

July 2008

The Outlook for Private Equity: Second Quarter 2008

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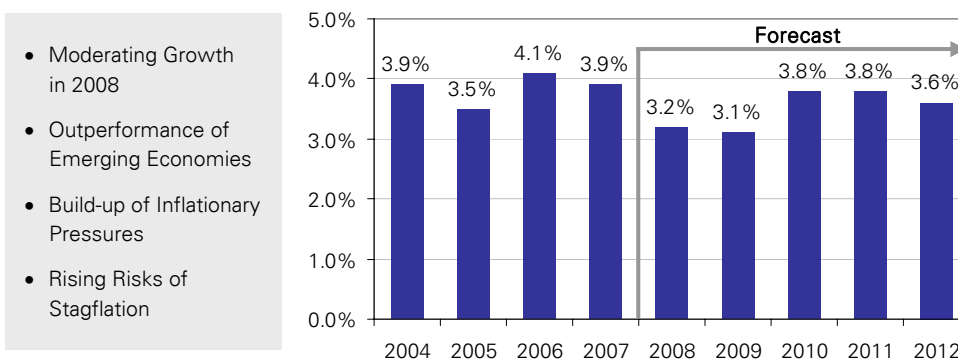
Introduction

The Year 2008 has not been one of the best for most participants in the private equity industry. The relentless seizure in credit markets globally has rendered buyout activity much more difficult for firms. Venture firms, meanwhile, have been more focused on keeping their business afloat as economic growth stagnates, particularly in the industrialized world. In this quarterly update, we focus on the outlook for global growth and the non-traditional investment opportunities available for private equity investors.

The Prospects for the Global Economy: A Downward Inflection Point?

Less availability and the higher cost of capital, housing woes, record oil and commodity prices and a US economy at brink of recession have created much more uncertainty surrounding the prospects for global growth. The recent rout in global stock investments underscores this uncertainty. Credit fears have also resurfaced as the global financial system remains vulnerable to further writedowns by financial institutions. TED spreads widened out again recently. And a new worry, inflation, is taking center stage. A global revival in inflation has put Central Banks on alert, raising expectations of interest rate hikes going forward.

Exhibit 1a
World Growth Downshifts
World Real GDP Growth



Source: Global Insight and RREEF Research

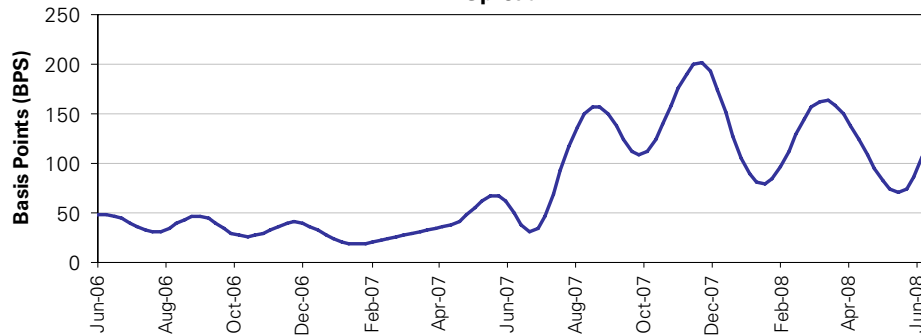
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- Moderating Growth in 2008
- Outperformance of Emerging Economies
- Build-up of Inflationary Pressures
- Rising Risks of Stagflation

Exhibit 1b
Financial Markets Remain Under Stress
***TED Spread**



*The TED spread is the difference between the interest rate for the three-month US treasuries and LIBOR. It is a measure of liquidity and shows the degree to which banks are willing to lend money to one another.

Source: US Board of Governors of the Federal Reserve System, Moody's Economy.com

The world economy is transitioning to much slower growth. Much of the slowdown is attributable to a downshift in activity in the industrialized countries. The US, Western Europe, and Japan are struggling. Emerging market growth should also slow, but expand at a pace that still exceeds past historical rates, as a revival in domestic-led growth offsets weakness in exports to the West. The only region where growth is expected to accelerate in 2008 is the Middle East and North Africa. These economies are less exposed to the US and to the current financial crisis gripping most regions of the globe and have benefited from higher oil and commodity prices.

The downshift of economic activity and simultaneous rise in oil and commodity prices should dampen corporate profit growth, especially in the beleaguered financial, housing, and auto sectors. Lower corporate profitability will hinder private equity activity as well as the less availability of leverage and higher cost of capital.

The Effects of the Credit Crunch: One Year Later

What a difference a year has made in the global private equity market. Those who rightfully called 2007 the peak of the current private equity cycle, even before the onset of the credit crisis, probably didn't envision how precipitously the market would drop over a 12-month period. By mid-year 2007, worldwide mergers and acquisitions activity reached \$2.7 trillion, concentrated in North America and Europe. Leveraged buyouts peaked at \$2.6 trillion, with 93 buyouts greater than \$1 billion (the largest being BCE valued at \$53 billion). Comparatively, the first half of this year has only witnessed \$1.9 trillion in mergers and acquisition activity, a 30% decline since the same time last year. Leveraged buyouts have suffered even more, totaling in May just \$1.5 trillion. This represents a drop of 40% over the same six-month period. Only 32 deals have surpassed the \$1 billion mark, the largest of which was the \$4.1 billion ConvaTec deal.

Exhibit 2
Credit Crunch by the Numbers
(US \$ Billions)

	1H07	1H08	Change
Fundraising	\$320	\$310	(3%)
M&A Activity	\$2,680	\$1,880	(30%)
North America	\$1,150	\$760	(34%)
Europe	\$1,060	\$610	(42%)
Rest of World	\$470	\$510	9%
LBO Activity	\$2,600	\$1,550	(40%)
North America	\$1,260	\$660	(48%)
Europe	\$1,000	\$470	(53%)
Rest of World	\$340	\$420	24%
VC Activity	\$28.1	\$44.9	60%
North America	\$22.6	\$40.2	78%
Europe	\$3.5	\$2.9	(17%)
Rest of World	\$2.0	\$1.8	(11%)
<hr/>			
Largest announced global LBO	\$51B (BCE)	\$4.1B (ConvaTec)	(92%)
Number of buyouts of more than \$1 billion	93	32	(66%)
Number of global corporate defaults	9	31	244%
Initial public offerings (IPOs) filed (ex SPACs and REITs)	147	57	(61%)
Global dividend recaps (\$B)	\$63.2 (83 deals)	\$1.8 (6 deals)	(97%)
IPOs withdrawn due to market conditions	15	44	193%

Source: Dealogic, Thomson Venture, WSJ, Preqin

These leverage-driven strategies, which represent the backbone of the private equity industry, were the unmistakable casualties of the credit meltdown. Although private equity capital has been funneled more into venture this year, there remains a vacuum in the choice of investment opportunities private equity firms can pursue. Debt financing remains scarce, deal activity has slowed, and the public equity market has become a less viable exit strategy as evidenced by the number of withdrawn IPOs. This lack of options, together with strong capital flows to the asset class and \$1 trillion in dry powder, has prompted managers to find alternative investment opportunities. Rather than sit tight and wait out the current environment, private equity investors have been prompted to regroup and re-strategize while staying within the parameters of the investment directives.

Reassessing Investment Strategies for the Current Market

One such trend is making minority investments in distressed or undercapitalized companies through PIPEs (private investment in public equity). With mega deals fading, firms are able to put large chunks of money to work through minority investments without having to shore up capital to take a company completely private. While not entirely a new phenomenon, private equity firms were previously disinclined to make these types of investments, mainly due to the fact that they have little to no control over the investment. However, the tide has turned and private equity firms are taking more minority stakes, especially in financial sector firms where leverage is already embedded. Notably, Texas Pacific Group has pumped \$7 billion into Washington Mutual and Corsair Capital has led a consortium of investors to put \$7 billion into National City. The Federal Reserve Bank has recently considered legislation that would make it even easier for private equity firms to recapitalize banks, a move that could have global implications. In the meantime, private equity firms are preparing to change the mandates of their funds to include PIPEs and other similar maneuvers in addition to traditional buyouts.

Another minority investment strategy taking hold in private equity is growth capital investing. These companies are in the life-cycle stage beyond the scope of early venture capital funding, yet lack the EBITDA for a full-fledged buyout. Private equity firms have stepped in to provide equity to these firms as an alternative to debt which has become

elusive. Furthermore, private equity managers are able to impart operational guidance and enhance value creation opportunities, thus producing solid returns upon exiting the investment. The combination of capital and guidance typically is used to foster expansion, restructuring and entrance into new markets. The advantage of this type of investing is that it doesn't rely on cheap debt to produce returns; instead it is based on strong underlying fundamentals and less perceived-risk. Growth equity has been an established sector in the US but this year private equity funds based in Europe and Asia are catching up. Carlyle Europe and Fidelity Ventures now have dedicated growth equity funds for Europe, Baring Private Equity has raised \$1.5 billion for Asia's largest growth capital fund and Abraaj Capital has a \$2 billion combined infrastructure and growth capital fund.

In addition to minority stakes, private equity managers are looking towards emerging industry sectors to deploy large amounts of capital and bridge the gap in returns. Infrastructure funds have been particularly attractive to investors for their risk/return profile, capacity to put large amounts of capital to work, inflation-hedging capabilities and forecasted product demand. In fact, Ernst & Young has estimated that private sources could account for 10% to 15% of the capital needed to fund infrastructure projects worldwide, equivalent to around \$300 billion each year. Traditional mega buyout shops such as KKR, Carlyle, CVC have all been debuting infrastructure products over the past six months, as have banks like Morgan Stanley and Lehman. Energy and commodities funds are also becoming popular for similar reasons. Fundraising by firms in these two sectors is up 85% compared to the same time last year.

Finally, in the face of reduced debt financing, private equity firms are heading downstream and targeting deals in the middle market. Middle market deals, loosely defined as those in the range of \$500 million to \$2 billion, still have favorable acquisition multiples vis-à-vis their large and mega-size counterparts. They also represent close to half of the buyout market in terms of deal volume. Having smaller targets will mean funds will have to do more deals in order to utilize all their committed capital. That will require increased due diligence and ultimately more staff. Limited partners still believe this is the way forward for private equity as witnessed by Collier Capital's latest Private Equity Barometer. Lower mid-market and mid-market buyouts ranked 1 and 2 respectively in terms of where general partners should be investing over the next 12 months. Growth/expansion capital, previously mentioned, ranked third.

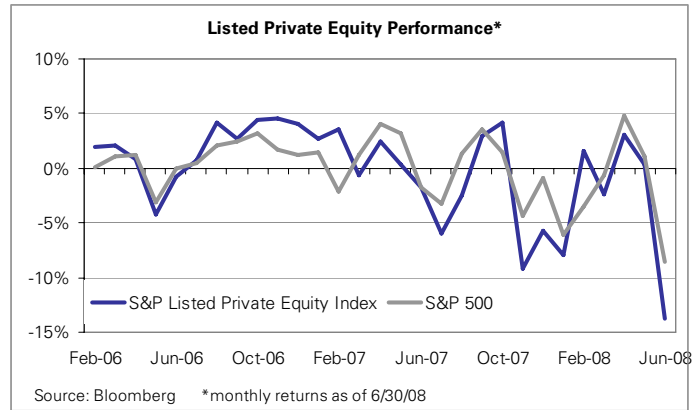
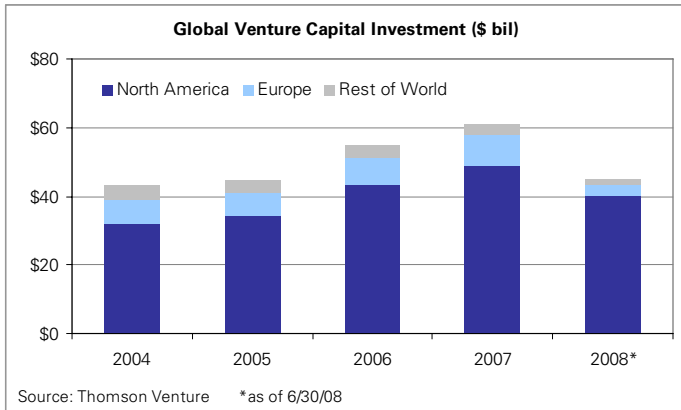
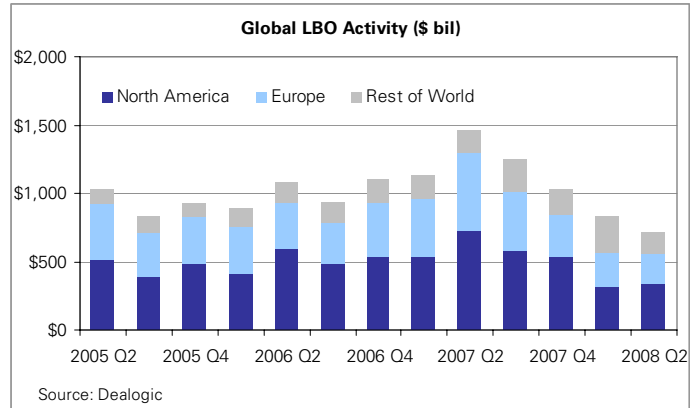
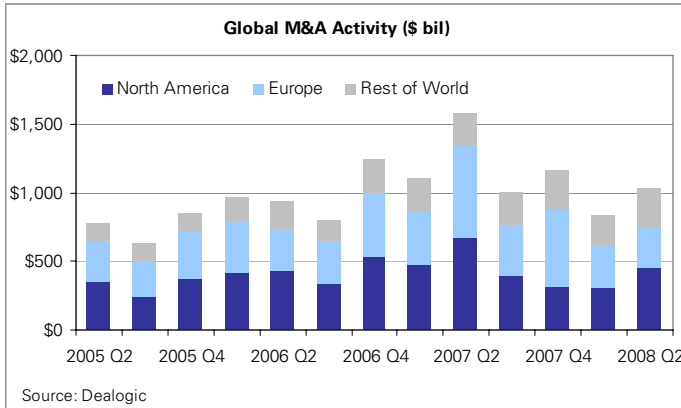
Exhibit 3
The Best Types of Private Equity Investment for GPs
over the next 12 months – LP views

	Overall Ranking
Lower mid-market buyouts (less than \$200m)	1
Mid-market buyouts (\$200m - \$1bn)	2
Growth/expansion capital	3
Mezzanine	4
Large buyouts (\$1bn - \$5bn)	5
Mega-buyouts (more than \$5bn)	6

Source: Collier Capital

In light of the prolonged disruption of the credit markets and tentative global economic outlook, many private equity funds have undergone a strategic shift in the way they've been approaching the asset class. Although this has been a noted concern for investors, style drift is an inevitable phenomenon in a rapidly changing environment. Those firms willing to adapt the quickest and become creative in the ways they approach private equity are apt to emerge from the current environment in a better position than those who were unwavering or disengaged from the market.

Private Equity Trends At a Glance



Current Private Equity Fundraising

Number of Funds on Road	US	Europe	ROW	Total
Venture	218	94	111	423
Buyout	163	73	52	288
Fund of Funds	105	74	16	195
Real Estate	205	104	56	365
Infrastructure	15	23	33	71
Other	109	32	19	160
Total	815	400	287	1,502

Source: Preqin June 2008 Private Equity Spotlight

The Best Areas for GP Investment over the next 12 months - LP views

	Overall Ranking
European buyouts	1
Asia-Pacific buyouts	2
North American venture	3
Asia-Pacific venture	4
North American buyouts	5
European venture	6

Source: Collier Capital Global Private Equity Barometer, Summer 2008

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