AUREUS
ASSET MANAGEMENT

One Winthrop Square
Boston, MA 02110

Aureus Asset Management, LLC
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Private equity investing; its attractions and challenges

Investors are now well aware of the publicity generated by private equity firms making very large acquisitions, and by the recent announcement of the Blackstone Group, a leader in this field, to sell shares publicly. Investors also realize that private equity investing has been very rewarding. However, because we at Aureus believe that current developments may well lead to a more challenging environment for private equity firms going forward, we think it timely to express our views on this matter.

I. What is private equity?

Private equity represents an ownership interest in an asset or company which is not traded on any public marketplace. The two most common forms of this industry are venture capital and leveraged buyout. Venture capital consists of a group of investors supplying seed money to a brand new company. Buyout firms take a publicly traded company private, by leveraging the capital structure through considerable debt. The common trait across all forms of private equity is that the partners eventually cash out of their investments through a sale to the public markets, or to another private or public company, or to another private equity investor. For the purposes of this paper, we will concentrate our attention on the buyout industry.

Private equity firms raise money through offerings normally restricted to institutions and wealthy families or individuals. Every three to four years, a private equity firm will offer another fund; the size of these offerings has expanded dramatically, to where firms now raise as much as $20 billion for a single fund, whereas a fund of more than $5 billion was unheard of five years ago.

Fees charged by private equity firms are generally much higher than those in the public markets. Typically, the private equity firm will demand a management fee on committed capital of around 1% per annum, but it also receives a 20% “carried interest” in every deal. To date, the profits generated by the 20% carried interest have been taxed as a capital gain at 15%, not as ordinary income at 35%. This has been a key reason for the amazing profits generated by private equity firms, which have produced several billionaires within the ranks of their partners. Private equity funds have typically little or no liquidity for a number of years. But these handicaps have been overcome by the fact that returns overall have been very attractive:

For periods ending 9/30/06
Total return (annually compounded rates)

Fund Type	3 Year	5 Year	10 Year
All venture capital	+9.4%	-1.0%	+20.5%
All buyout funds	+15.6	+9.2	+8.8
S&P 500	+9.9	+5.2	+7.5

With the exception of venture capital over the past five years, every major category of private equity has matched or substantially outperformed the major US equity averages in virtually all time periods over the past 10-20 years.

However, the differences between top and bottom quartile firms in private equity are vast, both in absolute and relative terms. For example, the top quartile venture capital firms registered a rate of return 15 times that of the bottom quartile; for buyout firms, the equivalent difference was 10 times. Compare that to the publicly traded equity markets, where differences between top and bottom firms are generally around 5 times or less. While this investment class may appear very attractive, it's only been truly rewarding for those investors with access to some of the best firms.

Major reasons for the recent success of buyout firms have been access to cheap capital as interest rates have plunged, reaction to the poor stock markets of 2000-2002, and healthy corporate balance sheets both in the US and around the globe which encouraged use of debt. Both institutional and high net worth investors have flocked to this market, investing over $130 billion in private equity in 2006 alone.

II. What does the future hold for private equity?

One of the largest and most successful firms in private equity buyouts, Blackstone, has filed an offering to sell about 10% of the firm to the public. Blackstone will structure its deal as a master limited partnership, allowing the shareholders a participation in the management company's profits while not permitting them any stake in their private deals, thereby skirting securities law restrictions.

Blackstone's past success has been remarkable. Its core private equity business has grown at a rate of 22.8% compounded since 1987. The firm is also very efficient, as the deal assumes a value of about $40 billion for the company, almost exactly that of Lehman Brothers, but Blackstone has 770 employees vs. 27,000 for Lehman.

When firms such as Blackstone go public, after stating many times that that the public markets are less attractive and less flexible than being private, it's time to take notice. This offering, to us, implies that future returns from buyout firms almost certainly will not be able to match the heady numbers of the past, because:

1) There is an enormous flood of money going into private equity which may take several years to be profitably employed
2) The price premium to take a company private, which already has increased in the last few years, will continue to rise
3) Firms will relax their formerly high standards, by entering into deals either in industries which would not have attracted any such attention a few years ago (such as high fashion or high tech) or in such size that inevitably raises questions of major risk
4) Congressional scrutiny of the capital gains tax break will increase
5) Greater attention will now be paid to the inherent conflicts of interest between the managers of companies and the public shareholders, when companies are taken private.

However, there are still reasons why this industry will attract capital. For example, to avoid the expenses and reporting requirements of Sarbanes-Oxley, managements of public companies are tempted to return to the private markets. In addition, opportunities to do private equity deals in Europe and Asia are expanding rapidly, thereby making this a truly global industry and expanding the industry's opportunities.

III. Conclusion

Private equity will remain a major force. Yet investors must recognize that rates of return in the future should reflect the factors listed above, rather than mirroring the superior results of the past. Also, investors should remember the wide differences in return between top and bottom tier firms.

The best days of this industry may be behind us. Investors should not reject this asset class, in our opinion, but should insist on increasingly stringent standards.