

Secondary Market Barometer

Look Back (Q4 2009)

Transaction Volume ▲
Pricing ▲
Bid/Ask Spread ▼

Look Forward (Q1 2010–Q2 2010)

Transaction Volume ▲
Pricing ▲
Bid/Ask Spread ▼

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Reflections on 2009 and Predictions for 2010

Review of 2009

The sharp decline in public markets globally in Q4'08 led many to expect that private equity investors would be forced to sell assets to rebalance their portfolios as a result of the denominator effect and/or to achieve liquidity to meet capital call demands. As a result, the market expected a significant increase of secondary transaction volume in 2009 over prior years. However, that surge of sales did not occur, and instead, 2009 proved to be a challenging year for the secondary market at best, described by the following themes:

- *Low transaction volume due to wide bid/ask pricing spreads and changing liquidity needs*
- *Emergence of new secondary buyers*
- *Tale of two markets*

Below, we discuss these themes and reflect on both the expected and unexpected of 2009.

Reduced Transaction Volume

We estimate that 2009 secondary volume was approximately \$8–\$10 billion, compared to \$14 billion in 2008 and nearly \$15 billion in 2007. The reduced volume of secondary activity in the face of a greater perceived need to sell is attributed primarily to an inability of the market to overcome large bid/ask spreads. While buyers continued to actively seek investment opportunities, the gap between buyers' bids and Limited Partners' ("LPs") reserve pricing remained wide for a significant portion of the year. Through Q3'09, bids were priced at steep discounts to General Partner ("GP") reported Net Asset Values ("NAVs").

The Probitas Partners Secondary Survey conducted in Q2'09 found that across all sectors, two-thirds of potential sellers would only be willing to transact at discounts to NAV of less than 40%. During 1H'09 however, most secondary bids — even for top-tier funds — were priced at steeper discounts to NAV, with the gap between bid and ask often exceeding 30% of NAV. As a result, while a steady flow of secondary transactions came to market, a significant number of transactions ultimately did not close as many sellers chose to wait for a better pricing environment. This gap in pricing was further hampered by an improving public market and firming portfolio company NAVs that, both psychologically and via the portfolio denominator, moderated the impetus to sell for several buyers.

Specifically, the delta in pricing in 2009 was attributable to several factors:

Increased return targets — Secondary buyers increased their return targets from the mid-to-high teens in 2007/2008 to the high-twenties or higher in 2009 because of valuation uncertainties. This increase was illustrative of the risk premium assigned to private equity investments beginning in Q4'08, as well as other fundamental issues discussed *infra*.

Extended exit timing — Faced with an uncertain exit environment for GP portfolio companies, buyers placed conservative estimates on projected exit timing and reduced exit valuations for potential realizations in their fund pricing models.

Lag effect in valuations — Although FAS 157 first officially impacted Q4'08 valuations, the public markets experienced continued significant declines in Q1'09. As a result of the lag effect in GP valuations, portfolio company NAVs appeared to be inflated relative to valuations for public company comparables. Consequently, bid prices during the earlier part of 2009 often reflected greater discounts to GP-reported NAVs to reflect buyers' internal valuations based on the then current and expected future economic environment.

"Falling knife" syndrome and limited visibility — As the economy continued to deteriorate, buyers' bids reflected expectations of further markdowns in fund portfolios. Between Q4'08 and Q1'09, we witnessed an average decline in GP-reported NAVs of 15%–20%. Consistent with our experience in the 2001–2002 time period, buyers faced with an inability to call a market bottom will price assets very conservatively (or not bid at all), resulting in higher discounts for assets and a widening bid/ask spread to avoid the risk of over-paying in the absence of market validation of stronger valuations. Uncertainty surrounding looming debt restructurings and whether or not the debt markets would be open further clouded value perceptions.

2009 secondary pricing reflected the interplay of all these factors. Pricing was tamped down by uncertainty and lack of visibility, all of which resulted in an increased underwriting discount rate that reflected lengthened time to expected exit, lower exit multiples, a probability for failed debt refinancings for some companies and more dour projections for company performance in the near-term.

In the face of a difficult secondary pricing market, LPs fearing they would need to find liquidity for capital calls found some relief as GPs became increasingly selective in new investments given the market uncertainty and unavailability of easy debt to support new deals. As a result, GP investment pace slowed appreciably, and LPs experienced a moderated capital call environment. Somewhat surprisingly in this difficult period, LPs even began to receive distributions from a number of their funds as M&A activity, primarily from strategic acquisitions, increased modestly in Q2'/Q3'09.

While not overwhelming, these distributions at a minimum eased the liquidity pressure and increased LP confidence in the future of the private equity markets. Without an impending need for liquidity, many LPs felt less pressure to sell assets at deep discounts and opted to wait for the market to recover in order to receive better valuations.

Most of the closed transactions that occurred in 2009 involved LPs that had to generate liquidity. This included instances when sellers faced default as a result of over-commitment strategies whose projected distributions from current investments would fund future capital calls. While such strategies were viable historically, a lack of distributions from current investments forced many investors to abandon the strategy and seek other ways to fund new capital calls; many turned to the secondary market to achieve their liquidity objectives.

In addition, 2009 witnessed a large number of single fund secondary sales. As buyers became increasingly opportunistic and selective in their investments, pricing for funds of lesser quality fell dramatically. Probitas Partners witnessed increased pricing for funds where the potential buyer had pre-existing knowledge of the existing assets or the manager, especially where they were an existing investor. In a significant number of situations, only buyers with this informed perspective bid on positions. As a result, combined pricing for larger portfolios was often poor, and the marketing of such portfolios fell out of favor. At the same time, pricing for quality positions from well-informed buyers firmed.

Emergence of New Secondary Buyers

The buyer universe for secondary positions changed markedly in 2009. We estimate that non-traditional secondary investors — including, but not limited to endowments, pension funds, and family offices — accounted for slightly more than 50% of 2009 transaction volume, versus less than 25% in prior years. Chart I illustrates how the Probitas Partners' buyer universe has evolved from 1H'08 to today's current market. These non-traditional secondary buyers emerged for several reasons:

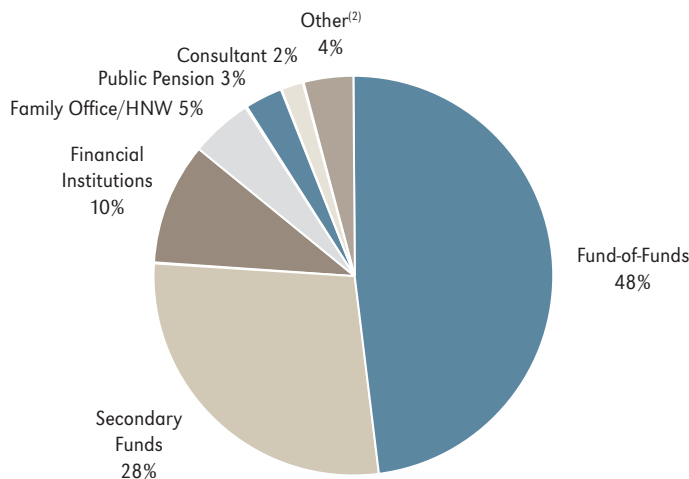
Buyers sought targeted increases in exposure —

With the secondary market shifting from portfolio transactions to transactions of individual fund interests, non-traditional buyers capitalized on the opportunity to target favored GPs or specific fund interests and increase or initiate exposure on a select basis. Not forced to participate in large portfolios

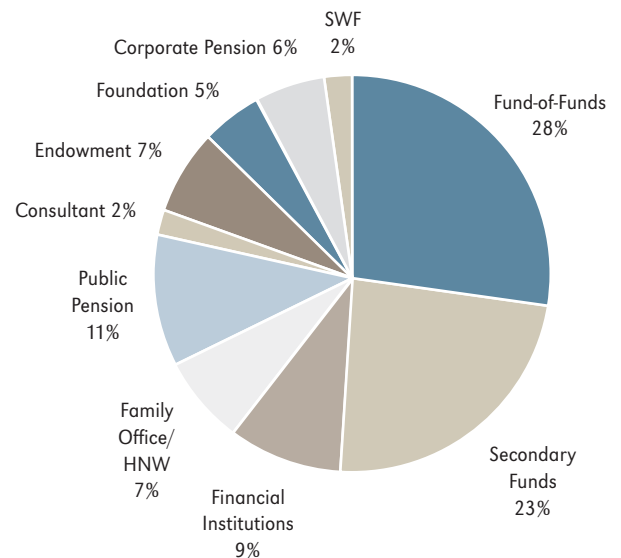
of funds, non-traditional buyers could invest in fund managers with whom they may have had difficulty investing previously, or had been cut back in their desired commitment amount. For newcomers to the private equity investment arena, this presented a particularly favorable opportunity to build strategic historical exposure as well.

Chart I Probitas Partners' Buyer Universe

Buyer Universe Summary — 1H'08⁽¹⁾



Buyer Universe Summary — Today⁽¹⁾



Source: Probitas Partners

(1) Analysis is based on number of buyers.

(2) "Other" included Sovereign Wealth Funds and Corporate Pension Funds.

Secondary supply shifted to more unfunded positions — As the bid/ask gap became more pronounced, LPs focused more on selling lesser funded positions rather than more fully-drawn positions. Investors still needed to reduce their overall private equity exposure and provide ample liquidity for unfunded capital calls, but they were unwilling to accept the market pricing for their invested assets as it typically represented a substantial loss on book values. Since the unfunded portions of fund investments are typically acquired at par (i.e., assumed by the buyer on a dollar-for-dollar basis), selling unfunded positions offered relief to sellers at a more acceptable price. Even if the transaction included a discount on invested capital, because the funded portion was small relative to the overall exposure, it represented a much smaller nominal loss compared with more funded positions.

Additionally, non-traditional buyers faced less competition for lesser-funded positions, as secondary funds and fund-of-funds buying secondaries typically seek 50% or greater funded interests under the terms of their funds' investment parameters. For the GPs, the non-traditional buyers represented more attractive purchasers. Since non-traditional buyers were acquiring strategically, they represented higher probability investors for successor funds. Frequently, this led to GPs spending more time and perhaps offering more visibility to such buyers.

Ideal environment for opportunistic buyers — Secondary specialists became increasingly selective in 2009. At the same time, non-traditional secondary buyers were presented with an attractive supply of funds. Looking to strategically acquire assets at deep discounts to underlying value and usually investing with a lower cost of capital than secondary specialists, non-traditional investors dramatically increased their market share. We expect this expanded participation to be a sustained change in the secondary market in 2010 and beyond, with non-traditional buyers representing an important, permanent source of secondary capital.

Tale of Two Markets

The secondary market witnessed two very different environments during 2009: one filled with low

pricing, low volume, uncertainty, fear, and failed auctions; the other filled with increasing enthusiasm, confidence, higher pricing, and closure.

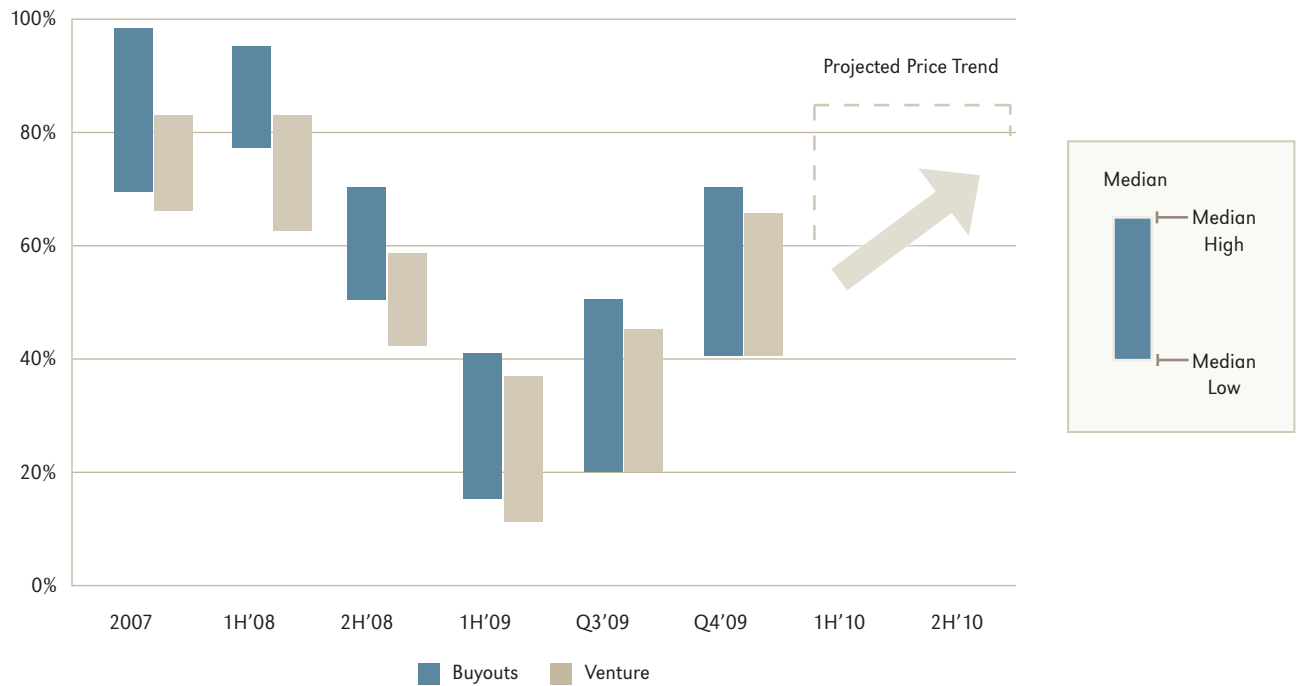
For reasons discussed previously, the first seven months of 2009 were filled with "rock-bottom" pricing and low transaction volumes. Closed transactions often involved distressed sellers and opportunistic buyers. During this period, many sellers seemed content to "wait out the storm," while buyers would only transact on what they perceived to be bargain deals.

In late August 2009, bid prices rapidly improved. Performance of underlying companies through the down cycle became better understood, leading investors to grow more confident in a global economic recovery. As the public equity market rally continued and NAVs firmed and in some cases increased, secondary buyers adjusted their targeted returns and purchase assumptions to more historically normal levels. In addition, GPs became more open to discussing their portfolios and working with potential buyers on secondary transactions, allowing buyers to become more comfortable with the underlying portfolios. This greater visibility and certainty resulted in higher pricing.

By December 2009, Probitas Partners recorded pricing of 80% of NAV at the high end of the range for a number of the more fully-drawn buyout funds. For select top-tier venture funds, Probitas Partners recorded pricing near par. Chart II illustrates the strong pricing improvement experienced over the past two quarters.

With improved pricing, sellers for the first time in nearly two years could transact without incurring a significant loss to their books, spurring increased volumes of transactions successfully closed through the end of the year. In addition, portfolio sales began to re-appear in the market toward the end of the year. Secondary investors became more comfortable evaluating a larger variety of positions, including a number of funds with which they were less familiar. As a result of these trends, secondary volume for the last four months of 2009 was disproportionately large, compared to the first eight months of the year.

Chart II Pricing Trends; Bid Spreads — Median High and Median Low



Source: Probitas Partners

Outlook for 2010

For 2010, we expect secondary market pricing and volume to rebound significantly from last year. While macro expectations for 2009 sounded similar, the market last year faced a number of obstacles that are not present in 2010. Further, the trend line from the end of 2009 is much clearer. Transaction volume in 2010 is likely to be particularly robust as a result of the following supporting factors:

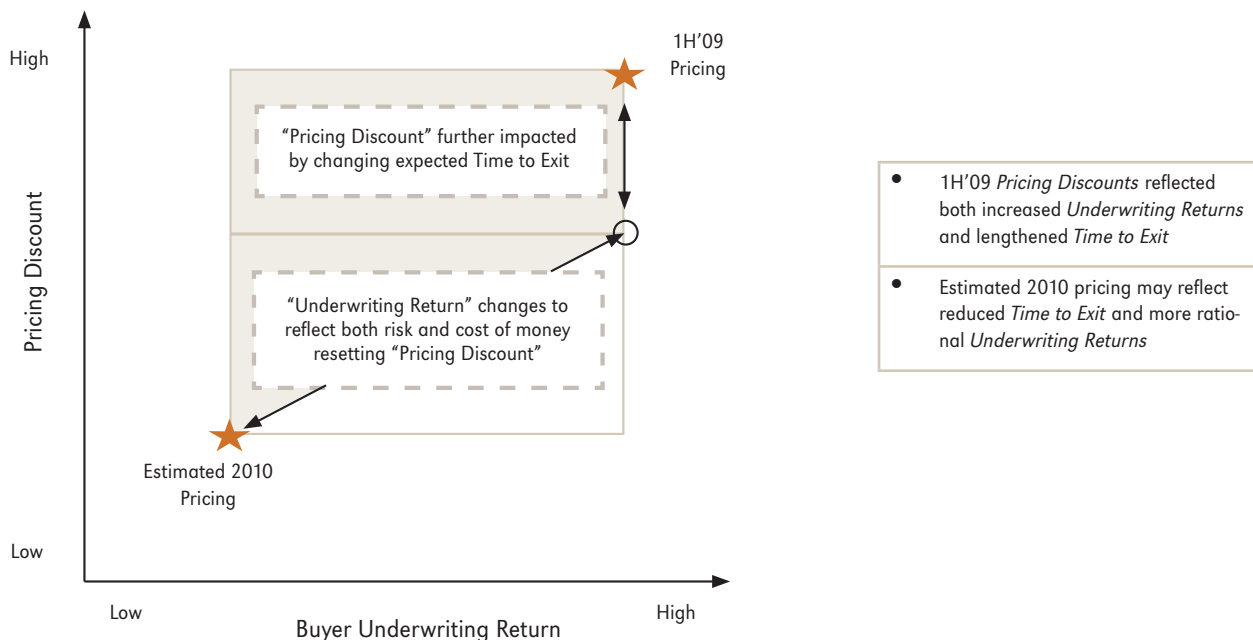
- Improved pricing environment
- Increased universe of secondary buyers
- Capital calls will create impetus to sell
- Need for buyers to put money to work

The synergy of these factors will drive increased transaction activity in 2010.

Improved Pricing Environment

The return to historically normalized pricing will increase both the number of sellers and closed transactions. We project, based on current transactions and trend lines, that by mid-2010, top-tier buyout funds will trade near par, and median bids for buyout funds will price above 80% of NAV. Furthermore, we believe that increased supply in 2010 will help prevent the formation of a price bubble and that persistent demand will maintain pricing at levels that will sustain stable transaction activity. Pricing for 2010 will reflect reduced perceived asset risk, shorter projected time to exit, and firming exit multiples, as illustrated by Chart III below.

Chart III Variables That Affect Pricing



Source: Probitas Partners

As shown in Table I below, if buyer underwriting returns reverted to their historical norms this year, secondary pricing could improve by 30%-40% or more.

Table I

	Time to Exit	Estimated Underwriting Return
1H'09	3.0	25.0%-35.0%
Estimated 2010 Pricing	2.5	17.5%-25.0%
Implied Secondary Pricing Improvement	30%-40%	

Source: Probitas Partners

However, we suspect that while buyer underwriting returns will moderate, their targeted returns will likely remain in the low 20's for the foreseeable future.

The improved pricing reflects a better alignment with fundamental asset values. From Q4'08 through Q2'09, pricing in the secondary market reflected significant uncertainty and fear. Probitas Partners witnessed a dramatic decrease in this sentiment, with

the result that pricing for assets today better reflects their fundamental value. This realignment is critical, as it provides potential sellers of positions comfort that they are not only receiving better pricing in the market, but pricing that leads to a good portfolio management decision. Further, it de-risks sellers appearing imprudent for selling at fire sale prices that improve dramatically only a few months later.

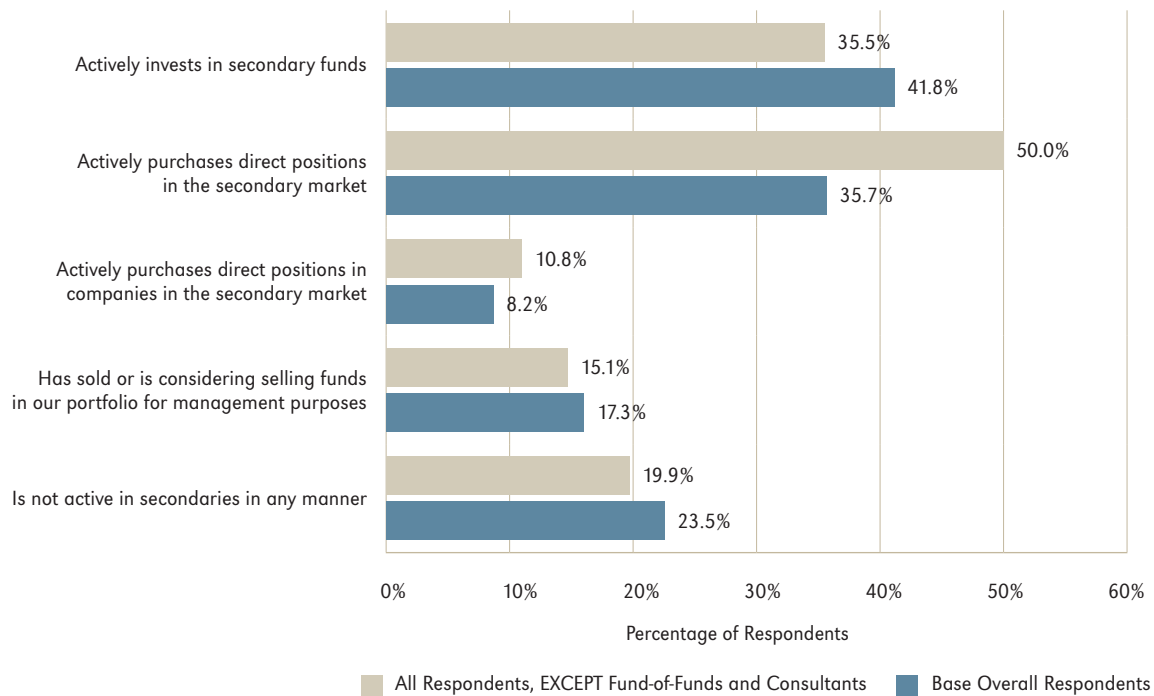
Increased Number of Secondary Participants

An increasing number of LPs will seek to transact as buyers or as sellers (or both) in the secondary market. *Probitas Partners' 2010 Private Equity Institutional Investor Survey*, completed in November 2009, found that over 75% of LPs are involved in some capacity in the secondary market.

The number of LPs active in the secondary market will increase further in 2010 as private equity investors continue to seek new ways to capitalize on the opportunities presented by the secondary market as an increasingly traditional portfolio management tool.

Chart IV illustrates institutional investors' interest in the secondary market.

Chart IV Secondary Market Investments
"In the Secondary Market, My Firm... (choose all that apply)"



Source: *Probitas Partners 2010 Private Equity Institutional Investor Survey*; Institutional respondents with HQs in U.S. (46%), Europe (36%), ROW (18%)

Capital Calls Create Impetus to Sell

The capital call environment for 2009 was relatively benign, reflecting a slow investment pace by GPs that were cautious and opportunistic in making new investments. With a stronger economic outlook, GPs have begun to invest again; already, Probitas Partners has witnessed an increase in capital calls starting in Q4'09. We expect that by 2H'10, some sellers will be unprepared for the increase in capital calls and may be pressured to seek further liquidity to fund those calls.

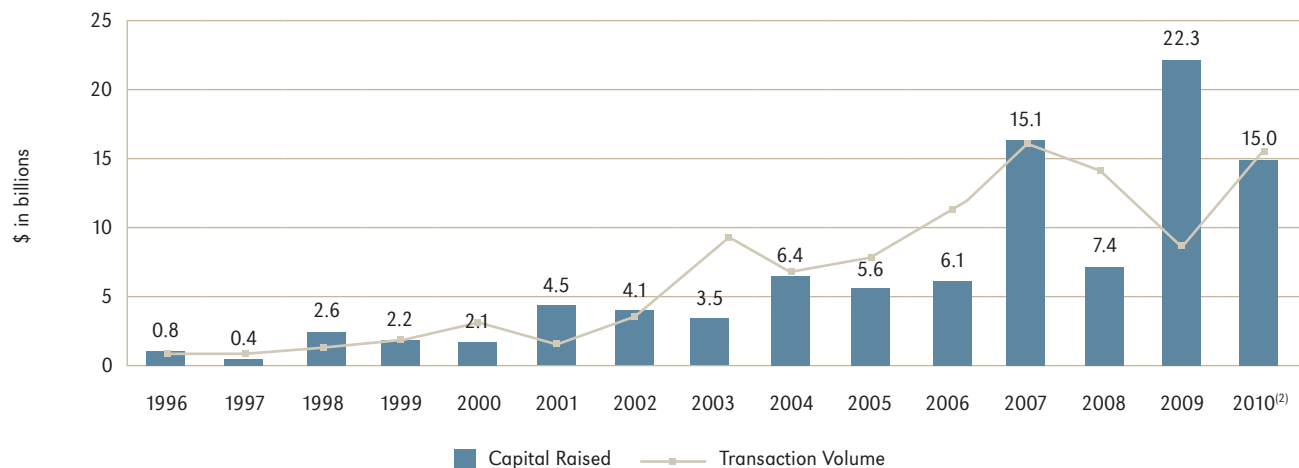
Supply of Secondary Capital

Although secondary specialists were cautious in deploying capital in 2009, they were very busy fundraising. In 2009, secondary specialists raised an estimated \$22 billion and have approximately

\$33 billion of dry powder available for investment. Further, secondary specialists – including funds that are expected to come to market in 2010 and secondary direct funds – are out fundraising and seeking approximately \$26 billion in additional capital. Assuming only half of the targeted capital, or \$13 billion, actually gets raised in 2010, secondary specialists will need to invest at least \$9.2 billion in 2010 to keep pace with their typical five-year investment periods.

Chart V shows the relationship between secondary funds raised and transaction volume from 1996 through 2010. A substantial gap existed in 2009 between capital raised and capital invested by secondary specialists. For the available capital to be invested, pricing must increase to levels that attract sellers, a condition that we believe is quickly approaching.

Chart V Secondary Funds Raised — Transaction Volume⁽¹⁾



Source: Probitas Partners, Private Equity Analyst, PREQUIN, AlpInvestPartners

(1) Transaction volume is defined as NAV plus uncalled capital.

(2) Totals are estimates, transaction volume for 2010 is estimated to be 0.9% of the last seven years cumulative capital raised.

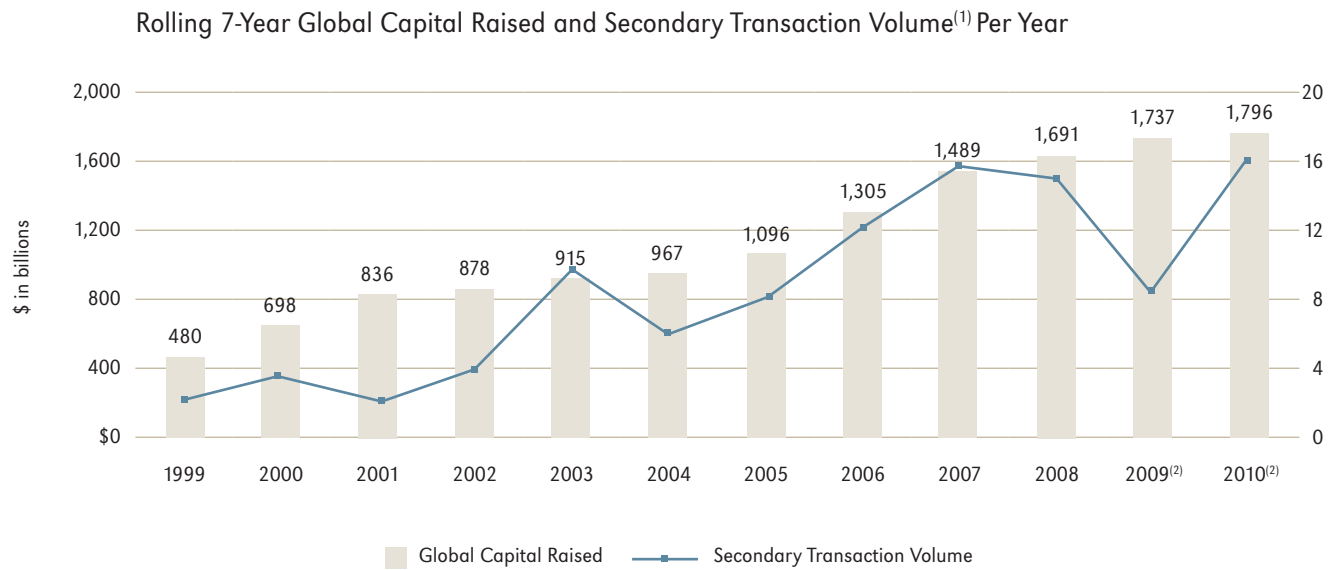
In addition, fund-of-funds represent an expanding capital base. A majority of primary fund-of-funds have the ability to invest as much as 20% of their funds in secondary transactions and have sought and received LP approval to increase this basket. In 2010, these primary fund-of-funds will focus on the secondary market (i) as a way to establish relationships with managers that were previously closed to them, (ii) to continue to deploy capital even if the primary fundraising market remains sluggish, and (iii) as a way to alleviate the J-Curve effect that still impacts many of their 2006–2008 vintage-year fund investments.

Continued participation of non-traditional secondary participants — While we expect that secondary specialists will represent over 60% of the 2010 buyer universe, non-traditional secondary buyers will continue to play an expanded role in the secondary market, representing an additional \$15–\$25 billion of available capital. Furthermore, we expect that many of these non-traditional buyers will dedicate resources and capital to the sector as a durable part of their investment activity.

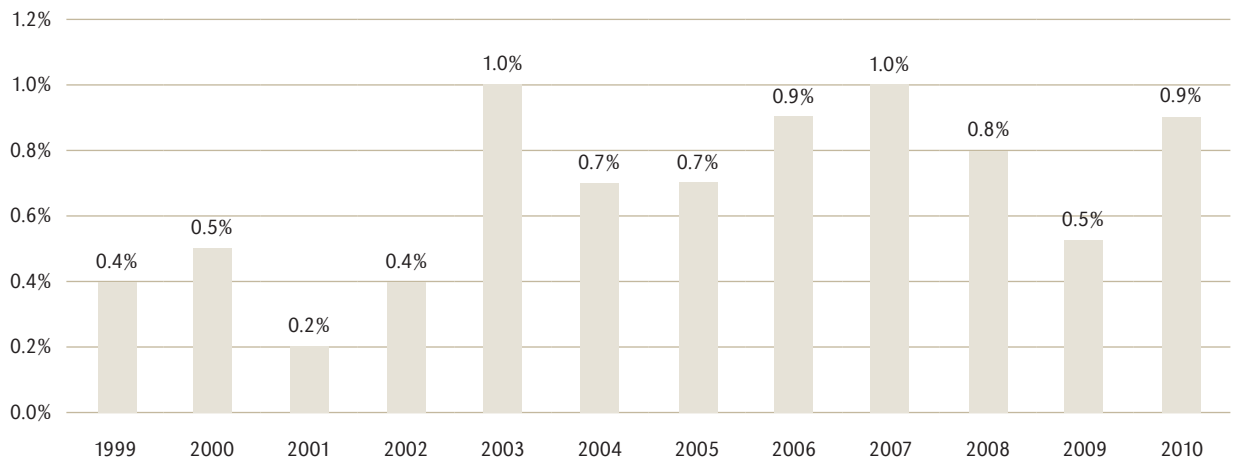
We project that secondary transaction volume in 2010 will reach or exceed \$16–\$18 billion, driven by the recent firming of bid prices to more normal levels, abundant capital available from secondary specialists, and continued strong and expanding interest from non-traditional buyers. This transaction level is consistent with historical secondary transaction volumes, calculated as a percentage of 7-year rolling capital raised, as illustrated in Chart VI.

From 2003 to 2008, secondary transaction volume averaged 0.9% of the rolling 7-year global capital raised. If 2010 normalizes around that average ratio, secondary transaction volume would surpass \$16 billion. However, given the foregoing capital availability dynamics and pent-up selling demand from last year's depressed volume, we project higher volumes are likely in 2010.

Chart VI Primary Capital Raised and Secondary Transaction Volume



Secondary Transaction Volume⁽¹⁾ as a % of Capital Raised Last Seven Years



Source: Probitas Partners
 (1) Defined as NAV plus uncalled capital.
 (2) Probitas Partners' estimates.

Fund Sector Preferences for 2010

Our market reconnaissance for favored and out of favor sectors has been a helpful indicator for expected pricing for certain funds. Table II presents our predictions for areas of most interest or lack of interest for 2010 based on recent feedback from our global buyer universe.

Table II Predictions for 2010

IN	OUT
Middle-market buyout	Distressed trading strategies
"Young" funds	European Venture
One-off transactions well known funds	Opportunistic U.S. Real Estate
Portfolio transactions	Unfunded mega buyout
Top-tier Venture	
High quality Asian funds	
Energy assets	
Fully-funded mega buyout	

Source: Probitas Partners

Summary

2010 represents a return to normalcy in the secondary market, with several attributes pointing to very strong activity for buyers and sellers. Specifically, the market today provides a viable market for sellers seeking to scale back, make adjustments to, or optimize their private equity portfolios. With the influx of new buyers in the market and the increasingly globalized investor universe, the key to maximizing price for portfolios, sub-portfolios, and individual positions will include identifying investors who strategically target a particular fund(s).

The market currently holds a supply/demand imbalance with significant pent-up demand. Sellers who come to market now will find that buyers are receptive to a wide range of potential transaction characteristics – with no portfolio too small, large, or complex to be considered in 2010. Even for sellers not seeking to reduce their overall exposure, 2010 will be an excellent time to divest non-core relationships and redeploy capital to higher-yielding or more strategic assets.

While bid prices are trending steadily higher, investors looking to sell assets in 2010 should be careful not to wait too long. We see a scenario where a surge of capital calls could force more motivated sellers to market. Buyers rationally responded to that market condition at the end of 2008 by reducing pricing to capitalize on the distress and increased supply. Our counsel: be proactive. Evaluate your options and establish your 2010 strategic secondary plan – buy and/or sell – today.

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