



August 18, 2003

Note on Private Placement Memoranda

A Private Placement Memorandum (PPM) is a document that explains the details of an investment to potential investors. A PPM is also known as an “Offering Memorandum.” A private equity firm will issue a PPM to prospective limited partners when it is attempting to raise capital through a fund offering. A PPM provides a broad range of information to help limited partners learn about the firm and its investment strategy, as well as the proposed summary terms and conditions of the investment opportunity. The PPM serves as an outline of the fund offering.

The main sections of a PPM typically include:

1. Executive summary
2. Firm and Fund investment philosophy
3. Investment Professionals and Advisory Committee
4. Summary of GP/LP terms and agreements
5. Investment track record and prior fund performance
6. Legal and tax matters
7. Inherent related investment risks
8. Accounting and reporting standards

There are few standards for PPMs; the SEC does not regulate PPMs as they do public capital investment offerings such as IPOs. As a result, the amount of information provided as well as the method in which the information is presented may vary from firm to firm. For example, the investment track record of a team can be presented by fund or by partner, and can be described in return percentages or cash multiples. These internal rates of return (IRRs) can be calculated based on total

This case was prepared by Theresa Sorrentino T'03 under the supervision of Adjunct Assistant Professor Fred Wainwright and Professor Colin Blaydon of the Tuck School of Business at Dartmouth College. It was written as a basis for class discussion and not to illustrate effective or ineffective management practices.

Copyright © 2003 Trustees of Dartmouth College. All rights reserved. To order additional copies, please call (603) 646-0522. No part of this document may be reproduced, stored in any retrieval system, or transmitted in any form or by any means without the express written consent of the Tuck School of Business at Dartmouth College.

fund returns or net to investors after fees. Despite the flexible nature of the document, PPMs serve an important purpose in the investment decision process and limited partners rely on them for key information.

Once a prospective investor reviews a fund's PPM and is interested in potentially committing capital to the fund, he/she must do further research and due diligence in order to make a well informed investment decision. Details of a typical screening process are described in sections below.

It is important to note that a PPM is a preliminary and summary description. The process of negotiating key terms with fund management teams leads to a Limited Partnership Agreement (LPA), which is the final, inclusive and binding agreement between the General Partner (GP) and the Limited Partner (LP).

Primary Sections of the Private Placement Memorandum

PPMs include both general and specific information about the fund offerings. As one practitioner has noted, LPs on average receive 5-7 PPMs a week, and finding the time to read all of them thoroughly can be a challenge. Below is a list of the typical sections of a PPM:

- *Executive summary*
This section includes information on fund size and term, anticipated closing dates, and general information about any previous funds raised by the firm's management team. The summary also includes a concise description of the General Partner, key investment strategies, opportunities in the current environment, and other noteworthy, differentiating information.
- *Firm and fund investment philosophy*
Information on the firm's background and history is included in this section. General information about the firm's prior funds is included, if applicable. The investment strategy is discussed in detail as well as the firm's key competitive advantages in its specified markets. The investment strategy will discuss the industry, stage, and geographical focus of the fund.

The GP should provide considerable detail in this section about the firm's investment thesis, process and criteria, as well as its deal flow sourcing and exit strategies.

- *Investment professionals and committee*

A PPM will list the key investment professionals, their roles in the respective new fund and their experience both within in the industry and specifically with the firm. Often their ages are listed, which can be helpful when considering a firm's succession planning. The principal investors' records are often included as well as current board seats held in portfolio companies of the firm's prior funds. This detail provides some insight on the firm's level of involvement in portfolio companies, as well as the capacity of individual partners to manage a new fund portfolio.

This section also includes information on the Investment Committee and/or Advisory Board. Committees and boards vary in composition and activity level. Relatively larger LPs often participate on advisory boards. The members, their affiliations, and their meeting schedule are included. The section will often explain in detail the investment committee's guidelines and valuation methodology for evaluating new and existing investments.

- *Investment track record*
The investment performance section varies significantly by firm. There is no standard or mandatory format that firms have to use, so naturally some firms' performance sections are more helpful than others. In general however, fund level performance is often presented in a table format. The prior fund sizes, vintage years, and IRR performance are included. Returns are often stated as gross returns for an entire fund rather than returns to limited partners net of fees paid. More robust investment performance sections will include additional performance statistics, such as unrealized/realized IRRs and detailed information on a representative number of portfolio investments.
- *GP/LP terms and agreements*
A PPM lists key GP/LP agreement terms including the distribution and the capital call schedules, the management fee, the GP commitment, and the fund's co-investment policy. The distribution schedule explains the allocation of distributions from investments among the limited partners and the GP. The GP's allocation of investment gains is referred to as the "carry". Additional terms may include a key-man clause, divorce clause, clawback provisions, and additional terms relating to the corporate governance of the fund.
- *Legal and tax matters*
US and non-US investor have different tax concerns and the PPM will discuss in limited detail relevant tax treatments. Unrelated business tax

income, or UBTI, concerns tax-exempt institutional limited partners. If a fund generates UBTI, the LPs may be subject to a tax liability. For example, UBTI could occur when a fund generates ongoing business income such as using fund capital for an investment in rental real estate. Additional tax treatments of fund investments and legal issues such as ERISA regulations are included in this section. The Employee Retirement Income Security Act of 1974 (ERISA) and subsequent regulations established federal laws for private pension plan administration and investment practices.

- *Inherent fund related investment risks*
This section includes a discussion on fund-related investment risks that concern matters at the business, management, and fund level. Business concerns may include the nature of investing in the specific industry, and/or the uncertainty within the business environment. Management risks may include relationships with other entities such as parent companies. Fund related risks might include cross-fund investments, co-investment activity by principals, or investments in public equities.
- *Accounting and reporting section*
Allocation of profits and losses and accounting for stock options and other such terms are included in this section. This section also includes when audited and non-audited financial statements and additional reports are to be issued. Generally, GPs will issue non-audited statements on a quarterly basis, and audited statements annually. LPs use the statements to understand the approximate valuation of their investment as well as keep track of their outstanding capital commitments and distributions to date.

Key PPM Criteria For Limited Partners

Often prospective investors consider the PPM as a starting point, and only one phase in their investment decision process. Based on several discussions with private equity practitioners, Limited Partners generally review a PPM to have a broad and basic understanding of the firm and the fund offering. Then they focus on three key areas of due diligence; 1) management team, 2) performance track record, and 3) the investment strategy.

Management team

Limited Partners generally review a PPM to learn about the management team, their backgrounds, their experience investing as a group, and often their individual track

records. The issue of inter-generational planning is a critical one. Some senior partners may choose to reduce their time commitments to a new fund and allow a newer generation of partners to make key investment decisions. If this newer generation does not appear to be fully prepared or properly compensated, there may be a risk of either sub-par performance or sudden personnel changes. PPMs that have addressed these issues can increase the level of interest from potential LPs. LPs will then conduct formal and informal due diligence by making calls to references and other contacts in order to gain a fuller understanding of the individuals on the team, their reputation and their personal investment experience.

Performance track record

Private equity has historically reported a significant differential between top quartile and lower quartile funds (see Appendix II). In addition, many argue that past performance dictates future performance. Successful private equity firms tend to continue to be successful. This is often in stark contrast to mutual funds that operate within a far more efficient and transparent market. Public equity funds tend to shift fairly frequently among performance tiers.

LPs evaluate the performance of a firm's prior funds, and the additional historical performance data often included in the PPM, for instance, highlighted investment "cases", and cash on cash returns. Some firms will include more of such additional performance data than others. The benefits of more detail and analysis of performance is of course to provide a clearer picture of success factors.

The LP tries to develop a sense of the firm's prior performance and uses the available data as a starting point for further diligence and investigation. Most private equity firms realize that LPs need comparable information to make their investment decisions, and performance measurement and presentation is slowly becoming more standardized.

Investment strategy and market opportunity

A firm's investment strategy is often described in detail in the PPM. Strategy, process, and criteria are important factors. GPs use this section in particular to drive home what differentiated advantages they hold over competing firms in their space. This section should answer a question that LPs commonly ask: "Why is this exciting now and for the next 7-10 years?"

LPs prefer that a firm has identified a market segment or sector and maintained a consistent investment strategy in multiple funds. The PPM helps the LP to assess the cohesiveness of the firm's investment strategy and answer the question of how is this fund differentiated from similarly focused funds. Key questions often asked

by LPs during a review of an investment opportunity and its PPM is detailed in Appendix I.

Roles of Placement Agents and Lawyers

The GP is responsible for writing and issuing its own PPM. In general, firm management will develop a preliminary draft of the PPM and review it with legal counsel. If the GP uses a placement agent, the agent would be very involved in the drafting process and assist the GP in all aspects of fundraising in exchange for a fee. This fee is typically a percentage of the total capital raised.¹

Each fund is unique and the GP's relationship with the placement agent will influence the development of the PPM. In general however, with a first time fund, the GP and the placement agent will work closely together. The GP will most likely draft the key investment strategy section, and collaborate with the PPM on the other sections. In the cases of a series of funds, the placement agent's role differs somewhat. Emphasis is on changes to the firm or fund strategy. The PPM should reflect any changes while maintaining prior relevant information.

Placement agents, like LPs, focus on the management, performance, and investment strategy sections. The agent ensures that it understands, and has access to, the underlying fund detail behind the performance summary. This information is then made available by request from prospective LPs that the agent introduces to the firm.

Placement agents also help firms position themselves for the market. For example, agents may advise a fund client on the appropriate level of capital to raise or how to articulate the investment strategy. Placement agents offer a large network of LPs and thus have a good understanding of the current market environment. Depending on the GP's relationship with its agent, a GP may seek advice on how to best differentiate itself from the other players in the market. The agent will then facilitate introductions and arrange meetings so the GP can make presentations to prospective LPs. After making introductions, placement agents continue to work with the GP through agreement negotiations and fund closing. The use of placement agents depends in large part to the GPs investor base. Some firms use the placement agent as a way to reduce partner time away from investment decision making and portfolio management.

¹ Industry standard is a 2% percentage fee. In many cases however, agents charge the industry standard on new money, and a smaller percentage fee on "re-up" money from existing LPs.

Once a preliminary draft is written, the firm's legal counsel will conduct a general review of the terms, investment strategy, and other PPM sections. Counsel will also ensure that the document conforms to regulations and recent interpretations of law.

Recent Trends

In the mid to late 90's, leading GPs had strong negotiating leverage for two main reasons. First, their performance from the mid 90's through '99 was very strong and hence there was very high level of investor demand for successful private equity funds. Second, there was a level of expectation among both GPs and LPs for continued industry overperformance. The record high levels of capital raised in the late 1990's thru 2000 reflect this. As a result, many LPs sought the top quartile funds and the supply demand imbalance gave GPs a wide range of discretion over setting fund terms. However, the pendulum may now be swinging in the opposite direction, as many investments made in the 1999-2001 timeframe have either been written off or have a low probability of producing above average returns.

LPs have become more conservative not only due to the rapid decline of fund IRRs but also because of portfolio management issues. LPs have become more selective about their investments as they try to balance allocation targets and capital calls against a lack of portfolio distributions. Beginning in early 2001, some LPs have argued that investor sentiment changed due to three main issues: LP's shorter-term focus, imbalanced partnership terms and conditions, and limited information transparency. However, the extent of LPs' greater negotiating leverage is subject to debate. Consistently successful funds continue to be oversubscribed and some LPs have increased their allocations to private equity. Fundraising activity is expected to increase in 2004 and 2005 and the aforementioned issues will certainly be topics of discussion.

The private equity investing cycle typically results in a "J-curve effect" as viewed on a plot of investment returns over time. Funds will initially produce negative returns while they are investing their capital, then typically generate positive returns during the harvesting period when investments are realized and proceeds are distributed. The boom and bust cycle of the late 1990s and recent years caused newer funds to have an "inverted J-curve" with early positive returns followed by later negative returns.

Much of the recent short-term focus is attributed to the rapid decline of private equity fund performance, corporate scandals in the market, and the participation of inexperienced LPs. Many members of investment committees in institutions such

as endowments and public pension plans are not completely familiar with private equity as a long term, illiquid investment asset class.

Management fees have remained largely consistent over the years. Many LPs have questioned fee compensation structures of relatively large, billion dollar funds. For example, a \$2 billion fund can collect \$40 million *per year* from a 2% management fee without generating any return for their LPs.² The arguably significant capital overhang produced by funds reducing their investment pace also has some LPs concerned.

Some GPs have responded proactively by releasing LPs from some of their capital commitments. In 2002, more money was returned in the form of reductions in commitments to LPs from private equity funds than was raised in new commitments in the market. Since the beginning of 2000, at least 27 venture capital firms, including well known groups such as Charles River Ventures, Walden International, Sevin Rosen Funds, and Kleiner Perkins have reduced their funds by a combined total of around \$5 billion. Four firms, Mohr, Davidow Ventures, Atlas Venture, Redpoint Ventures and Accel Partners have cut their funds twice.³ Other firms have based their management fees on budgets rather than on a percentage of capital under management.

Distribution schedules and clawback provisions are additional LP concerns, as they want to ensure their interests are protected as carefully as GP interests. Clawback provisions allow investors to claim some of the carried interest paid to GPs early in the fund's life if later investments do not perform well. Some LPs have asked for stricter clawback terms, or for GPs to place a portion of their carried interest from early successful exits into escrow accounts.

Many GPs have been responsive to their LPs' concerns, by making adjustments to their distribution and clawback structures. One example is to agree to subject fund distributions to a Net Asset Value (NAV) test. Net asset value is defined as the value of all investments remaining in the portfolio minus any long term liabilities as of a specific date. In general, the NAV test requires that the NAV of a fund portfolio be 120-125% of paid-in capital less distributions before a GP can collect its carried interest. Other GPs have tried to settle potential clawback obligations by agreeing to reduce future management fees.

² Based on a fund's committed capital. Some firm's have adjusted their management fee schedules to generate fees on called or invested capital.

³ AltAssets, April 9, 2003

Conclusion

A PPM provides a broad range of information to help potential LPs learn about the firm and its investment strategy, as well as the summary terms and conditions of the investment opportunity. As economic cycles unfold, LPs and GPs work together to adjust their agreements in order to achieve stronger alignment of interests. The PPM serves as a guideline for the fund offering and is an important component in the development of mutually beneficial long term partnerships.

Appendix I: Typical PPM Due Diligence Questions

As noted earlier, PPMs are a marketing document and thus should be evaluated with a level of skepticism. In general, Limited Partners review a PPM to get a broad and basic understanding of the firm and the fund offering. A potential investor should follow up with the management team and references if they have questions regarding the information included/omitted in the PPM, and then continue on with a more rigorous evaluation and diligence process.

Based on discussions with practitioners in the industry, the following questions are key issues to consider when reviewing a PPM and more pertinently, through the due diligence and investment decision process. Many of the questions listed below are not intended for a PPM review, but rather are appropriate for investment opportunities further along the decision process. Clearly there are a whole host of questions investors will want to ask to scour as much as possible an investment opportunity. Questions per section are prioritized and/or tiered in terms of priority to help guide the evaluation process.

1. Executive summary

- How has fund size changed from the previous fund? Does it seem reasonable?
- Is the investment strategy consistent with the historical strategy? (Just note in this section).
- Has the GP management structure changed since the last fund? (Just note in this section).

2. Firm and fund investment philosophy

Investment strategy

Tier 1

- How is this group different from other fund managers with similar investment strategies? Are the firm's competitive advantages sustainable?
- What issues do you see regarding the Fund's strategy? Does it appear that the Firm has thought out how the business plan will roll out?

Tier 2:

- If the industry, stage, and/or geographical focuses have shifted from prior funds, do the new sector decisions make sense given the firm's competencies and the current market environment?
- Is the investment strategy and focus demonstrated in prior funds' portfolios?
- How flexible/open is the strategy? This is particularly important to a LP if the fund is being considered as a sector allocation for a diversified private equity portfolio.

Investment style & process

- Does the Firm have a structured investment process?
- Does the firm have a well-articulated exit strategy? Is this strategy demonstrated in prior funds?
- How does the GP source its deals?
- What are individual GPs sourcing records, (if available?). Is deal flow reliant on a few key partners?

3. Investment professionals and committeeInvestment professionals*Tier 1*

- Does the management team have a broad range of skills and experience? Where are the weak points?
- What is the firm's succession plan? How is the carry split amongst the GP? (Try to understand the motivation of the senior GPs as well as the more junior team.)
- What are management's operational capabilities? (Examine prior individual portfolio companies' performance). This assessment requires an understanding of the markets and the sectors that the investments are in. Were the investments made by management good or bad decisions? Try to determine if the firm has the capability to not only choose the right companies but build the companies as well.
- How long has the GP on average worked together?
- (If the fund is an extension of the original firm strategy, e.g. European fund for a US firm), is there a new management team in place? What is the relationship with the parent fund?

Tier 2

- How involved are the GPs and what is the firm's level of control in its portfolio companies?
- What is the GP's capacity to invest and manage a new fund?
- Who is the managing GP of the Fund? Is this the same individual on the prior fund?

Investment committee

- Does the committee have a satisfactory valuation methodology for evaluating new and existing portfolio investments?
- Who comprises the board? Who are the members, what are their affiliations, and what is their meeting schedule?
- Are the committee's incentives properly aligned?
- How are public securities valued in a fund's portfolio? What discount rate (if any) is applied?

4. Firm's investment track record*Tier 1*

- How do prior fund IRRs compare to respective vintage year industry benchmarks?
- How does the firm present performance? What are fund IRRs' comprised of?
 - Composite of realized/unrealized investments
 - What are cash on cash realized returns? Fund and individual investment level.
 - Is performance made up of a few homeruns, or several investments?
 - How many write-offs, write-downs?
- Does the fund offering appear to be appropriately timed? (i.e. do prior funds have an unusually large % of un-invested capital, or % of unrealized investments and/or capital?)

Tier 2

- Are the funds' allocation (by industry) consistent with their investment strategy?
- What is the average investment size within funds?
- Are the funds' diversified by investment date? Are the funds invested consistently over the investment period?

5. GP/LP terms and agreements

Tier 1

- Have the terms remained constant with prior funds? Are they justified?
- GP's commitment should be at least 1% of the fund. Do GP's incentives appear to be aligned with LPs'?
- Is the key-man clause inclusive enough? Does the clawback provision appropriately protect the interests of the LP? Often such critical terms are omitted from the PPM, and it is critical for investors to inquire about them and/or refer to the LP agreement before making an investment decision.

Tier 2

- Does the firm have a cross-fund investment strategy? Does their investment strategy allow investments in Private Investments in Public Equities (PIPEs), derivatives, or other alternative investments? What are the limits?
- Does the fund have a co-investment policy for LPs and/or GPs? Are there conflicts of interest?

6. Legal and tax matters

- How does the fund handle unrelated business taxable income, (UBTI)?
- (If applicable), does the fund have the appropriate ERISA provisions?
- What is the fund's treatment of tax distributions? (Often a fund will distribute income in advance of its carried interest and will distribute it to LPs to avoid incurring a tax liability).

7. Inherent fund related investment risks

- Is the firm independent or does a parent own it? What is the relationship? I.e. are there any conflicts of interest? (Not in the PPM but important issue: how is carry allocated amongst the partners? Are the individual GP's interests aligned?)
- What industry or industries does the fund invest in? What are the investing lifecycles and inherent risks involved? How appropriate is this fund for inclusion in your portfolio from a diversification standpoint?
- How, if at all, do the co-investment rights pose risks on the LP and fund?

Appendix II: Performance of Top Quartile Venture and Buyout Funds vs. All Venture Funds, All Buyout Funds, and US Large Stocks

