CORKES

February 6, 2009

## *KRG Fund Investor Update*

As we move into a New Year and a new Administration, we want to take the opportunity to update you all on how our portfolio companies are responding to the continued economic challenges. With jobless claims increasing to new highs, housing starts declining to new lows, and an overall malaise around the markets, we recognize investors may be more interested than ever in communications from their GP's.

While we share the prevalent view that the next couple of years will be a very trying economic period, we also believe the disciplined and consistent actions taken by our firm and our portfolio companies over the last several years will help us endure the storm. Furthermore, we believe that these trying times will provide substantial opportunities to enter into new investments with attractive potential returns. Our beliefs are supported by the following:

**KRG's Investment Discipline**

The burst in the "Debt Bubble" has created severe constraints on the availability of capital for leveraged lending and on liquidity in the credit markets generally. We at KRG believe we may be fortunate to avoid significant fallout from the bursting of the Debt Bubble as we purposefully did not max out on leverage when it was in vogue. More specifically, from 2004 to 2007, the period attributed to creation of the Debt Bubble, we invested just over $1 billion of capital (including institutional co-invest). Although the credit markets at various times would have permitted significantly higher leverage, and equity returns on paper would have tremendously benefited from such actions, we stuck to our strategy which at its core emphasizes pursuing attractively priced acquisitions at more moderate leverage. The results of this investment focus are that KRG's average total leverage ratio for platforms acquired during this four year time frame was 3.1x, a conservative proxy when measured against the average for the middle market in general of 4.8x[1]. This consistent and disciplined investment strategy combined with a diversified portfolio has allowed us to survive prior market disruptions relatively well,

[1] Source: Standard & Poor's LCD, a division of The McGraw-Hill Companies, Inc.

including the recession of 2001 and 2002, and may once again position us to outperform during this current cycle.

<u>**Contingency Planning and 2009 Expected Performance**</u>

As discussed in our November 2008 letter, each deal team together with their respective portfolio company management team completed a downside contingency planning process to develop a phased-in approach to cost containment and liquidity enhancement assuming a 10-25% decline in fiscal 2009 EBITDA. The three phases of the plan were:

- **Phase I**: immediate cost containment and liquidity initiatives;
- **Phase II**: cost containment and liquidity initiatives in anticipation of a 10-15% decline in EBITDA, and
- **Phase III**: cost containment and liquidity initiatives in anticipation of a 25% or greater decline in EBITDA.

One of the most difficult aspects of any contingency planning process is knowing when to "pull the lever" to implement each phase of the plan. Management and KRG have addressed this situation by defining specific and identifiable "triggers" that we believe provide the objective evidence necessary to begin implementing each phase of the plan. Such triggers may include, for example, new business jet orders [REDACTED] oil and natural gas drilling forecasts [REDACTED] and credit card default rates [REDACTED] This extensive planning has thus far resulted in identifying total implementable cost savings of $167 million and liquidity enhancements of $138 million. More importantly, since September 2008 management ***has or is in the process of implementing substantially all Phase I and some Phase II*** initiatives generating aggregate cost savings of $76 million and improving overall liquidity by approximately $91 million.

Each portfolio company's contingency plan is also considered a "living document" requiring quarterly updating at a minimum and regular monitoring by both management and the board of directors. To achieve the former, KRG allots time in every weekly firm meeting for a rotating group of deal teams to provide all firm members with material updates to their contingency planning process. As to corporate governance "best practices," the respective boards of directors of each portfolio company have adopted (or are adopting at the next meeting) the contingency plan as an approved mechanism for operating the company vs. having a "static planning document" that sits on a shelf.

Looking forward to 2009, it is not surprising that certain companies in our portfolio are beginning to feel the effects of the global recession. At the moment the effect we are experiencing is principally a gradual decline in backlogs and bidding activity. Although we have not observed a significant deterioration in TTM or monthly budgeted EBITDA to date, it is inevitable that will occur in certain companies. Rather than react to these situations, we expect that our extensive contingency planning will prepare these companies to proactively reduce their costs as revenue and profitability begin to decline. We and our management teams are carefully monitoring our performance and the contingency plans are another tool in the KRG chest to assist with this process. Additionally, the *discipline* around creating these plans and reducing operational complexities (see further discussion on page 5) is something we will expect management teams to maintain to further bolster EBITDA and free cash flow even when the economy recovers.

**Managing Default and Refinancing Risk**

Average Senior Debt and Total Leverage ratios as of December 31, 2008 are not yet available for all portfolio companies, however, we do not expect material variations from the ratios as of September 30, 2008, which were 3.0x and 3.6x, respectively (excluding a Fund II portfolio company). These ratios reflect KRG's historical practice of conservatively leveraging companies to position them solidly for the add-on acquisition strategy, and to more easily adapt when projections are not realized as planned. As of the date of this letter, all companies are current on their required principal and interest payments and three companies and in Fund II and in Fund III), are in the process of amending their credit agreements for fourth quarter financial covenant violations. The bank debt for each company is held by groups we know well and believe will act appropriately given the individual company circumstances. Additionally, given the nature of the covenant violations for both and and each company's overall financial position, we do not expect to encounter any significant problems in the amendment process. Since the date of our last letter (November 2008), we have completed the following bank amendments for Fund III portfolio companies.

- [redacted] – Invested incremental $2.5 million in December 2008 principally to fund an earnout obligation from an acquired company; simultaneously amended the credit agreement to reset financial covenants.
- [redacted] – Invested $12.9 million in subordinated debt in Cetero in January 2009, the proceeds of which were used to purchase a state-of-the-art building constructed specifically for the company and completed earlier in 2008. Cetero originally anticipated completing a sale/leaseback transaction for the building, but the dislocation in the credit markets made such transaction economically unfeasible for the company. The bank consented to the transaction and simultaneously amended the credit agreement to re-set certain financial covenants.

The equity investments made in Focus and Cetero to address specific funding needs have been well received by the bank groups, and further demonstrate KRG's commitment to maintaining strong lending relationships, particularly in lending environments such as these.

**Operational Improvement Focus**

Since inception, KRG's investment strategy has been based on building platform companies that (a) focus on adding value to their end customers through a broader product and/or service offering and (b) continually and rapidly effect change through strategic, organizational and operational improvements that drive value. This strategy has historically generated top-quartile investment returns for KRG by enhancing value creation through EBITDA growth and multiple arbitrage versus paying down debt or other forms of financial engineering. With the virtual disappearance of vast amounts of credit for leveraged transactions, private equity firms such as KRG that emphasize operational improvement and revenue enhancement initiatives should be poised to fare better than those who made bets on generating returns through extensive leverage or significant debt pay down. Two recent examples of KRG's operationally focused initiatives are as follows:

***Revenue Enhancements*** – All deal teams have been charged with developing plans and tactics with their respective management teams to capture market share from competitors. This may be accomplished through hiring key sales, engineering, and/or business development personnel, acquiring a failing competitor's book of business, or acquiring competitors at attractive prices. To jump start the initiative, one of KRG's Managing Directors (and a former Operating

Executive) is hosting a seminar for the investment team to provide further direction and guidance for how to most effectively identify and capture these growth opportunities. The firm will also instill an internal measure of accountability for completing and measuring results from these plans as all firm members will be expected to present the details and status at each firm-wide quarterly review meeting.

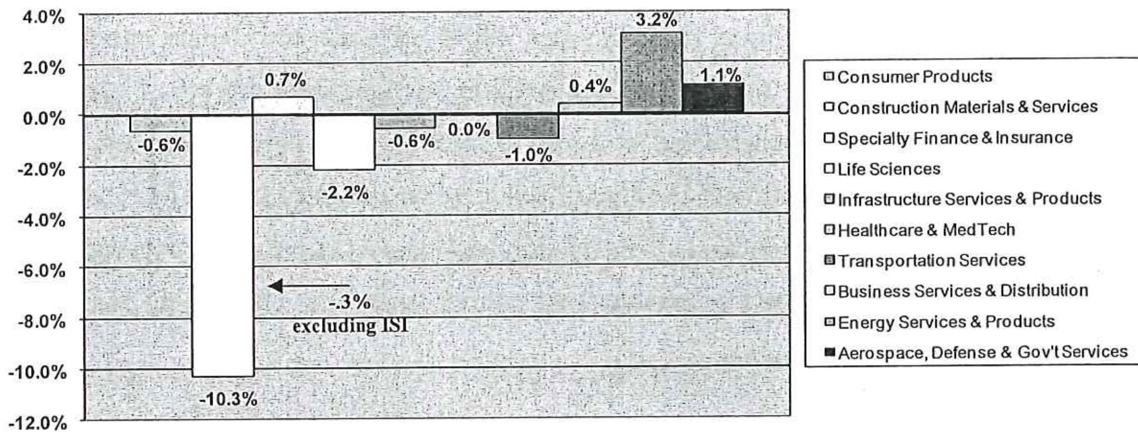
***Complexity Reduction*** – This process focuses on eliminating low value work or "waste in the system" to increase efficiency, lower cost, improve ability to scale and deploy capital more effectively. Studies have shown that key areas proven to be significant drivers of complexity include (a) a proliferation of customers and products; (b) multi-layered organizational structures; (c) processes that are low value or inefficient; and (d) low value activities and projects that waste critical resources. Complexity reduction also tends to yield longer-term savings as processes are actually changed and/or streamlined to generate cost savings versus just eliminating positions or decreasing specific line-item spending.

Complexities in any given process are measured by applying a quantitative model to assess the true value versus the actual cost of a process. We recently piloted components of complexity reduction in select KRG portfolio companies, and found in one such company that approximately seventy percent of customers accounted for just ten percent of revenues and collectively were marginally profitable. In response, we are in the process of raising prices, eliminating customer accounts and streamlining the business. Based on results thus far, we believe opportunities to reduce complexity exist throughout most of our platform companies, and are capitalizing on these opportunities by hosting a complexity reduction seminar for four of our companies in early March. Two of KRG's managing directors are leading the seminar which will be facilitated by one of KRG's long-term consulting firm partners.

**Company Financial Performance**

For the 2008 fiscal year end (which is December 31 for 10 out of 14 platform companies), organic (weighted) EBITDA for the entire KRG portfolio decreased 9.3% compared to the prior year, but increased approximately 1% after excluding [redacted] Although fiscal 2008 financial performance was generally in line with KRG's budgets and forecasts, it is a reflection of the economic conditions most of our companies are facing. A summary of the weighted estimated fiscal year 2008 EBITDA growth by industry is presented below. It should also be

noted that the negative EBITDA growth in the Construction Materials & Services sector is driven substantially by [redacted] a company that provides outsourced design and installation services primarily to new home buyers. Otherwise, the diversification indicates our portfolio overall is not over-exposed to any other default-prone sector such as consumer and retail or automotive.




Although none of us can fully predict what 2009 will bring, the more prepared our companies are to handle both the "expected" and the "unexpected," the stronger we believe they all will be on the other side of this recession. Preparing for the "unexpected" is no easy task, but extensive contingency planning and real time monitoring of key economic indicators and trends are two of the most important things we or any firm can do to attempt to stay ahead of unforeseen problems. In an attempt to measure what the "unexpected" may bring, we applied the downside EBITDA scenarios in each company's contingency plan to their respective fiscal year 2009 budgets (or most recent forecasts). In this scenario, if all plans are implemented as anticipated we should be able to mitigate approximately 75% of the related drop in EBITDA. Although results for individual portfolio companies and funds may be better or worse than this aggregate performance, the KRG portfolio overall should be in reasonable shape.

**Capital Deployed and Available for Investment**

From 2005 to 2007, a period in which acquisition multiples and leverage ratios continued an upward climb, KRG's investing and exit activity put us in the "net seller" category. During this three-year timeframe, the firm exited 14 of its 33 platform investments and acquired 11 new platforms. Aggregate equity invested in the 14 platforms sold was $417.1 million which

generated total distributions to fund investors of $970 million. This compares to aggregate equity invested in the 11 new platforms of $484 million (none of which are sold). As vintage 2005 funds are likely to be negatively impacted in the current economy to the extent companies were purchased at cyclical peaks with extremely high leverage, being a net seller in this timeframe as compared to a net buyer may bode well for longer term success.

With respect to our vintage 2005 Fund III, note that we have drawn down approximately 80% of Fund commitments as of the date of this report (an additional 20% of commitments are allocated for investment in existing platforms), and have invested this capital at a reasonable average acquisition multiple of 6.6x. Additionally, the average senior debt leverage ratio for the Fund III portfolio as of September 30, 2008 was only 3.0x. Although this capital deployment strategy alone does not prevent our companies from underperforming in the current climate, we expect we are favorably positioned in this vintage to generate competitive returns when the cycle turns and companies are sold.

With regard to new platform investing activity in KRG Fund IV, despite a sluggish M&A environment for much of 2008 coupled with the severe credit market dislocation, KRG was very active in 2008 reviewing over 260 potential new platform investment opportunities. Our narrow investment focus (e.g. high quality, low cyclicality and strong growth potential) allowed us to quickly sift through the volume and submit indications of interest ("IOI's") on over 30 companies. Although we ultimately acquired two platforms and one add-on acquisition from these submitted IOI's, we were outbid on at least half of these transactions and in other cases elected not to pursue the transaction. This intentionally patient investment pace has provided us with considerable dry powder available for investment in Fund IV. To that end, we acquired our third platform investment today investing $68.4 million and have one additional add-on acquisition under letter of intent. Additionally, as evidenced by the 4.25x EBITDA purchase price multiple paid for this third platform, we have sufficient capital available in Fund IV to leverage an acquisition climate where multiples are declining and seller expectations are slowly but surely beginning to realign with the reality of today's equity and credit markets.

**Deal Sourcing Initiatives**

We believe deal flow in 2009 will continue to be down from 2008, and as a result are refocusing on key deal flow efforts to find those diamonds in the rough. These include Top Down investing (i.e. identifying and researching with internal resources and/or industry experts

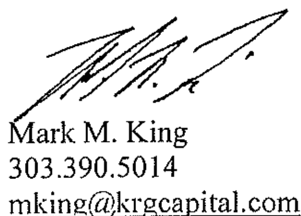
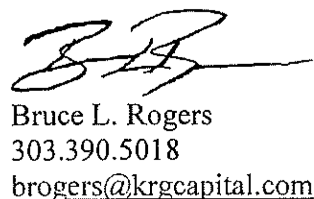
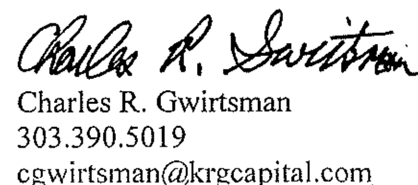
niche investment areas in previously identified Top Down industry sectors), canvassing competitors' portfolios, seeking out distressed companies (i.e. good companies with sub–optimal or over-leveraged capital structures), researching public company orphans or small-cap companies who may not be able to justify the costs of staying public or are trading at depressed valuations, and reviewing historical KRG deal logs for companies we pursued that may be the subject of a busted or failed auction process.

The firm also began the year with a concentrated marketing effort to the intermediary community, personally visiting over 20 bulge bracket and boutique investment banks in the last three weeks. The objective is to deliver a consistent and continuous message that notwithstanding the current credit markets, KRG is "open for business" and actively and aggressively pursuing acquisitions of quality companies in industry sectors we know well. Our buy and build acquisition strategy and capital available for investment allows us to pursue attractively priced acquisition opportunities ranging from less than $5 million in EBITDA to over $100 million.

**CLOSING**

In closing, we believe we have been diligent in preparing for what will be a very challenging 2009. We have a dedicated and highly focused team, the capital, and the business model (buy and build) to navigate this challenging market. Intense contingency planning efforts, difficult discussions with management teams, and board governance decisions that impact the future livelihoods of employees are not necessarily the most enjoyable part of the Private Equity experience. However the focus our team has dedicated to these initiatives will further develop each of our investment professional's experience and skills, and should lead towards delivering competitive returns to you, our investors. We appreciate your active and continued support, and are available at your request to discuss any of these matters in more detail or to answer any questions.

Sincerely,

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