



Date: March 3, 2009

To: Clients of Pension Consulting Alliance, Inc.

From: Michael J. Moy, Managing Director-Private Equity

Re: A Plan for Private Equity Investors

Investors have been attracted to the private equity asset class by its history of strong performance and its low correlation to public equities. The capital markets in 2008 and 2009 are undermining expectations of performance and highlighting the delayed correlation to the public markets. These issues have been exacerbated by the liquidity issues confronting many of the larger institutional investors. In summary, private equity investing is in uncharted territory.

Statement of Financial Accounting Standards No. 157, *Fair Value Measurements*, (FAS 157) issued by the Financial Accounting Standards Board is effective for fiscal years beginning after November 15, 2007. It is expected that most, if not all, general partners will issue December 31, 2008 financial statements compliant with FAS 157.

Because of the logistics related to accumulating portfolio-company data by the general partners and the concurrent reporting by the general partner to the limited partners, there is normally a ninety day lag between the date of the underlying data and its reflection in the limited partners' financial statements. At December 31, 2008, most limited partners are referencing September 30, 2008 limited partnership operating data when they are evaluating performance. The following issues should be considered during that evaluation:

- 1. Private equity results lag public market performance. In rising public markets, performance is understated. In declining markets, the reverse occurs. The following chart sets forth some reference points:

Date	S & P 500	Percentage Change	DJII	Percentage Change
9/30/2008	1,166		10,851	
12/31/2008	903	-22.6%	8,776	-19.1%
2/27/2009	735	-18.6%	7,063	-19.5%

- 2. To the extent that a general partner has employed leverage in its investment strategy, the expected results will be magnified.
- 3. In the latter stages of a private equity partnership, the general partners are normally compensated by a management fee that is calculated based on net invested capital (gross amount invested less distributions and write offs). Market value adjustments resulting from the application of FAS 157 may not reduce the basis for management fee calculations until the impairment is considered permanent and a write-off is required. As a result, the general partner is motivated to retain an asset (for the management fee it generates) rather than dispose of it (incurring a potential loss with the related management fee and carried interest implications). Consequently, on that



- issue, the general and limited partner's interests may not be aligned at that stage of the partnership.
4. Much of the leverage used by general partners in the last two years contained borrower-friendly covenants. As a result, as portfolio companies operate in this recessionary environment, their inability to service outstanding indebtedness may be masked by such covenants. Understanding how this impacts portfolio company valuations is in the limited partners' best interests.

Most public equity managers have seen a significant deterioration in portfolio values and related management fees. This is not the case among private equity managers. Most public equity managers have taken steps to align their work forces with the new management fee stream. The parallel issue confronting private equity managers is different, but has the potential to be as troublesome to the managers and investors. Their portfolio companies are living through an economic downturn that will have a significant impact on future valuations. Current portfolios are confronted with a prolonged time period before valuations will return to their pre-2008 levels. Most limited partnership agreements contain clawbacks that will adversely impact all the professionals in a private equity shop until previously recognized gains are offset against the losses that will be recognized prospectively. This may serve to demotivate the younger professionals who may be confronted with a long period of time before they can expect any positive carried interest. This could result in departures and future succession issues which potentially threaten the ultimate survival of a private equity manager.

The resulting reduced management fees combined with an uncertain fund raising environment for new funds could produce a fragility level for which the general partners may be unprepared. Investors should be cognizant of these potential outcomes and the related impact on their portfolios. Steps should be taken to understand how each of the general partners in your portfolio is addressing these issues currently and prospectively.

On a positive note, investors deciding to exit private equity will create opportunities for those interested in either commencing or expanding their exposure to the private equity space through acquisitions at discounted prices in the secondary market.