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Alternative Investment Strategies

PRIVATE EQUITY PARTNERS | MARKET UPDATE

August 2006

Closing Announcement for PEP III

As was mentioned last month, Private Equity Partners III ("PEP III") will hold a first closing on outside investor commitments on **September 28**. The general partners already held a first closing on August 1. Investor demand for PEP III has been strong and it is anticipated that the final closing will be held prior to yearend. The investment committee recently approved a commitment to Granite Global III, a heavily oversubscribed fund focused primarily on expansion stage tech investments in the US and China. Additional warehoused commitments include Alta Partners VIII, De Novo Ventures III, Doll Capital Management V, Lightyear II, Madison Dearborn V and Oak XII. Several other prospective commitments are in the final stage of review and roughly 60-70% of the managers for the venture fund and the LBO fund have been identified. **Please submit your subscription documents to Gretchen Postula prior to this date or contact her to secure your allocation if you have not done so already.**

The Evolution of the Secondary Market

The private equity secondary market has changed dramatically over the last few years. Once a market used by banks, corporations and wealthy individuals in (often dire) need of liquidity, the secondary market now also serves as a portfolio management tool used by an increasingly diverse group of buyers and sellers. **It also has turned from a buyer's market to largely a seller's market, and we urge caution for investors seeking to put capital directly to work in the secondary market.**

The Secondary Market Then

The secondary market developed in the early 1990s really as a market of last resort for sellers to exit illiquid investments in private equity. Typically, sellers were looking for liquidity or attempting to divest underperforming assets. The amount of dedicated capital to this asset class was small, as was deal volume.

Secondary market activity increased in the late 1990s as a result of banking regulatory changes regarding capital reserve requirements for private equity holdings (the Basel II rules) and increased *dramatically* after the internet bubble burst in 2000 when many over-extended investors ran for the exits. The typical fire-sale mentality of sellers up to this point in time usually resulted in buyers paying less than net asset value (NAV)—and in 2001 many buyers enjoyed a 100% discount on NAV and merely assumed the obligation to pay remaining capital calls. These attractive valuations generated significant interest and resulted in the creation of many dedicated secondary funds.

The Secondary Market Now

Times have changed. As you would expect, the market has become much more efficient. Most high quality secondary sales command premiums to NAV and most are sold at auction to a large cadre of dedicated secondary fund managers and a growing group of US and European pension plans, endowments and family offices. Over $16 billion of dedicated secondary funds has been raised in the last 2 ½ years, a tremendous increase compared to the $2.7 billion raised during the six-year period from 1992-97. Demand for such funds also has increasingly come from a new entrant—Europe—as revised pension rules have allowed more capital to be invested abroad. The result is that German, Dutch and other pension plans are now playing catch-up. We have witnessed several European groups over-paying (in our humble estimation) for "brand name" funds, hoping (mostly in vain) that this will enable them to re-up in subsequent funds.

Although difficult to measure, we also believe asset quality in the secondary market has deteriorated as allocations to top tier managers are typically bought by insiders and existing limited partners, especially

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for venture funds. When brand name funds do make it to the secondary market, we are regularly seeing winning bids at 115% (or more) of NAV.

Interestingly, the secondary market now also provides a portfolio management tool used by a broad range of sellers, including banks, pension plans, endowments and family offices. Today investors may trim private equity holdings for a variety of reasons, including (1) over-allocation driven by depreciation of their public equity or other assets, (2) to refine exposure to certain industry sectors or asset classes or (3) to consolidate their private equity investments with a few core managers. This has helped to increase somewhat the supply of secondary opportunities but not enough to satisfy demand or to significantly reduce what we view as generally expensive valuations.

Our Strategy Going Forward

Today, many private equity investors are seeking secondary exposure. But we want to ensure our investors understand that the market has shifted and that many of the returns being advertised today were generated under substantially different market conditions.

The secondary market can provide a means for securing allocations to top managers, vintage year diversification and, if you are lucky, lasting relationships for future funds. However, increased prices and market maturation have significantly reduced, if not eliminated, the availability of quality access at discounted valuations for all but the smallest allocations. We will selectively use the secondary markets going forward, but almost exclusively in non-auction, proprietary situations that we source ourselves with top tier firms where we can buy at a discount. In fact, we are in the late stages of reviewing exactly this kind of opportunity right now. We attribute our ability to selectively add secondary investments to each of our funds to (1) GPs seeking long-term strategic (deal flow) partners like us and (2) the small-by-design investments we tend to make that places us under the radar of many dedicated secondary buyers.

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, ***Private Equity Partners.***