Private Equity in 2010

The long-term timeframes and illiquid nature of private equity investments have compounded the effect of the economic downturn on the industry. An unwavering commitment to core strategies leaves the industry positioned to outperform other segments of an improving economy.

June 2010

Rothstein Kass

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In the wake of a global credit crisis, few private equity fund managers expected 2009 to be a banner year for the industry. As important sources of capital to growth companies, most private equity firms depend on the efficient functioning capital markets to generate long-term returns. Indeed, the causes for concern among industry participants were hard to enumerate, from more limited ability to identify suitable investments to unexpected murkiness surrounding proven exit strategies.

With IPO markets stagnant and a pronounced lack of attractive deals, many private equity firms were quick to recognize that delivering investment returns would more commonly require direct and sustained involvement with portfolio companies to unlock value. As they have devoted greater resources to these efforts, many private equity firms are benefitting from vertical industry concentrations that afford them in-depth understanding of the competitive environment. At the same time, an intensified regulatory spotlight has compelled many firms to consider the impact of pending legislation on operations.

Maintaining focus on long-term objectives while enhancing portfolio management practices has proven prescient, broadening the scope of industry expertise even as sector challenges have persisted. "Private Equity in 2010," a Rothstein Kass industry trends report, was commissioned to gain a clearer understanding of how the industry is prepared to conquer these challenges and recognize opportunity amid ongoing uncertainty. The report includes the findings of an extensive survey of senior managers at private equity funds for their views on topics ranging from fundraising initiatives to regulatory developments.

With ample capital still waiting on the sidelines, a shift toward the deal-making culture seems imminent. While the industry never shied away from capital-raising initiatives, renewed interest in this area also has the financial services community as a whole anxiously anticipating the next mega-deal, believing that this might mark a return to pre-crisis activity levels. Though much of the speculation has centered on the strategic intent of the largest private equity players, the middle-market community may be a truer measure of the industry's health. With lending to many companies still somewhat restricted, private equity represents a more critical source of capital to these enterprises than ever before. Smaller private equity firms have also been successful in competing for larger transactions by structuring club deals, a trend that could be bolstered by greater restrictions on the use of leverage.

As trusted advisors to a wide range of private equity funds and their portfolio companies, the principals of Rothstein Kass relied on their unique perspective to provide additional insights into statistical findings. We hope that you will find the resulting report incisive and informative.

Thomas Angell

Thomas Angell
Principal-in-Charge
Rothstein Kass Commercial Services Group

Key Themes

- Most private equity firms expect the fundraising environment to remain difficult and to experience downward pressure on fees in the coming year.
- The vast majority of firms surveyed believe that overall conditions are improving and that the credit crisis will have ended by the middle of next year.
- Transaction sizes are expected to remain constant or be somewhat smaller than in years past, but private equity funds may need to pursue more creative methods in order to complete larger deals.
- The majority of private equity executives believe they will need to take a more active role with their portfolio companies to deliver results.
- There is general agreement that it will take longer to sell portfolio companies and that proceeds from sales will most often be used to strengthen overall performance rather than pursue new deals.

To assess current market conditions, Rothstein Kass has again conducted research with the private equity community about their expectations for the coming year. Our survey explored a range of relevant topics across four key areas—industry outlook, investment opportunities, exit strategies and the regulatory environment.

Demographics

In the first quarter of 2010, we conducted a survey of 199 private equity firms. The respondents were managing partners or other senior executives who oversee at least one, and sometimes several, funds.

In years past, we have concentrated on established mid-sized firms with between US$50 million and US$300 million in assets under management. For the purposes of this study, about 60% of the participating firms had total assets under management below US$50 million, and the remaining firms had more than US$50 million in assets (Exhibit 1).

Exhibit 1: AUM (millions)

<US$50M	61.3%
US$50M+	38.7%

Industry Outlook

There is renewed optimism regarding the future of the industry, as approximately one-third of private equity executives say the credit crisis has ended. Over 80% of respondents believe that the crisis will end by the first half of next year (Exhibit 2).

"Private equity funds are again beginning to exhibit some optimism after what was an intensely challenging period for the industry and the broader economy. Liquidity concerns undermined fundraising efforts, while firms with acquisition capital to deploy found it extremely difficult to assess the underlying value of target companies amid growing uncertainty surrounding exit strategies," said Tom Angell, Principal-in-Charge of the Rothstein Kass Commercial Services Group and Private Equity practice at Rothstein Kass. "An overwhelming majority of private equity firms believe that the credit crisis has ended or will be over by the middle of next year. As a stagnant market continues to thaw, smaller private equity firms—particularly those with specialized knowledge—will be among the most active."

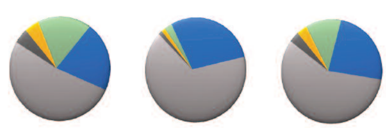
Exhibit 2: End of the "credit crisis"

	<$50M	$50M+	Weighted Average
It has already ended	34.4%	28.6%	32.2%
First half 2010	9.8%	11.7%	10.6%
Second half 2010	18.0%	15.6%	17.1%
First half 2011	23.8%	20.8%	22.6%
Second half 2011	10.7%	16.9%	13.1%
2012 or beyond	3.3%	6.4%	4.4%

Most private equity professionals still believe in the viability of their business model, with roughly 80% in disagreement with the idea that portfolio companies will turn to traditional lending rather than private investors for needed capital (Exhibit 3).

"Private equity firms provide essential financing to companies at critical phases in their life cycles. These sophisticated investors are often willing to take on a greater amount of risk in pursuit of superior returns, and have proven to be adept in a highly specialized industry. It's a model that doesn't work for traditional lenders," said Mr. Angell. "While private equity funds will always face some degree of competition from traditional lenders, the sectors are usually complementary, due to their distinct investment objectives and risk tolerances."

Exhibit 3: Traditional loans will more frequently replace private equity investment



	<$50M	$50M+	Weighted Average
Strongly agree	4.9%	1.3%	3.5%
Agree	17.2%	2.6%	11.6%
Disagree	20.5%	28.6%	23.6%
Strongly disagree	52.5%	66.2%	57.8%
Don't know	4.9%	1.3%	3.5%

Around 85% of firms with less than US$50 million in AUM plan to raise new investment capital during 2010, more than double the percentage of firms with more than US$50 million under management who have similar plans (Exhibit 4). Notably, half of the larger firms said they have no plans to raise additional capital in the coming year, which suggests they will focus instead on managing and enhancing their current investments. About one-in-ten of all firms are still undecided about their fundraising activities.

"In an industry that often seems to be in perpetual search of new capital, it is notable that nearly 35% of all respondents indicated that they are not planning to raise funds this year, or were undecided on the issue. This suggests that following the crisis, many funds are well capitalized to make opportunistic investments," said Mr. Angell. "However, more extensive due diligence processes and difficulties in establishing accurate valuations are still slowing the pace of capital deployment."

Exhibit 4: Planning on raising new capital in 2010

	<$50M	$50M+	Weighted Average
Yes	83.6%	39.0%	66.3%
No	4.9%	49.4%	22.1%
Don't know	11.5%	11.6%	11.6%

There is general agreement among firms of all sizes that the fundraising environment will be difficult in 2010, as investors remain somewhat skittish following a period of unprecedented volatility (Exhibit 5).

"The majority of private equity firms are raising new capital among investors with an ever-expanding array of allocation options. 'Transparency,' 'fair value,' and 'liquidity,' were once abstract concepts for most investors, but are now imperatives," said Mr. Angell. "Private equity firms must balance the market demand for greater openness against the need to preserve proprietary strategies that provide the slim margin required for success."

Exhibit 5: It will be more difficult to raise capital in 2010 than in 2009

	<$50M	$50M+	Weighted Average
Strongly agree	12.3%	15.6%	13.6%
Agree	63.1%	48.1%	57.3%
Disagree	10.7%	29.9%	18.1%
Strongly disagree	4.9%	3.9%	4.5%
Don't know	9.0%	2.5%	6.5%

When segmented by their assets under management, private equity firms are divided on terms for capital. Almost 70% of smaller firms feel that terms will be less favorable than in the past, while about half of larger firms do not agree with this assessment (Exhibit 6).

"Lenders continue to display less willingness to extend credit, limiting the amount of debt that can be used to finance acquisitions. This has contributed to smaller transaction sizes and less favorable terms for capital," said Joe Bailitz, a Principal in the Rothstein Kass Commercial Services Group. "As a result, we've seen reduced leveraged buyout (LBO) activity, particularly among the large private equity funds. This has created opportunity for smaller private equity firms that can rely on their agility and vertical industry expertise to unlock the inherent value of portfolio companies that do not meet the revenue requirements of larger private equity firms. While the terms for capital are less favorable now than in recent years, signs of a broader economic recovery are renewing interest in lending to the private equity sector.

Exhibit 6: Terms for capital will be less favorable in 2010

	<$50M	$50M+	Weighted Average
Strongly agree	39.3%	14.3%	29.6%
Agree	28.7%	29.9%	29.2%
Disagree	14.8%	28.6%	20.1%
Strongly disagree	7.4%	19.5%	12.1%
Don't know	9.8%	7.7%	9.0%

Firms are similarly divided on whether 2010 will see an increase in new private equity funds. About 55% of smaller firms believe there will be more new offerings, while 62% of larger firms think the number will decline relative to last year (Exhibit 7).

"Opinion is split as to whether the frequency of private equity fund launches will increase over the course of 2010. In the near term, it is likely that new funds will commence operations with smaller assets under management than prior to the credit crisis. Even large fund families will be measured in their introduction of new funds, wary of cannibalizing existing business or diluting the brand," said Mr. Angell. "Funds launching in a crowded marketplace for alternative investment products must differentiate themselves by clearly communicating objectives and strategies and resisting the temptation to shift beyond their comfort zones while working to uncover appropriate investment opportunities."

Exhibit 7: There will be more private equity fund launches in 2010

	<$50M	$50M+	Weighted Average
Strongly agree	32.8%	10.4%	24.2%
Agree	23.8%	19.5%	22.1%
Disagree	20.5%	36.3%	26.6%
Strongly disagree	13.9%	26.0%	18.6%
Don't know	9.0%	7.8%	8.5%

Opinion is fairly evenly split on the topic of fund closures, with about 40% agreeing that there will be more in 2010 than there were in 2009 (Exhibit 8). Smaller firms are more likely to think that the rash of fund closures is behind us, and a full 15% of those entities are uncertain what the future will hold.

"At the height of the credit crisis, many private equity firms found that a stagnant deal market had obscured overarching investment objectives by limiting the industry's ability to identify suitable investments. In the absence of viable opportunities, some funds elected to liquidate and return assets to investors and partners," said Mr. Angell. "Improving capital markets will continue to slow the pace of fund closures, though fierce competition for transactions, increasing compliance costs and lingering investor concerns will likely cause some additional near-term attrition."

Exhibit 8: There will be more private equity fund closures in 2010

	<$50M	$50M+	Weighted Average
Strongly agree	18.0%	26.0%	21.1%
Agree	13.9%	23.4%	17.6%
Disagree	41.0%	27.3%	35.7%
Strongly disagree	11.5%	18.2%	14.1%
Don't know	15.6%	5.1%	11.5%

About 70% of smaller firms and 50% of larger firms believe that fledgling private equity businesses are more likely to need seed capital in order to launch new funds, rather than gathering assets from institutional or high-net-worth investors (Exhibit 9).

"Few doubt the eventual return of the mega-buyout, and larger funds are actively engaged in fundraising among institutional investors seeking indirect access to private sector investment. Smaller funds can capture a portion of these allocations by implementing and maintaining institutional-quality practices and compliance. However, most new funds launch on a much smaller scale and must work to establish a reputation and track record that allow pensions and endowments to invest with confidence," said Mr. Bailitz. "These funds are more commonly offering attractive terms to early investors, in appreciation for the stability and marketability seed capital can provide to new funds as they grow assets under management."

Exhibit 9: New private equity firms will more frequently rely on seed capital

	<$50M	$50M+	Weighted Average
Strongly agree	13.1%	13.0%	13.1%
Agree	56.6%	37.7%	49.2%
Disagree	16.4%	26.0%	20.1%
Strongly disagree	10.7%	9.1%	10.1%
Don't know	3.2%	14.2%	7.5%

The majority—more than 70% of smaller firms and more than 50% of larger firms—believe that fee levels will come under scrutiny in 2010, though roughly 40% of firms with more than US$50 million under management feel that current pricing schedules will remain intact (Exhibit 10).

"Private equity fees have been studied and analyzed thoroughly to assess the true benefits of the sector, often with widely varying results. However, the most compelling evidence suggesting that these fees are justified is that sophisticated investors—from high-net-worth individuals to pensions and endowments—have been willing to pay. In fact, some of the best-known and most successful funds in operation have commanded a premium over industry standards in exchange for access," said Mr. Angell. "The fee pressure applied by these investors is likely to be alleviated by enhanced investor communication and credit market recovery. Political initiatives that would increase the effective tax rates for limited partners are of greater concern, as some legislators have indicated that the private equity and high-net-worth communities are likely sources of tax receipts required to support a wide-ranging and potentially aggressive regulatory agenda."

Exhibit 10: There will be downward pressure on private equity fees in 2010

	<$50M	$50M+	Weighted Average
Strongly agree	14.8%	14.3%	14.6%
Agree	57.4%	40.3%	50.8%
Disagree	11.5%	31.2%	19.1%
Strongly disagree	7.3%	10.4%	8.5%
Don't know	9.0%	3.8%	7.0%

Investment Opportunities

Investments are another area about which there are varying perspectives among private equity professionals. Roughly 60% of smaller firms believe there will be fewer good opportunities this year, while a similar percentage of larger firms think the post-crisis environment could hold some investment surprises (Exhibit 11).

"Smaller private equity firms have traditionally been more focused on relationship-driven aspects of the business, often employing customized sector strategies supported by in-depth vertical industry expertise or tactically-oriented approaches based on their understanding of complex finance structures. However, even industry participants with proven models for success and ample investment capital available for deployment have faced a dearth of suitable investment opportunities," said Mr. Angell. "In an uncertain economic environment, business owners and potential acquirers often found it difficult to agree on the underlying value of the enterprise. Businesses with sufficient liquidity were inclined to focus on day-to-day management and defer potential sales in anticipation that an improving economy would improve the ultimate sale price. As capital markets have stabilized and lending has resumed, private equity firms have been willing to pay more for businesses that are positioned for long-term success."

Exhibit 11: There will be fewer good investment opportunities for private equity firms in 2010

	<$50M	$50M+	Weighted Average
Strongly agree	26.2%	15.6%	22.1%
Agree	36.9%	18.2%	29.6%
Disagree	18.0%	20.8%	19.1%
Strongly disagree	10.7%	40.3%	22.2%
Don't know	8.2%	5.1%	7.0%

Approximately 60% of all private equity firms surveyed agree that they will use less leverage in their acquisitions of new portfolio companies in the coming year, though 34% of smaller firms and 40% of larger firms expect to consider and use leverage where appropriate (Exhibit 12).

"Restricting the use of leverage by private equity funds will have a profound impact on the industry by requiring many firms to pursue transactions with larger equity stakes. In the near term, some institutional investors will find this reassuring, anticipating greater alignment of investor and partner interests, and reducing fund volatility. Other investors are concerned that misdirected efforts to regulate leverage ratios could undercut the industry's ability to deliver superior risk-adjusted returns. For most sophisticated investors, private equity allocations represent only a small portion of total invested assets. They are comfortable with the aggressive use of leverage by private equity in pursuit of outsized returns, and balance these allocations against less risky components of a diversified portfolio of holdings." said Mr. Angell.

Exhibit 12: Private equity firms will be more restrictive in their use of leverage in acquisitions

	<$50M	$50M+	Weighted Average
Strongly agree	32.8%	23.4%	29.1%
Agree	26.2%	36.4%	30.2%
Disagree	21.3%	24.7%	22.6%
Strongly disagree	12.3%	15.5%	13.6%
Don't know	7.4%	0.0%	4.5%

Almost 80% of smaller firms say private equity investments will be more strategic due to changing conditions, but larger firms are less likely to agree with that characterization (Exhibit 13).

"The private equity industry has benefited from its diversity, offering a range of products and approaches to provide returns consistent with the risk profiles of investors representing a broad array of long-term objectives. As a result, most private equity investment is executed as a component of a clearly defined strategy intended to ensure alignment of interest among investors and partners in the fund," said Dan Byrne, a Principal in the Rothstein Kass Commercial Services Group. "Over the past few years, some funds ventured outside of their specific areas of expertise in pursuit of returns and suffered the consequences as uncertainty assaulted credit markets. As a result, private equity firms are even more committed to maintaining a clear, strategic focus derived from insight and experience."

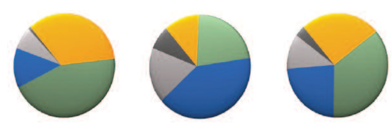
Exhibit 13: Private equity investments will be more strategic in 2010

	<$50M	$50M+	Weighted Average
Strongly agree	34.4%	11.7%	25.6%
Agree	44.3%	22.1%	35.7%
Disagree	13.1%	40.3%	23.6%
Strongly disagree	7.4%	18.2%	11.6%
Don't know	0.8%	7.7%	3.5%

Most private equity firms—two-thirds of firms with less than US$50 million and three-quarters of firms with more than US$50 million—think unfavorable market conditions will cause the transaction sizes to be smaller or unchanged than in past years (Exhibit 14). Though it's worth noting that a considerable percentage of firms, nearly one-quarter of smaller firms and 12% of larger firms, are unsure about how market conditions will impact the size of buyouts.

"The leveraged buyouts that once dominated the private equity landscape have essentially vanished, replaced by smaller transactions involving companies that are less mature. Consequently, there is increased activity among private equity firms that provide growth capital to developing businesses. Industry relationships are again a distinguishing factor for firms providing such financing," said Jeff Somers, a Principal in the Rothstein Kass Commercial Services Group. "Many of the businesses seeking to obtain capital to support expansion are not yet large enough to attract capital from the larger private equity players. However, there are several reasons that mega-funds are closely monitoring these situations. Many of the companies that are able to secure financing in this environment exhibit strong potential for scalability and could represent attractive acquisition targets as they seek additional rounds of financing down the road. The deployment of growth capital also offers a leading indicator into the prospects for the near-term recovery of the LBO market."

Exhibit 14: How will private equity transaction sizes be impacted by market conditions?



	<$50M	$50M+	Weighted Average
Transaction sizes will be significantly larger in 2010	9.8%	13.0%	11.1%
Transaction sizes will be significantly smaller in 2010	43.4%	20.8%	34.7%
Transaction sizes will be unchanged in 2010	23.0%	54.5%	35.2%
Don't know	23.8%	11.7%	19.0%

More than two-thirds of all firms surveyed, regardless of their size, do not agree that they will face amplified competition from hedge funds for prospective portfolio companies or that private equity firms will opt for minority stakes instead of majority stakes of total ownership when purchasing a new public company (Exhibits 15 and 16).

"Unprecedented volatility led to some speculation that the lines between the hedge fund and private equity industries would blur. However, both our experience and survey findings suggest that there will continue to be a clear delineation between the sectors, as each has evolved to meet specific and distinct portfolio objectives of sophisticated investors. Private equity funds remain the preferred structure for holding illiquid assets and have developed a broad range of skills to add value to portfolio companies to deliver superior long-term returns," said Mr. Angell.

"Some industry observers have also suggested that private equity firms would be inclined to dip a toe back into the investment waters before diving in headlong, more frequently acquiring minority stakes in public companies. The industry seems largely averse to this strategy because minority ownership does not afford firms the same ability to influence strategic direction and deliver returns. However, when a minority stake is acquired, it is often a precursor to a subsequent buyout," said Mr. Somers.

Exhibit 15: There will be increased transactional competition from hedge funds

	<$50M	$50M+	Weighted Average
Strongly agree	13.9%	10.4%	12.6%
Agree	24.7%	15.6%	21.1%
Disagree	33.6%	29.9%	32.2%
Strongly disagree	26.2%	44.1%	33.1%
Don't know	1.6%	0.0%	1.0%

Exhibit 16: Private equity firms will more frequently purchase minority stakes in public companies

	<$50M	$50M+	Weighted Average
Strongly agree	9.8%	9.1%	9.5%
Agree	20.5%	11.7%	17.1%
Disagree	50.0%	74.0%	59.3%
Strongly disagree	14.8%	5.2%	11.1%
Don't know	4.9%	0.0%	3.0%

Firms with more than US$50 million in AUM are divided on increased use of LBOs when pursuing a public company, but two-thirds of firms with less than US$50 million under management do not believe that LBOs will gain in use and popularity (Exhibit 17).

"There are many reasons to expect a steady but deliberate resumption of LBO activities, from tighter restrictions on leverage to uncertain enterprise values. However, there have been rumblings that the next mega-deal is already in the works. How the market reacts to these transactions will greatly influence the speed at which additional deals are announced, as they will help provide some clarity regarding the prevailing costs of capital, leverage ratios and business valuations," said Mr. Angell. "The equity market recovery will serve only to increase enthusiasm for LBO transactions, as reduced volatility will give private equity firms the confidence needed to undertake larger and riskier transactions."

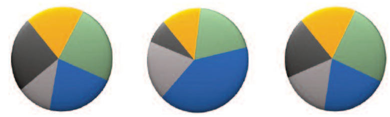
Exhibit 17: Private equity firms will more frequently pursue LBOs of public companies

	<$50M	$50M+	Weighted Average
Strongly agree	18.0%	29.9%	22.6%
Agree	15.6%	18.2%	16.6%
Disagree	37.7%	28.6%	34.2%
Strongly disagree	27.1%	22.1%	25.1%
Don't know	1.6%	1.2%	1.5%

Almost two-thirds of firms with more than US$50 million in AUM do not believe that private equity firms will boost their participation as part of a consortium of buyers to pursue specific deals (Exhibit 18). Smaller firms are more divided on the topic, and a full one-quarter remain undecided.

"At the height of transactional activity, club deals were a popular structure used to mitigate risk in acquiring multibillion-dollar enterprises across vertical industry sectors. With transaction sizes down substantially from the record-setting deals of recent years, more funds seem inclined to go it alone. Larger private equity firms, especially, generally have stores of dry powder available for deployment but are struggling to identify viable opportunities. Additionally, enterprise values for most target companies have yet to fully recover, further reducing the incentive to partner with other firms on acquisitions as they seek to capitalize on the upside of global economic recovery," said Mr. Somers.

Exhibit 18: Private equity firms will more frequently form consortiums to pursue deals



	<$50M	$50M+	Weighted Average
Strongly agree	18.9%	13.0%	16.6%
Agree	23.8%	19.5%	22.1%
Disagree	21.3%	40.3%	28.6%
Strongly disagree	11.5%	19.5%	14.6%
Don't know	24.5%	7.7%	18.1%

When it came to the following three techniques—share buybacks, PIPEs and distressed situations—we found a pattern among our respondents. Smaller firms were divided on all topics, while larger firms mostly disagreed and believe that use of the techniques will be similar to that in past years (Exhibits 19, 20 and 21).

"Backed by sophisticated, long-term investors, private equity is a mature industry that has thrived in previous downturns by being selective and sharpening its skills. During trying economic times, private equity funds are unlikely to abandon proven methods and processes to chase short-term returns," said Mr. Angell. "The private equity industry's diversity is one of its greatest strengths. Most funds have deep and specialized transactional or industry knowledge, and are continually looking to enhance their practices. However, if a fund has been successful working predominantly with growth companies, for example, it would not necessarily pursue distressed or loan-to-own strategies because of a down economy. "

Exhibit 19: Private equity firms will more frequently engage in PIPEs

	<$50M	$50M+	Weighted Average
Strongly agree	26.2%	11.7%	20.6%
Agree	30.3%	18.2%	25.6%
Disagree	23.0%	49.3%	33.2%
Strongly disagree	18.9%	20.8%	19.6%
Don't know	1.6%	0.0%	1.0%

Exhibit 20: Private equity firms will more frequently engage in share buybacks

	<$50M	$50M+	Weighted Average
Strongly agree	21.3%	18.2%	20.1%
Agree	33.6%	15.6%	26.6%
Disagree	24.6%	39.0%	30.2%
Strongly disagree	18.0%	26.0%	21.1%
Don't know	2.5%	1.2%	2.0%

Exhibit 21: Private equity firms will more frequently invest in distressed situations

	<$50M	$50M+	Weighted Average
Strongly agree	25.4%	10.4%	19.6%
Agree	23.0%	16.9%	20.6%
Disagree	27.0%	50.6%	36.2%
Strongly disagree	22.1%	22.1%	22.1%
Don't know	2.5%	0.0%	1.5%

Exit Strategies

Two-thirds of all firms surveyed feel that private equity owners will need to take a more involved and active role in their portfolio companies in order to ensure that specific objectives are met (Exhibit 22).

"Less leverage leads to smaller transactions, often involving companies at earlier stages in their development. In addition, uncertainty surrounding exit strategies is likely to persist in the nearterm," said Mr. Angell. "Fortunately, because most private equity firms possess a comprehensive knowledge of their portfolio businesses, the industry is well prepared to take a more active role in management to unlock latent value. Many smaller firms are currently entering into transactions with this specific strategy in mind, particularly in industries where they have a history of success."

Exhibit 22: Private equity companies will become more intricately involved with portfolio companies

	<$50M	$50M+	Weighted Average
Strongly agree	40.2%	27.3%	35.2%
Agree	29.5%	33.8%	31.2%
Disagree	17.2%	20.8%	18.6%
Strongly disagree	13.1%	16.9%	14.6%
Don't know	0.0%	1.2%	0.4%

Three-quarters of all firms surveyed agree that selling off portfolio companies will take much longer than it has in the past due to troubling market conditions (Exhibit 23).

"Some of the same forces that continue to slow the pace of capital deployment by private equity firms are likely to delay divestitures. Corporate assets were once transferred from firm to firm at an astounding rate. Today due diligence processes, financing challenges and valuation concerns can slow the sales process significantly," said Mr. Angell.

Exhibit 23: It will take longer to sell portfolio companies

	<$50M	$50M+	Weighted Average
Strongly agree	45.9%	46.8%	46.2%
Agree	30.3%	29.9%	30.2%
Disagree	15.6%	16.9%	16.1%
Strongly disagree	4.9%	5.2%	5.0%
Don't know	3.3%	1.2%	2.5%

About seven-in-ten firms with more than US$50 million in AUM believe there will be more initial public offerings (IPOs) among portfolio companies, rather than the dominance of private transactions that were seen in recent years (Exhibit 24). Conversely, smaller companies are more likely to disagree.

"It wasn't very long ago that nearly every initial public offering was greeted with fanfare and intrinsic investor demand. Encouraged by prognosticators, investors seemed more interested in whether they could gain access to oversubscribed offerings than in what they were actually buying. Few would believe that a return to those days is possible or even desirable. Instead, private equity firms are closely watching each offering for clues as to when the pipeline will again support a modest stream of activity. As a growing number of offerings are brought to market, their success will be predicated on pricing and the quality of the business," said Mr. Somers. "While private equity firms anticipate that the IPO market will eventually provide a viable exit strategy, they recognize that greater involvement with portfolio companies will often entail shepherding the business through additional rounds of pre-IPO financing."

Exhibit 24: There will be increased IPO activity among private equity portfolio companies in 2010

	<$50M	$50M+	Weighted Average
Strongly agree	13.1%	31.2%	20.1%
Agree	26.3%	39.0%	31.2%
Disagree	35.2%	20.7%	29.6%
Strongly disagree	23.8%	9.1%	18.1%
Don't know	1.6%	0.0%	1.0%

The majority of all firms surveyed agree that it will take extra rounds of pre-IPO funding to ensure a successful offering, although about 35% of smaller firms did not share that perspective (Exhibit 25).

Exhibit 25: Private equity portfolio companies will require extra rounds of pre-IPO funding

	<$50M	$50M+	Weighted Average
Strongly agree	18.9%	24.7%	21.1%
Agree	42.6%	49.3%	45.2%
Disagree	21.3%	26.0%	23.1%
Strongly disagree	14.8%	0.0%	9.0%
Don't know	2.4%	0.0%	1.6%

Most firms expect to use the proceeds from IPOs to help strengthen the performance of the remaining portfolio companies, though smaller firms are more likely than their larger counterparts to do so (Exhibit 26). A meaningful percentage of respondents also expect to use proceeds to help underwrite future transactions.

"The recovery of the IPO market becomes of even greater importance, considering that a sizeable portion of private equity firms intend to reinvest proceeds to strengthen underperforming portfolio companies. Longer-term involvement with portfolio companies can actually be reassuring to investors in smaller funds, as this affords a greater degree of transparency into the underlying value of portfolio assets," said Mr. Somers.

Exhibit 26: Private equity IPO proceeds will be used primarily to:

	<$50M	$50M+	Weighted Average
Finance future transactions	25.4%	39.0%	30.7%
Strengthen underperforming portfolio companies	63.9%	42.9%	55.8%
Other purposes	10.7%	18.1%	13.5%

More than three-quarters of all private equity firms agree that special purpose acquisition companies (SPACs) no longer make sense given the state of the technology sector, the current market environment and the changing regulatory landscape (Exhibit 27).

"The emergence of the special purpose acquisition company was a clear indication that even before the credit crisis investor demand for private equity investment had exceeded supply. The rapid deterioration of the global economy made it difficult for many SPACs to close transactions within their intended timeframes. Faced with a choice between absorbing a small loss and returning investor assets or pursuing a potentially disastrous transaction in a murky environment, many of these vehicles liquidated. There is some debate regarding the prospects for recovery. In the near term at least, SPACs do not appear to be a viable model for deployment of private equity capital," said Mr. Somers.

Exhibit 27: SPACs are no longer a viable model

	<$50M	$50M+	Weighted Average
Strongly agree	39.4%	37.7%	38.7%
Agree	34.4%	39.0%	36.2%
Disagree	15.6%	15.5%	15.6%
Strongly disagree	9.8%	7.8%	9.0%
Don't know	0.8%	0.0%	0.5%

Regulatory Environment

About 70% of smaller firms and 85% of larger firms expect to face increased regulatory requirements in the future, and about two-thirds envision new regulations that specifically address lock-up arrangements (Exhibits 28 and 29).

"In early 2009, there was nearly universal agreement that the private equity industry would face greater regulatory scrutiny. The fervor for reform has not dissipated with improving market conditions. In light of their appeal to institutional investors, many private equity firms are expecting an enhanced focus on the structure of lock-up agreements," said Mr. Angell. "While some firms are more willing to negotiate the terms of these agreements, most private equity investors understand that these arrangements promote long-term stability of the funds and allowed many to continue to function as intended even during the worst moments of the recent economic turmoil," said Mr. Angell.

Exhibit 28: There will be increased regulation of private equity firms

	<$50M	$50M+	Weighted Average
Strongly agree	51.6%	53.2%	52.3%
Agree	18.9%	33.8%	24.6%
Disagree	25.4%	13.0%	20.6%
Strongly disagree	3.3%	0.0%	2.0%
Don't know	0.8%	0.0%	0.5%

Exhibit 29: There will be enhanced regulatory guidance regarding lock-up arrangements

	<$50M	$50M+	Weighted Average
Strongly agree	27.9%	20.8%	25.1%
Agree	43.4%	44.2%	43.7%
Disagree	19.7%	23.4%	21.1%
Strongly disagree	9.0%	11.6%	10.1%
Don't know	0.0%	0.0%	0.0%

About 45% of smaller firms and slightly more than half of larger firms think that international financial reporting standards (IFRS) will be adopted, but a meaningful percentage do not feel similarly or have not yet formed an opinion (Exhibit 30).

"Though the IASB and FASB have reaffirmed their commitment to international financial reporting standards convergences, the private equity industry isn't so sure. Their skepticism is somewhat justified, considering the substantial disparities between IFRS and U.S. GAAP that must be reconciled before adoption," said Mr. Angell. "Ultimately, proponents of convergence must increase their educational outreach initiatives to convince U.S. businesses that the benefits of international accounting comparability outweigh the costs and challenges of implementation. For private equity firms, IFRS will eventually facilitate cross-border transactional activity and greater access to foreign markets," said Mr. Somers.

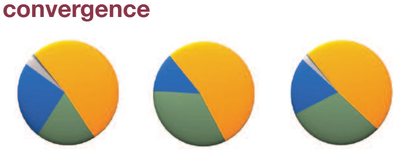
Exhibit 30: It is very likely IFRS convergence will be adopted

	<$50M	$50M+	Weighted Average
Strongly agree	13.2%	28.6%	19.1%
Agree	33.6%	28.6%	31.7%
Disagree	31.1%	27.3%	29.6%
Strongly disagree	9.0%	5.2%	7.5%
Don't know	13.1%	10.3%	12.1%

The majority of larger firms are not supportive of IFRS at the industry level, though smaller firms remain divided on the issue and about 10% of all firms are undecided (Exhibit 31).

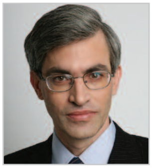
"The private equity industry has not reached consensus regarding whether IFRS convergence will be a benefit or a burden. A majority of survey participants doubt the advantages, indicating widespread concern about the costs and resources required for implementation. IFRS convergence is not strictly an accounting initiative, and will demand considerable training and education, as well as thorough evaluation of third-party relationships," said Mr. Somers. "The message from regulators, however, remains clear—convergence is coming. A scarcity of qualified IFRS experts ensures that firms that do not assess their needs now will face difficulties later, as the bulk of available expertise will initially be devoted to working with large public companies. Recently introduced IFRS guidelines for small- and medium-sized privately-held entities are applicable to the majority of private equity companies and are less extensive than full IFRS. For many firms, 'IFRS Light' is a more palatable alternative, offering greater comparability while limiting associated compliance costs."

Exhibit 31: The private equity industry would benefit from global IFRS convergence



	<$50M	$50M+	Weighted Average
Strongly agree	25.4%	14.3%	21.1%
Agree	18.0%	15.6%	17.1%
Disagree	29.5%	40.3%	33.7%
Strongly disagree	18.9%	19.5%	19.1%
Don't know	8.2%	10.3%	9.0%

About the Authors



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About Rothstein Kass

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

Rothstein Kass also provides a full array of integrated services, including strategic business counseling, regulatory compliance and SEC advisory services, insurance and risk management consulting and family office services, through its Commercial Services Group. The Firm advises organizations looking for financing/investment opportunities, as well as those looking to restructure as a business strategy. Rothstein Kass has offices in California, Colorado, New Jersey, New York, Texas and the Cayman Islands.

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