What is Private Equity?

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Private Equity Investment Strategies

Venture Capital

Venture capital implies multi-stage financing of rapidly growing companies and an innovative business idea for a product or service that is proprietary.

Buyouts (LBOs/MBOs)

Buyout investing provides leveraged capital and business development assistance to enable the restructuring and acquisition of existing businesses and industries that are more mature.

Growth Capital

Growth capital provides funding and business development assistance to enable the growth of existing businesses and industries that are more mature. Ownership usually remains unchanged.

Mezzanine

A fund investment strategy involving subordinated debt (the level of financing senior to equity and below senior debt). Capital supplied by mezzanine financing is used for various situations such as facilitating changes in ownership throughout leveraged buyouts or recapitalizations, financing acquisitions, or enabling growth.

Secondary Funds

The investment strategy is to purchase the private equity interests of motivated owners who have a need to sell their private equity interests. The interests are generally purchased at a discount to the valuation of the private equity interests. The funds generally purchase venture and buyout interests.

Distressed

This investment strategy seeks to purchase interests in financially troubled companies. Investors may be passive, profiting from trading distressed securities or active investors who seek control of the company in order to restructure or turnaround their investment.

Special Situations

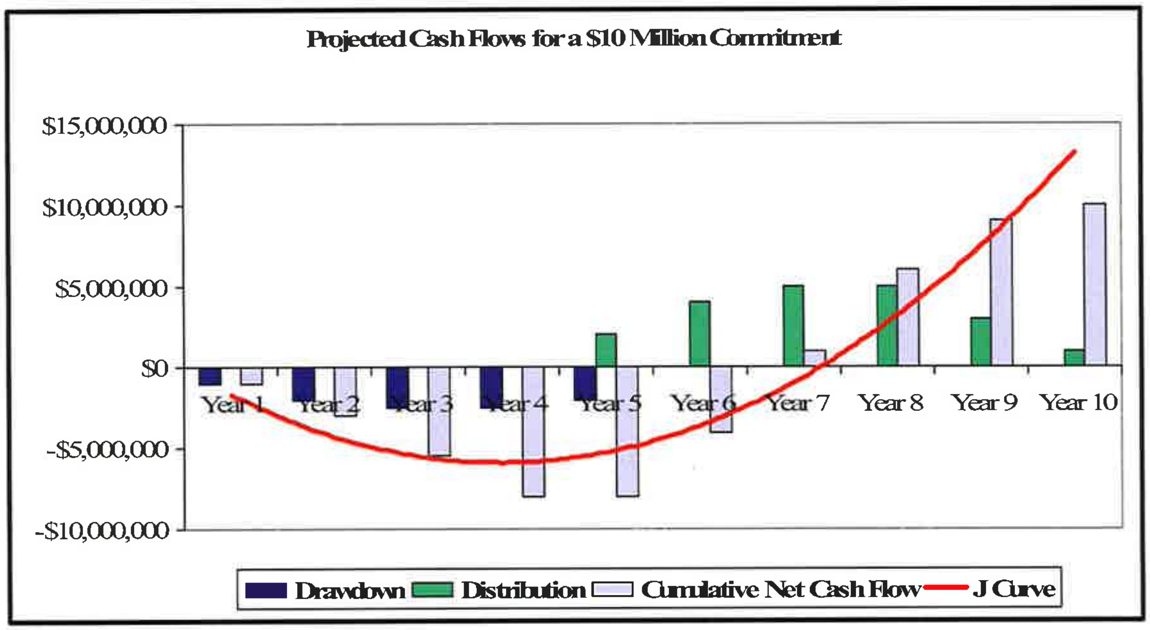
Funds that generally have a highly focused objective, seeking to capitalize on sporadic opportunities in a wide variety of sectors. Investments may include structured financing/venture lending, distressed, turnaround and restructuring opportunities, and special niche sectors such as Natural Resources.

What is Private Equity?

Setting Expectations: Private Equity Cash Flows

J-Curve

- *In the early years of an investment, the partnership is investing capital in portfolio companies which are typically valued at cost.*
- *During this early phase, the general partner is also drawing down its fees for the management of the partnership.*
- *Additionally there are some early investments which fail.*
- *All combined leads to what has been termed the "J Curve" which means returns improve as value and realizations develop.*



Why Private Equity?

Premium returns over public equity securities

- Opportunities in less efficient market
- Capture of the illiquidity premium: private companies usually sell at a discount compared with public counterparts to compensate investors for relative illiquidity
- Control of the investment

Diversification

- Low correlation with traditional investments mitigates overall portfolio risk
- Exposure to developing segments of the domestic and international economy and equity markets

Investment time frame is an opportunity for long-term investors such as pension funds

- Investors with longer term view benefit
- Private companies not under pressure to produce immediate results and can focus on value creation over time

Why Private Equity?

PE Correlation With Other Asset Classes

On an historical basis, the correlation between private equity and public equities and fixed income exhibit diversification benefits.

CORRELATIONS
INVESTMENT CHARACTERISTICS
FROM JULY 1979 TO DECEMBER 2010

	Private Equity	Barclays Capital Aggregate	S&P 500	90 Day Treasury Bills
Private Equity	1.00			
Barclays Capital Aggregate	-0.06	1.00		
S&P 500 Index	0.60	0.16	1.00	
90 Day Treasury Bills	-0.01	0.27	0.06	1.00

How to Invest in Private Equity

- There are several methods of private equity investing including:
  - Direct private company investments
  - Partnership investments
  - Fund of fund investments
  - Business Development Companies (BDCs)
  - Special Purpose Acquisition Corporations (SPACs)
  - Private Investment in Public Equities (PIPES)

- The best investment approach depends on a plan sponsor's resources and ability to evaluate, select, manage and monitor private equity investments.

- Institutional investors make up approximately 80% of private equity investments through partnerships and 20% through direct investment. Some fund-of-funds invest in both types – partnerships and direct investments.

How to Invest in Private Equity

Comparison of Investment Structures

Method of Investment	Advantages	Disadvantages	Typical Fees
Direct Investments	• Lower costs (no management fees) • Greater investment control • Greater selectivity	• Minimal fiduciary protection • Requires "deal flow" • Requires dedicated, experienced staff • Inefficient diversification	• None
Limited Partnerships	• Better diversification • Greater fiduciary protection • Potential loss is lower than direct investments since winners can offset losers within a portfolio • Can select managers based on unique domain experience	• Added fees paid to general partners • Requires extensive resources for partnership selection and monitoring • Less control versus direct investing • Specific manager risk- return volatility • Best partnerships may not be open • Larger funds have higher minimums	• Management Fee: o 1.5% to 2.5% of committed capital • Carried interest:* o 20% to 30%
Fund of Funds	• Greatest level of diversification across manager, sector, and style • Greatest level of fiduciary protection • Reduce internal resource needs • Access to highly subscribed underlying fund managers	• Additional layer of management fees • Allows no control on investment selections • Wider diversification may lower return potential	• Management Fee: o 0.50% to 1.25% of committed capital • Carried interest*: o 0% to 5% on primary partnerships o 10 to 20% on direct co-investment/secondaries - *Plus* fees on underlying limited partnerships

* Carried interest is the percentage of profits that general partners receive out of the investments made by the fund. Typically carried interest is only paid after limited partners receive their original investment back.

How to Invest in Private Equity

Private Equity Benchmarking Options

- **Peer Comparison – Venture Economics**
  - Measure of a Private Equity investment relative to similar Private Equity choices
  - Data set: Venture Economics Pooled IRR & Vintage Year IRR

- **Opportunity Cost – Public Market Indices**
  - Measure of Private Equity investment relative to traditional market returns
  - Given the relative risks of illiquidity and volatility associated with Private Equity investments, comparing performance over the long term to the more available investment option of traditional public market equities, helps determine whether a sufficient spread is being achieved to justify the inclusion of Private Equity in a multi-asset class portfolio.
  - Data set: Russell 3000 Index & MSCI EAFE Index

How to Invest in Private Equity

Opportunity Cost - Public Market Indices

- Advantages
  - Data is readily and accurately available within days of the quarter end
  - Indices are well understood by most investors

- Disadvantages
  - Difficult to compare performance results over the short term
  - No information regarding the value of the investment relative to other Private Equity investments is provided
  - Public indices measure performance based on time-weighted returns, while the performance of Private Equity investments is measure in a dollar-weighted internal rate of return

Risks in Private Equity

Private Equity "Asset Class" Risk

- **Illiquid Market**
  - Requires long-term investment horizon – difficult to adjust to rapid market changes.
  - Investment decisions are locked up for a fixed term.
  - Interests sold in the secondary market may be subject to discount pricing.

- **Difficult to Benchmark Performance**
  - No public market or price system exists - may reduce apparent volatility of returns.
  - Investment performance cannot be measured meaningfully on a short-term basis – not a mark-to-mark asset class.
  - Performance reported by funds and for the benchmarks lags by three months. As a result of this delay in performance, benchmark comparisons become difficult at best. Venture Economics provides "vintage" year results for those venture capital, buyouts and mezzanine managers who report their performance for that specific year.

- **Market Risk Does Exist**
  - Realizing value and exits are dependent on IPO and M&A markets.
  - Sensitivity to the economic cycle may exist. In particular, partnership returns are greatly influenced by the market and economic conditions during the year in which it was formed.

Risks in Private Equity

Elements of Addressing Risks

- Strategic Portfolio Planning
- Portfolio Construction
- Manager Selection/Due Diligence
- Monitoring

Risks in Private Equity

Due Diligence Components

Fund Background/People	Investment Strategy & Process	Performance/Track Record	Key Contractual Terms
Firm history	Clearly defined thesis and strategy	IRR and Multiple performance	Market consistent terms
Ownership structure	Clear decision making	Comparison of past returns to universe of peers	Alignment of interest between manager and investor
Role of each Senior Partner	Clear due diligence underwriting process	Realized proceeds analysis	Clearly stated fees and expenses
Industry experience	Consistent deal-flow pipeline	Consistent capital deployed/realized	Preferred Return, shared carried interest between team members
Experience working as a team	Identify major risks and mitigating factors	Returns Attribution	Clawback Provision
Current fund size relative previous funds	Pace of investment commitments	Unrealized portfolio valuations	Key Man Provision
Capital invested versus capital returned	Portfolio diversification	Write-off/write downs	
GP Commitment	Post commitment value creation		

rogerscasey

Risks in Private Equity

General Due Diligence Process

- **Evaluative Criteria – Unified Due Diligence Factors**
  - Fund Background/People
  - Investment Strategy and Process
  - Performance/Track Record
  - Key Contractual Terms

- **Fund "Ratings":**
  - Buy, Qualified, Not Recommended
  - Non-Traditional Review Committee

- **Client Deliverable**:
  - Research Opinion and Analysis and/or search book

Private Asset Class Due Diligence

Phase I Due Diligence

- Initial meetings
- Offering memorandum
- Marketing materials review
- Focus on
    - Fund's strategic alignment with market opportunities
    - Quality of investment team/ turnover rate
    - Firm background/ownership structure
    - Clarity of stated investment philosophy
    - Reasonability of Offering Terms
    - Competitive advantages/value proposition
    - Proprietary deal flow (P)
    - Strength of fund access (FOF)
- Evaluation captured in meeting note

Overall assessment satisfactory

If no

STOP

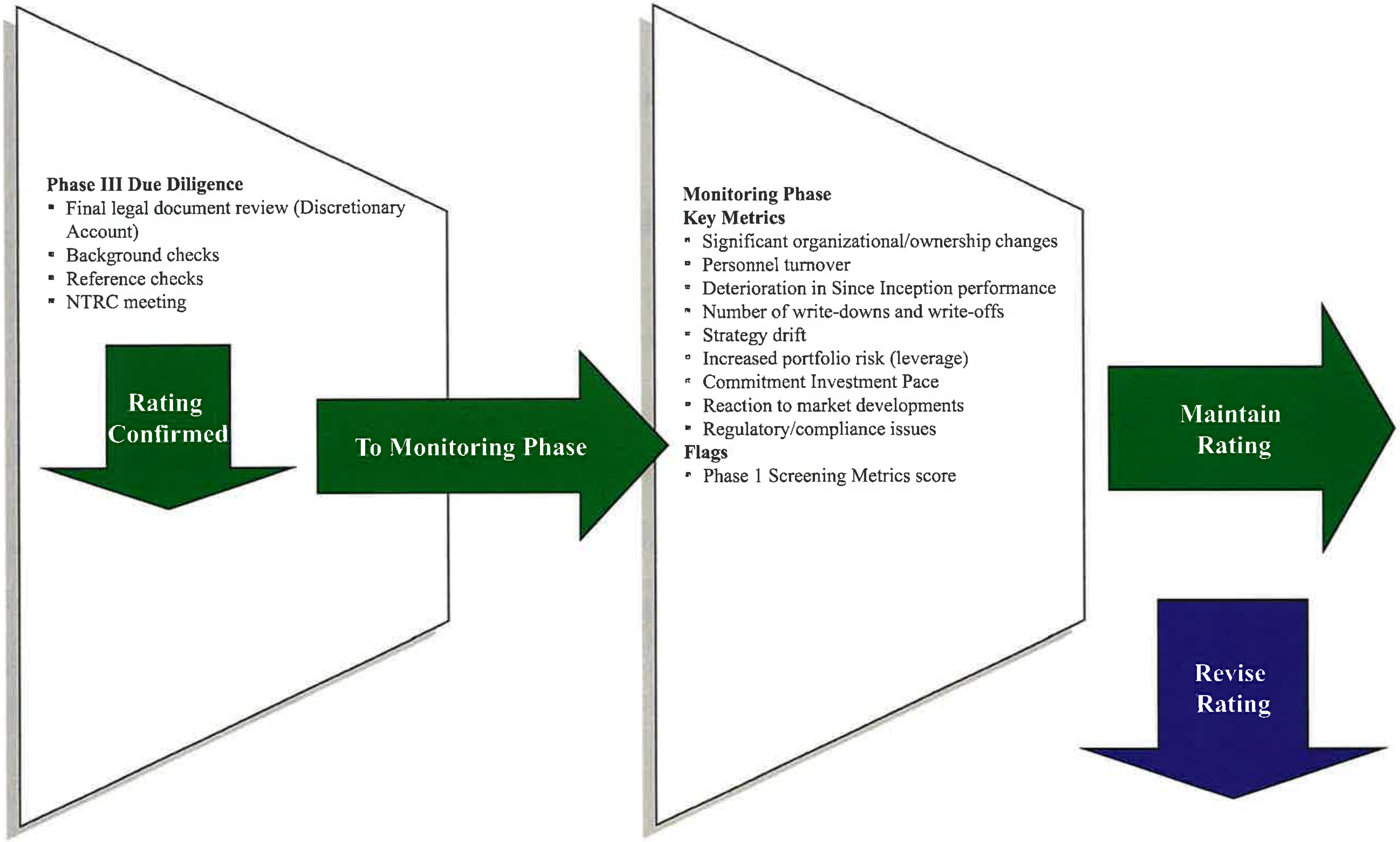
- Due Diligence Questionnaire completed by manager
- Annual & Quarterly Reports/Financial Statements

If yes

If no

STOP

Private Asset Class Due Diligence



Private Equity - Summary

Why own Private Equity?

- *Higher Return potential - Private Equity can enhance returns of the portfolio, however the investor must take a long-term view to capture those returns.*

- *Diversification - Returns from private equity do not move exactly in tandem with returns from public markets, therefore adding private equity to a portfolio of public securities can reduce overall portfolio volatility.*

Key Considerations

- *Long-term commitment with no exit in the short term*

- *Manager/fund selection critical*

Key Private Equity Terms

Management Fee:	Annual fee, typically a percentage of limited partner commitments to the Fund. Fees scale down in later years of a partnership, as committed capital converts to invested capital and the workload of the general partner is theoretically reduced.
Carried Interest:	The general partner's share of profits generated by the Fund – which is intended to be the primary incentive compensation. A 20% "carry" has been typical – although firms with exceptional prior performance can get 25-30%.
General Partner Clawback:	To the extent the general receives more than its fair share of profits (as determined by the carried interest), the individual partners are responsible for refunding the excess to the limited partners.
Catch-Up:	Once the general partners provide the limited partners with their preferred return, there is a catch-up period where it receives the majority of profits until the agreed upon profit split (based on the carried interest) is achieved.
Limited Partner Clawback:	Intended to protect the general partner against future claims, should it be the subject of litigation. The Fund's limited partners commit to pay for any legal judgment imposed on the general partner or partnership. Typically, this includes a limitation on timing or amount of the judgment.
Preferred Return:	The minimum annual IRR promised to the limited partners before the general partner shares in the profits of the partnership.
Key Man Provision:	If during the investment period, a specified key management team member is no longer involved, the Fund will go into suspension mode, where investments can be made in only limited circumstances until a replacement member is approved.