



# Assessing Private Equity and Venture Capital Opportunities

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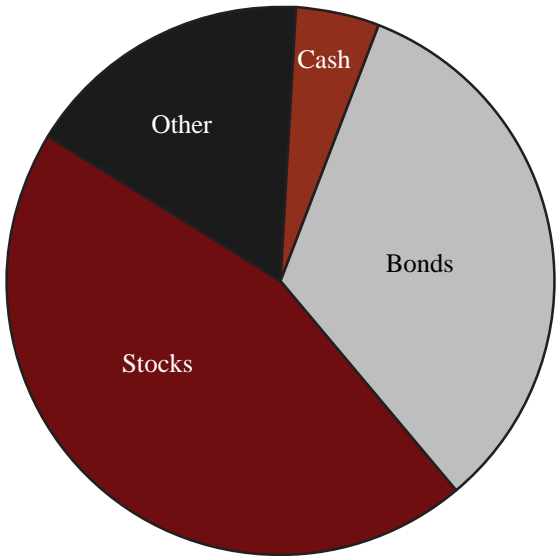
Founder and Managing Director

*Red Rocks Capital*

# Why Allocate to Private Equity?

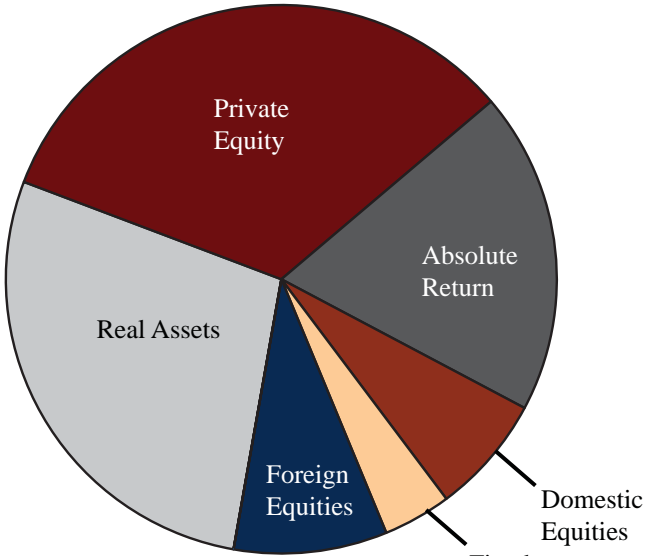
*“Substantial allocations to alternative assets offer a level of diversification unavailable to investors in traditional assets, allowing the creation of portfolios with superior risk and return characteristics.” –David Swenson, CIO Yale Investment Company*

**Yale Allocation in 1980's**

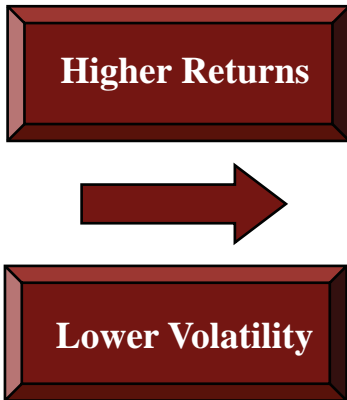


- Lower value-add
- Market returns
- Easy to access

**Current Yale Allocation**



- High value-add
- Difficult to access
- Dominated by institutions
- Drivers of outperformance



*“The Yale Endowment’s twenty-year record of 14.2 percent per annum produced a 2011 Endowment value of more than seven times that of 1991.” –Yale Endowment Annual Report 2011<sup>1</sup>*

# The Outperformance of Private Equity

Private Equity Benchmark Returns (Horizon IRR)	1 Year	5 Year	10 Year
Cambridge Associates U.S. Private Equity Index (excluding venture capital)	10.9%	7.2%	12.0%
Thomson Reuters' Private Equity Performance Index (all private equity)	6.6%	3.7%	7.2%
Thomson Reuters' Private Equity Performance Index (buyouts only)	7.5%	3.7%	8.9%
Public Market Returns	1 Year	5 Year	10 Year
Russell 3000 Index (including dividends)	1.0%	0.0%	3.5%
S&P 500 Index (excluding dividends)	0.0%	-2.4%	0.9%
S&P 500 Index (including dividends)	2.1%	-0.2%	2.9%
Analysis	1 Year	5 Year	10 Year
Median Private Equity Benchmark Performance (buyouts only)	9.2%	7.8%	10.0%
Private Equity Benchmark Outperformance (buyouts only)*	7.1%	5.7%	7.6%

Source: Private Equity Growth Council. 1<sup>st</sup> Quarter 2012 Update.

1. December 31, 2011 performance figures from Preqin are not yet available. Performance figures from State Street are no longer publicly available.

2. Private equity benchmark outperformance is calculated by subtracting the S&P 500 Index (including dividends) return from the median private equity benchmark performance. Past performance does not guarantee future results.

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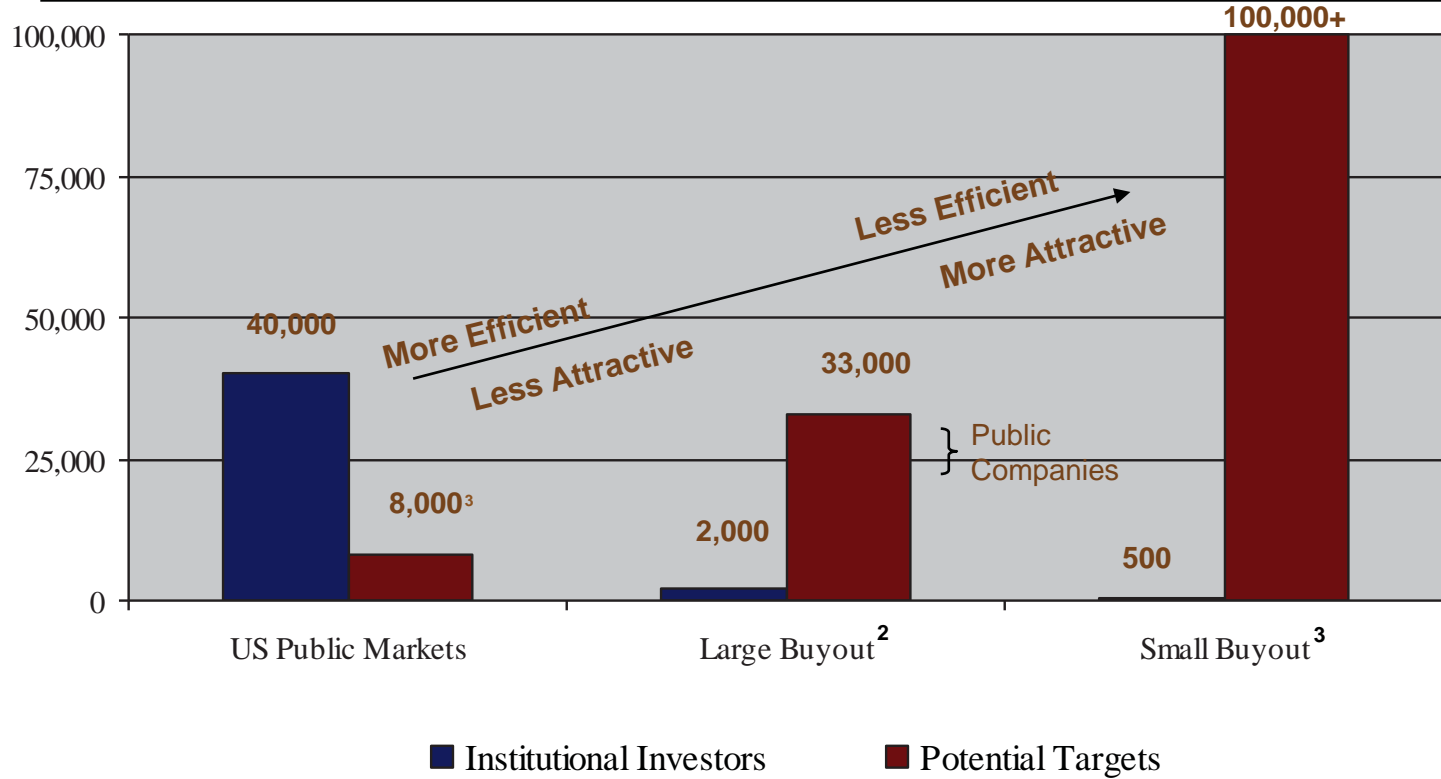
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# Why Small Buyouts?

## The Small Buyout Advantage: An Inefficient Market<sup>1</sup>



<sup>1</sup> Source: Dun & Bradstreet, Industry estimates.  
<sup>2</sup> U.S. Companies with greater than \$100 million in revenues.  
<sup>3</sup> U.S. Companies with \$10 to \$100 million in revenues



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# Financial Outlook and Opportunities

- More Equity, less debt...A good thing
- Exits remain steady
- Balance sheets in very good shape
- Debt markets remain open
- M&A set for major uplift if...
- Financial Engineering all but dead
- Hedge funds all but gone from PE
- Venture a world of have and have not's, all based on access to quality deal flow

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# Operational Diligence

- A large portion of an investment's return stream comes from operational performance, all PE firms say they do it but how does one perform due diligence such statements?
- Meet with actual underlying management teams
- Explore in detail how groups such as Capstone, an owned affiliate of KKR, add value and seek concrete examples – Example, Korean Brewing company, Oriental Brewery and KKR's purchase
- Seek to understand failures and what went wrong
- Seek to know the team and explore turnover
- References, better understand the operational improvement by speaking to past management teams after a sale of a business is complete

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# Global trends in PE

- PE Still represents the largest amount of alternative investment expressed by investment allocations\*
- Allocations to PE continue to grow in pension plans, family offices and sovereign wealth funds as investors seek better returns than from traditional capital market vehicles
- Emerging market PE is gaining meaningful traction in fundraising and sophistication
- VC requires more time to exit but companies are more mature in cash flow and steady revenue growth
- Entering a new technology cycle in IT and Med Tech
- Expect the accessibility to PE and VC to continue to evolve in structure in allowing for lower minimums and more access to institutional products for investment platforms and allowing you and your clients more choices on how to access private holdings in public vehicles.

\* NACUBO Commonfund Study of Endowments 2011

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# Closing Thoughts

- Many utilize PE as the cornerstone of an alternatives portfolio
- PE/VC represent real, non synthetic (derivatives) investments and have demonstrated better returns over long periods of time than many asset classes\*
- For better, non biased information on PE and case studies, please visit [www.pegcc.org](http://www.pegcc.org) - this site is made up of PE members and has great case studies and shows PE deals on a state by state basis

\* PEGCC.Org

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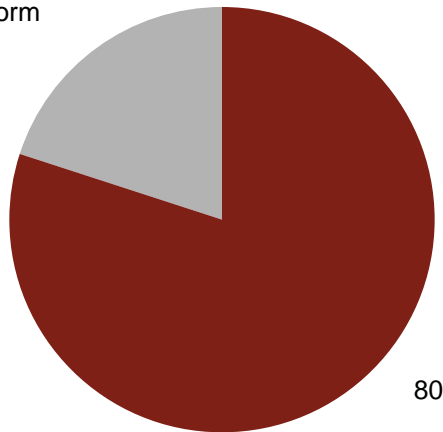
# Kauffman Foundation's Critique of the VC Industry

## Problem

"Limited Partners ... invest too much capital in underperforming venture capital funds on frequently misaligned terms." <sup>1</sup>

Only 20% of venture funds outperformed a public market index (i.e. Russell 2000) by >3% <sup>2</sup>

20% Outperform



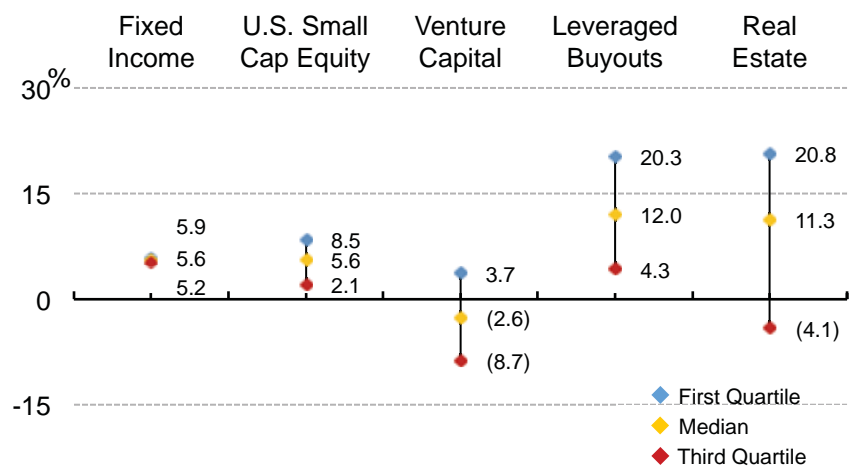
80% Underperform

<sup>1</sup> Source: "We have met the enemy... And he is us." Lessons from Twenty Years of the Kauffman Foundation's Investments in Venture Capital Funds and the Triumph of Hope Over Experience, May 2012.  
<sup>2</sup> Ibid.

## Solution

"Institutional investors will need to become more selective and more disciplined investors in venture capital funds. The best investors will negotiate better alignment, transparency, governance and terms that take into account the skewed distribution of VC fund returns." <sup>3</sup>

Dispersion among alternative asset returns (in %) <sup>4</sup>

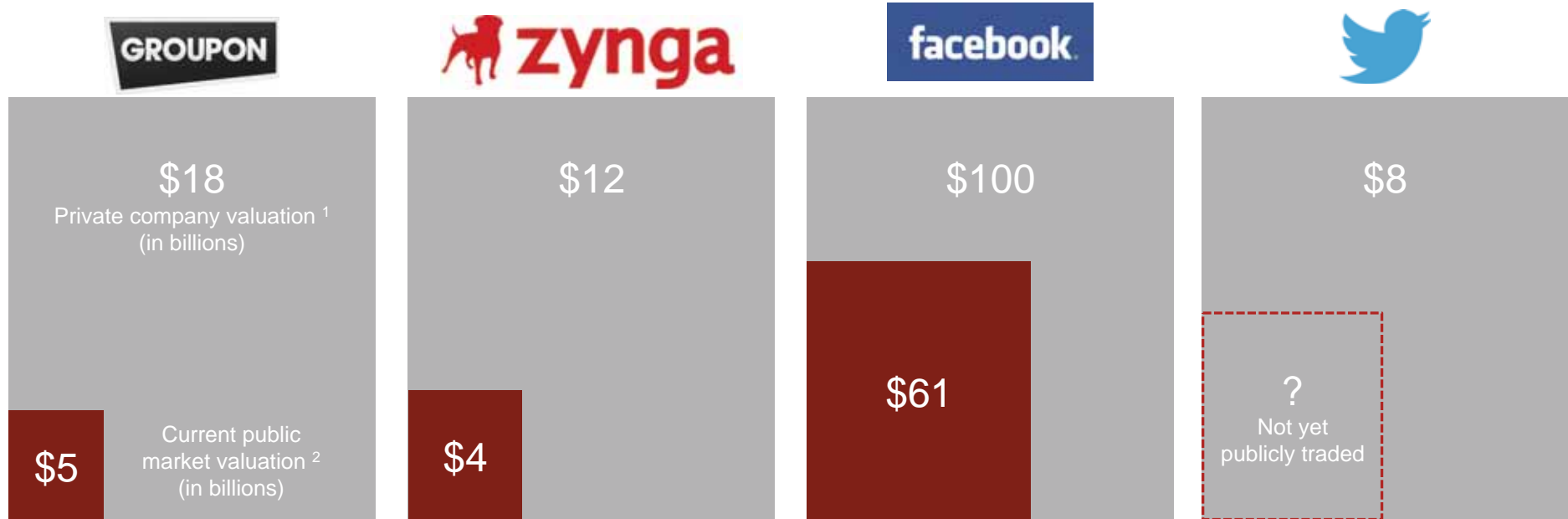


<sup>3</sup> Ibid.  
<sup>4</sup> Source: The Yale Endowment Annual Report for 10-year returns ending June 30, 2010.

# Flawed “Logo Chasing” Investment Model

“It’s not worth what we paid; we obviously paid some optionality for what it will be worth in three to five years.”

Henry Ellenbogen, T. Rowe Price, on investing in Evernote (a highly publicized private company)  
*Fortune Brainstorm Tech Conference, July 17, 2012.*



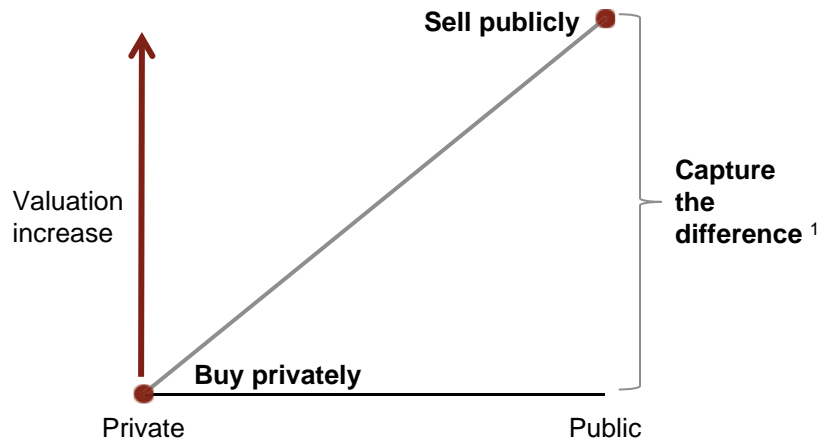
<sup>1</sup> Source: Estimated valuation based on SecondMarket transactions prior to IPO.  
<sup>2</sup> Source: Capital IQ as of June 23, 2012.

# Private to Public Valuation Arbitrage

## Strategy

- ◆ Maximize capital appreciation through the value accretion that typically occurs when a private company completes an IPO, which we refer to as **private to public valuation arbitrage**
- ◆ Primary source of investment return from capital gains realized from sale of portfolio company interests following a customary 180-day post IPO lockup period

### Private to public valuation arbitrage

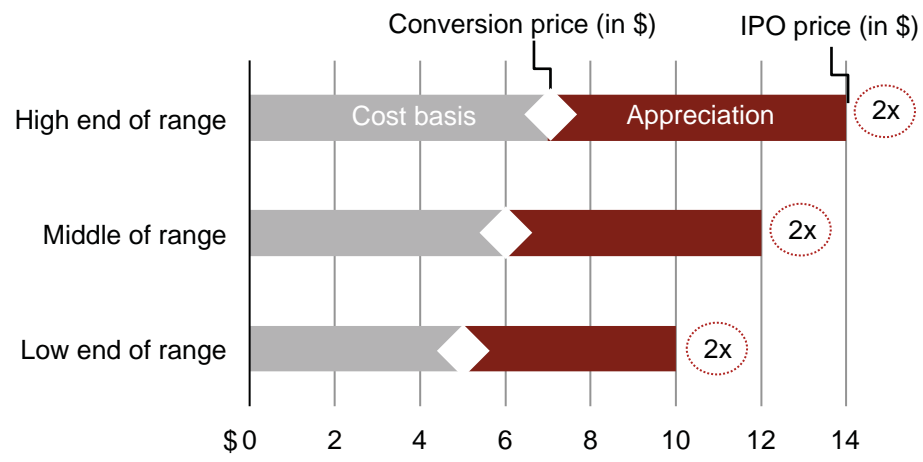


<sup>1</sup> There is never an assurance that any private company will complete an IPO or other liquidity events or that an investor will be able to realize any net capital gains from the sale of any publicly traded company investments.

## Potential 2x Return

- ◆ Structural protections that permit preferred stockholders to convert to common stock at a 50% discount to the IPO price equate to a 2x unrealized return at the time of an IPO, or a 25% IRR over 3 years
- ◆ In such cases, structurally protected appreciation is not impacted by the IPO price since the structural protections are designed to derive such appreciation at any IPO price at the time of the IPO

### Hypothetical IPO with a \$10-14 price range <sup>2</sup>



<sup>2</sup> The structurally protected appreciation is calculated assuming that each private company completes an IPO.