Quarterly Market Update – 4Q 2014

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Key Takeaways

- **Fundraising** – Continued strength in US and emerging markets, especially for top funds; European weakness.
- **Purchase Price Multiples** – At or near record valuations, comparable to the buyout boom of 2005-2007.
- **Leverage** – Frothy debt markets contribute to leverage levels that are again at or near buyout boom peaks.
- **Equity contributions** – Remain near historical averages despite availability of leverage. This will challenge GPs' ability to generate returns for the vintage.
- **Deal Volume** – 2014 is 6% higher than 2013, with the aggregate value of those deals up 10%.
- **Venture** – Very strong exit environment, as the IPO window is open and strategic acquirers are active. New investment is also high as investors' confidence increases due to a wave of successful realizations.

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North American fundraising continued its strength in 2014, although it was not quite as robust as 2013. The second half of the year slowed substantially from 2H 2013.

Fundraising during the year was marked by better managers whose fundraising timelines were incredibly fast. There are several reports of large LPs looking to narrow their roster of relationships, writing bigger checks to their highest conviction managers. Those GPs seem to be exhibiting little discipline regarding fund size, with several cases of funds doubling or even tripling from the previous size. These GPs have effectively abandoned the markets where they have built their reputations. This cycle is often a catalyst for new GP formation as younger partners and principals see opportunity to fill the void their firms have created from moving up market.

Fundraising in Europe is down significantly. Year-over-year, 2014 is 28% lower than 2013. While 2013 was the strongest year since 2008, investors appear to be hesitant to deploy capital into the macroeconomic headwinds that Europe faces. Additionally, purchase prices remain high, with narrow public versus private spreads.

Asia and Rest-of-World picked up in 2014 as expected, with several higher profile managers completing their fundraising process. The fourth quarter slowed somewhat, which resulted in a year-over-year increase of 10%.

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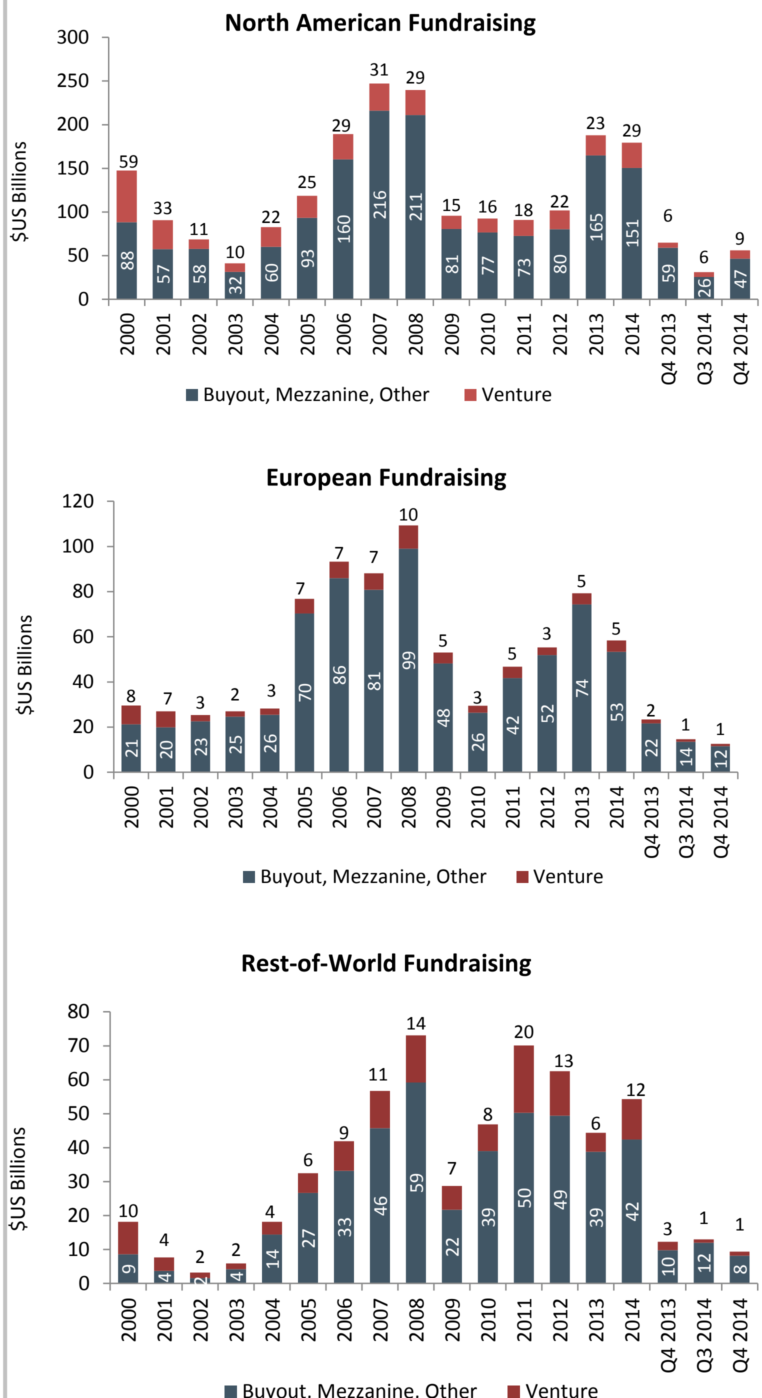
Fundraising by Geography

(Preqin)



Featured Note: Sector Specialization, Coming to a European GP Near You

Summit has long been a proponent of sector-focused funds. Qualitative benefits of sector specialization include: relationships with sellers, management teams, industry experts, clients, and potential buyers; improved asset selection; and more insightful operational and strategic decision-making. But to-date this has been largely a US dominated phenomenon. Europe remains either a story of country specific generalist managers, or pan-regional players with industry vertical teams. However, these vertical teams are more a way to organize work effort than true industry specialists. The best sector specialist groups are seen as quasi-strategic players in their sectors, perhaps former operators who are often seen as legends or visionaries in their fields.

History in the US

The movement to more sector specialist managers in the US began several years ago. Highly successful sector specialists like ABRY in TMT (founded in 1989), Roundtable in healthcare services (founded in 2001), Vista in software (founded in 2000), Corsair in financial services (founded in 1992), Catterton in consumer (founded in 1989), and First Reserve in energy (founded in 1983) were some of the first specialists in their sectors. Today each of those sectors has 10-20 US groups solely focused on the sector. Many of those early groups have generated significantly above market returns, and through that success and early mover advantages have entrenched themselves as the preeminent franchises in their respective sectors. As the private equity industry became more and more competitive in the US, these firms understood that specializing provided them a competitive advantage in the market. They won deals not because they were the highest bidder, but because they were the partner of choice, one that could truly help an entrepreneur take a business to the next level.

Europe

While there are a few longstanding sector specialists in Europe as well, the market has been historically dominated by more generalist firms. Single country GPs typically lack sufficient deal flow to only focus on one industry. Usually they are broadly generalist; at best focusing on perhaps three industries. Pan regional or European firms increasingly have industry vertical teams, similar to the way investment banks organize their coverage. But these teams are generally not viewed as true specialists. Further, most firms have been able to focus on navigating cross border complexities as their differentiator.

Opportunity

We think it likely that sector specialization in Europe will become more and more prevalent, and that LPs could experience the same benefits they have enjoyed with US counterparts. As the European private equity market place matures, private equity houses will need to evolve to generate differentiated above market returns. Sector specialization is the natural next step. Already there are a few firms emerging with strategies singularly focused on healthcare services, tech and financial services. Time will tell if these firms develop into the Roundtables, Vistas or Corsairs of Europe. We believe the groups with the right mix of talent will have strong opportunities to do so.

Performance
(Preqin as of 6/30/2014)

	Internal Rate of Return						Total Value to Paid In Capital					
	Buyouts			Venture			Buyouts			Venture		
Vintage Year	Upper Quartile	Median	Lower Quartile	Upper Quartile	Median	Lower Quartile	Upper Quartile	Median	Lower Quartile	Upper Quartile	Median	Lower Quartile
2013	n/m	n/m	n/m	n/m	n/m	n/m	1.1x	1.0x	0.9x	1.2x	1.0x	0.8x
2012	n/a	n/a	n/a	n/a	n/a	n/a	1.3x	1.1x	1.0x	1.2x	1.0x	0.8x
2011	16.7	11.0	4.7	26.4	9.4	4.0	1.2x	1.1x	1.0x	1.4x	1.2x	1.0x
2010	22.9	15.1	8.1	34.5	15.6	-2.0	1.5x	1.3x	1.1x	2.5x	1.4x	1.1x
2009	25.1	16.6	10.5	27.1	17.1	7.3	1.7x	1.4x	1.2x	1.8x	1.4x	1.1x
2008	19.6	11.7	8.6	17.1	11.6	-1.7	1.7x	1.5x	1.3x	1.7x	1.4x	0.9x
2007	16.3	11.7	7.8	14.5	8.6	1.1	1.7x	1.5x	1.3x	1.9x	1.4x	1.0x
2006	14.2	9.7	5.1	9.5	4.0	-4.4	1.8x	1.5x	1.2x	1.5x	1.2x	0.8x
2005	16.2	11.3	6.8	13.3	7.3	-3.5	1.9x	1.5x	1.3x	1.7x	1.4x	0.8x
2004	28.0	18.5	10.6	7.7	2.5	-2.8	2.3x	1.9x	1.7x	1.5x	1.1x	0.7x
2003	31.8	19.5	9.6	14.2	7.6	-0.1	2.3x	1.9x	1.4x	1.9x	1.3x	0.9x
2002	33.6	20.2	11.1	9.0	3.0	-5.1	2.3x	1.9x	1.4x	1.7x	1.1x	0.7x
2001	39.4	28.5	11.7	9.5	4.2	-0.3	2.8x	2.1x	1.5x	1.6x	1.3x	0.9x
2000	27.2	20.8	11.6	5.4	0.1	-5.6	2.5x	2.1x	1.6x	1.2x	0.9x	0.6x
1999	17.9	12.5	4.9	9.5	-1.7	-12.2	2.0x	1.6x	1.0x	1.4x	0.9x	0.5x
1998	18.0	9.3	0.4	20.0	8.2	-9.2	2.0x	1.6x	1.1x	1.9x	1.3x	0.5x
1997	17.0	10.5	2.2	69.8	32.3	8.2	2.2x	1.6x	1.1x	3.6x	1.9x	1.3x
1996	22.5	10.7	-1.3	56.7	18.0	6.8	2.2x	1.7x	0.9x	2.9x	1.8x	1.2x
1995	25.4	14.6	4.0	84.9	27.3	4.8	2.3x	1.7x	1.1x	5.3x	2.5x	1.5x
1994	37.3	20.5	12.0	59.6	27.0	9.4	2.4x	1.9x	1.5x	5.5x	2.2x	1.1x
1993	39.2	20.6	7.8	53.0	30.8	3.0	3.5x	2.2x	1.4x	3.6x	2.5x	1.1x
1992	38.1	21.2	10.7	28.6	18.2	4.4	3.2x	2.0x	1.4x	2.8x	1.7x	1.1x
1991	29.8	25.0	21.4	43.7	25.8	12.6	3.0x	2.7x	2.1x	3.9x	2.7x	1.8x
1990	31.1	19.5	8.9	22.0	16.0	2.7	3.3x	2.4x	1.6x	2.6x	1.9x	1.2x
1989	40.4	27.4	18.9	26.0	14.6	7.0	3.8x	3.1x	1.8x	3.1x	2.2x	1.4x
1988	25.4	14.2	11.3	32.0	22.5	9.8	2.7x	2.1x	1.5x	3.4x	2.6x	1.7x
1987	n/a	22.1	n/a	22.0	14.7	7.2	n/a	3.2x	n/a	3.3x	1.9x	1.2x
1986	62.7	19.1	9.9	15.3	10.3	5.5	11.2x	2.4x	1.7x	2.4x	1.8x	1.4x
1985	n/a	10.7	n/a	17.5	12.4	8.8	n/a	2.1x	n/a	3.2x	2.2x	1.6x

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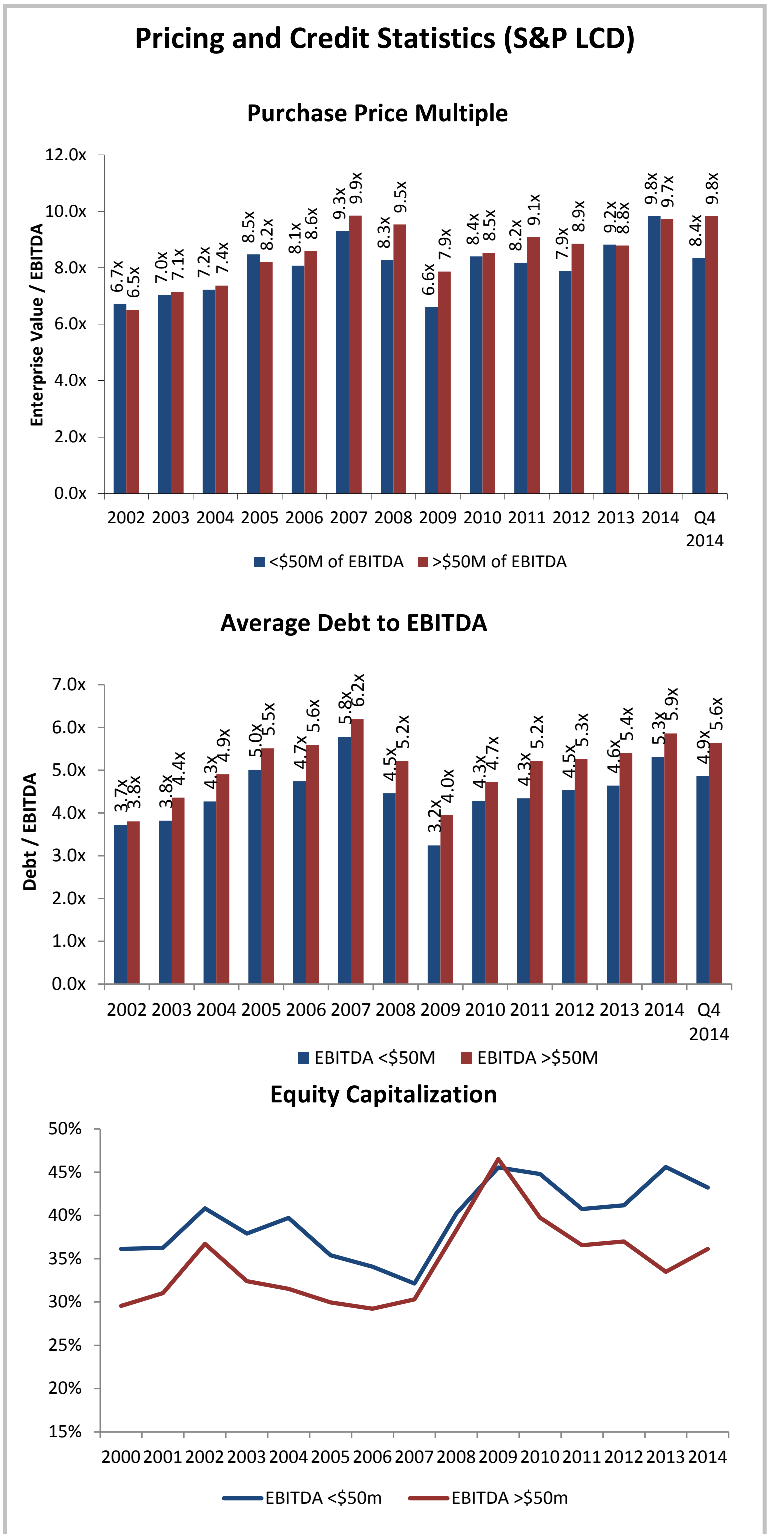
The volume of private equity deals in 2014 was 6% higher than 2013, and the aggregate value of those deals was up 10%. This results in the average deal size increasing by 4%, which is the highest level since 2007. The average purchase price multiple for deals less than $50m of EBITDA was the highest ever at 9.8x. Deals greater than $50m of EBITDA averaged 9.7x, second only to peak valuations of 2007. Only two other times have smaller deals been pricier than larger.

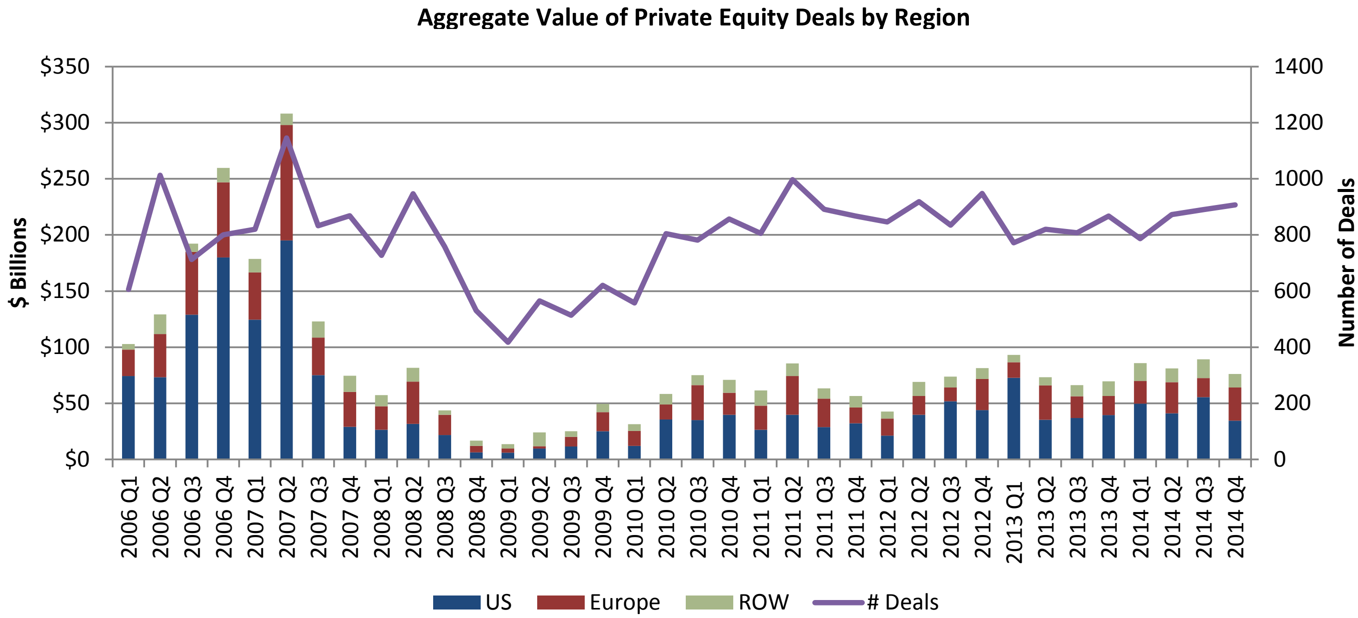
Hefty valuations are driven by frothy debt markets as well as significant amounts of dry powder (uninvested fund capital). Average debt to EBITDA levels are 5.3x in the lower middle market and 5.9x for larger companies. These levels continue to match 2005-2007 buyout boom peak highs.

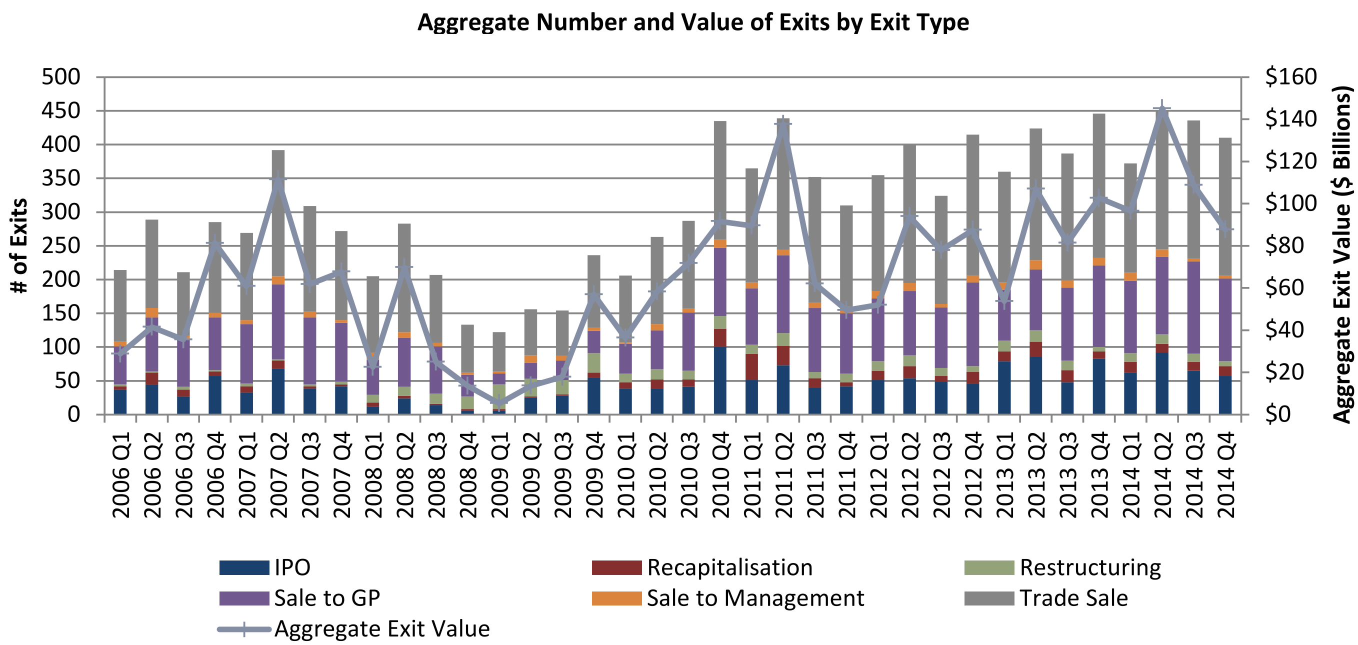
Equity contributions remain at approximately average levels. In the 2007 peak of the buyout market, equity capitalization dropped to ~30% of the capital structure. Today, larger companies require 36% equity contributions and smaller companies require 43% equity contributions. While this level of equity contribution implies a "normal" amount of leverage (relative to equity), the absolute level of leverage and the debt service required makes today's buyouts riskier. Further, all value creation must come from earnings growth and cash flow. On average, future exits are more likely to see multiple contraction given historically high valuations.



Deal Volume

(*Preqin*)





The IPO window continued to be open for venture-backed companies in the fourth quarter. Thomson Reuters and the National Venture Capital Association (NVCA) report that 27 venture-backed IPOs raised $4.4 billion in Q4 2014, which is the seventh consecutive quarter with 20 or more venture-backed IPOs. During the full year 2014, 115 venture-backed IPOs occurred, raising over $15 billion. This is the highest volume of IPOs since 2000, and second-highest in value since 2000 (only eclipsed by 2012 when Facebook went public). Biotech IPOs continue to lead the way, representing almost 60% of the IPOs in the quarter. There were 59 biotech IPOs in 2014, which is the strongest annual period for US listed ventured-backed offerings in the sector since records began in 1994. As of January, there were 52 venture-backed companies who filed publicly for IPO with the SEC. This does not include confidential registrations filed under the JOBS Act, where many believe the majority of venture-backed companies now file.

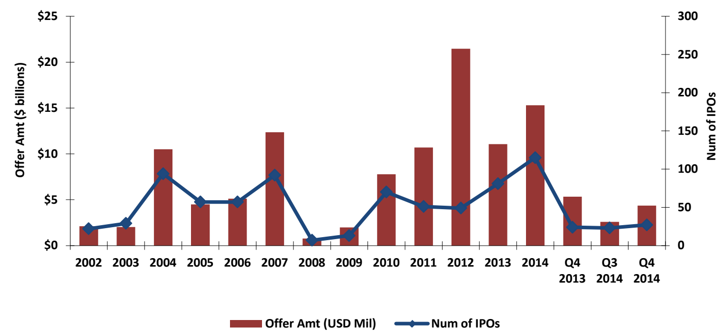
M&A exits of venture-backed companies are also strong. The NVCA reports the fourth quarter of 2014 was the second strongest quarter for venture-backed M&A by value since records began in 1994. Facebook's record breaking $19.5 billion acquisition of WhatsApp bolstered the total. Even excluding this deal, the full year haul was the highest since 2007. Unlike the IPO market, more of the M&A activity is attributed to the information technology sector (80 of the 95 disclosed deals in fourth quarter).

Aggregate value of all new venture investments in Q4 2014 increased 46% from the previous quarter. The full year 2014 is 61% more by total value than 2013 and the highest level since 2000. However, the actual number of deals only increased by 4% over 2013. This implies lofty valuations. From seed to late stage/pre IPO fundraises, companies are able to command very high valuations. The hot exit market and improved venture fundraising are likely contributors to this phenomenon.

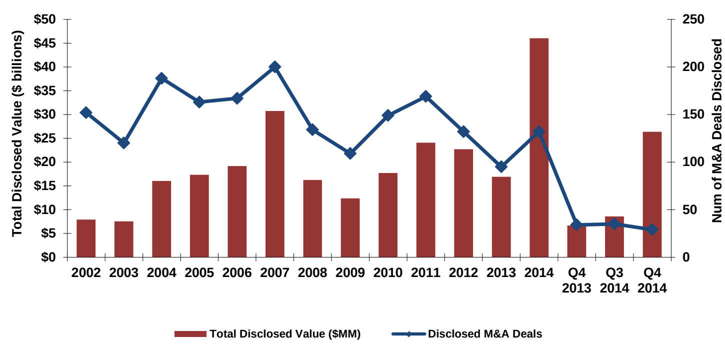
Venture Activity

(*NVCA/Thomson/Reuters*)

Venture-Backed IPO Exits



Venture-Backed M&A Exits



Venture Investments

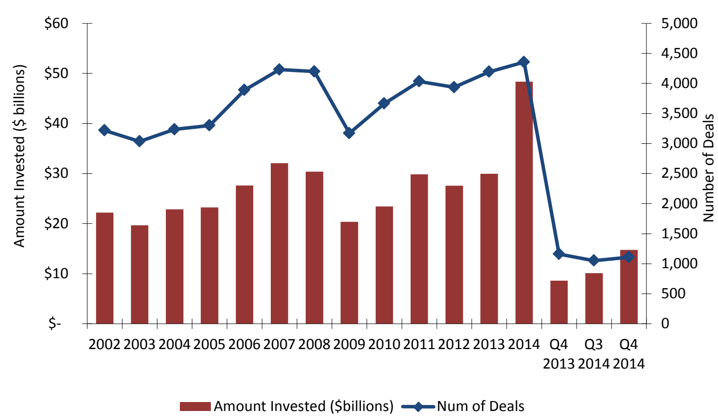


Table 1: Glossary of Terms

Distributions to Paid-in Capital (DPI)	The amount a partnership has distributed to its investors relative to the total capital contribution to the fund
Early Stage Venture	A fund investment strategy involving investment in companies for product development and initial marketing, manufacturing and sales activities
Financial Accounting Standards (FAS)	The Financial Accounting Standards Board (FASB) is a private, not-for-profit organization whose primary purpose is to develop generally accepted accounting principles (GAAP) within the United States in the public's interest
J-Curve	The curve realized by plotting the returns generated by a private equity fund against time (from inception to termination). The common practice of paying the management fee and a start-up cost out of the first draw-down does not produce an equivalent book value. As a result, a private equity fund will initially show a negative return. When the first realizations are made, the fund returns start to rise quite steeply. After about three to five years, the interim IRR will give a reasonable indication of the definitive IRR. This period is generally shorter for buyout funds than for early-stage and expansion funds
Lower Quartile IRR	The point where 75% is above the quartile and 25% below
Pooled Internal Rate of Return	A method of calculating an aggregate IRR by summing cash flows together to create a portfolio cash flow and calculate IRR on portfolio cash flow
Large Buyout	Issuers with EBITDA of $50 million or more
Late Stage Venture	A fund investment strategy involving financing for the expansion of a company which is producing, shipping and increasing its sales volume
Middle-market Buyout	Issuers with EBITDA of $50 million or less
Top Quartile IRR	The point where 25% of the sample is above the quartile and 75% below
Total Value to Paid-in Capital (TVPI)	Calculation performed by adding the residual value and the distributions received (cash out) and dividing that amount by the total capital contributed (cash in)

Table 2: Data Sources

S&P Leveraged Commentary & Data
Bloomberg
Preqin
Capital IQ
Private Equity International
National Venture Capital Association
New York Times
Financial Times
Wall Street Journal
The Deal
PitchBook Data, Inc.