PORTFOLIO ADVISORS, LLC

Presentation to LAFPP

Educational Retreat

January 6, 2011

Contents

What is Private Equity?

- Investments in non-public, non-traded securities
- Early, development, or growth capital
- Cash paired with debt, to purchase existing enterprises

Venture Capital

Leveraged Buyouts

Special Situations

Distressed Investments

Secondaries

Mezzanine

Co-Investments

Contents

Pre-Modern Era, 1850 – 1945

Four Major Eras/Epochs

- Early History, 1946 – 1981
- First Boom & Bust, 1982 – 1993
- Second Boom & Bust, 1992 – 2002
- Golden Age of Buyouts, 2003 – 2007

Source: http://en.wikipedia.org/wiki/history_of_private_equity_and_venture_capital

"Pre-Modern" (1850 to 1945)

JP Morgan

Carnegie

Phipps

Vanderbilt

Whitney

Warburg

Rockefeller

Source: http://en.wikipedia.org/wiki/history_of_private_equity_and_venture_capital

Early History of Private Equity, 1946

J.H. Whitney & Co.

1960: $$$ Millions

1946: $$ Thousands

Investment in

Florida Foods

(Minute Maid)

Source: http://en.wikipedia.org/wiki/history_of_private_equity_and_venture_capital

Early History of Private Equity, 1957

AR&D (or ARDC, Georges Doriot)

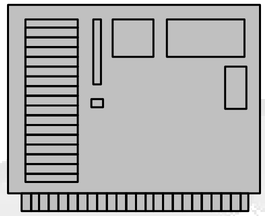
1968: $37,000,000

1957: $70,000

Investment in Digital Equipment Corporation

Source: http://en.wikipedia.org/wiki/history_of_private_equity_and_venture_capital

1960s



SBIC

Venrock – Fairchild Semiconductor

Limited Partnership vehicle

1964

Three Bear, Stearns investment bankers (Kohlberg, Kravis and Roberts) acquire Orkin Exterminating = a "bootstrap" deal

Source: http://en.wikipedia.org/wiki/history_of_private_equity_and_venture_capital

Early History of Private Equity, 1970s

1972

Victor Posner

Warren Buffet

Kleiner Perkins Caufield & Byers

Sequoia Capital

Sand Hill Road

1974

Thomas H. Lee & Company

Source: http://en.wikipedia.org/wiki/history_of_private_equity_and_venture_capital

History of Private Equity, into the 1980s

1978 KKR's first fund raises $30 Million

ERISA Revisions allow pensions to invest in Private Equity

1981 Capital Gains tax rates lowered

1989 KKR leveraged buyout of RJR Nabisco = $31+ Billion

"Barbarians at the Gate"

Source: http://en.wikipedia.org/wiki/history_of_private_equity_and_venture_capital

1982 to 1993: "First Boom" (and Bust)

LBOs

Junk Bonds

Corporate Raiders

Carlyle

Bain

Hicks Muse

Blackstone

First Reserve

Draper, Fisher Jurvetson

Canaan Partners

Venture Capital Fund of America

J.H. Whitney

Drexel Burnham Lambert goes under
S&L crisis crashes markets for PE

Source: http://en.wikipedia.org/wiki/history_of_private_equity_and_venture_capital

Venture Capital Boom (& Bust)

Cisco

Netscape

Yahoo

The Internet

Microsoft

Genentech

E-Bay

Google

Amazon

March 2000 to 2003: NASDAQ Crash

Source: http://en.wikipedia.org/wiki/history_of_private_equity_and_venture_capital

Syndicated Loan banking re-invigorates leveraged buyouts

Snapple

Quaker Oats

Continental Airlines

Duane Reade

Petco

Domino's Pizza

Source: http://en.wikipedia.org/wiki/history_of_private_equity_and_venture_capital

The "Golden Age" of Buyouts

2003 – 2007

Euro denominated funds and deals

Multi-Billion-$/€ "Mega Funds"

US, Europe and Asia

Low interest rates, "easy credit"

Source: http://en.wikipedia.org/wiki/history_of_private_equity_and_venture_capital

Worldwide Credit Crunch, leads to…

Financial Crisis

Global Credit Markets Seize Up

"Post-Modern" Private Equity

2010 and beyond… The "Fifth Epoch"?

Opportunity

Source: http://en.wikipedia.org/wiki/history_of_private_equity_and_venture_capital

Contents

Characteristics of Private Equity

- Longer-term asset class
- Illiquidity
- Active investment strategies
- Higher risk than public stocks
- Information is "private"
- Relatively high cost/fees

WHY INVEST IN PRIVATE EQUITY?

Characteristics of Private Equity

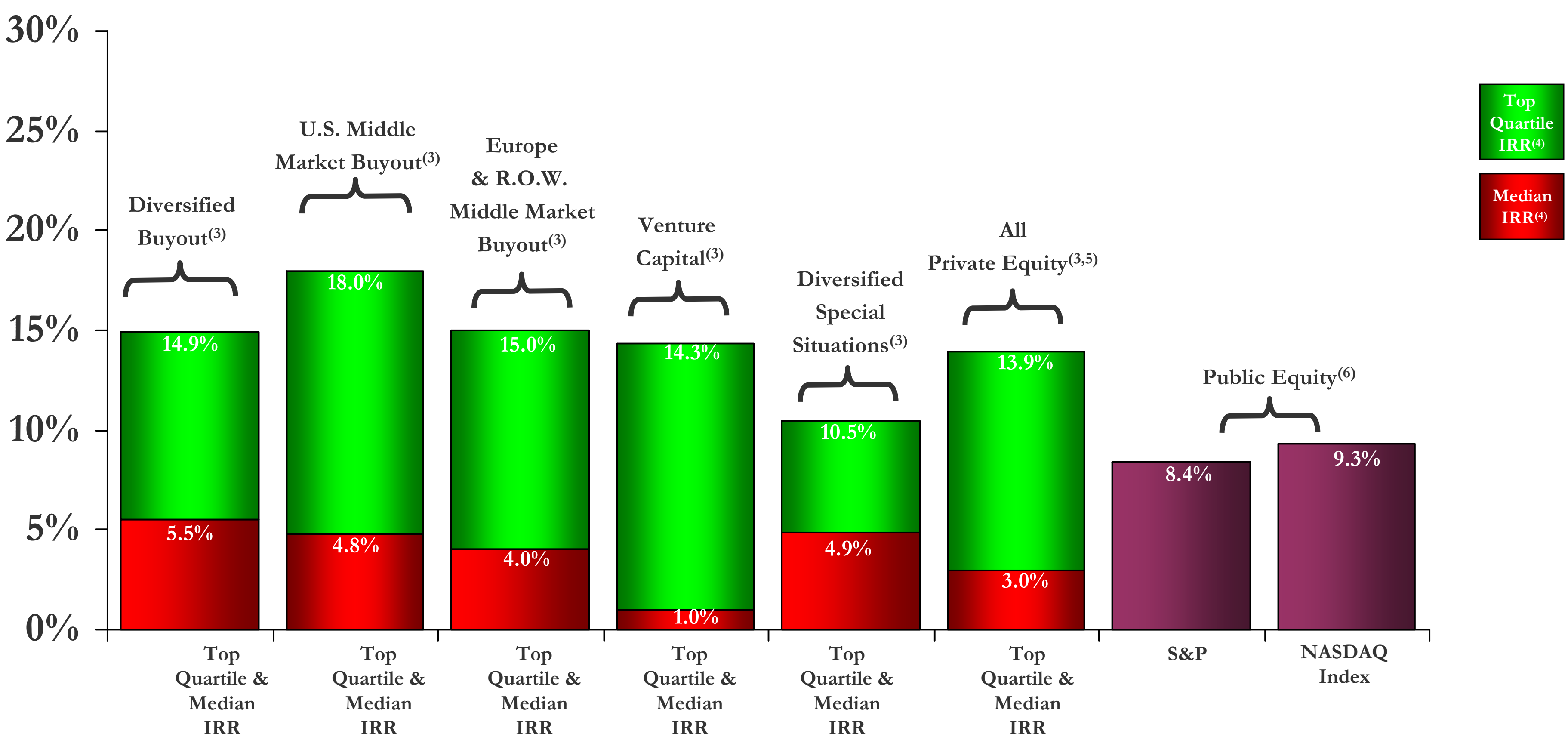
- ***Private Equity*** **investments offer investors the opportunity to achieve higher rates of return while improving portfolio diversification**

Performance	**Long-term *private equity* returns have outperformed public equities** • **Relative: S&P 500 Index, plus 300 to 500 basis points** • **Absolute: 15% net of fees**
Diversification	***Private equity* offers exposure and access to private and smaller companies** • **95,895 private companies vs. 4,467 public companies with revenue over $10 mm[1]** • **Within *private equity*: by style, industry, geography, stage, time**
Attractive Risk / Return Profile	**The introduction of *private equity* into a balanced portfolio of investments can reduce volatility and improve the risk / return profile**

(1) Source: *Zapdata.com, Dun & Bradstreet*, February 5, 2010

Characteristics of Private Equity[1]

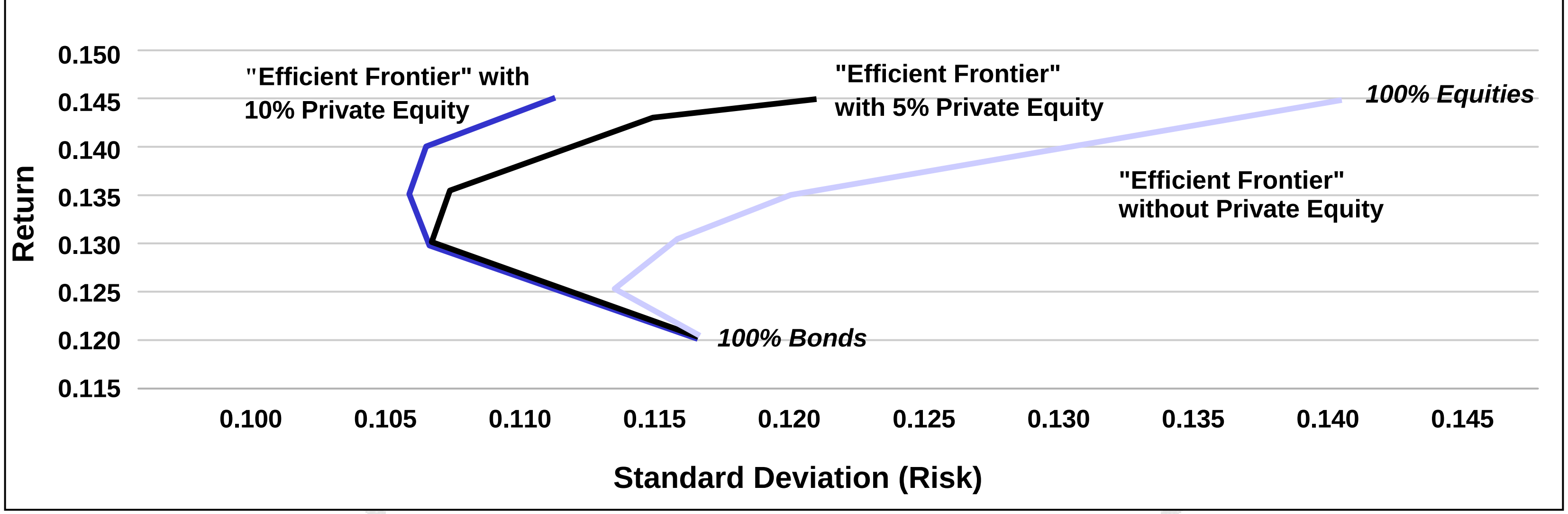
Twenty-Year Returns 1990-2010



Characteristics of Private Equity Investments

- The introduction of private equity into a balanced portfolio of investments can reduce the volatility and improve the risk/return profile.

Effect of Adding Private Equity to a Traditional Portfolio Mix



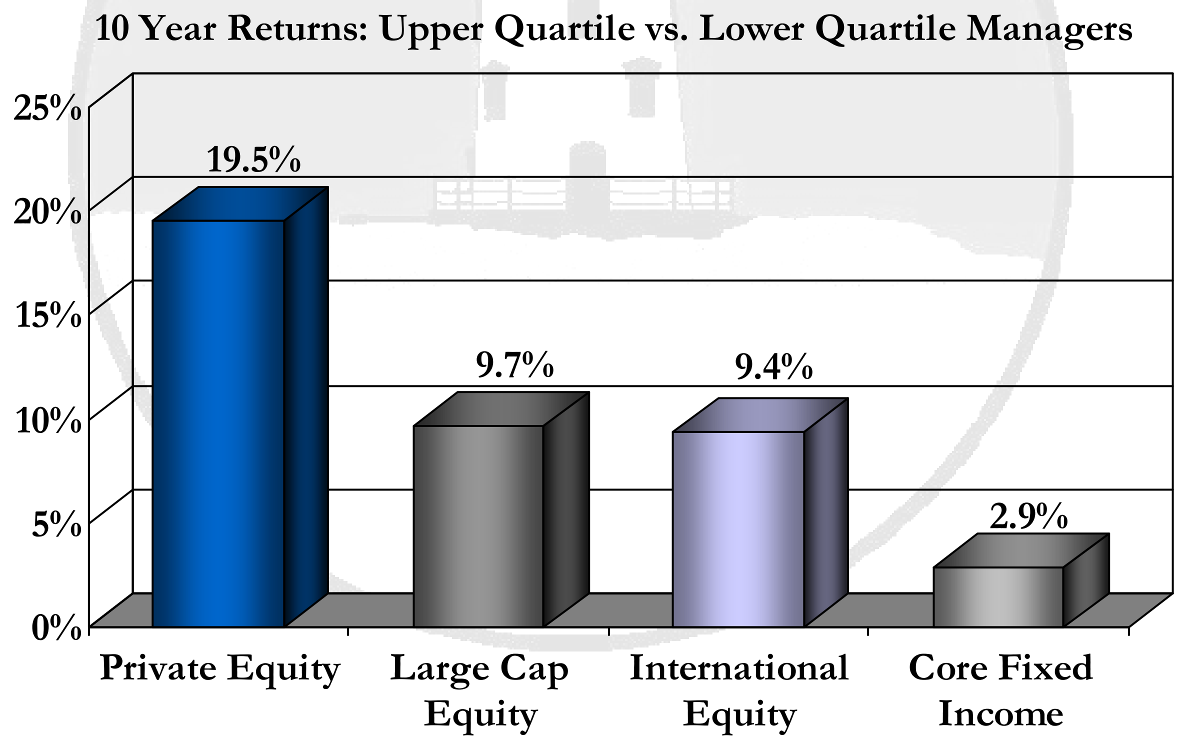
Source: Merrill Lynch Quantitative Analysis and Equity Derivatives Research

Characteristics of Private Equity Investments

- **Key success factors for private equity which distinguish it from other asset classes:**
  - Sectors targeted by Private Equity tend to grow faster than GDP
  - "Negotiated" investment and divestment process
  - Significant lack of transparency throughout life of investment:
    - Deal generation ("proprietary networks")
    - Negotiation, valuation
    - Exit management (buyer, price, timing)
  - Specific know-how/expertise:
    - Sectors, markets, technologies, competition etc.
    - Structuring, valuation
  - Importance of accumulated experience:
    - Due diligence, negotiation, valuation, exits
    - Active approach to value creation
  - Few "principal-agent" problems in cases where majority stake is held
    - More effective alignment of interests

Importance of Manager Selection

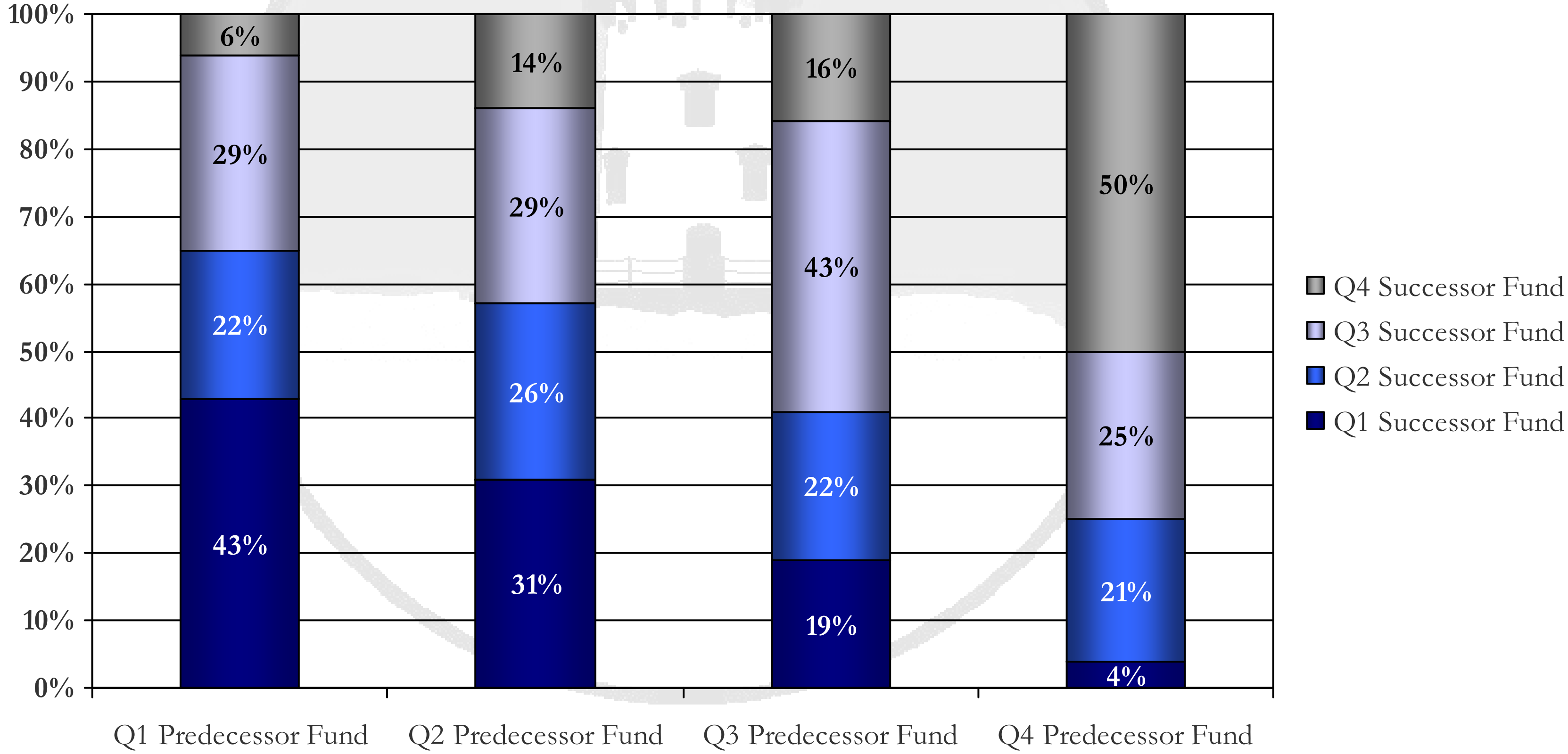
- Experience in manager selection matters
- The significant dispersion of returns in private equity highlights the importance of knowledge and access to top-quartile sponsors
- Dedicated resources and relationships are required to identify and access the best funds



Source: Clearbrook Perspectives, March 2010 (eVestment Alliance and Cambridge Associates)

Characteristics of Private Equity Investments

- **"Performance persistence" further underscores the importance of gaining access to the top-performing private equity managers**
  - A recent study by Preqin shows substantial "performance persistence" for Top Quartile private equity funds, e.g., 43% of Top Quartile funds managed to achieve Top Quartile performance with their successor fund; 65% "Top Half" performance



2010 Preqin Private Equity Fund of Funds Review

Characteristics of Private Equity Investments

- **The significant resource requirements and specialized skills required for successful manager selection in private equity lead many investors to rely on a competent external partner:**
  - Access to top-tier funds
    - Proven managers
    - Emerging managers
    - Specialized strategies
  - Specific know-how and accumulated experience
  - Dedicated resource requirements (Due Diligence, Monitoring, Reporting)
  - Significant "Back Office" administration requirements

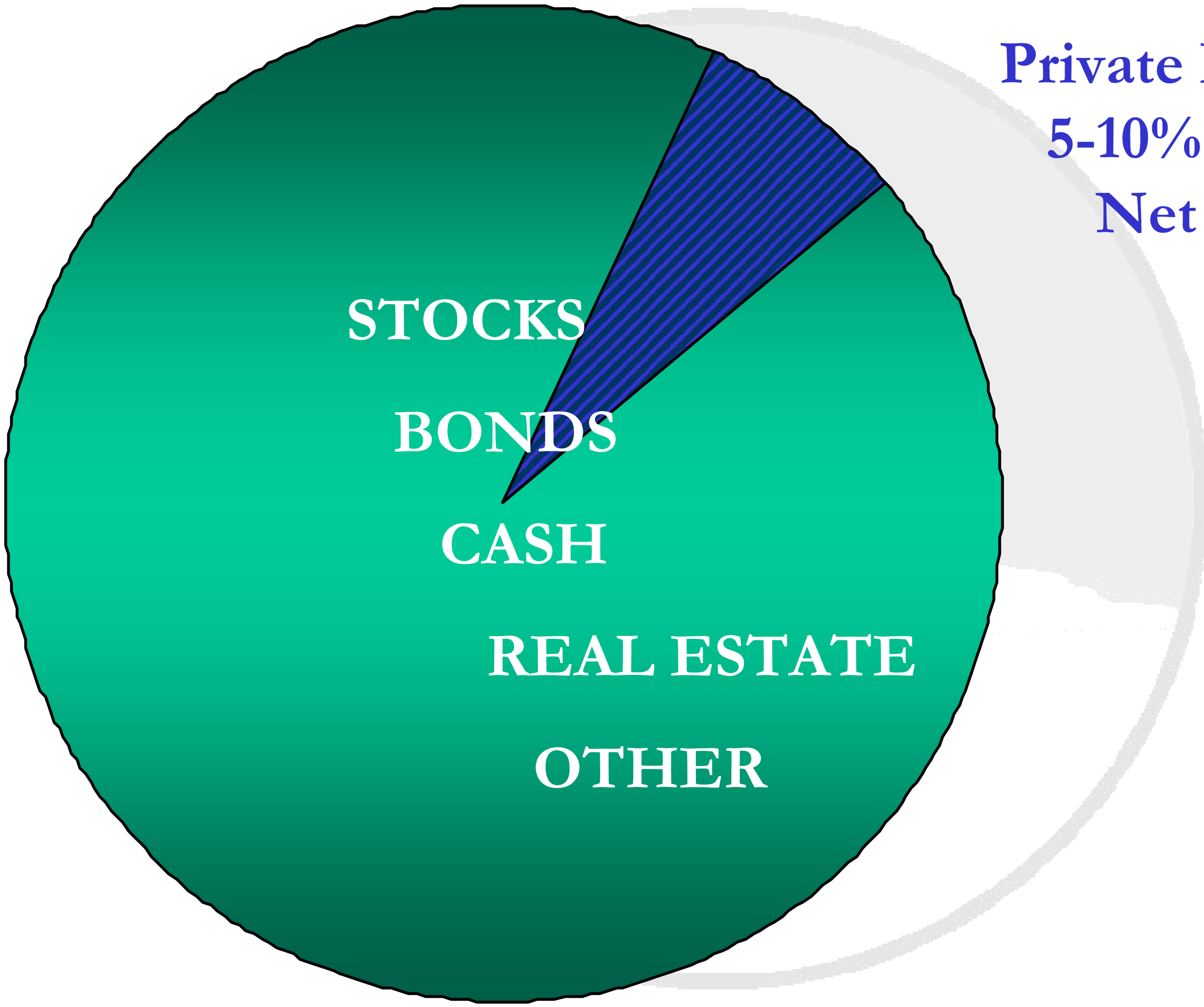
Contents

- What is Private Equity?
- History of Private Equity
- Characteristics of Private Equity
- **How to Invest in Private Equity**
- Summary

How to Invest in Private Equity

- **Allocations to private equity vary considerably amongst type of investor and region:**
  - Large U.S. institutional investors typically allocate 5-15% to private equity
  - Some U.S. endowments and family offices allocate over 20% to private equity
  - Allocations to private equity amongst European investors have historically been lower than their US counterparts with a range from 1-5%

Private Equity: High Net Worth/Family Office Investor



Private Equity = 5-10% of Total Net Worth

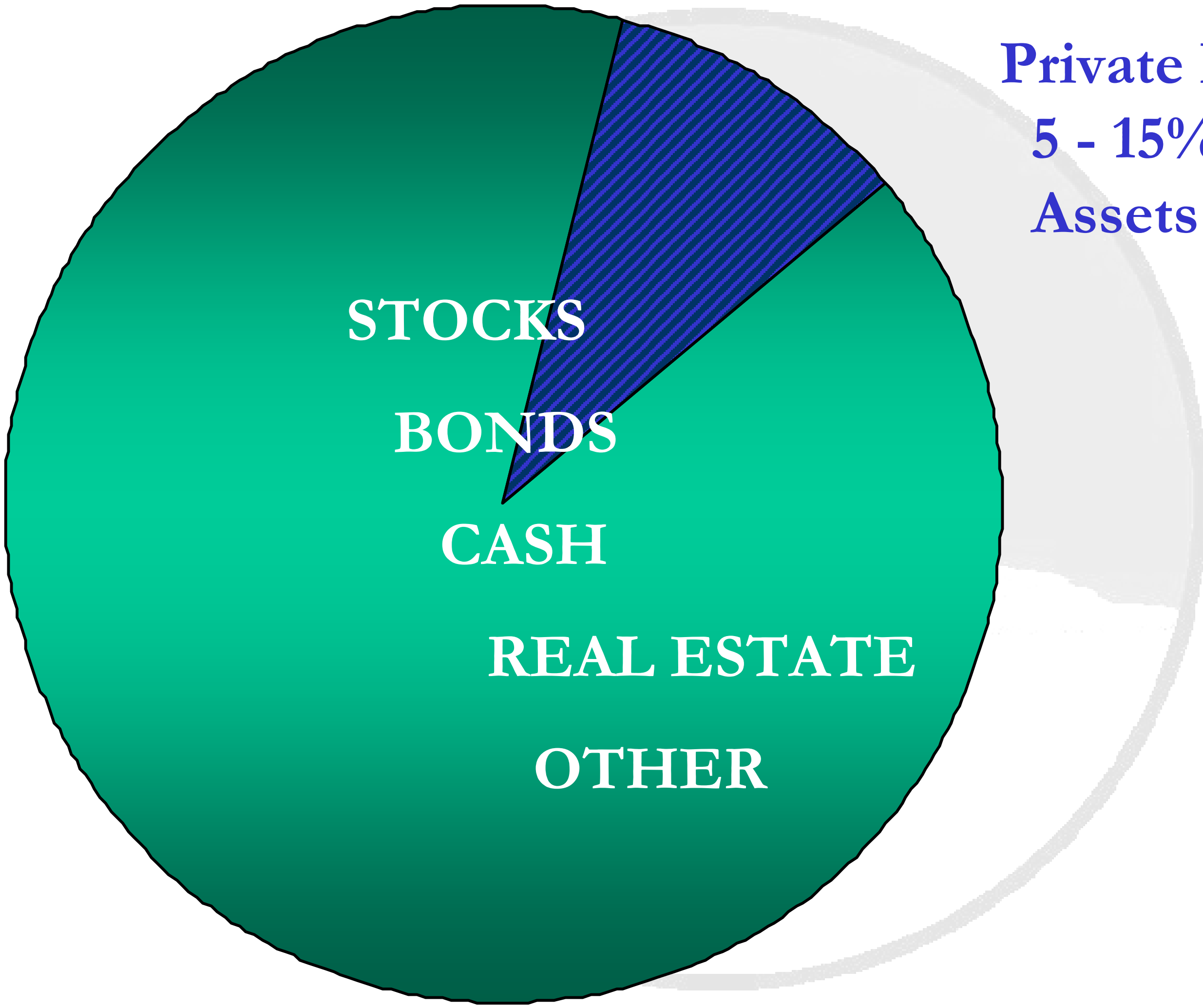
High Net Worth/Family Office Investor

36% of Global Family Offices surveyed are
At or Below Target Allocations to Private Equity
Another 30% have No Target
(PREQIN Research Report, March 2010; sample size = 34 global family offices, Europe, N. Amer., Asia and ROW)

28% of Global Family Offices surveyed have been
Active in Private Equity for at least 20 Years
Another 32% have been Active for less than 10 Years
(PREQIN Research Report, March 2010; sample size = 34 global family offices, Europe, N. Amer., Asia and ROW)

84% of Global Family Offices surveyed say that
Private Equity has Met or Exceeded Return Expectations
(PREQIN Research Report, March 2010; sample size = 34 global family offices, Europe, N. Amer., Asia and ROW)

Private Equity: Pension Plan Investor



Private Equity = 5 - 15% of Total Assets Invested

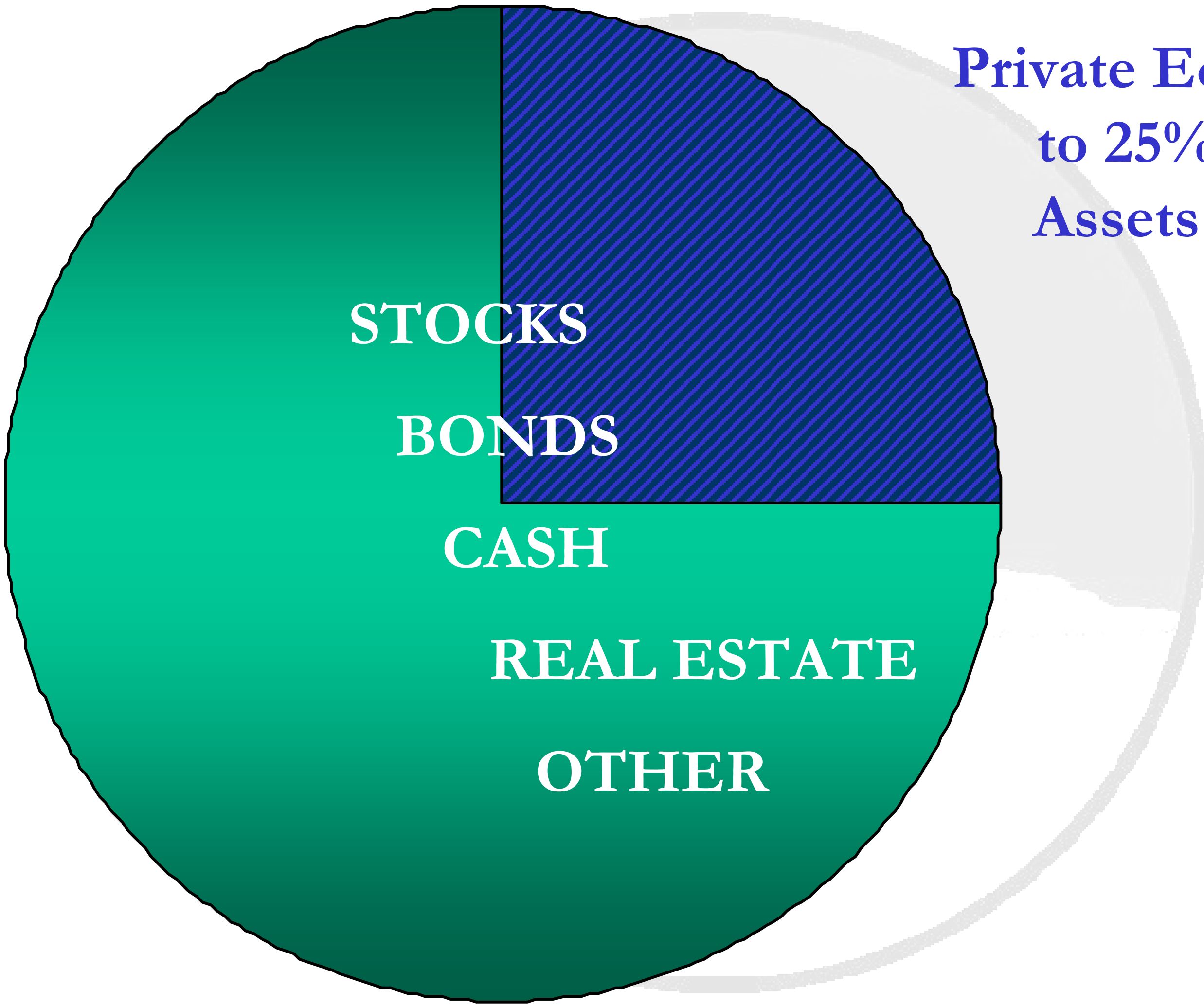
Pension Plan Investor

92% of institutional investors surveyed plan to Commit the Same or More to Private Equity in 2010
(PREQIN Research Report, February 2010; sample size = 106 significant institutional investors)

71% of public and private pension funds intend to Make New Commitments in 2010
(PREQIN Research Report, February 2010; sample size = 106 significant institutional investors)

Pennsylvania PSERS raised its target allocation for Private Equity to 21% in 2010
(PREQIN Research Report 2010)

Private Equity: Endowment Investor



Private Equity = Up to 25% of Total Assets Invested

Endowment Investor

64% of institutional investors surveyed expect to Increase Private Equity allocations in 2010

(Coller Capital's *Global Private Equity Barometer, June 2010;* sample size = 110 LPs globally)

77% of institutional investors say that Private Equity has Met or Exceeded return expectations

(PREQIN Research Report, February 2010; sample size = 106 significant institutional investors)

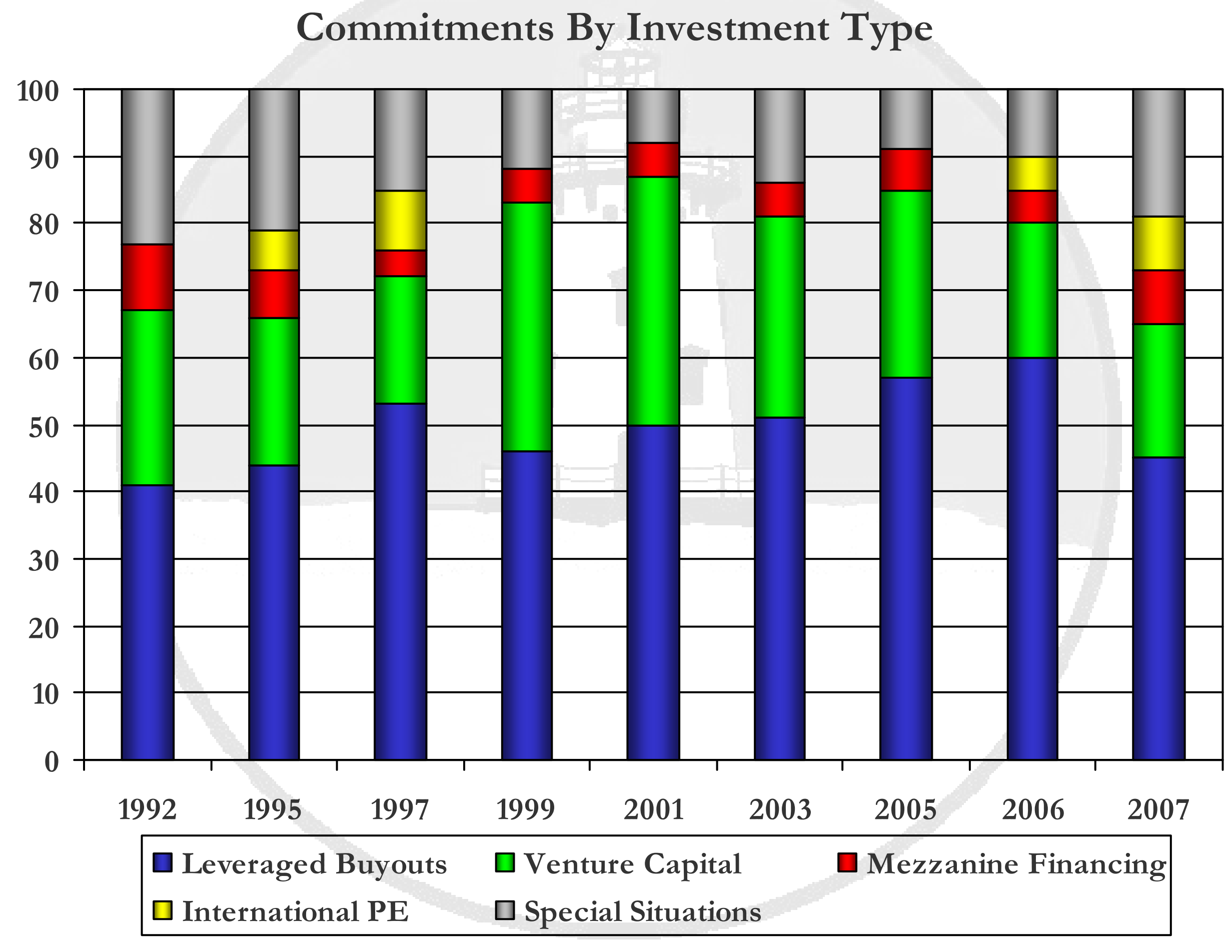
91% of endowments surveyed expect to Maintain or Increase allocations to Private Equity over the next 12 months

(PREQIN Research Report, October 2009; sample size = 100 endowments)

Yale University Endowment raised its target allocation for Private Equity to 26% in 2010

(PREQIN Research Report 2010)

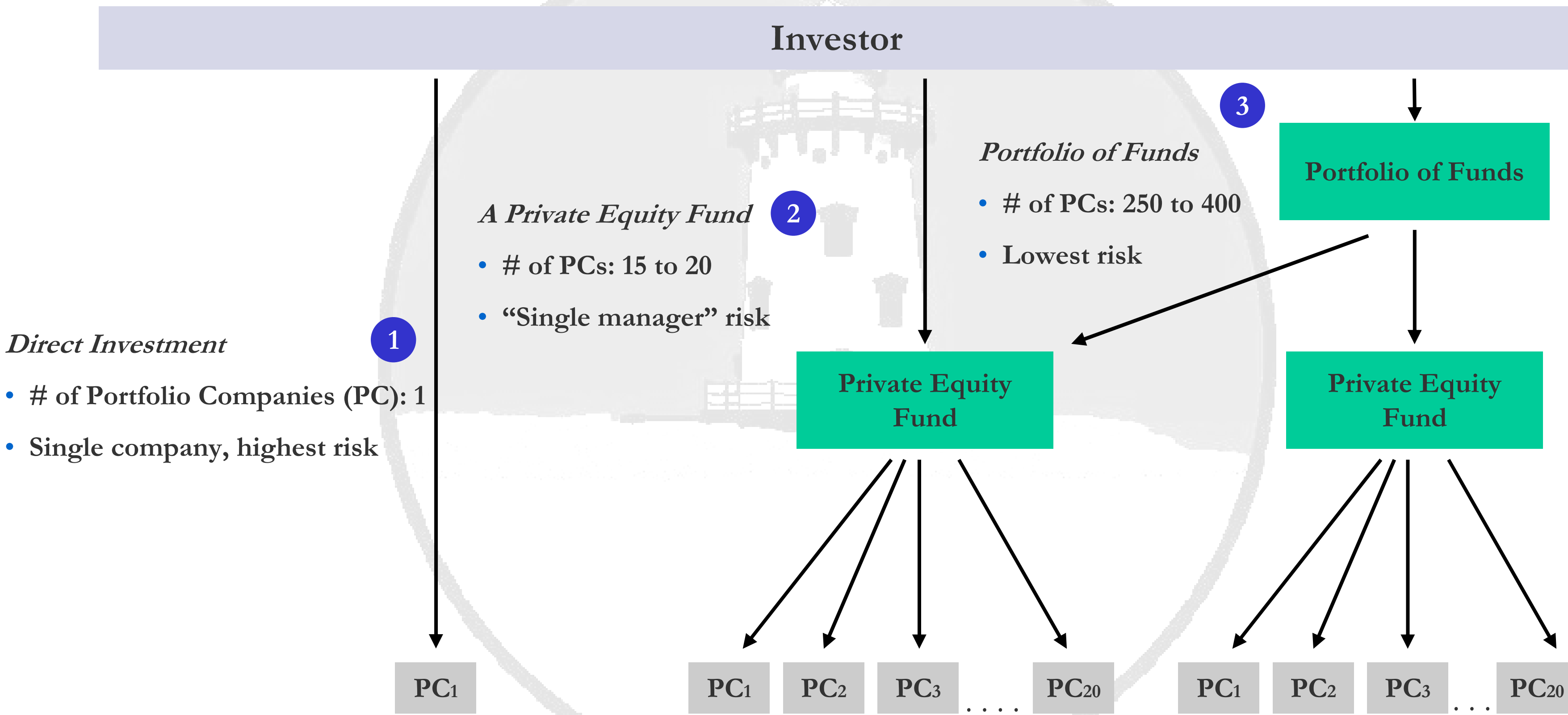
How to Invest in Private Equity



Source: *State of the Private Equity Market,* Dow Jones, 2008

Private Equity Investment Options

- Three distinct ways institutional investors may obtain private equity exposure
- Investing through portfolio of funds provides the greatest diversification



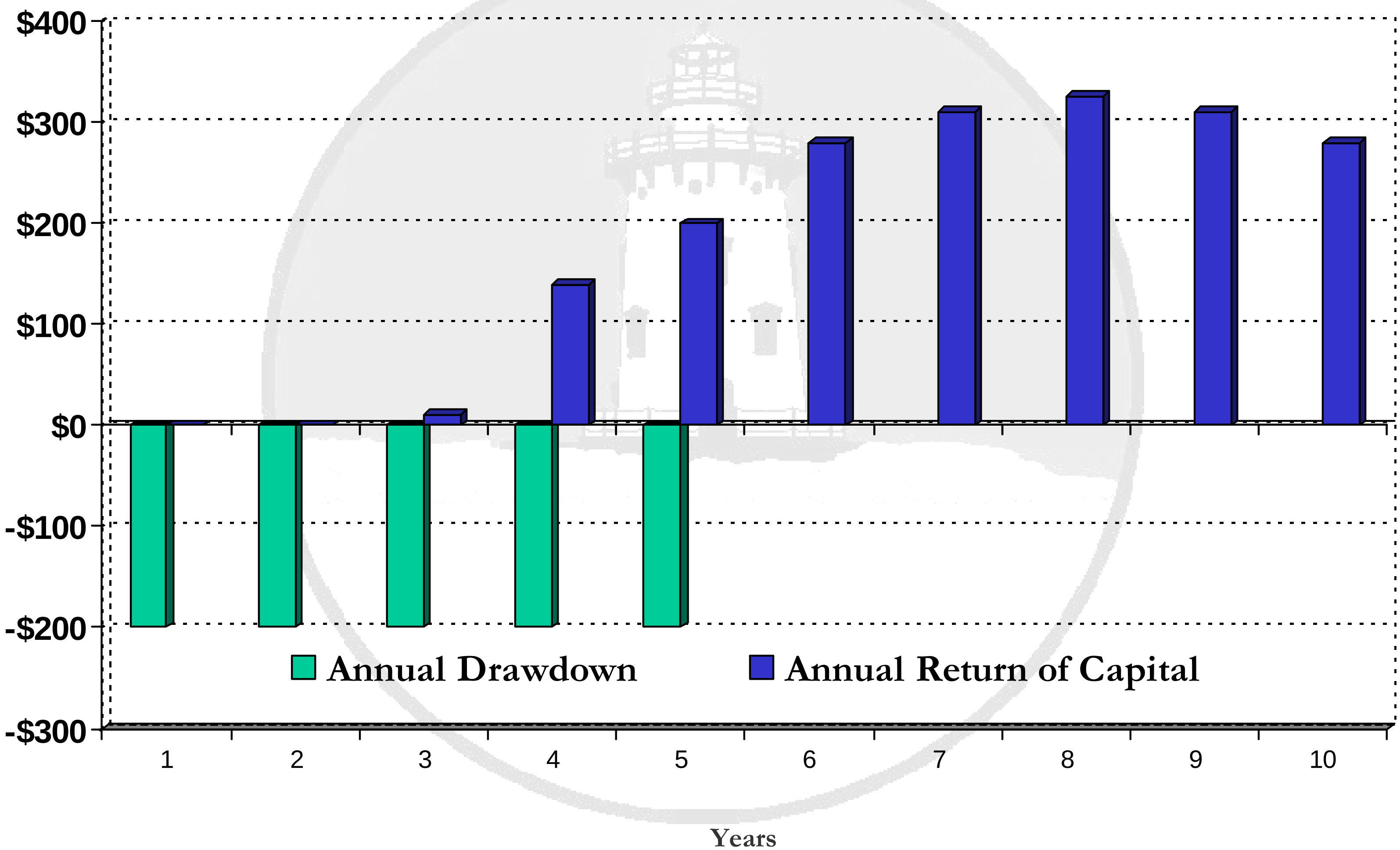
How to Invest in Private Equity

- **Each alternative has its advantages and disadvantages**

Form of Investment	Advantages	Disadvantages
Direct Investment	• Potential for highest return • Control/Flexibility • No Fund or Management Fees	• Highest risk ("Single Company") • High information and search costs (selection difficult) • Monitoring of investment is time intensive and costly • Other potential investments not possible
Private Equity Fund Investment	• Some level of diversification • Partial outsourcing of activities to specialists	• "Single manager risk," given the decision to invest in one manager/segment • Access to top tier funds often not possible – minimum amount/access/acceptance
Portfolio of Funds Investment	• Lowest risk due to diversification • Access to top tier funds • Complete outsourcing of activities to specialists	• High costs (which can be regarded as the "price" for significantly lower risk)

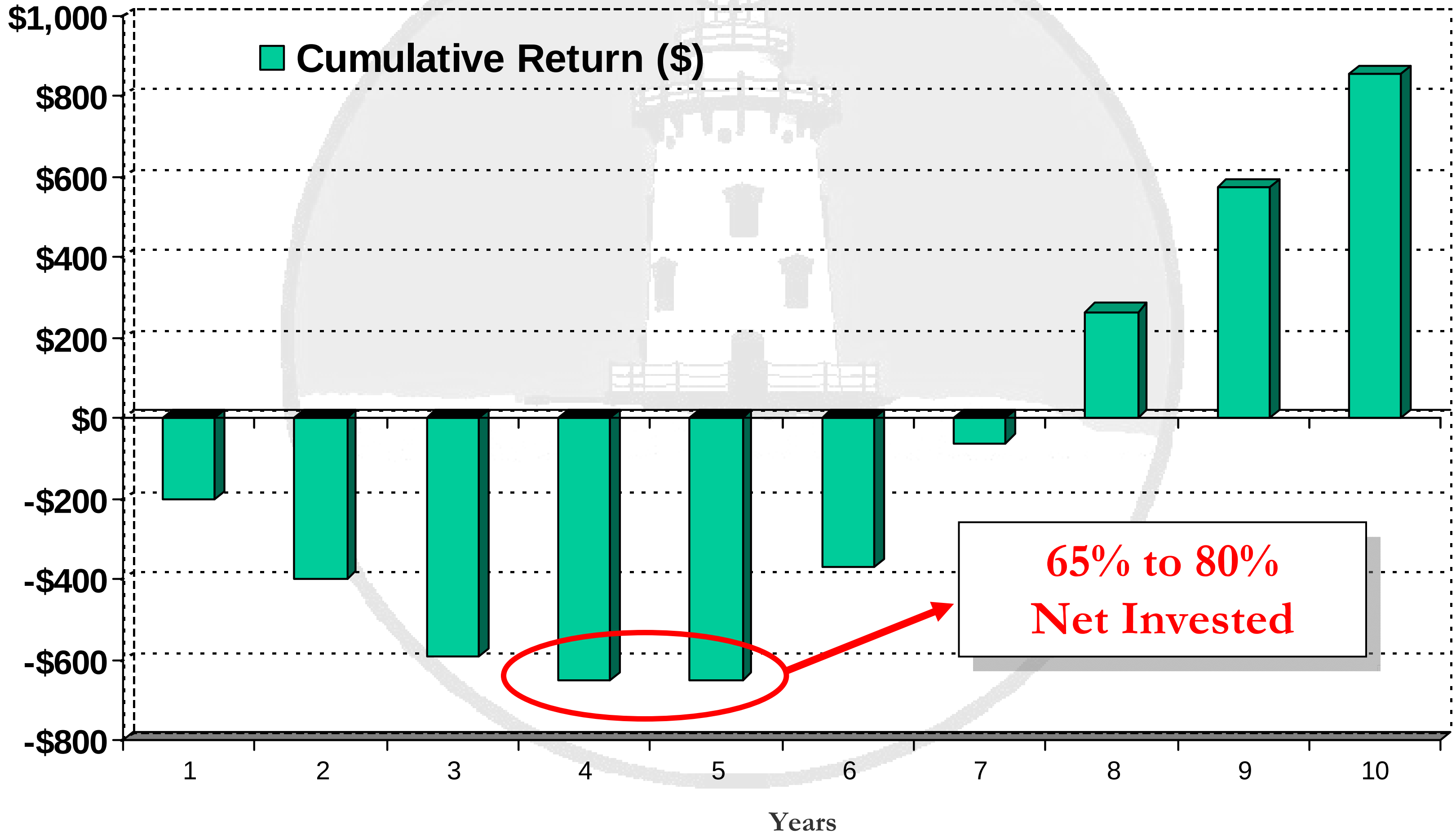
Basic Mechanics: Cash Flow

- **Annual cash flow: $1 million commitment**

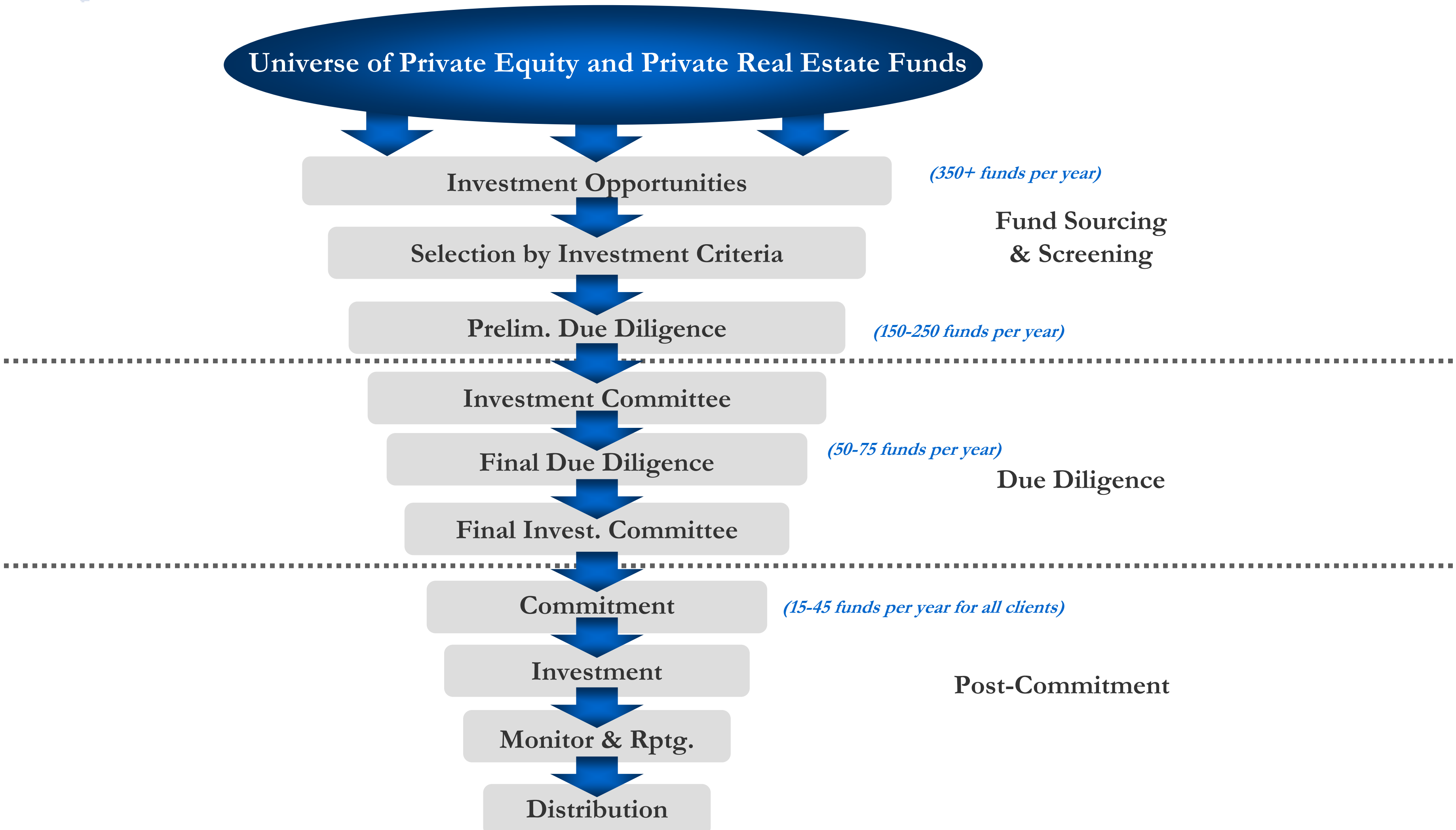


Basic Mechanics: Net Invested

- **Cash flow shows 65% to 80% net invested**
  - Varies with economic cycles



Due Diligence Advantage



How to Invest in Private Equity

A study conducted by the European Investment Fund (EIF) concluded that diversification significantly reduces the risk of private equity investments

Conclusions of the EIF Study:

Portfolio of Funds

The probability of losing **any** amount of investment in a private equity portfolio of funds is **zero%**

↓

Private Equity Fund

When investing in one private equity fund, the probability of a **total loss** of investment is **1%**; the probability of losing **part** of the investment is **5 – 15%**

↓

Direct Investment

The probability of a **total loss** of a direct investment in Venture Capital-backed company is **30%**

Source: European Investment Fund (EIF), Weidig and Mathonet (2004)

How to Invest in Private Equity

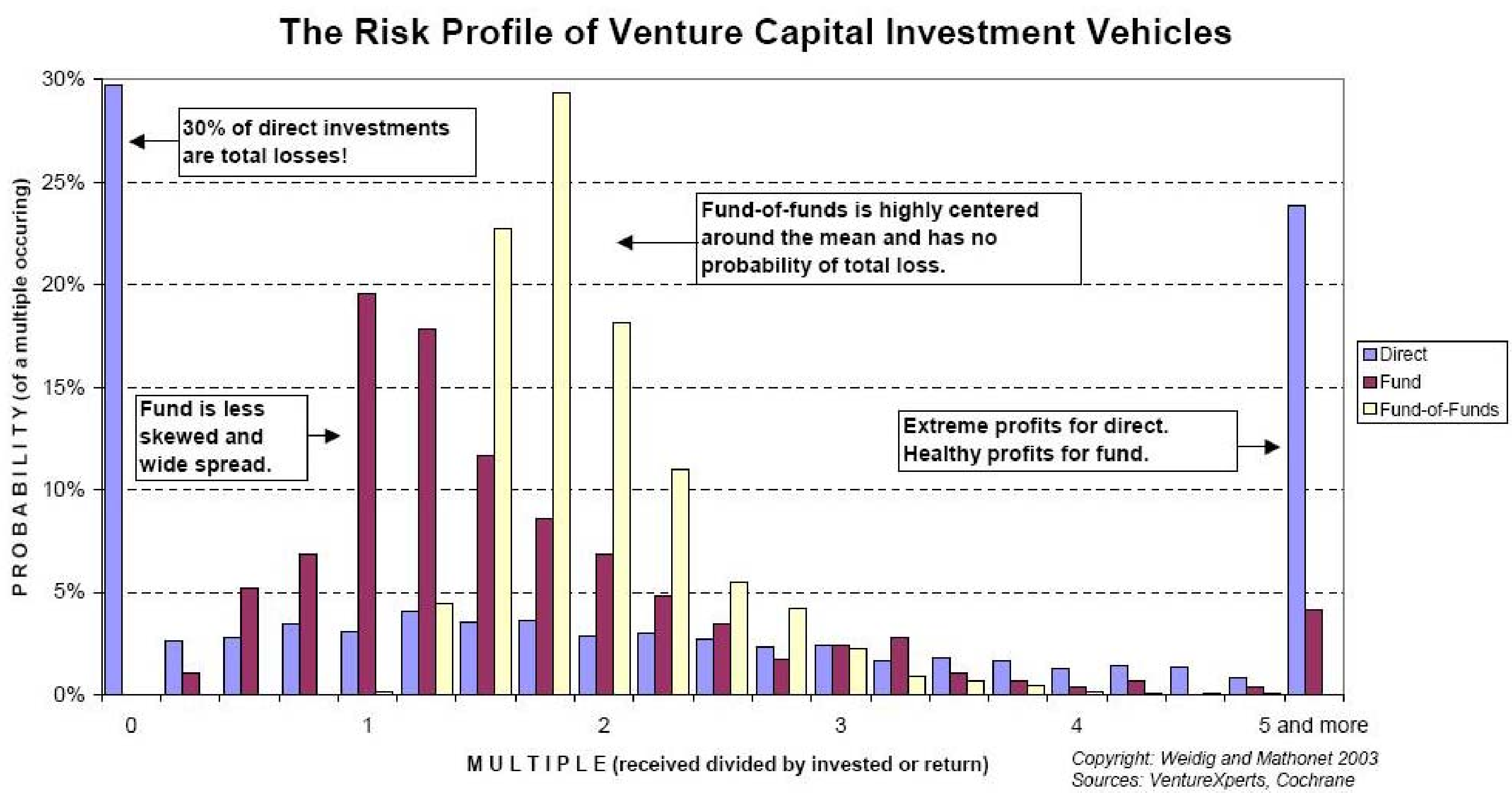


Figure 1: Comparing the risk profile of venture capital investment vehicles: Multiple distribution. (Data contains about 5000 direct investments (US data – no European data available), about 300 European funds, and 50,000 simulated European funds-of-funds.)

Source: European Investment Fund (EIF), Weidig and Mathonet (2004)

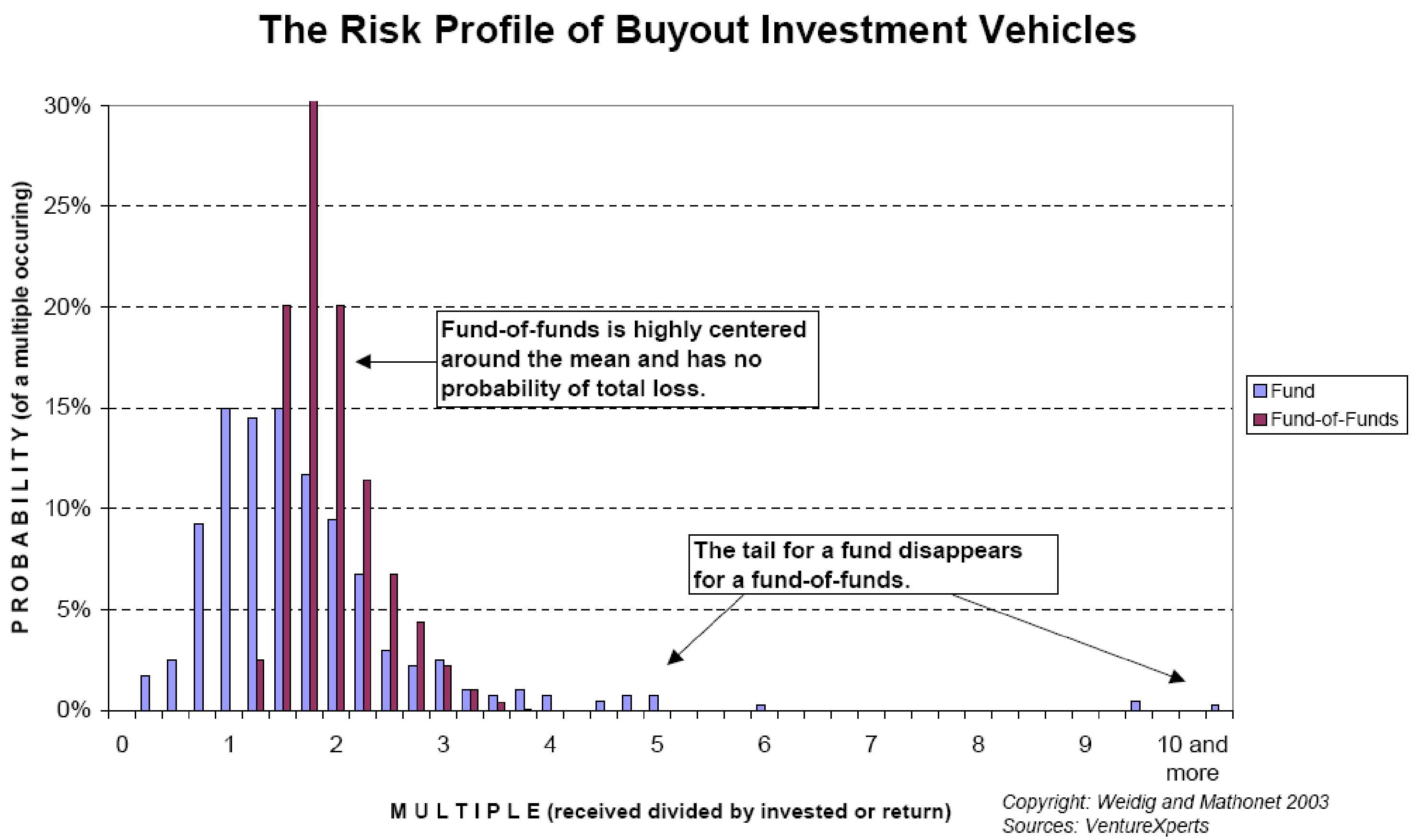


Figure 2: Comparing the risk profile of European buyout funds and funds-of-funds: Multiple distribution. (Data contains about 200 funds, and 50,000 simulated funds-of-funds.)

Source: European Investment Fund (EIF), Weidig and Mathonet (2004)

Investor Expectations and Allocations*

Outlook for 2010 to 2012

- Alternatives Allocations will Rise from 14% to 19%
- Private Equity will Increase as a share of Alternatives
- On average, PE will be 6% to 8% of Overall Portfolio

Why?

- PE can Reduce Volatility and Improve Risk-Adjusted Returns

Conclusions and Concerns

- Financial Crisis produced Few Surprises
- Advisors/FOFs add value in Manager Selection and Due Diligence
- Liquidity, Fees and Transparency are main Concerns

* Source: Russell Investments' 2010 Global Survey on Alternative Investing, June 2010

Contents

Summary

- Private Equity offers the possibility to generate **superior risk-adjusted returns**
- However, **manager selection** of top-tier funds is the **key to outperformance** in private equity
- **Specialized expertise** and **dedicated resources / relationships** are required to assess and access the best funds
- A portfolio of funds significantly **reduce the risk** of private equity investments through **diversification**

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