North Sky CAPITAL

First Quarter 2013

The Rise of Returns Projections

We have been shocked by the number of firms over the last few quarters that have begun to put "projected returns" information in their formal presentation books. In most cases, the projected returns are highly speculative and represent a stark contrast to the current state of the portfolio. This is often the online dating equivalent of being obese but telling prospective dates that you sincerely expect to be svelte by the time of your first date. For private equity firms, this is bad policy as it harms a firm's credibility and creates potential legal liability if the projections are overly optimistic and LPs were induced to invest based on the projections. We hope this trend is short-lived.

Returns Expectations

Recently our research turned up some interesting information about returns expectations generally among institutional investors and their consultants. While the survey was informal, it included the 2012 returns expectation from 20 institutional consultants and the information was shared with a large pension plan that actively invests in private equity and all other major asset classes. We thought the results were instructive and share them below.

Returns expectations for 2012:

Non-U.S. equity	7.2%
Emerging markets equity	8.3
Global equity	7.4
Core fixed income	3.0
High yield bonds	5.9
TIPS	2.7
Cash	2.1
Non-U.S. bonds	2.6
Core real estate	9.6
Private Equity	9.6
Commodities	4.7
Hedge funds	6.0
Inflation	2.5%

Three things popped out of the data. First, the returns expectation for private equity was less than 10%. This is down from the lofty high teens and low 20s expectations of just five years ago. This expectation seems very reasonable, perhaps even overly conservative. Second, we noticed respondents expected private equity returns (9.6%) to beat the various public equity returns by just 130-250 basis points. Again, a very reasonable expectation (perhaps overly conservative) and one that has fallen from loftier heights (e.g., 500 bps seemed a common yardstick five years ago). We think investors today should be rewarded with an illiquidity premium of 250-350 basis points. Finally, all of these 2012 predictions were down 13-181 bps from their 2011 predictions. So expectations were falling from 2011 into 2012. We suspect expectations for 2013 are beginning to rise slightly, especially in recent days as the stock market has risen so significantly.

Update on Market Conditions

Broadly speaking, we invest across buyouts, venture capital and cleantech (growth equity and infrastructure) and wanted to update you broadly on the prospects of each sector.

Buyouts: *We feel very optimistic about buyouts in general today.*

As we highlighted in last quarter's market commentary, lower middle market buyouts look very attractive when measured by competition among buyers, deal structure and expected returns; however, large deals generally are less attractive. Smaller deals tend to be characterized by less competition among potential buyers, resulting in lower entry prices. Smaller deals also tend to be more conservatively capitalized (more equity/less debt) and offer opportunities to professionalize the company thus creating value organically (rather than through financial engineering). Bigger deals by contrast often are priced to perfection today and involve significant financial engineering. Debt for all deal sizes is generally available and inexpensive. But it is being used in copious amounts at the upper end of the deal size range—at the high levels witnessed prior to the recession. Dividend recaps and covenant-lite debt structures are becoming prevalent again. Additionally, sponsor-to-sponsor deals are commonplace as companies grow in size and move up the food chain from lower-middle market firms to mid-market and large buyout firms. This is made possible by the large sums of "dry powder" available at middle and large market buyout funds. On a positive note across the spectrum of deal sizes, liquidity has improved significantly over the course of 2012 and year-to-date 2013 resulting in cash flowing back to investors. We have every reason to believe this trend will continue for the remainder of the year.

Cleantech: *We believe cleantech is one of 2013's best contrarian plays.*

Today, most investors think cleantech means simply solar panels and subsidies. To us, it means resource efficiency and industrial innovation across energy, food, water and other major industries. It also means global investment opportunity as there generally is an inadequate supply of investment capital for the many good opportunities that exist today.

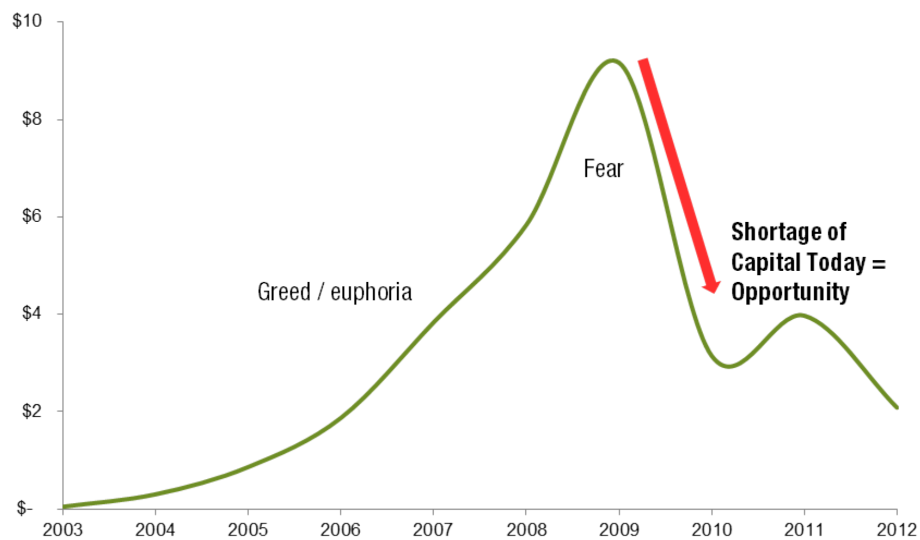
Conditions for renewable energy infrastructure are very good today. Development activity continues to be robust. Local, state and federal government support continues to speed permitting and deal execution and to add a few percentage points to expected returns through various programs. Tax equity financing and senior and mezzanine debt is readily available. We are seeing ample opportunities in solar PV, solar thermal (hot water systems), landfill gas and fuel cells that pencil out to 12-15% net IRRs. The abundance of good opportunities may come as a surprise to many of you, which leads to our next point.

Conditions for growth equity investments in cleantech are similarly very good, and are primarily the result of a boom and bust cycle that frightened investors in 2008-9 and that continues to stymy new investment today. As you know, a classic bubble formed in cleantech in 2005-8. Money poured into solar, wind, biofuels and smart grid, saturating them with "me too" companies and cannibalizing profits. Other sectors received only modest investment (e.g., water, agriculture, energy efficiency and recycling). Many good companies were funded (but of course so were weak ones during the euphoria). The Bubble popped in 2009 coincident with the debt crisis and global recession. The difficult economic times elongated investment holding periods, made additional capital too expensive and obscured future outcomes. Most companies went into a cash-conservation mode, while others went into cold-storage or filed for bankruptcy. The solar panel manufacturing business self-destructed, thanks in large part to (arguably unfair) Chinese competition and steep declines in natural gas prices which made solar and other renewable power appear less attractive for a period of time.

The ensuing period looked like a four-year long nuclear winter. Fundraising fell off a cliff for all but a handful of cleantech firms. The vast majority have exhausted their reserves and are unable to raise new funds. Generalist venture capital firms have abandoned these sectors to return to the tech sector, as described above.

However, today many of these companies have snapped back and are gaining customers, revenue and market share. They are surmounting some of the biggest problems facing businesses and consumers worldwide across the energy, food, water, transportation, construction, waste management/recycling and other industries. The strong companies survived and are poised to grow and to benefit the attentive few investors who are putting new capital to work in these areas. There also are a large number of secondary opportunities available—both partnership interests and secondary directs—and we believe only a very small number of potential buyers of them given the expertise required to pick through the various portfolios to distinguish between the walking dead and those with promising futures.

Commitments to Cleantech Funds* ($ billions)



*Source: Preqin. Excludes Infrastructure funds.

Venture Capital: *That which you cannot change, you must endure.*

The situation is improving but angels / newly-minted billionaires continue to overpay in seed and Series A rounds, making it difficult for disciplined institutional venture capital firms to invest in later rounds without underwriting to lower returns than investors expect from them. Many of the old guard in venture capital have lost their luster. A few rising stars emerged in the last five years but most of these firms will have a difficult time repeating the success of their first fund(s). Lady luck has a habit of flitting about the room and blowing on other people's dice. Furthermore, successful small funds tend to lead to bigger and bigger subsequent fund sizes, often forcing investment strategy changes in order to effectively put the additional capital to work.

VCs and angels continue to focus on gaming, big data, cloud computing and mobile computing / apps. Healthcare continues to be a troubled area due to uncertainty created by the FDA regarding drug and device trials, the unexpected transfer in February of $716 billion from Medicare Advantage and other existing programs (primarily for vision, dental and chronic-illness services for seniors) to Obamacare programs on February 15 and, of course, Obamacare itself, which will not come fully into effect, and its rules and its reach won't fully be known, until 2014 at the earliest. However, healthcare IT (information technology) may prove to be a bright spot as much of the required data collection and proof of compliance with the hundreds of new regulations is a direct consequence of this government intervention. We recommend only investing in venture capital today through growth equity firms or via secondaries or secondary directs where time-to-liquidity is shorter, value can more readily be ascribed and discounts to fair market value may be more readily attained.

Quote of the Quarter

The U.S. Solar Energy Industries Association ("SEIA") just issued a report showing that 2012 was another record year for the U.S. solar industry, which added 3.3GW of new capacity. The price of solar panels has declined 60% since the beginning of 2011, according to the SEIA, which has contributed to the growth in U.S. installations.

"There were 16 million solar panels installed in the US last year – more than two panels per second of the work day – and every one of these panels was bolted down by a member of the U.S. workforce. We've brought more new solar online in 2012 than in the three previous years combined. This sustained growth is enabling the solar industry to create thousands of good jobs and to provide clean, affordable energy for more families, businesses, utilities and the military…."

Rhone Resch, President and Chief Executive of the SEIA

Upcoming Events

We are regular speakers and attendees at key industry conferences. We hope to see you at these upcoming conferences:

April 16-17	**Good Jobs Green Jobs Conference**, Washington, D.C. www.greenjobsconference.org
May 1-2	**Ceres Conference**, San Francisco www.ceres.org
May 20-22	**US SIF Conference**, Chicago https://ussif.org/events/public_event_display.cfm?Event_ID=191

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