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UFT
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Private Equity Enhancement Credits;

A New Route to

Private Equity Investment Exposure

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A New Route to Private Equity Exposure

Private Equity Enhancement Credits are linked to the economic performance of a private equity investment via a related credit enhancement transaction. The lender in an Enhancement Credit is a private equity investor that not only participates in short-term performance-based distributions, but benefits from long-term growth of the underlying company.

Background

Growth in almost any investment market stems from the success of operating businesses in delivering products or services with a long-term and sustainable view. Investment instruments such as bonds, US Treasuries, and other traditional investment vehicles may represent investment security, but they do not propel true economic growth or inspire returns in the same way that both public and private equity can. Equity-based investments have long been a reliable route for investors to gain access to even a small part of a well-run company. These companies are the incubus for job creation, innovation, and act as the ignition point for increasing the velocity of money that carries other investment opportunities in the market forward. Investors wanting to take advantage of this momentum have largely turned to the public company sector – the stock market — with its on-call liquidity, to satisfy their appetites.

However, as robust as a public stock market may be, publicly listed companies represent only a small percentage of all commercial enterprises to which an investor might seek exposure. By definition, this marketplace excludes non-public companies that, without a doubt, represent a broad and diverse base of investment opportunity. It should be no surprise that private equity investment transactions have grown to play a small but critical role in the construction of a balanced and performing investment portfolio. Nearly two-thirds of all private investors today hold some form of private equity investments in portfolio, and the percentage of those investments relative to other types of investment in private investor portfolios has in recent years tripled in size. Well executed private equity investments have an extraordinary ability to jump-start portfolio performance by super-charging returns on a selection of individual trades that can sometimes soar into the triple digits over the long term.

"... thanks to technological advances and some creative thought … by a select few, new options are developing for investors and operating companies alike that may contribute to a re-shaping of the private equity investment sector ...."

In today's yield-compressed investment market, private equity holds some very significant attraction for investors that have the flexibility, expertise and appetite to participate. When an investment manager or investor folds private equity into their portfolio, they are betting on a long-term win that links directly to the success of an underlying operating company. If they are in the right place at the right time, they can occasionally capture the type of "big win" that comes when a disruptive technology is developed, properly capitalized and successfully commercialized. The problem with every private equity trade is that, as much as each opportunity possesses the potential to release great economic energy, it can also come saddled with equally great challenges and embedded risks – investment liquidity leading the way.

"Unpredictable exit routes combined with investment timelines dictated by the anticipation of possible future liquidity events produce a consistently dangerous prevailing market theme."

Private equity investing requires a long-term view because an operating company grows more like a living organism, sometimes taking years to reach the point of self-reliance, sustainability and, ultimately, economic harvest. It is a rare occasion when an investor drops into an investment in which growth comes quickly and returns exceed expectations in the short term. Most private equity transactions take time, patience and expertise and, in the meantime, an investor has locked-up cash and endures the opportunity cost associated with an investment that may produce little to no interim revenue. Worse yet, the company could ultimately fail, taking the bulk of investment capital down with it. This can be a dangerous game if an investor isn't certain that it can afford to wait for returns or sustain itself in the event of a total loss.

Moreover, even the best company can stumble due to a prolonged cash flow crunch or any number of unforeseen circumstances or delays in revenue generation. This often can signal that existing investors may even be unexpectedly called upon to contribute more capital to a venture in order to protect the stability of a previous investment, further raising the stakes. Should an investor increase its financial support in order to maintain the possibility of success or risk allowing the company to fail or stagnate due to a capital shortfall? This can be a difficult decision for almost any private equity investor when you factor in more global concerns over concentration risk, current income demands, and simple wealth preservation. Unfortunately, it is a situation that many will face at some point as they venture into this market.

With this in mind, private equity firms – investment companies that are specially equipped with expertise in identifying commercial opportunities and delivering "patient" capital – have over the years assumed a predominant role in driving the majority of direct investments in qualified private companies. These firms generally amass large pools of capital from other investors, employing restrictive redemption criteria and longer term capital "lock-up" provisions. The enormity of this kind of capital access has enabled PE firms to control whole investment opportunities, dominate entire sections of the market, minimize their field of competition, and significantly influence pricing and investment terms in their own favor. As with any market, this type of concentration of power doesn't bode well for long-term systemic equitability in both structure and execution.

This is not to say that the convergence of concentrated analytical expertise with large amounts of capital hasn't fueled phenomenal commercial success stories that have greatly benefited investors while enabling management teams to grow their companies into global brands. In the end, however, it remains debatable as to whether the margins earned by the private equity investor versus the gains generated by the operators are equitable and representative of the true value of each party's respective contributions toward the success of a venture.

The reality is that under the generally accepted investment structures deployed by PE firms today, company management frequently is forced to accept covenants or embedded performance triggers that can flip control away from management under the auspices of protecting the investor's interests. At first glance, this approach on the part of the PE firm could be painted as "best practice" when considering the PE firm's fiduciary responsibility to its sub-investors. However, when the penalty for a missed performance benchmark is management dilution and the reward to an operator for a job well done is their removal upon the sale of the private equity firm's ownership stake, this system may be worth revisiting. With little in the way of meaningful competition for these investment opportunities outside the framework of the community of PE firms, for good or bad, this approach has become the *de facto* model within which companies and investors expect to operate.

"There may be many variations on this theme, but in general, it boils down to a simple exchange of some form of cash for equity."

A Change in the Wind

In recent years, thanks to technological advances and some creative thought and innovation by a select few, new options are developing that may expand the universe of candidate private equity investors and reshape the private equity investment model such that the value of each side of the transaction is more equally weighted.

As we've discussed, an array of problems can arise for investors when trying to access private equity investment opportunities, including insufficient analytical expertise of an investor, lack of transparency resulting in difficulty in determining company valuation, and, most importantly, anticipating the true duration of an investment and managing related investment liquidity. All of these factors lead to the conventional wisdom that the private equity investment marketplace is best-suited for those PE firms or institutional investors that have ready access to business analysts and ample available capital. However, as technology and information delivery platforms become more sophisticated, highly specialized private investors or family office enterprises that have successfully grown businesses in a particular industry are gaining the confidence needed to invest directly in private operating companies with a similar industry focus.

Additionally, the private equity investment marketplace has consistently been a haven for opportunity-driven, one-off investment transactions in which an investor must be confident at the outset that the investment will remain stable throughout, despite an undefined investment duration and the potential for little or no cash flow along the way. Once invested, maneuvering out of a private equity investment during its term is very difficult within the context of currently available market tools. Unpredictable exit routes combined with investment timelines dictated by the anticipation of possible future liquidity events produce a consistently dangerous prevailing market theme. It is no wonder that many industry innovators over the years have focused their energy on introducing structures within the private company marketplace that mimic behaviors of the public stock market in an effort to generate consistent opportunities for investment liquidity. The introduction of a systemic vehicle that fosters daily, reliable liquidity for private company investments akin to that offered in the public stock market will forever change the landscape of private equity investment.

Over the last several years, there have been numerous attempts at improving liquidity in the private company marketplace. Two of the most frequented strategies have been (1) the establishment of financial exchanges on which a qualifying private company could be listed and its shares traded, and (2) the development of a functional secondary market for private equity shares via a "deal room" in which owners of shares can seek out potential purchasers of those shares on a bid-ask basis. In both of these examples, successes have come in fits and starts due both to complications inherent in efficiently trading private company shares and to the limited pool of prospective private companies whose shares may qualify. Neither of these options has yet been able to grow to the point of reaching out to encompass the true depth and breadth of the private company marketplace.

Private Company Financial Exchanges. Since the early to mid-1990's, many well known business brands in both financial exchange operations and private equity have launched exchange-based models. To date, none have gained the traction and adopted operational models possessing the neces-

" ...instead of attempting to meet the market where it is today by trying to cultivate liquidity in what are undeniably historically illiquid and somewhat clumsy assets, what if we changed the conditions of the test?"

sary agility to drive the type of volume required to manifest consistent liquidity sufficient to stabilize the target market. The overarching strategy that has been applied to creating a private company exchange relies heavily on a transposition of the tried and true "listing practices" as observed by public stock exchanges. Logically, in a private company environment, listing eligibility would be expected to apply a more relaxed set of standards as to share volume, capitalization and other disclosures that are more specifically designed to maintain the nature of a privately held and potentially smaller enterprise.

Conceptually, this approach serves as one possible solution for a private company that is in pursuit of a capital raise for a particular project or line of business, provided it can satisfy the minimum quality threshold established by the exchange and is willing to join the "listed company universe". However, the listing process can be narrow, and it is unlikely that this approach will serve the interests of private companies that do not wish to tender public disclosures of private company data — even over a private company exchange — or simply fall outside the eligibility profile for listing. Moreover, looking at this from a private equity investor's perspective, the exchange model is of no benefit if the investor is seeking liquidity for either new or existing investments in viable, but "unlisted" private companies.

Deal Rooms. This strategy for improving liquidity in the private company marketplace potentially has a much broader application and healthier implications for enhancing the performance of the private equity market. A virtual electronic forum is created in which the holders of private equity shares may proactively seek out suitors to bid on those shares. The creation of this type of private equity deal room can prove challenging for a number of reasons, including the lack of uniformity or standardization of shares being offered and a lack of transparency to underlying company data in the event the company is not economically incentivized to cooperate in the disclosure of non-public company information. There is also the potential risk for regulatory complication -- this type of electronic forum could circumvent regulatory controls built around the trade of shares in non-public companies. All of these challenges are manageable but come together to breed systemic and transactional latency in the operation of this type of platform.

Firms such as SharesPost[1] of San Bruno, California, have successfully navigated these obstacles and, when required, exchanged ideas with regulators to help differentiate between private equity share trading objectives and public stock trading practices and regulation. The result has been a better system to further the fundraising goals of select companies and to provide much needed liquidity for pre-IPO stakeholders in a wave of well known publicly traded companies, including FaceBook, for example. Through its development of a technology platform that could efficiently disseminate a broad range of company and share data to pre-qualified investors, SharesPost has been able to act effectively for shareholders in a limited selection of qualifying companies. However, like in our first example of a "private exchange" concept that mimics "public exchange" practices, thus far, the field of private company market participants whose shares are eligible to be represented on the platform has been relatively narrow compared with the private equity marketplace as a whole.

"What if we invented a dynamic instrument that is built for scale, efficiency, and trade that is anchored and stabilized by private equity shares? Such an alternative … would fundamentally change how a private equity investment is manifested and, ultimately, change the nature of the liquidity solution that the market is so actively seeking."

[1]As of the date of writing SharesPost has entered into a joint venture with NASDAQ OMX for the launch of NASDAQ Private Market, a private equity exchange expected to launch prior to the close of 2013.

"… the Private Equity Enhancement Credit would be most attractive to smaller independent private equity investors that may not be inclined to endure the opportunity costs and the extended period of illiquidity associated with a particular opportunity…"

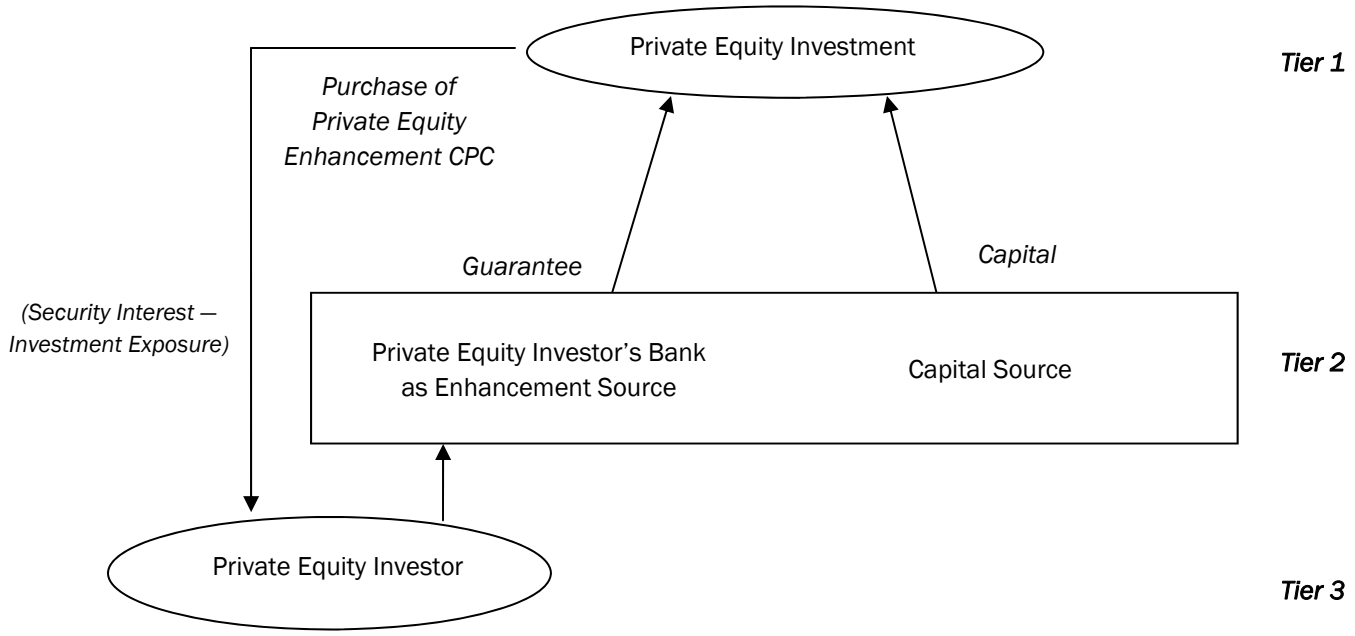
Changing the Conditions of the Test

We've looked at the broader issue of building liquidity in today's private equity marketplace systemically through the listing of private companies on an exchange or the operation of deal rooms to promote the sale and trade of private company shares. Provided either of these approaches found a way to standardize their private equity products such that investment volumes could be scaled, there is no doubt that investment liquidity could be enhanced, duration risk could be better managed, and a broader base of private equity investors could be welcomed to the market. Interestingly, however, to effect fundamental change in the behavior of the private equity marketplace, one must first look beyond the broader solution of simply introducing liquidity to existing securities and instead drill down to the foundations of how individual private equity investments are transacted.

In the most elementary sense, an investment is made when an investor acquires shares, options, warrants, or some other security representing equity in a private company in consideration for what is generally a capital investment in that firm. There may be many variations on this theme, but in general, it boils down to a simple exchange of some form of cash for equity. The instrument representing that equity becomes the focal point for developing liquidity. To date, the solutions proposed in both the exchange and deal room strategies have been to build a trading market around the most rudimentary instruments constituting equity – private company shares.

But, instead of attempting to meet the market where it is today by trying to cultivate liquidity in what are undeniably historically illiquid and somewhat clumsy assets, *what if we changed the conditions of the test?* What if we invented a dynamic instrument that is built for scale, efficiency, and trade that is an-

Figure 1: Anatomy of a Modern Investment Disaggregation



chored and stabilized by private equity shares? Such an alternative approach would fundamentally change how a private equity investment is manifested and, ultimately, change the nature of the liquidity solution that the market is so actively seeking.

Private Equity Enhancement Credits are the new dynamic instrument by which a private equity investor can provide much needed support to virtually any private company to which the investor seeks investment exposure. Through an application of the core principles of Modern Credit and Investment Disaggregation[2], appetite for a given private equity investment and the capital to enable that investment can be efficiently *sourced from wholly separate investor pools.* Under a disaggregated investment structure, the transaction participant takes only that part of the risk with which it is comfortable – either the cash exposure or the private equity exposure, but not both. Therefore, a wider spectrum of investors becomes potentially available in each source investor pool, thereby increasing the overall chances of successfully initiating an investment.

"… the Private Equity Enhancement CPC is simply a better and more liquid mousetrap for both the investment recipient and the independent private investor."

For example and as illustrated in Figure 1 on the preceding page, that segment of the investment community that has a desire to stay in highly liquid cash or cash-equivalent investments could provide the capital to a private company in conjunction with a Private Equity Enhancement Credit without actually taking on any investment exposure to that company whatsoever. Conversely, any private equity investor that seeks a specific private company opportunity but doesn't wish to liquidate assets or tie up capital for an extended period of time could provide the credit support for — and thereby leverage — that cash or cash-equivalent investment. Although appealing to a broad base of investors, the Private Equity Enhancement Credit would be most attractive to smaller independent private equity investors that may not be inclined to endure the opportunity costs and the extended period of illiquidity associated with a particular opportunity that requires a cash investment, thereby offering these investors the opportunity to comfortably enter the private equity marketplace in a whole new way.

As with all disaggregated investment protocols, the capital will be released to the company upon the delivery of a contingent credit undertaking in the form of a standby letter of credit on behalf of the private equity investor. The undrawn letter of credit evidences the investor's credit support for the investment and its commitment to deliver capital at some future date in the event of a technical or actual performance default by the operating company in which it has invested. That credit undertaking, or "enhancement", acts as the private equity investor's currency to purchase a new type of equity-linked security that constitutes a credit participation interest in a Private Equity Enhancement Credit. That participation interest is also known as a **Private Equity Enhancement CPC™**, which represents ownership of a beneficial economic interest in the operations of the investment recipient. The Private Equity Enhancement CPC is built to be readily traded across an electronic platform, whether on an OTC basis or via an exchange, thereby bringing the prospect of daily investment liquidity within reach.

Each Private Equity Enhancement Credit is directly secured by a pledge of private equity shares that carry with them a potential for both current yield and long-term capital gain that, through the disbursement of agreed performance-based distributions and gains associated with the pledged shares, echoes the performance of the underlying operating company. In this way, the private equity investor is able to gain highly desirable investment exposure to the target company through ownership of a more nimble security that is independent, but reflective of, an actual ownership stake in the private company with only a nominal cash investment tied to the cost of the standby letter of credit. The intended result — and the one that should follow for well-performing private equity investments — is that the investor will never be required to make a cash investment in the operating company.

[2] *See* "Modern Credit and Investment Disaggregation Theory; A Recombinant Approach to Originating an Investment" by Joanne Marlowe (2012) for an introductory Analysis.

A New Standard Unlocks Liquidity

Trading private equity shares in today's marketplace is finally possible due to robust information delivery technologies as developed by problem-solving entrepreneurial companies like SharesPost. However, private equity shares are not built for speed and agility in the market like their public company cousins. Try as one might, only a small percentage of the private market stands to benefit from systemic efforts to build liquidity for private equity shares as they exist today. In the battle to introduce liquidity and spread private equity market volumes across a broader and more diverse base of investors, the Private Equity Enhancement CPC is simply a better and *more liquid* mousetrap for both the investment recipient and the independent private investor. It effortlessly overlays almost any grouping of private equity shares that secure it, and picks up all of the economic characteristics of those shares while leaving behind the restrictive covenants, consents and governance issues that inherently breed transactional latency.

benefits

From the perspective of a private company in search of capital, the potential benefits to a properly performing, non-defaulting investment are fundamental. By contributing the business opportunity, the management and operating expertise, and pairing the capital to be applied opposite a private equity investor's acquisition of the Private Equity Enhancement CPC™, management could be expected to retain the lion's share of company ownership during the life of the investment and, in the interim, can expect to allocate and encumber approximately half of the shares it would have otherwise offered for purchase in a private equity scenario subscribing to the conventional PE firm model. In fact, it is only in the event of a default by the company in which the investor's letter of credit undertaking could be drawn and funded that the investment structure will revert to one that is more consistent with that demanded by PE firms today in which control vests with the private equity investors.

From a private equity investor's perspective, the Private Equity Enhancement CPC offers many desirable benefits:

Highly standardized – breeding opportunity for the more ready development of OTC trading and enhanced market-wide investment liquidity;

"Cashless" – enabling an investor to gain exposure to an investment while avoiding or, at the very least, deferring spending its own capital;

Yield enhancing – return on cash is significantly enhanced because of the investor's low cash-basis in each trade (estimated at 1% of the investment face value) and, with no disruption of performing assets on the investor's portfolio, current portfolio income continues and the private equity returns serve as a long-term performance enhancement;

Cooperative – conducive to the coordination of several private equity investors in the execution of much larger investments with only investment grade co-investor risk;

Credit-based – for as long as it remains "cashless" and the investor's contingent undertaking remains uncalled, able to be characterized as debt for tax purposes yet having the potential for generating equity-like returns;

Globally-minded – an exceptional vehicle for gaining cross-border/cross-jurisdictional private equity investment exposure without in many cases incurring the most common "in-country" trader business issues inherent in direct share ownership by investors;

Transparent – governance and disclosure controls are embedded in the standardized investment origination documentation to assure visibility to underlying operations;

Readily valued – in reliance upon third party independent daily indicative pricing reflective of both company disclosures and overarching premiums or preferred payments attributable to the Enhancement Credit;

Secure – directly collateralized by the pledge of a special class of shares that, upon default, triggers the vesting of operating company control with the

private equity investor; and

Equalizing – levels the playing field and removes the distinct market advantage historically enjoyed by larger PE firms over small independent private equity investors.

Conclusion

The Private Equity Enhancement CPC™ is a highly standardized security that enhances the economic accessibility of a private equity investment and can be readily made to trade alongside private equity shares on a free trading and transparent electronic platform. The systemic deployment of this type of instrument averts the lack of transparency and potential for latency that is inherent in transferring and trading private equity shares. It also promotes healthy competition among investors by expanding the stable of candidate private equity investors that are capable of competently entering the private equity market. It strikes a greater equilibrium of contributed value between the two primary participants in the trade, making for a more equitable balance between the structure of the venture and the sharing of future gains. And, finally, it casts a wider net that enables virtually any traditionally qualified private company in search of investment to participate using this structure. In short, by applying the technological prowess available through leading edge trading platforms today, a much broader array of private equity investment opportunities can be reached than ever before, leading to increased scale and enhanced market liquidity.

Although time and experience will paint the picture of what the next generation private equity marketplace will look like, technological access to data has unleashed a new audience of private equity investors that are no longer satisfied with solely making indirect investments via PE firms. These investors, varying from independent commercial operators, single family offices, multi-family offices and institutional investors, are growing ever-more confident in their ability to identify quality investment opportunities and are demanding new methods to gain direct investment access to what the market has to offer. They are looking for new vehicles to help them better manage opportunity costs, mitigate duration risks and access liquidity so they can compete with larger investment firms to win access to quality private equity investment opportunities.

The market is not only ready for, but needs, a standardized instrument that promotes this type of open competition. Under the bright light of market competition, the scale that weighs the interests of private company operators and private equity investors can be accurately rebalanced such that direct and more equitable investment opportunities will naturally evolve.

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