A Due Diligence Questionnaire

by

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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
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.

Investment Profile:
Example Corp., Inc.

ATTACHMENT A

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

Assumptions for Projected Purchase Multiple:
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.

ATTACHMENT A

Investment Profile: Example Corp., Inc.

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
Jim Jones	X			with New Ventures.
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.

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

K L

Fully Distributed Investments E

	Yr. Of First Investment	Yr. Of Exit	Contributed Capital*	Pre Carry Distributed Capital	Pre Carry Distr./Contr. Multiple	Pre Carry IRR	After Carry Distributed Capital	After Carry Distr./Contr. Multiple	After Carry IRR
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	%

Q

Partially Distributed Investments F

"Cash-On-Cash" - Using Adjusted Terminal Values (ATV) | Using Unrealized Values (UV)

	Yr. Of First Investment	Contributed Capital	Terminal Value	Pre Carry Distributed Capital	Pre Carry Distr./Contr. Multiple	Pre Carry IRR	After Carry Distributed Capital	After Carry Distr./Contr. Multiple	After Carry IRR	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)		$										
less: advisory fee rebates		$	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, do not insert alternative explanations or acronyms

	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																						
.																						
.			A					B			C				D					E		
Z .																						
.																						
.																						
.																						
.																						
.																						
12/5/96																						
1/25/97																						
3/18/97																						
4/6/97																						
9/30/97																						
9/30/97	T																					
J Total Contributed	$					$							$					$				
Total Distributed	K	$		$			$		$					$		$			$		$	
Distr./Contr. Multiple			x.xX	L	x.xX			x.xX		x.xX					x.xX		x.xX			x.xX		x.xX
IRR			%		%			%		%	%	%			%		%			%		%

		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
continued from page 7
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:

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

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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