Berkshire Capital | NEWSLETTER | 3rd Quarter 2007

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535 Madison Ave., 19th Floor
New York, NY10022
212.207.1000 (phone)
212.207.1019 (fax)

The Berkshire Capital Newsletter is distributed electronically.

To subscribe or unsubscribe, contact:
bcs.feedback@berkcap.com

Impact of Subprime Crisis is Mixed for Asset Management Industry

Globalization, deregulation and excess capital have been a boon for the world economy over the last three decades, generating an impressive level of wealth and comfort in both the developed and developing world. But this same mix has also proved combustible, creating an almost predictable pattern of excess leading to turbulent financial markets.

In the 1980s, the savings and loan crisis in the U.S. was an early indicator that deregulation wasn't cost-free, while the run-up in stocks that led to the 1987 global stock market crash showed how the weight of global capital could both drive and sink financial markets. The 1990s delivered the implosion of Long-Term Capital Management and the Asian currency crisis, and the new century offered up the dot-com bust.

With that history in mind – and the warnings from observers about the growing dangers of easy money – investors weren't caught entirely off-guard when the latest crisis hit the subprime mortgage and credit markets. Although many institutions held their ground, investors on the whole reacted predictably, with stock markets taking a dive in July and part of August, before rebounding and recovering their losses. At the same time, credit markets dried up, deal volume significantly slowed, and financial services firms considered their next moves.

For **Lehman Brothers** and **HSBC**, the next move meant exiting the subprime business altogether, decisions that cost 2,000 jobs. For the nation's largest savings and loan, **Washington Mutual**, the response involved boosting loan-loss reserves by $500 million to as much as $2.2 billion to cover its mortgage exposure. For five of the world's largest financial services firms, the crisis forced a collective write-down of $17 billion worth of securities, including $5 billion at **Merrill Lynch**; $3.4 billion at **UBS**; $3.3 billion at **Citigroup**; $3.1 billion at **Deutsche Bank**; and $2.4 billion at **Morgan Stanley**. **JPMorgan Chase** and **Bank of America** were expected to add a combined $3 billion to that total when they reported quarterly earnings.

The U.S. contagion quickly spread to Europe, where **IKB**, an obscure German commercial bank weighed down by U.S. subprime losses, had to be rescued by a domestic consortium of private and public banks. In the U.K., thousands of depositors lined up to withdraw savings from **Northern Rock** when that mortgage lender fell victim to the crisis. In Germany, **WestLB Mellon Asset Management** froze the assets in its ABS Fund, a structured credit vehicle, while French bank **BNP Paribas** suspended activity in three of its asset-backed securities funds, saying it could no longer properly value them. **Carlyle Group** was forced to loan $100 million to **Carlyle Capital Corp.**, a mortgage-backed bond fund it floated in Amsterdam over the summer.

Central bankers, playing their now-familiar role in such crises, added liquidity, with both the U.S. Federal Reserve and the European Central Bank (ECB) pumping more money into their respective banking systems than at any time since the 9/11 attacks. The Fed followed up by lowering the discount rate a half-point to 4.75%. Observers are taking a wait-and-see attitude regarding the impact on the global economy, particularly on the usually undaunted American consumer.

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Expensive Toll

Third-quarter write-downs on fixed-income assets

	$ billions
Merrill Lynch	$5.0
UBS	$3.4
Citigroup	$3.3
Deutsche Bank	$3.1
Morgan Stanley	$2.4
Goldman Sachs	$1.5

Sources: Corporate earnings releases

For August, the news in the U.S. was mixed, as consumer spending remained solid while new home sales fell 8.3%, to the lowest level in seven years. The September jobs report was positive, showing a gain of 110,000 jobs. In the euro area, a source of global strength of late, business confidence dipped, a potential harbinger of slower investment ahead, and in early October the ECB reported a drop in loan demand for businesses as well as tighter credit standards.

For traditional long-only asset managers, the impact has been mixed. In August, stock and bond mutual funds in the U.S. recorded relatively subdued outflows of $12.3 billion and $4 billion, respectively, according to the Investment Company Institute. At the same time, money market funds did experience a significant inflow of $154 billion, 44% of all such inflows during the first eight months of the year. Meanwhile, publicly traded asset managers watched their stock prices see-saw in tandem with market gyrations, with the Dow Jones Asset Managers Index dropping about 15% from its high in July before rebounding in September.

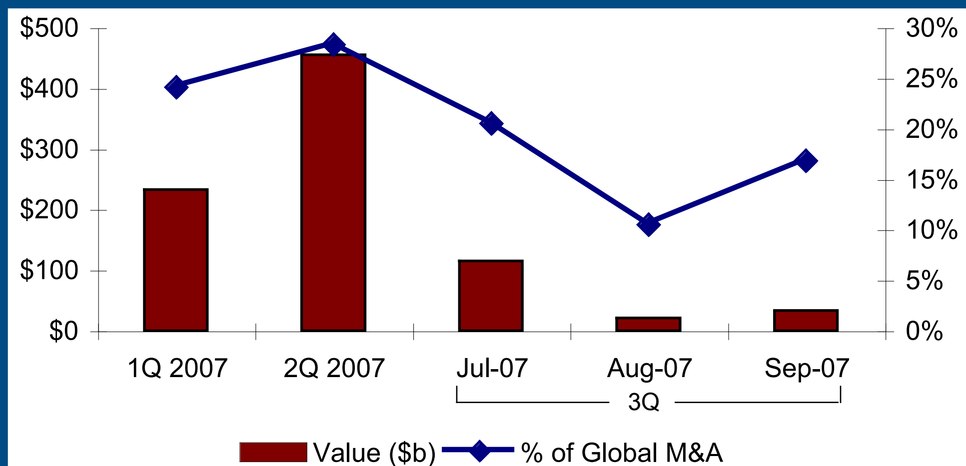
Predictably, the biggest impact was felt in the hottest sectors – hedge funds and private equity. In August, the hedge fund industry as a whole generated its worst performance since 2000, with the average fund declining more than 3%, according to Hedge Fund Research. Quantitative funds were particularly hard hit, including prominent vehicles such as **Goldman Sachs**' $3.6 billion Global Equity Opportunities fund, which lost 30% of its net asset value, forcing the company to inject $2 billion of its own capital and $1 billion from outside investors.

The AQR Global Stock Selection High Volatility Fund, run by noted "quant" firm **AQR Capital Management**, reportedly lost 33% of its value, while **Tudor Investment Corp.**'s $9 billion Raptor Global recorded a 9% loss in July, according to press reports. In the U.K., the $6.6 billion **Cheyne Finance** investment vehicle run by hedge fund **Cheyne Capital** began liquidating assets to repay debt as it breached capital loss provisions. At the same time that performance was tanking, some hedge funds began to feel the squeeze from prime brokers imposing tighter margin requirements.

While the pain was widespread, it wasn't shared equally. For the strongest firms, the crisis is creating opportunity, and one result of the credit dustup could be a more pronounced shift of capital toward brand-name firms and managers, along with an acceleration of M&A activity in the sector. In the most significant example so far of an opportunistic purchase, **Citadel Investment Group** (AUM: $14 billion), the hedge fund run by Chicago billionaire Kenneth Griffin, swooped in to buy the distressed assets of **Sowood Capital**, whose $3 billion portfolio lost half its value. In 2006, Citadel had acquired some assets from Amaranth LLC when that fund lost billions betting incorrectly on energy prices.

Meanwhile, **SAC Capital** (AUM: $14 billion), led by billionaire Steven Cohen, managed to raise $1 billion for its flagship fund, and **Gartmore Investment Management** attracted more than $200 million for a new fund to be run by Roger Guy, the noted hedge fund manager. **Man Group**, the largest publicly traded hedge fund company, reported that its AUM actually increased over the summer, by $1 billion to $68 billion.

Summer Dip | Global Private Equity Deals



Source: Thomson Financial

The experiences of SAC, Gartmore and Man are indicators that even in the face of a financial crisis, institutions and wealthy individuals continue to view alternatives as a necessary ingredient in a balanced portfolio, rather than a risk factor. As Dory Wiley, a trustee of the Teachers Retirement System of Texas (TRST), recently told *Barron's*: "The old formula of 60% equities and 40% bonds spells death in the long run." TRST plans to allocate 30% of its assets among alternative investments within the next five years.

One of the biggest beneficiaries of low interest rates, the private equity industry, felt the squeeze in August and September, when it accounted for just $55 billion in deals, or 14% of total worldwide deal value, compared with 27% for the first six months, according to Thomson Financial.

The end of easy money is one factor in the decline of private equity deals, but some high-profile firms surveying the new valuation landscape were also seeking to wiggle out of commitments. The investor group led by **JC Flowers** backed off its original $26 billion bid for **Sallie Mae**, leading the giant student loan firm to pursue legal action, and JC Flowers subsequently returned with a lower bid. **Kohlberg Kravis Roberts** and Goldman Sachs both walked away from the $8 billion deal to acquire electronics company Harman International.

These incidents aside, the industry is still sitting on a stockpile of as much as $350 billion, according to estimates from Private Equity Intelligence, and investors paying lucrative management fees expect their money

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to be deployed. Although **Blackstone Group** predicts fewer megadeals in the near term, they and other industry heavyweights have indicated they will continue to be on the prowl for attractively priced assets. At a minimum, investors appear willing to continue placing bets with quality players like Blackstone, as the firm closed a new $21.7 billion fund in early August.

To be sure, there are plenty of skeptics anxious about the longer term impact of the subprime implosion on the U.S. economy and corporate earnings. One notable observer, legendary bond investor Bill Gross of **Pimco**, warns that declining home prices could impact "Main Street" (and therefore economic growth) more than the stock market collapses of 1987 or 2000 and "will dominate Fed policy over the next several years, as will the lingering unwind of related financial structure and derivatives that have yet to be discovered…."

But if the markets are any indicator, that sentiment is not dominant, and by late September investors appeared to have gained some measure of equilibrium. As the top global investment banks lined up to announce massive write-downs of subprime-related securities, investors appeared to take succor, bidding up the share prices of the affected companies. The optimistic message from the markets: financial services firms are putting the mess behind them and moving forward with their business. In the asset management sector, M&A transactions continue to be announced, suggesting that the events of the last few months have not necessarily derailed ongoing discussions between buyers and sellers. In fact, the recent turmoil creates buying opportunities as smaller, non-name brand firms may rush to develop strategic partnerships with larger, established firms with deep pockets and infrastructure that provide greater comfort to jittery investors.

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