearer, activity will remain subdued.

What we can say with some certainty is that it is unlikely that the heavily leveraged mega deals of 2006/7 will be back in the near future. Access to finance remains difficult, although improving, but the increased threat of regulation, in particular the Alternative Investment Fund Managers (AIFM) Directive, is likely to have a sobering impact on the industry in the future. Thus the changes in capital structure that have characterised deals in recent months are likely to prevail. Over the past two years the industry has returned to its roots, focusing on nurturing the companies in its portfolios, and adding real value. The trend towards the mid-market looks set to continue.

The difficulties faced by GPs at the present time are helping to change the balance of power between GPs and LPs. Having for a long time been captive to GPs, LPs are now making their voice heard. A call for greater transparency, improved contract terms and more generous profit sharing from the Institutional Limited Partners Association (ILPA), a network of institutional investors, was taken more seriously than similar attempts of the past. One area in which they may meet with some success is on the question of fees: according to Preqin (Preqin 2010b), the average management fee at buyout firms trying to raise capital fell by 20bps to just over 1.8% between 2008 and 2009. And LPs have had success in negotiating a cut of deal fees, i.e. the fees GPs charge companies they own for completing transactions and advising, with an 80-20 split now the norm (The Economist, 2010). With the emergence from the difficult environment of the past couple of years, it is likely that the actors in the PE marketplace will find themselves operating on a much more level playing field.

Annex 1: 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 Corporation
- IFI: International Financial Institution
- IMF: International Monetary Fund
- IRR: Internal Rate of Return
- LMM: Lower Mid Market
- LP: Limited Partner
- M&As: Mergers and acquisitions
- 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 2: 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 addition to the repayment of their initial commitment, before fund managers become entitled to carried interest payments from 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 deal this 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 (i.e. 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

- Bain (2010). Global Private Equity Report 2010. Bain and Company.
- Economist Intelligence Unit (2010). Country Forecast. Economies in Transition. Eastern Europe and the former Soviet Union. March 2010.
- Conforti, A. (2010). Private Equity and Venture Capital indicators. A research of EU-27 Private Equity and Venture Capital Markets. *EIF Working Paper 2010/004*.
- Di Carlo, A. (2010). The Private Equity Market in Europe: Rise of a New Cycle or Tail of the Recession? *EIF Working Paper 2010/003.*
- European Central Bank (2010). Monthly Bulletin. April 2010
- EVCA (2009). 2009 EVCA Yearbook.
- EVCA (2010). European Private Equity Market - preliminary data www.evca.eu
- IMF (2009). Global Financial Stability Report. April 2009.
- IMF (2010a). World Economic Outlook. April 2010.
- IMF (2010b). Global Financial Stability Report. April 2010
- OECD (2010). What is the Economic Outlook for OECD Countries?, speech by Pier Carlo Padoan, 07 April 2010.
- Preqin (2010a). www.preqin.com/blog/101/2190/buyout-dry-powder.
- Preqin (2010b). Private Inequity. Cit in *The Economist*. 08 May 2010.
- The Economist (2010).Private Inequity. 08 May 2010.

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 2009, EIF had invested in more than 300 VC and growth funds with net commitments of over EUR 4.1bn. At the same date, the EIF net guarantee portfolio amounted to over EUR 13.6bn in over 160 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? February 2010.
2010/004	Private Equity and Venture Capital Indicators - A Research of EU-27 Private Equity and Venture Capital Markets. April 2010.
2010/005	Private Equity Market Outlook. May 2010.