PROBITAS PARTNERS

The Credit Cycle: Where Are We Now and Where Are We Heading?

June 2008

PROBITAS RESEARCH™

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Contents

Introduction 1

The Current Credit Cycle 2

The Growth of Leverage — and of Risk 2

Strategic Impacts on the Buyout Market 6

The Market Turn 8

The Next Stage: Increasing Defaults 11

Ramifications for Private Equity 14

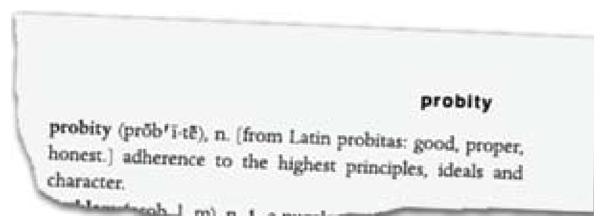
Distressed Debt & Restructuring Funds:
The Other Side of the Coin 15

Other Opportunities in Private Equity 17

Conclusion 19

Introduction

Probitas Partners is a leading independent knowledge, innovation and solutions provider to private markets clients globally. We focus our expertise in fund placement, liquidity management, and portfolio management to constantly build and grow powerful, lasting relationships that deliver value, execution, and service to our partners and clients. We emphasize private equity and real assets including debt and equity funds, venture capital, special situations, opportunistic real estate, and infrastructure from around the world.



probity

probity (prōb'ĭ-tē), n. [from Latin probitas: good, proper, honest.] adherence to the highest principles, ideals and character.

Accurate data is elusive in private markets. Probitas Partners offers research and investment tools on the alternative investment market as aids to its institutional investor and general partner clients. Probitas Partners shares this data in an effort to improve professionalism, consistently raise the bar on professional services, and assist all participants in their investment, portfolio management, and fund raising endeavors.

Recent publications by Probitas Partners include the *2008 Private Equity Deskbook* and the *2008 Real Estate & Hard Asset Deskbook*, both of which report on recent key trends and include listings of funds in or coming to market. *Investing in Infrastructure Funds* addresses the growing demand for this asset class. Probitas Partners' and Axiom Asia Private Capital's *The Emerging Private Equity Market in Asia* details the opportunities and challenges of private equity investing in Asia. Probitas Partners also holds roundtables on critical topics of interest for its private market clients.

Recently, we hosted a roundtable on the Distressed Debt Cycle featuring Dr. Edward Altman, an expert on corporate bankruptcy, high yield bonds, distressed debt, and credit risk analysis. This white paper summarizes the insights shared at the roundtable by Dr. Altman, as well as conclusions from a panel discussion with a distinguished group of general partners active in the sector: Bruce Grossman, Avenue Capital; Michael Madden, BlackEagle Partners; Mike Psaros, KPS Capital Partners; and Wilbur Ross, W.L. Ross & Co. Additionally, we present our further research and conclusions about the implications of current market conditions on the alternative investment space. Probitas Partners continues to host smaller, interactive, invitation-only roundtables. These gatherings bring together senior institutional investment professionals and industry experts to address the most meaningful topics of the day.

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The Current Credit Cycle

The turn in the credit markets was long expected. Anticipated even before the sub-prime crisis in the second half of 2007, the crisis in the broader credit markets firmly established itself during the first half of 2008. Earlier in the year, speculation focused on the possibility of a U.S. recession. This has since been replaced by serious discussion of how much pain the crack in the credit markets and seemingly imminent recession will bring. Indeed, today there are forecasts of skyrocketing defaults, with headlines covering the first wave of bankruptcies, including companies such as Aloha Airlines, ATA, Lillian Vernon, PRC and The Sharper Image.

We are at a key inflection point in the culture and practices of the global financial system. This white paper provides insights to investors on the impacts of this stage of the credit market cycle on different sectors of the private equity market, highlighting both areas of concern and targets of opportunity. It also underlines how this cycle is different from prior ones, especially in regard to the growth and evolution of the international private equity market.

The Growth of Leverage – and of Risk

The major factors that transformed the credit market in the last few years ultimately emanated from a fundamental and system-wide misreading and mispricing of risk. A glut of global liquidity expanded overall financial markets dramatically, spurring a corresponding growth of the institutional loan market, Collateralized Debt Obligation vehicles ("CDOs"), and second lien loans, while also dramatically increasing hedge fund and Mergers & Acquisitions activity (spurred by leveraged buyouts). In this changed environment, credit standards applied by both bank and non-bank debt arrangers slackened. Investment banks fought to broker deals to remain competitive. Many of these intermediaries focused on originating and selling loans as quickly as possible to generate syndication fee income, with little focus on holding the underlying assets or quantifying the inherent risk on their own balance sheets.

At the same time, new types of structured credit products — CDOs and Collateralized Loan Obligations ("CLOs") — multiplied to serve the demand for highly-rated interest paying investments. With investor interest in specific tranches primarily driven by their ratings, the inherent value of these products became increasingly complex to calculate. Historical models of risk and return were no longer adequate predictors of risk for these instruments as credit agencies helped to market these structured products with favorable "stable" ratings.

Increasing investor interest in buyout funds led to increased equity deployed in the sector and significant growth in amounts of leverage, spurred on by increasingly lax loan documents (so called "covenant-lite" arrangements). Chart I and Chart II highlight the surge in issuance of leveraged loans to support buyout activity in the U.S. and Europe over the last four years.

While the amount of leveraged loan activity increased over the last four years, the credit quality of the new debt being issued declined.

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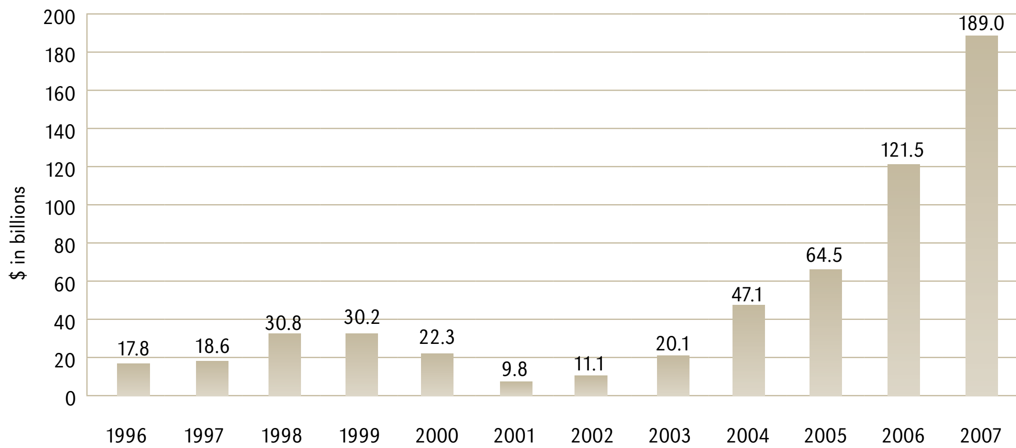
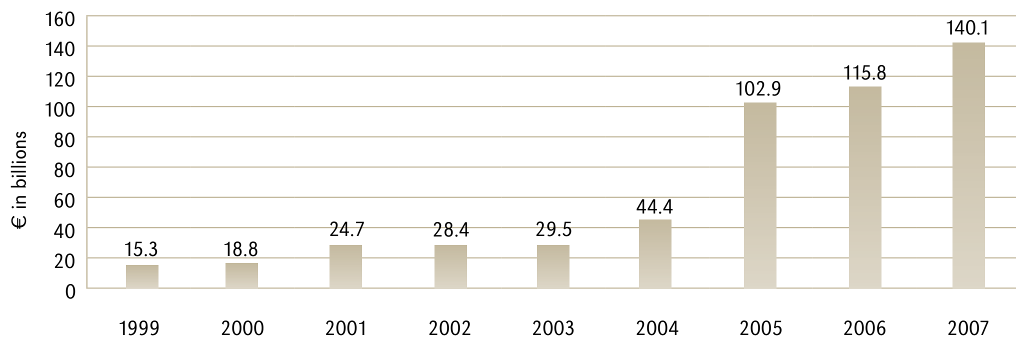
Chart I U.S. Buyout Leveraged Loan Volumes



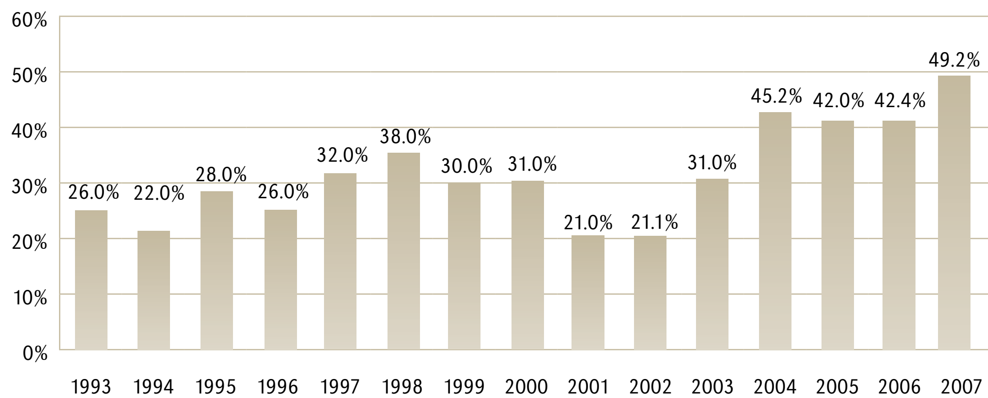
Source: Standard & Poor's Leveraged Buyout Review

Chart II European Buyout Leveraged Loan Volumes



Source: Standard & Poor's Leveraged Buyout Review

Chart III New Issues Rated B- or Below as a % of All New Issues



Source: Standard & Poor's LCD

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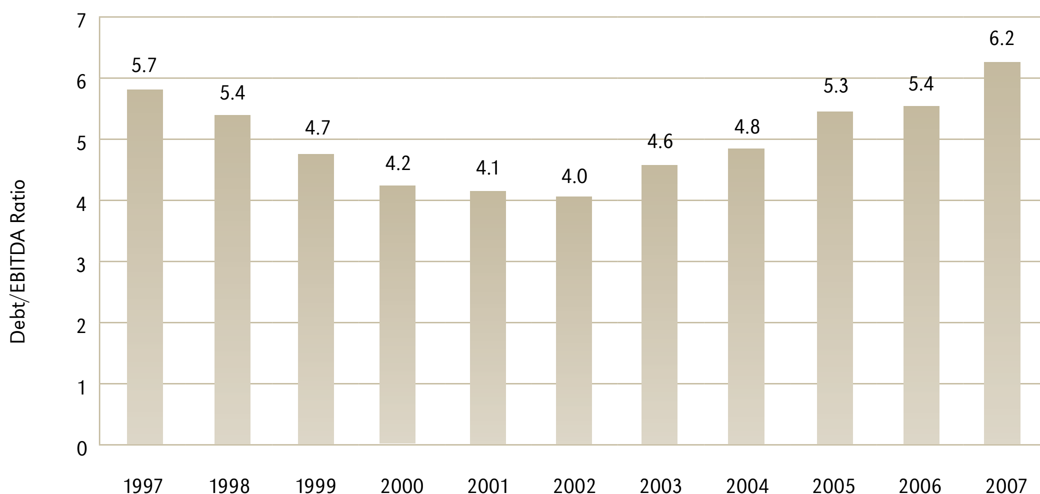
As noted in Chart III, beginning in 2004, over 40% of new issues were rated as B- or worse (a rating indicating a high probability of default). In 2007, newly issued bonds rated B- or worse reached an all-time high of 49.2% of all new issuances.

Chart IV and Chart V illustrate a key reason for this decline in the quality of new issuances — the steadily rising ratio of debt to earnings for U.S. and European buyout transactions during this period. Debt to EBITDA ratios for both large and middle market buyouts have risen steadily over the last five years, reaching a ten-year high in 2007 for both sectors. During this period, the debt multiples for larger transactions were higher and increased more rapidly than the debt multiples for middle market transactions.

Chart VI illustrates the other side of the coin — the decreasing liquidity cushion that these companies had to service their debt. After interest coverage ratios increased during the last period of economic weakness (1999-2002), these ratios began a steady decline in 2003, reaching a ten-year low of 1.7x in 2007.

Chart IV Average Debt Multiples of Large Corporate LBO Loans (i.e., Issuers with EBITDA > $50MM)



Source: Standard & Poor's LCD

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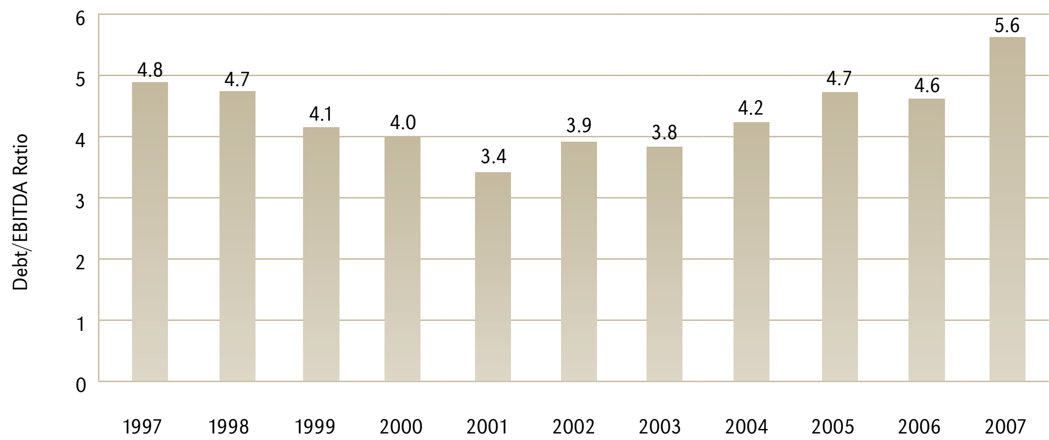
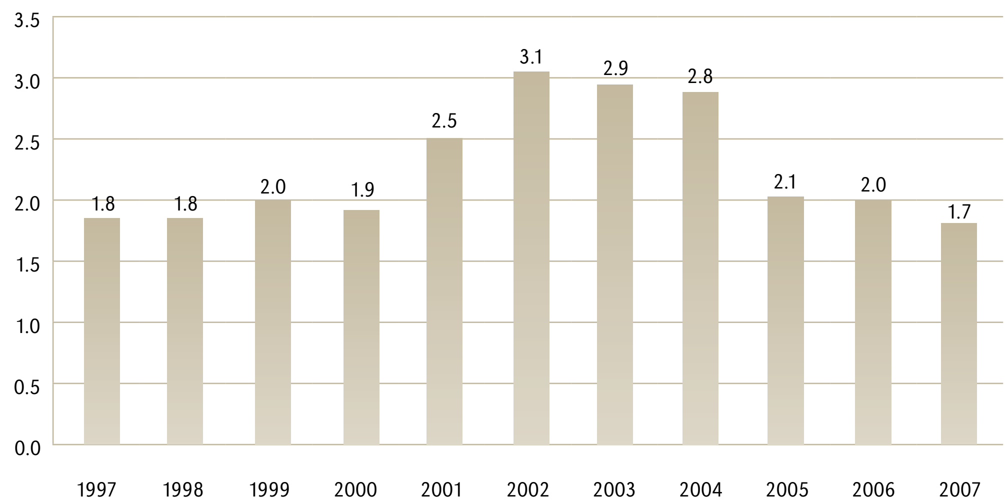
Chart V Average Debt Multiples of Middle Market Corporate LBO Loans (i.e., Issuers with EBITDA < $50MM)



Source: Standard & Poor's LCD

Chart VI (EBITDA-CAPEX)/Cash Interest



Source: Standard & Poor's Leveraged Buyout Review

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Strategic Impacts on the Buyout Market

The increasing availability of large amounts of debt over the past four years has transformed the private equity buyout markets in other critical ways. Over the past twenty-five years, small buyout funds have tended to outperform large buyout funds, as demonstrated in the bottom half of Chart VII, which shows time horizon return trends for U.S. buyout funds through 2002. The differentiated performance between smaller and larger buyout funds is intuitive. Though returns for small buyout funds are often volatile, their target companies are smaller and often not professionally managed, leaving fund managers ample scope to improve company-level operations and increase earnings.

As detailed in the top half of Chart VII, larger funds inverted this trend over the last five years. They began to utilize their deeper relationships with large financial intermediaries and their power in the capital markets fully to finance buyouts of increasingly larger target companies.

Chart VII Investment Horizon Performance in the U.S. Market (Small vs. Large Buyouts)

As of 12/31/07					
Fund Size	**1 Year**	**3 Year**	**5 Year**	**10 Year**	**20 Year**
Small Buyouts	15.00	7.30	8.10	4.20	11.90
Medium Buyouts	28.60	12.80	12.00	9.40	12.60
Large Buyouts	25.40	11.40	15.00	7.90	12.80
Mega Buyouts	25.40	15.10	16.50	9.10	12.30
All Buyouts	25.40	14.00	15.50	8.60	12.40
As of 12/31/02					
Fund Size	**1 Year**	**3 Year**	**5 Year**	**10 Year**	**20 Year**
Small Buyouts	-0.80	-1.30	1.00	11.20	16.50
Medium Buyouts	-1.30	-5.10	7.40	12.00	18.70
Large Buyouts	-4.10	-5.50	1.70	10.10	12.10
Mega Buyouts	-4.30	-4.90	0.00	7.80	9.30
All Buyouts	-3.90	-4.80	1.30	9.30	12.30

Source: Venture Economics

Definitions: *Small Buyouts = Funds less than $250 million in commitments*
Medium Buyouts = Funds greater than $250 million and less than $500 million in commitments
Large Buyouts = Funds greater than $500 million and less than $1 billion in commitments
Mega Buyouts = Funds greater than $1 billion in commitments

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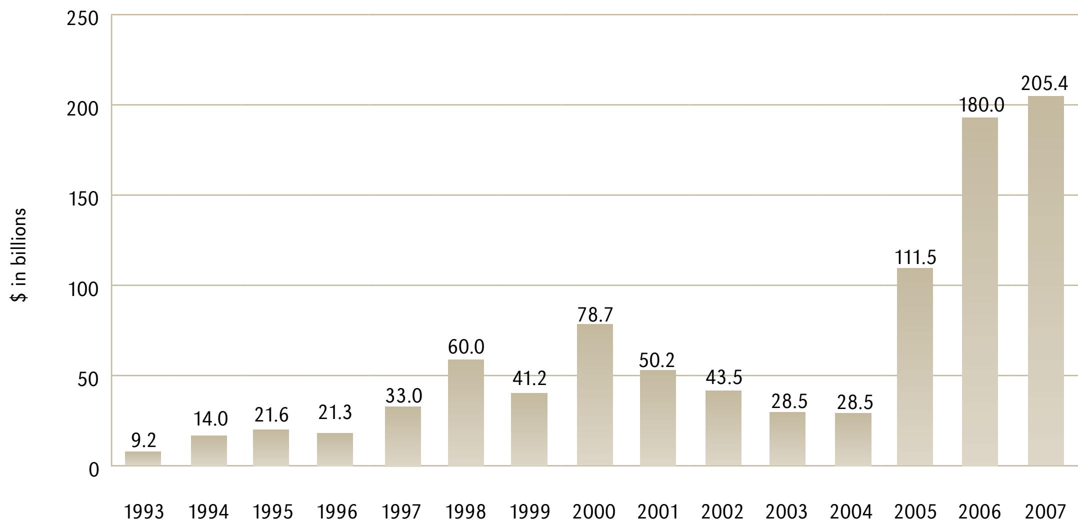
Financial engineering techniques such as rapid dividend recapitalizations came to the fore, allowing funds quickly to generate distributions and increase interim internal rates of return. These strategies worked well in the period of high liquidity that existed for the last four years.

The increasing attractiveness of buyout returns reflected in Chart VII and the formation of true Mega Buyout funds (funds with committed capital of more than $10 billion), led to a surge in buyout fundraising. Chart VIII tracks the long-term trends in buyout fundraising in the U.S. — the most developed fundraising market. After a volatile period from 1999 through 2003, each year since 2005 has seen a new record for buyout fundraising. The increased capital along with the availability of increasing leverage to support this capital made the largest buyout funds dominant players in the capital markets and enabled these funds, whether alone or in club deals, to acquire companies that were previously out of reach for private equity buyout funds.

The surge in buyout fundraising coincided with the rise of Mega Buyout funds. These vehicles became dominant factors in global M&A markets as well as in private equity fundraising. A number of these fund managers became global asset managers as well, with separate vehicles addressing real estate, hedge funds, mezzanine and distressed debt.

Chart VIII Commitments to U.S. Corporate Finance Private Equity Partnerships



Source: Private Equity Analyst, January 2008

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Chart IX lists the largest buyout funds that have either been raised or are currently in the market. Most of these groups are independent (Goldman Sachs being the notable exception), and all are headquartered in the U.S. or Europe, though most invest globally. Notably, all these funds either raised or began fundraising during the liquidity boom, and two managers — Blackstone and TPG — are on the list twice, with their second vehicles currently in the market.

The Market Turn

Though various danger signs for private equity credit markets were obvious over the past couple of years, it was the sub-prime mortgage market — where weakness became evident by the spring of 2007 — that triggered the turn in the cycle. Though many first thought that the sub-prime issues would remain confined to the mortgage sector, credit markets quickly reacted to a

Chart IX Largest Buyout Funds Raised or In Market

Fund	Manager	Size or Target (MM)	Vintage
Blackstone Capital Partners V	Blackstone Group	$21,700	2006
GS Capital Partners VI	Goldman Sachs Private Equity Group	$20,300	2007
Blackstone Capital Partners VI	Blackstone Group	$20,000	In Market
KKR Fund 2006	Kohlberg Kravis Roberts	$17,600	2006
Permira IV	Permira	€ 11,100	2006
Apax Europe VII	Apax Partners	€ 11,000	2007
CVC European Equity Partners V	CVC Capital Partners	€ 11,000	In Market
Apollo Investment Fund VII	Apollo Management	$15,000	In Market
Carlyle Partners V	Carlyle Group	$15,000	In Market
Texas Pacific Group Partners V	TPG	$15,000	2006
Texas Pacific Group Partners VI	TPG	$15,000	In Market

Source: Private Equity Intelligence

Note: Rankings adjusted for currency based on current exchange rates

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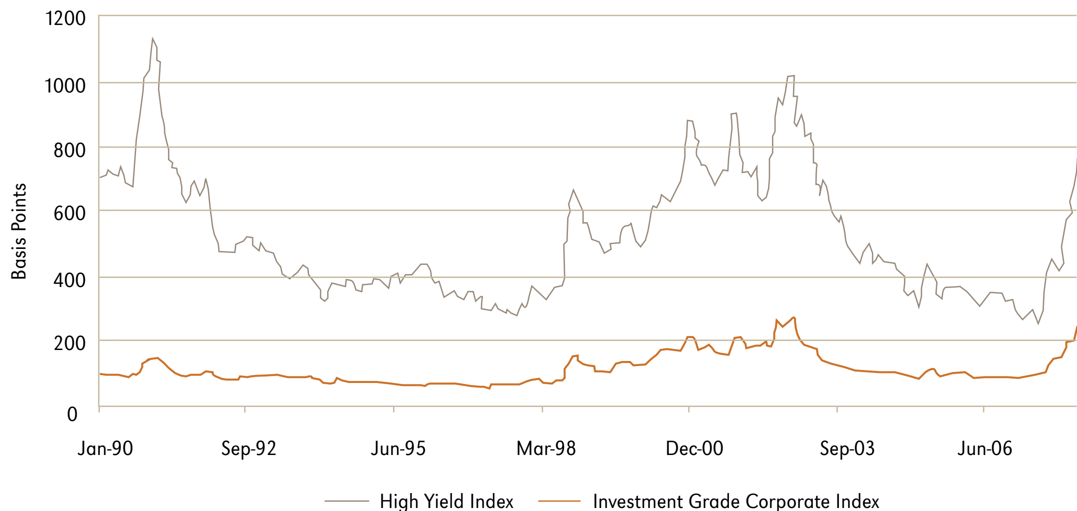
more general questioning of previous credit risk analyses. The credit markets began to reassess and re-price risk broadly across the full spectrum of investment classes.

Chart X shows the long-term trends for spreads over treasuries for both high yield and corporate bonds in the U.S. Noticeably, during this last four-year period of increasing debt issuance and decreasing credit quality, spreads continued to decline. The sudden sharp reversal of that trend in mid-2007 corresponds to the eruption of the sub-prime mortgage crisis.

Furthermore, this renewed focus on risk had specific impacts on private equity investing. The sudden increase in credit spreads detailed in Chart X hit many banks and other credit issuers hard. Many of these entities had underwritten loans in support of large buyout transactions with the intent of widely syndicating them. The sudden shift in the credit markets resulted in many loans being stuck or hung on lenders' balance sheets. The standard practice for lenders originating these loans was not to hold them on their books, but to generate syndication fee income by quickly selling them to other parties, such as hedge funds, CDOs and CLOs, once the transaction closed. To win these lucrative mandates, banks were required to use their balance sheets to pre-commit the financing at specific prices. The dramatic movement in credit spreads left these banks with loans and commitments that could only be sold at significant losses. The result, as has become evident, has been twofold: first, as banks sought to renege on their under writings, a number of transactions simply collapsed; second, massive losses have been sustained that lenders have been forced to recognize on their books when these value-impaired loans could not be sold at a profit.

Chart X Corporate Bond to Treasury Spreads



Source: Moody's Investor Service

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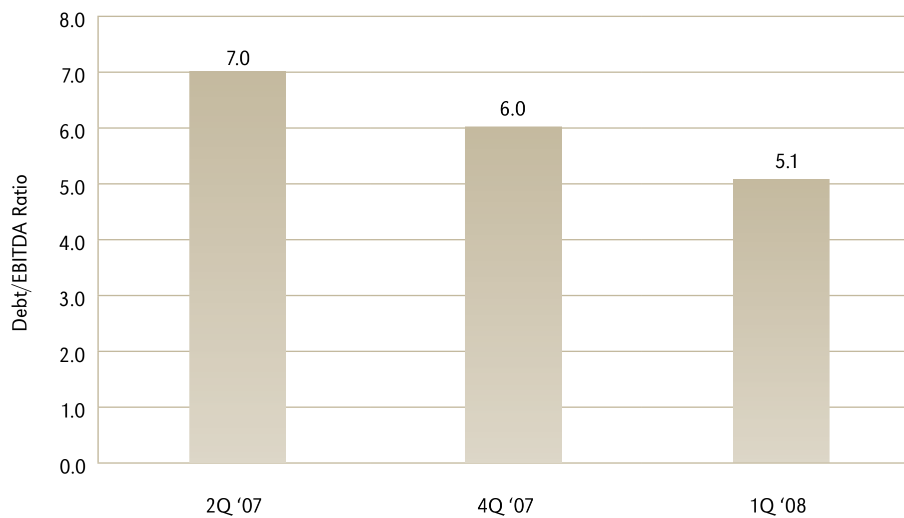
Debt multiples in private equity transactions — for those that could be completed in a market where access to leverage had become far more problematic — began to decline. Chart XI tells a very different story than that of Chart IV, which illustrated debt as a multiple of EBITDA reaching a ten-year high in 2007 for large buyouts. During 2007, debt multiples peaked at over 7x during the second quarter of the year, but as the year wore on, multiples contracted significantly, dropping to 6x by the fourth quarter of 2007, and then to 5.1x by the first quarter of 2008 (a fall to levels last seen in early 2005).

The immediate result of these changes on the private equity market has been a dramatic slowing of activity in the buyout market both in North America and Europe, especially in the large cap space. Leverage has both dramatically re-priced and become more difficult to access.

Chart XI Average Debt Multiples of Large Corporate LBO Loans (i.e., Issuers with EBITDA > $50MM)



Source: Standard & Poor's LCD

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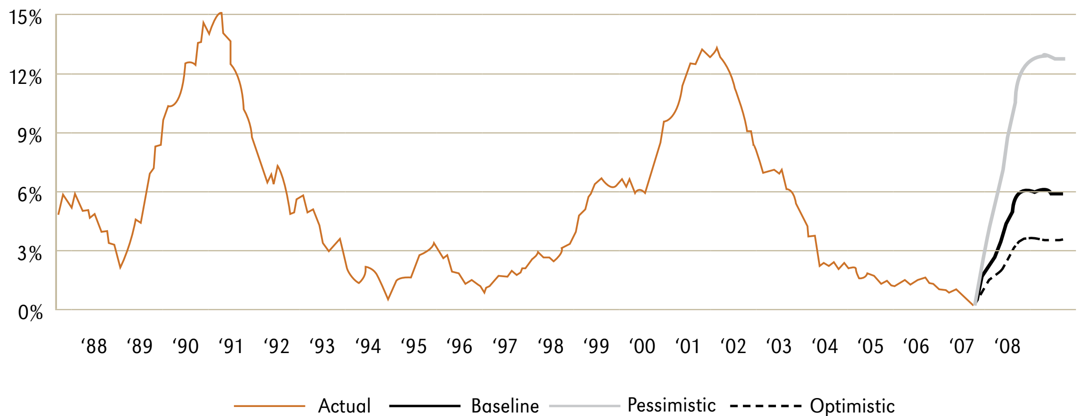
The Next Step: Increasing Defaults

As the year ended, the liquidity crisis of 2007 generated wider economic impacts. At the beginning of 2008, the sub-prime mortgage crisis spread to the housing industry, with rolling impacts on a number of industry sectors dependent upon housing. Increased credit spreads and incrementally more conservative credit standards meant that companies in financial difficulty were more likely to go into default as lenders became less willing to extend credit.

This changing dynamic was documented in December of 2007 in Moody's forecast for increasing global bond defaults. Their baseline forecast (outlined in Chart XII) at that point was based on an assumption of a slowing U.S. economy but no recession. Were there to be a recession, Moody's estimated that defaults could enter the double-digit range, a forecast built into their "pessimistic" scenario.

The number of defaults accelerated from a historic low at the end of 2007, and industries experiencing particular stress, such as the

Chart XII Global Speculative-Grade Default Rates (Actual and Forecast)



Source: Moody's Investor Service, December 2007

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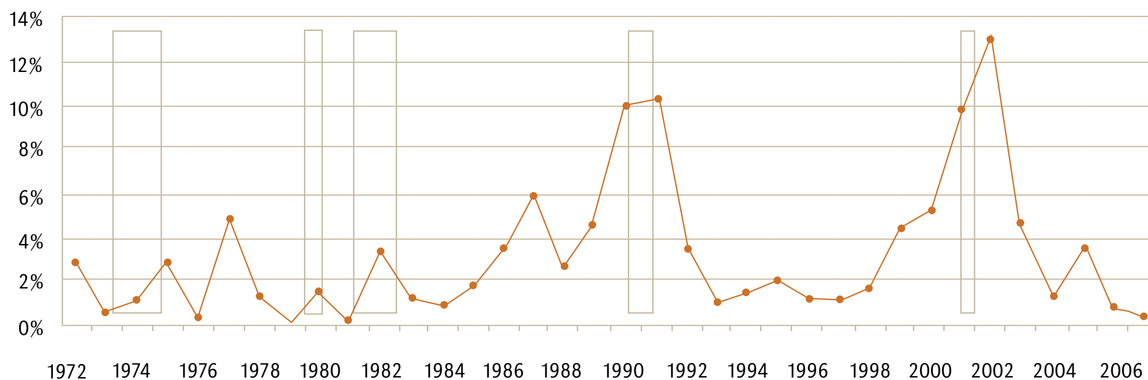
airline and retail industries, have seen a number of high profile bankruptcies over the last few months. A number of these bankruptcies, such as Aloha Airlines, ATA, Lillian Vernon and The Sharper Image, are portfolio companies of private equity funds. Through mid-March of 2008, 12 companies with rated debt worth $9.6 billion had defaulted on their debt. Though 22 companies defaulted on rated debt in all of 2007, the value of the debt that defaulted totaled only $8.1 billion.

Chart XIII illustrates that the dramatic spikes in default rates over the last thirty-five years have been linked to periods of economic recession. Since the creation of the new issuance market for high yield bonds in the 1980s, the last two spikes in default rates in 1990-91 and 2001 hit historic highs. Depending upon the depth and length of the recession, Moody's worst case scenario today may be optimistic. As of March 2008, Dr. Altman's worst case scenario forecasts that defaults could peak at 16%, a historic high.

Chart XIII Historical Default Rates and Recession Periods in the U.S. High Yield Bond Market, 1972-2007



Periods of Recession: 11/73-3/75, 1/80-7/80, 7/81-11/82, 7/90-3/91, 4/01-12/01

Source: Edward Altman (NYU Salomon Center) & National Bureau of Economic Research

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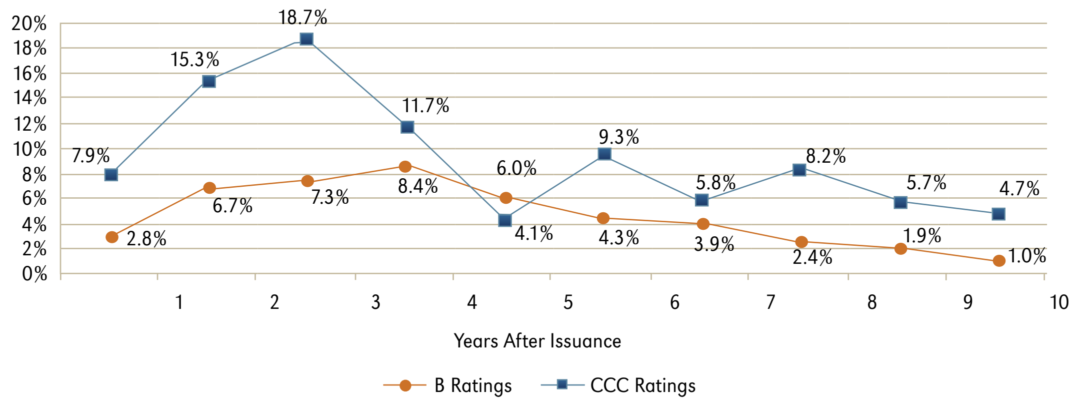
The increase in the issuance of "junk" bonds (those rated as single B- or lower) noted previously in Chart III shows that in the past four years almost half of the newly issued bonds have been rated as "junk" at their outset. Chart XIV shows the danger of default inherent in these bonds based upon long-term historical trends, with 53.6% of CCC rated bonds defaulting in just four years.

Over the last five years, defaults on "junk" bonds have been much lower than the long-term trends detailed above would have predicted, and forecasts of default by sources like Dr. Altman and Moody's, which depend upon technical analysis, have been higher than what has actually occurred. In retrospect, these deviations from the norm can be explained by nuances in this recent cycle: given the large amount of liquidity in the market over the recent five-year period, a number of bonds that would normally have defaulted were refinanced, while more recently the rise of "covenant-lite" bonds meant that, for these debt issuers, any event short of a failure to pay interest would not result in a default.

At this point, decreased market liquidity and increasingly conservative credit standards mean that these historic default rates are likely to recur, supporting the more pessimistic forecasts.

Chart XIV Default Lag After Issuance: B & CCC Rated Corporate Bonds



Source: Edward Altman (NYU Salomon Center)

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Ramifications for Private Equity

Of all the sectors of the private equity industry, the buyout sectors in North America and Europe are most dependent upon leverage. The problems in buyout portfolios are just becoming apparent, and the final impact on fund returns has yet to be appreciated.

At the Probitas Partners' Distressed Debt and Restructuring Roundtable, both Dr. Altman and the participating fund managers expected that the level of defaults would be modest early in 2008, building in the latter half of the year and into 2009. Perhaps only in early 2009 will the full extent of problems be evident. The participating fund managers, conversely, believe that only into 2009 will the full extent of the opportunities that they are seeing become evident.

The extent of future problems for buyout funds was made evident in Standard & Poor's latest quarterly update on its "Weakest Links" list covering those debt instruments rated B- or lower that either have a Negative Outlook or are on Creditwatch with Negative implications. An analysis by *Buyouts* magazine in March revealed that 42 out of the 114 firms on the list (or nearly 37%) were portfolio companies of private equity funds. Most of these companies are based in North America, reflecting the fact that 82% of the names on the overall list are U.S. companies, with another 6% based in Canada.

Chart XV lists the private equity-backed companies with the largest amount of debt outstanding that fall into the "Weakest Links" category. The list contains a variety of private

Chart XV Ten Largest Portfolio Company "Weakest Links," March 2008

Sponsor	Portfolio Company	Affected Debt	S&P Rating	Industry
Madison Dearborn Partners / Providence Equity Partners / TPG / Thomas H. Lee Partners	Univision Communications Inc.	$10.2 billion	B- / Outlook Negative	Media and Entertainment
Thomas H. Lee Partners	Spectrum Brands Inc.	$3.85 billion	CCC+ / Outlook Negative	Consumer Products
Carlyle Group	Hawaiian Telcom Communications Inc.	$1.36 billion	B- / Outlook Negative	Telecommunications
GS Capital Partners	USI Holdings Corp.	$950 million	B- / Outlook Negative	Insurance
Carlyle Group	Vought Aircraft Industries Inc.	$695 million	B- / Outlook Negative	Aerospace and Defense
GS Capital Partners	Euramax International Inc.	$667 million	B- / Outlook Negative	Capital Goods
Apollo Management Group	Linens 'n Things Inc.	$650 million	CCC+ / Outlook Negative	Consumer Products
Bain Capital	Guitar Center Holdings Inc.	$650 million	B- / Outlook Negative	Retail
Pegasus Capital Advisors	Merisant Worldwide Inc.	$546 million	CCC / Outlook Negative	Consumer Products
Cerberus Capital Management	IAP Worldwide Services Inc.	$535 million	CC / CreditWatch Negative	Capital Goods

Source: Standard & Poor's LCD, and Buyouts

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equity sponsors and companies operating in a number of industry sectors, though three of the ten are consumer products companies.

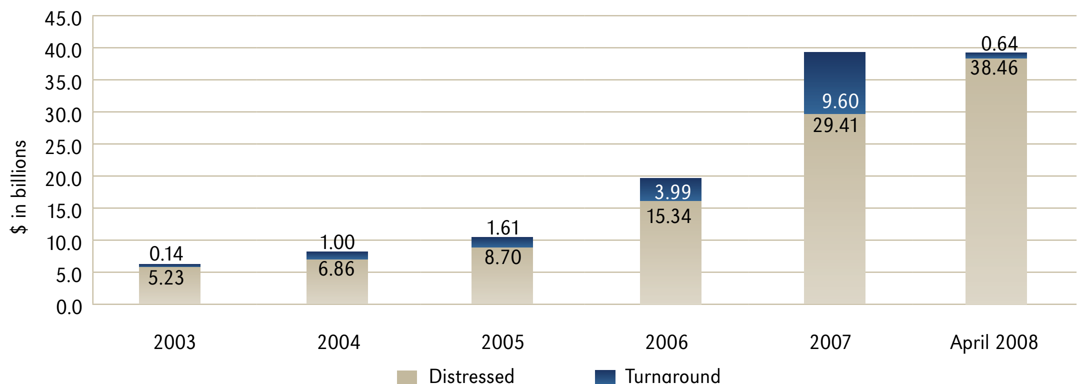
The month of April itself was difficult for airlines and their private equity backers. Though not on the "Weakest Links" list because they lacked publicly traded bonds, three small U.S.-based airlines sponsored by private equity firms ceased operations during the month: Aloha Airlines (Yucaipa), ATA (MatlinPatterson), and Eos Airlines (Golden Gate Capital, Maveron, and Sutter Hill). All three were impacted by the combination of recession, high fuel prices, and unforgiving debt markets. By the beginning of May, Apollo's Linens 'n Things moved from the "Weakest Links" list into bankruptcy court.

As 2008 unfolds, we see an increasing number of defaults impacting buyout funds, especially those from vintages 2005 and 2006. Which funds will be most impacted at this point is difficult to determine, but a deep and long lasting recession will have significant impact and will, of course, extend beyond buyouts. For example, even low leverage users like venture funds are not immune. Volatility in the public markets related to the recession has already had an impact on the IPO markets and on the plans of venture firms to exit long-held investments using the public markets.

Distressed Debt & Restructuring Funds: The Other Side of the Coin

Amidst this environment of gloom and doom, Distressed Debt and Turnaround fund managers see 2008 and 2009 as vintage years of opportunity. As noted previously, managers in both these sectors forecast an increasingly attractive investment environment as we move through this year and into 2009. Fundraising in these sectors began to increase substantially in 2006 (Chart XVI) in anticipation of a turn in the credit markets and set a new record in 2007. The fundraising pace quickened as the opportunity became clearer at the turn of the year. Through April 30, 2008, fundraising in these sectors has already matched that for all of 2007.

Chart XVI Distressed/Turnaround Fundraising



Source: Private Equity Intelligence/Probitas Partners

Fundraising in these sectors is not over. Chart XVII lists the ten largest funds currently in the market in the sector. These funds are seeking a total of $28 billion and, when combined with the smaller funds in the market, upwards of $37 billion is being sought for distressed and turnaround strategies. It is worthwhile considering "how much is enough," especially in certain strategies such as Distressed Debt Trading where hedge funds are particularly active. Both Chart XVI and Chart XVII track activity for investment vehicles utilizing private equity structures. The amount of money available in hedge funds for trading strategies is not included in these figures.

The bulk of the funds in Chart XVII are headquartered in and focused on the U.S. — as are the names on the "Weakest Links" list. Though there are companies in Europe experiencing difficulties, forecasts to date of defaults in Europe have been lower than in the U.S., in large part because leverage was not as aggressively used. The ultimate impact of a U.S. recession on the world economy and the ripple effects, not only in Europe but in the rest of the world, remain unclear, but we expect to see detrimental impacts globally. Year-to-date public markets in every country have been volatile, and most stock indices have produced losses in anticipation of difficult times ahead.

Chart XVII Largest Distressed Debt and Restructuring Funds in Market, May 2008

Fund	Manager	Type	Size (MM)
Texas Pacific Group Special Opportunities Fund	TPG	Restructuring	7,000 USD
Cerberus International Fund IV	Cerberus Capital Management	Distressed Debt	4,000 EUR
Avenue Special Situations V	Avenue Capital Group	Distressed Debt	4,000 USD
OCM Opportunities Fund VII	Oaktree Capital Management	Distressed Debt	3,000 USD
TCW Mortgage Credit Opportunity Fund	TCW Group	Distressed Debt	3,000 USD
Blackstone Distressed Opportunities Fund II	Blackstone Group	Distressed Debt	2,500 USD
Wayzata Investment Partners II	Wayzata Investment Partners	Distressed Debt	2,500 USD
H.I.G. Bayside Debt and LBO Fund II	HIG Capital	Distressed Debt	2,000 USD
OCM European Principal Opportunities Fund II	Oaktree Capital Management	Distressed Debt	1,250 EUR
Schultze Master Fund	Schultze Asset Management	Distressed Debt	1,500 USD

Source: Private Equity Intelligence/ Probitas Partners

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Other Opportunities in Private Equity

Distressed Debt and Restructuring funds represent the obvious immediate investment opportunities in private equity with the turn in the credit cycle, but there are others. The need for leverage in this market has increased investor interest in Mezzanine funds and other current income vehicles. Though the current lack of leverage in the market is not permanent but part of the overall credit cycle, the availability of leverage is likely to be low for at least two to three years (especially when compared to the period 2005 through mid-2007). This environment provides Mezzanine funds and current income vehicles (that are unburdened by problem-plagued legacy portfolios) with an attractive investment environment that will extend beyond 2008.

A number of credit dislocation funds have also been raised over the last few months. These vehicles were opportunistically raised to target the purchase of hung loans at the heart of the liquidity crisis, seeking to purchase these loans at a discount from lenders that could no longer syndicate them at par value. These funds do not represent a new sub-asset class, as new inventory of hung loans is not being created, but they are temporary capital pools addressing a unique opportunity. These vehicles do have some of the attributes of both mezzanine and distressed debt funds and, interestingly, a number of them have been raised by Mega Buyout groups who helped create the inventory in the first place.

Other investors are developing a renewed interest in smaller buyout funds. As detailed in Chart VII, the long-term trend in buyout returns before the recent liquidity boom favored smaller funds. A number of investors speculate that a more normal credit environment will favor smaller buyouts on a go-forward basis, with their focus on operating improvements generating increased earnings viewed as a more stable way to generate returns — if the fund manager has the right skill set.

Secondary funds have also seen an upsurge in interest. Investors anticipate a rerun of the 2001 to 2003 period, when the bursting of the Internet Bubble led to dramatically increased secondary sales as investors coped with the resulting problems. The year 2007 was the largest ever for secondary fundraising, with $15.1 billion of commitments closed. Nearly double that amount is currently being sought by secondary funds in anticipation of increased sales activity.

Many investors are also considering whether they are over-allocated to Mega Buyout funds, especially in the 2005 and 2006 vintages. In order to increase their exposure to current attractive investment opportunities, these investors have or are considering selling down a portion of their positions in these vintage year funds in the secondary market and freeing up capital for future investment.

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Conclusion

Five years of rapid growth driven by extremely liquid markets whose players had increasingly lost their risk discipline came to an abrupt end in the second half of 2007. Traditional measures of credit risk analysis are now back in vogue, and those tools of finance indicate that the markets in general, and private equity in particular, are in for increasingly difficult times, with more bankruptcies and other similar distress situations looming.

There are several impacts of this change in the credit markets on private equity:

- *Legacy Buyout Portfolios:* In the private equity sector, legacy buyout portfolios heavily dependent upon large amounts of leverage, especially those in vintages 2005 and 2006, are at particular risk for increasing bankruptcies and poor performance. Distributions from these portfolios to investors have slowed considerably and will remain slow.

- *Distressed Debt and Restructuring Opportunities:* Funds in these sectors are likely to find increasing opportunities as 2008 progresses, but fundraising levels in the sector, especially in Distressed Debt Trading strategies, where hedge funds are very active, may be worrisome.

- *Fresh Buyout Investing:* Legacy buyout portfolios will have their problems. Buyout fund managers with "dry powder" may find more interesting opportunities as the year progresses and seller price expectations begin to moderate. Leverage will continue to be difficult (and more expensive) to access, but fund managers, especially those investing with smaller funds with strategic focus and operating expertise, are likely to find increasing opportunities. Mega Buyout funds that are more dependent upon financial engineering are likely to find control investing more difficult as long as the drought in leverage lasts, especially when compared to the easier period of 2004 through mid-2007.

- *Other Areas of Private Equity:* For other areas of private equity, the major issue is not debt but the economic slowdown and how this impacts their specific plans. New Mezzanine funds and current income vehicles, for example, are likely to benefit by providing a scarce commodity — debt — while increasing energy prices are likely to continue to buoy that sector of the economy even as others falter.

- *Secondary Activity:* Interest in the secondary market is increasing, both from limited partners seeking to invest in secondary funds that will benefit from a more active secondary market and from investors seeking to use the market to rebalance their portfolio allocations in advance of a major re-pricing in the market.

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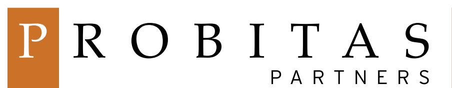

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