



C A M B R I D G E A S S O C I A T E S L L C

GLOBAL MARKET COMMENTARY

A TIME FOR SECONDARIES?

May 2009

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Introduction

The secondary market for non-marketable assets has evolved in recent years from a liquidity last resort or “distressed” market to an active portfolio management tool. However, the market today is reminiscent of its early days in that liquidity and other portfolio management considerations related to the current downturn have led many holders of such assets to consider selling their interests in whole or in part. Demand is increasing in response to the expected increase in supply of available secondary investments. For example, the *Financial Times* reported in early April that Goldman Sachs had just raised a \$5.5 billion fund, the largest ever, to invest in secondaries. Given the dislocation in the market, it is an opportune time to examine what sorts of opportunities are now or might soon be available for potential buyers. We conclude that it is indeed a propitious time to create or refine a private equity portfolio by adding/creating exposure to secondaries, especially for those with the scale and resources to buy exposure directly.

A Brief Overview of the Secondary Market

The secondary market for private trading of interests in non-marketable assets includes, most prominently, buyout and venture capital interests, but can also include other asset classes. In contrast to bonds and listed equities, secondary market assets generally provide no current income (real estate and some oil & gas partnerships are exceptions) and are difficult to value, partly because of their relative illiquidity.

Transaction activity was originally driven primarily by distressed sellers seeking to exit unprofitable positions, which meant buyers were able to acquire secondaries at deep discounts to net asset values (NAVs). As the industry matured, however, trading extended to strategic, non-distressed scenarios where limited partners (LPs) might be acting in response to a revised investment strategy, financial consolidation (e.g., as a result of merger & acquisition activity), regulatory changes, or a desire to lower volatility or limit the number of manager relationships. General partners (GPs), meanwhile, sometimes seek to sell an existing fund’s remaining portfolio companies in order to focus resources on their next fund.

Investors generally gain exposure to secondaries through secondary partnership funds, but also have the option of investing directly, although this is normally a more difficult proposition. In addition, investors may end up with exposure from having invested in funds-of-funds that make opportunistic investments in secondaries. As for secondary partnership funds, there are three types. The first purchases LP interests from private equity funds. The second engages in “direct” purchases of portfolio companies and manages them through either existing management (a classic spin-out) or a “direct secondaries manager,” which serves as a “replacement GP.”¹ The third type of secondary partnership fund is a hybrid of the first two kinds, buying existing LP interests and making direct purchases of companies.²

¹ In addition to managing portfolio companies purchased by a secondary partnership fund, a direct secondaries manager may also raise its own fund to acquire and manage portfolio companies.

² Our clients would be more likely to buy through a secondary fund than directly. For a broader analysis of secondary market structures, please see our forthcoming primer on the secondary market.

The number of funds and size of capital commitments have grown steadily over the last two decades, with the United States accounting for the bulk of secondary activity thanks to the size of its private equity industry and its investor profile. While industry figures are imprecise, given that transactions are private and do not include some investments (e.g., those by funds-of-funds), it is estimated that secondary funds invested \$78.4 billion over the last 19 years (Table A)³ and raised over \$60 billion in the last five years alone (Table B). In 2008 secondary funds raised an estimated \$23.7 billion and invested about \$16 billion. Substantial sources of capital are also said to be available from other potential buyers (e.g., fund-of-funds managers and institutions investing directly in secondaries).

Secondary fund performance has been strong, with an average net internal rate of return (IRR) of 14.9% for the 27 rolling 20-quarter periods from January 1, 2002, through September 30, 2008.⁴ On this basis, secondaries have outperformed U.S. buyout funds but lagged venture fund returns because of substantial venture capital outperformance from 2002 to 2004 (Table C). Median net IRRs for vintage year 1994–2003 funds, meanwhile, have ranged from 7% to 34%.⁵ It should be noted that while secondaries are known for having attractive IRRs, many investors focus more on the investment multiple (the sum of cash distributed and remaining NAV divided by paid-in capital). Investment multiples for our secondary universe (net to investors and on a weighted-average basis) during vintage years 1994–2003 ranged from 1.3 to 1.6. From a multiples perspective, secondaries have not performed as well as buyouts or venture capital, a result that is consistent with our theoretical view that they are a lower risk, lower reward proposition (Table D). Secondary managers expect to return investors their paid-in capital at a minimum, but the upper limit on multiples is also constrained. Thus, while only four out of 70 secondary funds from vintage years 1994–2003 failed to at least return investors' paid-in capital, just 11 funds achieved multiples of 2.0 or more.⁶

Buyer Incentives

Buyers have a number of reasons to purchase secondaries. For starters, an investment in a secondary fund potentially can provide or increase exposure to desirable private equity funds. This is especially helpful for investors with new non-marketable programs, as secondaries offer an opportunity to diversify a private equity portfolio across vintage year, geography, and industry sector relatively quickly.

Even in a non-distressed market, secondaries offer the attraction of both low cash outlays (relative to direct investments in private equity funds) and potentially high IRRs. According to Lexington Partners, a large secondary manager, the dollar-weighted average age of private equity partnerships sold in global

³ The investment figure, which expressly excludes real estate partnerships and royalty payments, is the total of the sales price of secondary transactions plus the unfunded amount of commitments that may still be called by the GPs of the funds or companies in which the secondary funds have invested. The figure apparently also excludes structured and synthetic transactions.

⁴ This is the pooled end-to-end return reflecting performance of the funds we track in aggregate.

⁵ Although return data is available for funds through vintage year 2007, post-2003 data are not meaningful due to the underlying funds' relative immaturity.

⁶ We note that two of the four funds failing to return investors' paid-in capital had an investment multiple of 1.0 when the number is rounded off. Meanwhile, four post-1993 funds have already achieved multiples of 2.0 or more.

secondary transactions since 1990 has been 5.4 years. This means substantial mitigation of the so-called “J-curve” return structure under which participants in the private equity market normally operate. Because secondary buyers invest in mature funds, they end up paying fewer years of management fees (and lower management fees on average, given that fees typically decline after the investment period). In addition, the time before underlying investments turn profitable should be reduced, boosting the investor’s IRR.⁷ Secondary funds also argue that they are able to cherry-pick the winners (and avoid the losers) from existing primary fund portfolios, thereby benefiting investors. Under this rationale, of course, investors with the necessary resources and scale may be best served by buying secondary LP interests directly. During times of liquidity-driven seller distress, meanwhile, as in the early days of the secondary market and during the dot-com boom of 2000–03, buyers may have significant pricing power.

Current Opportunities for Buyers

Whereas sales from 2005 to 2007 generally involved a *premium* to NAVs,⁸ subsequent pricing has reflected the fact that many sellers have been (or are perceived to be) under severe stress. For example, banks, which make up over one-fifth of the private equity investor universe, need capital. Some institutional, corporate, and private investors are now overweight their target allocations to non-marketable assets given the sharp decline in public markets.⁹ Many also have related liquidity concerns stemming from non-marketable programs that have seen a dramatic shift from positive to negative cash flows due to the combination of delayed private equity distributions and exits and continued capital calls from private equity investments. Other potential sellers require capital to meet possible redemptions or spending needs or have a strong desire, for precautionary purposes, to reduce exposure to recent funds that acquired assets at high valuations.

Although it is impossible to have any confidence regarding how much secondary funds volume will be available over the next few years, supply should be high given the sharp uptick in private equity fund raising and investments during the last cycle. Global private equity partnerships are estimated to have raised \$1.6 trillion from 2004 through 2008 (Table E).¹⁰ Forecasts (which vary widely) suggest supply could total anywhere from \$50 billion to \$150 billion of primary fund commitments, an amount many argue is substantially greater than estimated available capital and which would be at the high end of the roughly 3% to 6% of total capital commitments that industry professionals generally estimate are traded on the secondary

⁷ We caution, however, that some investors may believe they can quickly boost short-term IRRs by buying secondary interests at a discount to the GP’s reported value and then marking their purchases to market. While this was sometimes done in the past, it is a strategy fraught with risk in the current environment and should not form the basis of a decision to buy secondaries.

⁸ This was due to burgeoning demand from late entrants to the private equity world seeking to ramp up exposure quickly as well as the fact that equity markets were rising and expectations for future fund performance were high, meaning that NAVs were considered stale.

⁹ Institutional investors include universities and foundations. Corporate investors include insurers; pensions, meanwhile, are expected to become sellers as their programs mature and their liquidity needs change.

¹⁰ This estimate is from Lexington Partners. RREEF, the private equity arm of Deutsche Bank, estimates the market at \$1.2 trillion, but may be using a different time period. We also continue to see sales from funds created prior to 2004.

market over the course of a private equity or venture capital fund's life.¹¹ However, professionals believe turnover over the next few years is likely to be significantly higher than in the past.¹² As for demand, we believe secondary funds already have some \$40 billion of capital available to deploy, with a significant amount of further capital available from other potential investors. We are also familiar with approximately 35 secondary funds that are open or expect to be seeking a total of approximately \$30 billion through the end of 2010. In other words, *the existence of a significant supply-demand imbalance, either now or in the future, is by no means clear*, although industry fundamentals and current fund-raising activity suggest this is likely to be the case.

Some argue that the relatively immature real estate secondary market offers especially good opportunities because there are only a handful of firms focused solely on this market (despite ample expected supply). Indeed, because many institutions only began to invest in real estate well after buyout and venture investing became common, the real estate secondary market looks like the overall secondary market did a generation ago.¹³ Still, one could certainly envision a scenario in which more diversified secondary funds (and the new real estate secondary firms that are starting up) move into this space but overpay as a result of their relative lack of expertise, not only hurting their own investors but curtailing purchase opportunities for experienced real estate–dedicated firms.

The huge amount of fund raising by private equity firms in recent years and the pressures now facing many holders of private equity interests have affected pricing. Probitas estimates that pricing is 40% to 60% of December 31, 2008, NAVs and many deals are being done at much larger discounts; we are told investors are now seeking rates of return of at least 20% and perhaps much higher. According to industry professionals, investors have raised their net investment multiple target to 1.75 or 2 and are pushing their exit target out one to two years. We have even heard of distressed sellers *paying* buyers a fee to assume largely unfunded interests. Of course, the pricing of each transaction will also be driven by a variety of factors specific to the particular seller, buyer, GP, and portfolio (size, focus, public market exposure, percentage of unfunded capital, etc.).¹⁴

¹¹ Lexington Partners' estimate runs from \$90 billion to \$150 billion from 2009 to 2013 while RREEF's estimate ranges from \$50 billion to \$150 billion (which it believes will sell for \$30 billion to \$75 billion at current market discounts). Probitas, a secondary intermediary, has used a \$100 billion figure.

¹² The possibility that funds that sell too much of the underlying interests in their funds may be deemed publicly traded partnerships is a potential constraint on transaction volume, but this does not appear to have hindered transaction activity thus far.

¹³ This is even more true with respect to energy and natural resources–focused secondaries since primary funds focused on these sectors date back only about five years.

¹⁴ For example, over the past five years secondary pricing of buyouts has consistently been more expensive than that of venture capital interests, which likely reflects market participants' awareness that buyouts have outperformed venture capital as well as the fact that there have been fewer venture capital secondary transactions, making pricing more difficult.

Risks

Investors should be careful not to confuse anecdotes with reality. Despite all the talk, deal activity has slowed substantially since mid-2008 and is far below the amount of estimated supply. Wide bid-ask spreads indicate many sellers have been unwilling to accept the “new” market pricing while buyers appear generally to be lowballing their offers in light of both market uncertainty and their perception of seller distress. Meanwhile, a big disconnect still exists between what people want to sell—largely *unfunded* commitments in highly levered, vintage 2005–07 mega-buyout funds—and the largely *funded* positions that secondary players have traditionally bought and are currently seeking.¹⁵ At least two “early” secondary funds have been raised to address this disconnect and new structures that address the unique characteristics of the current environment are being considered.¹⁶

As for the supply-demand equation, it is possible that supply is not as out of step with demand as is generally supposed. The supply-demand imbalance that many are projecting might also not be sustained if secondary funds are able to tap the market for a significant amount of additional capital, pressure on potential sellers abates as a result of improving market conditions or for other reasons,¹⁷ or turnover of private equity investments runs lower than in the past.

Moreover, secondary managers typically charge an annual management fee of about 1% of committed capital during the investment period, although the manager will sometimes reduce fees thereafter.¹⁸ Although such fees are generally less than those that apply to clients making a direct fund investment, they are of course additive—secondary fund LPs will pay fees with respect to both the underlying and the secondary funds.¹⁹ Investors should also recognize that the investment multiple will generally be lower than in the case of primary fund investing; since they theoretically are taking less risk,²⁰ the reward should likewise be lower.²¹

In short, we believe the secondary market provides significant opportunities, but not for everyone. Buyers are trading liquidity in the public markets for illiquidity in secondaries and must be prepared and able

¹⁵ Commitments that are less than 50% funded are generally considered “largely unfunded” or “early” secondaries. However, investors should bear in mind that the difference *within* the early secondary universe (e.g., between a 5% and a 45% funded commitment) may in many cases be more than exists between a largely unfunded and a largely funded secondary.

¹⁶ For example, one structure that is being discussed would require the seller to continue funding part of the unfunded commitment while initial distributions on the investment would go to the buyer rather than the seller.

¹⁷ For example, the large endowments’ ability to raise money in the debt markets has reduced some of the urgency they felt previously to sell positions at steep discounts to NAV.

¹⁸ However, we are aware of managers whose management fees are as low as 33 basis points (bps) and as high as 200 bps during the investment period.

¹⁹ Secondary managers should be pricing this into their deals during underwriting to see what the net results will be for *their* investors. Underlying funds normally charge a management fee of 2%. Investors must also factor in two layers of carried interest, one to the underlying fund manager and the other to the secondary fund manager.

²⁰ Our data indicate, however, that while volatility of secondary fund returns is much less than that of venture capital funds, it is slightly higher than that of buyout funds.

²¹ This is much more the case with largely funded secondaries (the traditional market) than with less funded commitments. The less funded a secondary investment, the more its risk/return profile should mirror that of a primary private equity commitment.

to withstand a potentially lengthy period without income or exit from secondary investments or even a sharp drop in their NAVs—in other words, a continuation of the present market environment. Moreover, in part as a result of Financial Accounting Standards Board regulation 157 (FAS 157) reporting requirements, an allocation to secondaries (especially one to early secondaries) may bring unexpected volatility. Returns on secondary investments will ultimately be highly dependent on the initial purchase price as well as what happens in public equity markets and when. Secondary funds (or investors buying directly) must therefore model very conservatively, particularly with respect to unfunded positions, and maintain pricing discipline. We believe this is a particularly opportune time for investors that have the requisite scale and resources²² to buy LP interests directly rather than going through a secondary manager, as this will lower their expenses and give them more control over the timing of purchases and discretion in selecting assets.

Those investors not going the direct route should focus on quality managers that have access to the necessary data for evaluating and pricing assets. There is a huge information advantage for established players in this asset class, so good relationships with GPs are essential. For example, some managers invest separately in private equity funds in order to obtain regular information. Secondary managers that avoid excess leverage at the underlying portfolio level and are experienced in investing across different cycles are also relatively more attractive. Investors should be wary of secondary managers that use leverage in their funds as such an approach would magnify the leverage risk that most likely is already reflected in the underlying investments. Given the much higher risks inherent in largely unfunded commitments investors need to vet any early secondary managers especially closely and, in addition, explore with other secondary managers how hard and fast their guidelines are for investing in less-funded secondaries. Moreover, as with private equity funds, investors should keep a close eye on how much of an incentive particular managers have to earn high returns—as opposed to collecting fees on large funds.

Investors should also be aware that if the transaction involves the purchase of an LP's interest in a fund (the usual scenario), the GP's consent to an LP's sale of its interest in a fund normally is required and other LPs may have a right of first refusal. Legal expertise and financial structuring expertise are becoming more important given the greater complexity of certain transaction scenarios. Deals generally take at least two to three months to complete.

²² Such investors are likely to be those able to implement a non-marketable alternative asset program directly, although it might require additional internal or external resources to price secondaries appropriately, particularly in the current environment.

Evaluating Secondary Opportunities Versus Those Available in Public Markets

An investment in secondaries can be considered as part of the non-marketable asset allocation of the portfolio or a broader opportunistic investment allocation²³ and must be weighed against other available opportunities. In particular, investors must consider returns available in the public markets. We expect U.S. equities to compound at roughly 5.75% in real, inflation-adjusted terms over time, assuming no change in valuation multiples. Given that such equities are fairly valued today (although on the high side of a range we would consider to represent fair value), prospective returns over the next three to seven years can be estimated at roughly 5.5%. Bond markets are pricing in inflation of only about 1.1% over the next five years, which is low from our perspective but, assuming this is correct, that would mean an expected return for U.S. equities of roughly 6.5% in nominal terms. Private equities and illiquid assets are riskier than public equities and therefore require a risk premium. While there is much debate about the appropriate risk premium, based upon the premium embedded in our long-term return assumptions used for investment planning purposes we believe primary buyout and venture investments should compound at returns roughly 175 bps to 300 bps higher than U.S. equities. We further assume for purposes of the current analysis that secondaries *as a whole*²⁴ should demand a slightly lower premium than such primary investments, say 150 bps to 250 bps higher than U.S. equities, suggesting secondaries require nominal annual returns of 8.3% to 9.3% to be competitive with public market equities. If inflation over the next three to seven years is closer to the 3.1% average rate at which it has compounded annually during rolling five-year periods since 1900, however, secondaries would need to return 10.3% to 11.3% annually in order to be competitive.

A more appropriate hurdle today might be U.S. investment-grade corporate bonds, which are expected to provide attractive returns as a result of continued high spreads over Treasuries, particularly on a risk-adjusted basis.²⁵ The Barclays Capital Corporate Investment Grade Bond and U.S. Corporate BBB indices were priced at 6.5% and 7.8% yields, respectively, as of May 20, 2009. Assuming inflation of 1.1% to 3.1%, an equity risk premium of 300 bps, and a risk/liquidity premium for locked-up capital of 150 bps to 250 bps, secondaries might then arguably require a net average annual compound return (AACR) of 12.1% to 16.4%. To achieve this (let alone an AACR in the 20s, which we have heard about as a new investor target) necessitates an investment multiple that gets increasingly large as the exit period lengthens (Table F)—and which may be overly ambitious given historical multiples. As noted earlier, average net IRRs for secondary funds in recent years have been about 15% (Table C), suggesting that exits that take longer than four to five years would require difficult-to-achieve multiples. This would appear to be one reason for buyer

²³ Larger investors (or those with mature non-marketable programs) are more likely to see secondaries as an opportunistic investment, which could be part of either the non-marketable portfolio or a separate allocation within the portfolio. Smaller investors (and those with new non-marketable programs) are more likely to use a secondary program to build up a non-marketable program quickly. Investors might find it useful to break out early secondaries from more mature secondaries, perhaps lumping the former (in the case of commitments that have hardly been funded) with primary commitments to private equity given the similar risk/return profile.

²⁴ We recognize that an increased part of the secondary universe now consists of commitments that are less than half funded, thereby requiring a higher risk premium than largely funded commitments. Our analysis also recognizes that buyouts dominate the secondary market.

²⁵ The same is true for European investment-grade and U.K. investment-grade paper.

interest in largely funded commitments rather than less mature secondary interests and reinforces the importance of conservative modeling.

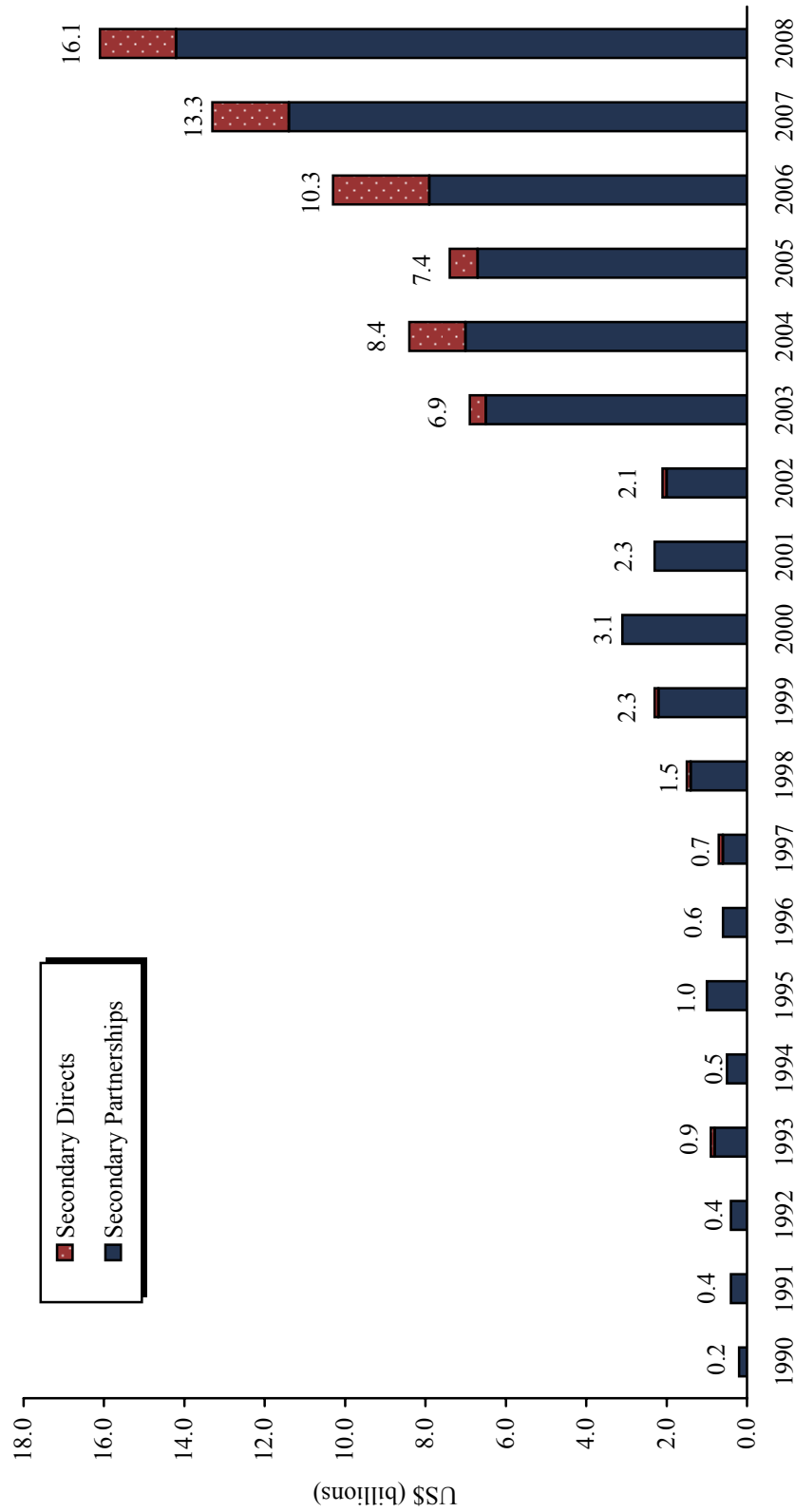
Conclusion

From a buyer's perspective, the secondary market appears to offer substantially more opportunities today than it previously did, in terms of both quantity and variety of products available and in terms of pricing.²⁶ Investors that have sacrificed some potential return in recent months in order to have "dry powder" available for these sorts of opportunities may now find their patience rewarded although those seeking the market bottom will probably need to wait a bit longer. Investors should understand what sorts of secondaries are worthy of consideration for their particular portfolios and must be able to tolerate the illiquidity of such investments for an extended period. Manager selection is crucial given the importance of relationships and the difficulty of pricing. However, those investors able to buy directly will perhaps be in the best position to capitalize on secondary opportunities, particularly in the shorter term.

Wide bid-ask spreads have constrained deal making to a significant extent thus far but should come in at some point in the wake of the release of annual reports for 2008 and quarterly reports in 2009, particularly in light of the stricter standards of FAS 157, which imposes new "fair value" measurements in financial reporting by both public and private companies. More importantly, the size of the primary private equity market, the historical turnover rate, and the likelihood of pressure on sellers suggest that at some point this market will become much more active, especially once buyers and sellers become comfortable with the new transaction structures that are now being developed to address their particular needs, and that there may be an extended period characterized by a significant supply-demand imbalance. As for pricing, buyers may not transact at the bargain-basement prices many are seeking, but by the same token distressed sellers are likely to come off their prices as well. Further market declines may put pressure on sellers to sell the funds buyers want to buy, not the ones sellers wish to sell. Similarly, if markets continue to recover, buyers may prove more flexible regarding what they are willing to buy. In the end, pricing will depend on the relative positions of buyers and sellers, which will be tied to the supply-demand equation, the health and stability of the public equity market, the economic environment in which portfolio firms operate, and the availability of financing. While investors need to keep a close eye on these and other developments, those that are large and liquid enough, that are able to find intermediaries or quality managers that will deploy capital patiently as the market further develops, and that have reasonable expectations are likely to find significant opportunities in secondary investments.

²⁶ We have taken the buyer's perspective in this paper, but note this could be a good opportunity for investors to sell (if the market becomes much more liquid) or to both sell and buy in order to upgrade managers and balance out a private equity portfolio.

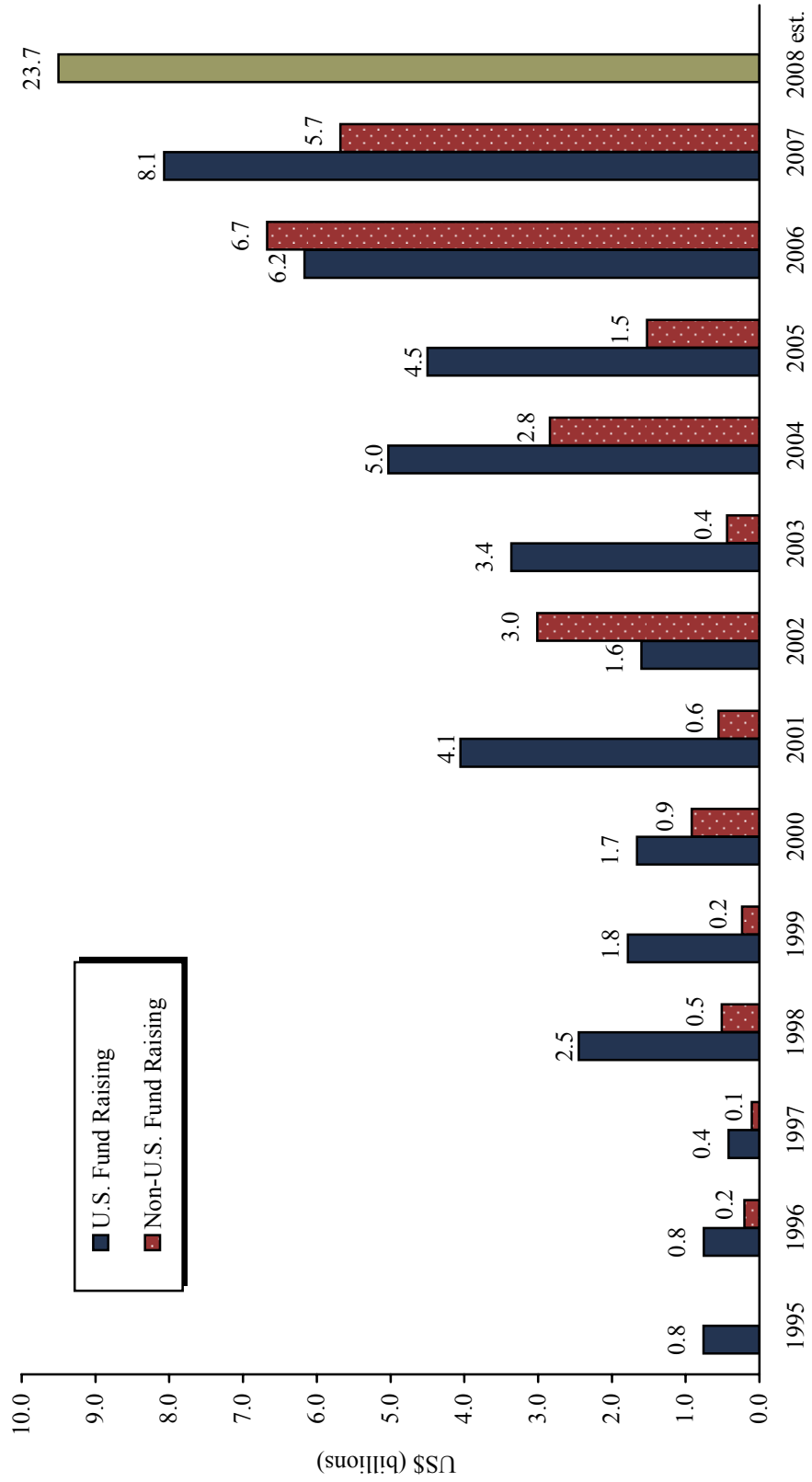
Table A
SIZE OF THE GLOBAL PRIVATE EQUITY SECONDARY MARKET
1990-2008



Source: Lexington Partners.

Notes: Excludes secondary transactions involving real estate partnerships and royalty payments. Numbers shown are totals.

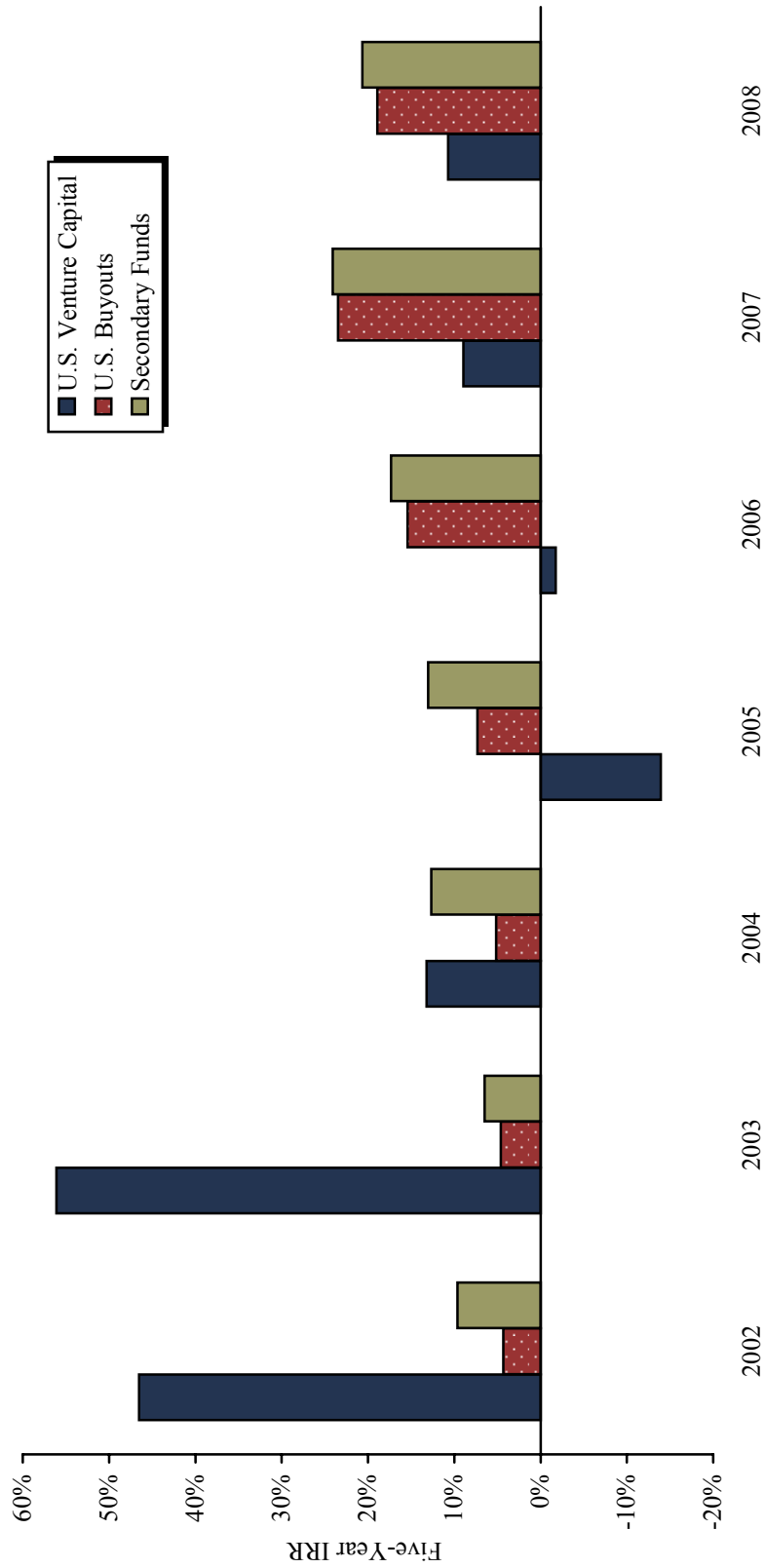
Table B
CAPITAL COMMITMENTS TO SECONDARY FUNDS
1995–2008



Sources: Lexington Partners and Private Equity Analyst.

Notes: Data include dedicated secondary funds only. The \$23.7 billion figure for 2008 is an estimate of *global* fund raising and the bar has been capped for scale purposes.

Table C
FIVE-YEAR POOLED END-TO-END BENCHMARK PERFORMANCE
2002-08



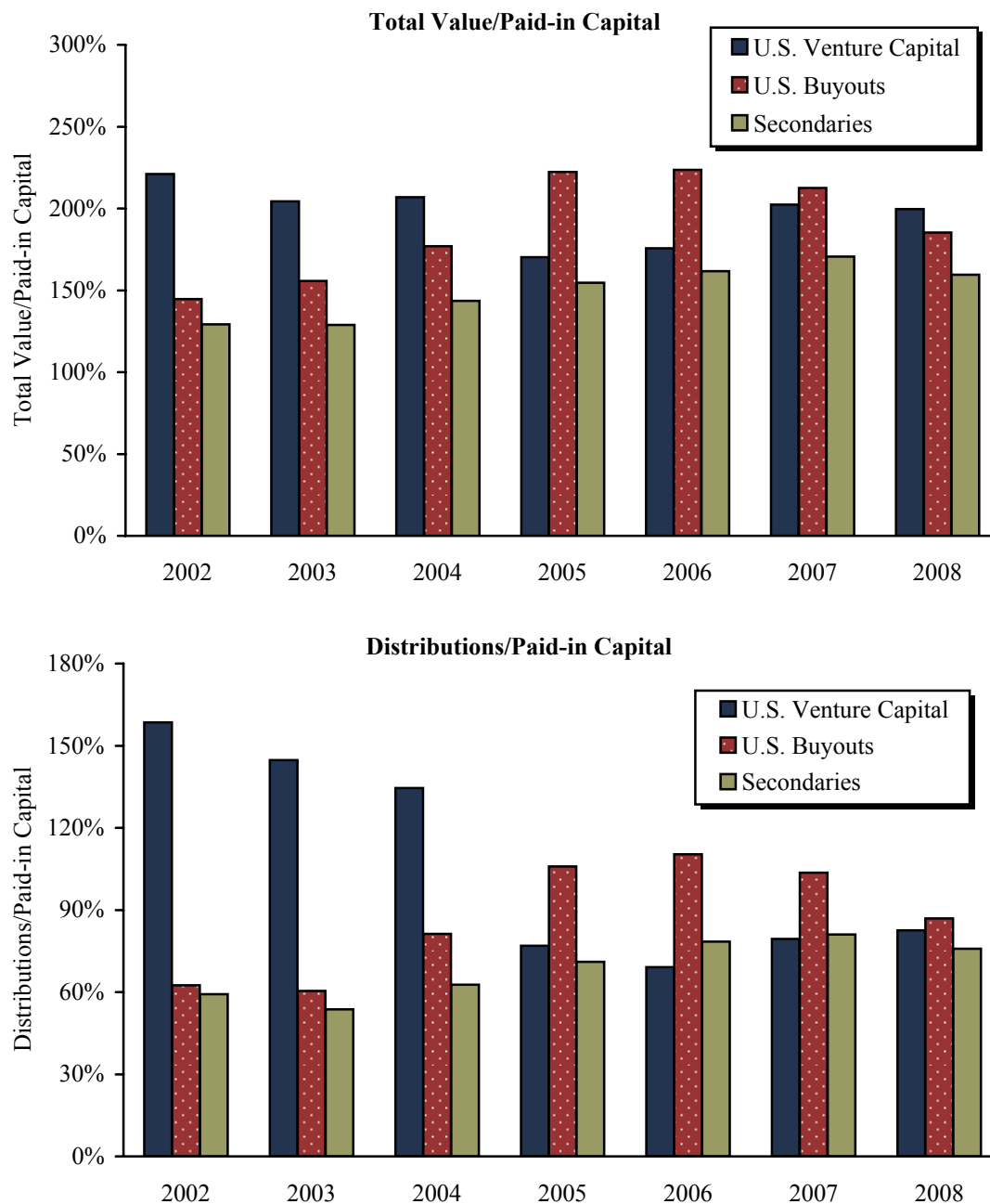
Source: Cambridge Associates LLC Non-Marketable Alternative Assets Database.

Notes: Returns are based on rolling five-year periods with ending dates September 30, 2002, to September 30, 2008. Data are based on the Cambridge Associates manager universe for U.S. private equity, U.S. venture capital, and secondary managers.

Table D

FIVE-YEAR NET INVESTMENT MULTIPLES OF PRIVATE EQUITY, VENTURE CAPITAL AND SECONDARIES

2002–08

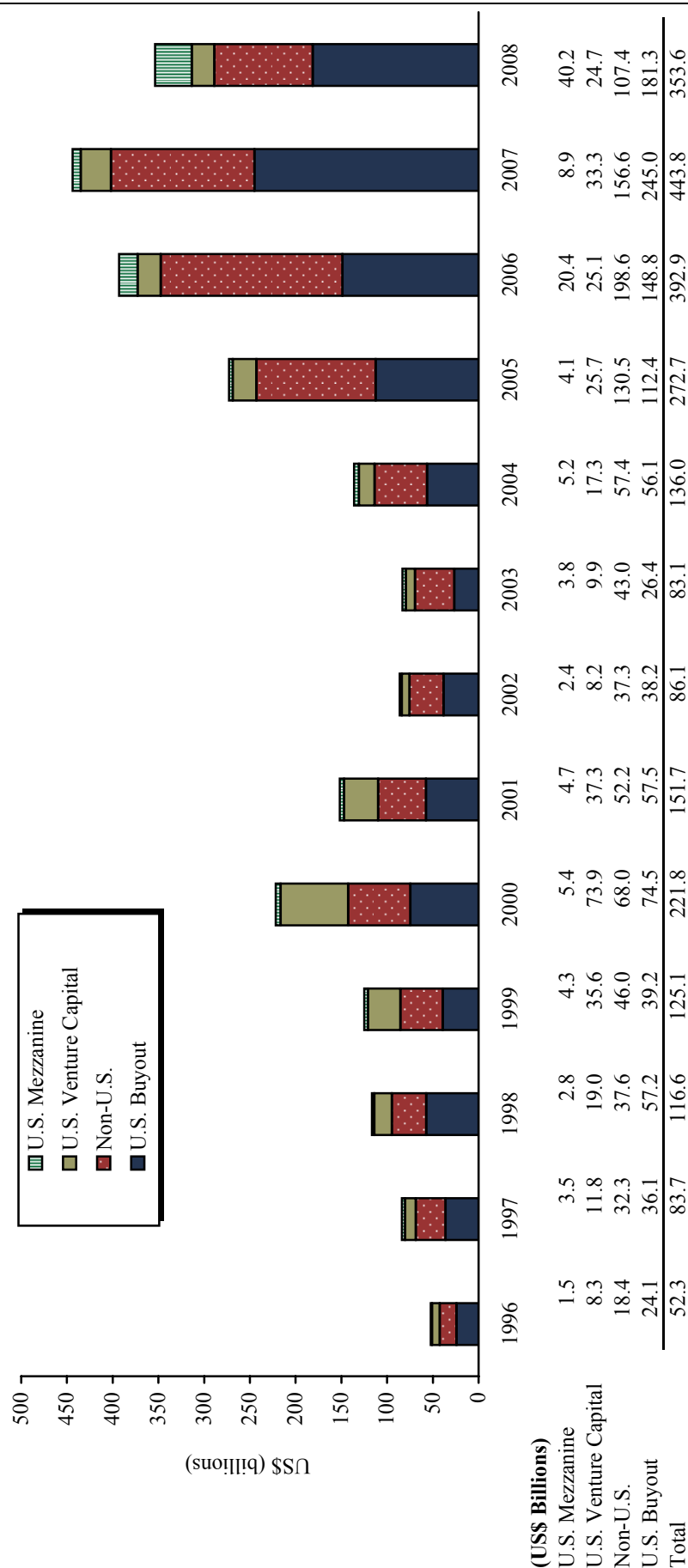


Source: Cambridge Associates LLC Non-Marketable Alternative Assets Database.

Notes: Returns are based on rolling five-year periods with ending dates September 30, 2002 to September 30, 2008. Data are based on the Cambridge Associates manager universe for U.S. private equity, U.S. venture capital, and secondary managers.

Table E
PRIVATE EQUITY BY FUND RAISING BY STRATEGY

1996–2008



Source: Lexington Partners.

Notes: Capital committed to non-US\$-denominated partnerships (2004–08 vintage) converted to U.S. dollars using December 31, 2008 exchange rates. Earlier vintage years converted to U.S. dollars using their respective year-end spot rates.

Table F**INVESTMENT MULTIPLES REQUIRED TO ACHIEVE DIFFERENT AACR TARGETS**

Holding Period (Years)	Target AACR %											
	8%	10%	12%	14%	16%	18%	20%	22%	24%	26%	28%	30%
1	1.1	1.1	1.1	1.1	1.2	1.2	1.2	1.2	1.2	1.3	1.3	1.3
2	1.2	1.2	1.3	1.3	1.3	1.4	1.4	1.5	1.5	1.6	1.6	1.7
3	1.3	1.3	1.4	1.5	1.6	1.6	1.7	1.8	1.9	2.0	2.1	2.2
4	1.4	1.5	1.6	1.7	1.8	1.9	2.1	2.2	2.4	2.5	2.7	2.9
5	1.5	1.6	1.8	1.9	2.1	2.3	2.5	2.7	2.9	3.2	3.4	3.7
6	1.6	1.8	2.0	2.2	2.4	2.7	3.0	3.3	3.6	4.0	4.4	4.8
7	1.7	1.9	2.2	2.5	2.8	3.2	3.6	4.0	4.5	5.0	5.6	6.3
8	1.9	2.1	2.5	2.9	3.3	3.8	4.3	4.9	5.6	6.4	7.2	8.2

Source: Cambridge Associates LLC.

Note: We modeled for a maximum of eight years, but recognize that exits from early secondaries may take longer.