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BRETT HAMMOND
CHIEF INVESTMENT
STRATEGIST

LEO KAMP
CHIEF ECONOMIST

DOUGLAS FORE
DIRECTOR OF PORTFOLIO
ANALYTICS

THE PRIVATE EQUITY GAME: FAD OR FUNDAMENTAL?

A little like hula hoops, Barbies, pet rocks, and Game Boys in their time, private equity investing is a popular “in thing” now and much in the news. Of course, private equity is a serious form of investment rather than a toy. For example, the global private equity market raised well over \$400 billion in 2006, almost 40% more than in 2005 (about 75% of that total was in the U.S.), compared with almost no new fundraising as recently as 2000.¹ And in the first half of 2007, spending on private equity deals totaled about \$900 billion.² Like Barbies and unlike pet rocks, private equity investing has waxed and waned, but is still with us. For example, college and university endowments and foundations have shown an increasing interest in private equity.

- How does private equity differ from other investments?
- What are its attractions to investors?
- How might the private equity “fad” end?

Private equity refers to an investment in a company that is currently private or could be taken private. This is a little different from the common definition, which emphasizes ownership in which the equity is not freely tradable on a public stock market. Our definition includes buyouts, where private equity money is used to take a publicly traded company private by buying out the

¹ Except where noted, all figures cited in this report are from Private Equity Intelligence 2007. *The 2007 Global Fundraising Review*.
² Thomas E. Heath, “Private Equity Deals Slow Down.” *Washington Post*, June 29, 2007.

shareholders. This contrasts with more traditional equity investing, where an investor purchases some of the shares of a public company that continues to trade on a stock exchange. As such, private equity is not highly correlated with stocks since investments are on a multi-year cycle. Therefore, it has the potential to be a source of diversification for an investor's portfolio.

Categories of private equity investment can include:

Buyouts: where a group of investors buy the public stock of a company, thereby taking it private. In 2006, 188 buyout funds raised over \$200 billion. A special case of buyouts is **leveraged buyouts** (LBOs), in which investors, often including the management, agree to have the company issue debt (leverage), which is then used to purchase all of the company's public stock.

Venture Capital (VC) is money invested in early stage start-up firms or small firms with exceptional growth potential, often realized when investors eventually issue an IPO (initial public offering) of stock.

Angel Investing involves one or more individuals who invest their own money in a start-up firm.

Mezzanine Capital refers to unsecured, high-yield debt that represents a claim on a company's assets that is senior only to that of a company's shareholders (can also be used as part of an LBO or early stage capital). Last year, 34 mezzanine funds raised over \$19 billion.

Growth Capital, which is a flexible line of credit that can be used by an early-stage start-up borrower to fund activities between rounds of more formal external financing, such as, VC or mezzanine investments.

Other Private Equity can include real estate and infrastructure funds that are used to buy real assets in these areas. Distressed debt funds and private equity fund-of-funds are also available.

A private equity fund — such as a buyout or VC fund — comes about when a private equity management firm (usually an independent firm or an investment bank) raises a pool of investor money that is used to gain significant or complete ownership of one or more companies. In the

ownership case, the private equity fund typically controls management of the companies in which it invests, and can bring in new management teams to focus on making the company more valuable. In the case of less than a controlling interest, the private equity firm may provide advice to company management. In either case, the objective is to improve the value of the company in anticipation of a future sale.

Since firms that are completely owned through a private equity fund are not listed on an exchange, fund managers must find a buyer in the absence of a traditional marketplace, such as, a stock exchange. The "exit" or "selling out" is often by way of an IPO; i.e., floating the company on a stock exchange, trade sale or through a secondary buy-out (sale to another private equity fund or firm).

Private equity management firms often create a series of funds, each of which are managed separately and is liquidated after sale of the assets in that fund. Firms that have managed successful initial funds; i.e., funds with superior returns, may need to ration subsequent funds as they can become oversubscribed by investors interested in tapping into what they perceive as the demonstrated special expertise of the management.

Interest in various forms of private equity comes and goes. VC funds were popular in the 1990s with that decade's emphasis on high-tech start-ups that were intended to go public. As the dot.com bubble burst at the beginning of the current decade, VC capital largely dried up. Recently, as new start-up ideas have taken hold, VC has become more popular again. Last year, 197 funds attracted about \$44 billion.

Similarly, LBOs were popular two decades ago as interest rates came down from historical highs and as there was enormous interest in improving the efficiency of companies whose management had neglected productivity improvements. In the latter half of the present decade, very low interest rates and unprecedented liquidity in asset markets along with somewhat lower expected returns on traditional public securities provided both a supply of investment dollars and a demand for alternative investments. The result was a wave of unprecedented private equity fundraising and record-breaking deals. Private equity firms such as KKR, Bain Capital, Texas Pacific Group, and Madison Dearborn Partners led buyouts of large

hospital, food service, auto, and other public corporations. And for the first time, a private equity firm (Blackstone Group) issued its own IPO and began to be publicly traded.

There are signs; however, that the private equity rush may be cooling off in 2007 as interest rates began to rise and investors reassessed their appetite for risk in light of the sheer size of some of the private equity deals on the market. Investors balked at the interest rates being offered for leveraged-buyout junk bond deals involving Chrysler and other firms. In several instances the investment banks who were underwriting these issues were forced to purchase the bonds themselves. And some private equity firms that had contemplated going public after the Blackstone IPO pulled back or trimmed their offerings (e.g., Carlyle Group).

What does this imply about the future of private equity? The private equity industry may have overreached recently, but with significant resources at its disposal, it is unlikely that this market will dry up any time soon. Private equity requires a different type of analysis and due diligence compared to purchasing publicly traded securities. Private investments offer the potential for considerable return, but they come with a commensurate amount of risk of a substantial loss. Moreover, the final payoff from private equity investing is often unknown for several years until the fund is liquidated. TIAA-CREF believes that private equity can provide excellent diversification in combination with other asset classes.

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Brett Hammond, Leo Kamp and Douglas Fore are available to comment on economic data. If you wish to speak with them, please contact Chad Peterson, Media Relations, 212-916-4808 or email cpeterson@tiaa-cref.org.

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