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In this installment of our private equity commentary we address the recent debate surrounding middle-market LBO opportunities available in today's marketplace.

Investment Environment for Middle-market LBO funds

We are regularly asked for our view on middle-market LBO funds. Many think the space is over-crowded and fear auctions occur too frequently, which tends to increase valuations and decrease eventual returns ("too much capital chasing too few good deals"). We began exploring whether a barbell strategy might now be more appropriate—where one would commit to LBO funds that do either very small or very big deals. Contrary to the opinion of many industry analysts, we do not believe that an authoritative argument for the barbell strategy can be made.

If the middle-market was indeed over-heated, we would expect to see a substantial increase in capital raised by middle-market LBO funds. Instead, we found that since the economic recovery began in 2002, virtually all the growth in new capital raised has been with the very large funds, which by their nature tend to focus on transactions involving large market capitalization companies.

LBO Capital Raised ⁽¹⁾ \$ in millions	2000	2001	2002	2003	2004
Fund Size: \$0-150	\$3,911	\$2,505	\$2,852	\$2,809	\$3,327
Fund Size: \$150-1,650	\$40,418	\$34,639	\$25,450	\$20,520	\$26,654
Fund Size: \$1,650+	\$44,851	\$28,409	\$19,906	\$16,037	\$24,183
Total	\$89,179	\$65,553	\$48,207	\$39,365	\$54,163

We also examined M&A transaction activity across size ranges. We limited the universe to transactions with disclosed valuation data. There has been a 20% increase in middle-market activity since 2002. This improvement is more consistent with the degree of economic recovery than either the 75% increase in large deal activity or the 7% decrease in small deal volume.

M&A Deals Closed ⁽²⁾	2000	2001	2002	2003	2004
Transaction Value: < \$50M	2,569	2,032	1,919	1,899	1,794
Transaction Value: \$50M - \$500M	1,239	774	775	902	930
Transaction Value: > \$500M	386	202	138	156	242
Total	4,194	3,008	2,832	2,957	2,966

Finally, we looked at recent valuations. EBITDA multiples have risen on both small- and middle-market deals but remain far below that of large capitalization companies.

Median EV/EBITDA Multiples ⁽³⁾	2000	2001	2002	2003	2004
Transaction Values: < \$50M	6.6x	6.6x	6.3x	6.8x	7.3x
Transaction Values: \$50M - \$500M	8.5x	8.6x	8.2x	8.1x	9.4x
Transaction Values: > \$500M	10.2x	9.6x	12.1x	11.9x	11.6x
All M&A Transactions	8.7x	8.6x	8.4x	8.2x	10.0x

This sampling of our analysis reflects the strong M&A market, which does pose challenges for LBO funds. However, the data does not make a convincing case for a "barbell" allocation to only funds focused on small and large companies. Instead, with think this investment environment underscores the importance of selecting "best of breed" managers, across the buyout spectrum. Specifically, we seek managers that can source deals outside the auction process and bring proprietary capabilities to bear in building value in their portfolio companies rather than simply seeking to arbitrage entry and exit multiples.

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- (1) Source: Thomson Financial. Data as of 12/31/04, run as of 2/15/05, and includes domestic-based buyout and mezzanine funds, excluding all funds of funds.
- (2) Source: Securities Data Corporation. Data as of 12/31/04, run as of 2/23/04, and includes disclosed transactions announced in each respective year.
- (3) Source: Securities Data Corporation. Data as of 12/31/04, run as of 2/23/05, and includes disclosed transactions and excludes multiples of greater than 25x.

A Note on Assumptions

We first assumed that the lower-market consisted of companies with enterprise values < \$50M, the middle-market consisted of companies with enterprise values of \$50M-\$500M and the upper-market consisted of companies with enterprise values > \$500M. We then assumed that funds with a total capitalization < \$150M would invest in the lower-market, funds of \$150M-1.65B would invest in the middle-market and funds > \$1.65B would invest in the upper-market. We determined this based on the midpoint of the enterprise value parameters for each tier and by assuming each fund would invest in 15 deals with an average equity contribution of 40%. For example, to determine the biggest fund that could be classified as "middle-market," we multiplied the midpoint of the middle-market range of transaction values (\$275M) by the equity contribution (40%) and again multiplied by the number of investments (15) to get a maximum middle-market fund size of \$1.65B.

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