Private Equity Education Series
Part 2: Investing in *Private Equity*

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UBS Financial Services Inc. (UBS FS) is pleased to provide you with information about alternative investments. There are a few points we would like to raise with you at the outset.

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Having discussed the fundamentals of private equity in the first part of the series, this installment highlights some advantages of investing in private equity, as well as some of the risks involved.

The fundamental reason for investing in private equity is to improve the risk and reward characteristics of an investment portfolio. Studies have shown that private equity returns do not correlate closely with returns from other asset classes, such as bonds and in certain cases public equities. Having an allocation to private equity therefore may help smooth out the returns of a balanced portfolio as well as provide additional sources of returns.

Why invest in private equity?

Source of long-term returns – If one considers available historical statistics, it becomes clear that the advantages of private equity investments must be viewed over the long term. Figures 1 and 2 show the average returns of private equity as an asset class. There is significant dispersion in these numbers between top quartile performing managers and the average for the asset class.

As illustrated in Figure 1, at the end of 2007, (before the distortions induced by the financial crisis) the average long-term return was around 10.7% over a 10-year period.

During 2008, as was the case with almost all other assets, valuations of unlisted businesses plunged, and distributions to investors came to a near standstill. After the crisis ebbed, valuations began returning to more normal levels as reflected in figure 2. The positive 1-year returns in Figure 2 reflect a swift bounce-back in valuations in 2009 vs. 2008.

Figure 1: Internal Rate of Return (IRR) % (Annualized)
Performance through December 31, 2007

Calculation Type : Pooled IRR	Primary Market				
Fund Type	**1 Yr**	**3 Yr**	**5 Yr**	**10 Yr**	**20 Yr**
All Venture	19.9	9.7	8.7	18.1	16.7
Small Buyouts	21.1	8	8.8	5.3	12.4
Med Buyouts	29.4	13.9	12.7	9.6	12.3
Large Buyouts	20.2	11.4	15.5	7.8	12.6
Mega Buyouts	13.5	13.8	16.2	8.8	12
All Buyouts	14.9	13.2	15.4	8.5	12.2
Mezzanine	7.3	5.2	5.3	5.7	8.2
Buyouts and Other PE	17.9	13.9	15.3	8.9	12
All Private Equity	18.4	12.7	13.4	10.7	13.7

Source: Thomson Venture Economics
PE = Private Equity

Figure 2: Internal Rate of Return (IRR) % (Annualized)
Performance through March 31, 2010

Calculation Type : Pooled IRR	Primary Market :				
Fund Type	**1 Yr**	**3 Yr**	**5 Yr**	**10 Yr**	**20 Yr**
All Venture	11.5	0.5	4.6	-1.5	17.8
Small Buyouts	0	0.5	4.4	3.3	11.8
Med Buyouts	12.8	3.7	8.1	2.7	10.9
Large Buyouts	16	2.6	6.9	3.9	10.5
Mega Buyouts	20	-1.3	4.9	4.2	7.8
All Buyouts	19.4	-0.5	5.4	4	9
Mezzanine	4	0.8	2.7	2.3	6.7
Buyouts and Other PE	24	0.7	6.2	4.7	8.9
All Private Equity	21.9	0.6	5.8	2.8	11.3

Source: Thomson Venture Economics

The Private Equity Performance Index is based on statistics from Thomson Venture Economics' Private Equity Performance Database, analyzing the cash flows and returns for over 1,750 US venture capital and private equity partnerships with a capitalization of $585 billion. Sources are financial documents and schedules from Limited Partners investors and General Partners. All returns are calculated by Thomson Venture Economics from the underlying financial cash flows. Returns are net to investors after management fees and carried interest. Buyout funds sizes are defined as the following: Small: $0 - $250 million, Medium: $250 - $500 million, Large: $500 - $1,000 million, Mega: $1 billion and over.

Past performance does not guarantee future results.

Access to selected opportunities in low macro-economic growth environments – In an environment in which growth in developed economies is expected to fall short of what we have seen in recent decades, seeking growth opportunities will be paramount. Successful private equity managers pick companies with growth potential and actively create the conditions for growth. In some cases, private equity funds own large controlling stakes in companies, with few (except for syndicated deals) other private equity managers having access to the same companies. This contrasts with mutual funds, which often hold largely the same underlying investments as their peer group, with variations in weightings being fine-tuned to a few basis points.

Potential to create absolute returns – Private equity is oriented toward generating absolute investment returns rather than beating a benchmark index. Excessive volatility and poor investment performance experienced by quoted equity portfolios, many of which have index-tracking strategies or are benchmarked to an index, have led to a swing in favor of strategies that seek absolute returns. Private equity managers do seek absolute returns and their traditional incentive structure, the "carried interest" (described in Part 1 of this series), is highly geared toward achieving net cash returns for investors.

Improved risk and volatility characteristics – Within a balanced portfolio, the introduction of private equity can improve diversification. Lower correlation of returns among some sub-sectors of private equity and public market classes remain an important feature of the asset class, and properly constructed portfolios therefore have the potential to reduce overall volatility.

Exposure to the smaller companies market – The private equity industry has brought corporate governance to smaller companies and provides an attractive manner of gaining exposure to the small and mid-market growth sectors. It also offers the ability to gain investment exposure to the most entrepreneurial sectors of the economy.

Has influence over management and flexibility of implementation – Private equity managers generally seek active participation in a company's strategic direction, from the development of a business plan to selection of senior executives, the introduction of potential customers, M&A strategy and the identification of eventual acquirers of the business. Furthermore, implementation of the desired

strategy can normally be effected much more efficiently in the absence of public market scrutiny and regulation.

Allows off balance sheet leverage – Leveraged buyout fund managers (described in Part 3 of this series) in particular are able to make efficient use of leverage. They aim to organize each portfolio company's funding in the most efficient way, making full use of different borrowing options from senior secured debt, to mezzanine capital and high-yield debt. By organizing the company's funding requirements efficiently, equity returns are potentially enhanced. In addition, because the leverage is organized at the company level and not the fund level, there is a ring-fencing benefit: if one portfolio company fails to repay its borrowing, the rest of the portfolio is not contaminated as a result. Thus the investor has the effective benefit of a leveraged portfolio with less downside risk.

Figure 3: Advantages and risks of private equity

Advantages	Risks
Source of long-term returns	Long-term illiquid investments
Access to growth opportunities	Uncertain cash flows
Potential for absolute reuturns	"Blind pool" investing
Improved portfolio risk/return characteristics	Valuation risk
Exposure to smaller company market	Speculative investments
Influence over management and flexibility of strategy implementation	
Possibility of off-balance sheet leverage	

Source: UBS Alternative Investments

What are some risks in private equity investing?

Private equity investing is not without risks, however. There are features of private equity investing that investors need to be aware of:

Long-term illiquid investment – Interests in private equity funds are generally not readily marketable and not redeemable. Interests are generally not transferable except in limited circumstances. Accordingly, investors have to bear the risks of investing in funds for their full duration. In general, holding periods between investment and realization can be expected to average three or more years. Because the underlying portfolio assets are less liquid, the structure of private equity funds is normally a closed-end structure, meaning that the investor has very limited or no ability to withdraw its investment during the fund's life. Private equity should therefore be viewed as a longer-term investment strategy even though there is a growing secondary market for investors seeking liquidity. In a certain sense, the illiquidity of private equity investments is one of the sources of return for investors. Private equity investors in effect expect to earn a liquidity premium for the investing commitments that they make.

Uncertain cash flows – An important feature related to illiquidity is the uncertainty surrounding the cash flows of private equity investments. The unpredictability of cash flows applies to both capital calls, which the investor must fulfil at earlier stages, and distributions to the investor at later stages. In both cases the amount and timing of cash flows is at the discretion of the fund manager. Investors needing cash flow predictability for cash flow management purposes must rely on other portions of their investment portfolio for such considerations. Hence, the importance of carefully considering cash flow needs in portfolios.

"Blind pool" investing – Investors do not know ex-ante what their funds will be invested in and rely on the skills and judgement of the private equity manager. Private equity fundraising is referred to as "commitments" because not all funding is made available immediately to the fund vehicle. Rather, funds are called up as projects covered by the private equity vehicle's mandate become available. When committing to a private equity fund, the commitment is typically to provide cash to the fund on short notice from the General Partner. While fund documentation will outline investment strategy and restrictions, investors give a very wide degree of discretion to managers to select the companies that they will have a share in. There is usually no

Growing Secondary Market

Private equity investments are generally considered illiquid. There are no popular exchanges, as there are for publicly traded securities, on which to buy and sell interests in private equity funds. However there is a rapidly developing market in interests in existing private equity funds, referred to as "secondaries". A secondary offering may comprise a single manager's entire fund of direct investments or, more commonly, a portfolio of interests in a number of different funds; there are a growing number of dedicated investors that specialize in purchasing interests in existing funds from their original investors. Managers of secondary funds do not generally invest directly in companies, but rather in the private equity funds managed by buyout firms or venture capital firms. The big difference is that they are buying their interests in a fund after the fund has been at least partially deployed in underlying portfolio companies. So, unlike fund of fund managers, which generally invest in blind pools, secondary buyers can evaluate the underlying companies that they are indirectly investing in.

For larger secondary portfolios, a buyer is commonly secured through an auction process. For smaller transactions, these are often affected in a confidential manner, sometimes with buyer and seller matched by the fund's manager or by an intermediary. One of the keys to a secondary transaction is securing the goodwill of the underlying General Partner. The fund manager often has the ability to refuse or restrict any transfer of interest. In addition, valuation of the underlying assets is facilitated by the co-operation of the manager.

The secondary market remains a relatively small part of the private equity world – 3% to 5% of the primary market. As institutional private equity programs increase and start to reach maturity, the ability for investors to realize some existing commitments in order to raise cash for future commitments will become more attractive. This will be an important factor that accelerates the development of the secondary market going forward.

Secondaries are important to private equity investing because it allows investors to maintain the positive attributes of private equity investing while mitigating certain risks, such as investing in a blind pool of investments made by new managers. From a portfolio management perspective, exposure to Secondaries can reduce the length and severity of a portfolio's "J-curve" (described in Part 4 of the series). Additionally, the private equity market's illiquidity, combined with the liquidity needs of some sellers, often allows for a price discount from the fair market value of the fund. Buying into a private equity fund at a later stage in its life also results in earlier liquidity by shortening the holding period and the waiting period for distributions.

ability at the launch of a private equity fund to preview portfolio assets before committing, because they have not yet been identified (except in a few cases where potential investments have been warehoused). Also, there is generally no ability to be excused from a particular portfolio investment after the fund is established.

Valuation risk – As private equity funds generally will invest in securities that are not readily marketable, securities generally will be carried at the values provided to the fund or at cost. These valuation procedures are subjective in nature and do not conform to any particular industry standard (though they do take guidance from widely accepted practices) and may not reflect actual values at which investments are ultimately realized.

Speculative investments – The investment strategies utilized by managers may include speculative investment techniques, highly concentrated portfolios, non-control positions and illiquid investments. Moreover, in the case of specific strategies such as buyouts, significant amounts of leverage can be involved, which can improve returns in good times but amplify losses under adverse conditions. Because of the specialized nature of these investments, an investment in a private equity fund should be considered within a total portfolio context.

Alternative Investment Funds Risk Disclosure
Interests of Alternative Investment Funds (the "Funds") are sold only to qualified investors, and only by means of offering documents that include information about the risks, performance and expenses of the Funds, and which Clients are urged to read carefully before subscribing and retain. This communication is confidential, is intended solely for the information of the person to whom it has been delivered, and should not be reproduced or otherwise distributed, in whole or in part, to third parties. This is not an offer to sell any interests of any Fund, and is not a solicitation of an offer to purchase them. An investment in a Fund is speculative and involves significant risks. The Funds are not mutual funds and are not subject to the same regulatory requirements as mutual funds. The Funds' performance may be volatile, and investors may lose all or a substantial amount of their investment in a Fund. The Funds may engage in leveraging and other speculative investment practices that may increase the risk of investment loss. Interests of the Funds typically will be illiquid and subject to restrictions on transfer. The Funds may not be required to provide periodic pricing or valuation information to investors. Fund investment programs generally involve complex tax strategies and there may be delays in distributing tax information to investors. The Funds are subject to high fees, including management fees and other fees and expenses, all of which will reduce profits. The Funds may fluctuate in value. An investment in the Funds is long-term, there is generally no secondary market for the interests of the Fund, and none is expected to develop. Interests in the Funds are not deposits or obligations of, or guaranteed or endorsed by, any bank or other insured depository institution, and are not federally insured by the Federal Deposit Insurance Corporation, the Federal Reserve Board, or any other governmental agency. Prospective investors should understand these risks and have the financial ability and willingness to accept them for an extended period of time before making an investment in a Fund. Investors should consider a Fund as a supplement to an overall investment program.

Private Equity
In addition to the risks associated with alternatives investments [and hedge funds generally], there are risks specifically associated with investing in private equity. Capital calls will be made on short notice, and the failure to meet capital calls can result in significant adverse consequences, including but not limited to a total loss of investment.

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