

WHAT IS PRIVATE EQUITY?

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Bas Solleveld is an investment analyst in the Multi-Manager Investment Program. His responsibilities include, but are not limited to, private equity and real estate manager due diligence and selection, in addition to monitoring approved manager performance and analysis of those illiquid markets. In collaborating with relationship managers and their clients, Bas seeks to find the most appropriate alternative asset managers within the framework of clients' risk tolerance and asset allocations. He joined Atlantic Trust in 2004 in the client strategies group, where he was responsible for client reporting and portfolio optimization. He earned a Bachelor of Arts from Franklin & Marshall College.

A discussion of private equity investment must begin with a proper definition of the term private equity. What, then, is private equity? It is the business of investing in securities of companies that are not listed on public exchanges or those that are in the process of being taken private.

For most individual investors, this type of investment is an onerous burden and represents a risky investment endeavor. Atlantic Trust advises that a more prudent approach to the asset class is through investment in private equity funds.

And what, then, is a private equity fund? A private equity fund is a pooled investment vehicle managed by a private equity firm -- referred to as the general partner (GP). The GP raises capital from sophisticated institutions and wealthy individuals who invest as limited partners (LPs) in the fund. An LP makes an unfunded commitment to the fund partnership for a specific period of time; a typical fund life is 10 years. The size of the fund is equal to the sum of all the capital commitments from all the LPs. When the GP finds a suitable investment, he or she draws down or "calls" capital from the LPs to fund each LP's pro rata amount of the investment in accordance with each LP's commitment. LPs do not participate in management decisions, and they are liable only for the cash they commit. The date of the first investment is considered the "vintage year" of the fund. The vintage year is used when comparing the investment performance of similar funds.

Types of Private Equity

Private equity funds can be divided into three classifications, or types. Each fund type has a unique strategy.

- **Leveraged buyout (LBO):** The acquisition of a mature company in which the purchase is leveraged through loan financing, rather than being paid for entirely with equity funding. The assets of the company being acquired are put up as collateral to secure the loan, and future cash flows are used to pay down that balance.
- **Venture capital:** Financial capital and resources funded to a startup or small business with high growth potential. Typically, the businesses funded are pre-revenue and the equity positions taken are minority in nature.

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- **Growth capital:** This is the middle ground between the venture capital and leveraged buyout strategies. A minority investment is made into a more mature but growing business. The capital is often used to expand the business and promote growth.

Phases of Private Equity

The life of a private equity fund can be broken down into three stages: investment phase (years 1 through 4), maturation phase (years 4 through 7) and, finally, the harvest phase (years 7 to liquidation).

During the investment phase, the GP sources and performs due diligence on investment opportunities. Once an investment is found, the GP calls capital from the LPs on a pro rata basis relative to each LP's commitment. Typically, a private equity fund invests in anywhere from 8 to 20 portfolio companies. The majority of committed capital is funded during the investment phase.

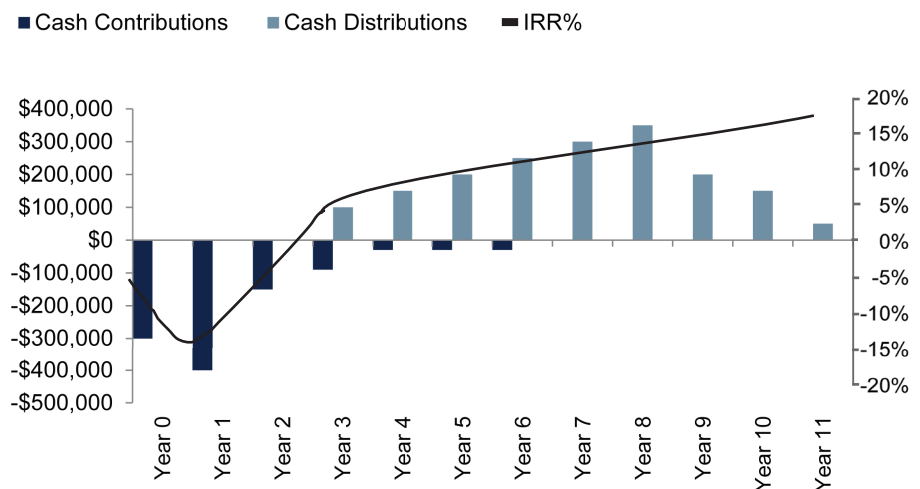
In the maturation phase, GPs are working with their portfolio companies to improve and expand the business. LPs may receive small capital calls for follow-on investments. The portfolio may experience some write-downs on investments that are not performing as expected.

The harvest phase is the period when the GP is actively looking to exit the investments. Since the investments are not publicly traded, the only ways that a GP can realize the LPs' investments are via an initial public offering, a sale, a merger, or a recapitalization. When a realization of the investments does occur, the LPs receive a distribution from the fund relative to each LP's ownership of the portfolio company minus any fees.

Figure 1 illustrates a generic private equity fund's cash flows and performance and is often referred to as the "J-Curve" due to its shape. The bulk of committed capital is drawn down during the investment period, and capital is distributed back to LPs during the maturation and harvest periods. Typically, an LP experiences negative returns during the investment period because of fees and write-downs. Management fees are often charged on committed capital and, as a result, the fees take up a large proportion of early capital calls.

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Figure 1: Fund Life Cycle and the J-Curve



Note: Assume \$1M commitment. Actual fund performance is not represented by this graph. For illustrative purposes only, as all numbers are hypothetical. Source: Atlantic Trust

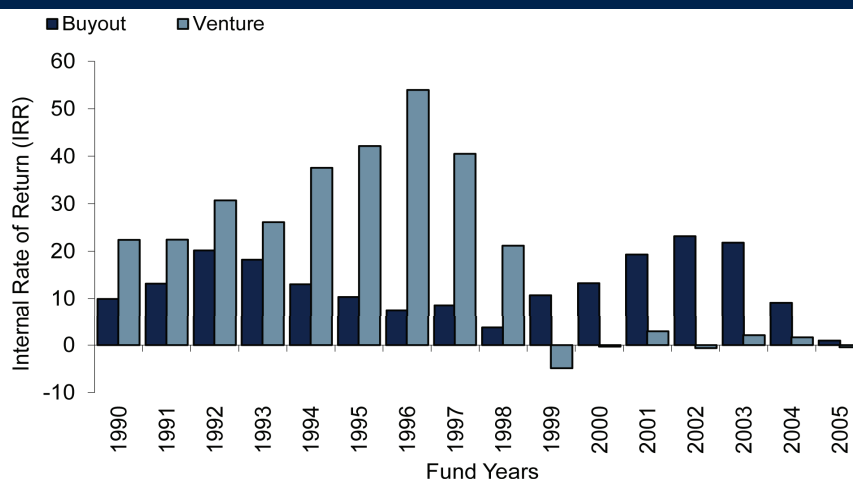
Private Equity Returns

Private equity returns run in cycles, much like the public markets. They are influenced by a host of variables, such as overall market conditions, access to credit and fundraising. It is critical that those who invest in this asset class do so with a long-term program in mind so that they can comfortably ride out the various cycles.

The most widely used measure of performance is the internal rate of return (IRR). An IRR takes into account the timing of cash contributions and distributions to and from the fund and the length of time an investment is held. When comparing the performance of funds, potential investors should compare funds of the same vintage year. Using a specific vintage year allows performance comparisons of funds that are invested in similar market conditions. Also, it avoids the commingling of mature and newer funds at different stages in their fund lives. It allows for a true “apples to apples” comparison.

Figure 2 shows the vintage year performance for the past 20 years of funds over 5 years old (fewer than 5 years is not meaningful because the funds are still investing). As illustrated, returns are cyclical and tend to be unpredictable. In the 1990s, venture capital outperformed, while in the 2000s, buyouts outperformed.

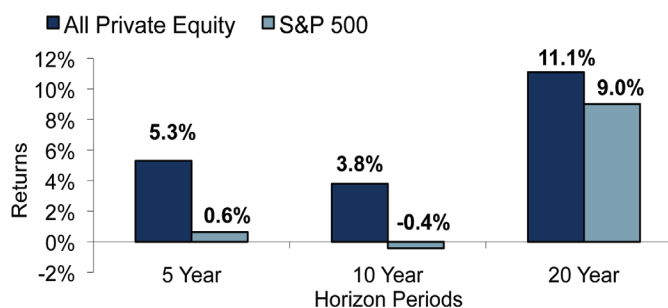
Figure 2: Vintage Year Performance



Source: Thomson ONE, 12/31/2010. Past performance is not a guarantee of future results.

Figure 3 illustrates private equity's outperformance in the long term over the S&P 500. Atlantic Trust advises that to have a successful program, an investor needs to consider the investment as long-term in nature; further, the investor must be diversified across fund stages and vintage years.

Figure 3: Private Equity vs. S&P 500 Index



Source: Thomson ONE, 09/30/2010

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Private Equity Risks

Many studies claim that private equity offers low to moderate correlation to public markets, but those claims may be overstated. The largest segment of the private equity asset class, leveraged buyouts, has a clear relationship with public markets. A strong public market means better opportunities for successful IPOs, corporate buyers have more cash and higher valuations for companies. Other types of private equity, such as venture capital and distressed, are less reliant on public markets and should have lower correlations.

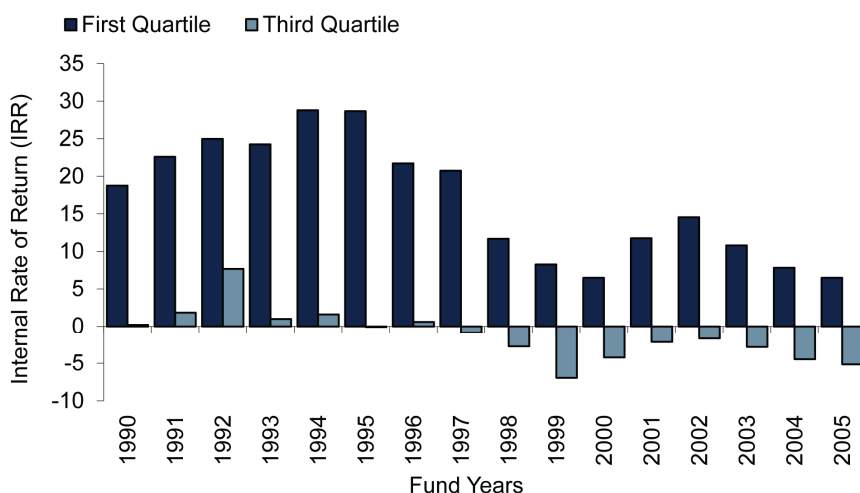
The perception of private equity as having a low correlation to the public markets has been largely a result of the way funds marked their investments. In the past, funds typically held their positions at cost until the funds were exited. This all changed in September 2006 when the Financial Accounting Standards Board (FASB) issued Statement No. 157, "Fair Value Measurements," commonly referred to as FASB 157. At its core, FASB 157 requires funds to value their positions at the price they would receive if they were sold today -- regardless of whether that was the manager's intention. Suddenly, private equity investments were much more volatile than in the past and tracked the public markets to a larger degree. Investors should understand that they must be comfortable with illiquidity – the largest risk in private equity. Once a commitment is made, the investor is locked into that partnership, and the penalty to abandon it is severe.

Access

As demonstrated by Figure 4, there is a large performance disparity between first-quartile managers and third-quartile managers. First-quartile managers are those who performed in the top 25% of all funds managers, and third-quartile managers are those in the lower 50 to 75%. This illustrates one of the key tenets of private equity investing: Access to top-quartile managers is essential. It is only worthwhile to invest in the private equity asset class if you have access to the best managers.

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Figure 4: Quartile Vintage Year Performance



Source: Thomson ONE, 12/31/10. Past performance is not a guarantee of future results.

What makes access so critical is the persistence of investment returns with private equity managers. A private equity fund's performance is closely correlated with the performance of its previous funds.* Managers who outperform in one fund are likely to outperform in the next, however past performance is not a guarantee of future results. Similarly, managers whose funds underperform are likely to repeat this performance.

*"Private Equity Performance: Returns, Persistence and Capital," Steve Kaplan and Antionette Schoar



Conclusion

Though investing in private equity is not without its challenges, qualified investors should consider the many benefits of gaining exposure to the asset class. Private equity offers investors access to an inefficient market that has historically generated higher returns than public markets. The most important aspects of a private equity investment program are to garner broad diversification by vintage year, stage and geography and to access top-tier managers. Atlantic Trust believes a private equity investment is an integral part of a well-diversified investment portfolio for qualified clients.

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General Private Equity Risk Factors

Speculative Investments: Private funds are speculative investments and include a high degree of risk, including loss of investment.

Restrictions on Transfer/Illiquidity: It is difficult to sell investments as they are illiquid and an investment in any private fund is highly illiquid. Limited Partners may not be able to liquidate their investments prior to the end of each Fund's term and interests are not transferable except with the consent of the GP.

Future and Past Performance: Since private equity funds make a limited number of investments and since the fund's investments generally involve a high degree of risk, poor performance by a few investments could severely affect the total returns to LP's.

Difficulty of Locating Investments: There is no guarantee that suitable investments will be available and it is possible that a private equity fund will never be fully invested.

Reliance on Certain Key Persons: Performance is linked to certain key persons and there can be no assurance that such persons will continue to be employed by the manager at all times.

No Right to Control Companies: There is no right to control portfolio companies in which the private funds invest.

Limited Operating History: Portfolio companies in which private funds invest have a limited operating history.

Regulation and Fees: Private funds are not subject to the same restrictions as registered investment companies.

Tax Investments: Tax investments in a private fund may involve complex tax structures and there may be delays in distributing important tax information.

Valuation of Interest: Private funds are not required to provide periodic pricing or valuation information.

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