

Investment Management **Why Private Equity?**

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For many years, a number of larger institutions and wealthy families have invested in private equity. Today it is a relatively standard investment for medium and large institutional portfolios. In addition, the average percentage allocation to private equity has increased significantly. **What has caused the significant growth in capital committed to private equity?**

The obvious answer is performance. Over the last twenty years institutions with private equity investments generated superior returns versus their counterparts without exposure to the asset class. The following discussion will not only help you understand how private equity managers generate excess returns but also how investors effectively access the asset class.

First of all, what is private equity? In simple terms, private equity represents ownership in a company that is not publicly traded. Private equity investors seek to profit by taking an active role in building or restructuring the company, and then exiting the investment through a “liquidity event” such as a public stock offering or a sale to a strategic buyer. There is a more detailed description of the various underlying sectors (Buyout, Venture, Mezzanine and Distressed) within the private equity universe attached as Exhibit I.

By investing in private equity one should reasonably expect to earn a higher return than on publicly traded securities as compensation for giving up liquidity. More importantly, private equity investors have two advantages that should provide them with an edge over their public counterparts. First, public investors are hard pressed to gain an information advantage over their competitors because disclosure requirements make information on public companies readily accessible to every investor. In contrast, leading private equity firms have what is known as “proprietary deal flow,” which means that they are often afforded an exclusive look at comprehensive information on a potential investment.

Second, public investors have little influence on the companies they own; they are passive shareholders. On the other hand, private equity investors often take an active role in their investments by serving as board mem-

bers, advisors to the company, or in some circumstances, as interim CEO's. They are actively involved in recruiting management, in determining the company's business strategy, in merger and acquisition decisions, and in determining the optimal form and timing of their exit. The bottom line is that skilled private equity investors have the opportunity to add significant value through their hands-on approach. This should lead to superior and potentially outsized returns, although this obviously does not happen for all managers.

Within the private equity world, the return difference between a top and bottom tier manager is staggering. Private equity funds are measured against their peers according to their vintage year which is the year that the fund first draws capital from its investors. Thomson Financial reports that through December 31, 2006, top quartile private equity managers with funds in vintage years from 1990 to 2004 outperformed their respective bottom quartile managers by between 9.3% (vintage year 2002) and 37.8% (vintage year 1996) compounded annually. Over this period, investors experienced vastly different outcomes investing in the same asset class. More than any other asset class, the level of investment success for private equity investors is determined by hiring the right managers.

Executing a Strategy

Given the expected return premiums, why doesn't everyone invest? Primarily because it takes access, significant assets and the requisite skills to construct a quality, diversified private equity portfolio.

Manager Access

Top private equity managers are able to choose the investors they want in their funds, thereby making private equity investing a relationship business. Our relationship with Bill Spitz has provided access to a wide network of successful managers and institutional investors like Vanderbilt, Princeton, Duke, and Yale Universities. This network has been built over his 20+ years of successful private equity investing. As a result, DTC Private Equity,

L.P., and DTC Private Equity II, L.P. have established relationships with a diverse group of private equity funds with long-term, credible track records. To illustrate, some of the highly successful investments by a few of our managers are included in Exhibit II.

Portfolio Management

While having access to quality managers is a necessity, other hurdles must also be overcome to successfully implement a strategy. First, leading private equity firms typically have minimum investment requirements of \$5 million or more, thus requiring a large amount of capital to structure a diversified private equity portfolio. Second, private equity partnerships are illiquid and generally require a time commitment of ten to twelve years. Third, private equity funds are administratively complex requiring most taxable investors to file income tax extensions because information is generally not available on a timely basis. Fourth, private equity returns have historically been cyclical, which leads to an important question of when is the right time to invest?

Finally, extensive due diligence is required to properly select each manager. Historical performance alone has proven to be a dangerous basis for making investment decisions in private equity. It is important to look behind the published numbers and ask hard questions. Have all investments which are obviously going nowhere been written off? Has a small additional investment been used to determine fair market value? Are returns shown net of all fees (which may be significant)? Have the players changed materially? Did one significant winner make up for a number of bad investments? The list can go on and on.

We also critically evaluate a firm's structure to determine whether the people actually doing the work have the proper incentives, experience and drive to be successful. We look carefully for what is referred to as "style drift," and we tend to avoid those firms that we perceive are not true to their discipline. We prefer investing with managers who are focused in only one area of private equity rather than "generalists" who tend to spread their investments among several sectors. The skill set needed by an early stage venture capital manager is typically very different than that needed for someone in late stage venture capital or buyouts.

Going Forward

In our opinion investing directly in several private companies through a local broker or placement agent does not equate to having a private equity strategy. In our experience, the vast majority of direct investments in private companies offered to individuals and small institutions result from an inability to raise capital from professional private equity managers. By comparison, we are aligned with investors who have consistently produced top returns as a result of their allocation to alternative investments. In two separate studies published this year by NACUBO and Commonfund, endowments with assets greater than \$1.0 billion produced greater returns than those endowments with less than \$1.0 billion in assets for the trailing one, three, five and ten-year annualized periods. According to both studies, large endowments achieved these results by investing more heavily in alternative assets, including a roughly 10% allocation to private equity. In addition to having a higher allocation, top endowments maintain relationships with top private equity managers.

If you were not already familiar with private equity investing, we hope this letter has introduced you to it from an institutional viewpoint. With DTC Private Equity, L.P., we have been careful to maintain what we consider a prudent level of diversification across vintage years, sectors, and geography. We have also improved our opportunity for outsized returns by investing with some of the top investors in private equity. Given both the commitment to and overall success from private equity investing by the most sophisticated investment pools in the country, we will continue to advocate a private equity allocation for most whom we advise.

DIVERSIFIED TRUST COMPANY

Exhibit I

- *Venture Capital* – This category is focused on making investments to start or expand private companies. It generally includes three stages: 1) early stage (where investors take equity positions in start-up to early stage companies), 2) expansion stage (investments in rapidly growing companies), and 3) late stage (where investors anticipate a short term sale or initial public offering).
- *Buyout* – Typically a combination of debt and equity is used to finance the purchase of a mature company or a division of a larger enterprise. In these transactions, leverage is employed to varying degrees depending on the company’s future growth prospects and perceived risk. This sector includes three sub-sets based on transaction size: Small Market is below \$250 million, Middle Market ranges between \$250 million and \$500 million and Large Market is above \$500 million.
- *Mezzanine Financing* – These investments include both debt and equity components. The debt portion is typically subordinated to senior debt but is above the equity layer (thus it is in the middle or “mezzanine.”). Because this debt is subordinated, it carries a higher interest rate than senior debt. The investor is also typically issued some form of equity in the company, such as warrants or preferred stock. Thus mezzanine investors receive both income and capital appreciation potential from their investment.
- *Distressed Securities* – In this sector, the corporate bonds of financially troubled companies are purchased at substantial discounts. As the financial health of the underlying company improves, these bonds can be repaid at improved values or converted to equity in the company.

Exhibit II

<i>Manager</i>	<i>Current Firm</i>	<i>Previous Investments</i>
Pete Thomas	ATA Ventures	Altierre, SPANSLogic & Therasnos
Stephen Feinberg	Cerberus	Aozora Bank, Air Canada, Blue Linx & Mervyn’s
Joseph Rice	Clayton, Dubilier, & Rice	Hertz, Rexel & ServiceMaster
Mike Beaumont	Industrial Growth Partners	AmerCable, Total Automated Solutions & Weasler
Chris Flowers	J.C. Flowers	ConcordRE & HSH Nordbank
David Roux	Silver Lake Partners	Avago, Instinet, NASDAQ & SunGard
Chuck Esserman	TSG Consumer Partners	Vitamin Water, GFA Brands & Pureology