ATTACHMENT 2: PRIVATE EQUITY WORKSHOP- SUPPLEMENTAL MATERIAL

I. PCA: A SURVEY OF PRIVATE EQUITY DUE DILIGENCE PRACTICES

II. PCA: A DUE DILIGENCE QUESTIONNAIRE

III. THE AMBACHTSHEER LETTER- MEASURING 'VALUE FOR MONEY' IN PRIVATE EQUITY INVESTING

IV. KPA ADVISORY: MEASURING 'VALUE FOR MONEY' IN INVESTING: TOWARDS A STANDARDIZED PROTOCOL

V. THE DISINTERMEDIATION OF FINANCIAL MARKETS: DIRECT INVESTING IN PRIVATE EQUITY- FANG, IVASHINA, LERNER

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XV. CAMBRIDGE ASSOCIATES: PRIVATE INVESTMENTS: FILLING A PENSION'S RETURN VOID

DISCUSSION DRAFT

A Survey of Private Equity Due Diligence Practices

NASIO 1998

PENSION CONSULTING ALLIANCE, INC.

DISCUSSION DRAFT

A Survey of Private Equity Due Diligence Practices

by

Pension Consulting Alliance, Inc.

1998

sponsored by the National Association of State Investment Officers

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Preface

Due diligence of privately-held investments is extremely important. Recent turmoil in the hedge fund arena makes this point intensely clear. The lesson learned from such events is that there is no tradeoff between effective risk management and simply trusting someone to take immeasurable risk. Informed disclosure of risk-oriented information is critical and necessary if the broader institutional community expects to embrace the privately-held asset classes in a material fashion.

An important aspect of this report is the premise that there is a need for improved disclosure of information within the private markets. This report only begins to introduce a few areas that might be of concern. An important next step will be for the institutional investment community (which also includes the sponsors of privately-held investments) to form areas of consensus where improved disclosure can occur. Through enhanced disclosure should come increased confidence, on the part of all parties, that investing in private markets should play a major long-term role in institutional investment portfolios.

Acknowledgments

Many different parties made significant contributions to this survey. First and foremost, the private equity groups of thirteen large pension funds sponsored the survey from its outset. These participants were:

California Public Employees' Retirement System;
California State Teachers' Retirement System;
Florida State Board of Administration;
Kansas Public Employees' Retirement System;
Lucent Technologies;
Massachusetts PRIM Board;
Michigan Department of Treasury;
Minnesota State Board of Investments;
Montana Board of Investments;
New Jersey Division of Investment;
New York City Retirement Systems;
Oregon Public Employes' Retirement Fund;
South Dakota Investment Council.

Many of the participants provided not only responses to the survey, but also provided internal due diligence documentation as well as general guidance into the survey process. In addition, several private equity consultants and investment advisory firms provided due diligence materials to PCA for review and study. Firms providing the information were:

Hamilton Lane;
Pacific Corporate Group, Inc.;
Pathway, Inc.;
Portfolio Advisors, LLC;
AMVESCAP/Invesco Private Capital.

Finally, several senior professionals at PCA conducted survey interviews, collected survey data, and edited this survey report.

PCA thanks all these participants and expresses its appreciation for the contributions made by these colleagues.

Executive Summary

In early 1998, NASIO asked PCA to survey many of its members about their private equity (or alternative investment) due diligence practices. This Survey is a natural extension of the findings of and discussions revolving around the 1996 Mercer Study. One primary function of the Due Diligence Survey (the Survey) is to encourage institutional investors to continue discussing the merits of the spectrum of structural issues associated with alternative investing. Through such discussions, a broader and deeper awareness of these issues should unfold.

Findings of the Survey

Summarizing the findings the Survey yielded important points about partnership due diligence:

- ***The overwhelming majority of Survey participants called for further standardization within the private equity industry.*** The Survey participants believe that standardization can occur in two areas:

    1. <u>Standard Review Process</u>. The Survey participants believe that a standardized framework can be developed to cover the critical issues of the due diligence process. (This is reflected, to some degree, by topical overlap among consultant and plan sponsor questionnaires.) There was, however, a wide divergence of opinion over whether the criteria used within such a process could be standardized. Appendix A represents a beginning blueprint of a standard set of due diligence issues that a plan sponsor might discuss with a prospective general partner.

    2. <u>Performance Reporting</u>. Many Survey participants believe the general partner community should be able to produce standardized performance summaries and supporting data that would allow for better comparability. In addition, further disclosure of IRR calculations would also prove beneficial.

       The majority of participants believed AIMR reporting standards for private equity vehicles were a small step in the right direction. At this point, enforcing and incorporating such standards into the reporting process of the general partners would prove valuable. (See Appendix C for the AIMR Standards.)

- ***While Survey participants viewed several mechanisms for aligning interests as important, general partner financial commitments to the partnerships they are sponsoring ranked as the most important.*** According to the Survey participants, an important caveat to this finding is that general partner commitments should be proportional to their own net worth. While this finding is intuitive, current industry practices (as reflected in this Survey) do not make inquiries into general partners' net worth. Rather, there is a high degree of trust in the general partners' statements.

- ***A phased approach to due diligence is a widely-used mechanism for managing limited due diligence resources.*** Phases of due diligence allows for the initial screening of readily identifiable unattractive partnerships. However, the criteria for determining unattractiveness will often vary across different investors. Discussion in this Survey highlights several different approaches the Survey participants use to screen private equity opportunities. These approaches vary considerably.

- ***Many Survey participants had some form of internal process for selecting, screening, and reviewing specific partnership opportunities.***
  - These processes, however, varied widely – from more intuitive approaches that reacted to opportunities as they became known, to more quantitative approaches that proactively attempt to apply top-down analytical procedures to partnership selection and review.

- ***The most important factor when applying an intuitive approach was the integrity of the general partner. Quantitatively driven approaches, on the other hand, emphasized verifying the ability to execute a specific tactically attractive strategy. The quantitative strategies also scrutinized the general partner's investment track record.***

Survey Background

According to Greenwich Associates, institutional interest in alternative investing continues to grow. In 1996, at the time of the Mercer Study, institutional investors had alternative investments valued at approximately $60 billion. In 1997, this amount had risen to $85 billion, and in three years (the end of 2000), alternative investments are expected to grow to $140 billion, nearly tripling their value since 1996.[1]

The Greenwich data indicates that the alternative investment asset class will be the fastest growing area of institutional interest. Such growth reflects institutional investors' continuing search for significant incremental returns.

Reflecting this heightened interest in alternative investments, commitments made to private equity partnerships continued to surge. In 1996, the year of the Mercer Study, partnerships raised $38 billion of new capital. At the time, it was the sixth year in a row that annual commitments had exceeded the prior period. 1997 was another hallmark year, with annual commitments of nearly $55 billion – another record. The first half of 1998 saw commitments totaling $38 billion, an amount equal to the entire amount raised in 1996.[2]

As institutional interest continues and funding of partnerships accelerates, there is concern that potential investors might become less disciplined during the due diligence phases of the partnership selection process, particularly when funding the larger franchise-name partnership groups that are in high demand. It is these groups that are receiving the bulk of investors' capital, and demand for funds from these groups continues to accelerate.

In many respects, some investors are concerned about whether this activity isn't a replay of the real estate markets of the late-1980's and their subsequent decline during the early 1990's. During the late 1980's investors placed significant amounts of capital with large, reputable real estate investment advisors. By the early 1990's many of the funds sponsored by these firms had incurred

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[1] *What Now?*, Greenwich Associates, March, 1998.

[2] The Private Equity Analyst, January, 1998 and July, 1998 issues.

significant losses. Using this latter phase as a lesson, many institutions are wondering whether the appropriate safeguards are in place to protect investors from a similar scenario unfolding in the private equity markets.

It is important to note that, even though the supply/demand dynamics in the private equity markets have proven challenging from the investor's standpoint, improvements in the terms and conditions under which the limited partners operate have evolved favorably, reflecting the original spirit and intent of the Mercer Study. Examples of these positive changes include: declining management fees as a percent of commitments, an increase in the use of fee formulas that decline after a general partner's investment period is completed, more general partners putting up more than the minimum 1% capital commitment requirement, and improved termination clauses across more partnership agreements.

In light of these incremental improvements, this Survey, as a result, should prove timely in fostering continued discussion of these key issues.

Purpose of Survey

There are many important issues that need to be addressed regarding private equity due diligence. In spite of this collective concern, however, there is currently no consensus on how to address many of these issues.

In this context, this Survey was designed to explore where plan sponsors might agree and disagree on specific due diligence issues. The results of this Survey should point to areas of consensus and agreement across a broad spectrum of plan sponsors. Within these specific areas, potential exists for developing straightforward solutions.

One area worthy of continued exploration is the need to improve the quality of information flowing out of the general partner community. This Survey represents an early attempt to begin identifying and quantifying industry-standard conventions that might prove helpful in assessing private equity opportunities.

Scope of Survey

Fifteen large pension funds participated in the Survey. Across all participants, total commitments to private equity amounted to over $20 billion. Coverage was broad by partnership and partnership type, with these institutions investing in over 200 different partnership vehicles.

The Survey asked questions covering four broad areas of interest: i) a review of current due diligence practices; ii) viewpoints about due diligence; iii) standardization of the due diligence process; and iv) alignment of interests. The results of this Survey present participant opinions and findings across these broad topical areas.

Survey Approach

This project began by reviewing the actual due diligence practices of several Survey participants. This review consisted of gathering volumes of due diligence material from the participants themselves, as well as their private equity/alternative investment consultants. In total, this review covered nearly 1,000 due diligence questions used by plan sponsors and consultants in their due diligence proceedings. The materials received

covered all functional aspects of the due diligence process including: i) several examples of consultant/plan sponsor questionnaires; ii) personal reference check materials; iii) contractual agreements; iv) track record verifications; etc. This information, when assessed in aggregate, provided a general framework for what is considered an acceptable approach to due diligence. This framework has provided a foundation for the Survey (See Appendix B – for the basic Survey).
The Survey contained both open-ended and quantifiable questions. Where possible, rankings were used to keep Survey participants' responses as objective as possible. While ranking systems may cause certain information to be excluded, they force the participants to prioritize their responses. Where these type of questions were used, a 1-to-6 scale was used to gauge the spectrum of possible responses (summary rankings appear in either boxes or tables under each Survey topic).

Approximately one-half of the interviews were conducted onsite with key private equity/investment staff. The other half of the surveys were conducted using personal phone interviews with key personnel.

Once surveys were completed, they were loaded into a database and collated by question. These questions were later categorized into the broad four areas described earlier.

Summary Comments

This survey reflects the views and perspectives of many of this country's largest institutional private equity investors. In this respect, there was an attempt to reflect these views clearly back to the reader rather than burden the reader with too many subjective opinions.

The results of this survey indicate that there is potential for institutional investors to develop consensus positions on a few key issues relating to private equity investing. Hopefully, the findings of this survey will help to spur additional discussion among both investors in private equity and the general partners who have delegated responsibility for investing the investors' capital in this asset class. One outgrowth of these discussions will be a standardized questionnaire-type tool that will assist plan sponsors in their due diligence procedures.

Introduction

In 1996, the National Association of State Investment Officers (NASIO) commissioned William M. Mercer, Inc. (Mercer) to publish an educational report on private equity investing. This report, titled Key Terms and Conditions For Private Equity Investing (hereinafter the "Mercer Study"), reviewed in detail many key aspects of private equity investing pertinent to institutional investors (as limited partners). The primary issue explored by the Mercer Study was alignment of interests between the general partner and limited partners of a limited partnership (the vehicle used by the overwhelming majority of investors investing in private equity).

An important goal of the Mercer Study was to "spark a paradigm shift in the way investors participate in and think about the private equity markets." Moving toward this new line of thinking in a practical manner, NASIO enlisted the assistance of Pension Consulting Alliance, Inc. (PCA) to survey several NASIO and other large pension funds about their private equity due diligence practices. Actual due diligence is closely related to the issues discussed in the Mercer Study since many of the issues raised in the Mercer Study make themselves evident, in a practical way, during the due diligence process.

The main thrust of this Due Diligence Survey (the Survey) is to develop, if possible, a consensus about what areas within the due diligence process deserve further scrutiny and possibly increased standardization. From this consensus position, the institutional investor and general partner communities can then come together to formulate more consistent practices that, in the longer term, enhance the use of private equity as a viable asset class. In this respect, the Survey complements the Mercer Study by encouraging institutional investors to begin thinking seriously about practical applications of the issues raised in the Mercer Study.

It is important to note that the private equity investment area remains the most "inefficient" of all the institutional asset classes. This inefficiency provides astute institutional investors with the potential to realize significant investment returns. Keeping this factor under consideration, improved standardization of *specific* components of private equity information should allow the prospective investor to focus on the more subjective issues associated with selecting private equity investment vehicles. Such enhancement of the investor's partnership selection process should prove highly beneficial to both investor and general partner communities.

Given the high level of fragmentation in the private equity markets, there is broad agreement among many institutional investors, including the Survey participants, that the quality of information flowing through the private markets can and should improve. The Survey i) begins to isolate those areas where improvement might occur and ii) also identifies areas of the due diligence process that may possibly best remain under the purview of the individual institutional investor.

Survey Review

Survey Participants' Intentions

When asked what they intended this Survey to accomplish, the Survey participants had three responses:

- A significant proportion of those interviewed indicated that some form of standardization of information and data disseminated by the general partner community is critical. The respondents said that this standardization could occur in two areas: i) investment performance reporting and ii) developing a set of fundamental issues that all plan sponsors should cover in a typical due diligence review (see Appendix B).

- Several participants were also interested in gathering information on the due diligence practices of their counterparts. Many stated that sharing approaches among plan sponsors might reduce the potential of being overwhelmed during the general partner marketing process.

- Finally, a handful of participants indicated that, collectively, groups of plan sponsors may be able to exert some form of negotiating leverage when reviewing terms and conditions of partnership agreements. The Survey participants viewed the NASIO process as a forum that sponsors might use to begin to organize in this manner. Other Survey participants, however, voiced concern over moving in this direction.

Current Practices

Approximately one-half of the Survey focused on the current due diligence procedures and approaches that the Survey participants actually performed. This information provides a backdrop for the discussion of perspectives reviewed later in the Survey.

Describe Due Diligence Process

The majority of the Survey's participants had some framework for reviewing private equity opportunities. Many of the participants had criteria that they used to screen funds (see below), but they varied in the criteria that they used and how it was applied.

Interestingly, certain criteria were independent of partnership-specific or performance-related issues. Examples of these more strategic-oriented criteria include:

- *Strategic Fit.* Determining whether the strategies of partnerships matched those strategic areas within the participant's private portfolio that were under-emphasized. If the strategies did not mesh, those partnerships were excluded from further due diligence.

- *Minimum partnership size.* Several Survey participants indicated that investing in partnerships below a specific size would provide virtually no economic benefit to either the private equity portfolio or the investment results of their total fund. If a partnership's fund raising goal fell below this minimum level, the participant would exclude it from further due diligence.

- *Tiered due diligence process.* If the offering under review was a follow-on investment in a partnership that the Survey participant had committed to previously, then an abbreviated form due diligence could occur. In contrast, offerings of partnerships that would require new relationships with the Survey participant would go through a more extensive due diligence process.

While the above criteria focused primarily on reducing the number of partnerships a Survey participant might consider, there were other procedures that some participants used to screen partnerships rapidly and also to enhance the traditional due diligence process. Examples of such procedures include:

- *Selective initial interviews.* For example, select a sampling of portfolio companies that a general partner would claim as part of its track record. The major issue is: Did the general partner execute the role it claimed in its marketing presentations? A short series of "off-the-record" questions was one tool used as an attempt to extract material information from portfolio company management.

- *Applied technology.* Use the Internet and other electronic delivery systems to gather information on general partners from as wide a spectrum of sources as possible.

- *Plan sponsor-driven references.* Use references relied upon by the investor, not the general partner. Such reference lists often deviate significantly from those reference lists provided by the general partner. Focused checklists usually rely on unique sources (e.g., executive recruiters) that evolve over time. In addition, such references could prove to be the most rapid source of relevant information.

- *Integrity focus.* Several Survey participants indicated making an effort to develop a subjective integrity rating of the general partner. Getting to this rating typically involved interviewing the general partner group. The nature of these "integrity interviews" varied. One technique used was to monitor certain individual principals across both partnership-related and unrelated activities (which might include personal activities, such as interaction with family members, friends, etc.). Another technique involved interviewing subordinate level employees of the general partner in private settings.

- *Consultant usage.* The Survey

participants used third-party consultants to varying degrees. Minimum levels of usage (if used at all) amounted to verifying partnership track records. At the other extreme, consultants played a significant role in partnership selection and private portfolio construction.

Macro Analysis

One area indirectly related to due diligence is the strategic overlay investors and general partners use in directing capital to specific areas of opportunity. This process of viewing overall trends within the economy and private markets may also prove useful as a tool for pursuing specific partnerships as well as managing overall private equity portfolio risk.

Half of the participants indicated they applied some form of proactive or disciplined top-down discipline to their partnership selection process. The other half indicated that their selection process consisted of reacting and then analyzing partnership opportunities as they became available.

Of those with a more top-down oriented process, the overwhelming majority of these participants selected partnerships based on the need or requirement to meet certain sector funding guidelines within a broader private equity policy. These guidelines may reflect some longer-term tactical views about the private markets, but these guidelines may not shift dramatically over time. Only one participant in this group indicated that it was taking a disciplined tactical approach to monitoring certain sectors of the economy, on an ongoing basis, to identify new areas that might yield above-market returns within the private markets.

Objectivity/Subjectivity of Process

When asked if their due diligence process was objective or subjective, the overwhelming majority of Survey participants indicated that they used a subjective process. A few Survey participants indicated that it was difficult to quantify the prospective abilities of individual general partners and that the process is really one of assessing a group's ability to work together to create added value. As a result, analysis of organizational issues could prove critical in assessing general partner abilities.

Scale: Objective – 1 : Subjective – 6
Average rating: 4.4 High: 6 Low: 3

Frustrations

The Survey participants raised several frustrations about the due diligence process. As expected, many believed that the review process was too time consuming and that there were not enough resources available to perform high-quality, efficient due diligence. Specifically, several participants indicated that a review period of approximately 100 days was excessive and that due diligence and approval should take place within a three-to-five week period. Such due diligence also includes review of legal documents, which many participants also believed was cumbersome.

Survey participants also voiced other frustrations. For example, some believed that the general partners were exploiting the current demand cycle for private investment products by constraining fundraising periods, avoiding investors with strong pro-investor positions, etc.

Survey participants also voiced certain frustrations where plausible solutions were within reach. For example, one Survey participant indicated that their current review process did not distinguish re-ups from new partnerships. (As indicated earlier, another participant considered this segregation as a key initial phase in their due diligence process.) Another Survey participant wondered how to develop an effective network of contacts to get rapid opinions on general partners. (Another participant has, over many years, developed a network of contacts that performs just that function.)

Viewpoints

This section of the Survey studies the collective opinions of the Survey participants on certain due diligence issues. Findings from this section are important for developing future areas of consensus.

Should Due Diligence Have Phases?

As follow up to describing their due diligence processes, each Survey participant discussed whether or not due diligence should occur through a series of phases. All Survey participants believed that a phased approach to due diligence was critical and applied some sort of phased review process.

Most interesting was that the types of phased approaches utilized differed significantly by participant. Examples of the first phase across various due diligence processes included: i) identifying whether partnership fits within strategic categories within the fund; ii) ensuring partnerships under review meet fund-level statutory requirements; iii) requiring partnerships to meet some level of integrity standard; iv) partnerships must meet some alignment standards; v) ranking partnerships across a multi-attribute system, selecting only the highest ranking offerings; and vi) selecting only those strategies that made the most intuitive sense to the Survey participant and its decision makers.

Due Diligence Homogeneous?

Survey participants were asked whether they apply different criteria to different types of partnerships by investment strategy (e.g., buyout, venture capital, mezzanine, etc.). The results were polarized, with more participants indicating that they use essentially the same process for judging the quality and investability of specific general partners. Almost one-half of the participant group indicated that they use the same process, regardless of partnership type. Only two participants favored using significantly different criteria for different types of partnerships.

Scale: Can Use Same Criteria – 1
Should Use Different Criteria – 6
Average rating: 2.4 High: 6 Low: 1

Rating Due Diligence Components

Due diligence information can be divided into several different categories. Many plan sponsors and private equity consultants define these due diligence components in subtly different ways. Up to this point, there has been no standardized due diligence package used by a majority of institutional investors.

This Survey allowed unique access to several questionnaires and due diligence practices across several consultants and plan sponsors. In an attempt to understand the various due diligence issues, questions from these questionnaires and procedures were collated into broad due diligence categories that would hopefully encompass the many facets of each individual due diligence approach. In total, this review covered a broad spectrum of due diligence questions plan sponsors and consultants apply in their due diligence proceedings.

For purposes of this Survey, the due diligence questions and information is broken into the following broad categories:

General Background –Descriptive information of the general partner (e.g., location, number of partnerships; number of professionals, etc.)

GP Structure – The GP organizational structure and how it functions (e.g., compensation and ownership structure among partners and employees, allocation of capital for specific investment ideas, sub-contracting of financing or operating aspects, team vs. star approach to managing companies, etc.);

Alignment of Interests – Review of various aspects and approaches used to align interests between the limited partners and the general partner. An important objective of these questions is to determine the extent to which general partners are aligned with their limited partner investors. Areas reviewed include fee levels, fee sharing arrangements, hurdle rate levels, carried interest schedules, etc.

GP Costs & Budgets – Review of the financial/operating structure of the general partner. Key attention is directed toward whether cash flow at the general partner level is commensurate or in-line with cash flows at the limited partner level.

Performance – Verification of performance track records is a major component of the due diligence process. Areas of analysis within this segment of due diligence include: i) review of valuation procedures, ii) verification of cash flows to the limited partners, iii) assignment of investments to specific individual principals, iv) the depth and breadth of a general partner's track record, etc.

GP Portfolio Strategy – Focuses on the value-added approaches of the general partner as well as risk management approaches that are used when constructing a portfolio. (e.g., is the general partner's stated strategy consistent with its historical experience?; use of financial engineering approaches to either take risk or manage risk; determining what approaches have had the most influence on the general partner's historical performance; etc.)

GP Background – Review of the personal histories of the individual principals within the general partner. Main objective is to determine the level of integrity of the key individuals involved in the general partner.

The Survey participants were asked to rank these areas in order of importance. The results may not prove surprising, but are interesting just the same (see Table 1).

Each participant was asked to rank these components on a scale of 1-to-6, with 1 being very low importance and 6 being considered very important.

Table 1.
Respondents' Rank of Due Diligence Areas

Due Diligence Category	Avg.	Min.	Max.

GP Portfolio Strategy	5.5	5	6
Performance	5.2	4	6
Alignment of Interests	5.1	3	6
GP Background	5.0	3	6
GP Structure	4.3	2	6
GP Costs & Budgets	3.9	2	5
General Background	3.6	1	6

The results indicate that the Survey participants ranked due diligence associated with executing portfolio strategy the highest. Closely following execution of portfolio strategy was developing a clear understanding of a general partner's performance and track record. Possibly surprising to some readers was that, while ranked high, alignment of interests did not rank as the top priority item in due diligence. However, both alignment issues and verification of the personal backgrounds of individuals within the general partner were critical (ranking, on average, at or above 5.0).

Structural considerations of the general partner were not as critical, although ranked as somewhat important. This finding indicates that if a general partner has: i) a well-defined strategy that ii) has been executed profitably in the past, iii) interests between the general partner and its limited partners are reasonably aligned, and iv) the general partners have operated with a perceived high degree of integrity, then the other factors are viewed as less of a priority in the due diligence process.

Is Criteria-based Due Diligence Helpful?

One of the most important issues of this Survey was trying to gauge the participants' views on whether certain aspects of the due diligence process could be standardized.

Another way of stating this proposition is: Do the Survey participants believe there is potential to develop quantitative criteria across the various aspects of due diligence?

The overall consensus view among the participants was that quantitative criteria within the due diligence process would be difficult to develop (see Table 2).

Table 2.
Respondents' Belief that Quantitative Criteria are Useful Performing Due Diligence
(1 – not useful : 6 – very useful)

Due Diligence Category	Avg.	Min.	Max.
Performance	3.7	1	6
Alignment of Interests	2.9	1	6
GP Background	2.9	1	5
GP Costs & Budgets	2.8	1	5
GP Structure	2.4	1	5
General Background	2.1	1	4
GP Portfolio Strategy	1.8	1	3

In only one area, measurement of partnership performance, did the majority of participants believe that there is potential for establishing quantitative standards. Across other areas, the collective view is that developing fixed criteria for approval or disapproval of private investments would prove unwise.

Across these results, however, there was a significant degree of polarity in the responses (as evidenced by the extreme positions of the maximum and minimum scores). Even in the most quantitative aspect of due diligence, performance analysis, one participant scored its response a "1," indicating that quantitative criteria or standards for historical performance would be of little use in executing partnership due diligence.

Finally, it is worth noting that the area deserving the least amount of criteria-based analysis, GP Portfolio Strategy, was scored earlier as the most important area of due diligence. This finding highlights that, even though there is interest in developing further standards within the private investment due diligence arena, due diligence and final selection decisions of specific partnerships will still prove to be a highly subjective process.

Reporting Standardization

This section highlights briefly the participants' views about performance reporting within the private equity arena.

Acquaintance with AIMR Standards

Sixty percent of the participants stated that they were acquainted with the AIMR standards for privately held investments. Of those that indicated familiarity with AIMR's standards, many indicated that the standards were more a reflection of industry practices rather than a driver of industry practices. Specifically, many participants were hoping that the AIMR (or other regulatory bodies) would be more forceful in dictating how partnership performance is calculated and presented.

Improving IRR Reporting

The overwhelming majority of respondents also indicated that IRR calculations and reporting should be standardized further. Only one participant believed that IRR calculations would continue to lack standards. However, all participants agreed further disclosure and discussion of calculations should occur.

Several participants desired to see some form of IRRs based on cashflows at the investor level (in contrast to "realized" IRRs typical reported to investors). Others sought disclosure of both gross and net IRRs. In addition, many participants indicated the need to develop an approach for disclosing how general partners arrived at their unrealized valuations.

Many of these suggestions were, in fact, reported by AIMR as being high-priority items that general partners should produce.[3]

Alignment of Interests

Alignment of interests is a major concern among the growing universe of private equity investors. However, there has been little discussion on investors' beliefs about how best to align interests. The Survey explored the collective views on this issue in some detail.

Alignment of Interest Issues

Alignment of interests is a critical aspect of the due diligence process. However, while the participants stated that the examination and negotiation alignment of interests is a critical step in the due diligence process, their individual views of how best to align interests varied.

To explore the alignment of interest issue, the Survey contained a framework that isolated the key methods used to aligning interests.

[3] "Report of the Subcommittee on Venture and Private Equity Placements," AIMR Newsletter, Vol 5, No. 2, 1994.

Four methods identified were:

Aligning Interests Through Contract Negotiations – Negotiating and reviewing contractual and partnership agreement matters typically requires significant resources and effort. A critical issue, therefore, is whether the contract is a highly useful tool for motivating general partners to act in the limited partners' best interests, or does it (at best) simply establish a framework for partnership activities?

General Partner Contributions – Capital contributions by the general partner may influence their activities materially. The more capital a general partner places in the sponsored vehicle, the more the general partner's return pattern should align itself with those of the other limited partners.

Third-Party Contributions – Often a major financial backer (such as an insurance company, investment bank, or strategic investor) will support a general partner with a significant amount of financial capital. Does this support help to align interests across the entire partnership?

Distribution Structure – Investors use varying distribution structures (in the form of preferred returns, carried interest formulas, and the timing and extent of profit allocations) to constrain general partners' allocations until the investors have received some acceptable level of return. How much influence do these structures impact alignment of interests?

As in other questions, the Survey participants were asked to rank each of the above alignment of interest components in terms of whether each alignment of interest tool provides confidence that interests are better aligned (see Table 3).

Table 3.
Qualitative Assessment of Certain Alignment of Interests Tools
(1 – low confidence : 6 – high confidence)

Alignment of Interest Component	Avg.	Min.	Max.
GP Contributions	5.1	3	6
Contract	4.1	2	6
Distribution Structure	4.0	1	6
Third-Party Contributions	3.1	1	5

As the table shows, collectively the Survey participants believe that general partners making significant contributions to their own funds is the best mechanism for aligning interests. The participants ranked the other tools as providing less confidence that interests between the general partners and their investors are aligned.

Two additional observations are worth noting about this issue. First, there was a degree of polarity in the responses – i.e., the Survey participants gave more extreme rankings rather than moderate rankings. This finding indicates a lack of consensus on the usefulness of these tools among the participants (the exception is GP Contributions, whose lowest ranking was a moderate 3).

Second, in spite of the fact that GP Contributions were viewed the best mechanism for aligning interests, the Survey participants made little effort to quantify these contributions in relative terms. Many Survey participants indicated that general partners who "contributed a significant portion of their net worth" were aligned with their investors. This rationale, in fact, was more important than the absolute dollar level of a general partner's commitment. However, when asked if they attempted to gauge a general partner's net worth, the overwhelming majority of Survey participants admitted to not making an attempt to quantify the general partner's (and its principals') net worth.

A Due Diligence Primer - a short list of priority due diligence items

Survey participants ranked four areas of due diligence as very important: the general partner's investment strategy; verifying a general partner's performance; alignment of interests; and the general partner's background and reputation. Listed below are several points within each of these categories that a prospective investor might consider reviewing. The list is by no means all-encompassing. However, based on the feedback from the Survey's participants, this information should prove very helpful in arriving at a more accurate assessment of a specific general partner.

General Partner Portfolio Strategy:

There is no standard approach that one can apply to determine whether or not a specific strategy fits well within an investor's mix of private investments. However, certain information can help to determine whether a general partner actually executes its stated strategy.

- <u>Determine how much performance came from financial engineering vs. application of strategy</u>. Compare proposed use of leverage with historical pattern.

- <u>Study trends in strategic applications</u>. Is stated investment strategy equivalent to those of prior funds, or is the strategy evolving?

- <u>Review investment histories and approaches of principals</u>. Who has corporate experience in strategic areas of interest? Was the principal (or principal team) really responsible for generating the return? What did he/she do to contribute to the results?

- <u>Ask for the general partner's due diligence package(s) for specific portfolio companies.</u> Was the general partner expecting multiple expansion to occur? How much leverage is general partner assuming to achieve its return objectives? What are the one or two underlying assumptions behind the plethora of data? Can the general partner execute to make sure these assumptions take place?

- <u>Review tranche structure of each(selected) investment(s)</u>. What type of equity was utilized (common, pfd., special voting rights?)? Are of protective puts in place?

- <u>Monitor commitment trends</u>. If general partner is raising significantly more commitments than prior fund, how will commitment growth be managed? Will investment and transaction sizes increase? Or will more transactions be executed?

- <u>Review guidelines for types of investments</u> (by sector, stage of investment, security type, etc.) allowed and to what extent. Are guidelines consistent with stated strategy?

- <u>Assess the track record's breadth and quality</u>. Was performance evenly spread across investments, or concentrated in a few select investments?

- Note current investment activity of principals (number of board seats, size of team vs. proposed number of investments, etc.). Will additional staffing be required to manage new partnership?

Partnership Performance

- Review valuation procedures of unrealized investments. Are they consistent? How do they compare to other partnerships executing equivalent strategies? How many unrealized investments are due to recapitalizations? How was recapitalization valued and by whom?

- Verify the timing and extent of cash flows to limited partners. Confirm IRR cash flows using audited financial statements where possible. Have general partners reconcile selected period cash flows.

- Assess performance versus vintage year peer group. Review not only IRRs, but also payback, distributions/value-as-multiple-of-contributions, etc.

- Disaggregate returns into realized and unrealized components. What proportion of aggregate IRR is coming from unrealized results?

- Review payback structure of partnership portfolios. What is the average holding period of prior investments? Have holding periods varied by partnership? Was there wide distribution of holding periods within a partnership? What is the shape of a partnership's J-curve?

- Require both pre-fee/incentive IRRs and after-fee/incentive IRRs.

- Request statement from general partner that performance reporting complies with AIMR standards. Several reporting issues may be resolved if there was better acquaintance with AIMR's standards and interested parties began to rely on them.

Alignment of Interests

The Mercer Study focused on identifying and defining key alignment of interest issues. Despite modest improvements in alignment of interests, these issues are still highly relevent. The suggestions below reflect both the key points of the Mercer Study as well as the priority views of the Survey participants.

- Determine general partner commitment to partnership. According to Survey, the key factor in aligning interests is the proportion of general partner net worth committed to partnership. How much of the general partner's commitment can the general partner pay out of its management fee? What is the documented net worth of the general partner's senior principals? For later-generation partnerships, general partners should be making highly significant commitments.

- Review termination/replacement rights of limited partners. There is movement toward no cause termination rights with approval of a super-majority of limited partner interests (typically 75% or greater). Other termination rights (key-man provisions, negligence, etc.) should be in place and executed at lower proportions of limited partner interests (simple majority to two-thirds). Well aligned partnerships will possess all these rights. If the general partner is a significant investor in the partnership, it is important that its voting rights as a limited partner are eliminated or severely restricted.

- Assess distribution structure. The typical structure allows the general partner to receive incentive distributions on an investment-by-investment basis. Currents trends show that more partnerships require that the limited partners receive some form of a minimum return of capital before the general partner receives any incentive compensation. Investors should seek incentive arrangements that reward the general partner only after a minimum return on aggregate contributed capital (rather on an investment-by-investment) has been achieved. One form of this arrangement is allowing the general partner to accumulate its incentive payments on an investment-by-investment basis, but placing them in escrow until a return hurdle has been achieved or the partnership winds down.

- Check for activity-based or scaled fee structures. The fixed management fee structure, as a percent of commitments over the entire life of a partnership, is becoming outdated. Typical fee structures now change the fee base after the investment period is over. Usually the fee base is some form of remaining invested or contributed capital. As investments are sold off as a partnership matures, the absolute amount of the management fee declines. More attractive fee structures also reduce the fee percentage after the investment period. For example, a midsized buyout fund might initially charge a 1.5% management fee based on total commitments during the investment period. Once the investment period is over, the base changes to remaining contributed capital and the percentage amount declines by 0.2% per year. In addition, general partners are beginning to introduce fee scales (roughly equivalent to their public market counterparts) based on total fund size and/or an investor's commitment level. Investors in the private markets should advocate these advanced fee structures whenever possible. Finally, investors should push strongly for capturing various fees that the general partner receives as part of the activities of the partnership. These fees include directors' and advisory fees, transaction fees, break-up fees, etc.

GP Background

There are a variety of sources of information that one can use to gather information on general partners. There is no substitute for making several reference calls across a variety of different practitioners associated with the general partner. It is important to develop a unique set of sources and procedures that, when completed, provide an accurate assessment of the capabilities and integrity of the principals of the general partner. The list below highlights various techniques used by Survey participants.

- <u>Check media sources.</u> Search not only for references on the general partner, but also underlying portfolio companies (particularly the underperformers). Information gathered from these sources provides background for further reference check discussion.

- <u>Call former investors.</u> There could be general partner-specific reasons why prior investors ceased providing capital. Did they cease making commitments because of performance issues? Management issues? Is there a specific event that caused an investor to question the integrity of the general partner?

- <u>Call the worst performing portfolio companies.</u> Are representatives from these companies excluded from the general partner's reference list? Do the company representatives still view the general partner in a positive light? Would they seek capital from the general partner again?

- <u>Interview syndicate and possibly competing lenders.</u> Typically, transactions involve more than one interested party. Off-the-record inquiries may provide valuable information into a general partner's reputation. How did the general partner treat the other groups? Were they collegial in their efforts to arrive at a transaction structure, or did the general partner force certain terms into the transaction?

- <u>Visit general partner and interview staff and others.</u> Onsite visits may provide key subjective information about the general partner. How are the senior principals viewing the subordinate principals? Is one senior principal dominant in articulating strategy and philosophy? Are associates in the general partner motivated to pursue partner status? Are the senior principals good managers of their internal teams?

PCA Initial Interview Form
Interviewee: XYZ Pension Fund, Private Equity Contact

1. ***Please describe your current due diligence process. What are its strengths and weaknesses?***

2. ***What do you believe is the basic objective of this study?***

3. ***How do you rate the overall partnership review process on an informal/formal scale? Which parts of the process deserve further formalization and improved procedures? Do you believe certain aspects of general partner-provided information requires further standardization? What specific areas?***

formal					informal
1	2	3	4	5	6

4. ***Due diligence can be broken into major functional categories (such as: general background, structure of general partner, alignment of interests, operating costs, GP***

past investment performance, portfolio structure and diversification, GP background checks, etc.) How would you rate these or other major categories in terms of importance?

General Background

not important					important
1	2	3	4	5	6

General Partner Business/organizaitonal Structure

not important					important
1	2	3	4	5	6

Alignment of Interests

not important					important
1	2	3	4	5	6

Operating Costs

not important					important
1	2	3	4	5	6

General Partner Past Performance

not important					important
1	2	3	4	5	6

Portfolio Structure, Diversification, Strategy

not important					important
1	2	3	4	5	6

GP Background Checks

not important					important
1	2	3	4	5	6

5. ***Are there specific issues within each major category (highlighted in question 4) that you believe deserve close scrutiny?***

6. ***Do you believe due diligence varies by partnership type (e.g. venture capital, buyout, mezzanine, etc.)? Or are there aspects of due diligence that are common to all partnership reviews?***

can use same standards					must use different criteria
1	2	3	4	5	6

Comments

7. ***Should due diligence occur in phases? If so, what is critical to cover in the first phase?***

8. ***What are your specific frustrations in executing partnership reviews?***

9. ***Would it be useful to establish minimum criteria for specific items (hurdle rates, GP investment standards, GP ownership structure, GP backgrounds, etc.) in the due diligence process across partnership types (buyout, venture, etc.)***

General Background

not useful					useful
1	2	3	4	5	6

General Partner Business/organizaitonal Structure

not useful					useful
1	2	3	4	5	6

Alignment of Interests

not useful					useful
1	2	3	4	5	6

Operating Costs

not useful					useful
1	2	3	4	5	6

General Partner Past Performance

not useful					useful
1	2	3	4	5	6

Portfolio Structure, Diversification, Strategy

not useful					useful
1	2	3	4	5	6

GP Background Checks

not useful					useful
1	2	3	4	5	6

Comments/Other Categories

10. Are you aware of AIMR compliance standards for private equity (see attachment)? Do you believe they are sufficient? Why or why not?

11. How would you rate general partner/sponsor alignment of interests with limited partners as a priority in the due diligence process? What gives you high confidence that interests are aligned? What gives you low confidence?

Alignment of Interests

low priority — **high priority**

1	2	3	4	5	6

Confidence assessment: Contractual arrangements

low confidence — **high confidence**

1	2	3	4	5	6

Confidence assessment: General partner capital contributions of ____%

low confidence — **high confidence**

1	2	3	4	5	6

Confidence assessment: Sponsor capital contribution of ____%

low confidence — **high confidence**

1	2	3	4	5	6

Confidence assessment: Preferred Return of ____%

low confidence — **high confidence**

1	2	3	4	5	6

12. How do you perform due diligence at the macro level? (e.g., how do you determine when its appropriate/inappropriate to participate in a certain investment type or economic sector?)

13. Currently there are several nuances and techniques used to calculate investment level and fund level IRRs. What is your view of these techniques? Should investors rely on a specific set of standards for calculating IRRs?

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A Due Diligence Questionnaire

by

Pension Consulting Alliance, Inc.

1999

Neil A. Rue, CFA
Allan R. Emkin

A Due Diligence Questionnaire

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Executive Summary

In early 1998, thirteen large pension funds asked PCA to survey a wide spectrum of large pension funds about their private equity due diligence practices. This review is an extension of the findings of and discussions revolving around a report sponsored by a similar group of plan sponsors and published in 1996 by William M. Mercer, Inc. (Mercer). This report, titled Key Terms and Conditions For Private Equity Investing (hereinafter the "Mercer Study"), reviewed in detail many key aspects of private equity investing pertinent to institutional investors (as limited partners). The primary issue explored by the Mercer Study was alignment of interests between the general partner and limited partners of a limited partnership (the vehicle used by the overwhelming majority of investors investing in private equity).

An important goal of the Mercer Study was to "spark a paradigm shift in the way investors participate in and think about the private equity markets." In this respect, actual due diligence is closely related to the issues discussed in the Mercer Study since many of the issues raised in the Mercer Study make themselves evident, in a practical way, during the due diligence process.

One important outgrowth of this review is to develop a questionnaire that investors could use as part of preliminary due diligence. Discussion and consensus acceptance of a preliminary due diligence questionnaire should prove highly advantageous to the widening universe of private equity investors and provide consistent reporting standards for an industry that does not currently have standards for the reporting of basic information such as the calculation of past returns.

It is important to note that, even though there is substantial potential for improving reporting standards in this area, improvements in the terms and conditions under which the limited partners operate have begun to evolve favorably, reflecting the original spirit and intent of the Mercer Study. Examples of these positive changes include: declining management fees as a percent of commitments, an increase in the use of fee formulas that decline after a general partner's investment period is completed, more general partners putting up more than the minimum 1% capital commitment requirement, and improved termination clauses across more partnership agreements.

Still, there is room for further enhancement. And, an important facet of such positive progress is providing methods for keeping as broad a base of institutional investors as informed as possible.

In light of these issues, this reports presents a standard questionnaire to be used by investors as part of their preliminary due diligence to ensure information is available in a consistent format, calculated using the same methodology, provides certain information and, thereby, provides a means for investors to have a method to assess partnership opportunities on a consistent basis. This questionnaire should also help the general partner because they will be able to provide basic data to the majority of investors in a consistent format rather than in unique formats for each potential investor.[1] In this respect, this project complements the Mercer Study by encouraging institutional investors to begin

[1] Please note that this questionnaire is not intended to be the final step in the due diligence process or represent a complete due diligence review of a specific partnership. It is only intended to provide investors with sufficient screening information to be used for further due diligence.

thinking seriously about practical applications of the issues raised in the Mercer Study. A standardized and focused series of due diligence questions should prove to be an excellent first step.

A final, but important consideration is that the private equity investment area remains the most "inefficient" of all the institutional asset classes. This inefficiency provides astute institutional investors with the potential to realize significant investment returns. Keeping this factor in mind, improved standardization of *specific* components of private equity information should allow the prospective investor to focus on the more subjective issues associated with selecting private equity investment vehicles.

Given the high level of fragmentation in the private equity markets, there is broad agreement among many institutional investors, including the project's participants, that the quality of information flowing through the private markets can and should improve. This questionnaire begins to isolate those areas where improvement might occur.

A Standard Due Diligence Questionnaire

The participants in this project ranked four areas of due diligence as very important: 1. the general partner's investment strategy; 2. verifying a general partner's performance; 3. alignment of interests; and 4. the general partner's background and reputation. Listed below are several questions within each of these categories that a prospective investor might consider discussing with prospective general partners. An additional section, Section 5, provides for other general questions. These questions are by no means all encompassing. However, based on the feedback from the project's participants, responses to these questions should prove very helpful in providing the information necessary for the plan sponsor to consider further investigation of the partnership opportunity in question. As such, this questionnaire may become the foundation for an industry-standard due diligence document.

This questionnaire assumes, in large part, that the general partner has a sufficient track record from at least one prior partnership. For general partners establishing a partnership vehicle for the first time, some of these questions may not have appropriate answers. It is incumbent upon the general partner of first-time partnership to disclose such issues with the user of this questionnaire and to develop a solution that is acceptable to both parties.

The general partner may already have provided sufficient information (through its Private Placement Memorandum, or "PPM") to answer one or more of the questions below. In such cases, the general partner should reference the location of the answer in the PPM.

Section 1. Investment Strategy/Proposed Terms:

General partners employ a variety of approaches (financial engineering, expansion and top-line growth, buy-and-build, turnaround, etc.) to produce added value. Answers to questions in this section should provide data that will help confirm the general partner's stated investment strategy as well as present an outline of the terms and conditions of the partnership under review.

1. Please review your investment strategy and market niche:

a) Provide a detailed summary of your investment strategy and market niche. Include data on the market opportunity and how your strategy is different from the strategy of other general partners.

b) What is your partnerships' specific competitive advantage?

c) Provide expected return information; explain how the return will be earned.

d) Discuss your ability to execute the strategy.
- How does your firm add value to portfolio companies on a strategic, financial, and operating basis?
- Why do you have an advantage in deal sourcing?
- How were prior investments sourced?
- Have you acted as a lead investor in previous investments?
- Describe the level of competition for deals you will pursue, and how you plan to be successful.
- Discuss your planned average holding period for investments. Is this different from prior funds?

a) Discuss the risks involved in your strategy, and how you plan to manage these risks.

2. Schedule of Terms and Conditions: Please fill-in the following table covering the terms and conditions of your partnership offering.

Descriptive Information	
Maximum and Minimum Levels of Committed Capital Allowed by the Partnership	
First Closing Date (if not past, projected)	
Final Closing Date	
Legal Structure of Partnership and General Partner	
Term (in years) of Partnership (please discuss extensions)	
Form and Amount of General Partner Capital Commitment	
Fees, Compensation, Allocations	
Management Fees and General Partner Compensation	
Additional Partnership Expenses	
Preferred Return (Compounded?)	
Carried Interest Allocation Procedure	
Treatment of Fee Income Derived by General Partner from non-Partnership Sources	
Allocation/Distribution Policies for income, gains, losses	
Clawback Features (are reserve accounts used?)	
Partnership Governance Issues	
Termination/Dissolution Provisions (including for cause, breach of contract, no-fault)	
Limited Partner opt-out and suspension provisions	
Limitations on Transfer of General Partner Interests	
Limitations on Transfer of Limited Partner Interests	
Key man provisions	
Investment limitations and restrictions	
Other Items	
Indemnification Provisions (at General Partner, Limited Partner, Advisory Committee level)	
Coinvestment Rights (for General Partner, Limited Partners, non-Limited Partners)	
Function of Advisory Committee (please also discuss who participates)	
Parallel Funds	
Records, reporting, inspection, and meeting rights	
Amendments	
Tax Issues	
Use of outside professionals	
Negligence Standard	
Description of Capital Commitment Procedures (timing, form, accounting for)	

3. Please provide written copies of your internal investment policies, and internal investment

approval reports.

4. Please summarize the partnership's investment guidelines. What are the limits on a company investment as a percent of capital? Are there sector limits? What are the maximum leverage guidelines? Is the partnership limited to specializing in only specific types of investments?

5. Were any special covenants used in your investments for risk management purposes? Please provide two examples.

Section 2. Details of Investment Performance

Questions in this section seek to standardize and verify general partner investment results. The answers to these questions should provide the reader with a reasonable detail of performance attribution, both at the portfolio company and partnership levels.

1. Please complete Attachments A (Investment Profiles) and B (Internal Rate of Return Schedules).

2. Please provide your latest partnership's most recent audited annual financial report. Does the disclosed partnership contribution and distribution data in the annual report reconcile with the contribution and distribution data used to calculate the partnership's IRRs (see Attachment B)? If not, please explain.

3. Please discuss the key factors that may impact the financial performance of your proposed partnership.

Section 3. Alignment of Interests

There are a variety of mechanisms general partners and limited partners use to attempt to align interests. Questions in this section focus on those alignment of interest issues that many indicated were of highest priority and explore certain due diligence issues in further detail. Answers to these questions should allow the reader to come to his/her own unique, but reasonable, beliefs about whether general partner alignment of interests are acceptable.

1. Please provide details (and diagrams if available) of the legal structure of the General Partner, and all affiliated management companies or corporations.

2. Please provide full ownership position information for each principal of the General Partner and related companies and corporations outlined in Question #1 above. Include information (voting rights, etc.) on any prospective organizations (e.g. limited partners) that are affiliated with the general partner.

3. Please discuss how interests will be aligned between the general and limited partners.

4. Please provide your pro forma annual budgets for the general partner/management companies for all funds you currently manage (including the proposed new fund). Note the duration of the investment/commitment periods for each fund.

5. Please quantify the following financial information on the individual principals of the general partner:

Principal Name	Expected Capital Contribution	Carry Points	Total Annual Expected Compensation From This Fund	Total Annual Expected Compensation From Other Sources	Carried Interest Compensation If Fund Meets Objective (see Section 1, Ques. 1c)
Joe Smith	$2,500,000	5			
Total All Principals	$8,500,000	17			
Affiliate 1	1,000,000	2			
Affiliate 2	500,000	1			
Total Principals and Affiliates	10,000,000	20			

1. For each principal in the partnership, please complete the following carried interest schedule for all prior partnerships the individual has an interest in:

Carried Interest Allocation – ABC Partnership I

Principal or Affiliate Name	Allocated Carried Interest	Amount of Allocated Carried Interest Distributed	Amount of Allocated Carried Interest Vested
Joe Smith	$7,482,000	$1,243,000	$6,239,000
Total All Principals and Affiliates	45,257,000	$6,722,000	$38,535,000

1. Please use the following table to provide full details of your planned management fee structure.

Initial Base Fee	%
Initial Capital Base:	Check one that applies
Committed Capital	
Contributed Capital	
Other Capital Base (please describe)	
Fee Reversion Features	Check all that apply
New Asset Base when Commitment Period Terminates	
Sliding Fee Reduction over Time	
Other Features:	Check all that apply
Fee Scaled on Capital Raised	
Advisory Fee Offsets	
Other Features (please describe)	

8. Using the checklist below please highlight what distributions take place before profit sharing (i.e., carried interest) takes place:

Type of Distribution	Occur before Profit Sharing?
Return of Lp's invested capital in individual investment	
Return of Lp's management fees associated with individual investment	
Return of Lp's share of writedowns associated with other investments	
Lp's Preferred return on capital invested in individual investment	
Return of Lp's share of management fees associated with all partnership investments	
Lp's preferred return on all of a limited partner's contributed capital	
Other	

Also, please provide full details (or a copy of) your planned distribution procedures.

9. For all principals involved with the Partnership, please complete the following table. Include all Board responsibilities (e.g. portfolio company boards, public company boards, non-profit boards, other boards).

Current Board Responsibilities

Active Investment / Principal	Company A	Company B	Non-Profit	Total Board Seats Held
Principal				
Joe Smith	P		A	2
Bob Jones	A	A	A	3
Henry Wesson			P	1
Total Principals on Board	2	1	3	

A - Active
P – Passive

9. Please provide copies of all side letter agreements with any investors, including but not limited to all Limited Partners and General Partners.

10. Under the proposed partnership agreement is the general partner allowed to coinvest alongside the limited partners outside the limited partnership?

11. Please identify all principals and/or affiliates of the general partner that will be coinvesting.

12. Will an advisory board give final approval to distributions? Who will be the members?

13. What steps have you taken to ensure that the Limited Partners will not be liable for any issues beyond the term of the partnership?

14. Identify and discuss any actual or potential conflicts of interest with respect to the General Partner and professionals involved with the fund.

15. Please describe "for cause" and general termination rights proposed in the limited partnership agreement.

Section 4. General Partner Background

Responses to these questions should provide the reader with sufficient reference sources to verify the business practices of the general partner. From this list each prospective limited partner will have to develop their own approach to checking references.

1. Please provide resumes of the General Partners and key professionals employed by the General Partner professionals, including affiliated operators. (Note: if these resumes are included in the PPM provide the page number).

2. Please provide at least seven (7) references (with title, relationship, and contact information) for each principal of the General Partner.

3. Please discuss the role of each of the principals of the general partner and specify how much of each principal's time will be allocated to the investment activities of this partnership.

4. Please outline your firms internal decision-making processes (Investment Committees, etc.).

5. Please complete the following table for all prior partnerships:

Partnership/Year	$ Committed	$ Invested	# of Investments	Major Investor(s)	Investor Contact(s)

1. Have any professionals left the general partner over the last five years? If so, please identify the portfolio companies these general partners participated in and to what degree.

2. Please provide contacts at all portfolio companies in last two partnerships.

ABC I Limited Partners	Contact	Title	Phone Number
Lasso TechnologyCorp.	Roy Rogers	CEO	(333) 555-4444
The Stirrup Mfg. Group	Will Rogers	President	(222) 666-7777
ABC II Limited Partners			
Pork & Beans, Inc.	Ginger Rogers	CFO	(111) 999-8888

8. Please provide a contact list of all agents, co-investors, and lenders used in the last two partnerships.

ABC I Limited Partners	Contact	Title	Phone Number
Heller Financial	Bob Jones	CEO	(333) 555-4444
Chase Manhattan Bank	John Smith	President	(222) 666-7777

8. Have any of the principals of the general partner or any of the general partner's affiliates been subject to any litigation? If litigation is currently in process, please provide (i) a detailed discussion of the case, (ii) the current status of the case, and (iii) a brief comment on the case's merits.

9. Please discuss your hiring plans for future partners and professionals. Please discuss organizational growth/succession plans.

Section 5. Other Questions

1. Please provide examples of your reports to LPs.

Attachment A – Investment Profile

Attachment A is compilation of investment profiles used by general partnership groups and private equity consultants. A screening of information in Attachment A should provide the reviewer with (i) a preliminary understanding of the investment in question; (ii) references that should have an informed understanding of the investment; and (iii) a highlight of the role of the general partner in the investment. Further analysis of specific investments will be the responsibility of the investor.

ATTACHMENT A

Investment Profile: Example Corp., Inc.

Company Name Example Corp., Inc.

Location City, State, Country

Industry Telecommunications Application Software

Business Example Corp. designs and services application software for the telecommunications industry. Software packages include logistical and management applications. Example Corp. holds the #2 market position in logistical software applications to rural telecommunications providers.

Financing History *(in $ 000's)*

	Initial Financing Nov-97	*Jun-98*	*Nov-98*	Total	Percent	Contact Information
Cash						
XYZ Bank			20,000	20,000		Bob Jones (415) 333-1111
123 Bank			5,000	5,000		Mary Kay (415) 333-1111
Total Credit Facility			25,000	25,000	14%	
ZZZ Credit Corp.		30,000		30,000		Hank Usury (435) 444-9898
Total Senior Debt		30,000		30,000	16%	
Junior Mezzanine Partners, LP	40,000			40,000		Joe Johnson (531) 321-7676
Total Convertible Debt	40,000			40,000	22%	
ABC Partnership, L.P.		10,000		10,000		Joe Smith (312) 222-8888
New Ventures, LP		5,000		5,000		Fred Stakes (617) 555-0123
Senior Preferred		15,000		15,000	8%	
New Ventures, LP	10,000			10,000		Fred Stakes (617) 555-0123
Convertible Preferred	10,000			10,000	5%	
Junior Preferred						
ABC Partnership, L.P.	5,000	10,000	20,000	35,000		Joe Smith (312) 222-8888
New Ventures, LP	5,000	5,000	20,000	30,000		Fred Stakes (617) 555-0123
Common Equity	10,000	15,000	40,000	65,000	35%	
Other (Please define)						
Total Transaction Value	60,000	60,000	65,000	185,000	100%	

Financial Performance

	1995	*1996*	*1997*	*1998P*	*1999E*
Sales	27,500	38,500	66,250	125,000	210,000
EBITDA	10,000	13,000	23,500	59,350	110,000
Debt/Equity Ratio	2.0X	1.4X	1.1X	1.0X	1.2X
Coverage (EBIT/Interest Exp.)	1.7X	2.9X	5.5X	6.0X	5.2X

Purchase Multiple

Based on:	Current/Trailing EBITDA	Projected EBITDA
	12.0X	9.0X

<u>Assumptions for Projected Purchase Multiple:</u>
Revenue growth 30% per year
EBITDA growth 25% per year

Use of Proceeds Proceeds of November 1997 used to acquire 50% of Example Corp. from existing management. Proceeds of June, 1998 financing used to acquire CellSoft, the No. #3 logistical software provider. November 1998 financing used to expand distribution capabilities by establishing a joint venture with InfoLogic, a broadbased consulting and software distribution firm focusing on logistical solutions.

Reasons for Investment Huge potential for top line growth in the telecommunications software industry, which is currently highly fragmented with over 50 providers. Example Corp. is considered a platform on which to build market leadership position.

Strategic Role within Partnership Investment consistent with stated industry focus of general partner. Buy-and-build approach consistent with stated strategy.

Modest leverage indicates lower emphasis on financial engineering approaches.

Guideline Conformity Investment conforms with partnership's stated guidelines using current valuations. On a cost basis, leverage exceeds 50% guideline.

Investment Profile: Example Corp., Inc.

ATTACHMENT A

Current Capital Structure

Latest Valuation Date:	*12/31/98*	Percent	Nbr. Of Sec. Hldrs.
Total Credit Facility	$25,000	6%	2
Total Senior Debt	12,500	3%	1
Total Convertible Debt	27,500	7%	1
Senior Preferred	22,500	5%	2
Convertible Preferred	5,000	1%	1
Junior Preferred			
Common Equity	330,000	78%	4
Other (Please define)			
Total Value	$422,500	100%	

Equity Ownership Structure

Securities	Date Issued	Cost Basis	Conversions	Current Value	Gain/ (Loss)
Senior Preferred	Jun-98	$15,000		$22,500	$7,500
Convertible Preferred	Nov-97	10,000	$(5,000.00)	7,500	$2,500
Junior Preferred					
Common Equity	multiple	130,000	5,000	330,000	$195,000
Totals		$155,000		$360,000	$205,000

Basis of Valuation: November, 1998 Common Equity financing @ $X.XX/share

Equity Ownership Summary

	Security Type: Sr. Pfd.	Conv. Pfd.	Jr. Pfd.	Comm. Eq.	Total	% of Total
ABC Partnership, L.P.	$15,075			$82,500	$97,575	27.1%
New Ventures, LP	$7,425	7,500		$82,500	$97,425	27.1%
Management				$165,000	$165,000	45.8%
Total	$22,500	$7,500	$0	$330,000	$360,000	100.0%

Role of ABC Partners Personnel

Partner	Negotiation	Monitoring	Exit*	Comments
Joe Smith	X	X	X	Smith played co-lead in transaction negotiation with New Ventures.
Jim Jones	X			
Michael Wesson			X	

*Projected

List of Board of Directors

Name	Role	Contact Information:
Fred Edwardson	Founder, CEO	(312) 999-1234
Allan Thomason	Founder, President	(312) 999-1234
John Jameson	Executive VP	(312) 999-1234
Joe Smith	ABC Partners, L.P.	(312) 222-8888
Fred Stakes	New Ventures, L.P.	(617) 555-0123

Peformance Comments

Company has exceeding original plans due to top-line revenue growth and improved operating margins. Original equity has increased nearly three-times due to Y2K awareness and burgeoning consulting efforts. Continued growth should continue if CellSoft acquisition meets objectives.

Attachment B – Internal Rate of Return Schedules

The attached IRR Schedules and Instructions are formatted to produce a variety of IRR statistics for use by prospective investors. There are two basic schedules: a summary schedule that provides IRR results at various levels and a cash flow schedule that provides detail on underlying cash flows used to generate the IRRs found in the summary schedule.

Instructions for Completing Attachment B
Internal Rate of Return (IRR) Schedules

Introduction

Attachment B contains two schedules for presenting partnership level and investment-by-investment level IRR and cash flow information. Schedule I presents summary information for the partnership and its investments. Schedule II presents a format for calculating the data found in Schedule I. These instructions guide the data provider through the formats of both schedules.

The purpose of these schedules is to provide the user with several different forms of IRR and cash flow statistics that, hopefully, can be used to assess a variety of partnerships in a standardized format. While the calculation and reporting of such statistics could become a burdensome exercise in precision, the two schedules provide sufficient detail for the reader to draw informed preliminary conclusions about the performance of a specific partnership's historical track record.

Review of Schedule I

Schedule I reports two levels of performance: Company-level performance (see **A**) and total fund performance (see **B**). At the total fund level, performance is presented both before management fees (see **C**) and after management fees (see **D**).

The company-level section has two sub-sections: i) **Fully Distributed Investments** (see **E**) and ii) **Partially Distributed Investments** (see **F**). Within these sub-sections performance is reported on a company-by-company basis.

Fully Distributed Investments are those that the general partner has fully liquidated, sending all proceeds from the investment to partnership's investors. Such proceeds may have been in the form of cash or securities, but the important point is that the partnership no longer holds any portion of the investment in question. The performance data on these investments is broken into two sections: Pre Carry (see **K**) and After Carry (see **L**). These sections display company-level performance both before and after the general partner has deducted their carried interest in the company's performance.

Within the **Fully Distributed Investments** sub-section, there are several company-specific attributes. These attributes (from left to right) are:

Company name (see **G**) – which is self-explanatory.

Year of First Investment (see **H**) – The year in which the limited partners first contributed capital to invest in a specific company.

Year of Exit (see **I**) – The year in which the limited partners received their final distribution from the specified company.

Contributed Capital (see **J**) – The total amount of capital contributed to the specified investment.

Distributed Capital (see **M**) – The total amount of capital distributed from the specified investment. This is not the same as Realized Capital, since some general partners elect to treat publicly-traded securities still in their possession as Realized Capital. In order for such securities to be treated as Distributed Capital in this sub-section, they must have already been distributed out of the partnership and into the partners' hands. Presented both Pre Carry and After Carry.

The Distribution/Contribution Multiple (see **N**) – Distributed Capital divided by Contributed Capital. This ratio is a simple measure of the general partner's ability to create additional value in a specified investment and return that value to the investors. Presented both Pre Carry and After Carry.

IRR (see **O**) – The internal rate of return on an investment, based on contributed and distributed capital cashflows located in Schedule II. The IRR will decline after general partner carried interests are accounted for. Presented both Pre Carry and After Carry.

The **Partially Distributed Investments** sub-section lists companies that are still active within the partnership. An investment should remain part of this list until it is completely liquidated by the general partner. At that point, its results can transfer to the **Fully Distributed Investments** sub-section above.

The first two attributes found in the **Fully Distributed Investments** sub-section are the same as found in the section above. **Year of Exit** is not included because the general partner has yet to fully liquidate any of the investments in this sub-section.

Where a **Partially Distributed Investment** differs from its fully distributed counterpart is in the treatment of the investment's remaining value (or "fair value"). For **Fully Distributed Investments**, this value is known with certainty since the general partner has distributed all proceeds to the holders of the investment. In the case of an investment that has not been (or is partially) liquidated, the general partner must arrive at some value for that remaining portion of the investment that is held by the partnership. Since these investments are often privately-held or traded in the public markets on a limited basis, general partners oftentimes rely upon a set of appraisal-based rules for setting the value of an investment. Since there is a degree of subjectivity that enters into this appraisal process, there is potential that an investment's reported remaining value could deviate from its eventual liquidating value by a substantial margin.

To account for this situation in the reporting of performance, there are two categories of investment results for **Partially Distributed Investments**: i) "Cash-On-Cash" performance (see **P**) and ii) performance based on reported Unrealized Values (see **Q**). "Cash-on-Cash" performance presents the investment return of each investment assuming no change in the value of the remaining investment, with the exception of additional contributions. Under this approach, the only way for an investment to produce a positive return is to have produced some distributions prior to the performance reporting date.

The attributes in the "Cash-On-Cash" performance category are calculated using a standard termed "ATV." ATV is short for Adjusted Terminal Value and is the remaining value of an investment, excluding any writeups in value. Formally, the definition of ATV is:

The lesser of i) an investment's remaining cost basis or ii) an investment's cost basis deducted for any previous writedowns. Also, the ATV should not contain any accrued interest or interest payments received, but not yet distributed.

Using this definition, the attributes in the "Cash-On-Cash" Performance category are as follow:

Terminal Value (see **R**) – The ATV of the specified investment.

As with the Fully Distributed Investments Section, "Cash-On-Cash" performance is presented both Pre Carry and After Carry. The three equivalent attributes in these categories are calculated in the same manner as in **K** and **L** above. The only difference is that the IRR figures will use ATVs for the terminal value of a company investment.

The second sub-section of performance are based on Unrealized Values ("UV") (see **Q**) reported by the general partner. Each attribute in this sub-section is equivalent to the attributes in the "Cash-On-Cash" Performance sub-section, except for the use of unrealized values as terminal values in the underlying series of cashflows used to calculate the IRRs.

Since there is no change in contributions and distributions when moving to a UV approach to calculating IRRs, there is no need to re-report these attributes.

The company-by-company investment results in both categories (**Fully Distributed Investments** and **Partially Distributed Investments**) are then combined to produce aggregate results for each of the attributes highlighted (see the **S**'s).

These two aggregates are then combined to produce **Total Fund Performance – Gross of Fees** (see **C**). Note that at this level of the summary, the reader is able to review aggregate fund level performance before and after the general partner's carried interest.

The final attributes that are highlighted are total management fees that were charged to the partnership (see **T**). These fees are presented in dollar terms and can be reviewed in the context of aggregate **Contributed Capital**, which is displayed directly above. In addition, management fees are broken into two components: i) Management Fee (before advisory fee rebates) and ii) total advisory fee rebates. Advisory fee rebates are reimbursements that the general partner may pay back to the limited partnership for fees that the general partner received from third parties (including portfolio companies) for rendering services closely linked to the limited partnership's investment activities. Such reimbursements may, at times, prove significant and could significantly offset a general partner's management fees. Net Management Fees are Management Fees reduced by such reimbursements.

Finally, the **Total Fund Performance – Net of Fees** line (see **D**) presents the summary cashflow and IRR attributes for the partnership on a fully aggregated basis. Reviewing this line in conjunction with the **Total Fund Performance – Gross of Fees** (see **C**) line should provide the reader with the appropriate summary performance information at a variety of important levels.

Review of Schedule II

Schedule II provides a format for organizing and categorizing the various cashflows that are relevant to assessing the performance and track record of a specific limited partnership. The format of Schedule II matches closely the approached used by Venture Economics to calculate fund level IRRs and other performance-related statistics. Schedule I as a summary of data used in Schedule II.

Schedule II is separated into eight major sections:

Section **A** – Presents cashflow and performance data on company investments that have been completely distributed;

Section **B** – Presents cashflow and performance data on company investments that have been partially distributed or completely undistributed, using the ATV approach to setting terminal value (see discussion of ATV under instructions for Schedule **I**);

Section **C** – Presents cashflow and performance data on company investments that have been partially distributed or completely undistributed, using the unrealized terminal value reported by the general partner;

Section **D** – Presents aggregated cashflow and performance data on the partnership's completely distributed investments. The data in this section is the aggregation of data in Section **A**;

Section **E** – Presents aggregated cashflow and performance data on the partnership's partially distributed investments, using the ATV valuation approach. The data in this section is the aggregation of data in Section **B**;

Section **F** – Presents aggregated cashflow and performance data on the partnership's partially distributed investments, using the reported unrealized values of the general partner. The data in this section is the aggregation of data in Section **C**;

Section **G** – Presents aggregated cashflow and performance data for the total partnership. The ATV approach is used to value the partnership's partially distributed and undistributed investments. The data in this section is the aggregation of data in Sections **D** and **E**.

Section **H** – Presents aggregated cashflow and performance data for the total partnership. The valuations of the partnership's partially distributed and undistributed investments use the general partner's reported values. The data in this section is the aggregation of data in Sections **D** and **F**.

Using the Venture Economics approach, the best procedure for tracking cashflow series is to begin with separate contribution and distribution flows. Once these components are established, they can then be aggregated accordingly to arrive at the proper cashflow series used to generate the required IRR. Schedule II moves significantly beyond the Venture Economics format by seeking to report a spectrum of different IRRs and performance data.

Venture Economics also seeks only to report net-of-fee partnership level data using general partner inputs. Schedule II segregates IRRs in various pre-fee and after-fee formats to show how fees and incentives impacted performance. In addition Schedule II seeks the data necessary to understand the impact of general partner valuation procedures as well as advisory fee rebates and general partner clawbacks.

To accomplish these tasks the major sections of Schedule II utilizes unique series of cashflows:

Contributions (see **A1**, **B1**, **D1**, **E1**, **G1**,) – Capital drawdowns made by the limited and general partners for each investment and aggregated where requested. Contributions are not the same as investments made by the general partner. The schedule of contributions should be closely linked to the wire transfer date(s) of the limited partners and not the investment dates of the general partner.

Distributions (see **A2**, **B2**, **D2**, **E2**, **G2**,) – Distributions made to the investors in the partnership for each investment and aggregated where requested. Distributions are simply proceeds sent to the partnership's investors. Distributions are not the same as realizations, which may be executed by the general partner significantly prior the time that the commensurate distributions occur.

In the case of Sections **C**, **F**, and **H** , Contributions and Distributions cashflow series are not displayed. The reason for their absence is that, in these cases, there is no change in the contribution / distribution patterns when moving from the ATV valuation approach to the UV valuation approach. The only item changing is the terminal value used in the aggregate Pre Carry and Post Carry cashflow series. Therefore, there is no need to redisplay redundant data.

Pre Carry Aggregate (see **A3**, **B3**, **C3**, **D3**, **E3**, **F3**, **G3**, **H3**) – The sum of the **Contributions** and **Distribution** cashflow series, both by company and aggregated where requested. The IRR created using this series of cashflows represents the performance *prior to* the general partner receiving its performance incentives.

Post Carry Distributions (see **A4**, **B4**, **D4**, **E4**, **G4**,) – The **Distribution** series (see above) reduced by cashflows used to pay general partner incentives.

Post Carry Aggregate (see **A5**, **B5**, **C5**, **D5**, **E5**, **F5**, **G5**, **H5**) – The sum of the **Contributions** and and **Post Carry Distribution** cashflow series, both by company and aggregated where requested. The IRR created using this series of cashflows represents the performance *after* the general partner has received its performance incentives.

The previous five attributes are used to generate all of a partnership's before-fee IRRs and performance data, at the company-level, sub-composite level, and total partnership level. To generate after-fee performance data (found in Sections **G** and **H**) three other cashflow series are required:

Fund Management Fees (see **G6**) – The series of total fund management fee charges.

Advisory Fee Rebates (see **G7**) – A series of reimbursements credited against the management fee charges. These reimbursements typically arise from agreements between the general partner and limited partners to share in any advisory fees received by the general partner in connection with services rendered on behalf of the partnership.

(Fund Management Fees less Advisory Fee Rebates should amount the actual management fee payments made by the limited partners to the partnership.)

GP Clawback (see **G8**) – This series represents any payments or credits made by the general partner at the end of the partnership's life to reallocated its cumulative carried interest per the terms of the partnership.

Once the above series are determined, a net-of-fee series can be created:

Net Carry & Fees Aggregate (see **G9** and **H9**) – Total Fund Post Carry Aggregate series (**G5** or **H5**) less the **Fund Management Fees** (**G6**) series, plus the **Advisory Fee Rebates** (**G7**) series, plus the **GP Clawback** (**G8**). The only difference between **G9** and **H9** will be the treatment of unrealized values remaining in the partnership (using either the ATV or UV approaches).

Other attributes necessary for computation of IRR and performance data include:

Cashflow Dates (see **Z**) – There is some debate about what frequency of dates is appropriate for calculating IRRs. According to Venture Economics:

"While the actual-day [IRR] method is probably more accurate, this accuracy is generally spurious since cashflow dates between LP's and GP's may deviate due to timing differences between the general partner date and actual transaction date from the LP's perspective. Standard industry practice has been to use monthly cashflow data."[2]

Calculating IRRs using actual cashflow date is gaining more acceptance within the industry and should be used where possible. However, from a data collection and organizational viewpoint, using monthly cashflows may prove more straightforward. At a minimum, general partners should organize their cashflow information on Schedule II using a monthly frequency.

Terminal Date (see **T**) – Terminal values should be listed separately using the last day of the current reporting period. At the company level, terminal values will appear under the appropriate Aggregate heading and never under either the Distribution or Contribution headings.

Total Contributed and **Total Distributed** (see **J**) – These attributes are the totals of the **Contributions** and **Distributions** cashflow series and should summed under these headings.

Distrib./Contrib. Multiple (see **K**) – The **Total Distributed** field divided by **Total Contributed** field. This ratio is computed for all Aggregates and should be located under the appropriate Aggregate heading.

IRR (see **L**) – The internal rate of return, using the **Cashflow Dates** series and the appropriate Aggregate cashflow series. IRRs should be calculated using a function that is equivalent to Excel's XIRR function found in versions 4.0 and higher of Microsoft Excel spreadsheet software.

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2 1997 INVESTMENT BENCHMARKS REPORT Buyouts and Other Private Equity, Venture Economics, 1997, p. 202.

Schedule I – Performance Summary for ABC Partnership, L.P.

ATTACHMENT B

A

Company Level Performance - Gross of Fees

Fully Distributed Investments E	Yr. Of First Investment	Yr. Of Exit	Contributed Capital*	Pre Carry (K): Distributed Capital	Pre Carry: Distr./Contr. Multiple	Pre Carry: IRR	After Carry (L): Distributed Capital	After Carry: Distr./Contr. Multiple	After Carry: IRR	Q
Company A	XXXX	XXXX	$	$	x.xX	%	$	x.xX	%	
Company B G	H	I	J	M	N	O				
Company C										
Company D										
Company E										
Company F										
Company G										
Aggregate of Fully Distributed Investments J			$	$ P	x.xX	%	$	x.xX	%	

Partially Distributed Investments F

	Yr. Of First Investment	Contributed Capital	Terminal Value	"Cash-On-Cash" - Using Adjusted Terminal Values (ATV) — Pre Carry: Distributed Capital	Pre Carry: Distr./Contr. Multiple	Pre Carry: IRR	After Carry: Distributed Capital	After Carry: Distr./Contr. Multiple	After Carry: IRR	Using Unrealized Values (UV): Terminal Value	Pre Carry IRR	After Carry IRR
Company H	XXXX	$	$ R	$	x.xX	%	$	x.xX	%	$	%	%
Company I												
Company J												
Company K												
Company L												
Company M												
Company N												
Company O												
Company P												
Company Q												
Company R												
Company S												
Company T												
Aggregate of Partially Distributed Investments S		$	$	$	x.xX	%	$	x.xX	%	$	%	%
B ***Total Fund Performance - Gross of Fees*** C		$	$	$	x.xX	%	$	x.xX	%	%	%	%
Management Fees (before advisory fee rebates)		$										
<u>less: advisory fee rebates</u>		$	T									
Net Management Fees		$										
Total Fund Performance - Net of Fees D		$	$	$	x.xX	%	$	x.xX	%	%	%	%

Notes:

If investment history is less than one year, then IRR is "NM" - Not Meaningful

Show negative IRRs, <u>do not</u> insert alternative explanations or acronyms

Schedule II – Cashflow IRR Analysis

ATTACHMENT B (cont.)

	Company Level Cash Flow / Performance												*Distributed and Undistributed & Partially Distributed Sub-Composites*									
	Before Fund Management Fees																					
	By Company - Fully Distributed Investments					By Company - Undistributed and Partially Distributed Investments (U & PDI)							Aggregate Fully Distributed Investments (FDI)					Aggregate U & PDI				
						Using Adjusted Terminal Values (ATV)					*Unrealized Valuations*							*Using ATV*				
	For Each Company A - G					For Each Company H - T					For Each Co. H - T		FDI	FDI	FDI	FDI	FDI	U &PDI	U & PDI	U & PDI	U & PDI	U & PDI
	Contri-butions	Distri-butions	Pre Carry Aggregate	Post Carry Distribtns.	Post Carry Aggregate	Contri-butions	Distri-butions	Pre Carry Aggregate	Post Carry Distribtns	Post Carry Aggregate	Pre Carry Aggregate	Post Carry Aggregate	Total Contri-butions	Total Distri-butions	Pre Carry Aggregate	Post Carry Distribtns.	Post Carry Aggregate	Total Contri-butions	Total Distri-butions	Pre Carry Aggregate	Post Carry Distribtns.	Post Carry Aggregate
	$	$	$	$	$	$	$	$	$	$			$	$	$	$	$	$	$	$	$	$
Cashflow Dates	A1	A2	A3	A4	A5	B1	B2	B3	B4	B5	C3	C5	D1	D2	D3	D4	D5	E1	E2	E3	E4	E5
1/23/86																						
2/15/86																						
2/15/86																						
5/29/86																						
6/8/86																						
1/19/97																						
4/18/87																						
.																						
Z .			A					B			C				D					E		
.																						
.																						
.																						
.																						
12/5/96																						
1/25/97																						
3/18/97																						
4/6/97																						
9/30/97																						
9/30/97	T																					
Total Contributed	$					$							$					$				
J Total Distributed	K	$		$			$		$					$		$			$		$	
Distr./Contr. Multiple			x.xX	L	x.xX			x.xX		x.xX					x.xX		x.xX			x.xX		x.xX
IRR			%		%			%		%	%	%			%		%			%		%

Schedule II – Cashflow IRR Analysis

ATTACHMENT B (cont.)

		Total Fund-Level Cash flows / Performance											
											Before Fees		
Aggregate U & PDI		Total Fund - All Investments									Total Fund - All Investments		
Using UV		*Using ATV*									*Using UV*		
U & PDI Pre Carry Aggregate	U & PDI Post Carry Aggregate	Total Contri-butions	Total Distri-butions	Pre Carry Aggregate	Post Carry Distribtns	Post Carry Aggregate	Fund Mgmt. Fees	Adv. Fee Rebate	GP Clawback	Net Carry & Fees Aggregate	Pre Carry Aggregate	Post Carry Aggregate	Net Carry & Fees Aggregate
$	$	$	$	$	$	$	$	$	$	$	$	$	$
F3	F5	G1	G2	G3	G4	G5	G6	G7	G8	G9	H3	H5	H9
F						G						H	
		$					$						
			$		$			$	$				
				x.xX		x.xX							
%	%			%		%				%	%	%	%

Attachment C – Glossary of Terms

Advisory Committee Typically a group of limited partners that review valuations of a partnership's investments as well as conflict-of-interest issues.

Advisory Fee Rebates Rebates or credits paid to limited partners for advisory fees paid to the general partner by portfolio companies or other interest parties for investment banking-related activities. These rebates typically range from 50% to 100% of the amount of the advisory fee.

After Carry Refers to profits or investment return that remain after the general partner receives its carried interest (see "Carried Interest" below).

Alignment of Interests Desired outcome of partnership negotiation process. Alignment of interests occurs when a general partner's financial risks and expected profitability mirror those of the participants in the limited partnership the general partner is sponsoring.

Adjusted Terminal Value (ATV) Value of a remaining investment used to calculate Cash-on-Cash IRR (see "Cash-on-Cash IRR" below). ATV does not include upward adjustments for any unrealized gains, accrued interest, or undistributed interest payments. ATV is computed as the lesser of the cost basis (see "Cost Basis" below) of an investment or Cost Basis minus any writedowns (see "Writedown" below).

Buy-and-Build An investment strategy executed by private equity groups. Implementation of this strategy involves first purchasing a company in a specific industry that can then be used as the foundation for purchasing other (often smaller) companies. The foundation company then purchases several other companies to bolster its competitive position within industry.

Capital Base Base used to compute manager fee. Capital base is multiplied by the manager fee percentage to arrive at a dollar figure for manager fee. The capital base can shift significantly over the life of the partnership.

Capital Structure The liability and equity side of a portfolio company's balance sheet. Privately-held companies can contain several levels (or tranches) of debt and equity in their capital structures.

Carried Interest The amount of profit allocated to the general partner. Typical carried interest that accrues to the general partner is 20%.

Carried Interest Allocation The allocation of the general partner's carried interest among the principals of the general partner. General partners have a variety allocation formats that they use to allocate carried interest.

Carry Points A carried interest point equals one percentage point of carried interest. For example, if a general partner's carried interest is 20%, then that general partner owns 20 carry points.

Cash-on-Cash Refers to a series of cash flows used to compute an internal rate of return that is independent of any unrealized gains in the underlying investment. Without unrealized gains, the only flows returning to the investor are cash distributions and the current value of the investment, which is held at its cost basis (see "Cost Basis" below).

Coinvestment Investments by parties outside of the limited partnership in investments held by the limited partnership. These investments could be made by existing limited partners or by other third parties. Coinvestments may prove beneficial for a variety reasons – for example, a partnership might need capital beyond the available limited partner capital to execute a favorable transaction; or current limited partners may be able to access increased investment in a specific opportunity without being encumbered by the limited partnership's fee structures. However, coinvestments are normally not protected by the fiduciary responsibilities of the limited partnership or general partner.

Commitment Amount of capital allocated to a specific partnership. The general partner has the legal right to collect the pro rata share of the partnership's total commitment from each limited partner. The general partner will collect commitments on an as-needed basis or using some predetermined schedule.

Commitment Period See Investment Period.

Contributed Capital Amount of capital contributed to a limited partnership by the limited partners. At any one moment in time, contributed capital may or may not be equivalent to the limited partnership's invested capital due to timing differences between contributions and making actual investments.

Cost Basis The value of an investment not taking into account unrealized gains associated with market valuations. Consists of: amount of original investment, any additional incremental investments, capitalized fees, retained earnings from the investment, etc.

Current Value The market value of an investment.

Distribution/Contribution Multiple Distributions of an investment or partnership divided contributions to that investment or partnership. This figure is a simple measure of investment performance that focuses on the pace and extent of an investor's return of capital.

Distributed Capital Amount of capital received by the limited partners, reflecting the investment performance of the limited partnership. Distributed capital can come in two forms: cash distributions and security distributions. If a limited partner receives security distributions, there may be instances where the limited partner is constrained from selling the distributions in the open market.

Due Diligence The process of investigating the merits of a prospective investment or limited partnership. Due diligence typically covers many areas – from alignment of interests to investment strategy and performance.

EBITDA (Earnings Before Interest Taxes Depreciation and Amortization) This is an accounting measure of operational earnings that provides a more accurate view of the performance of a company's core businesses versus the net earnings of a company.

Equity Ownership Structure A schedule of who owns what type of equity of a specific investment. There are a variety of equity instruments available to owners of a company, depending on their role and risk tolerance. Types of equity include various tranches of preferred stock, common equity, equity options, equity warrants, and possibly lower-tranches convertible debt that is entirely convertible into equity.

Escrow A temporary holding place for earnings of a limited partnership. Typically, a limited partnership will require a general partner to place all, or a portion of, its carried interest in escrow until certain performance milestones are met or the partnership is terminated.

Expansion An investment strategy executed by private equity groups. Implementation of strategy involves major attempts to increase a company's market share in its area of expertise. Expansion strategies are usually implemented just prior to taking a company public.

Fair Value The latest stated value of an investment. This could be based on the market value of publicly-traded securities or, if the investment has already been sold, the sale price of the investment.

Fee Floor The lowest possible annual management fee a general partner would charge after all fee scaling conditions have been met.

Fee Reversion Feature A condition in the management fee structure that triggers a change in the management fee calculation. Examples of such features include: a fee reduction scale based on the age of the partnership; a change in fees once the investment period (see "Investment Period" below) is competed; advisory fee rebates (see "Advisory Fee Rebates" above).

Fee Schedule The general partner's annual management fee structure. Could include one or more fee reversion features (see above).

Financial engineering An investment strategy executed by private equity groups. Implementation of strategy usually involves purchasing a company using a significant amount of leverage. Over time, the general partner seeks to reduce leverage, causing profits and equity value to accelerate rapidly as debt is eliminated and interest payments are eliminated.

For Cause A set of pre-established conditions for general partner termination. Usually involve an agreed upon level of negligence or key-man provisions (i.e., if a key principal leaves the general partner, this triggers the "for cause" condition).

General Partner The principal or set of principals responsible for executing the strategy of the limited parntership.

Internal Rate of Return (IRR) The discount rate used to equate all the cash flows of an investment and its terminal value (see "Terminal Value" below) with the value of its original investment. The computation used to compute the IRR is equivalent to that used to compute a bond's yield-to-maturity.

Indemnification An agreement between the general partner and limited partners to provide security, protection, or compensation for unplanned circumstances which might arise during the partnership's life.

Invested Capital Capital actually placed by the general partner in a specific investment opportunity. Invested capital may differ, from time to time, from contributed capital (see above) due to timing differences between receive contributions from the limited partner and actually making a planned investment.

Investment Period (or Commitment Period) The amount of time required by the limited partnership for the general partner to invest all committed capital in new opportunities. Typically, the general partner is allowed to make follow-on investments in currently-held investments after the investment period is completed.

Limited Partners Partners who provide capital to a limited partnership to allow the general partner to execute its investment strategy. Limited partners are allowed only limited governance powers over the general partner (e.g., termination rights, conflict-of-interest oversight) and are generally not allowed to influence the general partner's investment strategy. In return for these limited rights, the limited partners are liable only to the extent of their investment in the partnership.

Limited partnership Vehicle used to invest in private equity. Uses commingled investment format and once commitment is made, the limited partner has only limited rights to influence the direction and strategy of the limited partnership.

Net Management Fees Annual general partner management fee after taking Advisory Fee Rebates (see above) into account.

NVCA The National Venture Capital Association

Operators Individuals or principals with expertise of managing a business in a specified area of expertise. General partners may rely on operators to execute specific components of their investment strategies.

Organizational Expenses Expenses borne by the limited partnership to bring the partnership into operational mode. These expenses are typically paid by the limited partners, but are capped at a predetermined level.

Partnership Agreements Documents that define all the terms and conditions of the limited partnership.

Payback Structure The rate at which distributions flow back to the limited partner(s).

Portfolio Company Investments Investments executed by the general partner and held by the limited parntership. The typical investment in a limited partnership vehicle is a privately-held corporation.

Pre Carry Refers to profits or investment return that are generated before the general partner receives its carried interest (see "Carried Interest" below).

Preferred Return A pre-established required rate of return on an investment before the general partner's carried interest is calculated. Preferred returns are calculated using a variety bases, including: the cost basis of an investment, contributed capital associated with a specific investment, a limited partners' entire amount of contributed capital, etc.

Principals of the General Partner Key individuals that execute the investment strategy of the limited partnership. These individuals usually have rights to collect a certain amount of carry points (see above) allocated to the general partner.

Private Equity An all-encompassing term that is associated with making investments through the limited partnership structure.

Private Placement Memorandum (PPM) A document explaining the attributes of a specific limited partnership offering. Typically includes biographies of principals, statement of investment strategy, a summary of historical performance, and a summary of the terms and conditions of the partnership.

Purchase Multiple Valuation parameter associated with the purchase price of a specific investment. Analogous to the P/E ratio in the public markets. The denominator of the purchase multiple is based on some form of EBITDA (see above), depending on the strategy of the general partner.

Recapitalizations An investment strategy executed by private equity groups. Implementation of strategy usually involves purchasing a company that has a burdensome capital structure and then favorably altering that structure to improve profitability. This strategy could be considered a form of financial engineering.

Side Letter Agreements Agreements made between the general partner and one or more limited partners outside of the limited partnership's partnership agreement.

Special Limited Partner A limited partner that is affiliated with the general partner and may receive special rights. Examples of such rights might include a foregoing of certain management fees, participation in the general partner's carried interest, priority consideration for coinvestment opportunities, etc.

Standard of Negligence A legal standard of negligence on the part of the general partner.

Statement of Changes in Partners' Capital A financial statement that describes the change of the limited partners' investment value over a specified period of time.

Syndicate A group of firms that will simultaneously purchase securities from a corporation. This group is said to underwrite the offering.

Terminal Value The expected value of an asset at the end of an investment period. If the investment is not publicly-traded, then the terminal value is subject to the valuation and appraisal procedures of the general partner. These procedures may contain a high degree of subjectivity.

Termination Clauses Statements in the partnership agreement that dictates the limited partners ability to terminate the general partner.

Termination rights The ability of the limited partners to terminate the general partner. Limited partnership agreements usually provide that a general partner may be removed based on certain conditions.

Terms and Conditions Statements in the partnership documents that outline the rights of the limited partners and the activities of the general partners.

Top-line Growth The growth of a company's revenue.

Tranche of Security The priority of payment to the holder of a security. The capital structure of a company may contain several tranches of both debt securities and equity securities.

Turnaround An investment strategy in which the goal is to increase the value of a poorly performing company through various methods (i.e. reorganization and recapitalization of the company).

Undistributed Value The value remaining in an investment or partnership that has not yet been distributed to the limited partners.

Valuation Date The date on which a valuation is placed on an investment.

Vested Carried Interests The amount of the general partners' allocated profit that an individual principal has a right to, but is eligible to receive at a later point in time.

Without Cause The ability of the limited partner to take action without the general partner breaching their fiduciary duties.

Writedowns A decrease in the market value of an investment established by valuation procedures of the general partner.

Attachment D – AIMR Private Equity Presentation Standards

Performance Presentation Standards

Report of the Subcommittee on Venture and Private Placements

Mission: Since their introduction in 1987, the AIMR Performance Presentation Standards have been refined and expanded to cover asset classes in addition to publicly-traded stocks and bonds, as well as to securities markets outside the US and Canada. The fundamental ethical principles always apply; i.e., to fairly represent performance with full disclosure. The goal of the AIMR Subcommittee on Venture and Private Placements is to recognize the special requirements of these different asset classes within the overall ethical framework of the Standards.

Parties Affected: There are three different constituencies within the venture market that are affected by the performance presentation requirements of the AIMR Standards:

- Current and prospective clients of investment advisors and current and potential investors of fund raisers in limited partnerships;
- The general partner of a limited partnership (or fund raiser); the general partner solicits investment in a limited partnership from potential investors and then has sole discretion over the investment of the proceeds;
- The investment advisor or intermediary who recommends or selects investments in the partnerships.

The AIMR Standards are primarily designed to improve the information available to clients who are evaluating a prospective manager's historical record. Current clients have two interests: (1) to evaluate the risk and return of an investment relative to their overall investment objectives; and (2) to evaluate the return of the manager relative to peer universes or to benchmarks of publicly traded securities. The time-weighted, rather than the dollar-weighted, rate of return methodology is the industry standard for calculating comparative performance of portfolios of publicly traded securities. As this report will describe, however, the time-weighted return method may not properly reflect the performance of private equity investments. The report will address the presentation of venture and private placement results by general partners and by investment advisors to prospective investors and to current clients. The recommended calculation method, the dollar-weighted rate of return, allows current and prospective clients to compare the results of private equity investments. However, it is inappropriate to compare returns calculated on a dollar-weighted basis with time-weighted returns calculated for publicly traded securities, and it is recommended that managers include in their disclosures that such comparisons may be misleading.

Calculation Aspects: There are inherent problems in applying a time-weighted rate of return methodology as required by the AIMR Standards to investments in venture capital, private limited partnerships, and other private equity investments. The time-weighted rate of return method allows the evaluation of investment management skill between any two time periods without regard to the total amount invested at any time during that time period. The measure must be independent of the total amount invested because the manager normally does not control the inflow or outflow of money. Selection of the time-weighted methodology is predicated on the assumption that the portfolio investments have total liquidity to accommodate cash flows without distorting the performance results. However, neither the implicit liquidity assumptions that underlay the time-weighted rate of return method nor the lack of control over cash flows holds in the case of private equity investments. Liquidity constraints distort a time-weighted rate of return from several aspects:

- Attribution of investment performance;
- Cash flow distortion; and
- Pricing bias.

Attribution of Investment Decisions: In a public equity portfolio, secondary markets create liquidity. As a result, money can be moved in and out without an investment manager's control, thus changing the investment base from time to time. The time-weighted methodology was created to overcome the fact that because the manager does not control the timing of such client-directed cash flows, changing the investment base should not impact the comparative performance.

In a private equity transaction, control of cash flow is in the investment manager's (General Partners') hands, negating the need for making time-weighted cashflow adjustments for the purpose of equitable comparisons.

Cash Flow Distortion: The second liquidity issue is a more complex one. The cash flow pattern inherent in the life-cycle of private equity investments may create distortions in a time-weighted rate of return that are not indicative of true investment performance. In partnerships, the initial funding may be used for expenses resulting in a very large percentage loss on a very small investment base in the first few periods. In some cases, when fees use up the entire investment base, the percentage loss

Presentation Standards

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can approach 100%. A time-weighted methodology would make all subsequently linked returns show a loss of approximately 100%, regardless of good performance on later, larger cash flows.

Thus, time weighting may bias the cumulative return of private equity partnerships when compared to a cumulative dollar-weighted rate of return. The time-weighted return may never catch up from the marked valuation decrease and commensurate negative returns in the fund's early life. In this case, the dollar-weighted rate of return will be more representative of the performance of the total investment over multiple periods.

Pricing Bias: There is no trade-based pricing mechanism to determine a period-end value for private market securities as exists in the public markets. In addition, there are no generally accepted appraisal practices to value private investments at periodic intervals as there are in the real estate market. The usual practice is to adjust the partnership's security market values only after there has been some independent market action, such as the new issue of securities to outside investors. Because only cash flows and the closing market value are used in the internal rate of return (IRR) calculation, the return calculation is not affected by interim pricing inaccuracies, as would be the case for a time-weighted rate of return.

IRR as the Recommended Calculation Method: The recommended measurement of performance for single investment performance presentation of private equity investments is the internal rate of return since inception. IRR is the annualized implied discount rate calculated from a series of cash flows. The IRR is the return that equates the present value of all invested capital in an investment to the present value of all returns. Another formulation is that the IRR is the discount rate that will provide a net present value of all cashflows to be equal to zero.

It is formulated as:

$$O = \sum_{i=0}^{n} CF_i \ (1+r/c)^{-(1*c)}$$

where:

CF = the cashflow for period i (negative for invested capital, positive for distributions or ending period net asset value);

n = the total number of cashflows;
i = period of cashflow;

c = number of annual cashflow subperiods. For example, c = 12 for monthly cashflows, c = 4 for quarterly cashflows;

r = subperiod internal rate of return or implied discount rate; r is converted to R or the annualized internal rate of return by:

$$R = (1+r)^{12} - 1$$

The IRR must be calculated using quarterly cash flows (c in the formula) at a minimum. Monthly cash flows are preferred and daily flows are the most desirable.

Performance Gross or Net Of Fees: When a general partner reports historical investment performance, the IRR must be net of expenses, fees, and carry. Gross returns on the fund and on the portfolio investments are recommended as supplemental information.

When an investment advisor reports the results of either separately managed accounts or commingled fund-of-funds structures, the IRR must be reported net of fees, expenses, and carry to the general partner, but gross of investment advisory fees, unless net of advisory fee results are required to meet SEC advertising requirements. When not required to meet SEC advertising requirments, the IRR net of investment advisory fees (including any other administrative expenses or carried interest) is still recommended as important supplemental information.

When reporting net IRRs, results must be reduced by fees and expenses regardless of whether these are paid from fund assets or from outside the fund.

Composites: A fundamental requirement of the AIMR Standards is the inclusion of all fee-paying portfolios over which the manager has full investment discretion in one or more composites, or groupings of portfolios defined according to similar strategies and investment objectives. This concept does not apply to fund raisers; each alternative investment partnership must be reported separately. The concept of composites does apply to fund-of-fund managers who manage either pooled funds or separately managed accounts. All discretionary investments with the same vintage year (year of fund formation and first takedown of capital) must be aggregated into composites. After this primary grouping, investments may be aggregated according to similar investment strategies and objectives, and presented as supplemental information. For example, subgroupings could be constructed on the basis of geography or investment type (venture capital, LBO, other alternative direct private placement investments, public securities funds, and/or venture distribution funds). The required composite definition, however, is vintage year.

Presentation of Performance Results: In addition to the required disclosures for presenting performance as outlined in the AIMR Performance Presentation Standards 1993, the following requirements and recommendations apply to the presentation of single investment private equity returns by General Partners, and to the performance of separately managed accounts and non-partnership and partnership fund-of-funds structures presented by Investment Advisors to prospective clients.

Requirements--General Partners:

- IRR cumulative since inception of the fund net of fees, expenses, and carry to the limited partner;
- Presentation of return information in a vintage year format; for comparisons to peer universes, vintage year is defined as the year of the fund's formation and first take-down of capital;
- The presented IRR is based on cash-on-cash returns (with stock distributions valued at the time of distribution) plus the residual value which is based on the valuation practices used in the calculation and reporting of the limited partner's capital accounts;
- Disclosure of general partner changes since inception of the fund;
- Disclosure of type of investment (e.g., venture capital, LBO, or other alternative including mezzanine and turnaround);
- Disclosure of strategy (e.g., geography, early stage, balanced, middle market, large transaction).

Recommendations--General Partners:

- For valuation of venture capital investments, the National Venture Capital Association (NVCA) valuation guidelines should be used;
- For buyout, mezzanine, distressed, or special situation investments, valuation should be either cost or a discount to comparables in the public market;
- IRR net of fees, expenses, and carry without public stocks discounted:
- IRR net of fees, expenses and carry assuming stock distributions were held;
- Gross IRR (before fees and carry) on the fund and on the portfolio investments;
- Multiple on committed capital net of fees and carry to the limited partners;
- Multiple on invested capital gross of fees and carry;
- Distribution multiple on paid-in-capital net of fees to the limited partners;
- Residual multiple on paid-in-capital net of fees and carry to the limited partner.

Requirements--Intermediaries
(i.e.. Investment Advisors)

- For separately managed accounts and commingled fund-of-funds structures, IRR cumulative since inception of the fund net of fees, expenses, and carry to the limited partners but gross of investment advisory fees, unless net of fee performance is required to meet SEC advertising requirements;
- Inclusion of all discretionary pooled fund-of-funds and separately managed portfolios in composites defined by vintage year;
- For calculating composite returns, the IRR must be based as an aggregation of all of the appropriate partnership cash flows into one IRR calculation as if it is one investment;
- Disclosure of number of portfolios and funds included in the vintage-year composite, composite assets, composite assets in each vintage year as a percentage of total firm assets (discretionary and nondiscretionary committed capital), and composite assets in each vintage year as a percentage of total private equity assets;
- Disclosure of availability of a full list of firm composites.

Recommendations--Intermediaries
(i.e., Investment Advisors)

- Disclosure of the number and size expressed in terms of committed capital of discretionary and nondiscretionary consulting clients;
- Net cumulative IRR (after the deduction of advisory fees and any other administrative expenses or carried interest) for separately managed accounts and commingled fund-of-funds structures.

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Montana Board of Investments;
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State of Wisconsin Investment Board.

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