

OPEN YOUR WALLET – THE INSTITUTIONAL INVESTOR VIEW ON PRIVATE EQUITY

Presentation

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May 19, 2008

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➤ INTRODUCTION:

- The process of negotiating the terms and conditions of private equity funds
- The differentiated fund market
- Attempts to standardize private equity limited partnership agreements

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➤ ECONOMIC TERMS:

- Management fees
- Transaction fees
- Hurdles
- Carried interest
 - Aggregate versus deal-by-deal waterfalls
 - General partner clawback
- Limited partner givebacks

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➤ GOVERNANCE TERMS

- Keyman provisions
- No-fault rights
- Limited partner co-investment
- Advisory committees
- Amendments
- Change of control of general partner

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➤ SIDE LETTERS

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➤ CONCLUSION

Supplementary Materials

Management Fees

- A. Management fees for different fund categories
- B. Market pressure for lower fees

Transaction Fees

- A. Types of transaction fees
- B. Fee sharing between GPs and LPs

Carried Interest

A. History:

- True deal-by-deal with no netting of results.
- Current deal-by-deal: netting gains and losses across investments.
- Aggregate waterfall.

B. Issues:

- Is the carry "net" of pro-rated expenses and management fees, or is it "gross". Another issue is whether you take write-downs or write-offs into account before the carry will apply
- Sliding scale carried interests (real estate opportunity funds)

C. Priority Returns

- True preferred return means that carry is calculated as a percentage of profits remaining after the preferred return is deducted. Rare.
- A "hurdle rate" that applies before the GP can take carry is common.

Issues for hurdles:

- What base is the hurdle rate applied to?
- Does the meter start at the drawdown date and end at distributions to the LPs?
- What percentage for the GP catch-up: 80%? 100%

D. Other issues:

- Is there a holdback? One common test is the net asset-value test: if total distributions and value of unrealized investments exceeds 120% of contributed capital (a better test: no carry unless value of unrealized investments exceeds 120% of unreturned capital).
- Holdback or cushion could give rise to tax obligations not covered by distributions, which is why it is typical to provide for tax distributions to the GP.
- Withheld taxes as deemed distributions.

General Partner Clawback

- Purpose: protection against over-distributions
- History: Joint and several liability
- Clawback issues:
 - (a) Separate guarantee or in GP agreement
 - (b) Guaranty of payment, not collection.
 - (c) Liability for [110]% of distributions?
 - (d) Clawback to the hurdle
- Other protective devices (large institutions relying on the credit of individuals)
 - (a) Escrows
 - (b) Periodic True-Ups
 - (c) Deflection

(L.P. Giveback or “Clawback”)

- GP perspective: Reduces reserves that would otherwise be established for contingent liabilities.

- LP perspective:
 - (a) Make certain that the GP is subject to the giveback and that its obligation to return profit is not capped.

 - (b) Payments made pursuant to a giveback should be taken into account in the distribution waterfall.

 - (c) Giveback should be limited to indemnity payments, and not cover liability for all expenses (such as transaction fees).

 - (d) Giveback should be capped (e.g. lesser of distributions or 25% of capital commitments after exhausting uncalled capital commitments).

 - (e) Giveback should be limited in duration (e.g., 2 or 3 years from date of distribution or dissolution of fund).

 - (f) Fund of Funds: particular difficulties.

Keyman Provisions

- A. Typical keyman events
- B. Remedies

No-fault Provisions and General Partner Removal Clauses

“No-fault” termination of the Investment Period is becoming much harder to negotiate.

The percentage required to terminate the Partnership on a “no-fault” basis can be as high as 90%.

General Partner removal for “cause” provisions are becoming more difficult to implement, in some cases giving the General Partner the right to contest the removal through arbitration or otherwise.

Key Points to Negotiate:

- Continue to seek to include the right to terminate the Investment Period on a “no-fault” basis at 75% to 85%.
- Focus on maintaining low percentages (70% to 75%) for “no-fault” termination provisions particularly where this is the only “no-fault” remedy available.
- Seek to include a broad removal for “cause” definition such as: “Cause” shall mean (a) the criminal conviction of, or admission by consent or plea of no contest to, any felony by the General Partner or any Principal, (b) that a court of competent jurisdiction shall have found that the General Partner or any Principal has committed an act or omission that constitutes (i) a material breach of the Partnership Agreement or Subscription Agreement, (ii) a material violation of law (including any Federal or state securities laws (and including a plea of no contest to a permanent injunction prohibiting future violations of such securities laws)), or (iii) willful misconduct, fraud, breach or reckless disregard of fiduciary duty, bad faith or gross negligence in connection with the performance of duties relating to (A) the Partnership, (B) the General Partner, (C) the Investment Manager, or any of its

respective Affiliates, or (D) any corporation, partnership, limited liability company or other entity in which such Principal has within five (5) years prior to the Initial Closing Date of the Partnership held a position of officer, member, partner, principal or director or (c) the Bankruptcy or insolvency of the General Partner or any Principal, (each a “Cause Event”). Upon the occurrence of a Cause Event, the Commitment Period shall be automatically suspended. The General Partner shall promptly notify the Limited Partners in writing upon the occurrence of a Cause Event.

- Continue to seek confirmation that upon the occurrence of a Cause Event involving a Principal, such person shall be immediately prohibited from working on Partnership business.
- Push back on the General Partner’s right to contest a Limited Partner vote to remove the General Partner for “cause”.

Co-Investment by LPs

A. Reason for co-investment: General partners may have reached their diversification limits or may have determined that a Fund should not put any more money into a particular investment.

B. Reason LPs like co-investment:

- more money out the door
- no or reduced management fees and carry

C. Are co-investment opportunities offered pro rata to LPs?

- carve out from MFN
- LP strategies

D. New issues in co-investments

- Co-investment funds
- Will co-investors have to pay their share of reverse break-up fees?
- Top-Up funds that are raised by the GP and invest in the larger deals.

Advisory Boards

- A. Primary functions of Advisory Boards
 - 1. Approve valuation of investments made by the partnership
 - 2. Address conflicts of interest
- B. Secondary Functions
- C. Value of Advisory Boards

The Latest in Amendment Provisions and Practice

Increased Authority of the General Partner to Adopt Amendments

Wide Discretion Regarding “Tax Treatment” Amendments

Key Points to Negotiate:

- The General Partner’s authority to adopt an amendment should be conditioned on the amendment not being adverse to any Limited Partner;
- If the General Partner adopts a “materiality” standard with respect to adverse amendments, consider requesting Advisory Board oversight of such determination;
- Make certain that the scope of the General Partner’s right to adopt amendments is limited;
- Push back on the General Partner’s ability to adopt “tax treatment” amendments to the extent possible (e.g., amendments regarding tax treatment of carried interest); and
- Obligate the General Partner to promptly circulate amendments that are adopted.

Side Letter Practice – What’s New

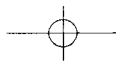
Increased Lack of Transparency

Growing List of Exclusions

Few Compendiums

Key Points to Negotiate:

- Continue to seek full MFN rights irrespective of commitment amounts;
- Make sure you have the right to receive copies of all side letters including those granted to parallel fund investors;
- Be certain that your side letter will apply to Alternative Investment Vehicles;
- Limit the excluded provisions as much as possible (advisory board membership; laws and policies not applicable to the investor);
- Focus on when side letters will be made available to you;
- Continue to request compendiums, and
- Consider requesting an obligation to obtain the same rights and provisions upon a re-up.



Wall of money

FUNDRAISING

During 2007, limited partners around the world inaugurated or increased allocations to the private equity asset class. David Snow investigates the reasons behind this trend and ponders the effects that the expected crush of capital commitments will have on the industry.

Think of it as Yale envy.

In 2007, institution after institution announced decisions to increase target allocations to alternative investments, led by private equity. There are a host of complex factors behind these moves, but if one were to simplify, it might be said that all these LPs want to be like Yale.

The endowment of the Connecticut university, led by investment guru David Swensen, has grown over the past 10 years from \$5.8 billion to \$22.5 billion, clocking in an annual overall return of 17.8 percent. Impressive – and envious institutional investors can't help but notice that 19 percent of Yale's endowment is allocated to private equity, which has returned a stunning 34 percent annually to Yale's performance over the past decade.

Swensen and team are also heavy into absolute return and "real assets", but private equity has vastly outperformed all the endowment's other asset classes.

Limited partners have seen Swensen's numbers and said, "I'll have what he's having."

Of course, the whole story is more complex. Many institutional investors face a worrying combination of looming liabilities and weak domestic equity performance. The groups that already have an allocation to private equity have, on average, seen superior returns from private equity funds formed during the early part of this decade, adding further justification to making private equity a

Limited partners have seen Swensen's numbers and said, "I'll have what he's having."

bigger piece of the overall portfolio pie. Institutional investors need higher performance, and they are losing confidence that the traditional stock/bond allocation mix can deliver this while at the same time gaining confidence that "risky" private equity is a risk worth taking.

The growth of the private equity industry around the world has essentially been a tale of increasing allocations to the strategy from institutional investors. But at no time in private equity's history have the allocation increases been as large on an absolute-dollar basis.

Take, for example, the case of the Washington State Investment Board, an \$85 billion (€57 billion) pool of defined-benefit capital that last year announced an increase in its private equity target allocation to 25 percent, up from 17 percent. Even at its prior allocation, Washington was already one of the biggest backers of private equity funds in the world. The increase potentially adds an additional \$7 billion into the private equity fundraising market.

In a statement, Washington explained the rationale behind its increase as such:

"First, we believe the private equity model can sustainably produce returns in excess of public market equities over the long term. Second, we believe we have relationships today with top-quartile private equity firms that will allow us to deploy capital to meet the 25 percent allocation target. We expect private equity to earn 400 basis points. . . over the return earned by public equity over the long term, which is a conservative assumption. . ."

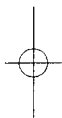
Washington's own experience tells it that private equity is a winner. In ten years, the private equity allocation turned in an annualized performance of 15.76 percent, versus the 7.85 percent of US equities and 6.51 percent of fixed income.

Just imagine Washington's overall performance if its private equity allocation had been double what it was over the last decade – its board members certainly have, and are taking action accordingly.

Private equity may now be benefiting from a modicum of maturity. According to Louis Singer, a partner in the New York office of law firm Morgan Lewis & Bockius who advises many LPs: "Allocations to private equity should be understood within the context of an institutional investor community that now has the ability to assess private equity returns over a 20-year period, in their own portfolio or in the portfolios of their peers."

Regardless of their tenures in the asset class, many large institutions around the world are doing the same math about private equity and coming to the same conclusions, which has led to an oft-described "wall of money" being allocated to private equity.

The most obvious effect of these new and increased allocations is that the private equity industry will become larger, measured by assets under management. Much of the growth will happen among the largest private equity



managers – the established players like Blackstone, Carlyle and Permira which can deliver global investment mandates. Major LPs like CalPERS have made quite clear their desire to invest more capital with fewer managers. Such a phenomenon is not unique to private equity – as industries mature, a small clutch of dominant brands tend to emerge.

Not that there won't be plenty of

money to go around. Limited partners have also indicated an increased interest in the mid-market (however defined), in emerging markets, and in niche strategies like distressed funds.

Somewhat spoiling the supersizing party is this half-whispered worry: what will happen to target allocations if the performance of private equity, on average, hugely disappoints over the next

several years, as some predict? No one knows the answer to this. But considering the painfully slow process many large LPs have gone through in gaining clearance to upsize their private equity programmes, it may well be that any attempts to later downsize these programmes could take so long that a coming mess will have sorted itself out before the wall of money is dismantled. ■

MORE OF THE SAME, PLEASE

Notable private equity target allocation increases during 2007.

Institution	Total AJM	Target PE allocation move	Notes
California Public Employees' Retirement System	\$240bn	To 10% from 6%	The closely watched California giant reshuffled its alternatives portfolio, declaring the move reflects "the promise of our private equity, real estate and asset-linked investment classes". The pension also promised to focus more on very large and very small funds.
Washington State Investment Board	\$85bn	To 25% from 17%	The WSIB, one of the biggest backers of private equity funds in the world, announced in November a major increase in its target allocation to private equity, along with other alternatives, in part because the asset class had produced "higher and stronger investment returns than could be obtained through more traditional investments".
Ford Motor	\$45bn	To 25% from 5%	The pension plan of the struggling car manufacturer said that in order to "improve our balance sheet and reduce our risk profile" it would increase its allocation to alternatives.
Ohio Public Employees Retirement System Health Care Fund	\$80bn	To 5% from 0%	Ohio inaugurated an allocation to private equity last year, along with an increased allocation to real estate. The fixed income allocation was reduced to 40% from 50%.
VER (Finland)	€11bn (\$15bn)	To 10% from 8%	Finland's national pension was enthused at the performance of its private equity, real estate and hedge fund holdings enough to increase its allocation to these strategies up to the 10% ceiling set by the Ministry of Finance.
AP3 (Sweden)	SEK227bn (\$42bn; €33bn)	To 5%	Although the Swedish "buffer fund", one of five that underpin the country's pension system, did not increase its target allocation to private equity, last year it indicated a desire to hit the max allocation currently allowed and ask the government for an increase to that.
Minnesota State Board of Investments	\$60bn	To 12.5% from 10%	The state pension also hopes to increase its commitments to funds active outside the US.
New Mexico Educational Retirement Board	\$8bn	To 10% from 5%	The increase falls within an overall increase to alternatives to as much as 35% of the overall portfolio.
Government Pension Fund (Thailand)	THB380bn (\$12bn)	To 5%-6%	The Thai pension will increase its international allocation to as much as 25% of the overall portfolio, and within this is a private equity and real estate allocation.
Teachers' Retirement System of Texas	\$113bn	To 10% from 2.2%	The pension drew attention with an August decision to dramatically increase its overall alternatives allocation to 29% from 5.5%. Within that private equity's increase was just as dramatic.

Source: PrivateEquityConnect.com; Private Equity International