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Navigating a new direction for maximum portfolio performance

2009 Managing Portfolio Investments Survey

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RSM McGladrey and McGladrey Capital Markets would like to thank the nearly 100 private equity senior executives and professionals nationwide who provided their information and insight for our March 2009 survey. The participants shared current concerns and business practices related to the management of their portfolio companies.

The research in this report reveals a range of business practices and trends among survey participants involved in a cross section of fund sizes and types.

Faced with a difficult economy and an anemic dealmaking environment, survey respondents have shifted their focus from acquiring new platform portfolio companies to managing the performance of existing investments. Information collected provides strong evidence of active monitoring and involvement with portfolio companies. Eighty-five percent of funds participating in the survey report that communication with portfolio companies has increased in the past six months—and as many are in contact with their portfolio companies on a weekly and daily basis.

The report provides an inside look at the key areas and priorities private equity executives are focused on to maximize portfolio performance. Consider the following:

- Acquiring new customers, expanding existing customers and enhancing existing products and services are the top three portfolio company growth initiatives in 2009.
- Add-on acquisitions are the most frequent management activity being considered in today's environment. Workforce reductions, working-capital management and salary freezes are the top three activities already implemented in response to the current economy.
- More than half of the respondents identified corporate strategy as the area they will focus on most to increase portfolio company performance and value.

These and other findings provide insight into how your peers are managing their portfolio investments and may serve as a way for you to examine new ideas for your own business practices.

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Executive summary

The 2009 Managing Portfolio Investments survey report provides research collected from nearly 100 private equity senior executives and professionals.

With private equity executives turning their attention to the management of their existing portfolio investments, the survey reveals activities and initiatives survey respondents are focusing on to improve portfolio performance and profitability.

The following is an overview of key findings from the survey:

Areas of concern

Survey respondents ranked a weak economy, the ability to meet business forecasts, and the potential for defaults on loan covenants as their primary concerns for 2009. Anecdotal observations suggest financial institutions that lend to private equity firms share these concerns.

Key management activities

Almost nine out of ten (88 percent) survey respondents said they have implemented workforce reductions in response to the current economic environment, while another 10 percent are actively considering such actions.

Significant majorities are also focusing on working-capital management (83 percent), salary freezes (75 percent), business process improvements (71 percent) and reductions in capital spending (68 percent).

High priority growth initiatives

Acquiring new customers, expanding existing customers and enhancing existing products and services are the top three portfolio company growth initiatives in 2009. These top initiatives appear to be aimed at investments that are likely to bring the quickest return and require the least amount of capital.

Areas of focus to increase portfolio company performance

Respondents identified corporate strategy as the area where they will focus most on increasing portfolio company performance and value. This is followed by operations and cash management—not surprising given the current marketplace where top-line growth is extremely difficult.

Survey methodology

In March 2009, RSM McGladrey and McGladrey Capital Markets asked private equity executives across the U.S. for information related to the management of their portfolio companies. This survey report is intended to provide insights into the current state of managing portfolio companies owned by private equity groups. Respondents shared information on key concerns and growth initiatives, as well as deal sources, industry and geographic investment focus, and the impact of important tax matters and accounting issues.

A total of 99 surveys were completed, with respondents representing a cross-section of fund types, including buyout funds, mezzanine funds and venture funds. Fund sizes ranged from less than $100 million in assets to more than $3 billion

All private equity responses in the survey are weighted equally.

Portfolio management and monitoring

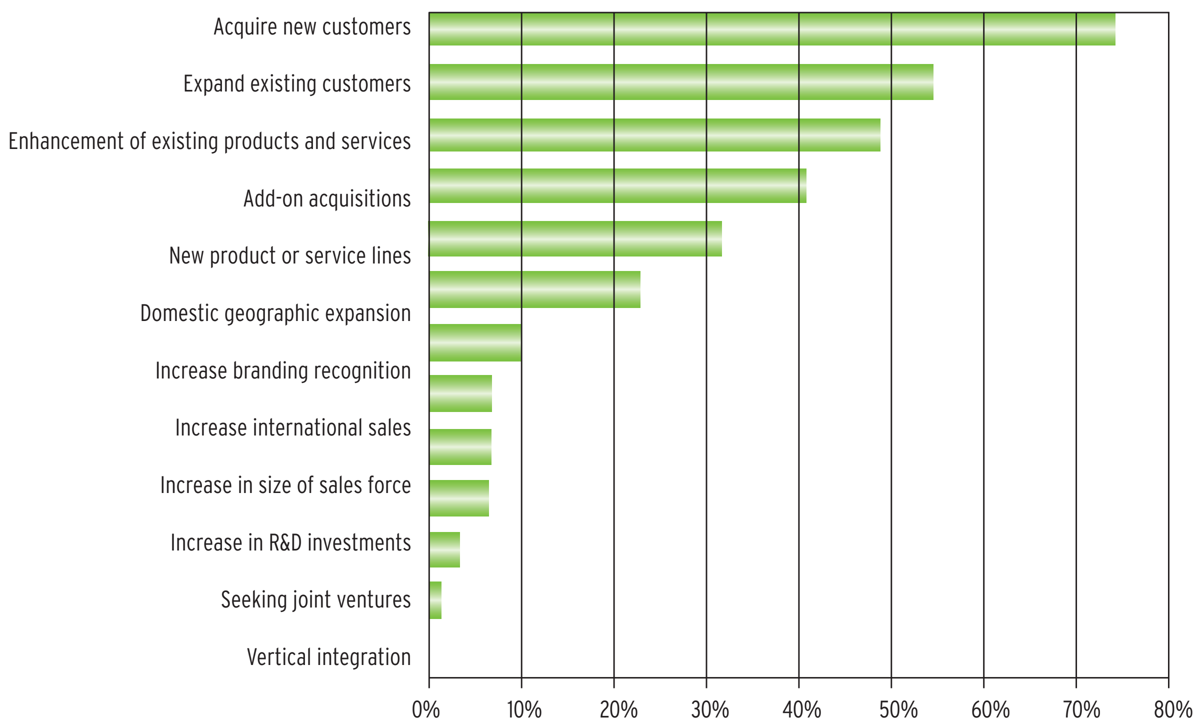
Indicate the top three growth initiatives for your portfolio companies in 2009

Acquiring new customers, **expanding existing customers** and **enhancing existing products and services** are the top three portfolio company growth initiatives in 2009. These top initiatives appear to be aimed at investments that are likely to bring the quickest return and require the least amount of capital. When implemented, these strategies should also bolster EBITDA results and enhance portfolio company value.

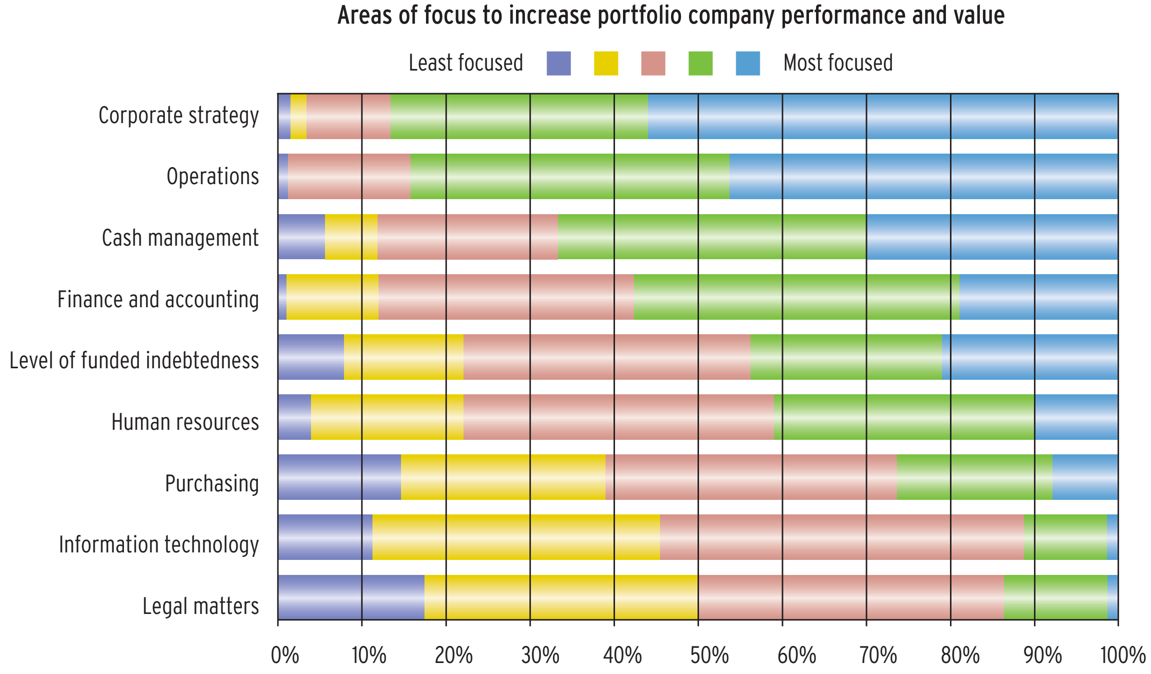
More than 40 percent of reporting funds indicate **add-on acquisitions** as a growth initiative—as highlighted by the large number of respondents mentioned later in the report who are considering add-on acquisitions as a key management activity in light of the current economic environment.

Survey findings indicate reporting funds are in cost-containment mode and are not currently looking to make large investments. However, with acquiring new customers as the top growth initiative, there is still an opportunity to expand customer base through smaller acquisitions.

Top growth initiatives in 2009



How closely will you focus on the following areas to increase portfolio company performance and value?



Respondents identified **corporate strategy** as the area where they will focus most on increasing portfolio company performance and value. This is followed by **operations** and **cash management**—which makes sense given the current marketplace where top-line growth is extremely difficult.

Survey findings indicate **information technology** is not a current focus area for driving portfolio company value and performance. This is not surprising given that—for reasons such as cash preservation and expense reduction—technology infrastructure spending for many companies has come to a near halt in the midst of the current economic crisis.

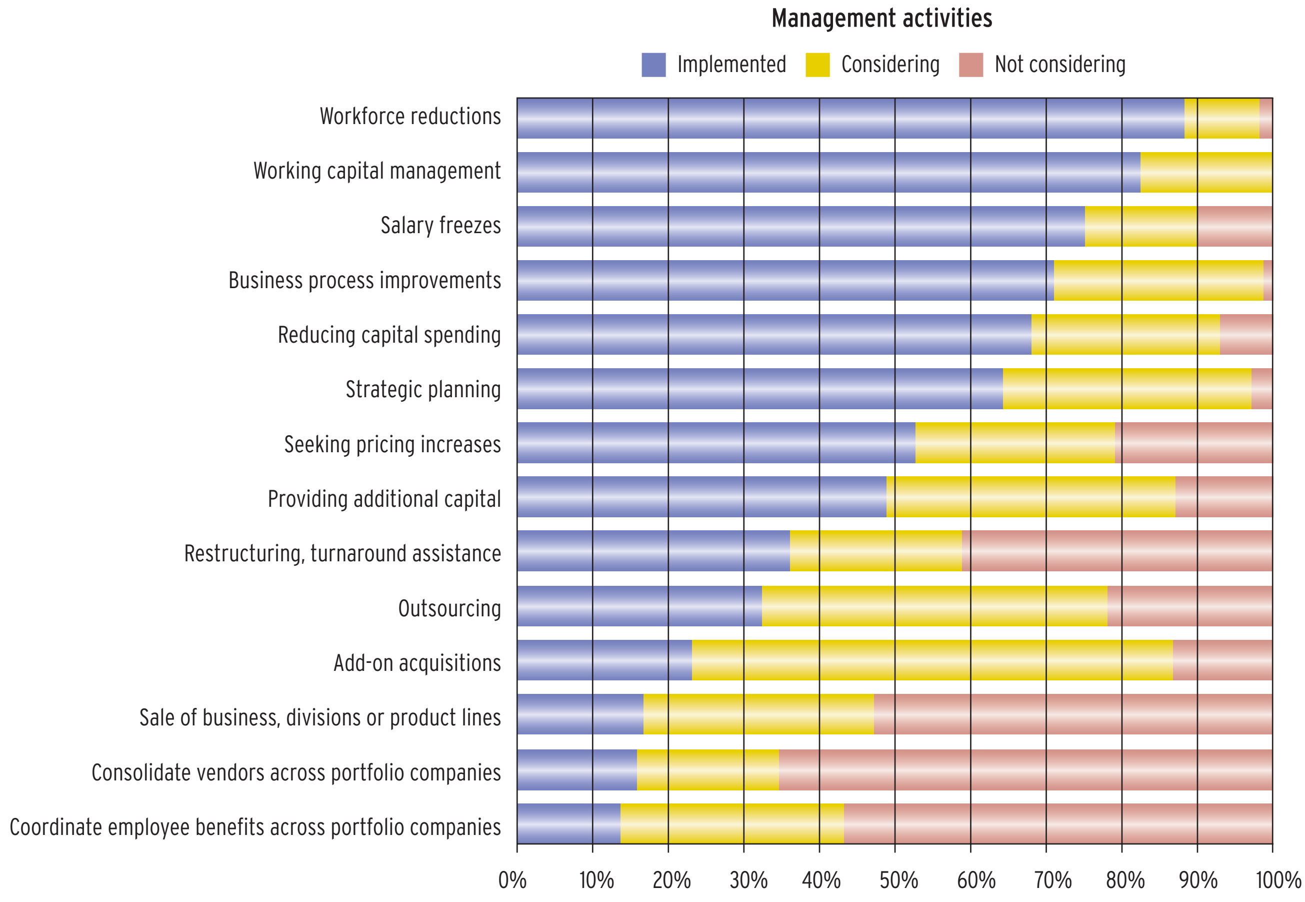
While deferring IT spending helps preserve cash in the short term, it could have long-term drawbacks:

- Possible loss of competitive position
- Potential for increased security breaches
- Diminished capacity to recover from disasters
- Pent-up demand for new technology may detract from other strategic initiatives

In light of the current economic environment, which activities have you considered implementing or have implemented at your individual portfolio companies?

In light of the current economy, more than 80 percent of respondents have already implemented **workforce reductions** and **working capital management improvements.** The next three most commonly implemented activities include **salary freezes, business process improvements and reduced capital spending**—with more than 68 percent of survey participants indicating that they already implemented these activities. Survey data indicates the responding funds have been very proactive in implementing initiatives to mitigate losses or improve cash flows in the economic slowdown.

Add-on acquisitions are the most frequent management activity being considered in today's environment, showing a shift from buying platform companies to making add-on acquisitions to an existing platform. In spite of the slowing economy, well priced add-on acquisitions provide an opportunity to increase sales while growing platform company value and market share.



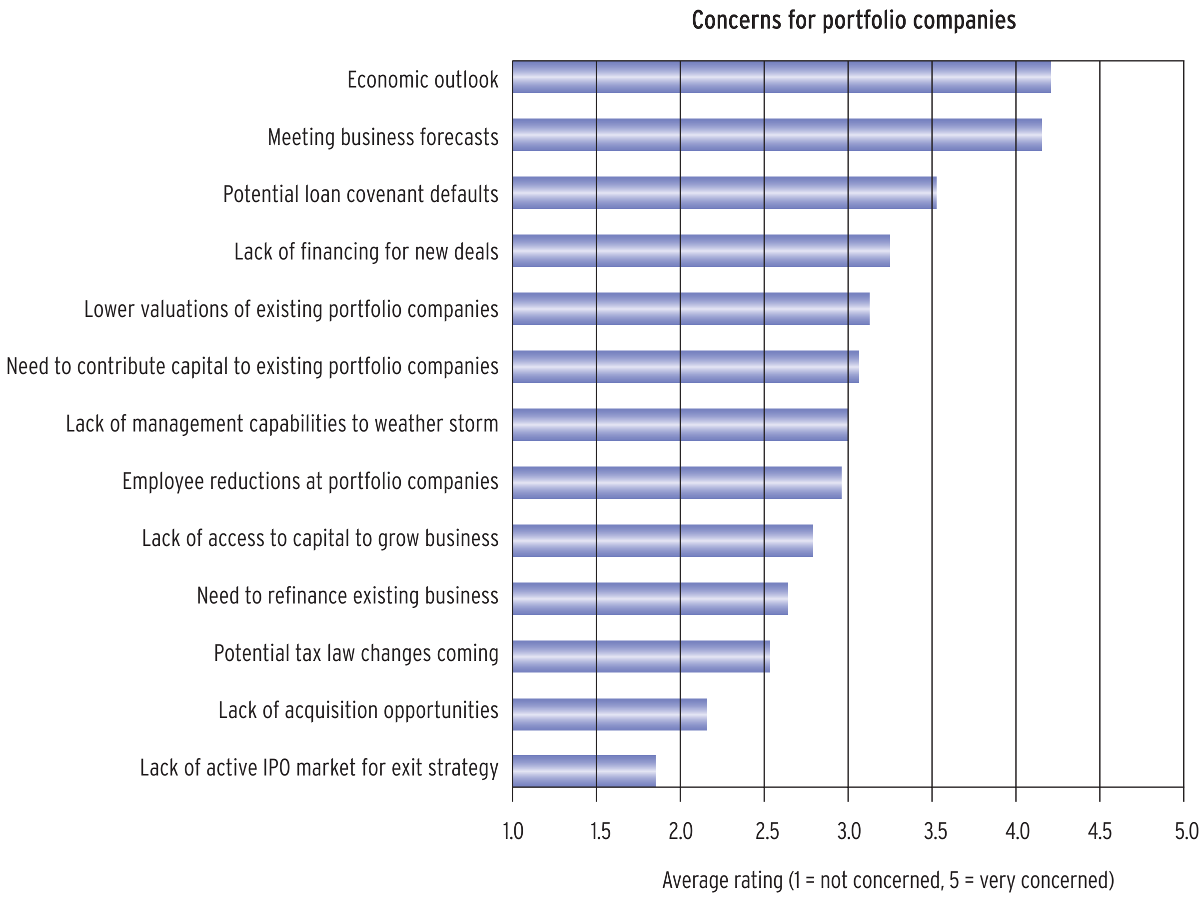
Larger reporting funds, defined in this report as funds with more than $500 million in assets, are more likely to be considering or are already providing additional capital, as well as implementing restructuring or turnaround assistance at some of their portfolio companies.

Fewer than 20 percent of respondents have sold portfolio company businesses, divisions or product lines and more than half have not even considered doing so—suggesting that not only are owner operators delaying selling businesses in this environment, but so are private equity firms. This means there will be a mountain of exits building because with most of the investments, there is a commitment to get the money back within five to 10 years.

As related to your portfolio companies, how concerned are you about each of the following?

Respondents say the top three concerns related to their portfolio companies are the **economic outlook, meeting business forecasts** and **potential loan covenant defaults.** The next greatest concerns include **lack of financing for new deals** and **lower valuations of portfolio companies.**

Based on further breakdown of survey respondents, venture funds—as might be expected—are more concerned about the need to contribute capital to existing portfolio companies and lower valuations of existing portfolio companies. Venture funds are also the respondents most concerned about the lack of an IPO market as an exit strategy.



One respondent cites "the ability to retain key employees as stock options lose value" as a concern. While repricing stock options may seem like a viable solution, the accounting treatment for repricing stock options (under SFAS 123R) can have unexpected implications on a company's bottom line. There are two key facts to be aware of:

1. The company will continue to record compensation under the old plan.
2. The company must record additional compensation expense for the difference between the value of the old stock option and the value of the new option.

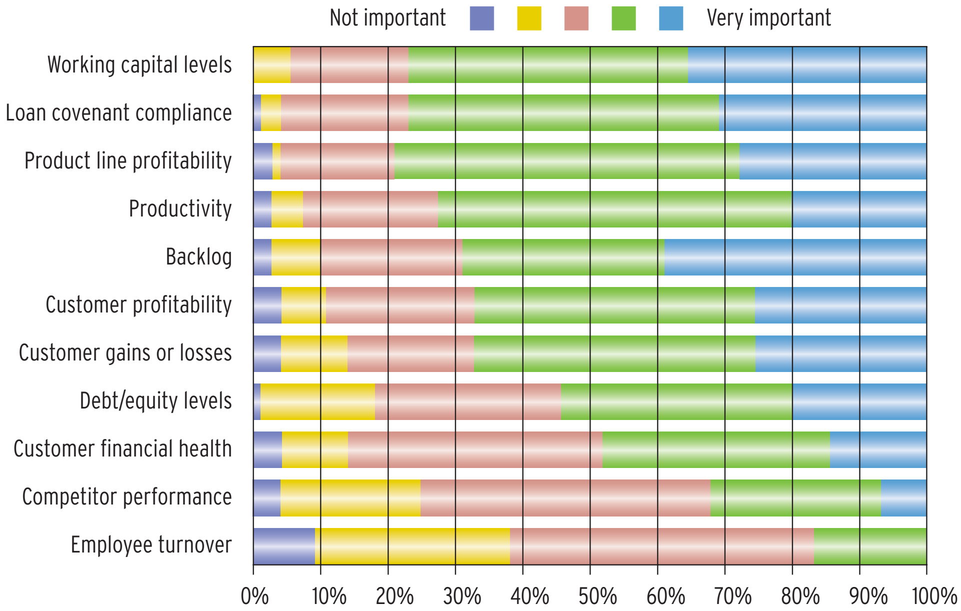
Depending on the number of options and the fair value differential, the company can have a large unexpected hit to compensation and earnings.

Most important key metrics for monitoring your portfolio companies in addition to monthly financials

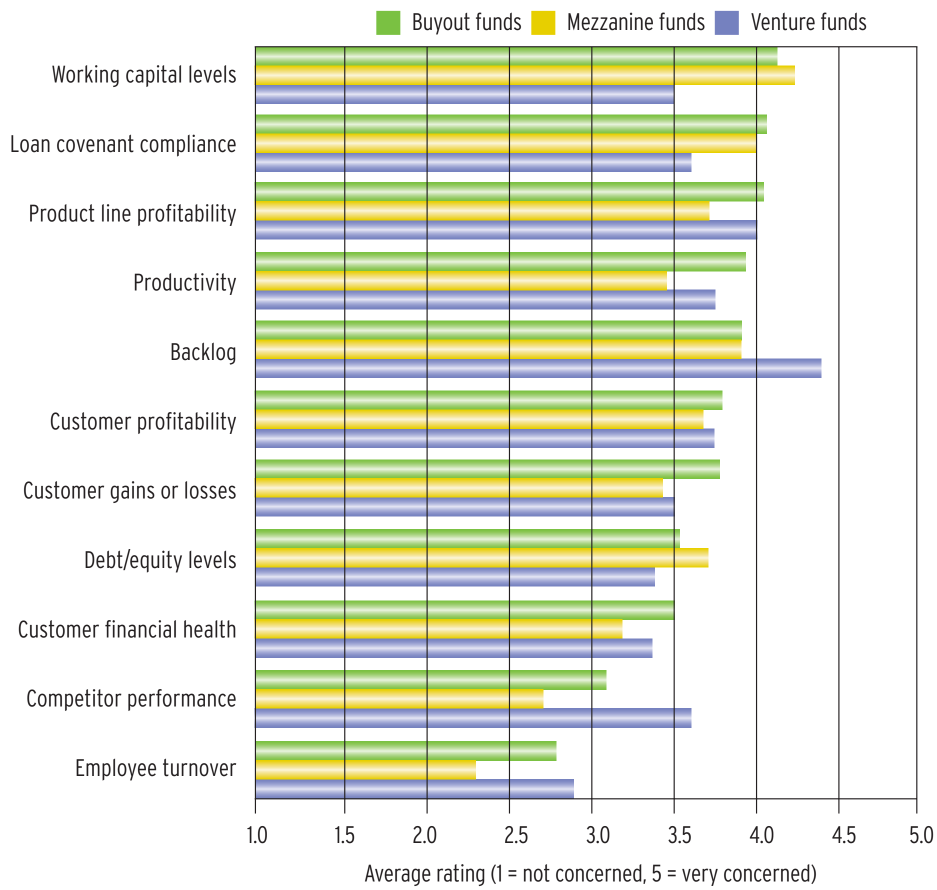
In measuring performance, reporting funds are focusing on **working capital levels, loan covenant compliance, product line profitability, backlogs** and **productivity** as the most important key metrics for monitoring portfolio companies. As fund size increases, product line profitability takes on increased importance.

Falling backlogs can be a leading indicator of declining financial performance. Be sure to look at comparative backlogs over time.

Most important key metric for monitoring portfolio companies



Most important key metrics for monitoring portfolio companies by fund type



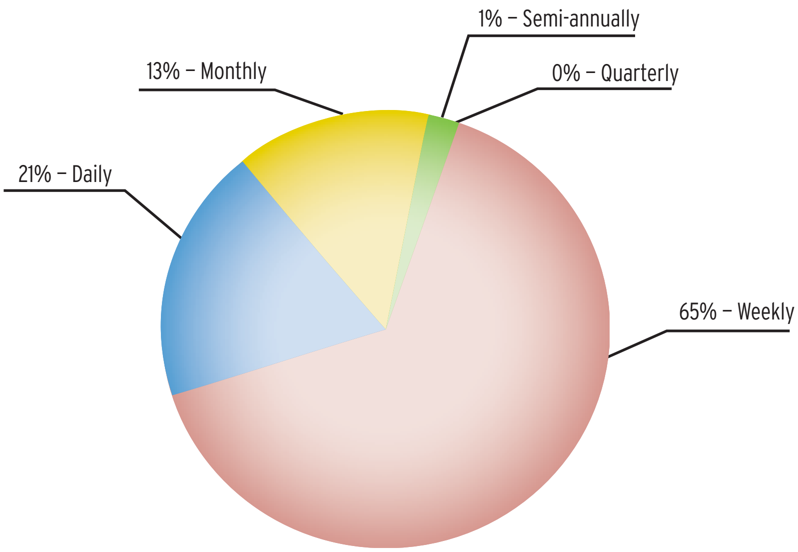
Based on further breakdown of survey respondents, venture funds identified backlogs and product line profitability as the two most important key metrics beyond monthly financials. This is consistent with the role that venture funds play with early stage companies.

Given that unplanned employee turnover decreases significantly in a down economy, respondents cited this as the least important metric currently being monitored.

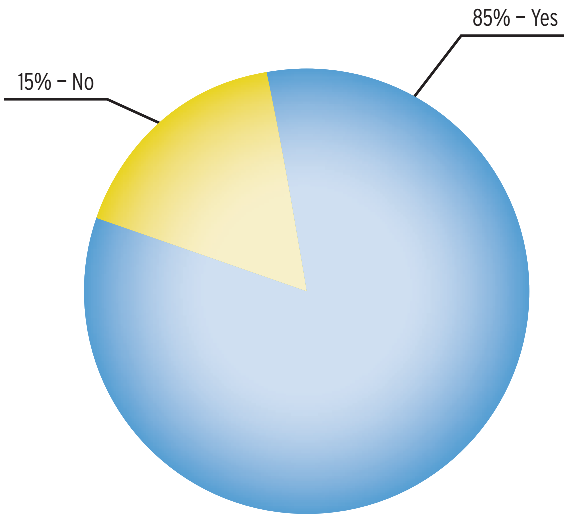
How often are you in contact with the portfolio company management team?

With the difficult economic climate, 85 percent of respondents report that communication with portfolio companies has increased in the past six months. Survey data provides strong evidence of active monitoring and involvement with portfolio companies. The majority of funds participating in the survey—86 percent—are in contact with their portfolio companies on a weekly and daily basis.

Frequency of contact with portfolio company management team



Has contact with portfolio companies increased in the past 6 months?

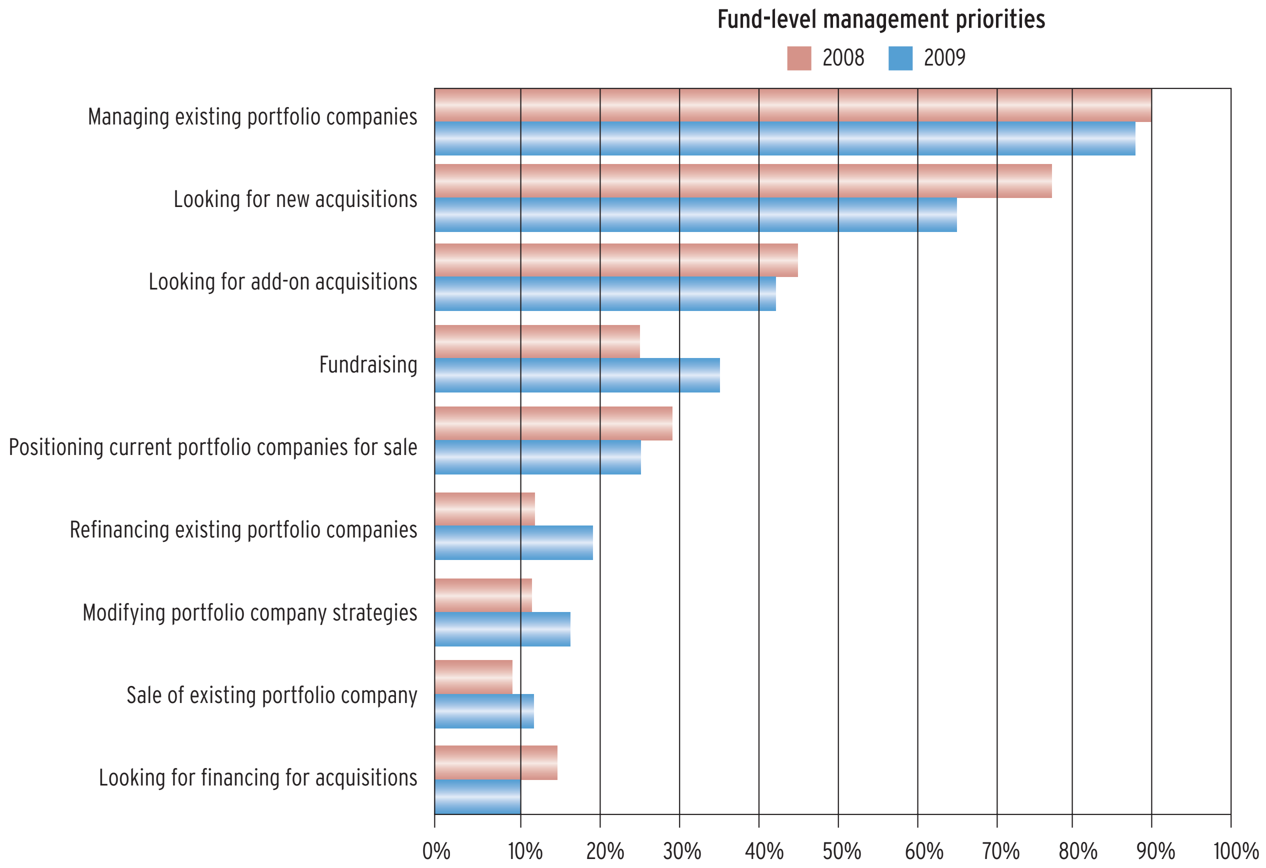


Top three fund-level management priorities

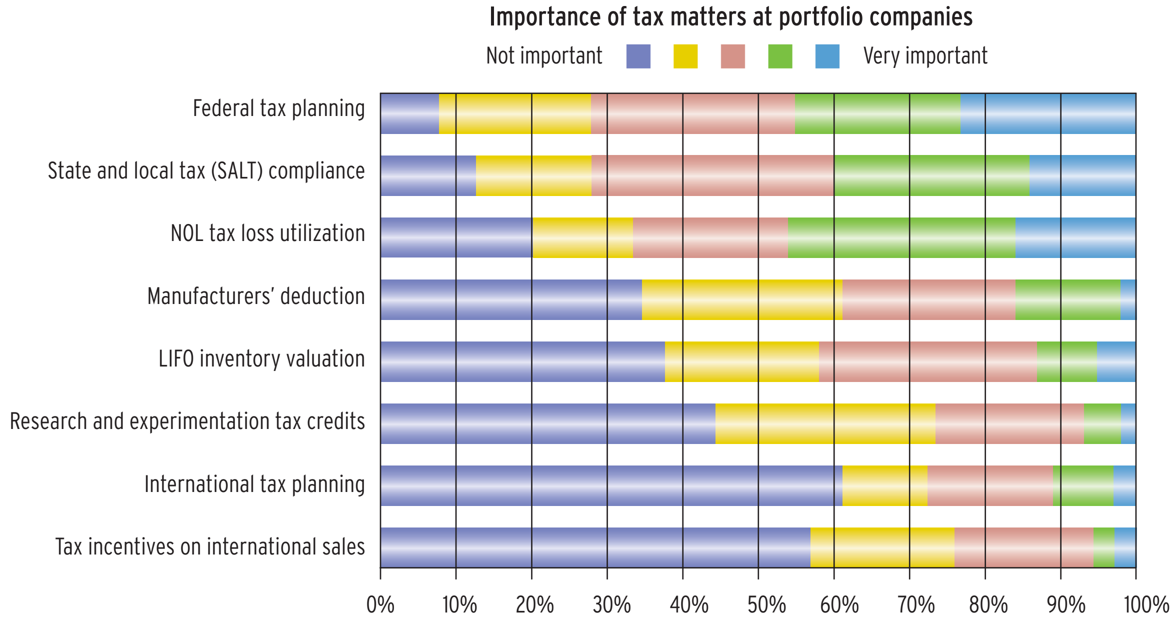
In both 2008 and 2009, the top three fund-level management priorities include **managing existing fund portfolio companies, looking for new acquisitions** and **looking for add-on acquisitions**.

Few respondents—less than 15 percent in 2008 and 2009—report planning a sale of a portfolio company as a top three priority, which supports the widespread notion that maximizing value in a sale is a significant challenge in the current market.

With fewer acquisitions taking place, obtaining financing for acquisitions is a low priority for reporting funds.



Importance of the tax matters at your portfolio companies



Federal tax planning, state and local tax (SALT) compliance and **net operating loss (NOL) utilization** were the three most important tax matters noted by respondents. Federal tax planning applies to all companies and would be expected to be of the most importance. On the other hand, tax incentives on international sales and international tax planning were rated by more than half as not important, most likely due to portfolio companies with few or no significant international operations.

Survey findings show that respondents aren't placing a high level of importance on research and experimentation, manufacturers' deduction and tax incentives on international sales. However, these areas present tax saving opportunities and could help to increase much-needed cash flow at distressed portfolio companies.

State and local tax compliance continues to be an area where due diligence issues are often found with privately held companies bought by private equity firms—due to the challenges they face complying with the laws of multiple state and local tax jurisdictions.

For buyers of portfolio companies with positive EBITDA, but with tax losses from the amortization of intangibles, NOL utilization is becoming increasingly important. In a slowing economy, the tax losses may become a larger part of a deal evaluation.

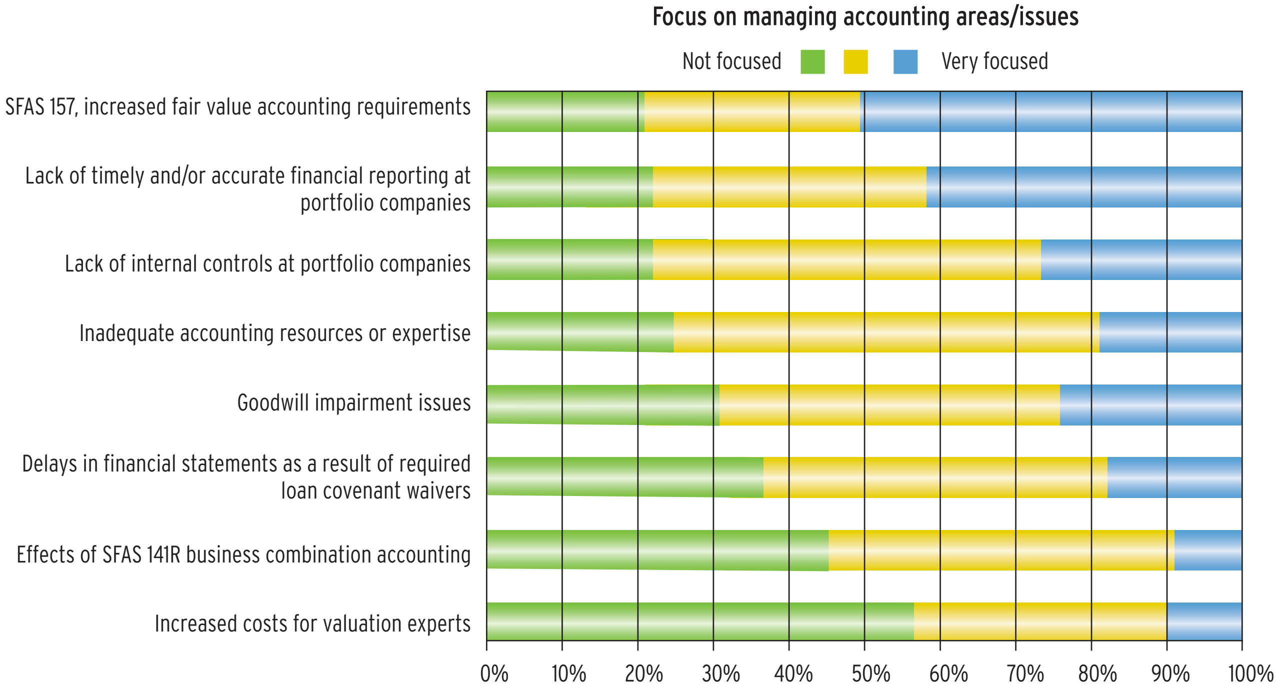
The American Recovery and Reinvestment Act of 2009 has already outlined new tax provisions and as regulations continue to change, tax matters are an area to keep an eye on.

How focused are you on managing each of the following accounting areas/issues?

Not surprisingly, more than 50 percent of respondents indicate they are very focused on **SFAS 157** reporting (change in definition of fair value). The valuation of fund portfolio holdings at the end of 2008 was impacted by both lower multiples and in many cases, lower earnings or EBITDA.

Forty-two percent of respondents are very focused on the **lack of timely and accurate financial reporting** at their portfolio companies. This suggests that for the hard decisions responding funds are facing in today's economy, having reliable financial information is of critical importance.

SFAS 157 requires even more rigorous evaluation and support for the valuation process and determination of multiples. In most cases, more than one approach to determine value is commonplace. The underlying premise of SFAS 157 is market participants—not the actual buyer—in a specific transaction. The focus of value is on the exit price and not the purchase price, which has far-reaching implications in numerous areas of fair value.



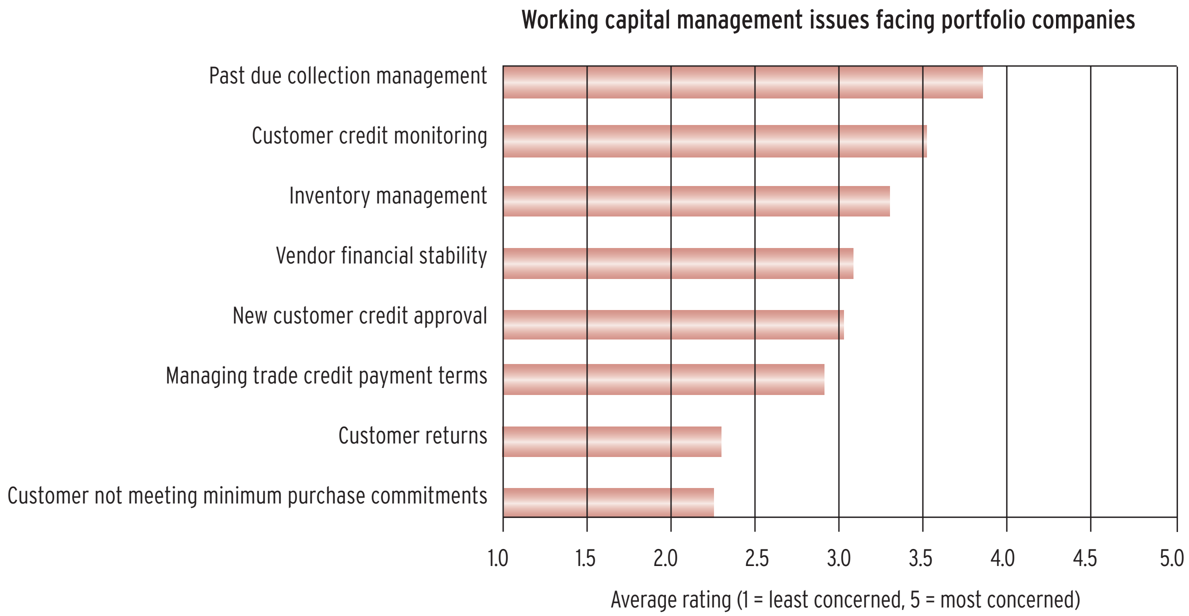
Forty-five percent of responding funds are not focused on the effects of **SFAS 141R** (reporting for business combinations). SFAS 141R went into effect in 2009 and the significant impact it will have on financial reporting at portfolio companies may not be fully understood yet—which could have contributed to the lower focus.

Under SFAS 141R, the most profound change is the use of a fair value model rather than a cost allocation model. As a result, private equity groups and portfolio companies will have to work through a number of new issues:

- Contingent consideration and earn-outs included in purchase agreements now require estimates and a current valuation as part of the initial purchase price allocation, rather than deferred treatment.
- Transaction costs are no longer considered part of the acquisition.
- Defensive assets will have to be considered and valued, if appropriate.
- Under the revised definition of a business, there could be more reporting units to test. Also, Step 2 under SFAS 142 will be under the guidance of SFAS 141R.

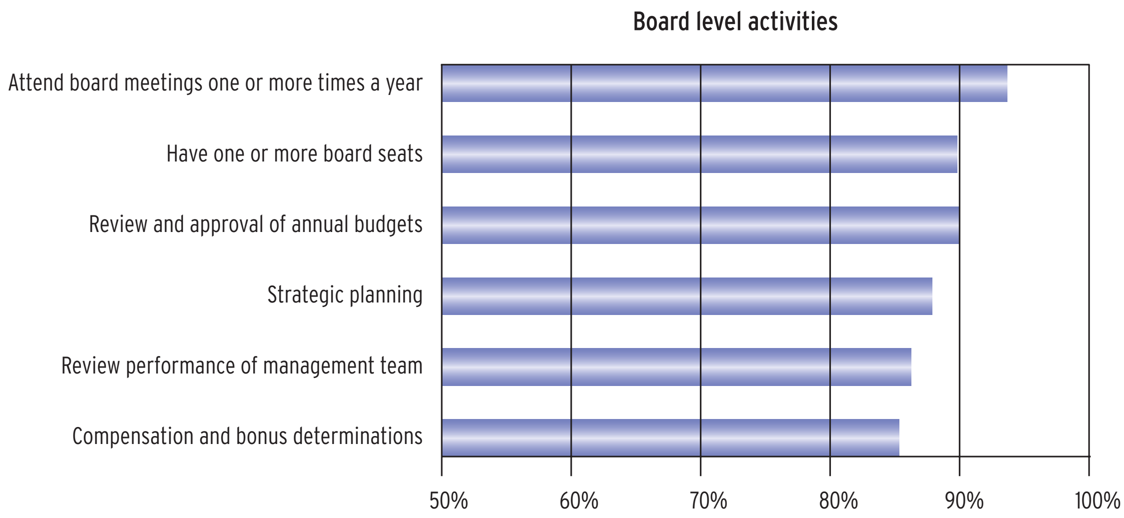
How concerned are you about the following working capital management issues facing your portfolio companies?

The three principal working capital issues cited are **past due collection management, customer credit monitoring** and **inventory management**. As respondents' fund size increases, so does the concern over customer credit monitoring. This area may get more focus as the recession drags on.



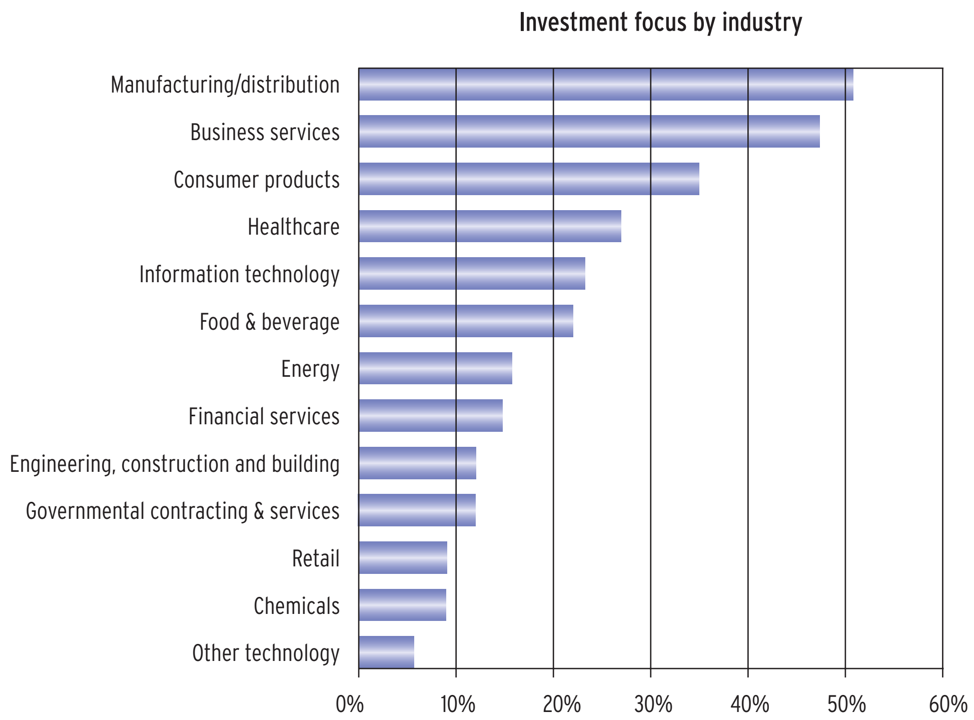
What board level activities does your fund maintain and participate in?

More than 90 percent of all respondents report involvement in key management oversight activities at their portfolio companies, with high levels of participation in **board meetings** and the **review and approval of annual budgets**.



Transaction and investment information

Investment focus by industry or sub-industry



With 40 percent of respondents focused on investments in multiple industries, survey data indicates that responding funds consider themselves widely diversified. The largest specific focus is on **manufacturing/distribution**, followed by **business services, consumer products** and **health care**.

> Food manufacturers competing in non-commoditized categories with little private-label threat will fare the best in the current environment where commodity prices are falling and price hikes pushed through in 2008 remain sticky, according to McGladrey Capital Markets' *Food & Beverage Review (2009: Q1)*.
>
> The uncertain economic environment is also drawing capital into the relatively stable food sector and large manufacturers may begin taking advantage of lower valuation multiples.

Certain industries appear to be weathering the difficult economic climate and are remaining relatively stable. According to McGladrey Capital Markets' *Consumer Products & Services Review (2008: Q4)*, despite overall dampened consumer sentiment, some sectors within the consumer products industry have demonstrated remarkable resiliency and, in fact, are expected to grow in 2009.

In contrast, technology providers continue to struggle to simply maintain revenue numbers. And while information technology is still a focus for more than 20 percent of responding funds, the experts within McGladrey Capital Markets' Technology Group expect that as enterprises continue to delay IT expenditures, M&A volume will be down for remainder of the year.

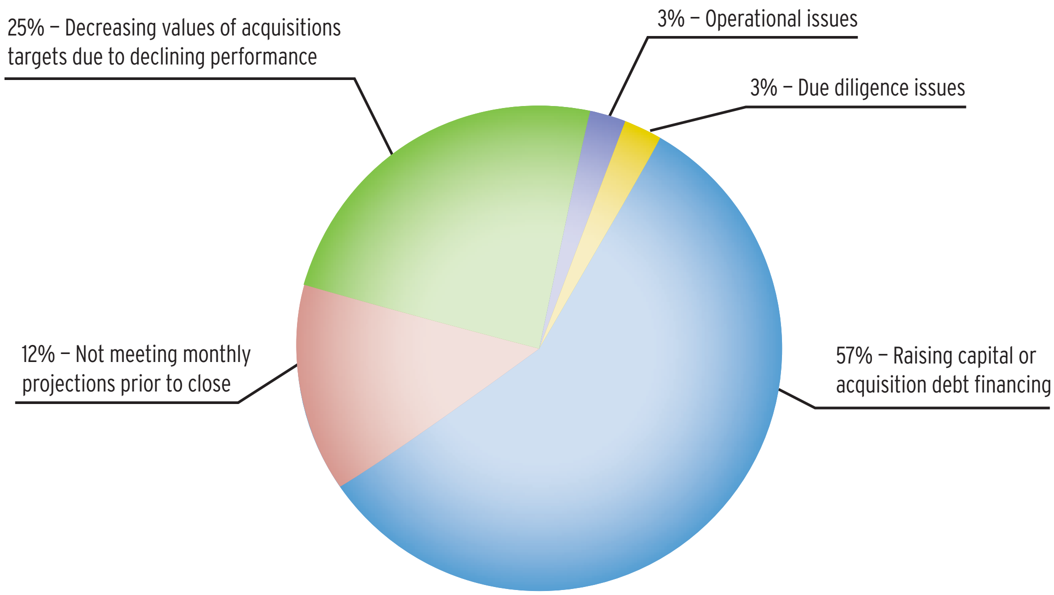
Industries least focused on by respondents include retail, chemicals and other technology.

Which of the following do you expect to be the most difficult issue you will encounter in closing deals during 2009?

The majority of funds—57 percent—expect difficulty **raising capital** or **acquisition debt financing** to be the largest obstacle for closing deals in 2009.

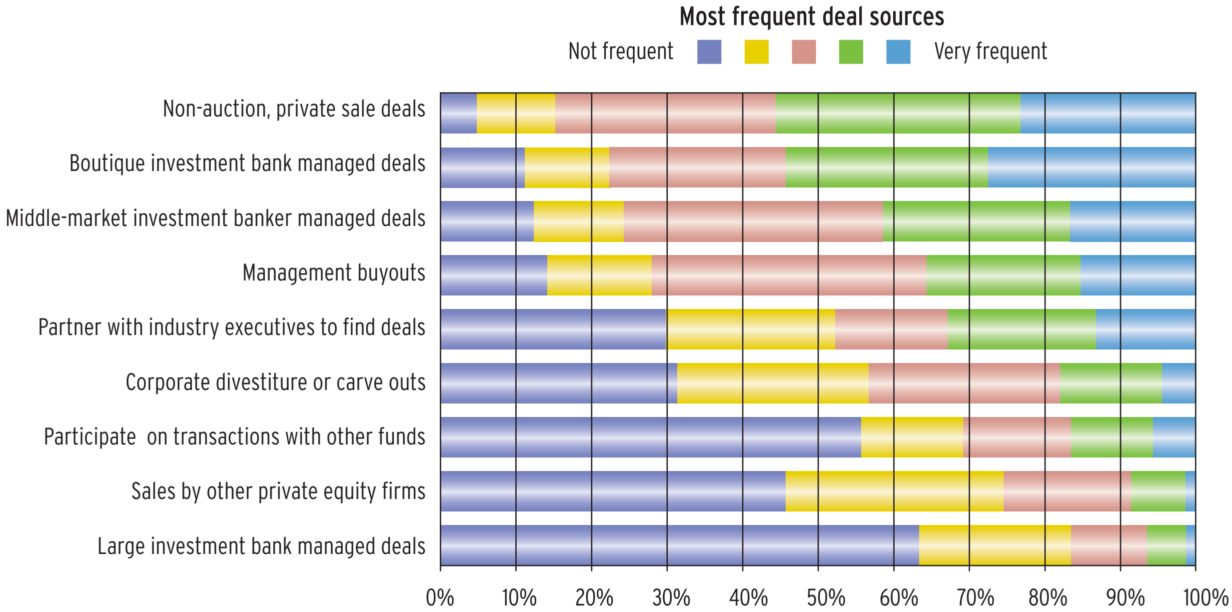
One respondent cites "seller value expectations" as an obstacle to closing deals in 2009. Many sellers' expectations aren't aligned with the current market. For deals to close in this environment, the gap between buyer and seller expectations must be bridged—allowing buyers to maintain their confidence and comfort level and protecting sellers against eroding values and retrading purchase prices. To achieve this, sellers must go to market with optimal financial transparency and credibility.

Most difficult issue in closing deals in 2009



What are the most frequent deal sources for your portfolio company acquisitions or investments?

Private sale (non-auction) deals, boutique investment bank managed deals, middle-market investment bank managed deals, and **management buyout**s are the most frequent deal sources reported. When considering the fund size of the respondents, survey data indicates that this does not impact the frequency of deal sources.

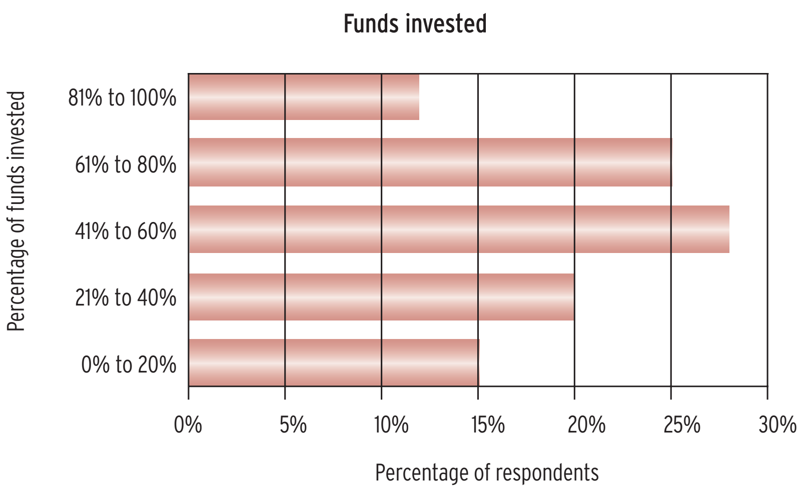


While sales by other private equity firms is not a frequently reported deal source, this may change as more and more companies become private equity-owned. And given that there are differing philosophies on how to improve a company, one private equity firm's "trash" might be another's "treasure." As a result, those companies may be owned multiple times.

Fifty-six percent of respondents don't frequently participate with other funds on transactions. Large investment banks and sales by other PE firms are the least frequently reported deal sources.

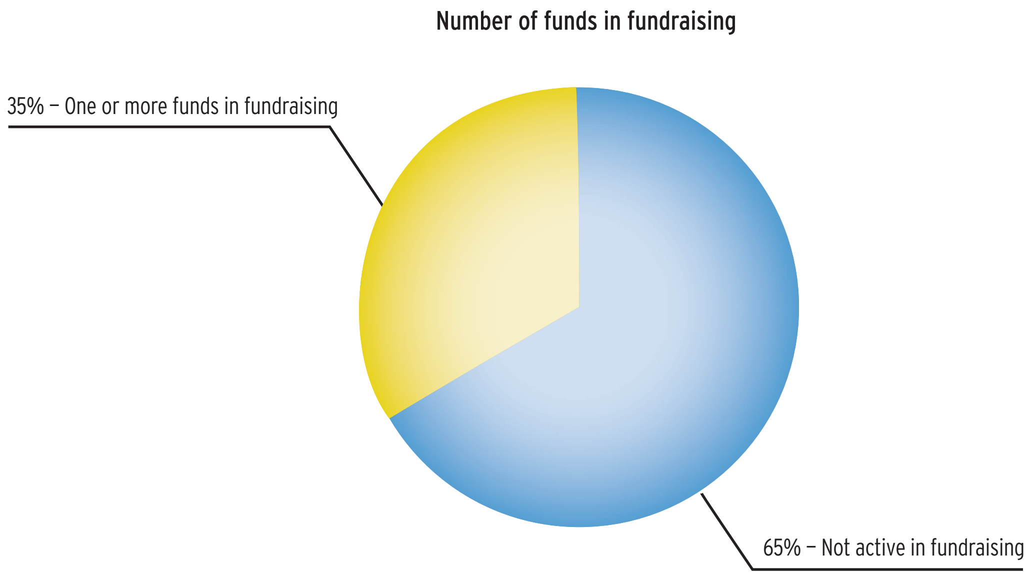
Funds invested

Sixty-five percent of respondents had more than 40 percent of their current fund invested and 35 percent have less than 40 percent invested. This data indicates there is still a significant amount of capital yet to be deployed. In this challenging economy, most private equity firms are likely to invest in companies that don't compound their troubles, but rather help improve overall returns—which means sound businesses will still get sold and less stable companies likely will continue to struggle to find a buyer.



Funds in fundraising

Thirty-five percent of respondents report having one or more funds in fundraising—a bit surprising in light of the widely-reported difficult fundraising environment. But while fundraising remains challenging, the buying binge in the last few years created a need for more capital, and even a down market presents buying opportunities.



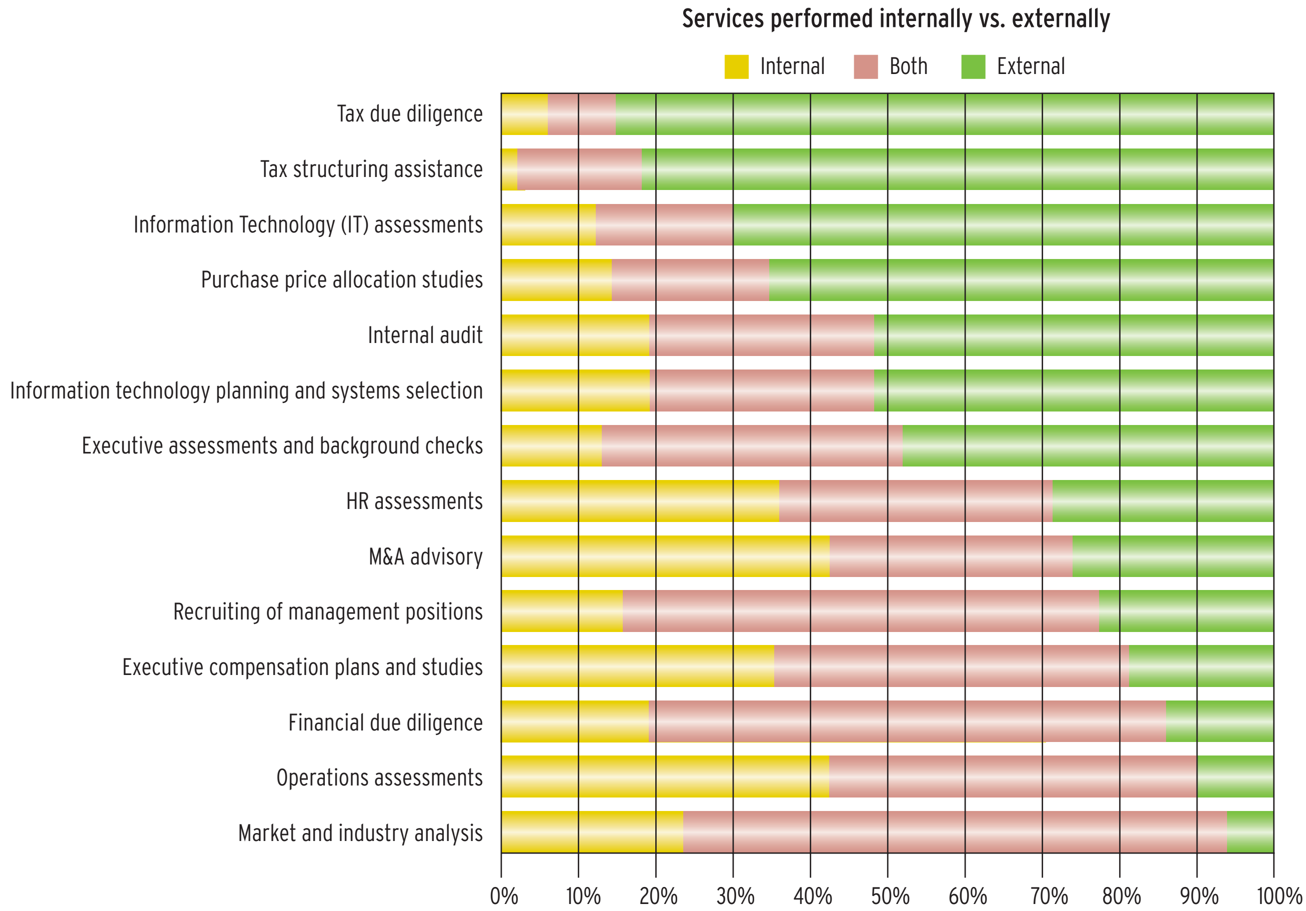
Services performed internally vs. externally (outsource) during the acquisition process or subsequent to the acquisition

Eighty-five percent of respondents outsource **tax due diligence** services. This is followed by **tax structuring assistance**, with 82 percent of responding funds using external resources for this service. This data suggests that respondents recognize the benefit of specialized expertise for effective tax planning.

Information technology assessments are the third-highest outsourced service, which is likely due to the need for a deep understanding of technology trends, information security issues and effective technology governance. Specialized expertise can be helpful, if not necessary, to identify effective IT strategies—such as integration opportunities—as well as inadequate information systems that may create a severe risk or future investment requirement.

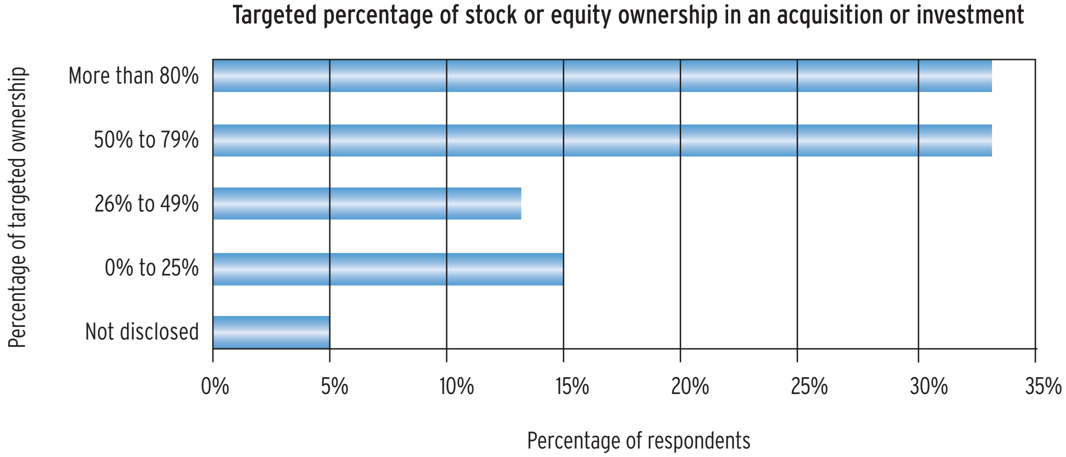
More than 40 percent of survey participants perform operational assessments internally. This seems to indicate that responding funds are typically buying companies in industries where they have industry experience and expertise.

In comparison, the majority of respondents use both external and internal resources to conduct market and industry analysis (70 percent) and recruit management positions (60 percent).



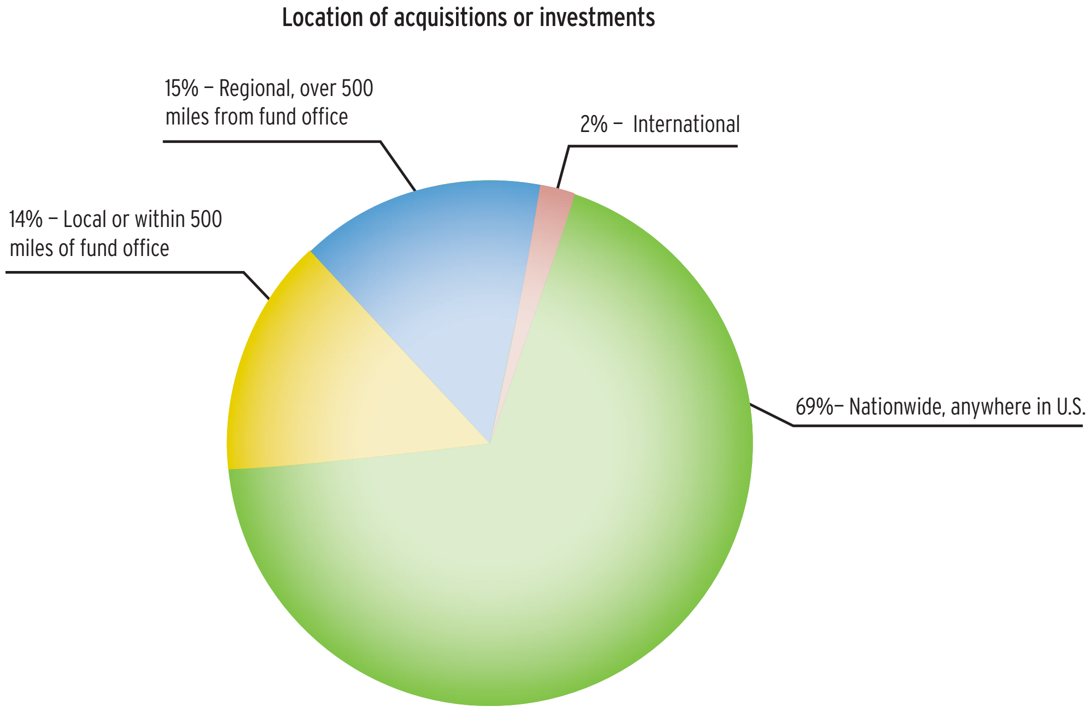
What percentage of stock or equity do you target to own in a typical acquisition or investment?

More than 65 percent of reporting funds target a controlling interest in a typical acquisition or investment. Based on further breakdown of survey respondents, the majority of reporting mezzanine funds target ownership of less than 25 percent and venture fund respondents generally target ownership of 50 percent or less.



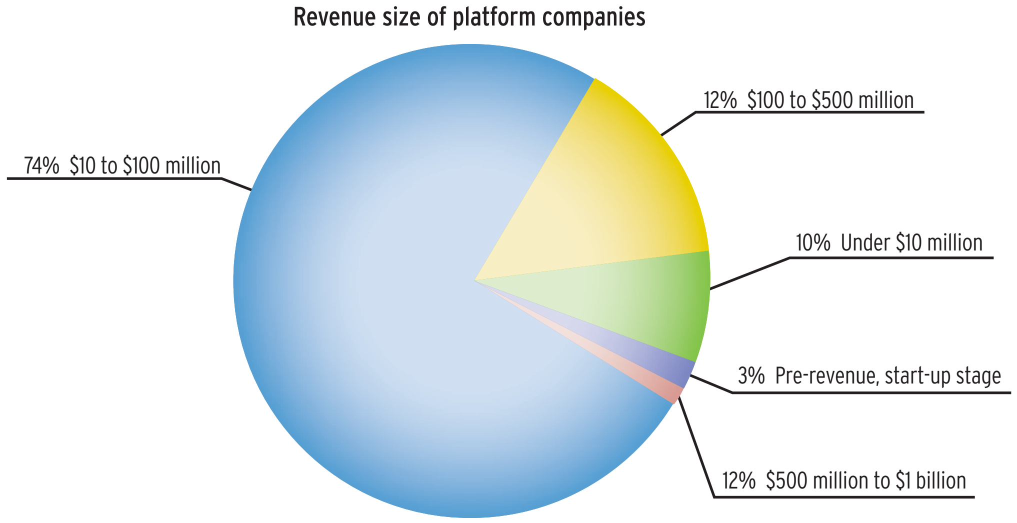
Where are most of your acquisitions or investments located?

Nearly 70 percent of respondents make investments nationwide, which appears to indicate responding funds are more interested in finding the right investments and location is of lesser importance. Interestingly, even in today's global environment, only 2 percent of responding funds make most of their investments internationally.



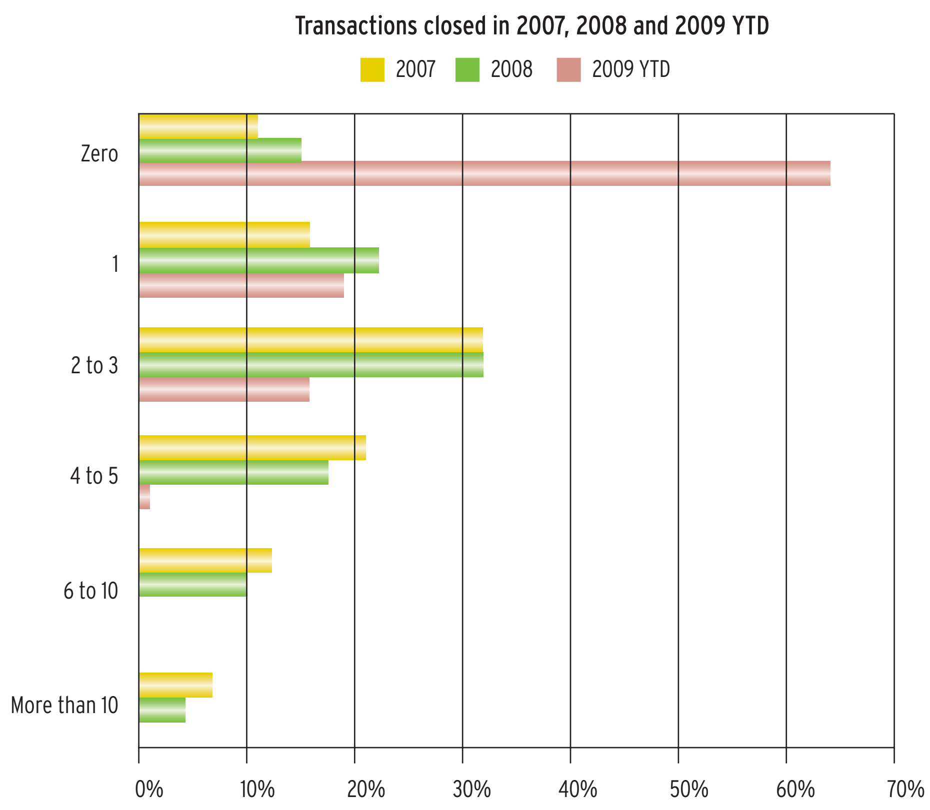
What is the typical revenue size of your platform portfolio companies?

Most respondents—nearly 75 percent—acquire or invest in companies with revenues of $10 million to $100 million.



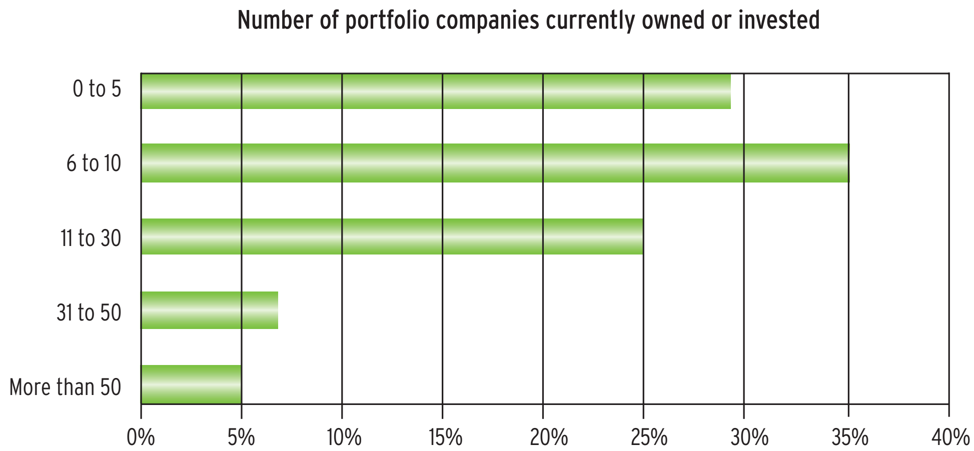
How many transactions did your fund close in 2007, 2008 and 2009 YTD?

More than 30 percent of responding funds closed two to three transactions in 2007 and 2008. As expected, overall deal activity fell in 2008 from 2007. With half of the respondents not yet closing a deal as of March 2009 (when the survey was conducted), the year is off to a slow start. As expected, survey data indicates that the larger the fund size, the more transactions the responding fund closed in 2009—which is the same for 2008 and 2007 as well.



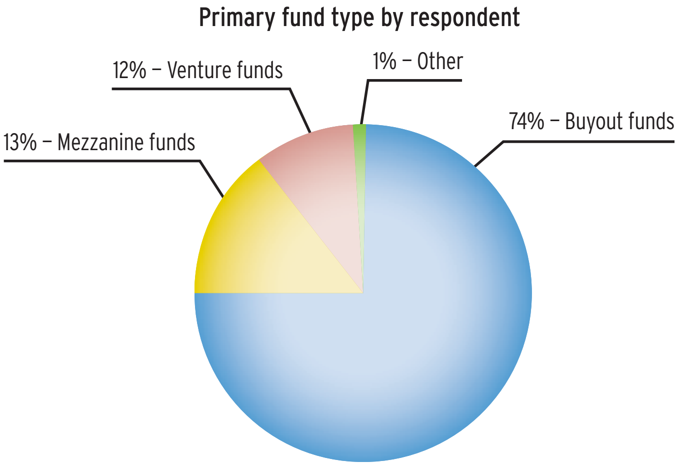
How many portfolio companies do you currently own or invest in?

Nearly 35 percent of reporting funds have invested in six to 10 portfolio companies. This is consistent with the fund sizes of survey respondents.

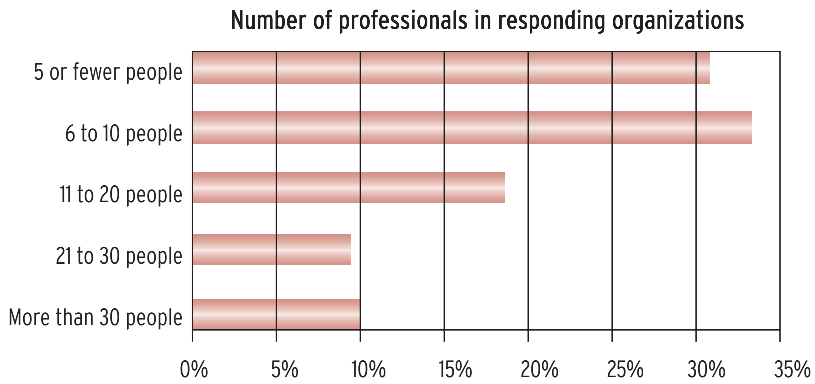


Respondent demographics

Primary fund type



Employees



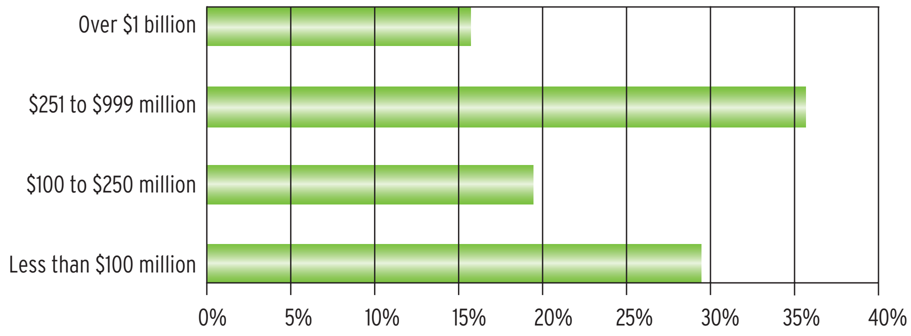
Position of respondent

Position	Percentage
Managing Director, Managing Partner	40%
Principal	19%
Vice President	16%
Chief Financial Officer	10%
Senior Vice President or Partner - Deals	7%
Associate	6%
Senior Vice President or Partner - Operations	2%

Number of active funds by respondent

Active funds currently investing	Percentage of respondents
0	1%
1	73%
2	18%
3	3%
4	5%

Asset value under fund management



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About McGladrey Capital Markets

McGladrey Capital Markets LLC (www.mcgladreycm.com) is a global provider of investment banking services to private and public companies with annual revenues of up to $1 billion. The firm's services include mergers, acquisitions, divestitures, recapitalizations, capital raising, fairness opinions and restructurings. McGladrey Capital Markets, which offers in-depth expertise in 13 distinct industry sectors, brings together companies, capital and creativity on a national and international scale to help clients achieve their personal and strategic objectives. McGladrey Capital Markets is affiliated with RSM McGladrey Inc. The firm is a member of FINRA and SIPC.

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