Private Equity in 2009

Private equity fund managers are targeting new investment from high-net-worth communities amid a credit crisis they expect to last into 2010. Intense competition for assets and less certain exit strategies are causing firms to take a more active role with portfolio companies to unlock inherent value.

May 2009

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Private equity investment has represented a highly effective but under-utilized strategy for wealthy individuals seeking early stage opportunities in exclusive private market deals. In a relationship-driven industry, there was broad understanding of the inherent risk/reward equation. Because these investments tended to be longer-term and more illiquid than traditional asset classes, sophisticated investors have, generally, been careful to balance private equity positions alongside more traditional holdings to ensure that investment portfolios are consistent with overarching financial and lifestyle objectives.

Astute managers were likewise discerning in selecting limited partners, drawing from a pool of qualified individuals and families to create a stable base of investors with appropriate risk tolerances. The success of this model has led to the dramatic proliferation of private equity funds and products, intensifying competitive pressures to produce outsized returns. In its quest for performance, the industry has historically been aggressive in its use of leverage to boost investor returns. Consistently strong results attracted interest from not only high-net-worth communities, but also from a growing roster of institutional investors, including pensions, foundations and endowments. Amid growing demand for its products, the private equity industry went public.

Initial public offerings of multibillion dollar global firms allowed a still greater range of investors to access the private equity space. Widespread speculation grew around announced and rumored deals, raising the industry's profile even among mainstream audiences and generating awareness of the important role the industry had come to play in the proper functioning of capital markets. In the face of competition from larger, better-established brands, many middle-market private equity firms developed niche practices and deep relationships with their portfolio companies to unlock value. Their nimbleness and expertise now leave these firms well-positioned to capitalize on emerging opportunities even as they work to confront a host of near-term strategic, operational, and regulatory challenges.

Drawing from the experience and insight of our principals, Rothstein Kass regularly publishes research and surveys intended to help our clients comprehend an ever-changing competitive landscape. Our latest report, "Private Equity in 2009" features the results of a recent survey of senior managers at middle-market private equity firms on topics including fund-raising intent, the likely duration of the credit market weakness and key concerns about the investing environment. Our findings suggest that stagnant capital markets are creating opportunity for firms that combine the right capital structure and liquidity model with a specialized approach. Smaller firms can overcome resource limitations by demonstrating a superior understanding of vertical industry practices, taking a long-term approach to building value, and generating returns through organic growth of portfolio businesses. In this respect, the middle-market private equity industry promises to be an important source of financing for the research and development pipelines for biotech, pharmaceutical, telecommunications and green energy, among other sectors.

"Private Equity in 2009" draws on the expertise of the Rothstein Kass Commercial Services Group to provide context for statistical results, contrasting 2009 data against our 2008 research where applicable. Our report also includes a stand-alone survey of high-net-worth investors on their perceptions of the private equity sector. We hope that you will find this research absorbing and compelling, and encourage you to contact us if you would like to discuss our findings.

Thank you for your interest and support.

Steve Kass
Co-Managing Principal
Rothstein Kass

Key Themes

- Given the economic climate, private equity professionals foresee persistent challenges to their efforts to raise new assets

- Ultra-high-net-worth investors and single-family offices are expected to be the primary source of new assets, surpassing institutional investors and other sources

- Downward pressure on fees, especially management-related expenses, is viewed as another likely byproduct of current economic conditions

- Substantively all private equity firms anticipate more stringent regulations

- A growing number of private equity managers believe it will take greater involvement with portfolio companies to achieve investment targets

- Investors believe private equity investment presents promising opportunities, but most are generally dissatisfied with current private equity holdings

About the Research

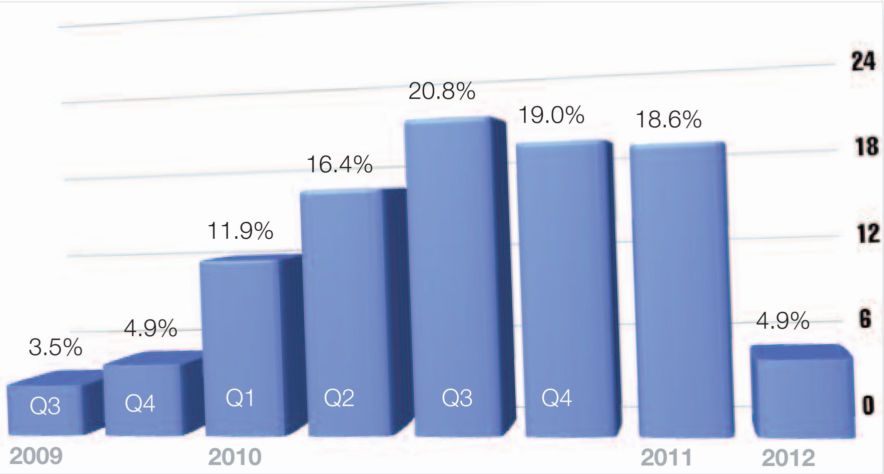
In the first quarter of 2008, we surveyed 323 managing partners of middle market private equity firms about the economic environment and the emerging trends shaping the competitive environment. At that time, we found that most managers remained optimistic regarding long-term growth prospects even as they predicted that an extended credit crisis would adversely impact the private equity community. A little more than a year later, we revisited this research to see how perceptions have shifted and what steps private equity firms are taking to position themselves to capitalize on investment opportunities in an intensely competitive market for high-net-worth assets.

For our 2009 report, we conducted telephone interviews with 226 managing partners of private equity firms to revisit some of the most compelling aspects of our 2008 research to provide contrasted findings. In 2009, we also expanded our areas of concentration to include a more detailed look at anticipated operational and regulatory concerns. Survey participants were managing partners overseeing at least one private equity fund, with total firm assets under management between $50 and $300 million. This report also features the findings of a survey of 108 private equity investors to evaluate how private equity firm strategies relate to investor expectations.

The Economic Crisis

Our 2008 research indicated that although the extent of the capital market weakness was still not clear, many private equity fund managers accurately predicted that the credit crisis would worsen over the balance of the year. With capital market weakness still the prevailing condition, speculation is rampant regarding when the U.S. economy will experience sustainable recovery. From our 2009 report, it is apparent that private equity managing partners are not anticipating a quick resolution to the economic uncertainty, with more than half expecting the credit crisis to continue for at least another 12 months. About two-fifths anticipate meaningful improvement in the economy in the second half of 2010 (Figure 1).

Figure 1:
The End of the Credit Crisis



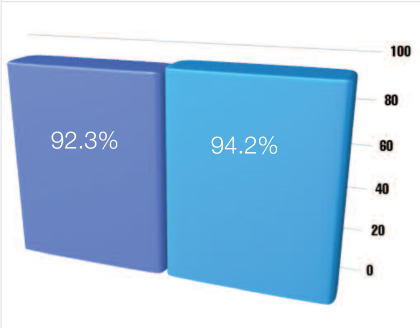
N = 226 PE managing partners

"Credit market weakness and recessionary conditions have continued to wreak havoc on the strategies and operations of small- and mid-sized private equity firms by restricting access to affordable acquisition capital and limiting viable exit strategies. While capital markets have shown some signs of a thaw, the vast majority of managers we surveyed believe that the credit crisis will persist into 2010," said Tom Angell, principal-in-charge of Rothstein Kass' national Commercial Services Group and its Private Equity practice. "These firms are also finding it more difficult to leverage investments to generate outsized returns, making it more difficult to compete with larger funds with ample cash positions to pursue undervalued assets. Taking all this into account, it is reasonable to expect that mid-sized private equity firms will be even more aggressive in their fundraising efforts than their larger counterparts."

Raising Money

The vast majority of survey participants reported interest in raising more money to invest (Figure 2). Small- to mid-sized private equity firms have historically been aggressive in their fundraising efforts, and are often highly leveraged to compete with much larger funds for investment opportunities. As the LBO market becomes stagnant, the market favors private equity players with strong cash positions that can be deployed to acquire undervalued assets.

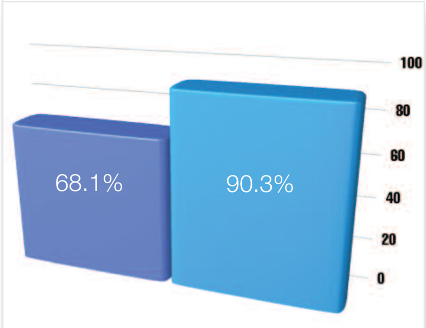
Figure 2:
Interested in Raising More Money to Invest



2008	92.3%
N = 323 PE managing partners	
2009	94.2%
N = 226 PE managing partners	

"The almost universal desire to raise more money to invest expressed by survey participants also suggests recognition of the opportunities that abound in the marketplace. Businesses of all sizes and across industry segments have experienced difficulty in meeting capital requirements, driving down valuations and building a niche for non-traditional capital sources," said Jeff Kollin, a director in the Financial Services Advisory practice at Rothstein Kass. "Government initiatives intended to restore efficient functioning of collateralized debt markets also have the potential to deliver returns more in line with historical rates, by allowing for the measured deployment of leveraged capital while minimizing risk."

Figure 3:
Difficult to Raise New Capital

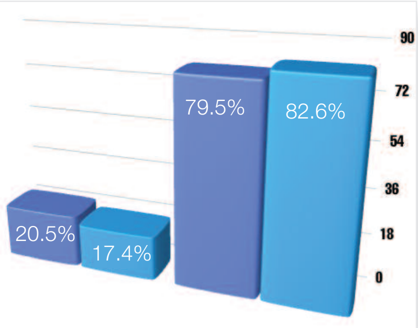


2008	68.1%
N = 323 PE managing partners	
2009	90.3%
N = 226 PE managing partners	

As in 2008, managing partners expect raising new capital in 2009 will be quite difficult (Figure 3). In 2009, over 90 percent of respondents expressed agreement, compared with nearly 70 percent in 2008.

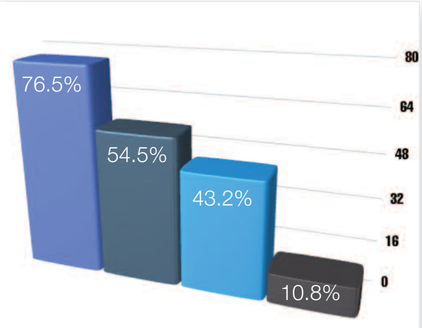
"Prior to 2008, private equity firms could rely on superior performance to support strong asset flows. Less-impressive recent performance has created skepticism among some investors adding to fund raising challenges. High-net-worth and institutional investors are more frequently demanding a greater degree of transparency to help them differentiate among the widely disparate available offerings," said Mr. Angell. "Performance, investment strategy, and cohesive communications are all considerations for investors as they evaluate options. With the pace of activity still well off peak levels, investors are gravitating to funds that have a long-term philosophy that is consistent with their own investment objectives."

Figure 4:
Primary Source of New Capital



	Hedge Funds	Private Equity Funds
Current investors	20.5%	17.4%
New investors	79.5%	82.6%
N	233	213

Figure 5:
Very Important Sources of New Capital



High-net-worth investors	76.5%
Single-family offices	54.5%
Institutional investors	43.2%
Other	10.8%

N = 213 PE managing partners

The pervasive desire to raise additional funds in a fiercely competitive marketplace suggests that private equity firms will need to look beyond their current set of investors to meet objectives (Figure 4). These results are consistent with the findings of a survey we conducted in the first quarter of 2009. (See *New World Order.*)

"Poor performance has contributed to investor dissatisfaction, even with those money managers that had previously been successful in generating market-independent returns. A good deal of capital will change hands as investors reallocate from other asset classes to managers who are a better fit with risk tolerances," said Seth Blackman, a principal in Rothstein Kass' San Francisco office. "Private equity firms seeking to grow market share will need to guard against defections even as they attract new investors to their funds. Private equity managers should stay true to stated objectives to avoid brand confusion and avoid alienating the long-term investors who provide stability to their funds."

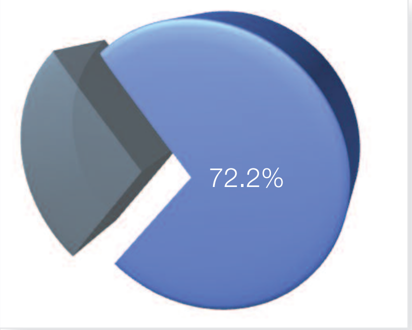
Much like the hedge fund community, private equity firms currently report that high-net-worth investors and single-family offices are the best potential sources of new monies (Figure 5).

"Private equity firms will face stiff competition from all segments of the investment community as they target high-net-worth assets, with our earlier research suggesting that the hedge fund industry, in particular, is undergoing a shift back to its roots. Family offices represent a virtually unexplored source of assets flows, as declining net-worth and a desire to share resources has led to increasing demand for comprehensive wealth management services," said Rick Flynn, a principal in the Family Office Group at Rothstein Kass. "Through their asset allocation businesses, family offices will be an important source of funds to private equity ventures that communicate effectively with the investment advisory sector."

Cultivating the Wealthy

There is good news for managing partners at private equity funds interested in reaching out to high-net-worth investors and single-family offices. Within the context of a large-scale survey of 108 jet owners (net-worth = $30 million or more), we evaluated their attitudes towards private equity investing. While respondents shared important concerns regarding private equity investments, they also indicated a strong willingness to consider new allocations to the sector.

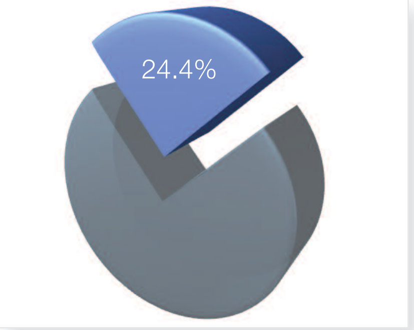
Figure 6:
Investing in Private Equity Funds



Invested 72.2%

N = 108 high-net-worth investors

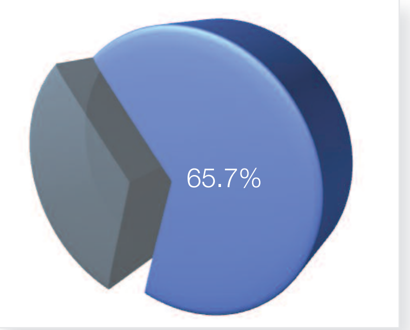
Figure 7:
Satisfied with Their Private Equity Funds



Highly satisfied 24.4%

N = 78 high-net-worth investors

Figure 8:
Would Consider Investing Today in a Private Equity Fund



Highly likely 65.7%

N = 108 high-net-worth investors

Of the 108 multi-millionaires surveyed, about three-quarters have invested in private equity funds (Figure 6).

"The relatively high percentage of ultra-high-net-worth individuals that report private equity holdings indicates that this community remains cognizant of the advantages of private equity investment and have not abandoned the space. Instead, they are focused on structuring their entire portfolio of investments to support advanced planning objectives including asset protection and estate planning," said Mr. Flynn. "Since private equity vehicles typically offer less liquidity than other investment classes, these positions must be balanced against capital requirements to allow financial flexibility."

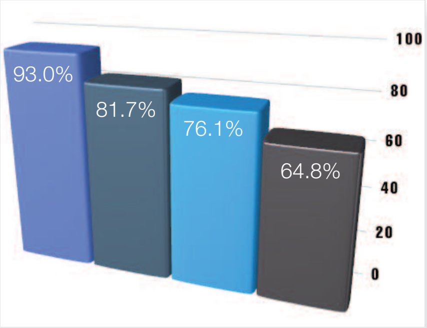
One cause for concern is that only one-quarter of those high-net-worth investors report that they are "highly satisfied" with these investments (Figure 7). Performance is only part of the equation.

"The level of dissatisfaction reported by high-net-worth investors regarding their private equity holdings can primarily be attributed to performance. However, to state that performance is the only issue ignores underlying factors that must be addressed during the industry's anticipated recovery," said Mr. Angell. "In the near-term, the competitive environment will make it difficult for firms to identify and close quickly on appropriate deals. As they compete for assets, some managers might be tempted to widen their investment style to appeal to a broader range of investors. This short-sighted approach could cause brand confusion at a time when managing investor expectations through consistent communications is imperative."

Over 65 percent of the high-net-worth individuals we surveyed said that they would consider investing in a private equity fund today (Figure 8). However, using factor analysis, we were able to ascertain several key concerns that could negatively influence the pace of assets flows if not adequately addressed. (Figure 9).

"Despite the general discontent expressed regarding current private equity holdings, it was encouraging to see that over 65 percent of high-net-worth investors surveyed would consider investing in a private equity fund today. This is likely a byproduct of the industry's consistently strong track record prior to 2008, and also the plethora of appealing investment opportunities that are emerging," said Mr. Angell. "Again, however, it's critical that individual firms do not depart from their core capabilities. Especially for smaller firms, it's better to stand out for a particular skill set than be known for providing broad but unfocused expertise. This enables firms to attract the right type of investor to their funds, promoting long-term stability."

Figure 9:
Top Concerns



The exit strategy	93.0%
Ability to source deals	81.7%
Company vetting methodology	76.1%
Contingency strategies	64.8%

N = 71 high-net-worth investors

Investment returns are still a critical differentiator for a firm. More than ever before, however, investors are demanding a greater degree of transparency. Before committing resources, investors are increasingly questioning managing partners on matters once thought to be proprietary, from exit strategies to valuation methodologies. Four out of five high-net-worth investors reported that it is crucial to understand how deals are sourced and vetted.

"Many private equity firms are currently holding illiquid or hard-to-value assets in their portfolios. With the IPO pipeline essentially halted and the deal flow reduced to a trickle, investors are much more concerned with precisely how private equity firms intend to deliver returns," said Mr. Angell. "In most cases, small- and mid-sized private equity companies possess a skill set or expertise that differentiates them from larger competitors – whether that entails experience as a chief restructuring officer or insight into specific vertical industry sectors. These capabilities allow firms with a clear strategic focus to be more successful in creating value by working closely with portfolio companies."

Another matter of growing importance to wealthy investors is the development of contingency plans for the managing partners of the funds and portfolio companies. Succession planning is required to ensure continuity of operations in case of an unforeseen event.

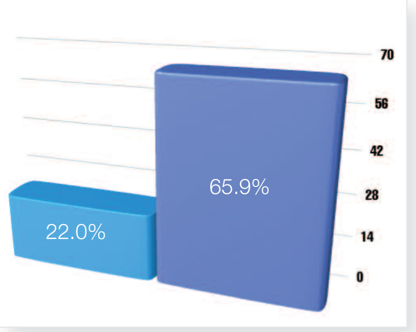
In summary, being a talented investment manager no longer ensures that a firm will be able to raise capital. Mid-sized firms, in particular, should evaluate performance, reporting and marketing functions collectively and rely on well-conceptualized client communications to appeal to diligent high-net-worth investors and family offices made more hesitant by recent market volatility.

"Prior to the global credit crisis, private equity was about leverage. In the aftermath, the buzzword is 'liquidity.' Investment management firms of all types were blindsided by liquidity demands by their investor base, constraining deal-making ability and forcing liquidation of profitable investments to offset illiquid holdings," said Mr. Kollin. "Funds are now more conscious that the alignment of firm liquidity requirements with the objectives of their investors requires thorough and regular evaluation to guard against disproportionate withdraws in the event of a market-changing event."

The Changing Landscape

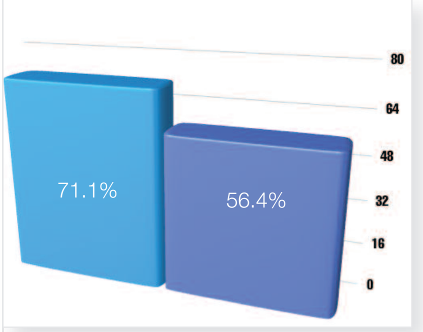
Investor dissatisfaction regarding recent performance coupled with intense competition for new assets will conspire to increase pressure on industry fee structures. More than three times as many of the managing partners anticipate fee pressure in the current study compared to last year (Figure 10).

Figure 10: Expect Increased Fee Pressure



2008 22.0%
N = 323 PE managing partners
2009 65.9%
N = 226 PE managing partners

Figure 11: Increased Fee Pressure by Type



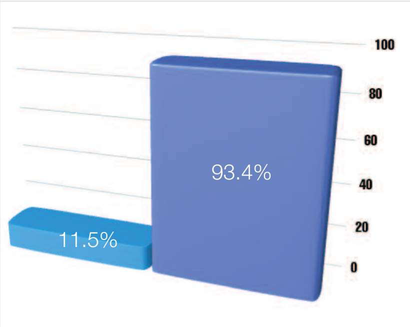
Management fees 71.1%
Carried interest 56.4%
N = 149 PE managing partners

Among the managing partners who see increased pressure on the fees they charge, they foresee strong pushback on management fees (Figure 11). Still, 56% also anticipate investors wanting lower carried interest participations.

"The biggest names in the private equity space—those with established and respected brands—will continue to adhere to the "two and twenty" fee structure commonly associated with private equity and hedge fund investing. For other participants, the future is less certain. Competition among providers has empowered private equity investors to negotiate investment terms," said Mr. Angell. "Firms that are more flexible regarding fees could enjoy a short-term advantage in capital raising initiatives. However, this strategy will require firms to streamline operations and deliver greater returns to offset the loss of fee income. If margins are stretched too thin, they could ultimately create a barrier to entry."

"Based on our findings, the majority of private equity managers can expect both management fees and carried interest to be challenged. A management fee representing two percent of assets under management and a 20 percent carried interest on investment returns may be considered excessive to certain investors. Before committing to lower fee structures, firms must consider how this impacts existing investors and whether the revised value proposition is still sufficient to justify enterprise risk," said Mr. Blackman.

Figure 12:
Expect Increased Regulatory Oversight

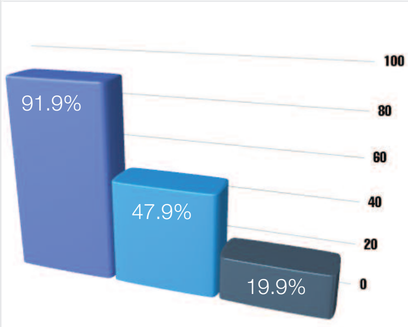


2008 11.5%
N = 323 PE managing partners
2009 93.4%
N = 226 PE managing partners

Considering the bailout activities of the government coupled with public outrage, it's hardly surprising that the survey participants anticipate increased government regulation of their industry. (Figure 12).

"Nearly all private equity managers we surveyed in 2009 agreed that increased regulatory oversight is expected. To date, much of the discussion surrounding this issue has centered on how measures supporting enhanced disclosures and transparency will increase operating costs for alternative investment firms. However, as more details become available, there is greater understanding of how private equity firms stand to benefit from these efforts over time," said Mr. Angell. "If regulatory efforts are able to promote transparency without undermining proprietary strategies, the private equity community will benefit from increased asset flows. Moreover, programs intended to restore asset-backed securities issuance are being structured to encourage participation by alternative investment firms."

Figure 13:
Anticipated Areas for Regulation

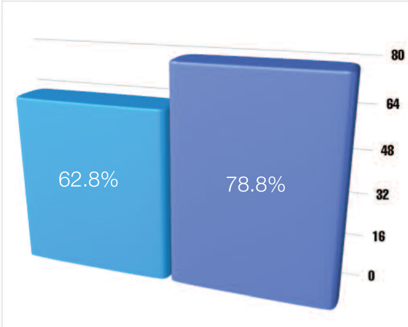


Greater disclosures 91.9%
Taxing carried interest 47.9%
Limiting lockups 19.9%
N = 211 PE managing partners

While the fact that greater regulation of the financial services sector appears inevitable, just what form this will take is not immediately apparent to survey participants. Most agree that greater disclosures will be required, but there was less consensus on specific regulatory measures such as taxing carried interest and restricting lockup periods (Figure 13).

"Private equity firms acknowledge that greater disclosures will support stronger asset flows, particularly from institutional constituencies because of their fiduciary responsibilities. They are less supportive of measures that eliminate investing tools or require disclosure of limited partner stakes," said Mr. Angell. "They are also somewhat critical of draft proposals that would tax carried interest as ordinary income rather than as capital gain, since this would have a significant effect on the after-tax benefits of a private equity structure."

Figure 14:
Expect Greater Involvement by Private Equity Firms with Their Portfolio Companies



2008 62.8%
N = 323 PE managing partners
2009 78.8%
N = 226 PE managing partners

Private equity firms are also envisioning a more extensive and direct involvement with portfolio companies (Figure 14). In 2008 we saw that around 60% of the managing partners expected to become more involved with their portfolio companies. That percentage rose to about 80% in the 2009 survey.

"Uncertain exit strategies and an increase in illiquid balance sheet assets will mandate greater involvement by private equity firms with their portfolio companies. Many firms are now 'buy and hold' investors. Fortunately, small- and mid-size private equity firms are well-suited to such ventures. The scale of operations has typically caused such firms to be more selective and targeted in their investment approach, eschewing generalist strategies in favor of niche positioning. As a result, many managers are trusted advisors to portfolio companies and can work closely with management to grow the business organically during periods of capital market uncertainty," said Mr. Angell.

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Rothstein Kass Publications

New World Order
Rothstein Kass' third-annual report on alternative investment industry trends surveys 239 US-based hedge fund senior partners for their perspectives on the shifting competitive landscape. "New World Order" features insight on issues ranging from fundraising intent to regulatory concerns, and finds that the hedge fund sector is anticipating a return to its roots as a niche investment class.

Beyond Performance: How Hedge Funds Can Strengthen and Build Their Affluent Client Base
As competition in the hedge fund sector intensifies, it will be more important than ever for hedge fund professionals to zero in on the priorities and expectations of their client base. Authors Russ Alan Prince and Hannah Shaw Grove share the research they have conducted with wealthy individuals and families that invest regularly, and significantly, in hedge funds and funds-of-funds. Their findings will help hedge fund firms understand the most effective ways to reach, cultivate and retain high-net-worth investors.

Copies of publications are available upon request via www.rkco.com

About Rothstein Kass

A full-service C.P.A. firm, Rothstein Kass provides audit, accounting, tax and regulatory compliance services through its Commercial Services Group. The Firm advises organizations, including public and private middle market companies, private equity funds, investment advisors and other entities looking for financing/investment opportunities, as well as those looking to restructure as a business strategy.

Recognized nationally as a top service provider in the industry, the Firm also provides audit, tax, accounting and consulting services to hedge funds, fund of funds, broker-dealers and registered investment advisors through its Financial Services Group. The Financial Services Group consults on a wide range of organizational, operational and regulatory issues, and advises on fund structure, both inside and outside the US, compliance, and financial reporting, as well as on tax issues from a federal, state, local and international compliance perspective.

Rothstein Kass has offices in New York, New Jersey, California, Colorado, Texas and the Cayman Islands.

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