First Quarter 2009

Follow the Lemming

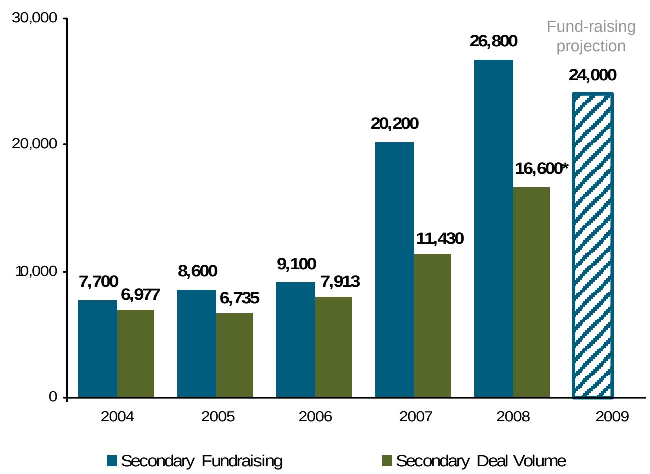
For obvious reasons, institutional investors are in shock today. Their public equity investments have been slashed in value, often accompanied by dramatic losses in other parts of their portfolios (hedge funds, real estate, etc.). Many institutions are now out of compliance with their own allocation policies—the so-called denominator effect. Liquidity and the ability to meet fixed expenditures may also be of concern for some investors. All of which has CIOs, trustees and investment committee members asking “what do we do now?”

If an institutional investor has cash to invest or intends to rebalance its portfolio, where should it invest in 2009? A very popular answer is that it should be invested in either a secondary private equity fund or a distressed fund. The argument in favor of secondary funds is that there is widespread talk of panicked sellers poised to sell billions of dollars worth of private equity commitments at steep discounts. The argument in favor of distressed funds is that many companies are experiencing financial difficulty and the number of bond defaults and bankruptcies is rising.

There is one distinct problem with this line of thinking. Nearly EVERYONE seems to have come to the same conclusion. No special insight was required to observe that we are in a global recession and that secondary and distressed funds ought to benefit. Put another way, boats are known to capsize when all the passengers rush from one side to the other.

Most secondary funds buy from the same three secondary brokers: Probitas, UBS and Cogent. These brokers sell secondary interests by conducting competitive auctions in what has become a pretty efficiently priced market. Capital is flooding into the coffers of secondary funds, and the pressure for them to put money to work is mounting. In fact, $47 billion was raised in 2007-2008 by secondary firms (and another $24 billion is slated for 2009). To put this in perspective, total deal volume in the secondary market was only $28 billion in 2007-2008. This leads us to believe there is a capital overhang within secondary funds and the consequence will be heated competition for deals in an efficient, auction-oriented market. As a result, discounts actually achieved by most secondary managers likely will be far less favorable than advertised. It further leads us to believe that only the managers who can avoid those auctions and source nearly all of their deals on a proprietary basis (being alerted to potential willing sellers via special relationships with VC and LBO managers) are likely to meet or exceed returns expectations. Our experience suggests that dedicated secondary funds are not able to meet these criteria. (Please note at the end of this commentary how we incorporate this experience into our own investment strategy.)

Too Much Capital Chasing Too Few Deals



Based on data from Private Equity Analyst, Private Equity Intelligence, Thomson Financial VentureXpert and UBS Investment Bank estimates

* Estimate

Caveat Emptor

If one wishes to invest in a secondary or distressed fund, another age-old problem remains: how would you know which one to pick? What characteristics are indicative of a good secondary or distressed manager? Track record? Name recognition? Size of the team? Golf handicap? Fund size? Geographic focus? For most investors and their consultants, if they are being honest with themselves, the most important thing is track record and everything else pales in comparison. For us, as a fund of funds manager, track record actually ranks about third or fourth on our

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priority list for venture and buyout funds and maybe one notch lower in priority when we assess distressed funds (we invest directly in secondaries, so we do not invest in secondary managers, but the same logic would apply).

So let's discuss track record and why it might not be a very good indicator of the future performance of a current vintage distressed or secondary fund. Notably, there are few such funds that have track records longer than five or six years. Few teams in their present form have experienced multiple downturns from which they could gain experience. Arguably no team has experienced a downturn like this one because this one seems to be much different than recessions in the past—massive leverage on a global basis, toxic assets still on banks' books, a residential real estate market in tatters, quasi-nationalization of banks and insurance companies, the increasing likelihood that bankruptcy judges soon will be able to rewrite the terms of mortgage contracts, as yet undetermined further government intervention, a large and growing U.S. federal deficit, prospects for near-term deflation and medium term inflation, etc. All of this should lead investors to ask: "what if the track record I am being shown from the last boom that went bust (2002-2004) is utterly meaningless?" We think it is. Below are additional reasons for this conclusion presented in a "what if" format:

Secondary and Distressed Funds: Oasis or Mirage?
When pondering a secondary or distressed manager in 2009, what if:

- this time the buyout portfolios are going to have many more write-offs due to high acquisition valuations and excessive leverage?
- there actually is less panicked selling this time because FAS 157 (mark-to-market rule) begins to push down private equity valuations, thus alleviating the denominator effect that was the impetus for selling in the first place?
- there is increased competition for what turns out to be relatively few deals?
- discounts on average are far less than in years past?
- the fund manager you select raises a much, much bigger fund than it did in 2002-2004?
- the manager you select has morphed into a Wall Street asset gatherer and cares more about its annual management fee than generating a big return for you?
- the economic downturn is (miraculously) shorter than expected, thus forcing your manager to put money to work in an unfavorable environment for a secondary or distressed fund?
- the economic downturn is worse than expected and your secondary or distressed manager puts all of its capital to work too early and loses money when valuations fall further?
- your distressed manager decides to use a buy it and flip it strategy that, if successful, would generate high IRRs and low cash on cash multiples based on very short holding periods but would likely result in a low real return to you after you factor in the cash you tie up in money market accounts to continuously fund the inflows and outflows from this manager?

Piper Jaffray Private Capital Strategy
We have always incorporated purchases of secondary fund interests and allocations to distressed managers within our broader market strategy. Both can be significant contributors to the high IRR and cash on cash return hurdles we set for our funds. But the key is not getting locked into a secondary strategy if market conditions change or prove to be less favorable than initially thought, and also making sure we aren't over-allocating to distressed managers. Balance and flexibility is essential. We maintain the flexibility to dial up or down our allocations to these sub-asset classes depending on market conditions and, equally as important, those allocations are made within a broader global series of investments that encompass small- and mid-sized buyouts, buyouts by industry specialists (e.g., technology, health care), multi-stage venture and CleanTech. Furthermore, all of our secondary purchases since our inception have been proprietary—where we were the only bidder. While we participate in bidding auctions to gather market intelligence (and to throw in the occasional low-ball bid), we believe those auctions, over time, have become too efficiently priced and too competitive for any winning bidder to achieve the high returns expectations we set for ourselves and our investors.

Personally, we think our broader investment strategies offer a better risk/reward profile to investors than rifle-shot investments in secondary and distressed funds, while still offering meaningful exposure to these two sub-sectors. With the credit markets still functioning for small deals (funded by regional banks) and based on historical returns, small buyouts are one of the areas we expect will generate the biggest returns over the next investment cycle. Late-stage and growth equity-focused venture capital firms are also well-positioned in this market due to the lack of an IPO market and the favorable shift in valuations and negotiating leverage to later-stage funds. Another area of great opportunity is CleanTech, an area of significant Piper Jaffray focus and expertise. CleanTech investors are poised to benefit from increasing concerns regarding national security/energy independence, resource scarcity, population growth and urbanization, aging infrastructure, and demand for cheaper and more energy efficient products and "cleaner" solutions, as well as the sheer size of the industries being transformed by CleanTech (e.g., transportation, water, construction). The stimulus bills passed in Australia, China, Europe and the U.S. will provide additional tailwinds for investors in CleanTech.

Recent Government CleanTech Stimulus Efforts

($ in bn)	U.S.	EU	China	ROW	Total
Energy Efficiency	16.4	17.2	0.0	20.1	**53.7**
Mass Transit	17.7	13.6	N/A	3.1	**34.4**
Clean Autos	3.3	18.9	N/A	4.2	**26.4**
Renewable Energy	9.0	8.4	29.0	0.5	**46.9**
Smart Grid	11.0	0.8	70.0	0.0	**81.8**
Water	13.0	0.0	2.9	17.8	**33.7**
Research	7.1	1.3	0.0	0.0	**8.4**
Env. Cleanup	7.1	0.0	1.8	0.0	**8.9**
Tax Credits	21.6	0.0	0.0	0.0	**21.6**
Total	**106.2**	**60.2**	**103.7**	**45.7**	**315.8**

Source: DeAm

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Investments Underway for Private Equity Partners IV

PEP IV affords investors the opportunity to access highly sought after Venture, LBO or CleanTech managers through fund of funds structures. PEP IV also offers a Direct Investment fund that is strategically positioned to invest alongside the top CleanTech managers worldwide, as well as in other proprietary CleanTech investment opportunities. Investors may allocate their capital to any of these four components.

PEP IV highlights:

- VC Fund of Funds
  - Emphasis on small, capital efficient managers, select late-stage funds and international exposure focused on China
  - Seeking proprietary secondaries
  - Four commitments have been completed, two more in final diligence
- LBO Fund of Funds
  - Focus on smaller funds doing lower middle-market buyouts plus appropriate exposure to Europe/Asia and distressed managers
  - Seeking proprietary secondaries
  - Two commitments have been completed, four more in final diligence
- CleanTech Fund of Funds:
  - Follow up to the first U.S.-based CleanTech FFs, which we launched in 2005
  - Global in scope, emphasis on late stage, growth equity and buyouts
  - Seeking proprietary secondaries
  - Five commitments have been completed, a sixth commitment is pending and four more are in diligence
- CleanTech Direct (co-investment) Fund:
  - Growth equity focus, low/no technology risk, often revenue generating, global in scope
  - Two investments completed and numerous other deals under active review

The final closing is scheduled for June 30. If you would like additional information about PEP IV, including information on the commitments made to date, please contact Gretchen Postula at 612 303-6331 or gretchen.s.postula@pjc.com.

Upcoming Events

We are regular speakers and attendees at key industry conferences. We hope to see you at upcoming conferences:

- **March 26:** Mike Pohlen will be speaking at the Geneva Forum for Sustainable Investment in Geneva, Switzerland
  www.gfsi.ch
- **May 19:** Scott Barrington will be speaking at the Private Equity and Venture Capital Clean Energy Investor Forum in London (in association with AltAssets)
  www.newenergyworldnetwork.com/forum
- **June 23-24:** Piper Jaffray Fourth Annual Europe Conference, London
  www.piperjaffray.com/europe2009

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