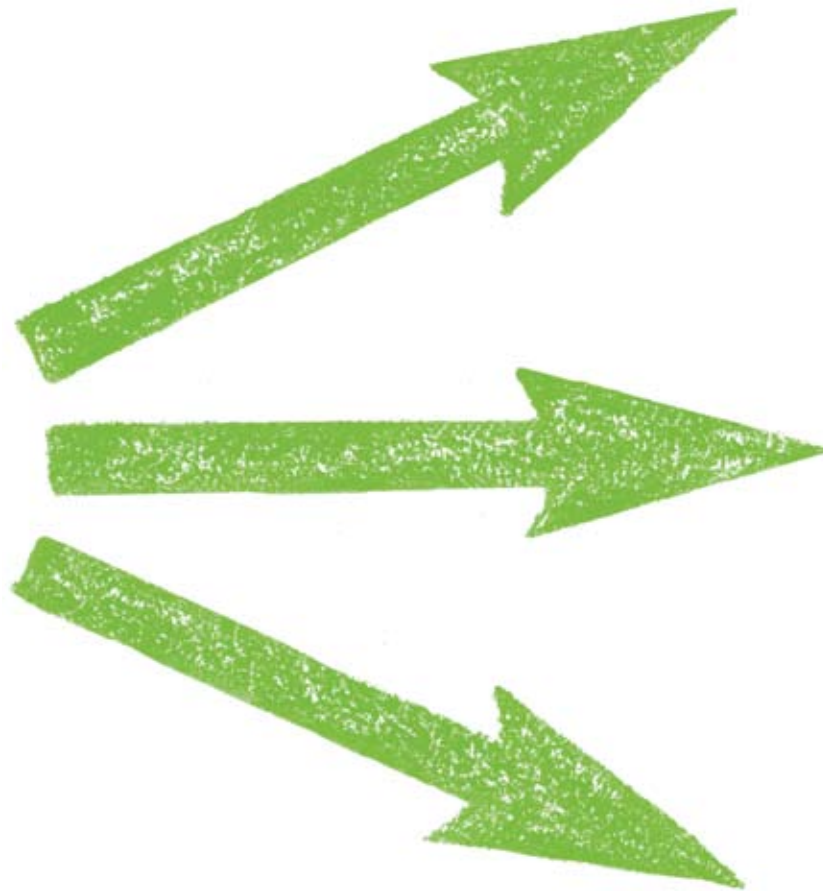


Private equity in the post-boom era: What's next?

Timely topics in private equity Issue 2

ACG



About the author



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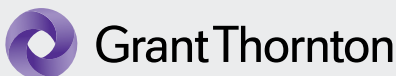
Harris Smith possesses a deep understanding of the accounting and business issues of several industries, including manufacturing, distribution, construction and service, and has served clients ranging from large owner-managed organizations to publicly traded multinational corporations.

Smith is a member of the firm's national leadership team overseeing services to private equity firms. He is responsible for the development of strategic relationships for the firm, working closely with private equity firms and their portfolio companies. These relationships serve to further elevate the firm's reputation and to create relationships with key influencers to deal with challenges in the marketplace and to enhance our brand.

Smith has more than 30 years of public accounting experience. He started his career in the Baltimore office of Grant Thornton in 1976. Harris was later promoted to partner, and in 1989 he relocated to the Southern California office to head up its Audit practice. In 1998, he was promoted to office managing partner of the Greater Bay Area offices, and in 2003 he became the West Region managing partner. In 2008, Harris became the Audit practice leader for Southern California and managing partner of private equity for the firm.

Smith is a director, and immediate past chairman of the Association of Corporate Growth (ACG). He served as president (2003) and director of the San Francisco chapter of ACG beginning in 2000. He is a member of the California Society of Certified Public Accountants and the American Institute of Certified Public Accountants. Smith graduated from the University of Baltimore with a Bachelor of Science degree in accounting.

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Executive summary

The credit crisis and the U.S. recession significantly altered the private equity industry: Exit opportunities, fundraising and deal making have all changed dramatically. This white paper, produced by Grant Thornton LLP and the Association of Corporate Growth, explores liquidity opportunities and the fundraising market in the post-boom era.

To offer readers a better understanding of the changes taking place in the liquidity markets and on the fundraising front, we have interviewed key industry experts and analyzed data points from a number of sources such as Dealogic and Thomson Reuters. Through our external sources and original reporting, we discuss not only where fundraising and exit opportunities are today, but where they are heading.

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The credit crisis and the U.S. recession significantly altered the private equity industry: Exit opportunities, fundraising and deal making have all changed dramatically.

The current environment

The subprime meltdown has sent the U.S. economy into a tailspin, presenting every industry with a new set of challenges — and private equity is no exception. 2009 will likely go down in history books as one of the most difficult years for the private equity community. Deal volume has sunk to its lowest level in more than a decade. Fundraising totals are at their lowest since 2003, and exit opportunities have become increasingly difficult to find.

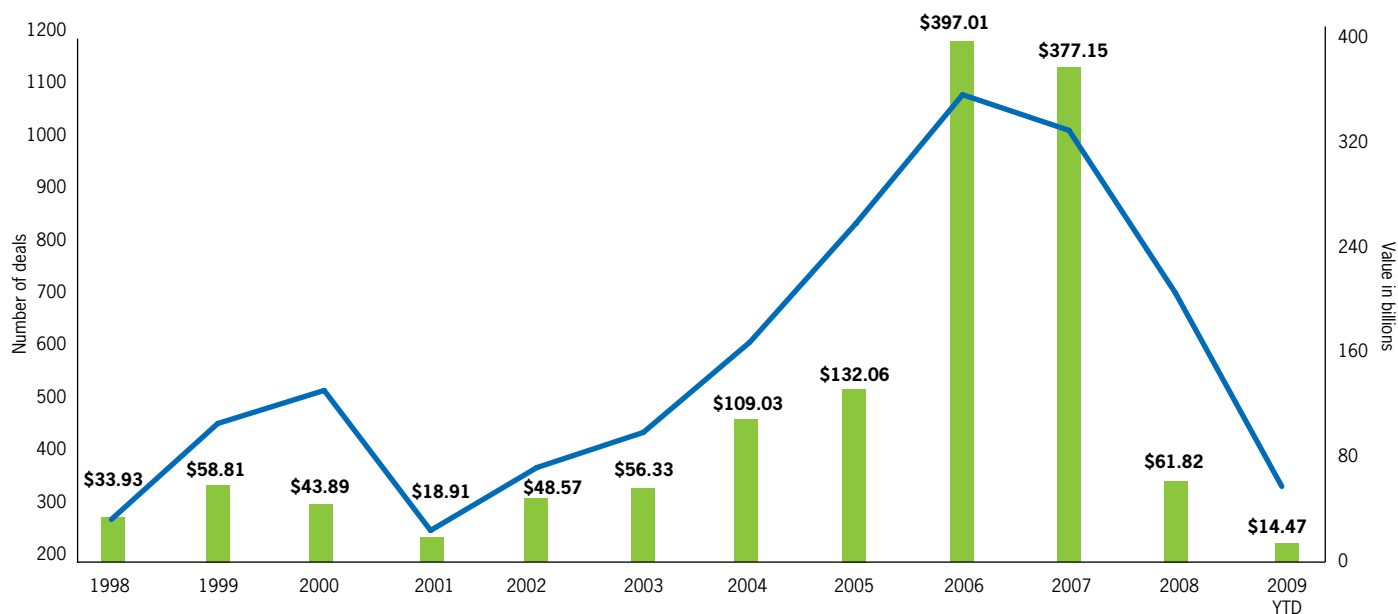
Private equity firms are being forced to adjust to a new set of rules as they work through these unique conditions. On the fundraising front, many limited partners are not reupping to private equity funds as quickly as they did in years past. According to Reuters Buyouts, in the first half of 2009, private equity funds had only raised \$36 billion — a drop in the bucket compared with the \$264 billion raised in 2008. Further, no one denies that there will be a flight to quality.

Private equity firms that have not performed well have only a slim chance of raising new funds and general partners with anything less than a stellar track record at a reputable firm are not likely to be starting their own firms. Indeed, The Boston Consulting Group predicts that 20 percent to 40 percent of the 100 largest private equity firms will disappear. This prediction may be a little excessive, but buyout fund sizes will shrink and marginal firms will disappear.

Ironically, even though it is difficult to raise a fund at this time, investments made during the next couple of years will most likely generate stronger returns than investments made during the past three years.

While many observers will remember 2006 and 2007 as active acquisition years, returns on investments made during this time period will probably fall short of investors' expectations. (Figure 1)

Figure 1
Announced U.S. buyout deal volume (\$B)



Year to date: 1/09 - 9/09
Source: Dealogic

Past investment cycles reveal that this is typical. According to Thomson Reuters' *Investment Benchmark Report*, investments made in 2001 — after the dot-com bubble burst — were reporting an average return of 13.4 percent by 2007. However, private equity investments made in 1999 — at the height of the bubble — were reporting returns of just 5.9 percent as of 2007.

This isn't surprising. Investors usually overpay for companies during economic boom times and are able to negotiate better deals during leaner times. "Now is going to be a once in a lifetime opportunity to buy," says Stephen McGee, national practice leader of Corporate Finance for Grant Thornton. "Multiples will be ratcheted down for quite some time. There is a major difference in pricing now."

Because of the lack of available leverage and supply of quality deals in the market, however, deal making hasn't been robust. From 2005 to 2008, private equity deal making thrived as the global economy expanded. During the last decade, unprecedented performance led private equity deal volume to grow significantly from 2000 to 2007. The total capital invested in private equity buyout deals went from being three percent of all M&A activity in 2000 to more than 25 percent in 2007. Today, private equity makes up about three percent of all M&A activity, according to Dealogic. Until the debt markets recover, private equity deals of any meaningful size will be difficult to complete.

No one knows for sure when the banks will resume their offers of sizable loans, and experts are split on when the lending markets will see full recovery. "It will be an extended period until we see a return in the credit markets for lending to private equity deals. The banks need to straighten themselves out first," says Josh Lerner, professor of investment banking at Harvard Business School. "And even when banks do recover, they are expected to be much more conservative in terms of lending."

Others are more optimistic that leverage will become more accessible now that the recession is abating. "We are not going to slide anymore; it seems clear the worst is over. The leverage markets haven't recovered, but there's stability in earnings," says Hiter Harris, a managing director with Harris Williams & Co.

Not only are the conditions poor for making deals, liquidity opportunities are also extremely difficult to find. Sponsor-to-sponsor sales, once a very popular exit strategy, barely exist at present because of leverage constraints. Strategic buyers are getting back in the game, but cautiously. For now, the IPO market is the only exit option showing signs of life — and that doesn't necessarily help lower- to middle-market private equity firms.

Despite the current challenges facing private equity, it is important to remember that the market is cyclical. Indeed, change is the only constant. This part of the cycle will come to an end and another will begin. The good news is that there are indications that the private equity industry is ready to begin the next phase of its evolution. The number of funds raised and transactions completed are expected to remain low, but a slight uptick is likely to occur by the end of the year and continue into 2010, barring major catastrophic events. The public markets are proving to be stronger now than they were during the past few years, and investment banks are starting to see more deal flow. The fact that economists are predicting the end of the recession is helping to calm fears and stabilize the marketplace. Over time, this stability will help strengthen not only the private equity industry, but the economy as a whole. The worst should be behind us, but the economy is expected to remain fragile for the next year, and the road ahead will not be an easy one.

"It will be an extended period until we see a return in the credit markets for lending to private equity deals. The banks need to straighten themselves out first."

Josh Lerner
Professor of investment banking at Harvard Business School

Exit opportunities

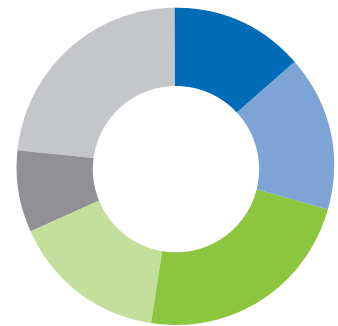
Where's the liquidity?

Before gearing up to raise new funds, private equity firms need to demonstrate successful exits from past investments. Funds that were raised in 2003 and 2004 are nearing the end of their investment periods and will need to return money to their limited partners (LPs). The question, of course, is how. (Figures 2, 3)

In recent years, sponsor-to-sponsor transactions were a viable exit strategy, but with little leverage available, sponsor-to-sponsor transactions are not easy to complete these days. Strategic buyers are starting to perk up, but they are acting conservatively, waiting to make sure the economy has stabilized before they proceed. And, despite its having had a few years of lackluster performance, the IPO market is starting to look much more attractive to private equity firms.

Figure 2
Remaining time horizon on current fund

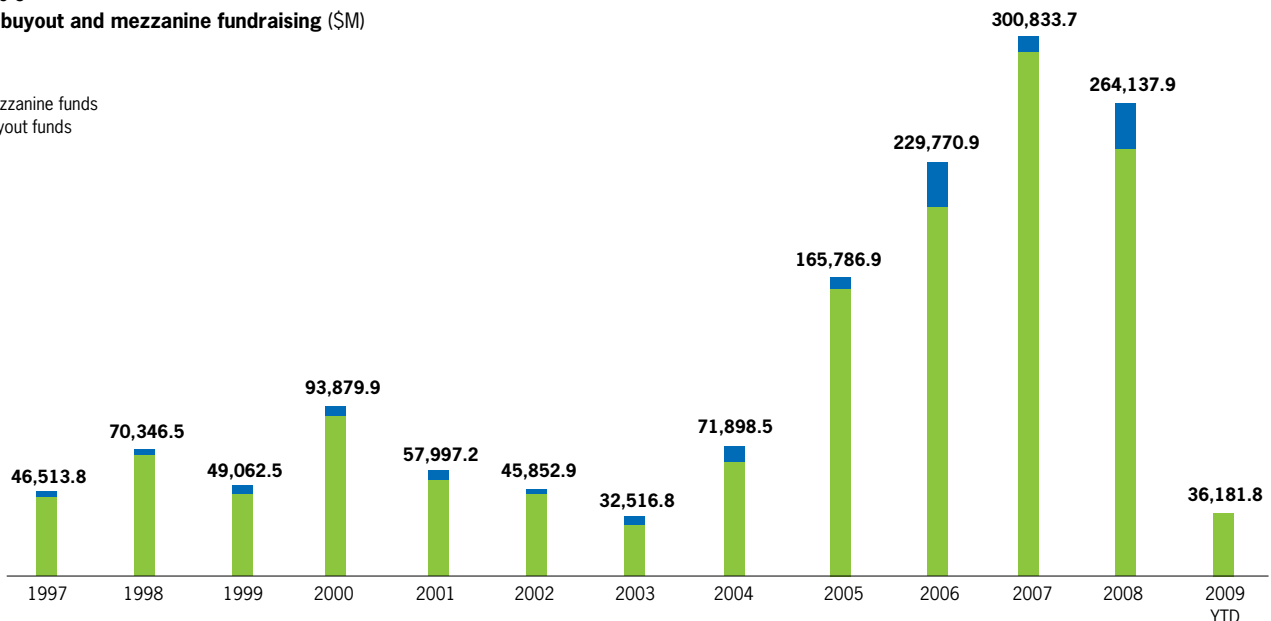
- 1 year 18%
- 2 years 15%
- 3 years 22%
- 4 years 15%
- 5 years 8%
- 6 ≥ years 22%



Source: Pepperdine University Graziadio School of Business and Management

Figure 3
U.S. buyout and mezzanine fundraising (\$M)

- Mezzanine funds
- Buyout funds



Year to date: 1/09 - 6/30/09
Source: Reuters Buyouts

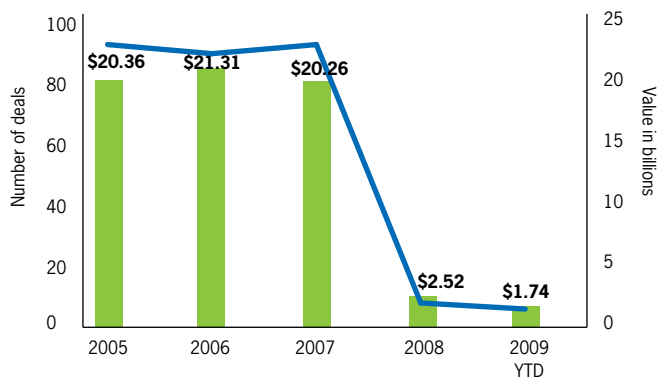
“Few sellers want to push their companies into this marketplace, but you do have sellers of necessity,” says Paul Carbone, director of Baird Capital Partners. “The more perceived stability in the marketplace, the more activity we will see. If people are dour and gloomy even good assets won’t sell. We are at an inflection point where things are bouncing back. There are liquidity needs, and the equity market is opening up.”

The IPO market

Exiting investments through the IPO market has not been a strong prospect since the beginning of the downturn. 2007 was the last year in which a significant number of U.S. companies went public. Private equity-backed IPOs accounted for close to half of the IPOs in 2006 and 2007. The figures for 2009 through October 19, don’t paint a great picture because there have been only 11 financial sponsor-backed IPOs in the U.S. during this period — but having 11 IPOs in 10 months is an improvement over eight for all of 2008. And the past 10 months don’t tell the whole story. (Figures 4, 5)

Private equity firms are looking at the public market as one of their stronger exit options. During the three months ending Sept. 30, 35 S-1 forms have been filed with the Securities & Exchange Commission. It is the largest quarterly number in two years. Twelve of the filings are from private equity-backed companies.

Figure 4
U.S. financial sponsor-backed IPOs (\$B)



Year to date: 1/09 - 9/09
Source: Dealogic

The gain in stock prices toward the end of the summer contributed to restoring private equity firms’ confidence in the public market as an exit option. And the pricing or impending pricing of a few private equity-backed companies is also adding to the optimism surrounding the public markets. Welsh, Carson, Anderson & Stowe and Thoma Cressey Bravo recently floated 30 million shares of Select Medical Holdings at \$10 per share, while Kohlberg, Kravis Roberts (KKR) and Silver Lake Partners took semiconductor maker Avago Technologies public in August 2009. And General Atlantic and Hellman & Friedman’s portfolio company Emdeon Inc. also made its debut on the public market this August. In addition, KKR’s portfolio firm Dollar General has filed for an IPO to raise \$750 million.

“In general, the public markets have to be a viable way to

Figure 5
U.S.-listed financial sponsor-backed IPOs 1/1/09–9/1/09

| Priced | Value (\$M) | Issuer | Industry | Exchange | Bookrunner | Financial sponsor |
|---------|-------------|----------------------------|-----------------------|----------|---|---|
| 8/11/09 | 422.5 | Emdeon Inc. | Technology | New York | Morgan Stanley; Goldman Sachs; UBS; Barclays Capital | Hellman & Friedman LLC; General Atlantic LLC |
| 8/5/09 | 745.2 | Avago Technologies | Technology | NASDAQ | Deutsche Bank; Barclays Capital; Morgan Stanley; Citi | Silver Lake Partners LP; Kohlberg Kravis Roberts & Co. |
| 6/24/09 | 101.4 | MediData Solutions Inc. | Technology | NASDAQ | Citi; Credit Suisse | Insight Venture Partners |
| 5/19/09 | 174.2 | SolarWinds Inc. | Technology | New York | JPMorgan; Goldman Sachs; Morgan Stanley | Austin Ventures LP; Bain Capital Partners LLC; Insight Venture Partners |
| 4/15/09 | 129.4 | Rosetta Stone Inc. | Technology | New York | Morgan Stanley; William Blair & Co LLC | ABS Capital Partners; Norwest Equity Partners |
| 4/14/09 | 163.0 | Bridgepoint Education Inc. | Professional services | New York | Credit Suisse; JPMorgan | Warburg Pincus LLC |

Source: Dealogic

exit. There aren't going to be strategic buyers for all businesses, some will have to go public, but it's a race to who can price first," says Justin Abelow, managing director of the financial sponsors coverage group at investment bank Houlihan Lokey.

Sponsor-to-sponsor transactions

Sponsor-to-sponsor transactions were an extremely popular exit option during the heyday of investing just a few years ago. (Figures 6, 7). Mattress maker Simmons Bedding Company was passed around from private equity firm to private equity firm for years until it finally landed at Thomas H. Lee Partners in 2003. THL bought Simmons from Fenway Partners for \$1.1 billion.

The sale marked a huge home run for Fenway, which bought the mattress maker from Investcorp five years prior for \$513 million, including \$148 million of equity. Fenway pocketed a return of slightly more than four times its initial investment. However, the landscape has changed. Simmons is now in the process of being sold to Ares Management and Ontario Teachers' Pension Plan in a \$760 million transaction that includes a bankruptcy filing. The latest groups will be the company's sixth private equity owner. Simmons failed to meet its loan obligations associated with the THL buyout. THL still profited from its investment through two dividend recaps of \$375 million, but the additional leverage weakened Simmons's ability to weather the economic storm and contributed to its need to file bankruptcy.

Figure 6
Top 10 U.S. sponsor-to-sponsor transactions announced since 2004

| Announced | Value (\$B) | Acquirer | Target | Selling sponsor |
|-----------|-------------|---|-------------------------------|---|
| 12/21/07 | 3.00 | Bain Capital Inc; 3i Group plc; TPG Capital LP (Texas Pacific) | Quintiles Transnational Corp. | One Equity Partners LLC |
| 10/22/07 | 2.59 | Hellman & Friedman LLC | Goodman Global Holding Co. | Apollo Advisors LP |
| 5/11/07 | 5.20 | Terra Firma Capital Partners Ltd | Pegasus Aviation Inc. | Oaktree Capital Management LP |
| 5/02/07 | 3.50 | Madison Dearborn Partners LLC | VWR International Inc. | Clayton Dubilier & Rice Inc.; Banc of America Equity Partners |
| 4/26/07 | 4.24 | Madison Dearborn Partners LLC; Providence Equity Partners Inc; Welsh Carson Anderson & Stowe LP | Asurion Corp. | TA Associates Inc. |
| 4/20/07 | 3.39 | CVC Capital Partners Ltd | Day International Corp. | Greenwich Street Capital Partners Inc. |
| 3/12/07 | 2.40 | Lehman Brothers Co-Investment Partners LP; First Reserve Corp; Carlyle/Riverstone Global Energy & Power | Dresser Inc. | Odyssey Investment Partners LLC |
| 6/12/06 | 2.64 | Vulcan Capital Management; EnCap Investments LLC | Pacific Energy Partners LP | Lehman Brothers Private Equity |
| 8/29/05 | 7.01 | Apollo Advisors LP; Permira Ltd; Madison Dearborn Partners LLC; Apax Partners LP | PanAmSat Holding Corp. | Carlyle Group Inc.; Providence Equity Partners Inc.; Kohlberg Kravis Roberts & Co. |
| 6/14/05 | 3.24 | Blackstone Group LP | Wyndham International Inc. | Thomas H. Lee Partners; Apollo Advisors LP |

Source: Dealogic

Sponsor-to-sponsor transactions will return. “It is the credit markets that have stopped sponsor-to-sponsor deals. You can’t do these deals without leverage,” says Edward Altman, a professor with New York University’s Stern Business School. “It’s easier to find leverage now than it was six months ago, but it’s still difficult.”

However, there are recent instances of sponsor-to-sponsor transactions utilizing debt exchanges to alleviate liquidity constraints for a portfolio company.

As *Mergers & Acquisitions Journal (MAJ)* reported, the sale of Global Tel*Link by the Gores Group to Veritas Capital at the end of last year did serve as a strong example of why sponsor-to-sponsor deals can make sense. For the lenders involved, Credit Suisse and Wells Fargo Foothill, the transaction effectively served as a debt exchange offer and gave Gores a suitable exit opportunity.

According to *MAJ*, the total leverage climbed slightly, but the senior debt tranche was pared, while the terms and protections were sweetened. The first lien was syndicated with a coupon of Libor plus 600 basis points, and a three percent Libor floor. This was up from Libor plus 350 basis points and no floor under Gores.

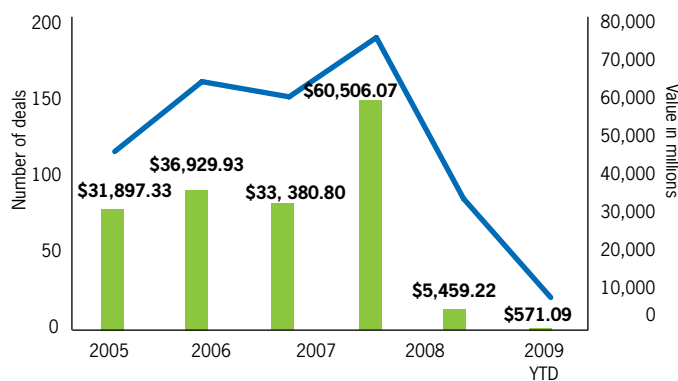
However, debt exchanges represent only a small segment of sponsor-to-sponsor transactions. And there were just 16 sponsor-to-sponsor transactions in the first nine months of 2009. (Figure 8 on page 8)

When there are liquidity issues and a debt exchange can’t be agreed upon, bankruptcy is often what happens next. Equity sponsors are not totally in control of these situations — debt holders usually drive portfolio companies into bankruptcy instead of into a debt exchange.

“Many times, more can be recouped in bankruptcy,” says one private equity professional. “Bankruptcies have become prevalent. We see more bankruptcies than IPOs or sponsor-to-sponsor transactions.” (Figure 9 on page 9)

Figure 7

Sponsor-to-sponsor transactions (\$M)



Year to date: 1/09 - 9/09
Source: Dealogic

“It is the credit markets that have stopped sponsor-to-sponsor deals. You can’t do these deals without leverage. It’s easier to find leverage now than it was six months ago, but it’s still difficult.”

Edward Altman
Professor at Stern Business School of New York University

Figure 8

Sponsor-to-sponsor transactions 1/1/09–9/1/09

| Announced | Acquirer | Target | Target industry | Selling sponsor |
|-----------|---|---|---|---|
| 7/17/09 | Cerberus Capital Management LP | Alpha Media Group Inc. | Publishing-periodicals | Quadrangle Group LLC |
| 7/6/09 | Sterling Partners Inc. | Professional Career Development Institute LLC | Professional services-schools/universities | DLJ Merchant Banking Partners |
| 6/23/09 | Relativity Capital | MHF Logistical Solutions Inc. | Transportation-services | Allied Capital Corp. |
| 6/23/09 | Republic Airways Holdings Inc. (Wexford Capital LLC) | Midwest Airlines | Transportation-airlines | TPG Capital LP |
| 6/22/09 | Swander Pace Capital LLC | Insight Pharmaceuticals Corp. | Health care-drugs/pharmaceuticals | Allied Capital Corp. |
| 6/17/09 | Friedman Fleischer & Lowe | Cajun Operating Co. (Church's Chicken business) | Dining and lodging-restaurants | Arcapita Bank BSCC |
| 6/15/09 | NDS Surgical Imaging LLC (Riverside Partners LLC) | Tzero Technologies | Telecommunications-equipment | August Capital LLC; Quilvest Private Equity |
| 6/12/09 | Golden Gate Capital Corp; Summit Partners LP; Parallax Capital Partners LLC | SoftBrands Inc. | Computers and electronics-software | Abry Partners Inc. |
| 6/2/09 | ev3 Inc. (Warburg Pincus LLC) | Chestnut Medical Technologies Inc. | Health care-drugs/pharmaceuticals | Japan Asia Investment Co. Ltd |
| 6/1/09 | OMERS Private Equity | Nordco Inc. | Transportation-equipment and leasing | Riverside Co. |
| 5/29/09 | Court Square Capital Partners | Wyle Laboratories Inc. | Professional services-miscellaneous | Littlejohn & Co. LLC |
| 5/5/09 | Milestone Partners LLC | Avure Technologies | Machinery-machine tools | Gores Group LLC |
| 4/2/09 | FleetCor Technologies Inc. (Advent International Corp; Summit Partners LP; Bain Capital Partners LLC; Advantage Capital Partners) | CLC Group Inc. | Professional services-management consulting | Nautic Partners LLC |
| 3/10/09 | Vesta Inc. (RoundTable Healthcare Partners LP) | ExtruMed LLC | Health care-instruments | Graham Partners; Wedbush Capital Partners |
| 1/6/09 | TGF Management Corp. | Sterling Foods Inc. | Food and beverage-miscellaneous | ICV Capital Partners LLC |
| 1/26/09 | Hilco Consumers Capital; Gordon Brothers Group LLC | Linens 'n Things Inc. | Retail-home furnishings | Apollo Advisors LP |

Source: Dealogic

Figure 9
Private equity-backed bankruptcies in 2009

| Company | Date filed | Sponsor(s) | Year of purchase/ deal value |
|---|------------|--|--|
| Interlake Material Handling Inc. | 1/5/09 | Wynnchurch Capital Ltd. | 2006/\$48M |
| Blue Tulip Corp. | 1/6/09 | Highland Capital Partners | 2006-2008 |
| Merisant Worldwide Inc. | 1/10/09 | Pegasus Capital Advisors and co-investors | 2000/\$570M |
| American Restaurant Group | 1/15/09 | Versa Capital Management Inc. | 2008 |
| Star Tribune Co. | 1/15/09 | Avista Capital Partners | 2007/\$530M |
| Wall Homes Inc. | 1/17/09 | Warburg Pincus; Jen Partners | 2005/\$50M |
| Von Weise | 1/21/09 | Sun Capital Partners | 2007/\$10M |
| Edscha | 2/2/09 | Carlyle Group | 2003/\$247.6M |
| Bruno's Supermarkets | 2/5/09 | Lone Star Funds | 2004/\$660M for Bruno's and Bi-Lo, which filed for Ch. 11 on 3/23/09 |
| Fortunoff | 2/5/09 | NRDC Equity Group | 2008/\$80M |
| Fluid Routing Solutions Inc. | 2/6/09 | Sun Capital Partners | 2007 |
| Muzak Partners LLC | 2/10/09 | ABRY Partners LLC | 1998/ \$250M |
| Pliant Corp. | 2/12/09 | CCMP Capital Advisors LLC | 2000 |
| Aleris International Inc. | 2/13/09 | TPG | 2006/\$1.7B, plus the assuming of \$1.6B in debt |
| Forward Foods LLC | 2/17/09 | Emigrant Capital Corp. | 2006 |
| Nailite International Inc. | 2/17/09 | Graham Partners; Argosy Partners | 2003 |
| Everything But Water | 2/27/20 | Bear Growth Capital Partners | 2006 |
| Regal Jet LLC | 2/27/09 | ABS Capital Partners; AIG Global Investment Group; Argosy Partners; Brantley Partners; CD Ventures LLC; HSBC Pte Equity (Asia) Ltd | 2006 |
| G.I. Joe's Inc. | 3/4/09 | Gryphon Investors Inc. | 2007 |
| Masonite International Inc. | 3/16/09 | Kohlberg Kravis Roberts & Co. | 2005/\$2.7B |
| Drug Fair Group Inc. | 3/18/09 | Sun Capital Partners | 2005 |
| Indalex Aluminum Solutions | 3/20/09 | Sun Capital Partners Inc. | 2006/\$425M |
| MMC Precision Holdings | 3/22/09 | Brazos Private Equity Partners LLC | 2006 |
| Bi-Lo LLC | 3/23/09 | Lone Star Funds | 2004/\$660M Bi-Lo and Bruno's, which filed for Ch. 11 on 2/5/09 |
| F.T. Sifles Inc. | 3/25/09 | Quantum Equity Partners | 2005 |
| Zohar Waterworks LLC | 4/2/09 | Patriarch Partners LLC | 2005 |
| Big 10 Tire Stores Inc. | 4/3/09 | Sun Capital Partners Inc. | 2006 |
| United Subcontractors Inc. | 4/4/09 | Wind Point Partners | 2004/\$275M |
| Jane & Co. LLC | 4/6/09 | Walnut Group; Stone Canyon Venture Partners; Hauser Davis; Tyroe Rorie | 2006/The firms own respective stakes of 30%, 20% and 18%. |
| Signature Aluminum Inc. | 4/7/09 | HIG Capital Management | 2005 |
| Aventine Renewable Energy Holdings Inc. | 4/7/09 | Metalmark Capital (previously Morgan Stanley Capital Partners) | 2003 |
| Dayton Superior Corp. | 4/20/09 | Odyssey Investment Partners LLC | 2000 |
| EuroFresh Inc. | 4/21/09 | Bruckmann, Rosser, Sherrill & Co.; Banc of America Capital Partners | 2001/\$20M |
| Source Interlink Co. | 4/27/09 | Yucaipa Cos. | 2007/\$1.2/B |
| Victor Oolitic Stone Co. | 4/28/09 | Audax Group | 2005 |
| Chrysler LLC (Chrysler Holdings LLC) | 4/30/09 | Cerberus Capital Management LP | 2007/\$7.4B |
| Mark IV Industries Inc. | 4/30/09 | Sun Capital Partners | 2007 |
| U.S. Shipping Partners LP | 4/30/09 | Sterling Investment Partners | Undisclosed |
| Accredited Home Lenders Holding Corp. | 5/4/09 | Lone Star Funds | 2007/\$296M |
| White Energy Inc. | 5/7/09 | Ares Management; Columbus Nova | 2006/\$272M |
| J.G. Wentworth | 5/19/09 | JLL Partners | 2005 |
| Anchor Blue Retail Group Inc. | 5/27/09 | Sun Capital Partners Inc. | 2003 |

Continued >

Figure 9

Private equity-backed bankruptcies in 2009 (continued)

| Company | Date filed | Sponsor(s) | Year of purchase/ deal value |
|-------------------------------------|------------|--|------------------------------|
| Consolidated Bedding Inc. | 5/27/09 | HIG Capital; American Capital Strategies | 2004 |
| Hawaii Superferry | 5/30/09 | J.F. Lehman & Co.; Norwest Equity Partners | 2005/\$237M |
| Nukote International Inc. | 6/3/09 | Richmont Capital Partners | 2000/ \$17M |
| Berean Christian Stores LLC | 6/9/09 | JMH Capital | 2006 |
| MagnaChip Semiconductor LLC | 6/12/09 | Court Square Capital Partners; Francisco Partners | 2004/\$828.2M |
| Extended Stay Inc. | 6/15/09 | Lightstone Group LLC | 2008/\$8B |
| Global Safety Textiles Holdings LLC | 6/30/09 | WL Ross & Co. | 2004 |
| CCS Medical Inc. | 7/8/09 | Warburg Pincus LLC | 2005/\$630M |
| RathGibson Inc. | 7/13/09 | DLJ Merchant Banking Partners | 2007/\$440M |
| Lang Co. | 7/17/09 | Catterton Partners | 2003 |
| Stant Corp. | 7/28/09 | HIG Capital LLC | 2008 |
| Station Casinos Inc. | 7/28/09 | Colony Capital LLC | 2007/\$8.9B |
| Cooper-Standard Holdings Inc. | 8/3/09 | Cypress Group; Goldman Sachs | 2004/\$1.165B |
| Cygnus Business Media Inc. | 8/3/09 | ABRY Partners | 2000 / \$275M |
| SkyPower Corp. | 8/12/09 | Lehman Brothers Private Equity | 2007 |
| Reader's Digest Association Inc. | 8/24/09 | Ripplewood Holdings LLC; GoldenTree Asset Management; GSO Capital Partners; J. Rothschild Group; Magnetar Capital; Merrill Lynch Capital Corp. | 2007/\$2.4B |
| Freedom Communications Inc. | 9/1/09 | Blackstone Group LP; Providence Equity Partners Inc. | 2004 /\$1.7B |

As of 9/1/09

Source: peHUB and Reuters Buyouts research. Source for equity investment information: VentureXpert

Strategic exits

While strategic buyers may not be experiencing the same issues that private equity firms' portfolio companies are, many strategics are not ready to start deploying their capital freely. Strategic M&A is significantly down this year. Most strategics are on the sidelines waiting for earnings to stabilize, which some commentators believe has already begun to happen. In the meantime, strategics are strengthening their balance sheets. (Figures 10, 11)

Figure 10

Announced U.S. M&A activity

| | Strategic M&A | | Buyouts | |
|----------|---------------|---------|-------------|---------|
| | Value (\$B) | # deals | Value (\$B) | # deals |
| 1998 | 1,428.67 | 10,623 | 33.93 | 278 |
| 1999 | 1,447.09 | 9,812 | 58.81 | 461 |
| 2000 | 1,414.87 | 9,437 | 43.89 | 524 |
| 2001 | 723.70 | 7,369 | 18.91 | 257 |
| 2002 | 383.55 | 6,505 | 48.57 | 377 |
| 2003 | 459.83 | 6,269 | 56.33 | 444 |
| 2004 | 651.28 | 6,727 | 109.03 | 616 |
| 2005 | 913.38 | 6,510 | 132.06 | 843 |
| 2006 | 1,027.46 | 8,224 | 397.01 | 1,088 |
| 2007 | 1,022.51 | 8,642 | 377.15 | 1,020 |
| 2008 | 872.21 | 7,286 | 61.82 | 710 |
| 2009 YTD | 417.26 | 3,939 | 14.47 | 341 |

Source: Dealogic

Figure 11

Top 10 U.S. strategic M&A deals announced since 2008

| Announced | Value (\$B) | Acquirer | Target | Target industry | Acquirer advisor | Target advisor |
|-----------|-------------|--------------------------|-------------------------------|-------------------|--|--|
| 1/26/09 | 68.10 | Pfizer Inc. | Wyeth | Health care | Barclays Capital; JPMorgan; Citi; Goldman Sachs; Bank of America; Merrill Lynch | Evercore Partners Inc.; Morgan Stanley |
| 6/11/08 | 59.58 | InBev SA | Anheuser-Busch Companies Inc. | Food and beverage | JPMorgan; Deutsche Bank; Lazard Freres & Co. LLC; Centerview Partners; BNP Paribas | Goldman Sachs |
| 7/21/08 | 46.76 | Roche Holding AG | Genentech Inc. (45.61%) | Health care | Greenhill & Co. | |
| 3/09/09 | 45.91 | Merck & Co Inc. | Schering-Plough Corp. | Health care | JPMorgan | Goldman Sachs; Morgan Stanley |
| 4/28/08 | 22.64 | Mars Inc. | William Wrigley Jr Co. | Food and beverage | JPMorgan | Goldman Sachs; William Blair & Co. LLC |
| 9/15/08 | 18.53 | Bank of America Corp. | Merrill Lynch & Co. Inc. | Finance | Banc of America Securities LLC; JC Flowers & Co LLC; Fox-Pitt Kelton Cochran Caronia Waller (USA) LLC; | Merrill Lynch & Co. Inc. |
| 7/10/08 | 18.34 | Dow Chemical Co. | Rohm & Haas Co. | Chemicals | Merrill Lynch & Co Inc; Greenhill & Co; Morgan Stanley & Co Inc; Citi | Goldman Sachs; Lazard Ltd |
| 5/04/09 | 14.67 | DIRECTV Group Inc. | Liberty Entertainment Group | Telecom | Morgan Stanley & Co. Inc. | JPMorgan; Goldman Sachs |
| 6/11/09 | 13.50 | BlackRock Inc. Investors | Barclays Global | Finance | Morgan Stanley; Perella Weinberg Partners LP; Credit Suisse; Citi; Bank of America; Merrill Lynch | Lazard; Barclays Capital |
| 5/13/08 | 13.30 | Hewlett-Packard Co. | Electronic Data Systems Corp | Technology | JPMorgan; Lehman Brothers North America | Citigroup; Evercore Partners Inc. |

Source: Dealogic

“Strategic buying is not robust. They are looking to find good buys — the no-brainer deals — that can add growth; however, not many of those deals exist right now,” says Carbone. “But strategics are becoming a bigger factor and need to be part of the recovery puzzle.”

Harvard’s Lerner agrees that there can’t be just one place for sellers to exit their investments. “Corporate buyers are going to have to pick up the slack. The IPO market is showing signs of recovery, but there’s going to have to be other places to exit.”

Indeed, even if the IPO market remains healthy, going public can’t be the answer for every private equity portfolio company. Some businesses just aren’t made to be public companies. Strategic exits will always be an important option. “Corporate buyers are really strong and they are starting to step up,” says Harris. “Their balance sheets are clean and earnings have stabilized, which is piquing their interest.”

Grant Thornton’s view

As the markets continue to show signs of improvement, sellers are going to jump at the chance to sell. Private equity funds and private businesses that missed their chance to sell at the height of the market have been anxiously awaiting the chance to exit their businesses.

“There’s going to be a flood of exits. People can’t wait for the lofty multiples of 2007. They need the cash. Cash triumphs multiples. A lot of business owners had unrealistic expectations of sales multiples and when they never came, they didn’t get out. These sellers have learned their lesson the hard way,” says McGee.

To that end, the pace of private equity-backed IPOs will continue to increase with more activity expected by the end of 2010. However, the IPOs of today don’t mean the same as they did in the glory days. Proceeds of today’s IPOs are expected to be used much more carefully. Instead of paying out dividends, the money is often being used to lower debt and strengthen companies’ balance sheets. That said, the public market will never be a good exit strategy for all companies. Some companies naturally lend themselves to an IPO, while others do not.

In addition, leverage distributions are a tool of the past. “Raising debt to put it in your pocket isn’t going to be in favor. It was easy to get liquidity by leveraging the company,” says McGee. “This is now going to be the exception rather than the rule. The use of funds is going to be scrutinized.”

Strategics’ appetite for acquisitions is growing, as is their confidence about the overall economy. There have been some significant M&A deals either announced or completed recently: Dell’s pending purchase of Perot Systems for \$3.9 billion, Xerox’s acquisition of ACS for \$6.4 billion, and Abbott’s acquisition of Solvay Pharmaceuticals for \$6.6 billion, among others. These deals instill confidence in the marketplace.

“Strategic buyers have been cautious in 2009, but they do have the capital to become more active. I expect strategic exits will become a more fluid opportunity for private equity firms looking to exit portfolio companies,” says Steven Brady, a national managing partner in the Transaction Advisory Services division of Grant Thornton.

Finally, sponsor-to-sponsor transactions may be unpopular for now, but they will not disappear: As portfolio companies change and grow, they can become targets of larger market private equity firms or sector-specific firms. In addition, there are some companies that simply won’t be big enough to be publicly traded and may not find strong corporate buyers. When leverage becomes more available, sponsor-to-sponsor transactions will return.

“Sponsor-to-sponsor transactions became prevalent between 2005 and 2007. We might not see the headline-grabbing deals for quite some time, but sponsor-to-sponsor transactions will make a come back,” says Brady. “You have a number of private equity firms that need successful exits and at the same time there is a lot of undeployed capital the private equity firms need to put to work. Both buyer and sellers are looking forward to the opportunity to execute sponsor-to-sponsor transactions.”

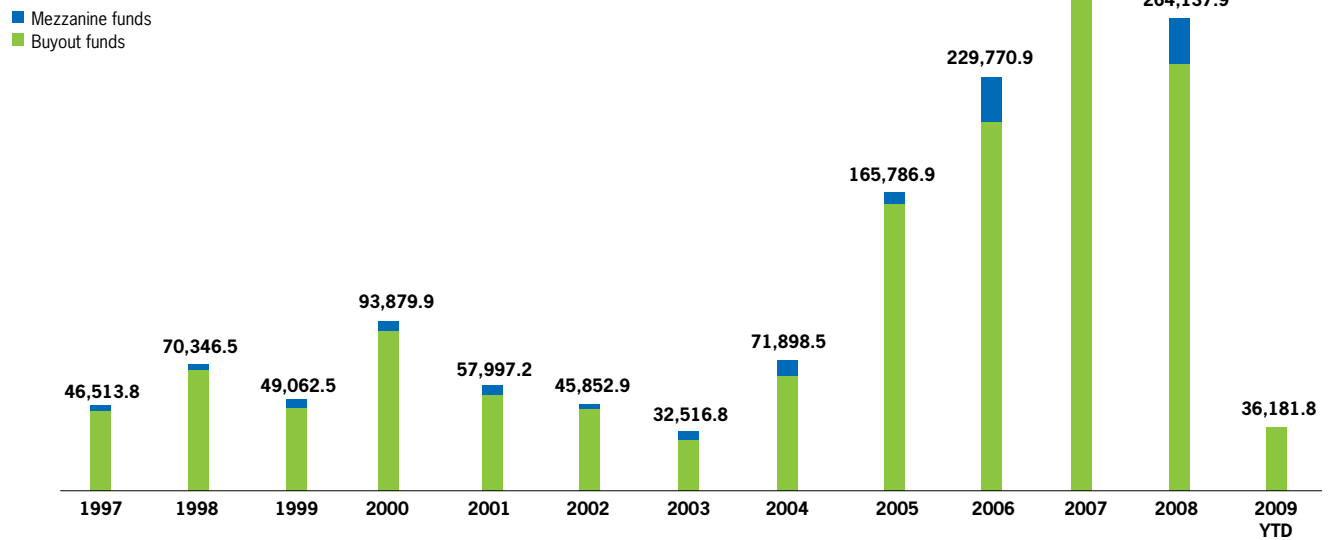
“A lot of business owners had unrealistic expectations of sales multiples and when they never came, they didn’t get out. These sellers have learned their lesson the hard way.”

Stephen McGee
National practice leader of Corporate Finance at Grant Thornton LLP

Fundraising

After investing more than \$1 trillion in private equity funds in the past decade, many limited partners are now anxious about investing in the asset class. Driving much of the decrease in private equity commitments is the dramatic decrease in available funds due to losses across limited partners' endowments and pension plan portfolios, and the need for liquidity to fund retirement and other benefits. (Figure 12)

Figure 12
U.S. buyout and mezzanine fundraising
 (\$M)



Year to date: 1/09 - 6/30/09
 Source: Reuters Buyouts

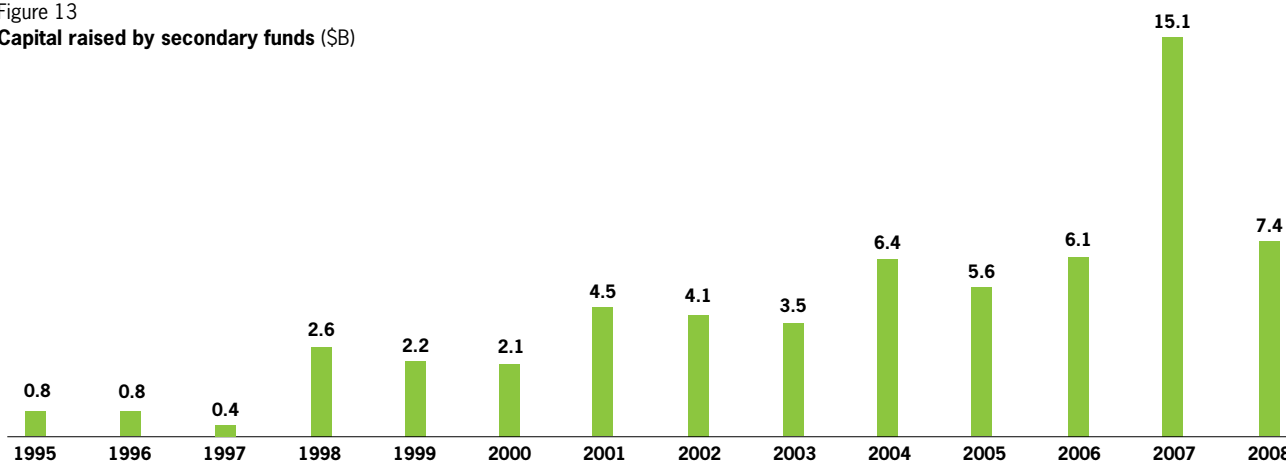
California Public Employees Retirement System's (CalPERS) investments are down 29 percent for the 12-month period ending May 31, 2009. In addition, Harvard University's endowment declined by 27 percent for the year ending June 30, Yale University's endowment declined by 30 percent and Princeton University's endowment lost 23.7 percent for the year ending June 30.

The decline in investments returns, coupled with the troubled economy and liquidity issues, left limited partners skittish about investing in private equity funds. In 2007, those concerns became apparent when capital raised in the secondary market peaked. (Figures 13, 14)

"The smaller LPs are questioning private equity as an asset class and whether the investments make sense given the difficulty of the situation. Even the larger LPs are scaling back because of liquidity issues," says Harvard's Lerner.

As public market valuations fell, the percentage of other assets in a portfolio, including private equity, rose. This phenomenon is known as the denominator effect. As a result, many limited partners became overallocated to this asset class, which forced them to sell off stakes for cash they could return to their investment pools. In the past two years, CalPERS has sold stakes in private equity and venture capital firms in order to reduce its administrative burden and cut the number of its private equity firm relationships. Harvard's endowment also sold a portion of its \$1.5 billion in fund partnerships on the secondary market. Stanford University, which has lost more than a quarter of its endowment, is currently looking to sell off \$1 billion of combined funded and unfunded commitments in private equity, venture capital, timber, oil and gas and real estate.

Figure 13
Capital raised by secondary funds (\$B)



Source: Probitas Partners

Figure 14
The 10 largest secondary funds as of April 2009

| Fund | Firm | Vintage or status | Fund size (\$M) |
|-----------------------------------|------------------------------------|-------------------|-----------------|
| GS Vintage Fund V | Goldman Sachs Private Equity Fund | 2009 | \$5,500 |
| Lexington Capital Partners VII | Lexington Partners | In market | \$5,000 |
| Coller International Partners V | Coller Capital | 2006 | \$4,800 |
| Lexington Capital Partners VI | Lexington Partners | 2005 | \$3,774 |
| Pantheon Global Secondary Fund VI | Pantheon Ventures | In market | \$3,750 |
| Partners Group Secondary 2008 | Partners Group | In market | €2,000 |
| GS Vintage Fund IV | Goldman Sachs Private Equity Group | 2007 | \$3,000 |
| AXA Secondary Fund IV | AXA Private Equity | 2006 | \$2,900 |
| Dover Street VII | HarbourVest | 2009 | \$2,900 |
| Coller International Partners IV | Coller Capital | 2002 | \$2,600 |

Source: Private Equity Intelligence, Probitas Partners

Being over-allocated to private equity has left many limited partners in a precarious position. If private equity firms had made capital calls, many LPs would have been pressed to make good on their obligations, leaving them strapped for cash. Stanford University, for example, has committed to make \$6.1 billion of capital calls to investment partnerships in the coming years, according to Moody's Investors Service. Meeting these funding obligations — when many of its current investments are still illiquid — could put a strain on Stanford's operations.

"There are enormous liquidity issues. Limited partners were holding their breath waiting for capital calls to come in. When that didn't happen it gave them all a little breathing room. But the liquidity constraints, coupled with the troubles in the public market, was a double whammy," says David Dinerman, CFO and COO of Probitas Partners.

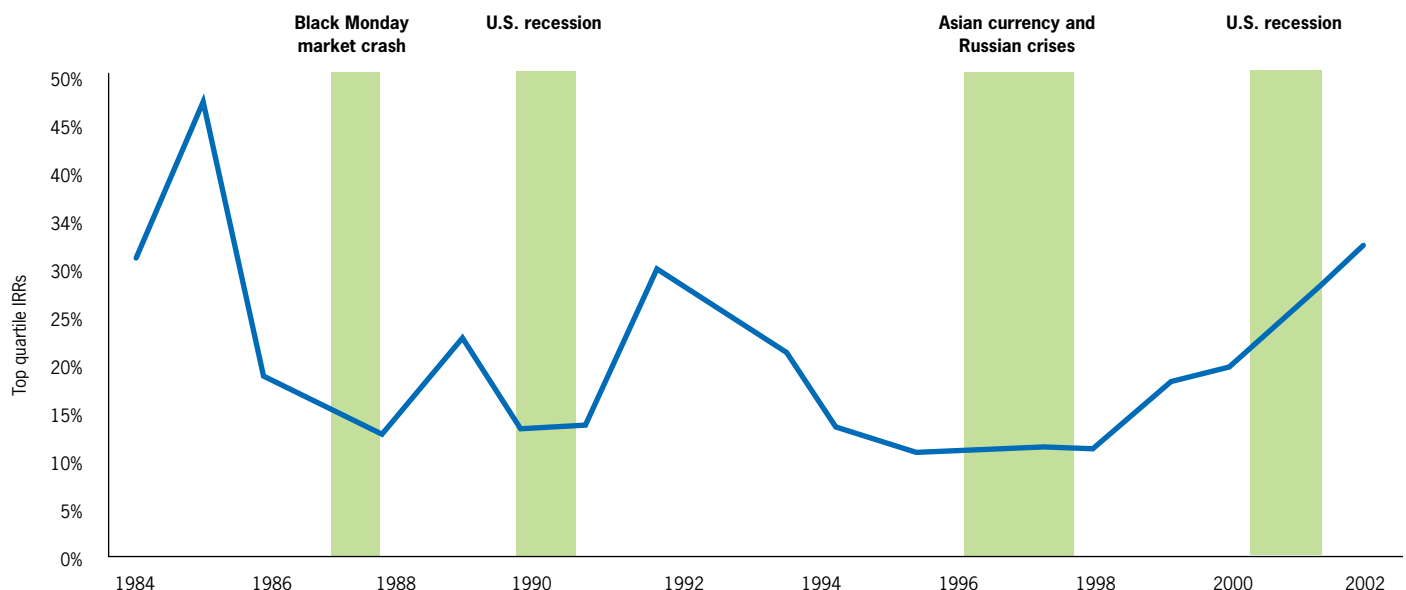
Many LPs started the year with uncertainty about their commitments, with most citing liquidity as the constraint. The Michigan Department of Treasury's Bureau of Investments, which invests for several state pension funds, decided to hold off on private equity investments in 2009. Cincinnati Retirement System and Ohio Highway Patrol Retirement System also decided not to invest in private equity for the time being.

Yet, other LPs aren't willing to throw in the towel just yet. Most LPs are disappointed, but understand investments made during the next couple of years will most likely generate stronger returns than investments made during the last three years.

Figure 15 tracks top-quartile buyout IRRs (Internal Rate of Return) during and following four economic crises from 1984 to 2002. Funds raised immediately after recessionary or troubled economic times tended to outperform those raised before the economic downturn. The key drivers boosting returns are the lower purchase prices and the greater ability to drive incremental value in the portfolio as economic conditions improve.

Further evidence comes from Thomson Reuters' *Investment Benchmark Reports*, which tracks returns of private equity and venture capital funds. Clearly, the majority of funds invested during the boom have much lower rates of return than funds invested immediately after times of crisis. For example, funds that were invested during the 1990 U.S. recession had an IRR of 5.9 percent. Funds invested in 1991 — just after the recession ended — had an average return of 10.1 percent, while 1992 investments had a return of 18 percent by 2007.

Figure 15
U.S. buyout historical returns



Source: Probitas Partners

In addition, businesses typically rely on private equity capital for liquidity and growth in post-recessionary times. According to a survey conducted by Pepperdine University, 64 percent of private equity professionals believe that the demand by companies for private equity will increase over the next 12 months. Limited partners want to make sure they have a stake in new funds as they provide capital to those businesses. And most limited partners favor middle market shops to larger ones. (Figure 16)

Hoping to cash in on this trend and recoup some of its losses, CalPERS increased its private equity allocation from 10 to 14 percent. Despite recent bumps in the road, CalPERS has seen a 7.3 percent return from its alternative investments over a 10-year period. That compares to global equity's 10-year net return of just 0.5 percent, global fixed income's return of 5.9 percent and the total fund's return of 3.1 percent. Others, such as Teachers' Retirement System of the State of Illinois have increased their exposure to the asset class.

"The best of the best LPs got slammed. But the smartest investors like Warren Buffett, who said be fearful when others are greedy and greedy when others are fearful, know that now is not the time to abandon the asset class," says Dinerman. "Limited partners might become more conservative, but they will not leave the asset class."

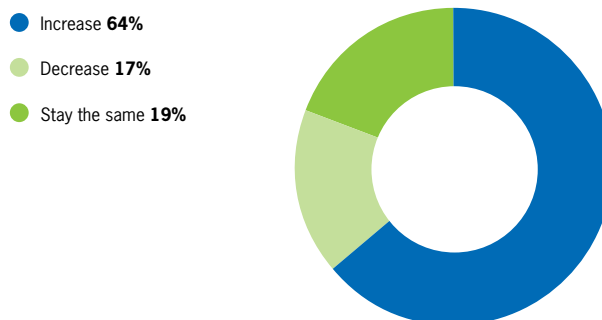
Even so, it will not be easy for private equity firms to raise new funds. More than 900 global private equity and venture funds are currently trying to raise new funds. LPs will be intensely scrutinizing private equity firms, many of which will not receive new commitments. The Boston Consulting Group predicts that 20 percent to 40 percent of the 100 largest private equity firms will disappear. "Funds that haven't generated returns will melt away, but it won't happen over night because the duration of private equity partnerships is long," notes Carbone.

Larger firms will probably face the biggest hurdles raising new funds. Over the past few years, the megafunds made headlines with record-breaking fundraises and unforgettably bad investments.

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David Dinerman
CFO and COO of Probitas Partners

Figure 16
Demand for private equity forecast (12-month)



Source: Pepperdine University Graziadio School of Business and Management

"The megafunds got overbought. Some of the larger firms have had notable and significant blowups. When their first tranches of debt come due in 2011 and 2012, they are going to have trouble, unless they are able, in a tougher regulatory and lending environment, to rework those loans. Banks will likely require pay downs, which will put a lot of pressure on the larger firms. The middle market will suffer less," says Dinerman.

Indeed, the middle market is expected to return more quickly as banks start to provide loans again. The megafunds, which were much more dependent upon second lien loans, collateralized loan obligations and collateralized debt obligations, will be much slower to come back.

"The alternative lenders have imploded," says McGee. "This type of lending funded the biggest deals, but ultimately was very disruptive to the market."

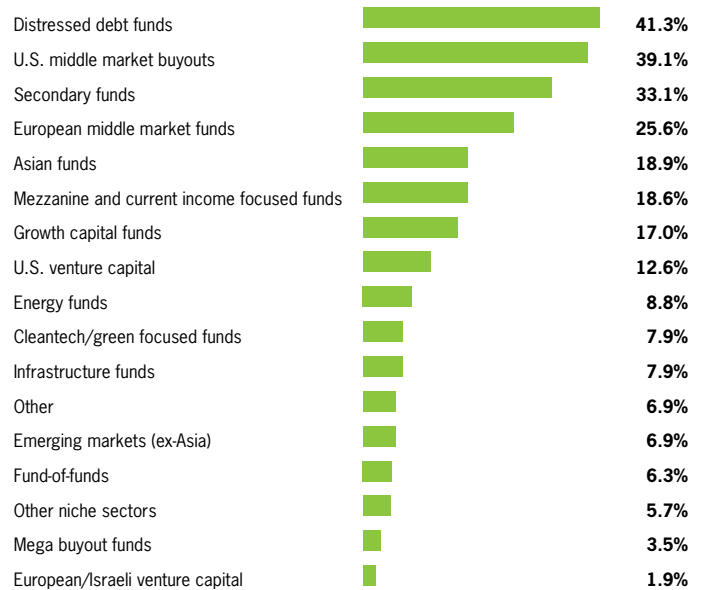
LPs are banking on the middle market recovering faster. The Probitas Partners *Institutional Investor Private Equity Survey*, conducted at the end of 2008, asked LPs which areas they planned to focus on in 2009. The top four responses were distressed debt funds, U.S. middle market buyouts, secondary funds and European middle market buyouts, with mezzanine/current income vehicles and Asian-focused funds following closely. Perhaps unsurprisingly, mega buyout funds garnered very little interest. (Figure 17)

“Middle market private equity shops are going to be the winners. We will see a reaction against the mega-buyout shops, but not a big movement toward VC. Many limiteds have concluded that VC investing is hard because there’s a number of small groups with small investments,” says Lerner.

Venture firms are expected to have difficulty raising money as well. “Venture hasn’t returned much money over the last 10 years. The only venture funds that will be able to raise money are early stage funds investing in high-growth companies or companies that focus on hot spots like green technology,” says one private equity investor.

New funds and emerging managers are also going to be in the hot seat. “Why would an LP put money in a first fund now?” says Carbone. “Existing managers with strong track records will fare best. It will be a difficult go for the new fund managers to raise their first fund in this market. It’s hard even for the experienced fund managers.”

Figure 17
Areas of LP interest



Source: Probitas Partners 2009 Institutional Investors Survey

“Why would an LP put money in a first fund now? Existing managers with strong track records will fare best. It will be a difficult go for the new fund managers to raise their first fund in this market. It’s hard even for the experienced fund managers.”

Paul Carbone
Director of Baird Capital Partners

Indeed, even for general partners with impeccable reputations, raising a first fund is not an easy task. Huntsman Gay Global Capital, founded by Robert Gay, who was previously with Bain Capital, and Jon Huntsman, an experienced and well-regarded businessman, didn't have an easy time. The firm was able to close its first fund with \$1 billion in commitments, but not without a great deal of effort. "We are a new fund, and a lot of investors didn't want to talk to us because of that. ...A lot said they wanted to wait until we were on our second fund," Gay told *MAJ*.

Transparency will also play a role in raising new funds. Limited partners want to see more transparency and will favor funds that provide it. The Institutional Limited Partners Association recently came out with guidelines on best practices, which CalPERS has endorsed, and which offer private equity firms some best practices on being transparent. (Figure 18)

Gay told *MAJ* that the firm's commitment to transparency helped it raise its fund. "The first big commitment came from CalPERS. CalPERS is big on transparency, and we are a publicly registered fund. That really helped us."

Transparency has become somewhat of a buzzword as FAS 157 has gained more attention. Fund managers should take notice: Thorough FAS 157 reporting will give firms with good track records another area where they can distinguish themselves in the market.

FAS 157 is also helping ease the impact of the denominator effect. FAS 157 forces private equity firms to value their portfolio holdings at fair market, making it easier for LPs to evaluate and compare their public and private portfolios.

"FAS 157 is driving a closer correlation between the public markets and private equity," says Dinerman.

Figure 18

Guidelines on disclosure

- 1 Fee and carried-interest calculations should be transparent and subject to limited partner and independent auditor review and certification.
- 2 Detailed valuation and financial information related to the portfolio companies should be made available as requested on a quarterly basis.
- 3 Investors in private equity funds should have greater transparency as requested with respect to relevant information pertaining to the general partner.
- 4 All proprietary information should be protected from public disclosure.

Source: Institutional Limited Partners Association



Fund managers should take notice: Thorough FAS 157 reporting will give firms with good track records another area where they can distinguish themselves in the market.

Grant Thornton's view

There is no doubt that private equity firms that bought companies during the debt-fueled boom will find it very hard to generate their targeted returns. In order for investments to generate even acceptable returns the stars must align and everything has to go perfectly, which seems unlikely given the global economic conditions.

Simply put, some limited partners are overallocated and others aren't ready to jump back on the horse. One thing is almost certain: Investments made in the next few years will likely generate significant returns. Limited partners with money available to invest will try to reap the benefits of being involved in deals that happen during this period. While limited partners are going to be more willing to part with their money by the middle of 2010, they will undoubtedly be selective about whom they entrust it with. Only GPs with an outstanding track record and specific wins to point to, have a chance of raising new funds in the near future. Others should wait until market conditions have improved.

Funds with strong track records that invest in clean energy, health care and technology will be popular, thanks in part to President Obama's initiatives in the sectors. "Any areas that receive government attention and public subsidies are areas where there will be opportunities," says Lerner. "Shifts in policies create disconnects and investment opportunities."

Grant Thornton thinks all three sectors will fare well, but health care in particular is expected to flourish. The industry is fairly recession-resistant in bad times — and in good times, it's appealing. The need for health care-related companies continues to grow every day. There will be plenty of opportunities in this space for the next 10 to 15 years. Health care reform will create even more opportunities. However, while health care reform creates opportunities, it can also bring risks. There is uncertainty about what's coming down the pike.

Energy and power will remain a hot area for investment as well. President Obama's \$4.5 billion initiative to make America greener will certainly create opportunities in the sector down the road. In addition, there are smaller companies in the power and energy sector that are venture funded now and won't be able to access the public markets because of their size, but will be in need of an exit in the near future.

Finally, private equity firms that raise funds that have a flexible mandate will also fare well. These funds will be in a good position to take advantage of minority stake investments, which are gaining popularity. Business owners who are reluctant to sell their businesses in this market but have liquidity needs have been pursuing partial sales to put some cash in their pockets. Buying minority stakes in businesses is gaining popularity because buyers don't need a lender to finance the transaction.

"A minority investor can help shore up the balance sheet by providing capital and deleveraging the company. It also allows a seller the ability to gain some liquidity without totally cashing out in a down market," says McGee. "



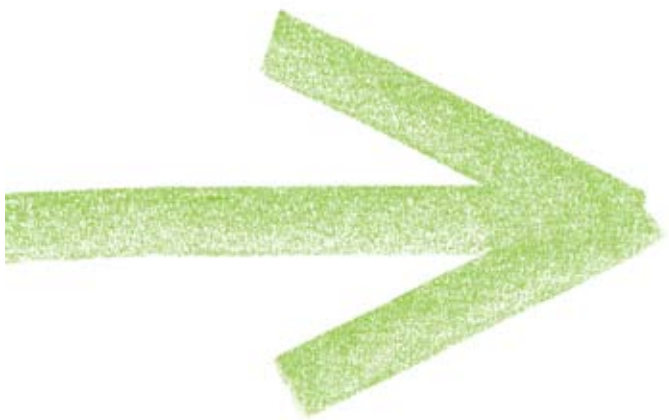
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Conclusion

There is no question that private equity has seen its fair share of troubles over the past year. Although global economic conditions can be blamed for a large part for these troubles, the private equity industry would be in better shape now had leverage levels not gone up as much as they did. The good news is that the industry is ready to move forward, albeit gradually: Portfolio companies are becoming more stable, and overall market conditions are improving.

Private equity has learned some difficult lessons from the recession. In this post-boom era, the industry will not look quite the same. There will be fewer funds, stricter equity requirements, and deal values will remain lower than they were during the boom. But even though the industry may not seem quite as fast-paced or exciting as it did before the recession, private equity is set for a solid comeback — and going forward, it will be even healthier and stronger.

The good news is that the industry is ready to move forward, albeit gradually: Portfolio companies are becoming more stable, and overall market conditions are improving.



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