Introduction

For the first time since private equity became an asset class in most institutional portfolios, the asset class faces broad challenges globally. Beyond the inherent macro fundamentals that are confronting all companies today, institutions that invest in private equity are facing unique issues, in terms of the cash flow dynamics of funds' contractual structure, the impacts of fair value accounting, and the massive buildup of committed capital now overhanging the market. Furthermore, limited near-term realizations will strain investors' ability to self-fund capital calls.

For nearly all investors, this is uncharted territory.

Nearly everyone has read and re-read ad nauseam accounts of the series of events that have profoundly restructured Wall Street and other financial markets worldwide. The global capital markets are reacting with extreme volatility, forcing investors to shift their orientation dramatically to a defensive one —and consider scenarios that were, only a very short time ago, unthinkable.

Forecasting in general is inherently difficult; however, the ripple effects of actions targeted to address specific problems in a turbulent market requires especially clear thinking and analysis. It is difficult to assess how this crisis will play out, as this is, in many ways, unprecedented territory. While our view remains cloudy, we can offer our experience, perspectives and insights on the action steps to best position institutional private equity portfolios in these difficult times.

From inception, Probitas Partners has built long-term relationships with investors based on consistently sharing top-quality research, insights, and advice at all stages of the market cycle. Today, we offer you what we perceive to be the best practices and steps that forward-thinking investors are taking to position portfolios to weather the storm and to find ways to capitalize on what are likely to be extraordinary investment opportunities in the next two years, especially in attractive spinouts, distressed and other special situation funds, and emerging winners in the private equity and hard asset arenas.

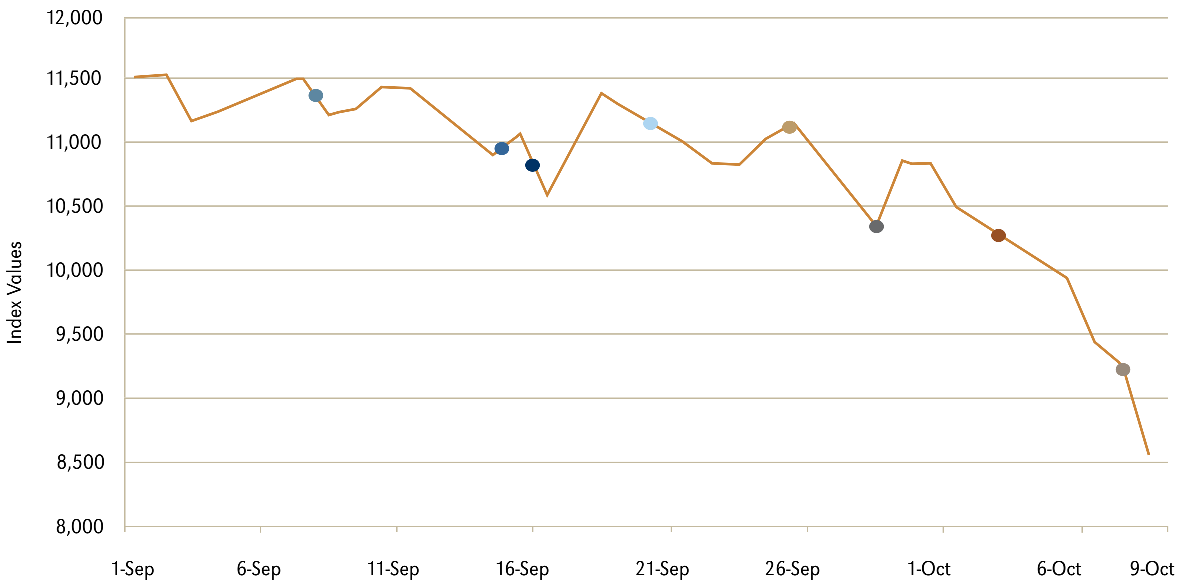
While current market events are discomforting for institutional investors and fund sponsors alike, one thing is certain: we all must continue to participate in the market to protect our respective investments and, at the same time, seek means to capitalize on the new opportunities created by these disruptions. To do anything less presumes that we are powerless to change an established course — and that is not the case.

Market Overview

Clearly, the numerous attempts of the past month to instill confidence in the public markets have failed. In the U.S., the takeover of Fannie Mae and Freddie Mac by the Federal Government, the elimination of bulge-bracket investment banks as a distinct category, and a year of bank failures in the U.S. including the largest such failure in history, have propelled the U.S. government to take drastic measures that have yet to stop the bleeding.

The chart below summarizes the volatility in the U.S. stock market triggered by these events.

Chart I Dow Jones Industrials, 9/1/08 to 10/8/08



9/8/08	●	Fannie and Freddie taken over
9/15/08	●	Lehman files for bankruptcy, BofA takes over Merrill
9/16/08	●	Government “lends” AIG $85B; two money market funds “break the buck”
9/20/08	●	Treasury proposes a $700B rescue plan
9/25/08	●	WaMu fails, largest bank failure in U.S. history
9/29/08	●	Fortis, B&B, Hypo Real Estate rescued or taken over
10/03/08	●	U.S. Congress passes bailout plan
10/08/08	●	U.K. announces bank rescue program

Source: Probitas Partners

Neither the enactment of the U.S. government's $700 billion rescue package nor the worldwide interest rate cuts have noticeably boosted confidence in the financial markets, especially in the European and Asian markets. Individual European countries, led by Iceland, England, and Germany, have acted unilaterally to nationalize or recapitalize their banks — without any coordinated plan for the European Union. Further afield, the stock markets of Japan, China, Russia, India, and many emerging markets have reached new lows.

The impacts of the credit turmoil on private equity portfolios are numerous; some are obvious and some less obvious. The purpose of this brief is to provide some clarity on expected impacts, and then what the best, brightest and most prudent institutional investors are and should be doing proactively to be well-positioned for the foreseeable future.

Impacts

The top-line impacts of the current market on institutional private equity portfolios will certainly include the following:

- **Protracted holding periods for existing portfolio companies due to challenging underlying fundamentals and the unavailability of debt financing will lead to less near-term liquidity to offset allocation issues**
- **Continued capital calls will further stress allocation issues**
- **Likely lower returns on existing portfolio companies will translate to diluted performance and a reduced ability to meet matched liabilities in the future**
- **Forced or strategic consideration of liquidity alternatives will be undertaken to mitigate over-allocation issues and to regain control over new capital deployment**
- **Institutions will see existing private equity investments dramatically under-perform compared to their performance over the past decade because of weak fundamentals and the implementation of FAS 157**
- **Internal portfolio management assessment will be undertaken holistically by many LPs for the first time, driven by their diminished ability to meet capital calls and commit to future re-ups and new funds**

Best Practices & Prudent, Proactive Steps

In an effort to convert our market observations and the likely impacts of the turmoil into an action plan for your private equity portfolio, we offer several key recommendations for prudent institutional investors:

Think Strategically; Plan Ahead. For many investors who have kept a frenetic commitment pace over the past several years, now is the first opportunity they have to catch their breaths and re-assess strategy and direction. Almost overnight, investor focus has shifted from staking out positions in wildly successful mega funds to evaluating their portfolio over-exposure and ability to meet capital calls in the face of over-allocation to private equity in many cases. Our recommended action plan in this environment is multi-fold:

- *Determine where you are.* Holistically evaluate your overall portfolio exposure. Determine cash needs for forward commitments assuming no (or at least substantially lower) realizations to support those capital calls. Recalibrate and rerun your investment pacing model of draw downs and distributions with new assumptions. Determine what, if any, holes are first priorities to fill with dry powder; and
- *Triage existing manager positions*. Re-assess and clarify your strategic plan for existing investments. Determine the existing managers you want to support to preserve long-standing relationships, in order to retain best performers and to capitalize on those best positioned in the current market environment or those that are sacred cows. Next, determine those managers who you would not likely support even in the absence of capital constraints. Finally, rank every other fund until you have established your priority list for where capital is first applied in the event you have to make tough choices.

> *Probitas Partners' proprietary analytic model can help you understand the point of indifference between holding your current portfolio and selling all or a portion of it at a discount to redeploy capital into future investments.*

Liquidity Management As A Permanent Portfolio Management Tool. Utilizing the secondary private equity markets, a process we call "liquidity management," has come of age for modern private equity portfolio management. In the current environment, it is moving quickly from a strategic effort, used by only a few, to a necessary tool used by many to address over-allocation and cash management issues. This strategy offers flexibility and options previously not available in this asset class that include the following:

- *Reactively or proactively planning for liquidity.* While investors may not ultimately look to the secondary market to create liquidity and achieve relief from allocation constraints for redeployment into what are likely to be better vintages (2009-2010), investors need to:

    (A) Understand the current state of the secondary markets;

    (B) Appreciate how specific positions in their portfolio will be received if they seek liquidity;

(C) Clearly establish goals for liquidity via the secondary markets; and

(D) If selling positions, make certain that the institution (e.g., boards, CIOs, etc.) understand and are prepared for such an undertaking and that proper resources are available.

- *Get set up for success.* Staffs that lack current delegation of authority to sell or buy will want to obtain that delegation to be able to capitalize on market opportunities and challenges nimbly. Smart investors will seek both the ability to sell and buy secondary positions — buying being another lesser-used means for institutional investors to enhance performance and hedge existing positions.

Start Educating "Up" Internally and Externally — Now. With the exception of venture funds impacted by the popping of the "Tech Bubble," private equity has largely been a flat or outperforming asset class in the U.S. from inception. Boards and beneficiaries have grown accustomed to this perceived stability relative to other asset classes in market downturns.

As discussed above, overall market conditions, coupled with changing valuation rules (FAS 157), will present a very different picture for private equity for the first time by the beginning of 2009. Prudent institutional investors will begin an aggressive educational campaign today with their CIOs, boards and beneficiaries to offer them perspective for the declining performance picture in order to fend off a possible reactionary "sell" mentality for private equity portfolios at the wrong time and for the wrong reasons.

Stay Out of the Bunker. While it may be tempting for many institutional investors to crawl into the bunker until the market turmoil subsides, that is not the right response. The current market dynamics do not represent a brief bout of turmoil. Rather, the market is likely to experience a protracted period of continued volatility. Real-time market knowledge and continued iteration of scenarios and best responses will be important to best manage your portfolio.

While we are not advocating taking lots of new meetings with managers to whom you are unlikely to commit, new fund sponsors with relevant strategies for the upcoming market environment provide an important source of market reconnaissance that can aid you in the process of dynamically assessing the market and your portfolio. Ultimately, the markets will improve, liquidity will return, and you will want to be well-positioned to take advantage of those developments. Further, as an active participant in the markets, you want to keep the lines of communication open with trusted industry sources, peers and your best fund managers.

Conclusion

The current market is tough, unnerving, uncertain and likely to get more so before it gets better. We are collectively in uncharted territory. But the market will improve through this cycle, like all others prior, and those investors thinking ahead and best positioning their portfolios today will reap the benefits of their planning and execution.

Probitas Partners is here to help you in any way we can. We will continue to bring you the very best investment ideas and funds to capitalize on market opportunities. We will continue to offer you the very best in honest, unconflicted liquidity management advice and execution (if selling). We will also continue our long-standing tradition of providing you with our best insights, ideas and tools to help you weather the storm and produce the best possible investment performance for you and your stakeholders.

As always, please let us know how we can assist you.

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