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PRIVATE CAPITAL
Alternative Investment Strategies
PRIVATE EQUITY PARTNERS | MARKET UPDATE

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Affiliate Fund Investment Quiz

In the last 18 months there have been an unprecedented number of fund offerings by new firms that are affiliated with established managers like NEA, Benchmark, Sequoia, DFJ, Mayfield, CCMP and TPG. For example, NEA IndoUS Ventures, Benchmark Israel, Sequoia China, Sequoia India, Sequoia Israel, DFJ Element, DFJ Dragon, GSR Ventures (Mayfield), CCMP Capital China and TPG Aqua were all announced in this time period, among about 50 others.

Question: Why so many?

Multiple Choice Options:

a) established managers are altruistic to a fault and freely share their brand name, investors and investment philosophy with all budding VCs who ask in a polite, reverent tone

b) it's tough to launch a stand-alone VC or LBO fund from scratch these days (especially a VC fund) so new firms seek the help of established firms to get started

c) established managers see opportunities to invest in other parts of the globe, other investment stages or a promising new investment sector like CleanTech so they proactively seek a qualified team to invest in those opportunities on their behalf

d) established managers use the affiliates to learn about a new investment sector at little risk to their core investors

e) an affiliate fund enhances the established manager's deal flow

f) established managers are monetizing the value of their brand name

g) all of the above, except for (a)

h) one or more of (b) – (f) depending on the firm

Answer: Most likely (g) or (h) but a little background info is in order.

Affiliate relationships come in many forms, but the basic premise is the affiliate fund uses the sponsor's established brand name to help raise capital and attract deal flow. The affiliate may also get back-office support, some investment oversight and other benefits from the arrangement. In exchange, the affiliate fund pays a portion of its management fee and/or carried interest to the partners of the established manager. Payments often range from 10-25% of each fee but can be higher or lower depending on the relative strengths of the parties and the overall purpose of the arrangement. Given the strong investor demand established managers are enjoying lately, these "franchising" arrangements have been quite effective, resulting in the establishment of many new managers.

Our Take on Sponsors

Generally, we believe these franchising arrangements are good for the established managers/sponsors because they typically result in more deal flow to the sponsor and may also enable the sponsor to test a new investment strategy or a new geographic region with little risk to their main funds. One area of caution, however, is that these arrangements can be quite lucrative for the sponsors and one might worry that this harms the alignment of interests between the sponsors and their direct investors—the theory being that if you get enough affiliates paying franchise fees to a sponsor, maximizing the IRR of the main fund (and thus the carry paid to the general partners) becomes less important to the general partners. This is not a big concern of ours but it is worth

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noting. We have invested in the main funds of sponsors before and have witnessed the deal flow and other benefits firsthand. A perfect example of this is the DFJ network, which consists of DFJ and 16 affiliate funds located around the world. The firms in that network review over 10,000 business plans annually and share information and investment opportunities with each other. That is a powerful model and we enjoy investing in the main DFJ fund because it leverages this large affiliate network to its distinct advantage.

Our Take on the Affiliate Firms

We are generally a little skeptical of affiliate funds but we have no absolute rules about them. We evaluate each affiliate fund de novo and judge each on its own merits.

Our skepticism is based on a few seemingly self-evident truths, namely (1) if a firm is truly exceptional it should be able to stand on its own and wouldn't need an affiliate to help it raise capital or attract deal flow and (2) if the sponsor was so highly confident that the team or strategy was going to be wildly successful, the sponsor would instead incorporate the team or strategy directly into the sponsor's main fund to better capture the full economic benefit (carried interest). The problem is it isn't always that simple. Affiliate relationships arise for a multitude of reasons and their structures depend on many variables, including the knowledge, investment experience and deal flow of the affiliate team, investment restrictions on the sponsor's main fund and the appetite for change in the sponsor's LP base. After all, it IS hard to raise a first-time fund and it shouldn't surprise us that a fair number of teams want to minimize the time spent on fundraising and back-office matters in order to focus their efforts on investing capital in promising companies.

We have invested in a handful of affiliate funds where the team and strategy was compelling and the affiliate fund came into existence for the right reasons. On the other hand, we have turned away a number of "big name" affiliate funds recently, often because their strategies were limited to a certain region or were not significantly differentiated from existing funds or because their teams were not yet sufficiently battle-tested. We also turned down one or two such funds because a deep due diligence dive indicated that the primary motivation for creating the affiliate fund was so the sponsor could further monetize its brand name.

Conclusion

We have reviewed and committed to funds on both sides of the affiliate relationship in the past and expect to continue to do so in the future. We will continue to evaluate each fund on its merits and insist that each fund be viable on a standalone basis prior to investing.

PEP III is Well Underway

Activity in **Private Equity Partners III** (PEP III) continues to accelerate, with 70% of planned commitments already made or reserved for commitment to top-tier VC and LBO managers and our underlying managers already investing capital on our behalf. In fact, a portfolio company on the LBO side of PEP III already has filed for its IPO. In short, our $75 million warehouse line is working admirably.

PEP III is targeting $200 million in commitments, allowing us to continue our strategy to raise modest amounts of capital and be highly selective about the underlying managers we choose. The next closing for the fund is scheduled for December 1. To accommodate client requests, we anticipate an additional closing will be held in Q1 2007 and the final closing will be held in Q2 2007. Please contact Gretchen Postula (gretchen.s.postula@pjc.com or (612) 303-6331) to reserve your allocation or to obtain the offering documents for PEP III.

Piper Jaffray was established in 1895 and has grown to become a nationally and internationally recognized firm serving growth companies and growth company investors. We have a significant commitment to alternative assets through our series of fund of funds.