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PRIVATE EQUITY PARTNERS | MARKET UPDATE

November 2004

This is the next installment of our private equity updates. Last month, we described liquidity opportunities for VC and LBO firms via IPOs. This month, we turn to M&A exit opportunities for such firms.

M&A Statistics YTD

The M&A market is robust today, providing much needed liquidity to VC and LBO firms, and indicators look positive for continued near-term liquidity. As of 9/30/04, 247 VC-backed companies had completed deals this year[1]. Available LBO data is limited. However, based on the 660 middle-market M&A transactions YTD, we estimate that 250-300 LBO-backed companies had completed deals this year. Of those reporting deal values, there was a 45% increase in average deal size for VC-backed companies and a 90% increase for LBO-backed companies, compared to 2003[1]. Several factors may account for this valuation increase, including (1) improving economic conditions, (2) increased activity by strategic buyers and (3) greater availability of senior debt to LBO firms (banks loaned at the rate of 2.8x EBITDA in Q3 04 vs. 2.3x in 2003).

Sales to Strategic Buyers

Piper Jaffray M&A specialists are reporting that approximately 75% of buyers in Piper-advised deals are now strategic buyers, a dramatic increase from a year ago. Strategic buyers were largely absent during 2002-3 but began acquiring companies in earnest again in 2004. Large companies like Cisco, IBM, Medtronic, St. Jude, Symantec, Veritas and Yahoo have been actively buying VC- and LBO-backed companies this year. Cisco recently completed its sixth such acquisition when it acquired network security company Perfigo, which was backed by Greylock. After focusing on survival the last few years, much of corporate America is once again seeking top line growth. However, innovation often being what it is (or rather isn't) at large companies, many realize they must look to outside entrepreneurs to supplement in-house R&D and creativity. At today's valuations, acquisitions enable strategic buyers to cost-effectively capture the innovation and time-to-market efficiencies of smaller companies.

Sales to Other Private Equity Firms

Around 1992, LBO firms started to exit portfolio companies by selling them to other LBO firms. A casual observer might ask why a LBO firm would buy a company that had already been through the buyout process. It turns out that LBO firms had evolved from being mere financial engineers to teams that add significant operational value to their portfolio companies. For example, if one firm bought a company and simply levered it up to earn a 2-5x return, another LBO firm with strong operating capabilities later could buy that company and again earn a 2-5x return by upgrading the company's IT system, adding more capable managers, expanding manufacturing capacity, lowering supply costs, opening new sales channels, etc. This is a simplistic example but each firm has its strengths and weaknesses. Where one firm's ability to add value to a portfolio company ends, another's ability to add value often begins.

This practice is now common. In such transactions, one should understand the seller's motivation, which is typically driven by normal holding period considerations, and the buyer's capability to wring additional value from the company. Investors should note that exposure to too many LBO firms could result in horse trading within their own portfolios of LBO funds—resulting in a distribution from one fund (net of carry!) and a corresponding capital call from another. Investing with smaller funds (including emerging managers) may help to alleviate this problem since such funds tend not to source deals from other LBO firms.

[1] Source: Thompson Venture Economics

*Piper Jaffray was established in 1895 and has grown to become a nationally and internationally recognized firm serving growth companies and growth company investors. We have a significant commitment to alternative assets and currently are offering our next fund of funds, **Private Equity Partners II**. This innovative fund offers unique benefits. **First**, we already have identified funds sponsored by premiere LBO and VC firms for possible commitments. These hard-to-access firms have reserved allocations for us in their next funds, including Weston Presidio, TA Associates, De Novo and Draper Fisher Jurvetson. **Second**, we offer total allocation flexibility. Investors may allocate their commitments to LBO funds, VC funds or both, in any proportion that they choose. **Third**, management fees are billed at cost (and capped at 20-40 bps) for commitments ≥$2.5 million.*

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