Private Equity Education Series
Part 3: Private Equity *Strategies*

Reports in this series

Report Highlights	Page
Part 1: What is Private Equity (PE)?	
Part 2: Investing in Private Equity	
Part 3: Private Equity Strategies	
Leveraged buyouts	1
Venture capital	3
Mezzanine debt	3
Distressed investing	4
Special situations investing	5
Growth capital	5
Economic drivers of Private Equity strategies	5
Part 4: PE Portfolio Construction & Performance Measurement	

UBS Financial Services Inc. (UBS FS) is pleased to provide you with information about alternative investments. There are a few points we would like to raise with you at the outset.

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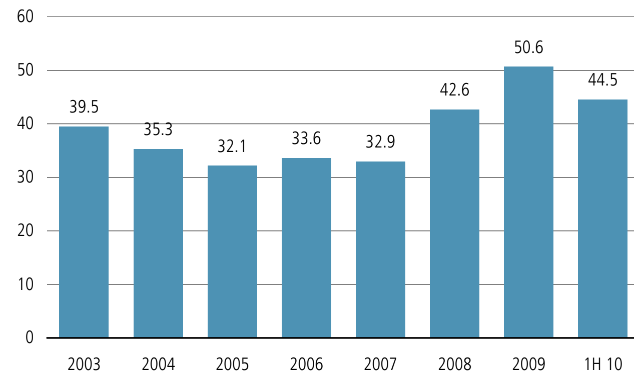
Private equity is an extremely heterogeneous asset class with many sub-sectors. These sub-sectors (e.g. distressed investing, different stages of buyouts and venture capital, mezzanine finance, special situations funds etc.) have very different asset characteristics. This means that each sub-sector has different performance drivers, which investors need to understand to make informed decisions.

This installment of our private equity series highlights the most common private equity sub-sectors and describes their salient characteristics.

Leveraged buyouts

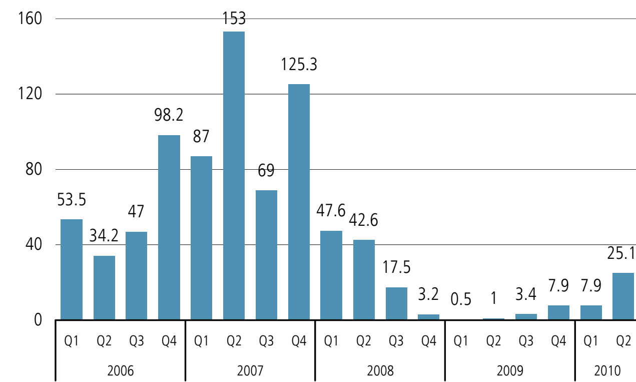
Leveraged buyout (LBO) firms specialize in helping entrepreneurs to finance the purchase of established companies. The approach of such firms is to provide a management team with enough equity to make a small downpayment on the purchase of a business, and then to pay the rest of the purchase price with borrowed money (hence the term “leveraged”. A typical LBO is funded with four main types of capital: bank debt, high-yield bonds, mezzanine debt and equity. Bank debt may account for 50% of an LBO’s funding, junk and mezzanine debt for 20% and equity around 30%. The assets of the business are used as collateral for the loans, and the cash-flow of the company is used to pay off the debt. The companies acquired are usually divisions being sold by corporations that are refocusing on their core businesses, or businesses owned by families that wish to cash out. To earn an attractive return on their investment, LBO firms build value in the companies they acquire. Typically, they do this by improving the acquired company's profitability, growing the acquired company's sales, purchasing related businesses and combining the pieces to make a bigger company, or some combination of these techniques. A popular technique is consolidation, aka "buy-and-build."

Figure 1: More equity required for LBO deals
Average equity levels contributed, in %



Source: S&P LCD Comps

Figure 2: US buyout activity
LBO volume (2006 – 2010, in billions of dollars)



Source: S&P LCD Comps

The mega LBO segment within this sub-sector is by far the largest component of the private equity space. Prior to the financial crisis, one reason why the LBO market had grown so much was the readily available pool of debt financing. At the height of the LBO boom, in H1 2007, $606 billion worth of leveraged loans were issued, surpassing the amount originated in all of 2005. Also, because buyout firms were willing to band together into so-called "club deals," the deals themselves had become larger. It has also been the segment most susceptible to the economic crisis though recent months have seen an uptick in both the volume and the number of mid-market deals, supported by larger equity contributions than in the period leading up to 2008.

The mega and large buyout segments are expected to face several debt-related challenges in the next few years. The most significant include re-financing the wall of buyout debt due for repayment in 2012-14, the more conservative capital structures required by the marketplace (greater equity requirements, see Figure 1), the limited availability of debt for new LBO investments and greater difficulties in bringing together debt syndicates.

Middle market – Generally defined as companies with revenues of $10 million - $250 million, assets of $200 million - $500 million and earnings before interest, taxes, depreciation, and amortization of less than $50 million, this market represents a large universe of potential target companies. Companies of this size usually share some common characteristics, such as seasoned management teams, proven business models, and critical size in terms of infrastructure. As going concerns, they are also frequently available at attractive entry price valuations.

Targeting the middle-market space means situational investing in companies that have successfully grown to a size that minimizes the enterprise risk associated with smaller companies, but offer lower entry multiples relative to large-cap companies. Additionally, middle-market companies are generally small enough in the sense that they are not widely brokered by the corporate finance community – therefore private equity funds can often acquire them with less price competition. Also, middle-market companies that are going through distressed times tend to be more responsive to value-added initiatives. Lastly, investors in middle-market companies typically can pursue a variety of exit options, which often create opportunities to realize multiple expansions upon exit. The usual exit strategies for debt investors are to either "fix" a business (by restructuring it and implementing a turnaround strategy), divest it (sale of debt or equity), or liquidate it.

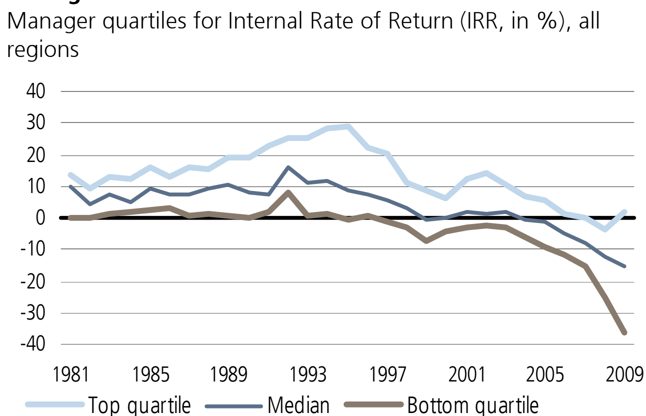
Venture capital

Risk capital for starting, expanding and acquiring companies is critical for any economy to grow. Preqin is a company that provides comprehensive data and research on private equity, real estate, hedge funds, infrastructure funds and other alternative investments. They estimate that "around 3,700 venture funds have raised $558 billion since 1998, with North America-focused funds consistently raising the most capital each year."

Most are quite specialized, often investing in a single field, such as telecommunications or health care. Venture capital firms also tend to specialize by stage of investing. There are no hard and fast definitions for these stages. Broadly, however, seed-stage firms tend to provide a few hundred thousand dollars, and perhaps some office space, to an entrepreneur who needs to develop a business plan. These are the riskiest investments with the highest failure rates. Early-stage venture investors back companies at a point where they have a completed business plan, at least part of a management team in place, and perhaps a working prototype. Late-stage investors typically provide a second or third-round of financing, often of $2 million - $10 million or more, that funds production, sales and marketing, and carries the company into the revenue-producing stage. Mezzanine (or pre-IPO-stage) investors provide a final round of financing that helps carry the company to an initial public offering.

Figure 3: Wide dispersion of returns across venture capital managers

Manager quartiles for Internal Rate of Return (IRR, in %), all regions



Source: Thomson One Banker: All Regions IRR as of June 30, 2010

When investing in venture funds, it is important to be aware that the dispersion of returns between well-performing fund managers and laggards is especially pronounced (see Figure 3). Therefore access to the best managers, who are often capacity constrained, is a very important consideration.

Mezzanine debt

The mezzanine debt specialties of private equity share characteristics of both private debt and private equity financing. Mezzanine debt firms provide a middle level of financing in leveraged buyouts below the senior debt layer and above the equity layer. A typical mezzanine investment includes a loan to the borrower, in addition to the borrower's issuance of equity in the form of warrants, common stock, preferred stock, or some other equity investment. Often, the loan is contractually subordinated to a loan made by one or more senior secured lending institutions. Typically, the note evidencing the loan has a maturity of 6-10 years, with interest paid only during the first five years. Because the loan is subordinated, the interest rate is generally higher than the rate on the senior debt, and a limited amount of equity is issued to the mezzanine investor for nominal consideration.

Mezzanine investments have been used extensively to help fund the purchase and recapitalization of private, middle-market companies. Mezzanine investors also invest in smaller public companies and in foreign entities. Often, the borrower is highly leveraged after the investment is made.

Because mezzanine investments include both debt and equity portions, mezzanine investors have defied the traditional classifications of lenders, on the one hand, and equity investors, on the other. The flexible financing nature allows a mezzanine investor to emphasize the capital preservation and current-pay features of a loan and, at the same time, seek significant upside on its investment through the equity participation.

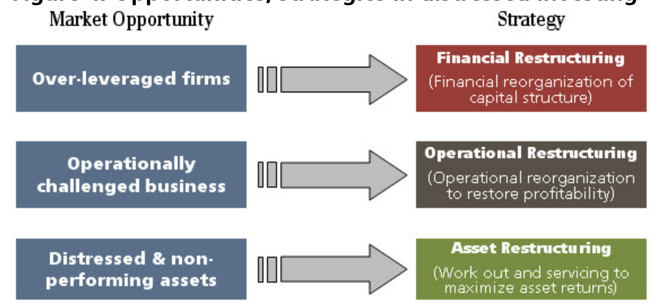
Distressed investing

Over the past 20 years, distressed debt investing in the United States has become a mainstream investment strategy. The distressed debt market has increased in size with private equity firms and hedge funds now key players in this market. There are around 170 United States based, and 20-30 Europe based credit managers who invest in distressed debt managing $120-$150 billion of private capital (hedge funds and private equity – often they overlap). We estimate that, over the past few years, $50 to $70 billion has been raised by dedicated distressed middle-market opportunity funds – the bulk of which was in 2008. Traditional investors, who mainly seek to generate capital gains and investment returns through exposure to distressed debt investments, have been joined by strategic investors undertaking distressed M&A.

As corporate, legal and capital structures have grown more complex, the level of expertise and differentiation in the "style" of investment has kept pace. Approaches to distressed debt investing include private equity-type structures practicing control-oriented[1] and restructuring[2] strategies as well as in hedge fund-type trading[3] and non-control[4] structures. Consistent with investment activity, public and corporate pension plans, endowments and foundations, as well as fund of funds have been large investors in the distressed sector.
The middle-market space continues to bring compelling investment opportunities. These opportunities include: i) the purchase of companies that are distressed or out-of-favor, for low multiples of cash flow and/or low percentages of asset value; and, ii) the acquisition of quality companies with excessive leverage or those that are going through bankruptcy that requires restructuring.

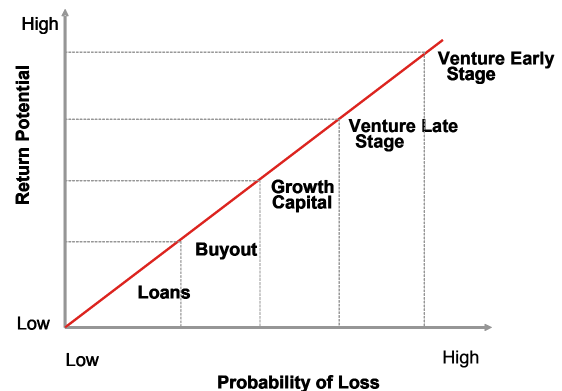
The economic and financial crisis has had a negative effect on the cost and availability of credit. This has further increased opportunities. The level of analytical sophistication, both financial and legal, necessary for successful investment in the space is unusually high, creating entry barriers for participants. Special bankruptcy situational investments are expected to be attractive segments for distressed investing.

Figure 4: Opportunities, strategies in distressed investing



Source: UBS

Figure 5: Growth capital exhibits intermediate levels of risk and return



Source: UBS

[1] Control-oriented investing is largely practiced by private equity funds that generate returns by accumulating large distressed debt positions that allow them to acquire a position of control in bankruptcy proceedings – they make active operational and managerial interventions.

[2] Restructuring funds invest in financially distressed companies, but they do so by investing new equity in companies in order to take control. They are, for the most part, equity investors and not debt investors.

[3] Trading-oriented strategies are largely the preserve of hedge funds. These funds generate returns by buying undervalued debt securities and have very short holding periods.

[4] Returns come from passively holding securities - where the value of securities is enhanced through active negotiations during the bankruptcy process.

Special situations investing

Special situations investing is a broad category which encompasses variants of opportunistic distressed debt plays, equity-linked debt, project finance, one-time opportunities resulting from changing industry trends or government regulations, and leasing. This category is not clearly defined and may include investment in structured equity or debt or mezzanine debt financing, where the debt-holder seeks equity appreciation via such conversion features as rights, warrants or options.

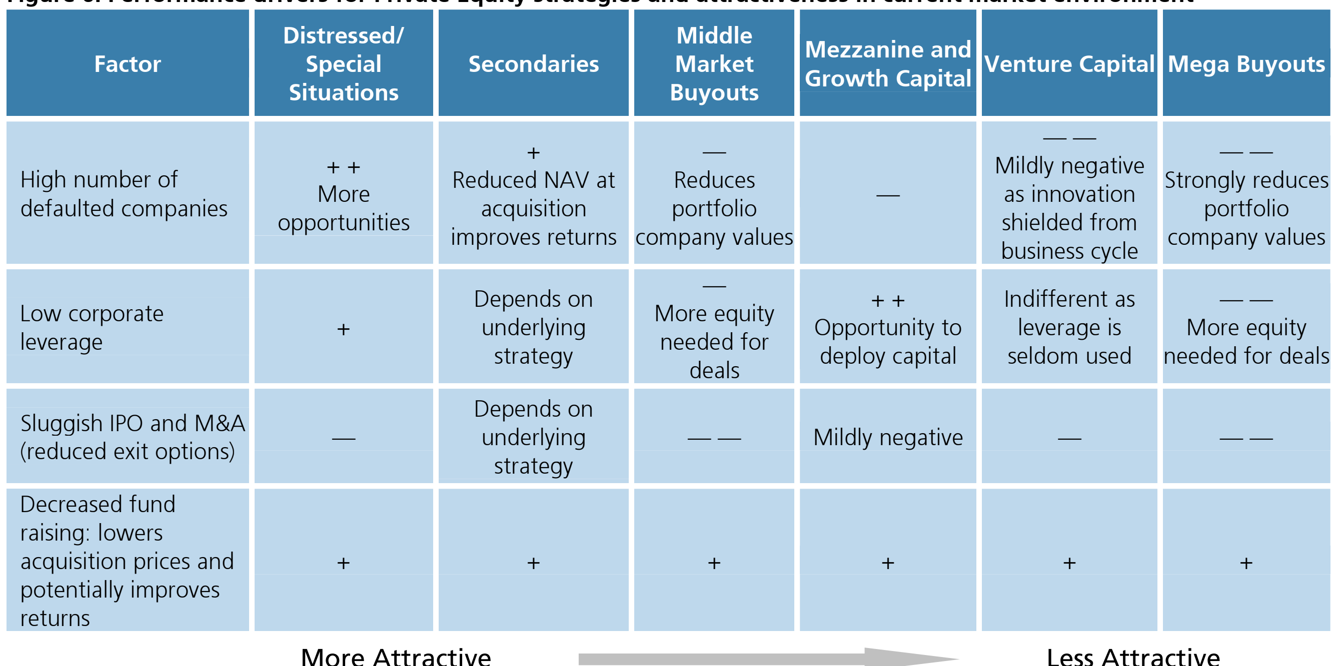
Growth capital

Growth capital describes funding that enables established firms to undertake expansion activities such as investing in new plants or marketing or enhancing distribution. The nature of growth capital varies in its structure or product form. It exists both as term debt, often from traditional sources such as banks as well as in the form of equity or equity-type investments from private equity providers. It also exists to a limited degree as mezzanine finance – term lending, with less security than bank debt but at a higher cost, often through a final "kicker" payment or share in the company's equity. What differentiates growth capital from other types of investment is the level of risk. It is positioned between the two extremes of high risk – high return pure venture equity investment and lower risk, usually fully secured, bank lending.

Economic drivers of private equity strategies

Changes in macroeconomic and industry conditions have varying degrees of impact on the performance of different subsectors of private equity. We believe the current environment is especially favorable for distressed and special situations investing as well as secondaries (discussed in "Part 2: Investing in Private Equity"). Middle-market buyouts, mezzanine and growth capital are in the middle of the pecking order, while venture capital and mega buyouts appear less attractive at the moment (see Figure 6)

Figure 6: Performance drivers for Private Equity strategies and attractiveness in current market environment



Factor	Distressed/ Special Situations	Secondaries	Middle Market Buyouts	Mezzanine and Growth Capital	Venture Capital	Mega Buyouts
High number of defaulted companies	+ + More opportunities	+ Reduced NAV at acquisition improves returns	— Reduces portfolio company values	—	— — Mildly negative as innovation shielded from business cycle	— — Strongly reduces portfolio company values
Low corporate leverage	+	Depends on underlying strategy	— More equity needed for deals	+ + Opportunity to deploy capital	Indifferent as leverage is seldom used	— — More equity needed for deals
Sluggish IPO and M&A (reduced exit options)	—	Depends on underlying strategy	— —	Mildly negative	—	— —
Decreased fund raising: lowers acquisition prices and potentially improves returns	+	+	+	+	+	+

More Attractive → Less Attractive

Note: "+" denotes supportive factor; "–" denotes unsupportive factor. Source: UBS, Stylistic illustration

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Private Equity
In addition to the risks associated with alternatives investments [and hedge funds generally], there are risks specifically associated with investing in private equity. Capital calls will be made on short notice, and the failure to meet capital calls can result in significant adverse consequences, including but not limited to a total loss of investment.

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