The Triago Quarterly

November 2011

Dear Reader,

Powered by activist general partners who roll their sleeves up and get their hands dirty improving assets, successful private equity investing depends more on individual manager talent and gumption than market cycle. The outliers in private equity often perform better relative to averages than outliers in more liquid markets because they rely on knowledge and experience that is harder to replicate than passive investment picking.

As one of our roundtable participants says, “compared with stock and bonds, you get a ‘free lunch’ in private equity if you get involved with the best managers.” Successfully identifying the best in such an inefficient asset class is a big ‘if’. But investors that manage this feat achieve outsize returns for relatively low risk.

As always, we hope the information found here helps you make informed decisions.

Sincerely,

Antoine Dréan
Triago Founder and Chief Executive
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INSIDE

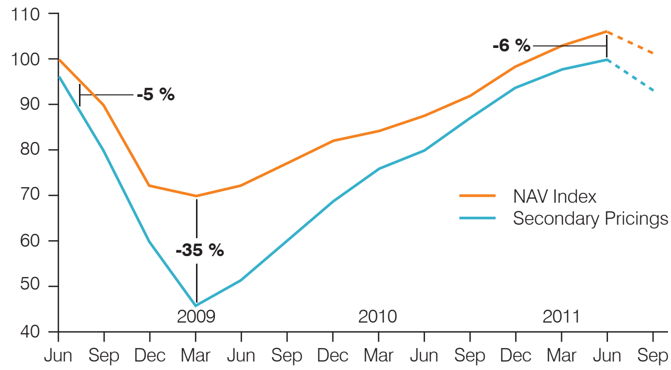
SNAPSHOT

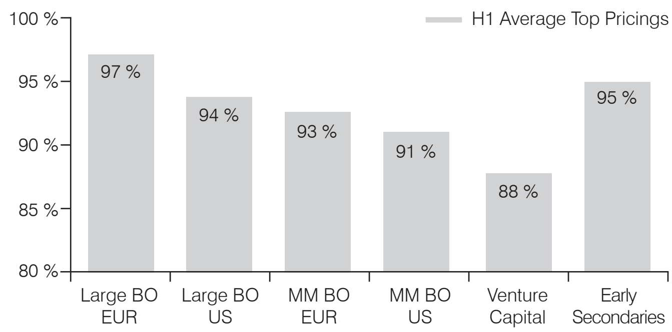
PEAK NET ASSET VALUES SEEN DECLINING…

NAV Evolution

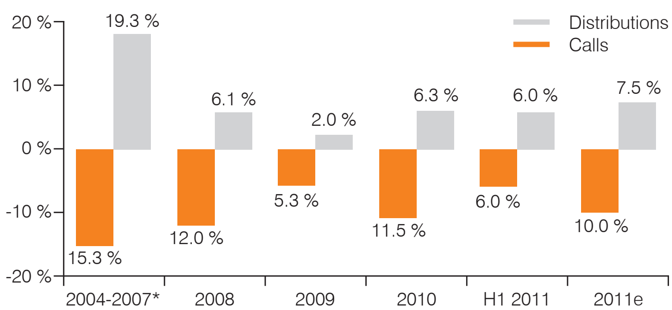
STRATEGY	FY 10	Q1 11	Q2 11	H1 11
Large BO	+27.0 %	+3.4 %	+3.2 %	+6.7 %
MMBO	+21.5 %	+3.0 %	+2.1 %	+5.2 %
VC	+10.2 %	+6.5 %	+2.8 %	+9.5 %
Special Sit.	+20.6 %	+3.7 %	+1.1 %	+4.8 %
Energy	+15.9 %	- 1.3 %	- 1.7 %	- 3.0 %

…AS MODEST LIKELY DROP BUFFERS SECONDARIES…





…AND DISTRIBUTIONS OFFER NO NET CASH.



* Annual average

Source: Triago’s proprietary data

Market Snapshot Analysis: Season of Positive Surprise?

Net asset values, secondaries, deal multiples, seen headed for just enough of a Q3 drop to help transactions; distributions catch up with calls, at least temporarily.

Triago estimates net asset values across all categories of private equity funds fell 3 to 5 percent on average in the three months through September. In contrast, many listed comparables for private equity portfolio companies registered double-digit losses over the same period, in line with major market indexes. In a significant deviation from the average, more aggressive markdowns can be expected for funds with significant listed holdings.

The estimate of a modest third quarter decline for private equity values is based on the weightings assigned to listed comparables, versus valuation variables that remain positive, like rising corporate profits and discounted cash flow. In the first half of the year, net asset values across all categories of private equity funds rose above pre-financial crisis levels for the first time, increasing 6.8 percent in the six months through June and 2.9 percent in the second quarter, outperforming major global listed stock indexes in both periods.

The relatively small estimated markdown for third quarter net asset values, plus an expected drop in purchase price multiples, could aid leveraged buyout volume, if not in the fourth quarter, then in the first half of 2012. But this scenario for a kind of "Goldilocks decline" that helps the fair price expectations of private equity sellers and buyers meet is conditional on improving global economic visibility, although not necessarily on a rapidly growing economy.

The average purchase price multiple for leveraged buyouts rose to a relatively lofty 8.8 times EBITDA in the second quarter, 11 percent above the ten-year average, from a multiple of 8.5 the previous quarter, according to Standard & Poor's Leveraged Commentary and Data. Any sustained hike in the purchase price multiple is likely to have been short-circuited over the summer by declining global growth forecasts, sparked by Europe's sovereign debt crisis, and to a lesser extent, by Standard & Poor's downgrading of the United States' sovereign debt rating and the threat of rising inflation in China.

The increasingly credible prospect of a particularly long period of slower than average global economic growth, as threats to solvency in developed countries are contained through years of deleveraging, may serve to keep purchase price multiples below second quarter levels for some time, even as GPs, attracted by lower multiples, look for transactions that allow them to spend private equity's aging supply of near-record dry powder. As of October, buyout funds held $385 billion in dry powder, with just over 50 percent of that overhang scheduled to reach the end of investment periods between the fourth quarter of this year and the end of 2013.

In the first half of 2011, calls and distributions were running even, at 6 percent of total capital commitments for Triago's universe of funds. For the year, Triago estimates cash distributions to limited partners will amount to 7.5 percent and cash calls to 10 percent of committed capital, as lower deal multiples and investment period deadlines spur more purchases than exits. The expected resurgence in call growth, relative to a more modest distribution increase, will, on average, provide LPs with little free capital for new investment, making for a very tough fundraising environment well into next year, and quite possibly, beyond. Triago expects approximately $200 billion will be raised in 2011, equivalent to last year's total, which marked a six-year fundraising low.

Cushioned by expectations of modest markdowns, secondary market pricing remains strong, with the average top bid at a 6 percent discount to net asset value.

Cushioned by purchasers' expectations of modest third quarter markdowns, pricing in the secondary market remains strong, with the average top bid at a 6 percent discount to March net asset values, and deal volume on track to exceed last year's record of $20 billion. On the buy side, $20.7 billion was raised for secondary funds and the secondary pockets of funds-of-funds in the first ten months of the year, exceeding the previous annual record of $19.5 billion in 2007. Triago estimates $25 billion will be raised this year by secondary specialists, surpassing our previous estimate of $22 billion. A particularly bullish note for secondary market activity: specialist funds now have nearly $46 billion in dry powder.

Roundtable

Taking on Risk

How can limited partners construct private equity portfolios with the lowest possible risk of loss?

Assembling a high-return, low-risk private equity fund portfolio is a bit like trying to tag your opponents in a game of blind man's bluff when you're "it". Investors don't grope for suitable targets with eyes covered, but they must commit capital to investment pools that don't yet hold assets, and which tie up money for roughly a decade of unpredictable economic change. Compared with stock, bond and commodity funds, managing private equity risk is further complicated by serious gaps in data availability and reliability, and the illiquidity of both private equity funds and their underlying portfolio company investments.

Triago invited four prominent limited partners, who collectively oversee in excess of $65 billion in alternative assets-under-management, to discuss mastering private equity risk. Not surprisingly, they underline the importance of unconventional approaches in an asset class where quantifiable risk is in short supply.

TRIAGO: Should an LP ever assume that he or she can beat the averages? Aiming for outperformance seems to mean bearing significant risk of loss.

Christopher Kojima, Global Head of the Alternative Investments & Manager Selection Group at Goldman Sachs: What is reasonably clear is that the dispersion of performance between top managers and average managers is very wide, and that the best GPs outperform both the public equity markets and private equity averages, often by a considerable margin. So there is certainly an opportunity for LPs to beat the averages. Selecting the top managers can be a complicated, resource intensive activity, requiring an in-depth analysis of historical track records, a deep understanding of investment strategy, and a thoughtful assessment of GPs' individual decision-makers.

David Belmont, Chief Risk Officer at Commonfund: The question assumes market efficiency. But the relatively wide dispersion of manager performance shows that private equity is inefficient. Compared with stock and bond funds, where performance is more tightly correlated, you get a "free lunch" in private equity if you get involved with the best managers. Moreover, if you don't seek out the best GPs, adding private equity to your overall portfolio is not going to improve your risk/return profile, since most studies show that the average private equity fund return is inferior to public market returns.

David Turner, Head of Private Equity at Guardian Life Insurance Company of America: The proprietary nature of information in private equity explains why the odds of outperforming averages can be higher than in more liquid markets, where managers trade on uniform public information. Private equity proprietary knowledge can be based on experience, networks or even a brand advantage that allows one GP to see a deal before the competition does. Correctly gauging the proprietary advantages of GPs is key to earning a higher than average return with lower than average risk.

Michael Studer, Head of Portfolio & Risk Management at Partners Group: When LPs commit capital to a GP's primary investment program, they are investing in a blind pool. So, investing some capital in the secondary market, where you can evaluate some real investments, further improves your chance of outperformance with low risk. It can also inform primary and direct investing, providing indicators of what industries, types of companies and deal structures are promising.

TRIAGO: A challenge in successfully managing private equity risk seems to be the static long-term nature of portfolios. How can LPs adjust risk profile to changing market and economic circumstances?

DT: You can say private equity is "static" based on the illiquidity of the asset class. But if you consider that private equity is based on activist management, you realize that this concept is misleading. If you examine the changes that occur over the life of a private equity fund, you'll find strategic and tactical shifts are made by the GP - or by the managers of individual portfolio companies - that adapt the investment to evolving economic and market circumstances. As an LP, we don't try to adjust the risk profile of our existing private equity portfolio because GPs and portfolio company managements already do that.

CK: GPs are managing their own funds' risks, not their LPs' program-wide concerns. A "commit and hope" strategy is not really a risk management strategy, and simply approving or disapproving new additions to the portfolio is likely insufficient. LPs looking across the entire portfolio might address private equity risks more efficiently by adjusting more liquid investments in other parts of the broader portfolio. Even more activist are initiatives that immediately reshape the portfolio. For the over-allocated LP, a secondary market transaction streamlining non-core managers or trimming unwanted concentrations may be sensible. For the under-allocated LP, selective secondary market acquisitions - at the right price - might deliver an efficient solution.

Marc Tyler Nobleman

MS: I would underline that our use of the secondary market changes the nature of our portfolio very significantly over time. In 2007, secondary interests were trading at a premium, and so we underweighted them. Yet in 2009, when discounts were large, over half of the private equity investments we made were in secondary interests. So, assessment of price versus potential return, and weighting investment accordingly at particular points in time, helped us avoid some of the worst investments and make some of the best investments of recent years. Our buy and sell strategies on the secondary market also shorten investment duration and increase our turnover versus a portfolio of only primary holdings. As a result, we adjust weightings to changing views on the economy, sectors and geographies with greater flexibility and frequency than would otherwise be possible.

DB: I agree that there are at least a couple of levers you should be pulling when it comes to active private equity risk management. You can't carry out change in a day or a week, but you can within a year, particularly if you view risk management of the private equity bucket as inseparable from total portfolio risk management.

Triago: What principles are key for constructing a private equity portfolio that is minimally correlated with stocks, bonds and other asset classes?

MS: The essential principle is to diversify across private market strategies. People traditionally sold buyout funds as being uncorrelated with stocks, but it is clear that this assumption is not correct, at least not to the extent people assumed before the financial crisis. We believe we can create a portfolio with low correlation to other asset classes by investing in buyouts at the same time we invest in debt strategies, mezzanine, real estate and infrastructure. This private equity mix gives us different value drivers, a nice diversified return stream, plus built-in inflation protection.

DB: I would only point out that if you are successful in working with buyout managers who create value in the individual companies they invest in, that is a source of return that by definition will be largely uncorrelated with stocks, bonds or other asset classes.

TRIAGO: So your faith in the lack of correlation of traditional buyout funds post-financial crisis is less shaken than Michael's?

DB: I wouldn't say you can eliminate correlation with other asset classes, but you certainly can reduce it significantly by going with managers whose sales multiples on investment exits are driven more by the value they've created than by market cycle.

DT: Building diversity and investing with managers driving value change are essential, but more specifically, when constructing private equity portfolios, we think the key is to hold a combination of venture and buyout investments. The reason for this is the historical lack of correlation between buyout and venture investment returns. We studied five-year rolling returns for a twenty-five year period through 2006 and found that venture and buyout were almost perfectly inverse to one another. A portfolio of the top quartile venture and buyout funds over any five years would have exceeded S&P 500 returns by a minimum of six-hundred basis points. Variability between venture and buyout returns, and the two segments' overall low correlation with other asset classes, should be the foundation for all private equity portfolio construction.

CK: I would like to pick up here on the idea of how private equity risk is changing post-financial crisis. The environment following the financial crisis has made the manager selection exercise - already a difficult challenge - much more complicated. How unfamiliar is the burden of managing resources on a thinly-staffed GP, whose efforts were subsidized by a buoyant market in good times, but

> *"Gut feeling is the touchstone for shaping a low-risk, high-return private equity portfolio."*
>
> **Michael Studer, Partners Group**

who, in tough times, must prioritize resources to support struggling companies? How committed are GPs' mid-level deal partners if carried interest is compromised? LPs must routinely ask these questions as they construct and manage private equity portfolios. Organizational stability and generational transition were always risks that the industry needed to address, but financial crisis amplified this.

TRIAGO: We've mentioned diversity quite a bit. How many different strategies with statistically distinguishable cash flow and valuation patterns should an LP invest in to maximize returns and minimize risk? How many vintages?

DB: For the typical client we would seek to invest in twenty to twenty-five strategies. In a global portfolio we would want sixty to one-hundred funds that have exposure by geography to those strategies. In terms of vintages, we aim to smooth the ups and downs of economic cycles. So, that would dictate a minimum of five vintages. We base these parameters on twenty years of private equity experience. That said, it is difficult to rely on data to come up with ideal parameters. This is one aspect of private equity risk management that is qualitative rather than quantitative.

DT: I would emphasize that an important strategy for neutralizing LPs' risk of overexposure to economic cycles depends on committing fresh capital in every vintage year, in amounts that will vary depending on the attractiveness of the opportunity set. Of course, this requires discipline. The real error that many LPs with poor performance made during the 2005-2008 credit bubble years was not poor manager or strategy selection, but vintage over-concentration.

MS: I agree with twenty-five as roughly the correct number of strategies an investor should aim to invest in, and with the absolutely essential importance of investing in every vintage year you can.

CK: A rough cut by number of fund commitments is a good starting point for diversification. But optimizing this exercise requires continual re-adjustment, given the unpredictable nature of capital calls and distributions. Concentrations across companies, strategies and regions can always accumulate, sometimes unexpectedly. Also, as LPs tackle the challenge of reducing risk through diversification, it's key to not rely on labels GPs assign their own funds, but instead, "tag" strategies based on LPs' own probe into portfolio company behavior.

TRIAGO: Given gaps in data availability and reliability, is risk assessment in private equity portfolio construction more "art" than "science", and is this radically different from the situation in other asset classes?

MS: A lot of it is art. When you are determining allocations to particular strategies and geographies, you look at expected growth rates as well as the terms, circumstances and results of actual private equity deals. There's a degree of irony in reducing the relative importance of judgment to a percentage, but I'd say seventy percent of your final decision is based on qualitative judgments and only thirty percent on numbers you can crunch. Over the years, I think we've all developed a gut feeling that acts as our touchstone for shaping a low-risk, high-return private equity portfolio.

DB: As I implied a moment ago, relative to other asset classes, I agree that you have to take a much more judgmental approach determining risk and opportunity in private equity. Still, you must stay focused on the first principles of risk management: diversification, adequate risk control and doing business with managers you trust.

DT: As far as we are concerned, this is a completely people-driven business, with success determined by relationships and experience. This assumption brings you by default to the determination that qualitative judgments are more important than quantitative ones for each private equity selection decision. Even properly carrying out due diligence is an art, with a good dose of luck, but very little science involved. A GP might have a great track record but can the team replicate it? Before I partner with a GP for ten years, I want to look the team in the eyes and determine what kind of individuals they are. The character of team members is absolutely fundamental to their ability to convince top company managers or entrepreneurs that they should partner with them. Personal grit also determines whether GPs have what it takes to withstand the "trial by fire" that activist private equity investing is, particularly when market or company prospects are challenging.

CK: What I would add is that we have to be more imaginative in finding information sources, whether qualitative or quantitative. LPs must cut through the traditional fund structure, focusing on the underlying companies, and triangulating where possible with insights from places like the secondary market. Whether you see the process as more "art" or "science", risk management can't be effective without continual, rigorous evolution of tools and procedures.

Private Equity Blog

A round-up of market issues and opportunities for limited partners and general partners.

BULGE EFFECT

Nearly half of the $3.9 trillion raised for private equity since 1969 - or $1.8 trillion - was committed to funds during the 2005 to 2008 credit bubble. Only the best performing buyout funds from this period have returned 30 percent or more of paid-in capital to their limited partners, with most value held in unrealized investments and dry powder. This has been reflected in a significant lengthening of average overall hold times for GPs' portfolio companies, reducing the already limited liquidity of the asset class, and accounting for the popularity of private equity investment vehicles that can reduce investment duration. Today's unprecedented median hold time for a portfolio company is five years, versus three-and-a-half years in 2007. GPs running credit bubble vintage funds feel greater pressure to invest aging dry powder than to sell companies bought at peak multiples, so look for average hold periods to reach new records.

Many buyout firms struggling with reduced fee and carry levels are experiencing a talent exodus.

EVERYBODY'S A SPECIALIST?

LPs are increasingly attracted to GPs with hard-to-replicate specialist knowledge, since it reduces competition and increases returns in what many view as an overcrowded private equity asset class. The popularity of specialization has not been lost on GPs. Asked to explain their investment strategy in a recent survey conducted by service provider McGladrey, 33 percent of GPs described their firms as generalists, but said they are in the process of narrowing their focus to specific sectors. The ranks of specialist GPs in McGladrey's universe should rise to 51 percent of private equity fund managers from only 18 percent today. But count on LP due diligence to whittle down the number of GPs considered specialists - at least by anyone other than themselves - significantly.

THE LOST GENERATION

If current trends continue, one-quarter to one-half of today's GP firms may disappear over the next half-decade or so. Poor returns from credit bubble vintages, and smaller commitments to fewer managers - as LPs concentrate on efficient use of resources - is driving attrition. But any long-term shakeout among GP firms does not mean their numbers will diminish. Many buyout firms, struggling with reduced fee and carry levels for the first time, and which have seen prospects for follow-on-fund growth stall, are experiencing an exodus of relatively junior partners with good track records. Dubbed "the lost generation" by some of their own number, they often have expertise in specific sectors, yet disproportionately populate large, generalist teams at bigger buyout firms. As they jump ship to found their own funds and firms, they may eventually acquire a more positive name: "the new generation."

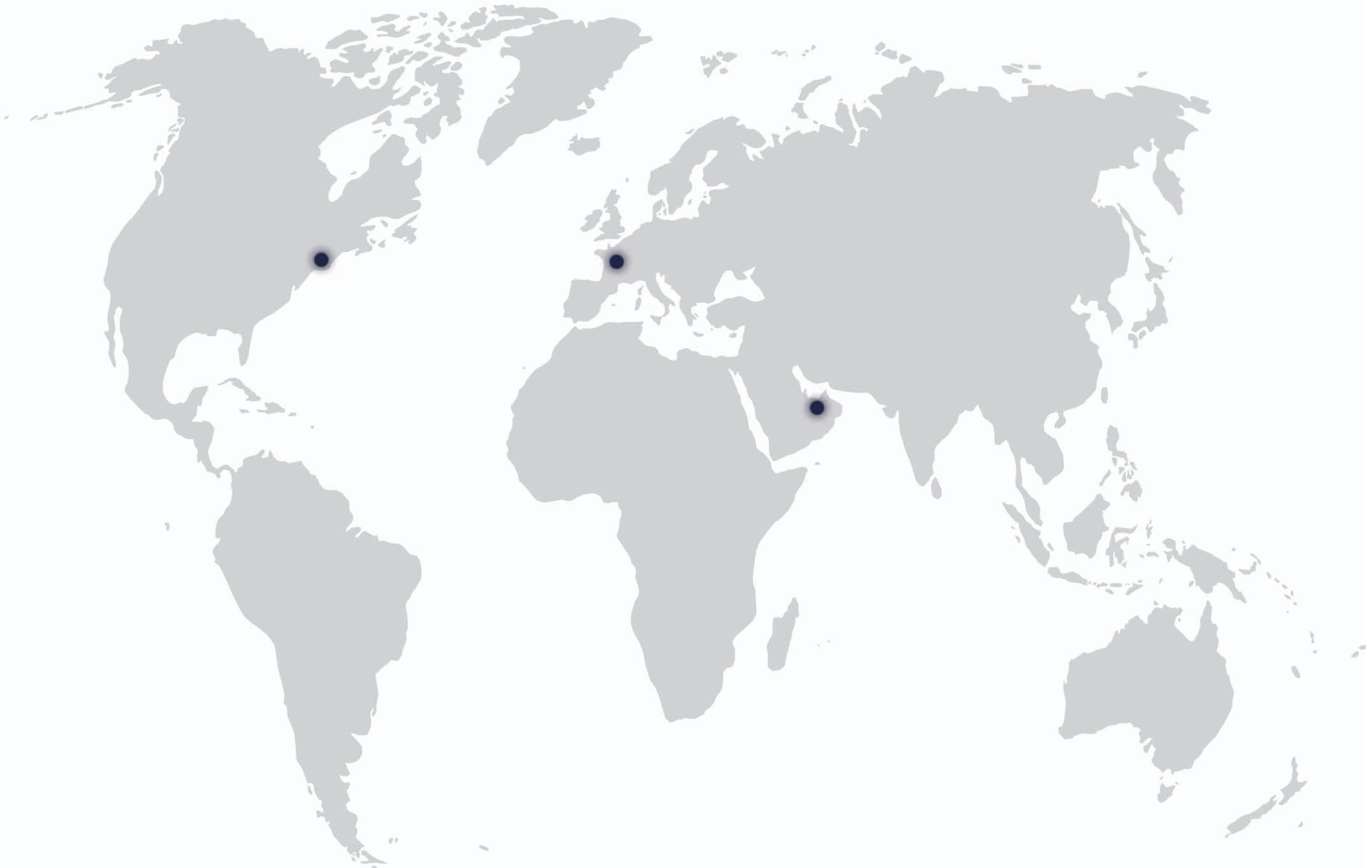
DENOMINATOR IMPACT

Investors seem to have a new and healthy disregard for the "denominator effect". The effect occurs when the value of assets such as stocks fall, causing better performing asset classes to rise above target allocations. Reducing commitments to private equity might seem a logical reaction to the effect, but during the meltdown, it led investors to cut exposure at precisely the wrong time. Following double-digit declines in stocks this year, many LPs are again suffering from above-target allocations to private equity, but they are often ignoring it. Instead of viewing portfolios as separate asset class silos, investors are looking across asset classes, judging relative overexposure based on sector or industry, and reducing their more liquid investments, like stocks.

EMERGING MARKETS DOMINATION

Whether LPs are investing in Asia or Latin America, they are overwhelmingly piling into single countries. Figures from the Emerging Markets Private Equity Association show that out of the $16.4 billion raised for PE in the first half of 2011 for developing Asia, nearly 63 percent, or $10.3 billion, went to China. If the relatively piddling $347 million earmarked for Australia, Japan and New Zealand is included, China's share drops about a percentage point. In Latin America, $3 billion, or 72 percent of the total raised for the region, went to Brazil. Great opportunities exist in both China and Brazil, but LPs may want to take a close look at neighbors for relatively neglected regional plays.

Contact



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