

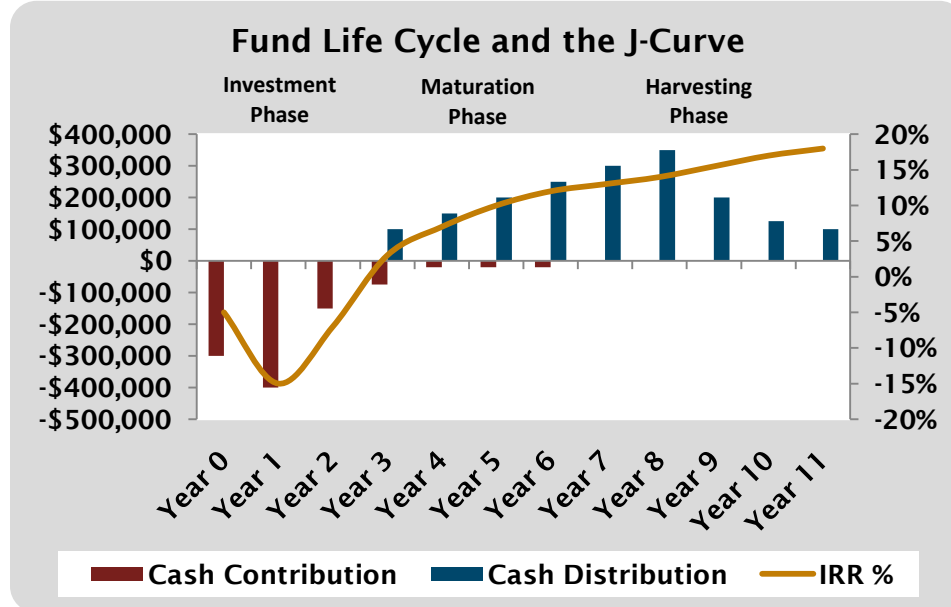
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White Paper No. 40: Private Equity Investing

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Note: Assumes \$1MM commitment. Actual fund performance is not represented by this graph. For illustrative purposes only, as all numbers are hypothetical.

Investors who are new to private equity are often horrified by the sudden drop in value of their investment, but more experienced investors recognize that the J-Curve is almost inevitable. The J-Curve occurs for a number of reasons but the primary ones are these:

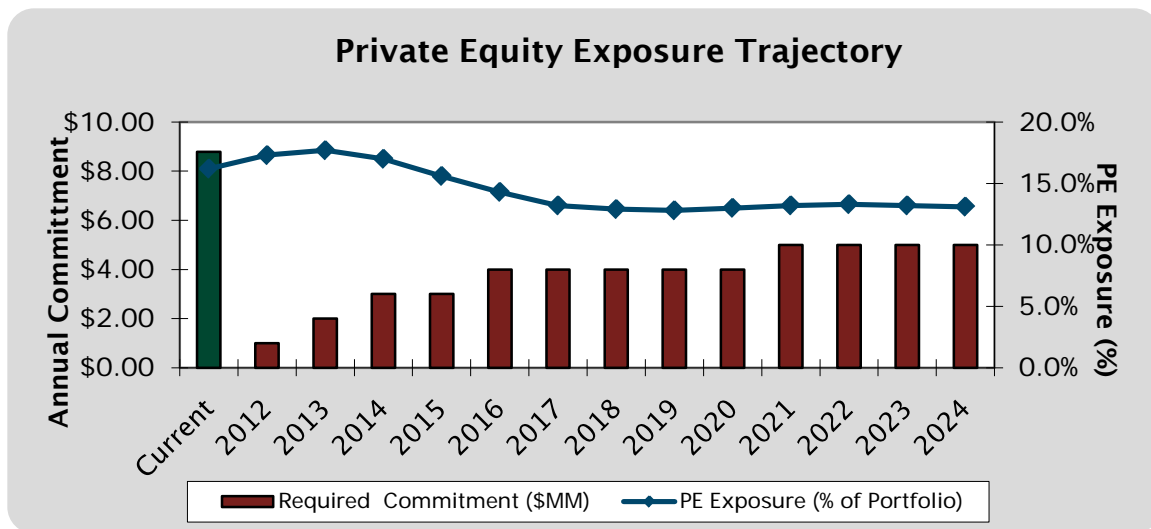
- ◆ Organizational expenses of private equity partnerships are deducted immediately, so no sooner does an investor meet the first capital call than his or her return immediately turns negative.²
- ◆ Smart general partners will identify bad investments quickly and write them down or off, while good investments will take time to pay off.
- ◆ Most of the better PE firms follow very conservative policies when writing investments up or down: bad developments cause immediate write-downs, while happy developments don't result in write-ups until some event occurs confirming the higher valuation.

² Another unhappy effect of the J-Curve is that fees, including startup fees, are applied against a smaller asset base, making already-high PE fees look even more outrageous. This situation will, however, correct itself in time.

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get to that target. Taking into consideration various commitment sizes also allows us to project the out of pocket exposure over time.

For example, the following graph shows the yearly required commitments for an investor with \$160 million in assets to achieve a chosen allocation to private equity (15%). The goal is to maintain a 15% exposure over time, despite unpredictable returns, varying capital call and distribution schedules, and a broader non-private equity portfolio that compounds over time.



Waterfall analysis is a useful tool that can pave the way for more detailed planning, such as potential ways to accomplish diversification by strategy, geography and vintage year. However, it is important to remember that a waterfall analysis is only an estimate. Therefore, a private equity program should be re-evaluated regularly throughout the forecast period as the actual investments materialize and market conditions change.

❖ Secondary Offerings

Secondary investing is the business of buying limited partnership interests from investors in funds prior to their maturity. There are several motivating interests for a limited partner to opt out of its commitment during the life of the fund. In some cases the investor's strategy or target allocation might change. The investor might become unable or unwilling to meet its commitment. Whatever the cause, the most likely solution is a sale to a third party, e.g., a secondary buyer. In most cases the general partner will control the sale. In the case of very large sales, an auction may take place among

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larger secondary funds. At this writing there are numerous multi-billion dollar secondary funds pursuing this strategy. We think that the auction process tends to drive up prices, thus diluting return potential. But there are a handful of smaller, focused, exclusively secondary funds that deal one-on-one with general partners for smaller interests that have produced high, counter-cyclical returns by raising and disbursing small funds aimed at “bite-sized” investments. The typical approach is to carefully evaluate each partnership interest based on the underlying company valuations, thereby lessening risk and accelerating returns. The advantage of these funds is that the money goes out faster, there is little or no “J-Curve” effect and returns occur earlier. Secondary investing, opportunistically, is an excellent enhancement to a diversified program. It can also serve to accelerate attaining an investor’s target allocation to the asset class.

❖ Terms and Conditions

An investor’s interest in a fund of funds is governed by a partnership agreement. While the list of important terms and conditions is lengthy and interrelated, there are several issues that rise to the top. First, is the fee structure fair? Management fees range from 50 to 100 basis points per annum. Often, there is a scaling down in the latter years of the life of the fund, recognizing the declining work load of the general partner. Second, is the general partner’s interest aligned with that of the limited partners? This is generally reflected in the profit sharing structure between the two parties. Profit sharing, or the so-called “carry,” is an important indicator of alignment of interests. While the carried interest will impact returns, it serves as an incentive for management to produce higher returns and has less of an impact on overall returns than the management fee. While it is true that funds of funds represent another layer of fees to the investor, we consider these fees to be more than offset by access to the top performers that the best funds of funds provide. Lastly, are there any potential conflicts of interest and are there remedies to control them?

❖ A Word about Conflicts of Interest

The best independent FOFs carefully avoid most conflicts of interest and provide access to the best underlying partnerships. At the other end of the spectrum are often FOFs sponsored by banks, where the offering memorandums normally articulate in elaborate detail the potential for conflicts of interest. These include the relationship that bank affiliates, such as investment banking arms, maintain with large buyout firms that they will be investing with, where they have fee relationships. The banks may have a lending or underwriting relationship with the operating companies in the banks’ funds. Other affiliate funds of the bank may compete with the bank’s FOF for investments in underlying funds and/or companies. The banks might be working with firms that will be bought from, or sold to, their own fund. Also, in the event that there is the potential for secondary

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investing, investors have to be concerned with these conflicts as they relate to affiliated advisors to the transaction and the potential that the seller is a related party. Further, since FOFs and secondary offerings are “blind pools”, it is uncertain whether they will be dealing with their own offerings and/or clients. Finally, and perhaps of most concern, the general partner of the sponsored FOF is usually the ultimate parent firm whose interest lies with all of its subsidiaries, including competing funds, investment bankers, underwriters, asset managers, and the like. There is little or no protection for the limited partners in the partnership agreements.

Conclusion

Private equity investing is not without its challenges. However, long-term historic returns argue strongly for exposure to this asset class for most significant investors. The most important considerations are structure of the investment program (that is, vintage year, geography and stage diversification), access to top-tier performers, and knowledge about emerging private equity firms.

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