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Private Equity Returns Continue to be Impacted By Falling Valuations and Limited Exit Opportunities

January 14, 2003--Newark, NJ--Short-term private equity fund performance showed a slight improvement in the third quarter of 2002 compared to the second quarter of 2002 according to Thomson Venture Economics and the National Venture Capital Association. For the period ending September 30, 2002, one-year returns for venture capital and private equity were a -22.3% and -12.3% compared to a -27.9% and -16.5% for the period ending June 30, 2002. Although short-term performance showed improvement, the prolonged economic downturn is now beginning to affect three-year performance figures. For the period ending 9/30/2002, the three-year performance figures for venture capital and private equity were 15.1% and 1.0%, which is a significant decline from 26.0% and 5.4% from the previous period ending June 30th 2002. The decrease in the three-year returns is a result of the prolonged economic downturn, limited liquidity options (through IPO's or acquisitions) and heavy weighting of capital toward recent vintage year funds.

Figure 1. Venture Economics' US Private Equity Performance Index (PEPI)

Investment Horizon Performance as of 09/30/2002

Fund Type	1 Yr.	3 Yr	5 Yr	10 Yr	20 Yr
Early Stage	-28.6	19.4	44.1	34.2	20.7
Balanced	-19.2	19.4	22.0	22.1	14.7
Later Stage	-16.4	4.6	13.3	23.7	16.1
All Venture	-22.3	15.1	26.8	26.3	16.7
All Buyouts	-8.2	-4.3	1.4	8.8	12.4
Mezzanine	-1.6	5.2	7.7	10.9	11.0
All Private Equity	-12.3	1.0	8.3	15.1	14.5

Source: Thomson Venture Economics/National Venture Capital Association

**Venture Economics' Private Equity Performance Index is calculated quarterly from Venture Economics' Private Equity Performance Database (PEPD). The PEPD tracks the performance of 1400 US venture capital and buyout funds formed since 1969. Returns are net to investors after fees and carried interest.*

Private equity returns are derived from distributions back to investors and interim portfolio company valuations. Due to the fact that valuations have fallen significantly in recent years and distributions back to investors have been minimal due to the sluggish IPO and M&A markets, three-year returns were very much valuation driven. For much of the past two years, venture capitalists have been working to rework their portfolios in an effort to enhance the ultimate result of their funds. This has entailed shutting down failing companies, recapitalizing and strengthening companies with the best prospects and looking for new investments. Distributions back to investors and actual return on investment will determine which private equity firms weathered this economic downturn successfully.

According to Jesse Reyes, Vice President at Thomson Venture Economics, "This is the seventh consecutive negative quarter for venture funds. The current quarter continues to indicate that the correction in the performance of venture funds has not abated although it ostensibly has slowed. What is more troubling is that the longer 20 year performance for the entire private equity industry is now less than 15%, which albeit is higher by a significant amount than public equities, but barely meets the 15-20% expected returns that limited

partners had when making these investments. While the final outcome may ultimately redeem these investments, it does appear that it will be an uphill climb to meet investor expectations."

"It will likely take several years for short-term private equity performance to return back to normal levels as it will take sometime for company valuations to rise and the IPO and M&A markets to recover. Today, venture capitalists are focused on building strong, sustainable businesses so that when liquidity options do emerge, they will be able to produce attractive returns for their investors," explained Mark G. Heesen, president of the National Venture Capital Association.

Figure 2. Third Quarter Company Valuations

Time Period	Avg Val (\$Millions)	Median (\$Millions)
2000-3	83.63	37
2001-3	51.73	26
2002-3	35.26	24.45

Comparison of Recent Funds to their Predecessors after 3 Years of Activity

Venture funds have lives on average of 10-12 years. Their performance during their first three years of investment activity are difficult to measure and volatile. This is because significant investment has been made in young companies that are generally pre-revenue, pre-profit, and often pre-proof-of-concept. Analyzing the performance of young funds does not accurately predict the ultimate performance of the funds.

However, in the current challenging times of falling portfolio company valuations and limited opportunities for exits, it is worth looking at the early performance of recent funds and comparing them to their predecessors. For example, after 3 years of their activity, 1996 vintage year funds had returned 1.17 times the original investment to the investors. In addition, companies remaining in the portfolios had a remaining combined valuation of 4.03 times the original investment. We know now that 1996 vintage year funds as a group performed extremely well.

More recent funds are challenged. At the 3-year mark, vintage year 1998 funds have returned 59 cents on the original investment dollar and the remaining companies in the portfolio had a valuation (residual value) of 94 cents on the dollar. The 1999 funds as a group are even more challenged with a combined paid amount and residual value at only 67 cents on the original investment dollar.

Figure 3. Results for Selected Vintage Years--Three Years from Inception

Venture Funds (Vintage Year)	Measurement Date (3 years from inception)	Realized Return (DPI) (times)	Unrealized Return (RVPI) (times)	Total Return TVPI=DPI+RVPI (times)
Year of Fund Formation				
1984	12/31/1987	0.05	1.00	1.05
1990	12/31/1993	0.14	0.99	1.13
1996	12/31/1999	1.17	4.03	5.20
1998	12/31/2001	0.59	0.94	1.53
1999	09/30/2002	0.16	0.51	0.68

Source: Thomson Venture Economics/National Venture Capital Association

DPI (distributed to paid-in) = ratio of distributions paid out to investors to the original invested capital

RVPI (residual value to paid-in) = ratio of remaining portfolio holdings as valued by the venture firm to the original invested capital

TVPI (total value to paid-in) = ratio of distributed and undistributed portfolio value to the original invested capital

The National Venture Capital Association (NVCA) represents more than 450 venture capital and private equity firms. The NVCA's mission is to foster the understanding of the importance of venture capital to the

vitality of the U.S. and global economies, to stimulate the flow of equity capital to emerging growth companies by representing the public policy interests of the venture capital and private equity communities at all levels of government, to maintain high professional standards, to facilitate networking opportunities, and to provide research data and professional development for its members. For more information about the NVCA, please visit www.nvca.org.

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