Private Equity Asset Class Discussion and Market Overview

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Managing Director

BlackRock Private Equity Partners

The University of Chicago Booth School of Business
1. Asset Class Discussion
   - What is Private Equity?
   - Who invests in Private Equity?
   - Why invest in Private Equity?
   - How much should one invest in Private Equity?
   - How does Private Equity work in practice?
     - Structures
     - Cashflow Mechanics
     - J-Curve
   - What are some risks associated with Private Equity?

2. Private Equity Market Overview
   - Current Macro Environment
     - Capital Raised
     - Credit Markets
   - Fund of Funds Environment
   - Is the Party Over?
     - Historical Performance Across Market Cycles
     - Outlook for the Future
Private Equity
Asset Class Discussion
**What is Private Equity?**

*Private equity represents investments in private or unlisted companies:*

- Traditionally thought of as an alternative asset class
- Is a sizeable asset class in its own right
- Generally includes investments in the following categories:

<table>
<thead>
<tr>
<th>Venture Capital</th>
<th>Buyouts / Restructuring</th>
</tr>
</thead>
<tbody>
<tr>
<td>Seed</td>
<td>Development Capital</td>
</tr>
<tr>
<td>Early Stage</td>
<td>Leveraged Buyout</td>
</tr>
<tr>
<td>Expansion Stage</td>
<td>Management Buyout</td>
</tr>
<tr>
<td>Later Stage</td>
<td>Restructuring</td>
</tr>
<tr>
<td>Pre-IPO</td>
<td>Mezzanine</td>
</tr>
</tbody>
</table>
Private Equity returns are driven by three basic premises:

1) How well do you purchase the asset?
2) How well do you develop the asset?
3) How well do you exit the asset?
How is Private Equity Investing Different than Buying Public Equities?

- **Level of Due Diligence** - PE has access to proprietary information
- **Entry Valuations** - Private firms typically trade at a discount
- **Control of Investment** - PE investors take board seats as majority owners
- **Value-Added Investing** - PE investors are operators vs. passive observers
- **Time horizon** - Longer-term investing
- **Exit Options** - PE investing has flexibility across IPOs, M&As and ReCaps
Who Invests in Private Equity?

Investors in Private Equity Based on Available Dry Powder

- Endowments: 6.0%
- Public Pensions: 30.0%
- Insurance: 17.0%
- Non-Public Pensions: 16.0%
- Financial Institutions: 15.0%
- Sovereign Wealth Funds / Government: 10.0%
- Family Offices / Foundations: 6.0%
- Endowments: 6.0%

*Fund of Funds represent approximately 10-15% of LP commitments to PE firms.*

* Fund of Funds, asset managers and secondary fund of funds excluded from study because they are intermediaries.
How Much Should One Invest in Private Equity?

- Investors in private equity seek higher long-term return and risk diversification
- Returns typically are above those available in the public markets
  - Investments made in companies at the start of an anticipated period of rapid growth
  - Potential premium for illiquidity
- Diversification
  - Many of the factors that drive returns to private equity investors are unrelated to what is happening in the public markets
Private Equity Has Outperformed Public Equity and Fixed Income, However…

Data as of December 31, 2008.

Includes performance of all private equity funds in every vintage. All Asset Classes except for private equity are sourced from Thomson DataStream, using ready made indexes: MSCI USA-Index (USD); MSCI World Index (USD); S&P/Citigroup W. Gov. Bond Index (USD). Index performance assumes reinvestment of all distributions for the period ended December 31, 2008. “Top Quartile Mean” represents the average of the top quartile population. Private equity returns shown above are investment horizon pooled IRR returns, calculated on a total return basis, for the 10- and 15-year periods ended December 31, 2008, compounded annually, net to investors of all fees, expenses and carried interest. Private equity returns are derived from the Venture Economics VentureXpert database as of May 15, 2009 which contains a representative sample of the private equity universe. Cash flows collected from investors and general partners are used to calculate IRRs based on cash-in/cash-out returns, with consideration of the net asset value of the remaining partnership holdings. The IRR is an annualized compounded rate of return calculated using monthly cash flows and annual valuations. Public market returns are typically stated as time-weighted returns, while private equity returns are stated as internal rates of return, or dollar weighted returns. Thus, care must be taken when making direct comparisons of public and private market performance. Please see accompanying End Notes for additional information on quartile rankings. Performance data reflects past performance and does not guarantee future results. The returns shown are not predictive of the Fund’s future returns.
Manager Selection is Critical to Generate Superior Returns

Persistent, wide disparity between median and top-quartile private equity returns in the United States and Europe

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1 Venture Economics Information Services, Cumulative Vintage Year Composite Performance IRRs for the 15-year periods ended December 31, 2008 for US and Europe PE. Private equity returns are internal rates of return net to investors after fees and carried interest. Private equity returns are derived from the Venture Economics VentureXpert database as of May 15, 2009, which contains a representative sample of the Private equity universe. Cash flows collected from Investors and General Partners are used to calculate IRRs based on cash-in/cash-out returns, with consideration of the net asset value of the remaining partnership holdings. The IRR is an annualized compounded rate of return calculated using monthly cash flows and annual valuations. Please see accompanying End Notes for additional information on quartile rankings. Performance data reflects past performance and does not guarantee future results. The returns shown are not predictive of the Fund’s returns.
### PE Return Dispersion: All US Private Equity Funds (Vintages 1969 through 2008)

<table>
<thead>
<tr>
<th>Vintage Year</th>
<th>Max IRR</th>
<th>Upper Quartile</th>
<th>Median</th>
<th>Lower Quartile</th>
<th>Min IRR</th>
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</thead>
<tbody>
<tr>
<td>1969-75</td>
<td>36.20</td>
<td>24.50</td>
<td>19.90</td>
<td>12.50</td>
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<tr>
<td>1976-79</td>
<td>74.10</td>
<td>43.80</td>
<td>31.20</td>
<td>14.00</td>
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<tr>
<td>1980</td>
<td>41.10</td>
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<td>13.70</td>
<td>9.10</td>
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<td>1980-83</td>
<td>146.70</td>
<td>13.30</td>
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<td>0.90</td>
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<td>1981</td>
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<td>14.80</td>
<td>10.10</td>
<td>0.10</td>
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<td>1982</td>
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<td>9.10</td>
<td>4.20</td>
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<td>1983</td>
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<td>1984</td>
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<td>4.20</td>
<td>1.00</td>
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<td>1985</td>
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<td>1.80</td>
<td>-10.20</td>
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<td>1989</td>
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<td>4.40</td>
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<td>1990</td>
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<td>1.70</td>
<td>-10.00</td>
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<tr>
<td>2000</td>
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<td>2.40</td>
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<td>-24.10</td>
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<td>2002</td>
<td>54.60</td>
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<td>1.30</td>
<td>-2.20</td>
<td>-19.10</td>
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<tr>
<td>2003</td>
<td>41.60</td>
<td>13.60</td>
<td>5.80</td>
<td>2.00</td>
<td>-7.60</td>
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<tr>
<td>2004</td>
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<td>9.40</td>
<td>1.50</td>
<td>-7.60</td>
<td>-35.20</td>
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<tr>
<td>2005</td>
<td>29.80</td>
<td>7.90</td>
<td>0.70</td>
<td>-5.50</td>
<td>-18.80</td>
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<tr>
<td>2006</td>
<td>19.90</td>
<td>2.00</td>
<td>-8.70</td>
<td>-19.00</td>
<td>-67.70</td>
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<tr>
<td>2007</td>
<td>78.40</td>
<td>-10.40</td>
<td>-21.50</td>
<td>-32.30</td>
<td>-68.70</td>
</tr>
<tr>
<td>2008</td>
<td>24.10</td>
<td>-24.70</td>
<td>-38.90</td>
<td>-57.00</td>
<td>-91.70</td>
</tr>
</tbody>
</table>

Source: Venture Economics Information Services, Cumulative Vintage Year Performance for all US Private Equity funds through the period ending December 31, 2008. Private Equity returns are compounded annually, net to investors after fees and carried interest. Private Equity returns are derived from the Venture Economics VentureXpert database as of August 31, 2009, which contains a representative sample of the Private Equity universe. Cash flows collected from investors and general partners are used to calculate IRRs based on cash-in/cash-out returns, with consideration of the net asset value of the remaining partnership holdings. The IRR is an annualized compounded rate of return calculated using monthly cash flow and annual valuations. Performance data reflects past performance and is not indicative of future results. The returns shown are not predictive of the Fund’s returns.
Diversification Within PE is Also Important

Data Source: VentureXpert database from Thomson Venture Economics, Cumulative Vintage Year Performance as of December 31, 2008.
How Much Should One Invest in Private Equity?

• Set allocation target as a % of the overall plan. Factors to consider include:
  – Risk appetite
  – Liquidity
  – Plan liability profile
  – Time horizon
  – Level of diversification sought
  – Be a consistent investor; do not try to “time the market”
  – Achieve appropriate levels of diversification

• Institutional research suggests an allocation of 5% to 15% to alternative assets does not significantly increase volatility
How Much Should One Invest In Private Equity?


How Does One Invest in Private Equity?

Ways to Invest in PE Include:

- Direct investment into private companies
- Private Equity Funds
- Quoted Closed-End Private Equity Funds (primarily in Europe)
- Private Equity Fund of Funds
How Does One Invest in Private Equity? Mechanics of Traditional Funds and Fund of Funds

**Traditional Fund Structure**

- **Investors (Limited Partners)**
  - Cash investment
  - Cash returns

- **Fund Manager (General Partner)**
  - Investment A
  - Investment B
  - Investment C

**Fund of Funds Structure**

- **Investors (Limited Partners)**
  - Cash investment
  - Cash returns

- **Fund of Funds Manager (General Partner)**
  - Fund Manager A
  - Fund Manager B
  - Direct Co-Investment A
  - Direct Co-Investment B

- **Investment in underlying company or fund**
- **Return from underlying company or fund**
How Does One Invest in Private Equity?
Mechanics of Traditional Funds and Fund of Funds

• Limited Partnerships are legal contracts
  – Generally 10 years
  – Provisions to extend, usually in one to two year increments

• Investment minimum is typically $5 million or greater

• Investments are made over three to five years
  – Capital is drawn from investors “as needed” to fund individual investments
    – Typically 10 days notice

• Investments are made in 10 to 30 portfolio companies, depending on the type of fund (VC or LBO)

• Thereafter, investments are managed and gradually realized

• Distributions, if any, are made either in cash or stock to limited partners
How Does One Invest in Private Equity?
Cash Flow Example

- Representative cash flows on a $100 commitment to a 10-year partnership assuming a 2.5x return, a 5-year investment period, and a gross IRR of 33%

<table>
<thead>
<tr>
<th>Year 1</th>
<th>Year 2</th>
<th>Year 3</th>
<th>Year 4</th>
<th>Year 5</th>
<th>Year 6</th>
<th>Year 7</th>
<th>Year 8</th>
<th>Year 9</th>
<th>Year 10</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Drawn Cash</td>
<td>$ (5)</td>
<td>$ (25)</td>
<td>$ (35)</td>
<td>$ (30)</td>
<td>$ (5)</td>
<td>$ 45</td>
<td>$ 60</td>
<td>$ 50</td>
<td>$ 5</td>
<td>$ 250</td>
</tr>
<tr>
<td>Cash Returned</td>
<td>-</td>
<td>-</td>
<td>$ 10</td>
<td>$ 25</td>
<td>$ 35</td>
<td>$ 45</td>
<td>$ 60</td>
<td>$ 50</td>
<td>$ 20</td>
<td>$ 5</td>
</tr>
<tr>
<td>Net Cash Flow</td>
<td>$ (5)</td>
<td>$ (25)</td>
<td>$ (25)</td>
<td>$ (5)</td>
<td>$ 30</td>
<td>$ 45</td>
<td>$ 60</td>
<td>$ 50</td>
<td>$ 20</td>
<td>$ 150</td>
</tr>
</tbody>
</table>

- Capital is drawn as needed during years 1 through 5
- Capital is returned as investments are realized (typically years 3 through 10)
- In this example, 100% of committed capital is drawn (not always the case)
- Due to “netting” of cash flows, investor is only out-of-pocket $60 in year 4

*This graph is provided for illustrative purposes only and does not necessarily reflect the future results of any specific private equity fund or fund of funds. Private equity funds are long term investments and, although they seek to appreciate in value, there is no guarantee that investors will recover all or a part of their capital contributions or that the investment will follow this pattern of returns. The results of the Fund may differ materially from the results shown in the graph above.*
Historical Valuation of Private Companies

- Underlying investments are illiquid, so valuations are necessarily subjective
- Value of underlying investment is only certain when realized
- Interim valuations tend to be quite conservative (e.g., cost) and write-downs are not uncommon due to restructuring, growth and changes within an investment, especially in the early stages
- Investments generally are written up from cost upon the occurrence of a valuation event (e.g., a subsequent financing round or IPO)
- FAS 157 is rapidly changing the landscape
Fees and Carried Interest

• The annual management fee for a fund is roughly 2% to 2.5% of committed capital for venture funds, 1.5% to 2% for buyout funds

• “Carried interest” is the General Partner’s share of partnership profits (i.e., performance fees):
  – Most often set at 20% of capital gains, typically after committed capital is returned

• Most funds offer a preferred return (or a hurdle) of 5% to 10% per annum before the General Partner begins to receive carried interest
Successful private equity investment returns typically follow a “J curve” pattern.

What is the “J-Curve” in Private Equity?

Hypothetical Private Equity Return

Note: Chart does not reflect actual data. This graph is provided for illustrative purposes only and does not necessarily reflect the future results of any specific private equity fund, or fund of funds. Private equity funds are long-term investments and, although they seek to appreciate in value, there is no guarantee that investors will recover all or a part of their capital contributions or that the investment will follow this pattern of returns. The results of a private equity investment may differ materially from the results shown in the graph above.
What are the Risks in Private Equity Investing?

- Not diversifying across all segments of the market
- Not diversifying over time
- Investing in immature markets
- Not being in a position to accept inherent illiquidity of the investment
- Greatest risk is choice of fund given wide dispersion between the bottom and top quartile returns
Private Equity Conclusions

- Private equity has the potential to enhance returns and provide diversification for long-term equity investors.

- Benefits of private equity investing are realized over the long term, so investors should be patient.

- Care in the choice of individual funds is vital as top performers significantly outperform the median.

- It is crucial to build a diversified portfolio when investing in private equity.

- A long-term strategic commitment is key as private equity cannot be easily timed:
  - Keeps true to strategic commitment through the cycle
  - Leaves specific timing decision to General Partners.
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Market Overview
Historical Commitments to Private Equity

U.S. and European Commitments to Private Equity 1990 to 2008

Source: Venture Economics VentureXpert US and Europe Commitments Per Fund Raising (by year) All Private Equity as of December 31, 2008.

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Leveraged Loan Spreads Volatile Amidst Credit Crisis

Average Secondary Spreads by Rating
Source: Standard and Poor’s LCD and S&P/LSTA Leveraged Loan Index
Excludes all loans trading at 70% of par or less and facilities in default
1997 - 8/21/09

Assumes discount from par is amortized evenly over a three-year life.

Source: Standard & Poor’s LCD. Data as of 21 August 2009.
Leveraged Loan Secondary Prices Plummet; Distressed Players Line-Up

Average Bid and Ask
Source: Standard and Poor’s LCD and S&P/LSTA Leveraged Loan Index
Selected Large Institutional Flow Loans

Source: Standard and Poor’s LCD. As of 21 August 2009.
Covenant-Lite Transactions Evaporate

Covenant-Lite Transaction Volume

Source: S&P (PMDZone). As of 30 June 2009

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Credit Market Correction Forces Down PE Leverage Multiples...

Average Total Debt/EBITDA for US and European Transactions

Source: S&P (PMDZone). As of 30 June 2009. Average Debt Multiples of Large Corporate LBO Loans for US (Defined as issuers with EBITDA of more than $50M). US data as of 30 June 2009 is not available due to small sample size.
...And Leveraged Loan Volume

Global New-Issue Leveraged Loan Volume

Source: S&P (PMDZone). As of 30 June 2009
LBO Valuations Starting to Moderate

**US LBO: EV/EBITDA Multiples Paid**

**EU LBO: EV/EBITDA Multiples Paid**

Source: Standard and Poors (PMDzone). Data as of 30 June 2009. US data as of 30 June 2009 is not available due to small sample size.
M&A and LBO Activity Has Followed Suit

Data as of 30 June 2009.
Default Rates Reaching Record Levels

Source: Standard and Poors (PMD Zone) as of 30 June 2009.
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Fund of Funds Market Overview
Historical Commitments to Private Equity Fund of Funds

Total Raised by Fund of Funds

Total Raised by the Five Largest Fund of Funds

Source: Private Equity Analyst
## Key Fund of Funds Competitors

### Global Fund of Funds Managers by AUM

<table>
<thead>
<tr>
<th>Rank</th>
<th>Management Firm</th>
<th>AUM ($ Mil)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Goldman Sachs Asset Management</td>
<td>31,000</td>
</tr>
<tr>
<td>2</td>
<td>Credit Suisse Customized Funds</td>
<td>24,000</td>
</tr>
<tr>
<td>3</td>
<td>Pathway Capital</td>
<td>22,500</td>
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<td>4</td>
<td>Partners Group</td>
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<td>HarbourVest Partners</td>
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<td>7</td>
<td>Pantheon Ventures</td>
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<td>8</td>
<td>Adams Street Partners</td>
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<td>JP Morgan Investment</td>
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<td>12</td>
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<td>AIG Global</td>
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<td>14</td>
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<td>15</td>
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<tr>
<td>19</td>
<td>BlackRock Alternative Advisors (PEP)</td>
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</tbody>
</table>

### US-based Fund of Funds Managers by AUM

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<tr>
<td>12</td>
<td>Morgan Stanley Alternatives</td>
<td>7,500</td>
</tr>
<tr>
<td>13</td>
<td>BlackRock Alternative Advisors (PEP)</td>
<td>6,100</td>
</tr>
</tbody>
</table>

### Total Universe

<table>
<thead>
<tr>
<th></th>
<th>Global</th>
<th>US-based</th>
</tr>
</thead>
<tbody>
<tr>
<td># of managers</td>
<td>107</td>
<td>77</td>
</tr>
<tr>
<td>Total AUM (mil)</td>
<td>$424,969</td>
<td>$282,272</td>
</tr>
</tbody>
</table>

Of the top 18 managers, only 3 started on/after 1999, making BlackRock PEP a recent entrant to the marketplace.

Source: Private Equity Insider, 20 May 2009. Operators of Private Equity Fund of Funds
Key Fund of Funds Market Trends

**Strategic Partnerships**

- Large plans (or UHNW family offices) recently entering or greatly expanding exposure to PE
- Targets have staffing limitations
  - Need to outsource some discretionary management
  - Seek advice on overall PE program
  - May wish to develop in-house expertise
- Choose to partner with a firm willing to provide training, transparency and access to broader resources of the firm
Key Fund of Funds Market Trends

Specialization

- Sophisticated private equity investors with core private equity portfolios already built-out
  - Targets may do core investing in-house or else have entrenched third party providers
- Seek discretionary managers for hard-to-access/analyze specialty private equity areas, e.g.
  - Venture capital
  - Small-market buyouts
  - Direct co-investments
  - Secondaries
Private Equity Performance Across Market Cycles:

- Is The Party Over?
Economic Dislocations Benefit Private Equity, But...

US Buyout
First Quartile (25th Percentile) Vintage Year Returns

...Primarily in the Top Quartile

US Buyout
Vintage Year Returns: Net IRR Differential
Top Quartile (25\textsuperscript{th} Percentile) vs. Bottom Quartile (75\textsuperscript{th} Percentile)

Commitments to PE Follow the Public Market, But…

S&P 500 Index Value vs. Annual Private Equity Commitments Raised (US Buyouts)

- Black Monday
- Recession
- Vintage Year
  - Asian & Russian Financial Crisis
  - Dotcom Burst
  - 9/11
- Credit Bubble

S&P 500 Index Value annual year-end index value from 1984-2006 sourced from Bloomberg.

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...Returns and Commitments Are Not Correlated (US)

US Buyout
First Quartile (25th Percentile) Vintage Year Returns vs.
Annual Buyout Funds Raised

Our Response to Current Market Conditions

• While the market is correcting, there is more to come
  – Prices are still high
  – Leverage is difficult to find
  – Default rates—after an extended period below historical levels—are rising quickly
    • Helped by “covenant-lite” structures
    • Distress will come when borrowers default on Interest and/or when refinancing comes due in 2013-2014

• Things will likely get worse before they get better
Private Equity Conclusions

• As always, take a diversified, long-term approach to private equity investing
  – Diversifying by region, investment focus, vintage year, industry and manager helps to mitigate market risk
  – Be positioned to sell into hot markets and buy into markets currently out-of-favor

• Invest with quality PE firms that demonstrate buying discipline
  – In volatile periods, top-performers significantly outperform

• While we don’t “time the market” history suggests we are entering a prime buying opportunity
  – Falling asset prices
Outlook For Future Private Equity Returns

• Private Equity returns will still outperform public markets

• Private Equity industry returns will come down
  – Magnitude will vary across segments
  – Capital calls will slow
  – Distributions become a trickle
  – Holding periods increase

• Gap between top performers vs. average performers vs. poor performers will widen
Outlook For Future Private Equity Returns

- FAS 157 will introduce additional volatility into Private Equity returns in the US
- Average premium over public markets will narrow
  - But could vary by segment
- Conclusion:
  - Private Equity is still an attractive option compared to broader financial markets
  - It is still important today to be with people who have the experience and proven track record

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