

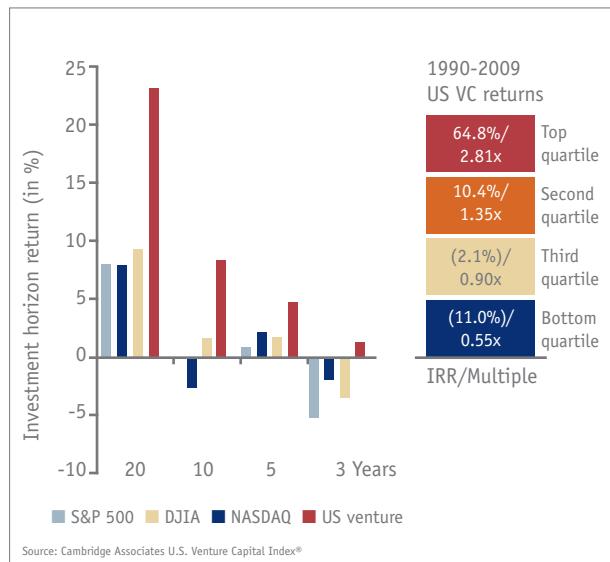


Key commentary

United States venture capital performance continues to compare favorably with other equity classes.

Returns have consistently outperformed the Dow Jones Industrial Average, NASDAQ and S&P 500 total return indices over three-, five-, 10- and 20-year investment horizons since 1981, according to the Cambridge Associates US Venture Capital Index. The US' return to growth in the third quarter of 2009 makes the time ripe for both investments and exits. Low prices support investments, while higher stock markets and high cash positions among public companies will ultimately spur exit activity. Furthermore, there are new strategies emerging that make a closer look worthwhile.

By Spencer Punter
Director, Investment Management



In-depth – US venture capital, an oasis of opportunity

Productivity growth in the world's largest economy continues to be above trend despite the challenging economic backdrop. This is partly due to innovation, which, buoyed by a strong academic atmosphere encouraging entrepreneurship, technology transfer and a fertile investment environment, continues to thrive. Further, the transition from academia and large corporations to start-ups is encouraged by immediate access to sales, legal, accounting, and other professionals experienced with high-growth start-ups, and ready access to expansion capital from venture capitalists. Innovation is further supported by a stable, entrepreneur- and investor-friendly corporate legal structure in the US.

Health care, cleantech and social media are poised to deliver attractive investment opportunities

Three areas warrant a closer look: cleantech – spanning a spectrum of new industries designed to increase productivity and efficiency while reducing operating costs, energy consumption and pollution; healthcare and biotech – established sectors begging for a fresh look; and social media – becoming more than just a friendly forum.

Cleantech's rapid growth and attractive performance prompted the creation of a cleantech public equity index in 2006. In 2008, global investments in cleantech companies spiked 38% to USD 8.4 billion from 2007, representing 567 deals and the seventh straight

year of increases. Despite the economic downturn, preliminary figures for 2009 deals are at 557, with an investment value of USD 5.6 billion.

Government funding is set to accelerate, spurred by two new initiatives. The first is the American Recovery and Reinvestment Act of 2009. Passed last February, the act is intended to jumpstart economic activity through tax cuts and direct federal investment in the domestic renewable energy industry, among other things, according to government website recovery.gov.

Over the next 10 years, the Federal government has committed up to USD 16.8 billion on renewable energy and energy efficiency programs alone. Especially pertinent for venture capitalists are the USD 2.5 billion earmarked for research and development, demonstration and deployment projects, according to the American Council on Renewable Energy.

This is further supported by the American Clean Energy and Security Act of 2009, passed by the House of Representatives last July and now before the Senate, which sets incentives for dramatic advances in energy efficiency and pollution reduction. It includes USD 90 billion in energy efficiency and renewable energy technology incentives, and a USD 60 billion incentive for carbon capture and sequestration technology – ensuring available funding for cleantech entrepreneurs.

In-depth – continued

Evolving consumer awareness and technology advances that reduce substitution costs have also altered consumption behavior, with consumers opting for cleantech and energy efficient products. Higher oil and gas prices have led to both higher consumer and investor interest in alternative fuels and technologies that address efficiency, such as improved batteries for hybrid vehicles. As demand for cleantech products and services grows, opportunities for venture capital managers grow in tandem.

Companies providing cost-curbing and energy-reducing technologies are well positioned to generate value

Health care and biotech spending are also tipped for growth, driven by three demographic trends: longer life expectancy, population growth and an ageing population in the US (76 million American baby boomers will start to turn 65 in 2011) and around the globe.

The US spends more on health care as a share of gross domestic product (GDP) than any other industrialized nation. According to Plunkett Research Ltd., expenditures have increased along with average ages for five decades. In 2009, health care spending landed at approximately 17.6% of GDP, or about USD 2.50 trillion, up from USD 2.39 trillion in 2008. Plunkett forecasts spending will reach approximately 20.3% of GDP by 2018.

Demographic trends are compounded by health care costs, accelerating “at rates far exceeding the rate of inflation in general,” according to Plunkett. Any company that can slow these costs will generate value for investors, which creates opportunities for venture investing. Plunkett also said “we are now entering what will long be remembered as the beginning of the Biotech Era. Breakthroughs in research for drug therapies are occurring at a rapid pace, creating financial and ethical challenges along with opportunities.”

Social networking is emerging as an important IT and consumer internet subsector. Facebook in particular, with its 400 million active users – 50% of whom return to the site on any given day, according to the company’s factsheet – has the potential to evolve from a social forum into a preferred online platform.

Since its debut in 2004, Facebook has grown to rival Yahoo!’s nearly 100 million daily users. With Facebook users averaging almost an hour on the site each day, it is an attractive location for social gaming companies like Zynga to offer their applications. Zynga’s FarmVille® – launched last June – is Facebook’s largest social game with over 65 million virtual farmers, 26 mil-

lion of whom play every day, according to a November company press release. In October, the *New York Times* reported Zynga’s Mafia Wars and Café World games are Facebook’s second and third most popular social games.

Facebook, itself launched with the aid of venture capital backing and generating around USD 500 million in 2009 annual revenues according to sources close to the company’s financial holders, and other social networking media are ripe for new applications developed by venture-backed companies like Zynga.

Conclusion

The US venture capital market presents an attractive alternative investment in a global market still finding its footing following unprecedented unrest, especially as venture investments don’t require debt financing.

Cleantech, healthcare and biotech, and social media are branding themselves as growth sectors thanks to growing markets and an interesting stream of innovations in the US and across the globe.

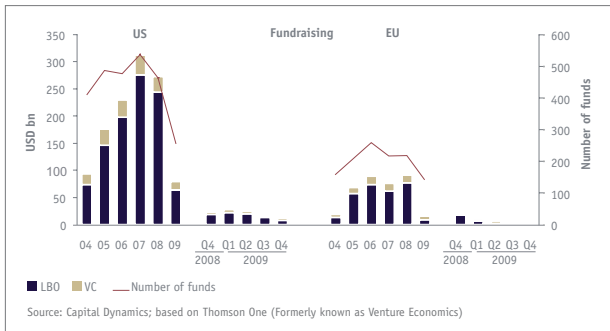
The best-performing venture capital funds were able to exit successfully, irrespective of economic cycles. For instance, since 1981, the top 25% of all venture capital funds have returned an average of 60% of all venture capital distributions. Since 1990, the average US venture performance has been high due to extremely well-performing top quartile funds producing a pooled internal rate of return (IRR) averaging 64.8% and total values at 2.81 times of paid-in capital.

Those figures support that access to top managers is a driving component of long-term investment performance. The caveat is that top-tier venture funds are often access constrained, and typically don’t accept new investors. So for most, access can only be gained via specialists in the field who have long-standing relationships with top-tier fund managers.

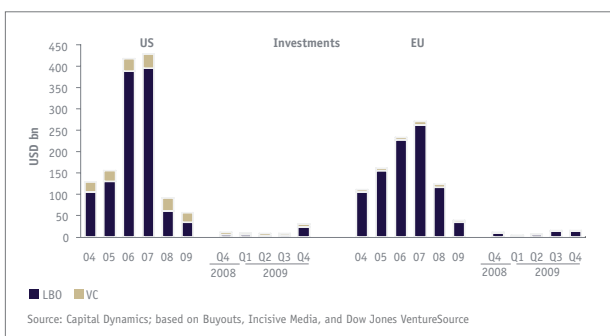
Investing with top managers has been an important source of long-term investment performance in the venture space

We believe this outperformance can continue. Moreover, entry valuations are declining across investment stages. From the end of 2008 through the third quarter of 2009, median second-round entry valuations decreased to USD 15.3 million from USD 19.5 million, while median later stage valuations decreased to USD 35.7 million from USD 54.5 million during the same period.

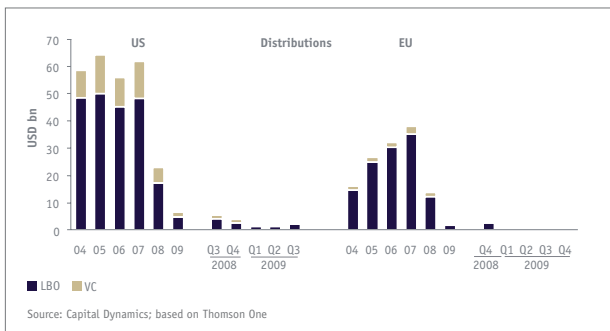
Key market figures



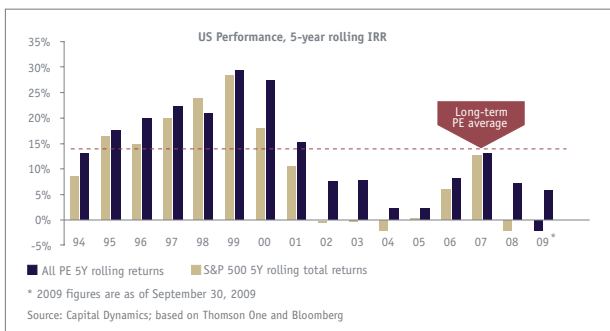
Fundraising activity continued to decline throughout 2009, with the fourth quarter the quietest fundraising quarter in the US since 2004. However, annual volumes still exceeded levels recorded during the previous recession. Large buyouts suffered the most, while the decline in VC fundraising was not as dramatic. Fundraising is expected to increase in 2010. However, most managers will continue to require longer than average to raise funds, and to reduce target fund sizes from predecessor funds.



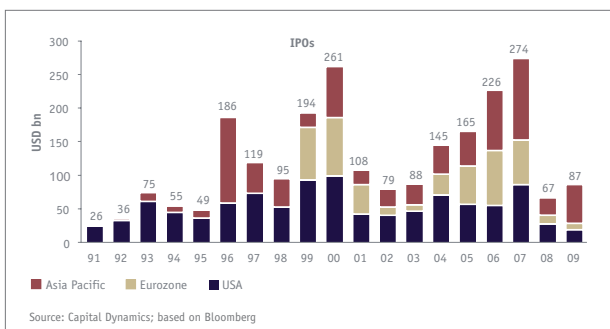
VC investment levels were down by a third from 2008, as managers refrained from granting further financing rounds to companies failing the test of an economic downturn. Buyout investments in 2009 tracked significantly lower than 2008 volumes, especially in Europe. However, they trended up in the second half, with a number of mega deals – absent in the first half – closed. Continued capital constraints of corporate sellers narrowed the gap in pricing expectations, leading to a number of solid investment opportunities for private equity funds.



Distributions to investors reached historic lows in 2009, as the IPO market and M&A activity remained weak for most of the year. However, US private equity fund distributions increased in the last two quarters, supported by the opening IPO market. Substantial portions of IPO proceeds, however, were used by sponsors to deleverage the IPO companies. We believe that recent vintage years will struggle to make significant distributions in 2010.
























The five-year rolling return for US private equity funds continued to decline, although the first half of 2009 stabilized a bit due to the slight increase in net asset values reported primarily by buyout funds. VC funds continued to report small, single-digit write downs, as the typically small VC portfolio companies have been more adversely impacted by trading conditions. Private equity returns continue to outperform public indices, despite the recent rally in public equities.



























Global IPO activity increased sharply in the last two quarters of 2009, resulting in volumes exceeding prior year volumes by 30%. Asian companies were in the lead, with volumes increasing twofold from last year. Private equity funds were among the first to benefit from the increased IPO activity, with a number of successful exits.

Private equity market overview

Current portfolios

	US	EU	Asia
Geography			
LBO small/mid			
large/mega			
growth			
Venture capital			
Distressed/turnaround			
Mezzanine			

Future investments

	US	EU	Asia
Geography			
LBO small/mid			
large/mega			
growth			
Venture capital			
Distressed/turnaround			
Mezzanine			
Secondary			

Allocation: ■ Initial portfolios ■ Portfolio build-out ■ Sophisticated portfolios

- Valuations of current portfolios have stabilized. The health of small/mid cap portfolio companies is showing the strain of a continuing weak economy. Under-performing large cap companies have an opportunity to recover as bankruptcy pressures are eased by favorable covenant-light financing terms put in place in 2005-2007, and opportunities to refinance, albeit on more onerous terms.
- Timing for certain investment styles is crucial. Distressed debt deals made in the fourth quarter 2008 and the first quarter 2009 had very attractive risk return dynamics, with senior loan risk earning equity-like returns. However, turnaround managers are reporting realized losses and bankruptcies as companies purchased prior to the fourth quarter 2008 suffered further earnings deterioration. Many turnaround deals seem to have been made too early.
- Global LBO and VC investment activity increased in the fourth quarter. A few mega LBO deals were concluded in the second half of 2009, and more have been announced thus far in 2010. These are early signs of confidence returning to the market. However, the lending constraints continue to impact investment activity for smaller transactions.
- IPO activity increased recently, with a few large VC later stage/growth companies going public in the US and Asia. European exits increased from a low in the fourth quarter. The IPO pipeline for 2010 suggests an increase in private equity-backed IPO exit activity.
- Due to a sizeable capital overhang and low liquidity, private equity fundraising activity has tumbled. However, it may increase moderately in the second half of 2010, as more private equity managers are planning to launch new funds and investor interest is gaining momentum.

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