The Outlook for Private Equity: First Quarter 2008

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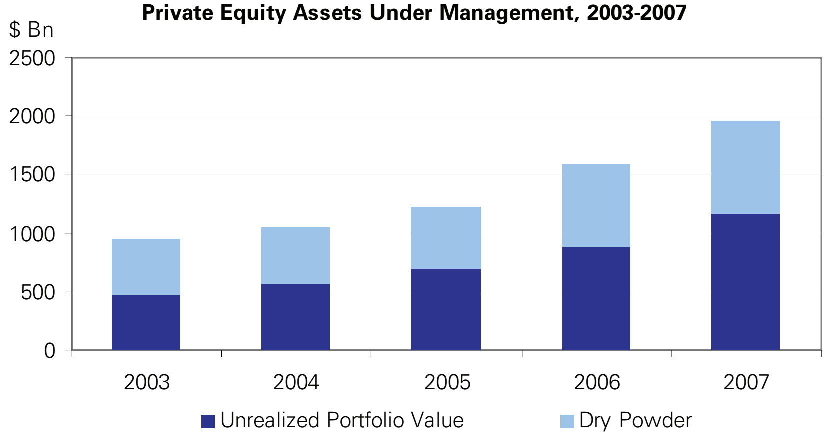
Introduction: Existing Market Conditions

The global private equity industry has undergone dramatic growth in recent years, doubling in size from $1 trillion assets under management (AUM) in 2003 to $2 trillion by year-end 2007. (Please refer to Exhibit 1.) This AUM figure includes both the equity value of companies currently in a portfolio, as well as the "dry powder" raised but not yet invested capital commitments. This new threshold was achieved despite the current credit market turmoil which has only intensified since the second half of 2007. The expansion of the private equity market has been broad-based across geographies and fund types including mega buyout funds, middle-market and smaller buyouts, distressed debt, mezzanine, venture, and, more recently, real estate and infrastructure.

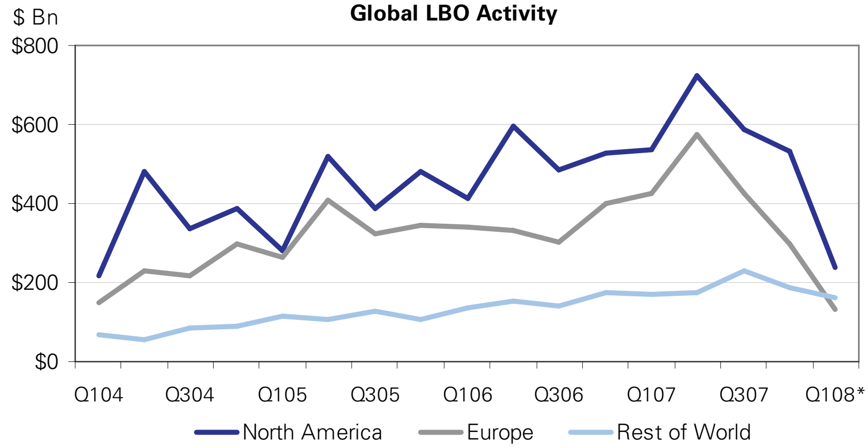
Exhibit 1
Private Equity Assets Under Management, 2003-2007



Source: 2008 Prequin Global Private Equity Review

The current credit crunch has altered the private equity landscape. Following two years of increasingly favorable lending conditions, leverage is no longer readily available. The market continues to languish amid the on-going liquidity crunch. As a result, deal volume has declined considerably during the second half of 2007. The slowdown in the large scale buyout market is most acute. As depicted in Exhibit 2, leverage buyout activity (LBO) has fallen around the globe, most significantly in the US and Europe.

Exhibit 2
Global LBO Activity

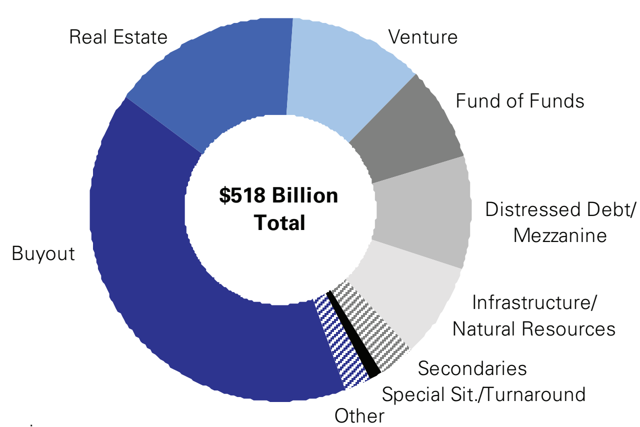


Source: Dealogic *as of 3/15/08

Across the broad private equity industry, managers of large buyout and real estate funds have been most affected, facing much more challenging conditions in 2008. Credit spreads on both corporate and commercial real estate loans have widened dramatically. Since both mega private equity buyout and real estate deals are highly leveraged, the lack of leverage and the higher cost of leverage have put a stop to such deals. The market turmoil has made buyers of LBO debt highly skittish. There also exists an estimated $390 billion of existing loans that banks have failed to syndicate. This has led to the cancellation of many deals as well as the seizure of debt support for many of the new deals. Indeed, the worsening credit environment has halted the syndication of many leveraged loans, causing a digestion problem for banks.

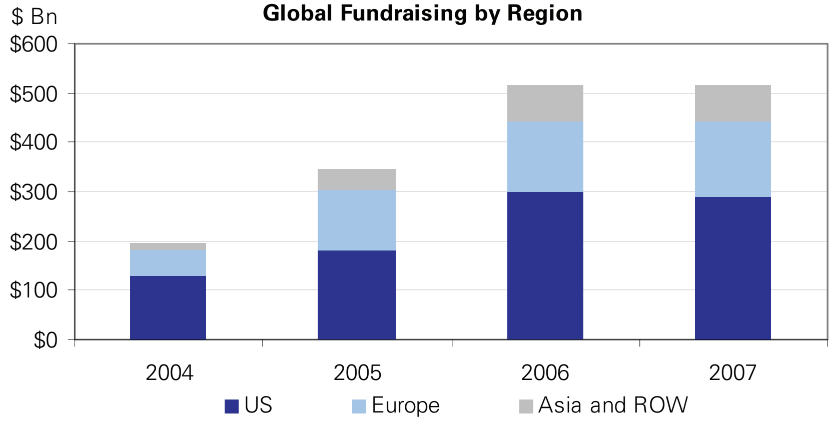
The credit crunch has also prevented many buyout funds from making new investments or recapitalizing existing portfolio investments. Not surprisingly, broken deals, bankruptcies and underperforming funds are on the rise. The combination of a weakening economy and heavy debt loads is causing trouble for companies that went private in leveraged buyouts since the start of 2006. The reduction in credit should also dampen return expectations for private equity relative to where they have been over the past several years.

Exhibit 3a
2007 Fundraising by Fund Type



Source: Preqin

Exhibit 3b
Global Fundraising by Region



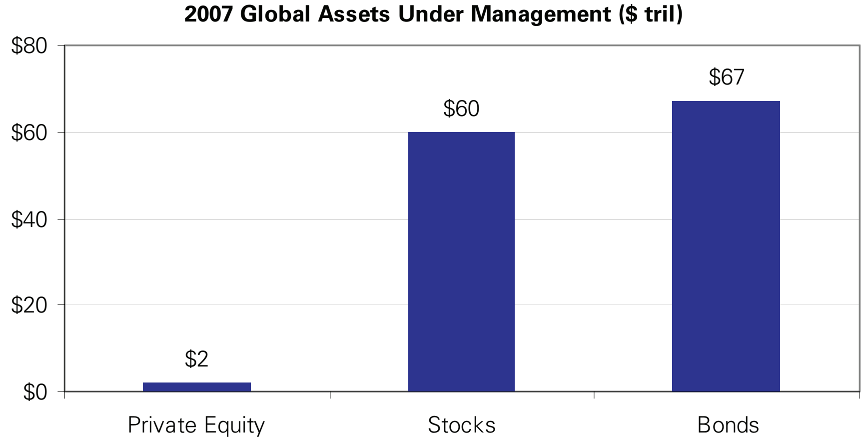
Source: Preqin

Despite the worsening credit climate, there remain drivers that should continue to propel the private industry forward over the longer term. There remains ample committed but not yet invested capital. The AUM figures presented in Exhibit 1 include both committed and not yet invested capital, "dry powder", and equity value of companies in private equity fund portfolios. Funds with recent vintages still have uncalled capital. During 2006 and 2007, nearly $500 billion of capital was raised yearly. Exhibits 3a and 3b show fundraising trends by fund type and geography.

Despite the credit woes and heightened market volatility, institutional allocations to private equity are expected to increase as well. New sources of capital are showing up. Sovereign wealth funds (SWF) have been aggressive in their appetite for private equity, drawn to their historically high relative returns. Such government-controlled SWFs are expected to control up to $5 trillion in capital over the next 5 years[1]. There is, thus, a huge volume of yield-hungry financial capital looking for investment opportunities.

Most surveys indicate increased allocations to private equity, which should support its growth long term. But despite this growth, private equity still remains an emerging asset class. Even after passing the $2 trillion benchmark, it accounts for only 3% of the market capitalization value for both global equities and bonds. (Please refer to Exhibit 4.)

Exhibit 4
2007 Global Assets Under Management ($ tril)



Source: Preqin, World Federation of Exchanges, Merrill Lynch

[1] 2008 Preqin Global Private Equity Review

According to the 2008 Private Equity Intelligence Report, private equity AUM should grow to $5 trillion within the next 5 to 7 years. Many of the risks to this industry, therefore, are near-term. The prospects for the private equity market will also depend on the global economic and credit market outlook. The capital market dislocation globally, the downshifting of growth prospects, and declining corporate profitability have considerable implications for the private equity industry going forward. In the next section, we provide brief insights as to our outlook for world economic growth in the near-term.

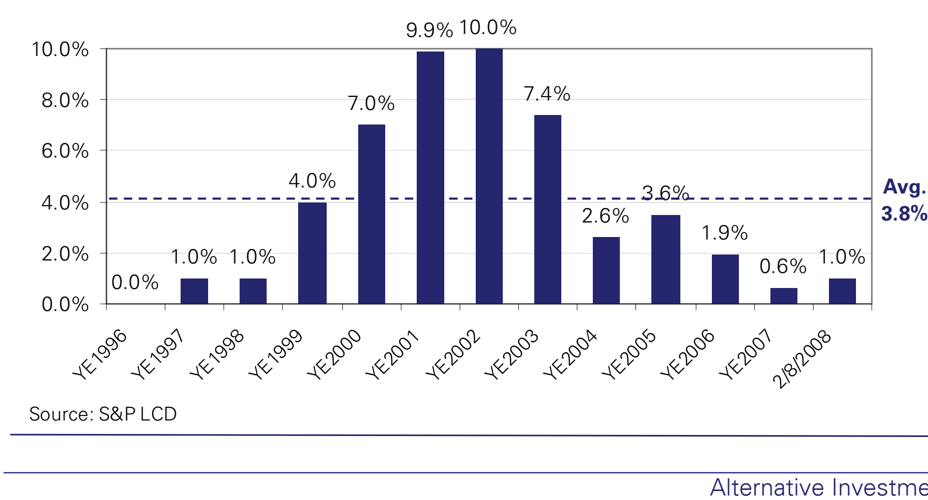
Prospects for the Global Economy and Credit Markets

At the epicenter of the outlook for the global economy are growth prospects for the US. Despite the vast improvements over the past decade in the economies of many emerging markets, and the rise of China and India as engines of world growth, the world still remains vulnerable to the health of the US consumer. The outlook for the US economy and consumer has also worsened considerably under the weight of new evidence. The continued deterioration in financial markets and negative incoming data strongly suggest that the US economy will contract during the first half of the year. With the second consecutive drop in payrolls, the odds of avoiding a recession are getting larger. The US housing market continues to decline, with prices dropping at a record pace. Record oil prices are also squeezing consumers globally. The drivers of high oil prices seem to be a combination of strong demand from emerging countries, China in particular, combined with a flow of liquidity into commodities as an inflation hedge against aggressive interest rate cuts by the US Fed and the declining value of the dollar.

We expect that US GDP should decline by 0.5% during the first quarter and another 0.2% in the second quarter. In many ways, the recession of 2008 will have many similarities to the recession of 2001. In both cases, the contraction in economic activity is mild and interest rates are very low. Additionally, aggressive monetary policy and fiscal stimulus should set the stage for economic recovery during the second half of the year. The government expects that the rebate checks should arrive in May and we have included that assumption in our quarterly economic forecast.

Another reason for the mild nature of this recession is that inventory-to-sales ratios are very low, much lower than where they were in 2001. The corporate sector is also in much better financial shape than they were during past recessions. Indeed, corporate default rates, which directly impact the private equity landscape, remain significantly lower than where they were in the 2001 recession. (Please refer to Exhibit 5.) But as the economy weakens, corporate default rates are expected to rise.

Exhibit 5
Default Rates Have Remained Low Over the Past 3 Years
(Percentage of Outstanding Leveraged Loans in Default or Bankruptcy)



Source: S&P LCD

Another bright spot in the US outlook is the shrinking trade deficit. Growing net exports are expected to add 50 basis points to growth in 2008, making the difference between a mild recession and a much deeper one. Finally, US monetary policy has been highly expansionary and preemptive. The Fed has lowered the funds rate to 2.25% and has provided additional liquidity support to the financial sector, living up to its old responsibility of lender of last resort.

The rest of the world will not be immune to a US recession, as talk of decoupling from US growth prospects is premature. As reflected in the forecast highlights table below, world growth should slow from 3.8% in 2007 to 3.2% or even less in 2008. The slowdown that began in 2007 was concentrated in North America, as some regions, notably the emerging markets in Asia, decoupled from the US. This year, however, all regions should downshift with the exception of the Middle East and Africa (MENA). The broad MENA region has benefited from high commodity prices and insulation from the credit turmoil. As long as the US economy avoids a protracted and deep recession, the world economy should be able to avoid a more serious downturn.

Growth will decelerate more sharply in the industrialized Western European economies and Japan and stronger currencies are dampening exports. Housing markets in many Western European economies are also downshifting, albeit not to the same degree as in the US.

Economic growth should also slow in China, but on a relative basis, growth will remain strong. Export gains are slowing as the world economy weakens. But most of the slowdown is due to the US downturn. Inflation, especially food inflation, remains a top concern for the Chinese government. The government needs to slow growth but any meaningful policy action will remain on hold until after the Beijing Olympics.

Exhibit 6
World Economic Overview: Forecast Highlights
(Real GDP Percentage Growth)

	2006	2007	2008	2009	2010
Real GDP Growth					
World	4.0	3.8	3.2	2.5	3.7
US	2.9	2.2	1.2	2.0	3.2
Eurozone	2.9	2.7	1.6	1.9	1.8
Japan	2.4	2.1	1.5	1.6	1.6
China	11.1	11.4	9.9	8.9	8.3

Source: Global Insight and RREEF Research

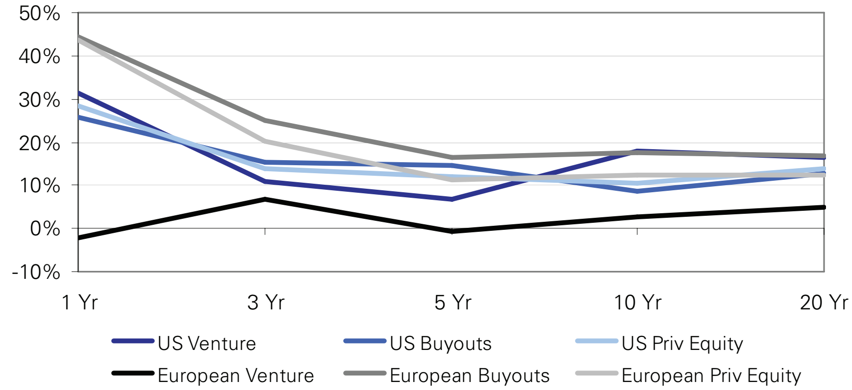
As long as Chinese growth holds up in the high single digits, emerging markets will be able to withstand an imminent US recession. Emerging markets have greatly benefited from high commodity prices and expanding world trade. These countries also benefit from increasing foreign direct investments.

Why Private Equity Continues to Remain Attractive

As many industry veterans lament the passing of the "golden age" of private equity for what has now been deemed the "purgatory phase", uncertainty in the market has not diminished the continued benefits of the asset class and the role it plays in an investment portfolio. The advantages of private equity, mainly its potential for high risk-adjusted returns and diversification vis-à-vis other asset classes, has upheld under the current global financial and economic situation.

As of third quarter 2007, one-year, five-year and ten-year annualized returns for US private equity were 28.2%, 12.0% and 10.6% respectively[2]. Similarly in Europe, one-year, five-year and ten-year annualized returns were 43.8%, 11.3% and 12.5%[2]. Despite the credit crunch in latter half of 2007, quarterly returns for both US and European private equity remained above their long-term historical averages, supporting the notion that private equity performance can withstand some capital market fluctuations. Exhibit 7 illustrates the industry's performance over an extended time period.

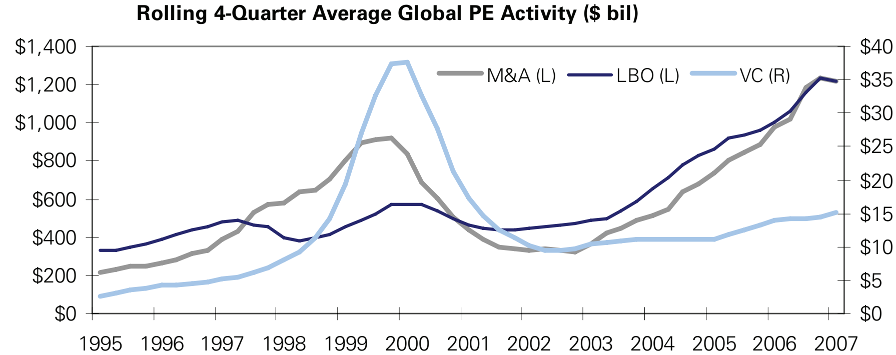
Exhibit 7
Investment Horizon Performance*



Source: Thomson Venture *data ending 9/30/07

Undoubtedly, the global private equity market is headed for a downturn in terms of deal activity in the coming quarters due to reduced availability and increased cost of credit. By most analyst projections, the industry peaked in 2007 with this year already starting to show signs of a softening environment. What's essential to keep in mind is that private equity, by nature, is a cyclical business that is not impervious to both highs and lows (please refer to Exhibit 8). Back in 2001, private equity entered a similar downturn with peak-to-trough declines in deal volume and investment of 65% in mergers and acquisitions, 25% in leveraged buyouts and 75% in venture capital. It didn't take long for the market to rebound though; over a span of three years private equity activity began to strengthen once again. Moreover, funds raised during periods of distress actually outperformed those of vintage years when the economy and private equity market was at

Exhibit 8
Rolling 4-Quarter Average Global PE Activity ($ bil)



Vintage Year	**US**	20.6	18.5	16.3	7.5	1.3	5.3	10.5	11.0	21.7	12.8	nm	nm	nm
Returns %	**Europe**	30.6	13.7	17.7	7.1	0.9	0.7	22.6	23.1	21.4	4.6	nm	nm	nm

Source: Dealogic, Thomson Venture

[2] Thomson Venture

its height. Vintage 2000 funds in the US have achieved a current average return of 5.3% whereas vintage 1995 funds have an average return of 20.6% and vintage 2003 funds have an average return of 21.7%[2]. The same scenario emerges for European returns; vintage 2000 funds have achieved a current average return of 0.7% while performance was far superior for vintage 1995 and vintage 2002 funds producing returns of 30.6% and 23.1% respectively[2].

Although the range of returns for this current private equity cycle is not yet meaningful, conventional wisdom holds that this pattern will repeat itself. Some industry experts claim this is because private equity performance lags that of public markets by three years while others attribute this phenomenon to recessionary environments producing more reasonable valuations and therefore greater return potential in light of a reduced competitive landscape. A sense of investment discipline also begins to take hold during these time periods which may account for outsized returns.

Trends and Outlook for Private Equity

With buyout and takeover activity on the wane globally, the industry has been shifting its gaze towards strategies that can capitalize on the current credit situation, penetrate growing markets or represent a niche investment opportunity. Debt products (mezzanine and distressed) as well as special situation/turnaround funds have been gaining favor amongst general partners for their potential to produce above-average returns in a setting where the availability of capital is greatly reduced, default rates are expected to kick-up and firms are inclined to declare bankruptcy rather than restructure internally. Among debt products, credit opportunity funds in which senior tranches can be purchased at a discount with mezzanine returns, look to benefit from a contraction in collateralized loan and debt issuance. The counter-cyclical behaviors of these types of investments are what will partially help the industry weather the current downturn.

Additionally, two areas starting to attract greater inflows of capital are: emerging economies and the middle-market. According to the most recent Coller Capital Private Equity Barometer, Asia Pacific buyouts and venture capital rank first and third respectively as the best areas for investment over the next 12 months. There has already been a healthy amount of buyout activity in the region, especially in the middle-market, but there is still more capacity for venture capital deals. Although lower on most investors' radar, Latin America is in the midst of its second generation of private equity investing, the first being in 1993. A booming commodities market, domestic growth and an expanding middle-class will be the key drivers of the economy and hence, private equity, in the coming years. Private equity is also benefiting from European Union accession and economic integration plans in Eastern and Central Europe. The region still has attractive pricing and manageable leverage as compared to other markets which has kept it more stable.

In North America and Europe, middle-market buyouts are increasing in popularity as a viable domestic strategy. They are less capital intensive, tend to have better acquisition and exit multiples, represent more opportunities for value creation and constitute a greater investable universe. By some forecasts, half of all buyout fundraising in 2008 will be dedicated to the middle-market.

The secondary private equity sector has been continuing along its growth trajectory in recent months in terms of both capital raising and deal activity. The current market size is estimated to be around $63 billion with annual growth projected at between $10 and $12 billion[3]. Most recently, the industry reached a milestone with the California Public Employees' Retirement System selling the largest portfolio of commitments ever valued at close to $3 billion spread across 50 funds. Dealflow is expected to remain robust through the latter half of 2008, once the market correction of the past nine months is reflected in private equity fund reports. Furthermore, pricing for these commitments has come down since mid-2007 and should approach par with net asset value this year.

Specialized private equity funds, such as infrastructure and natural resources/energy, are helping to diversify portfolios and allow certain general partners to differentiate themselves from their competitors. Infrastructure funds have an attractive risk/return profile and tend to reduce the effects of the j-curve by paying out distributions faster depending on the maturity of their underlying investments. Natural resource and energy funds are also gaining in prominence as the world seeks to reduce its dependence on foreign oil and develop alternative and clean energy sources to support future economic growth and development.

Exhibit 9
Expectations for Private Equity by Sector

Strategy	Outlook
Distressed Debt	Rescue financing and work-out options serve as only a temporary fix in the current market environment. Corporate default rates will inevitably rise in the coming quarters making it an opportune time to invest in distressed debt.
Infrastructure	Global need for infrastructure investment is estimated at $10-$30 trillion. With mounting government pressure to privatize and structural demand drivers in play, the sector will increase in prominence.
Secondaries	Decline of public equity markets has caused some institutional investors to be over-weighted to private equity. Secondary commitment sales should benefit from this and the market should in turn deepen.
Mezzanine	Alternative debt instruments such as second-lien and payment-in-kind financing have started to retrench making way for mezzanine. Its counter-cyclical nature and risk/return profile make it an attractive near-term strategy.
Natural resources	Record oil prices, the on-set of global warming and a growing need for renewable energy all favor investment in natural resources. Socially responsible clean technology will attract venture capital in the forthcoming cycle.
Special Situations/ Turnaround	Overly leveraged firms with strained balance sheets are becoming prime targets for private equity turnarounds. Recent changes to bankruptcy law may make it more likely that firms will be sold rather than restructure internally.

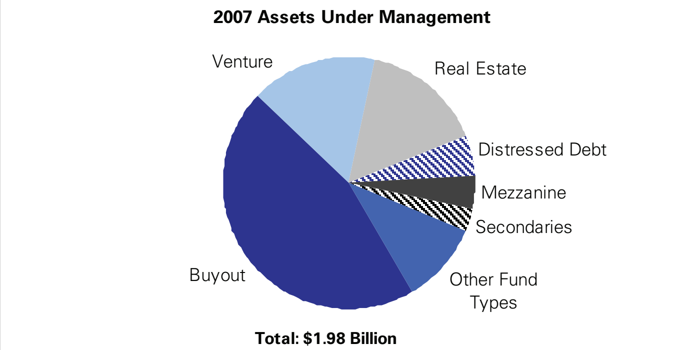
Source: RREEF Research

The overall outlook for private equity can be described as cautious at best with a wait-and-see mindset for many investors. The diversity of strategies that private equity encompasses assures some near-term and medium-term winners; however, buyout and mergers & acquisitions activity still remains in flux. The credit crisis has shown few signs of abatement and liquidity is still an issue to contend with in the marketplace.

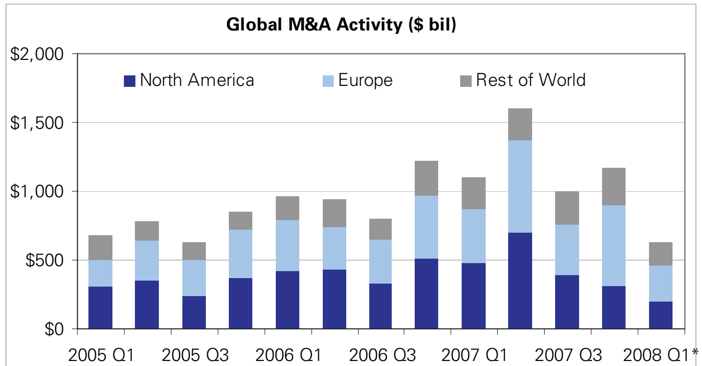
Despite this current business environment, investors have exhibited optimism towards the industry. They are taking a more active role in choosing a diverse set of fund managers that can consistently deliver solid results. Investors' focus on performance is not limited to beating the benchmark; instead, there is an emphasis on achieving alpha returns, rather than beta. This has been made clear to fund managers who have all heard from limited partners that they should focus on deal quality over quantity, a sentiment that has not been quite as strong in recent years when the market was at full-force.

[3] Pensions & Investments, March 2008

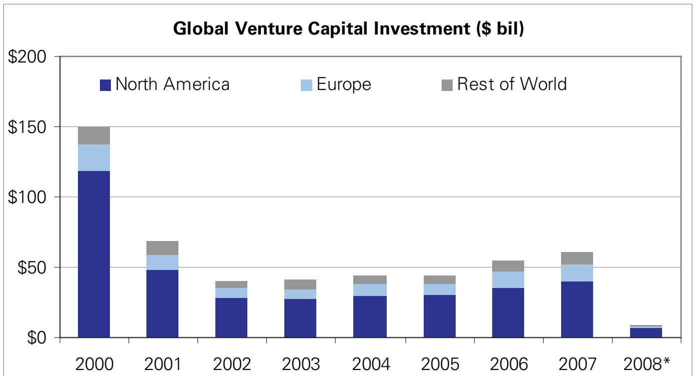
Private Equity Trends At a Glance



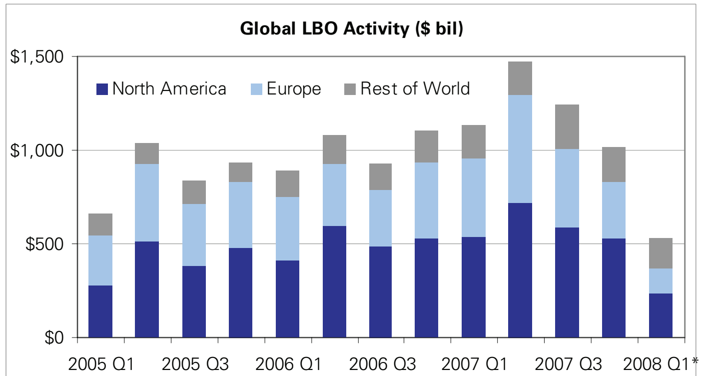
Source: 2008 Preqin Global Private Equity Review



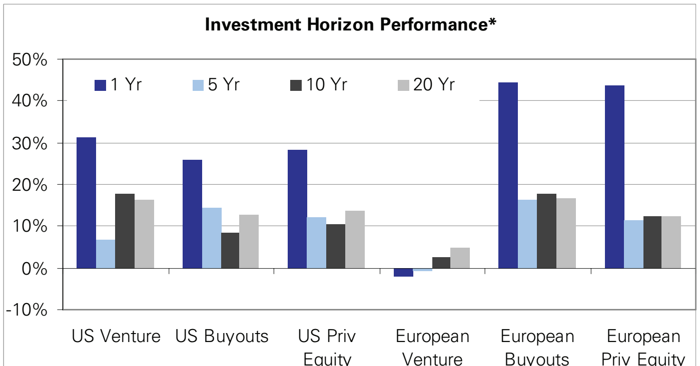
Source: Dealogic *as of 3/15/08



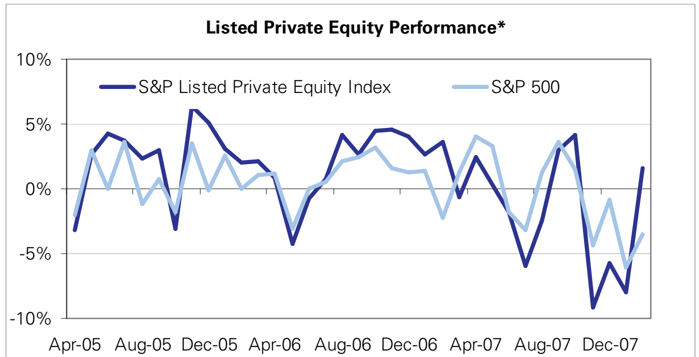
Source: Thomson Venture *as of 3/15/08



Source: Dealogic *as of 3/15/08



Source: Thomson Venture *data ending 9/30/07



Source: Bloomberg *monthly returns as of 2/29/08

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