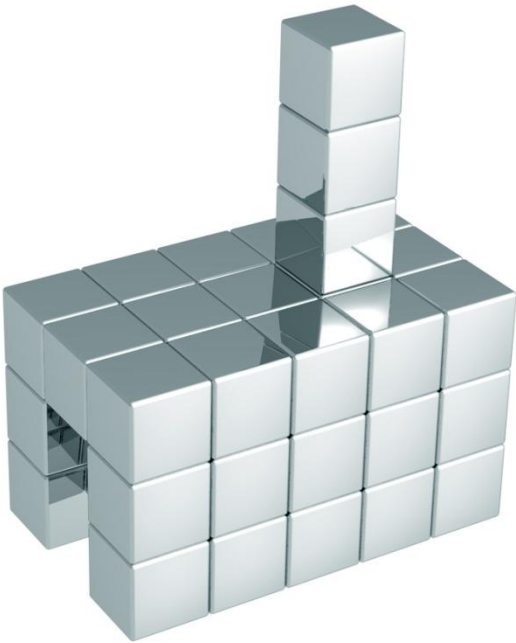


**2009 – ANNUAL REVIEW OF PRIVATE EQUITY  
TERMS AND CONDITIONS**



## INTRODUCTION

SCM Strategic Capital Management AG (“SCM”) is pleased to present you the 2009 annual review of private equity terms and conditions.

The study covers the period from 2007 – 2009 and it particularly **highlights the impacts of both the current crisis and the recently published Private Equity Principles of Institutional Limited Partners Association (“ILPA”) on the terms and conditions of fund offerings in 2009.**

The report is structured in 5 sections: 1. Description of Sample, 2. Fundraising Environment 2009, 3. The ILPA Guidelines and their Impact, 4. Key Findings, and 5. Conclusions and Outlook.

It is important to note that the data sources for this research study were the terms and conditions shown in Private Placement Memoranda (“PPM”) and not negotiated terms from Limited Partnership Agreements (“LPA”).

## DESCRIPTION OF SAMPLE

SCM's fund database has continuously grown and includes close to 2'400 Private Equity funds as per year end 2009. The sample used for this research report is composed of funds reviewed during the last 3 years.

The composition of the sample experienced three significant changes during the 2007 to 2009 period: (i) a significant decrease of fundraisings of European firms (their share dropped from 29% in 2008 to 18% in 2009), (ii) the re-focus on smaller funds sizes (funds with a target fund size of < USD 0.5bn accounted for 70% of all fundraisings by number in 2009) and total absence of mega fundraisings in 2009, and (iii) many more funds with an element of distress were raised in 2009 than in the previous years (the category “Distressed / Turnaround” includes equity funds (e.g. distress for control) while the category “Other” includes debt funds (e.g. mezzanine or distress debt for non-control). Their market share jumped from 7% and 10% in 2008 to 14% and 15%, respectively in 2009.

### SCM Sample Description (2007-2009)

Classification	2007		2008		2009	
<b>Sample size</b>	277 direct closed-end funds (excluding fund-of-funds and open-end funds)		368 direct closed-end funds (excluding fund-of-funds and open-end funds)		224 direct closed-end funds (excluding fund-of-funds and open-end funds)	
<b>Geographic split</b>	North America	34%	North America	27%	North America	42%
	Europe	25%	Europe	29%	Europe	18%
	Asia and RoW	19%	Asia and RoW	20%	Asia and RoW	21%
	Global Funds	22%	Global Funds	24%	Global Funds	19%
<b>Target fund size</b>	< USD 0.5bn	61%	< USD 0.5bn	50%	< USD 0.5bn	70%
	> USD 0.5bn & < USD 1bn	14%	> USD 0.5bn & < USD 1bn	29%	> USD 0.5bn & < USD 1bn	20%
	> USD 1bn & < USD 5bn	20%	> USD 1bn & < USD 5bn	14%	> USD 1bn & < USD 5bn	10%
	> USD 5bn	5%	> USD 5bn	3%	> USD 5bn	0%
<b>Fund strategy</b>	Buyout	38%	Buyout	26%	Buyout	24%
	Balanced	17%	Balanced	22%	Balanced	26%
	Venture	30%	Venture	35%	Venture	20%
	Distressed / Turnaround	8%	Distressed / Turnaround	7%	Distressed / Turnaround	14%
	Other (incl. Mezzanine)	7%	Other (incl. Mezzanine)	10%	Other (incl. Mezzanine)	15%
<b>Fund history</b>	1st time funds	28%	1st time funds	35%	1st time funds	33%
	fund size > predecessor	56%	fund size > predecessor	47%	fund size > predecessor	46%
	fund size ≤ predecessor	16%	fund size ≤ predecessor	18%	fund size ≤ predecessor	21%

## FUNDRAISING ENVIRONMENT 2009

The fundraising environment for private equity funds was clearly a challenge in 2009. According to Preqin, private equity had its worst year in 2009 since 2004, with only USD 246 billion raised globally; 61% down from the USD 636 billion raised in 2008 and 62% down from the record USD 646 billion raised in 2007.

This was particularly the case because US investors (primarily pension funds and endowments) had always been amongst the largest capital allocators to private equity funds and given the losses they experienced across different asset classes and the over-exposure to illiquid assets they had to deal with, an important investor base of such funds got in trouble in no time. Another large group of investors, Sovereign Wealth Funds (“SWF”), slowed down their investment pace as well and the investor base which continued investing was just not large enough to fill the gap which the others left behind.

**As a result fundraisings took much longer than anticipated by the managers (e.g. closings were delayed in almost all cases) but unlike in private equity real estate where the fundraising came to a complete standstill in 2009, private equity funds were still able to raise capital.**

However, many of the managers which had to go fundraising had to cut the size of their funds (not necessarily in the PPM but during the fundraising process) and the ones which had the flexibility postponed their fundraising plans. This was also visible in the fact that SCM reviewed ~40% less PPM’s in 2009 than in 2008.

**What does it all mean for this terms and conditions study 2009?** Managers which launched their private equity funds in 2009

certainly understood that they could not just copy / paste the terms and conditions from their last funds, which were raised in a different market environment. But the managers were not exactly clear what terms Limited Partners (“LP” or “Limited Partner”) would accept and neither did they want to give up all negotiation power already in the PPM. As a result, managers changed some of their terms and conditions already in the PPM while other terms were left unchanged for negotiations later in the process.

Therefore, SCM does not consider the terms and conditions in 2009 PPMs anything close to current market practice. Nevertheless, some changes were certainly meaningful enough to be discussed in this report.

## THE ILPA GUIDELINES AND THEIR IMPACT

ILPA is a non-profit association with a global membership of nearly 220 organizations (public pensions, corporate pensions, endowments, foundations, family offices and insurance companies) which represent well over USD 1 trillion of private equity assets under management.

**In September 2009, ILPA published a white paper laying out best practices regarding terms and conditions in order to (i) correctly align interests between managers and Limited Partners, (ii) enhance fund governance, and (iii) provide greater transparency to investors.**

This was the first initiative by Limited Partners which tries to align the interests between the investors in order to achieve more LP-friendly terms & conditions in Limited Partnership Agreements (LPAs).

Although SCM supports a better alignment of interest between managers and Limited Partners, the ILPA guidelines seem to go a bit

too far in the Limited Partners direction. Therefore, it is not surprising that in more recent due diligence projects, SCM made the experience that ILPA members were not strictly sticking to the guidelines but focused more on the points they consider key. This being said, a few ILPA members seem to take the guidelines very serious even if it means that they miss a top-in-class fund.

Going forward, SCM believes that managers will think very carefully which ILPA guidelines they want to adopt right from the beginning (and reflect such terms & conditions in a PPM) and which ones they try to resist granting during the negotiations. Some commercial points seem easier acceptable for managers (e.g. netting of transaction fees against management fees) while others could have serious impact on an organization and therefore will probably meet more resistance (e.g. removal for cause, tighter key man provision, etc). SCM's next year terms and conditions study could bring some more clarity in this regard.

## KEY FINDINGS

### Alignment of Interests: Ownership, GP-Commitment, Carry, Hurdle, Waterfall

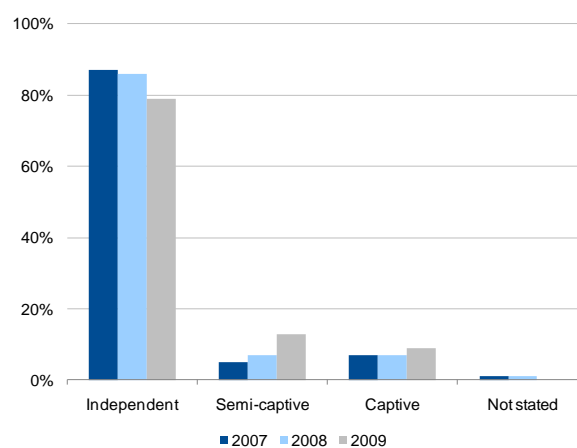
The sample experienced an increase in **ownership** of semi-captive managers in 2009 (Chart 1), i.e. managers which could rely on commitments from a cornerstone investor who either was somehow involved in the management of a fund and / or participated in such fund's economics.

SCM does, however, believe that this increase was just related to the current difficult fundraising environment. With a cornerstone commitment in hand, semi-captive managers certainly felt more comfortable to approach the fundraising market than independent firms which stepped on the brakes. As soon as

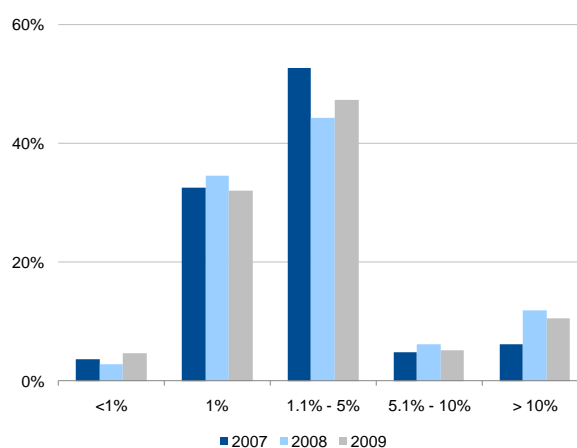
markets normalize again, independent managers will probably regain market share.

As regards "fully" captive funds (e.g. bank sponsored teams), the situation may be different. Such teams will experience pressure from two sides, namely the parents which may be under financial distress and not be able to fund their private equity businesses going forward or regulators which may put a ban on such activities. Therefore, one may see the market share of captive funds to drop going forward.

### (1) Ownership Structure



### (2) GP-Commitment



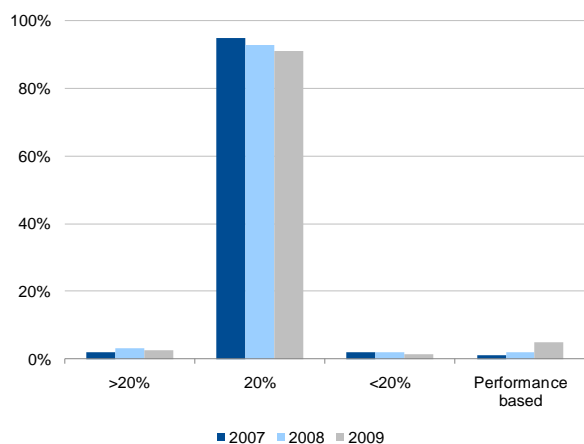
**A GP participation in the 1% - 5% range was the norm in the period from 2007 to 2009** (SCM made the experience that most of such funds received a GP commitment of up to around 2.5%).

The funding of such commitments got certainly easier during the last bull market cycle for two reasons: (1) managers received high carried interest payments from exits and, (2) perhaps even more importantly, managers of buyout funds made significant amounts from transaction fees. In a more recent due diligence project, SCM made the experience that pressure on fees had the effect that the GP had to reduce its commitment. This may perhaps become a wider phenomenon in the industry going forward.

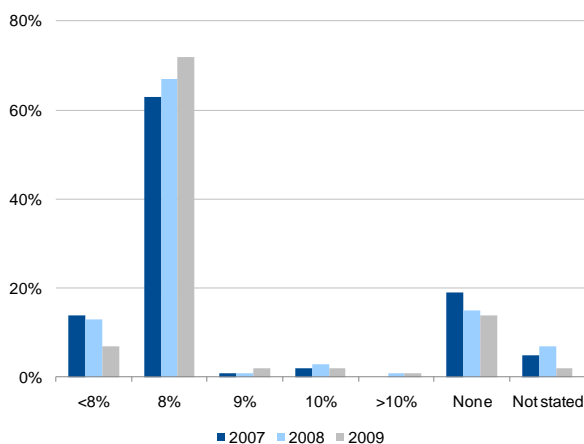
The **carried interest** of the vast majority of all private equity funds (Chart 3) stood at **20%** (Chart 3) and the **hurdle rate at 8%** (Chart 4).

Although not a significant development at first sight, SCM observed an **important change in the venture capital industry**. After a decade of disappointing performance, even some of

### (3) Carried Interest



### (4) Hurdle Rate



the high profile venture capital firms (where there was no correlation between reputation and returns) were no longer able to push through 25%+ carried interest (the share of venture capital funds with a 25%+ carried interest stood at 13% in 2009).

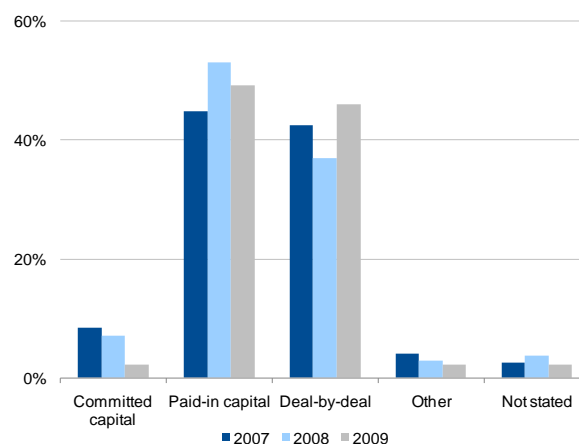
This being said, some venture capital firms could not stop dreaming of the good, old times but realized that they had to offer a better deal to Limited Partners: they switched from a flat to a performance based step-up carried interest model (e.g. 20% carried interest if an 8% hurdle rate (preferred return) is achieved and a 25% carried interest if a 15% hurdle rate is achieved).

Going forward, SCM believes that the 20% carried interest / 8%+ preferred return model will become market practice across all private equity funds.

Unlike in private equity real estate, where a shift in **waterfalls** from deal-by-deal carried interest to fund-as-a-whole carried interest was observed, the private equity industry was not moving in this direction in 2009 (Chart 5).

However, the increase in deal-by-deal waterfalls from 37% in 2008 to 46% in 2009 was solely sample related, i.e. caused by a weaker deal flow in Europe. European firms normally apply a fund-as-a-whole carried interest (“paid-in capital”) while US firms normally have a deal-by-deal carried interest.

### (5) Waterfall



But most interestingly to note was the **sharp drop of a deal-by-deal waterfall in the venture capital industry**. Only 21% (2008: 51%) of all funds in the SCM sample applied a deal-by-deal waterfall while a surprisingly high 65% (2008: 40%) first returned the capital to Limited Partners before they received a carried interest (but still 75% of all venture capital funds in the SCM sample did not apply a preferred return mechanism).

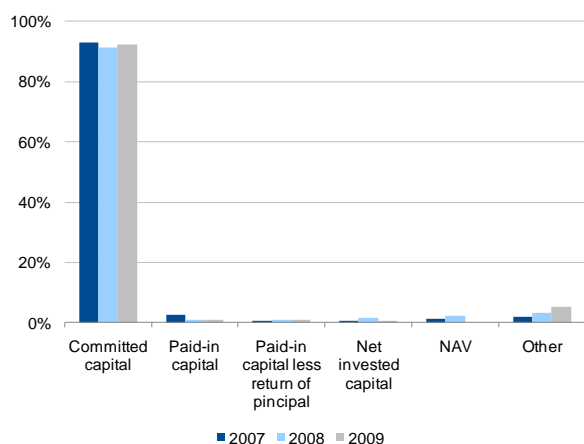
### Management Fees

The **management fee base** (Chart 6) **during the commitment period was in more than 90% of all offerings the committed capital (and invested capital post-investment period)**.

While the management fees in most PPMs were left unchanged from the last fundraisings, the success of Limited Partners' efforts to reduce fees becomes apparent when looking at negotiated LPAs of funds which started their fundraising efforts in 2009.

Half of the funds which started fundraising in 2009 (and not already in 2008) and in which SCM clients invested, either reduced their management fees and / or changed the split of the transactions fees in favor of the Limited Partners. SCM expects Limited Partners to continuously **pressure for more investor**

### (6) Management Fee Basis during the Investment Period



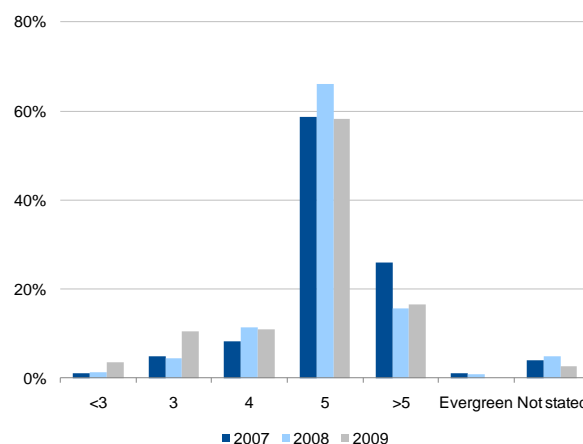
**friendly economic terms** when many established managers come back to the market during the second half of 2010 and 2011.

### Length of Investment Period / Investment Term

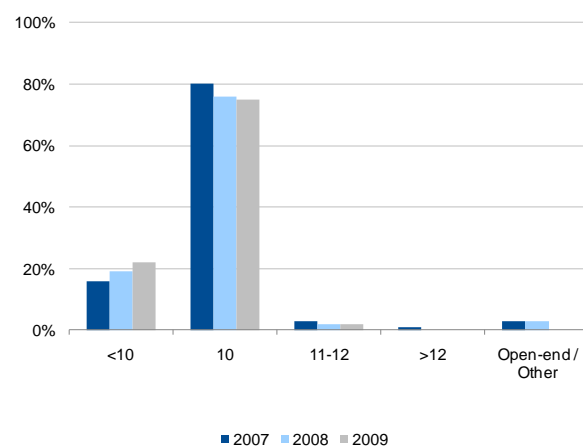
**Investment periods** (Chart 7) and **fund terms** (Chart 8) **of classic private equity funds are normally 5 years and 10 years respectively**.

However, the sample in 2009 shows outliers in both investment period (more than 25% < 5 years) and fund term (22% < 10 years). This is mainly related to an increased number of distressed debt fund offerings in 2009 which generally have a shorter fund life.

### (7) Length of Investment Period



### (8) Fund Term

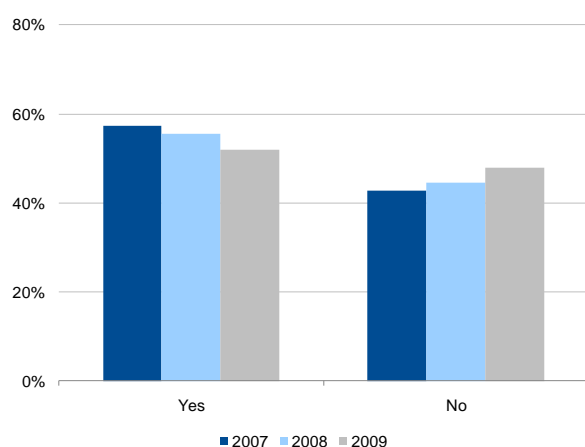


## Use of Placement Agents

The percentage of firms that used a placement agent **dropped from 57% in 2007 to 52% in 2009** (Chart 9). This may come as a surprise as in a difficult fundraising environment one would expect managers to flee into the arms of placement agents.

SCM believes that this development is less a result of fewer managers trying to engage placement agents but rather the placement agents' decision not to accept mandates, which in their view will never come to a successful end.

### (9) Use of Placement Agent



For this purpose some placement agents changed their model from a pure success fee to a mix of retainer and success fee. While such model improves the placement agents' position, managers will probably be more reluctant to award mandates to placement agents where the fundraising success and duration seems questionable.

Once there is more visibility about fundraising success again, SCM has the view that a window of business opportunity could open for placement agents because managers will need to find new pools of capital which fill the gap which current Limited Partners leave behind.

## CONCLUSIONS AND OUTLOOK

This study revealed a few important changes in the private equity terms and conditions in 2009, the most LP-friendly, which was already reflected in the PPMs, probably being the changes in the waterfall of venture capital funds.

Because 2009 was a weak fundraising environment with few negotiated terms and conditions, the whole degree of pressure on the terms and conditions will only be visible once more funds have completed a full fundraising cycle under the new market conditions.

Like in the past and despite the ILPA guidelines, SCM believes that Limited Partners will have different foci in the negotiations of terms and conditions but they will probably have a common understanding of the goal that should be achieved: lower fees, better alignment of interest and stronger corporate governance.

**Therefore, SCM expects that the following terms and conditions will be amongst the ones where managers will experience most pressure from Limited Partners:**

### Commercial Terms / Alignment of Interest

**Preferred return:** SCM expects pressure from Limited Partners for (slightly) higher preferred returns in the range of 9% - 10%.

**Carried interest:** A 20% carried interest will probably become the norm for all private equity funds, except for a handful of venture capital funds (as long as they deliver exceptional returns). In SCM's view performance based carried interest models will not find great acceptance amongst Limited Partners.

**Waterfall:** Limited Partners will continue to push for the European model (“fund-as-a-whole carried interest”) and against deal-by-deal carried interest models which were often applied by US managers and global funds. SCM expects great resistance from US managers when negotiating this partnership clause as it delays payments to the teams.

**Management fees / other fee income** (e.g. transaction fees, directors’ fees, etc.): Paying high fees was justified by high returns. While GP historically could get away with a 60 / 40 or 80 / 20 split, a full offset against management fees is expected to become the norm.

**GP-commitment:** SCM expects different forms of GP-commitments to come under increased scrutiny. Limited Partners clearly prefer true cash contributions by the teams over using (excess) management fees or transaction fees and should Limited Partners be successful in negotiating a netting of the fees, managers of larger funds will lose a truly important source of income. As a result, managers will have to fund their GP commitments out of their taxed income which makes a big difference to the status quo. The flipside of the medal may be lower GP commitments (if not significantly smaller funds will be raised).

## Fund Governance

**Removal for cause / no-fault removal:** The right to remove a GP for cause or no-fault is certainly amongst the strongest rights an investor can have. As a consequence, managers tried to resist any change requests in favor of Limited Partners or they requested high compensation in case a removal event was triggered. Given the importance of such rights, SCM believes that Limited Partners will

try to shift power from managers to Limited Partners (e.g. managers shall give up all future carried interest or management fee payments if a removal for cause event was triggered).

**Key man event:** While most old fund documentation included a key man provision, SCM believes that Limited Partners are keen to make such provisions more effective.

**Role and power of advisory board:** SCM believes that the advisory board will have a more important role governing funds going forward. This would require very clear formulations of advisory board involvement in all potential situations that could arise during the lifetime of a closed-end fund. But the new role will also put an obligation on Limited Partners to appoint experienced investment professionals to the boards and not to view advisory boards as classrooms for junior professionals.

**Overall, SCM believes** that 2010 will again represent a tough fundraising market and therefore, most managers that intend to raise new funds will have to make concessions on the terms and conditions of their offerings if they want to raise a significant pool of capital in a reasonable timeframe.

The pressure on managers may ease again in a few year’s time but SCM has no doubt that there is a common understanding amongst Limited Partners that terms and conditions have to become more LP-friendly for the long-term.

Therefore, SCM looks forward to interesting and demanding rounds of negotiations with managers, with the hope that going forward the pendulum of power does not anymore shift too much in either direction.

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