SOMERSET CAPITAL

FAMILY OFFICES • PRIVATE MARKETS

Data Service

Volume 18 – January 2011

FAMILY OFFICE INVESTMENT IN PRIVATE MARKETS: 2010

2010 has been a recovery year across private equity, real estate and hedge fund markets during which the pendulum of investor interest which reached standstill (arguably) in the first half of 2009, started to swing back on a new arc, initiating a new market cycle. As part of this process family offices returned cautiously to market, albeit with a new set of concerns, requirements and investment goals.

One interesting point is that while fundraising has seemed extraordinarily tough for the last two years, the levels of capital being raised across both private equity and real estate markets are in fact significantly higher than during the last market downturn in 2002-2004.

It is also worth noting that whereas 2009 totals included a large proportion of commitments that were in reality a carry over from the pre-Lehman fundraising environment, the 2010 totals, which are not flattered by this effect, are in line with 2009 and in our view represent levels of capital that have been raised post crisis, and that can be considered as part of the new market cycle.

Family office investors that we deal with cite the following issues as their main concerns as we go into the new year:

- Inflation. Governments and central banks have undertaken an unprecedented bail-out of financial markets since the financial crisis which raises the very real risk of a sustained and damaging period of inflation. Investors are taking this threat very seriously and are re-engineering their portfolios towards assets classes that offer some protection, notably real assets, equities and commodities, and away from cash and bonds.

- Emerging markets. Investment in growth markets such as China, India and Brazil has dominated the agenda for 2010 as investors seek to increase allocations to these markets "en masse", as well as to asset classes such as commodities and energy that benefit from this trend.

- Direct deals. We are hearing more and more of the family offices that we deal with looking to implement a direct strategy, both in private equity and real estate. A couple of points are often made in this regard: firstly that such families very often have significant industrial experience, and secondly that from a return perspective the family is competing on a gross basis with the net returns of a fund manager, which provides a good amount of room for manoeuvre.

Private Equity

Private equity fund investment among family offices has attracted a subdued level of interest in 2010. The majority of offices that we deal with are maintaining significant allocations to private equity. The overriding concerns have been the overhang of capital, the fee basis, and a scepticism as to whether buyout firms will be able to deliver attractive returns in a low leverage environment.

Interest in private equity funds has been contained to a handful of niche segments of the market, and to managers with an exceptional track record. From our experience and discussions in 2010 the following market segments were of interest to investors:

- Small buyouts, where the teams have entrepreneurial or industrial skill sets, remain a credible investment theme, particularly turnaround specialists.
- Certain special situations funds such as secondary, distressed and mezzanine have also attracted interest.
- As previously mentioned, 2010 was a year when investors racked up airmiles to review funds in exotic parts of the world.

Hedge Funds

Hedge fund inflows reached a total of $240 billion (in the year to November 2010), with about $80 billion in net inflows, and $162 billion coming from positive performance in the industry.

Hedge funds overall were up about 7.8% during 2010, with mortgage backed arbitrage strategies at the top of the list (23.8% returns) and market neutral strategies at the bottom, losing 9.71% over the course of the year.

Long/short equities returned 9.32% overall last year, and distressed was up 12.9%, based on the Bloomberg indices.

Real Estate

Fundraising levels for private equity real estate in 2010 continued to skid. 89 funds closed in 2010, raising a total of $35.8 billion, according to Preqin. This represented a 28% decline versus $49.8 billion raised in 2009 and 74% off a peak of $137 billion in 2008.

Evidence of stronger confidence in the 2011 fundraising market may exist, however, as a number of fund managers raised fundraising targets in the final quarter of 2010.

We believe two main real estate investment themes remain compelling for 2011. First, the significance of the real estate debt and distressed markets has accelerated over the past two years. We expect that over 50% of capital raised for real estate in 2010 will be directed at work-out and distressed opportunities.

Secondly, we expect the shift in real estate capital flows toward Asia and other emerging markets to continue.

Finally, we expect a continuation of interest in direct and deal-by-deal real estate investment opportunities, which permit investors to achieve better transparency and retain more control over liquidity, asset selection and the use of leverage.

PRIVATE EQUITY FUNDRAISING 2010

US MARKET

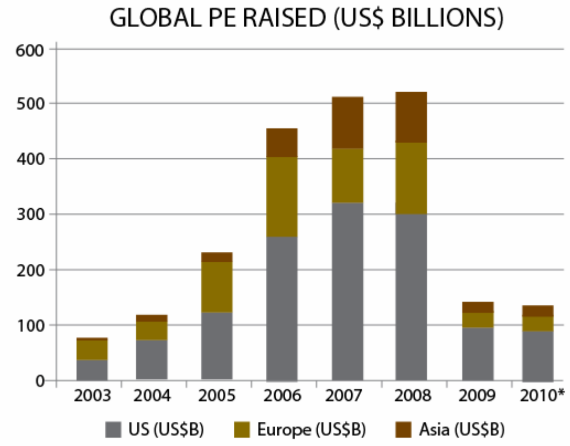
- We estimate US PE fundraising at $90 billion by the end of 2010, down 6% from the $95.7 billion raised in 2009.
- US PE dry powder was estimated at $485 billion in Q1 2010. Funds above $1 billion comprise the largest portion of this overhang at 82%.
- Buyout funds constituted around 60% of total capital raised in the US in 2010, an approximate 10% increase from 2009 levels. The largest fundraising of the year was Madison Dearborn which closed a $4.1b fund.
- Restructuring / distressed debt managers raised c.$18 billion in 2010 with closings from Oaktree ($3.3b), Littlejohn ($1.34b), Centerbridge ($2b) and Blackstone ($1.5b) among others.
- Secondary funds had another strong year in 2010, raising $8.5 billion in the first half, on top of the $17.4 billion raised in 2009. Lexington and Landmark both closed funds in the year.
- VC funds raised approx $12 billion in 2010 (vs $13 billion in 2009) with closings from NEA, Oak, Khosla, Battery and a Sequoia China fund being some of the highlights.
- Latin America fundraising more than doubled to $5 billion in 2010 from $2.2 billion the year before.

EUROPEAN MARKET

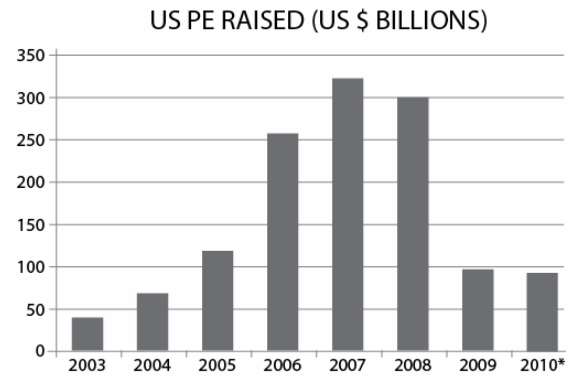
- By 1H2010, $15.5 billion had been raised in Europe and it seems that year end totals will come in at a level similar to 2009.
- The overhang remains high, with dry powder estimated at $281 billion in April 2010.
- Fundraising in 2010 was dominated by growth capital and buyouts funds. Significant closings during the year were Frankfurt's Triton buyout fund at €2.25b ($3.1b), Apollo's distressed debt fund at c. $2b, London based HG Capital buyout fund at and 3i's growth fund at £1.9b ($3.4b) and €1.2b ($1.8b) respectively, Antin's infrastructure fund based in Paris at €1.1b ($1.4b).
- The Nordic region saw a fundraising uplift in 2010. Litorina based in Stockholm closed a buyout fund at SEK2.5b ($365m). Verdane, an Oslo secondary direct fund closed at SEK$1.5b ($219m).

ASIAN MARKET

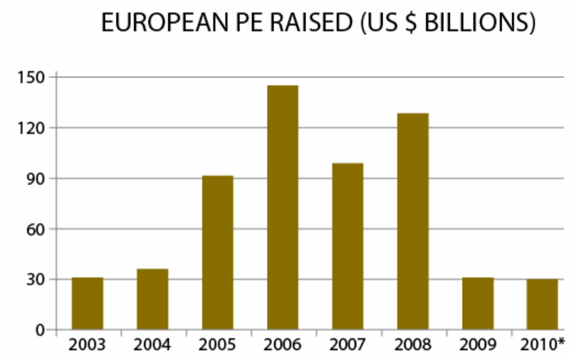
- 2010 fund raising figures look likely to come in similar to 2009* at around $28 billion
- By 1H2010, over $15 billion was raised. Out of this total, growth equity funds had more than 60% share and China focused funds represented about 80% (driven by growth in RMB denominated funds).
- Up until Sept 2010, eight funds have been known to achieve a first or final closing above $1 billion in size (averaged at $1.4b) according to APER. These are mainly successor funds raised by global PE firms, that have more than doubled the size of its predecessor funds; Carlyle closed at $2.55b, CITIC raised a 9b yuan denominated fund ($1.35b), SAIF raised $1.25b, Navis Capital closed at $1.2b, Sequoia at $1b and Shenzhen Cowin at $1b.
- **Excludes China's $8.7 billion state backed Industrial Investment Funds (IIFs)*



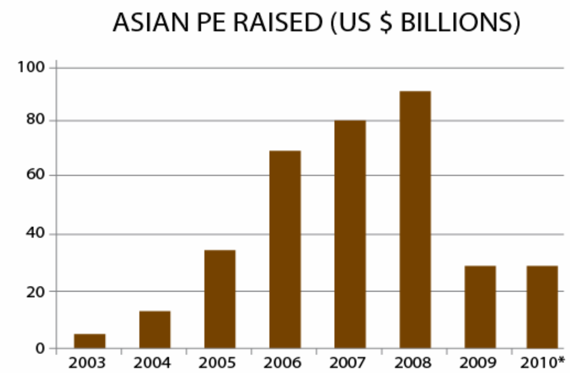
Somerset's estimates based on PEA, NVCA, EVCA, APER and AVCJ



*Source: NVCA (2003-2006), PEA (2007-2009), *Somerset's estimate*



*Source: EVCA (2003-2006), PEA (2007-2009), *Somerset's estimate*



*Source: APER (2003-2004), AVCJ / Preqin (2005-2009), *Somerset's estimate*

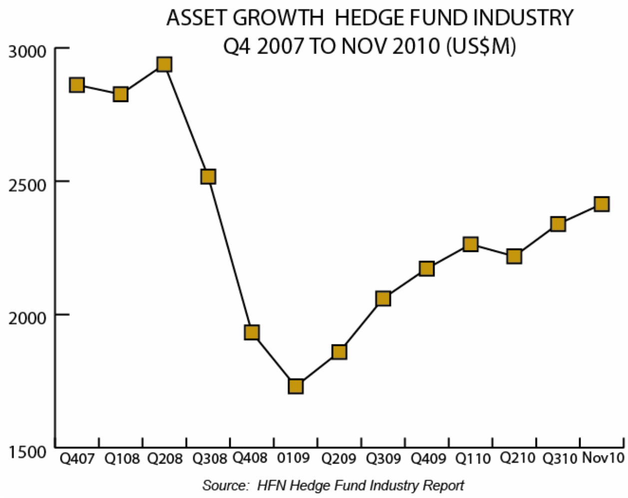
HEDGE FUND ASSET FLOWS 2010

- Total estimated hedge fund assets at the end of November 2010 were $2.414 trillion, with a fifth consecutive month of positive flows.
- In the year to end November, investors added $80 billion to the total hedge fund asset base while performance added $162 billion.
- Funds investing in Latin American have seen above average investor inflows in 2010. The trend persisted through the end of the year, despite outflows in October.
- Allocations to funds investing in mortgage related securities continued their strong pace. Mortgage sector funds were the best performing sub-strategy last year, with the funds in the Bloomberg Hedge Fund index up 23.88%
- In the US, multi-strategy and diversified long/short equity strategies had the biggest inflows during the last two months of the year in the US. Our industry contacts suggest that US-dedicated long-biased equity long/short funds are attracting investor attention for 2011 allocations, while emerging market and event driven have been favoured over the last few months.
- Asian strategies attracted $700 million in net inflows in November, concentrated in a few funds. Quality of the manager seems to have driven those flows more than the strategy or geography.
- European event driven allocations are growing, according to a major prime broker.
- IT has the highest net holding for a third year, financials and health care remain the top three sectors for net exposure, though financials now beats health care.

(Sources: Eurekahedge, Morgan Stanley, Hedgefund.net, and Bloomberg)

HFN Index	Dec	YTD 2010 (thru Dec)	2009
HFN Aggregate Indices			
HFN Hedge Fund Aggregate Index	3.36%	10.95%	19.44%
HFN Fund of Funds Aggregate Index	1.95%	4.87%	9.56%
HFN Equity Hedge Aggregate Index	3.82%	11.17%	23.31%
HFN Relative Value Aggregate Index	1.65%	9.40%	20.16%
HFN Regional Indices			
HFN Asia Index	2.75%	8.57%	21.91%
HFN Europe Index	3.53%	8.99%	16.01%
HFN Global Index	3.11%	8.52%	12.63%
HFN Latin America Index	2.24%	12.14%	46.44%
HFN Middle East/North Africa Index	3.03%	14.43%	22.14%
HFN North America Index	3.38%	12.53%	21.00%

Source: hedgefund.net database



REAL ESTATE FUND RAISING 2010

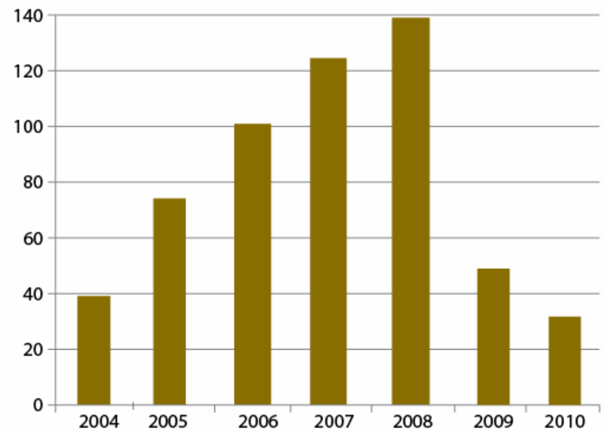
Summary of 2010

- Only 89 funds closed in 2010, raising $35.8 billion in total, a 28% decline versus $49.8 billion in 2009, according to Preqin. This was 74% off a peak of $137 billion raised in 2008. The 2010 results, the lowest annual volume since 2003, required managers to spend an average 17.6 months on the road, versus 10 months in 2007.
- The final quarter of 2010 saw a number of fund managers raise fundraising targets, perhaps indicating stronger confidence in the fundraising outlook for 2011.
- Globally in 2010, 45 funds focused on North America raised a total of $22.5 billion. In Europe, 19 funds raised a thin $3.4 billion, while 24 funds focused on Asia and the "rest of the world" raised $10 billion.
- Most major cities have seen liquidity return adequately at the prime end of their direct real estate markets, compressing cap rates to pre-crisis levels.

Looking ahead

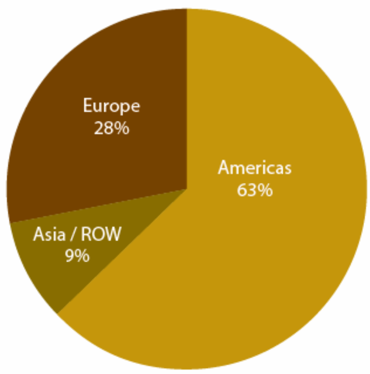
- We believe two real estate investment themes in particular remain compelling for 2011.
- First, we expect that overall fundraising targeting debt and work-out strategies will exceed 50% in 2011.
  - While the anticipated deluge of troubled assets onto the market from bank balance sheets has not materialised, many managers believe the assets must be off-loaded eventually and the quantum represented is substantial.
  - Banks have learned from the previous downturn and are incrementally negotiating orderly solutions. The opportunity requires managers to have not only good relationships with the banks, but also skill and credibility in providing creative work-out solutions designed to optimize the outcome for banks. Such skill is not widespread and the level of due diligence and negotiation required is multiplied; hence, the process will take time.
  - While the banks have shown they are not pressured to release assets at dramatic discounts, managers who can deliver solutions will still be rewarded with ample upside.
- A second investment theme we expect to continue to make sense is the shift in real estate capital flows toward Asia and other emerging markets.
  - Asia now includes 8 of the world's 20 largest property investment markets by volume versus only 3 just five years ago, according to an annual ranking by Cushman & Wakefield.
  - CBRE recently reported that Central and Eastern Europe saw a 90% increase in direct investment turnover to €5 billion in 2010 (from €2.6 billion in 2009).
- Finally, we believe many investors will continue seeking solutions to shortcomings of the blind pool fund format. Alternatives include incremental commitments and direct or deal-by-deal strategies, which permit investors to achieve better transparency and retain more control over liquidity, asset selection and the use of leverage.

REAL ESTATE FUNDS RAISED (US$ BILLIONS)



Source: Prequin

FUNDS CLOSED: % OF TOTAL FUNDRAISING BY GEOGRAPHIC FOCUS FOR FUNDS IN MARKET / COMING TO MARKET



Source: Private Equity Real Estate

Somerset Capital Ltd
Walsingham House, 35 Seething Lane
London, EC3N 4AN, United Kingdom

T. +44 (0)20 7264 2431
www.som-cap.com