



Excellence in Co-Investment

Series: Best Practices in Private Partnerships

This document brings together all the supporting content attached to this Privcap video program. You may watch the program in its entirety and access all of the content herein at www.privcap.com

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Excellence in Co-Investment / Moderator's Note

The subject of co-investment is an appropriate one with which to launch Privcap, because it is an activity that requires careful consideration and close conversation between investors and their managers. This is what Privcap is here to facilitate.

As Siguler Guff's Solomon Owayda says during the program, once an investor decides to allocate capital to the vast universe of private companies, it needs to solve the challenging question of how exactly to direct its capital to those "private equities." Should the institution go out and do its own deals, or should it hire teams of general partners (all of whom claim to be private equity investment experts) to do deals on its behalf?

The rise of the private equity asset class has mostly been a history of institutions deciding on the latter strategy—investing in private equities through limited partnerships.

But in recent years, limited partners have been more interested in "co-investing"—investing capital directly into deals alongside the GPs to whose funds they have already committed capital.

In my many conversations with limited partners in recent years, first as editor-in-chief of PEI and then as I was building Privcap, I was struck that so many LPs claimed to want to co-invest. And then in separate conversations with many GPs, I encountered great skepticism about the abilities of most of these LPs to put their direct-deal money where their mouths were.

"Excellence in Co-Investment" is Privcap's effort to generate a candid discussion among co-investment experts about the resources and people needed to build a successful co-investment and direct-investment program.

As you'll see, Privcap's assembled table of experts argue that the human-capital and administrative costs of co-investing are significant. Furthermore, they highlight an important difference between passive co-investors who arbitrarily "take" deal flow, and those active (and well staffed) co-investors who actively "seek" opportunities—and who often say "no" to their GP friends when direct opportunities are offered up.

I hope you enjoy watching "Excellence in Co-Investment" as much as I did moderating it. You'll also be pleased to find that our co-investment experts possess not only great intellect but senses of humor, as well, attributes that you may enjoy fee-free.

Best,

David Snow

Founder, Privcap

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Excellence in Co-Investment / Biographies of Participants

Scott Gallin Managing Director, PineBridge Investments



Scott Gallin is a managing director of PineBridge Investments, a multi-strategy global asset manager, where he has worked since 2002. He also serves as chairman of Flash Global Logistics and on the board of the Body Shop of America. He previously served on the boards of Legendary Pictures, Everest Connections and Best Brands. An adjunct professor of finance and economics at Columbia Business School, he previously taught at the Hass School of Business at the University of California, Berkeley, and at Tsinghua University in Beijing. Prior to joining PineBridge, Gallin worked for Kluge & Co., the private equity arm of Metromedia Co. From 1996 to 1997, he was a business analyst in Andersen Consulting's Strategic Services group. Gallin received a B.A. and an M.A. in regional science from the University of Pennsylvania, and an M.B.A. in finance from Columbia Business School. He studied economics at McGill University as a Fulbright Scholar.

Michael S. Kramer Managing Director, Neuberger Berman



Michael joined the firm in 2006. Michael is a member of the Private Fund Investments Group and a Principal in Co-Investment Partners Fund. Prior to joining the firm, Michael was a vice president at The Cypress Group, a private equity firm with \$3.5 billion under management. Prior to that, he was an analyst at PaineWebber Incorporated. Michael holds a BA cum laude from Harvard College and an MBA from Harvard Business School. He is currently a Director of Group Ark Insurance Holdings Ltd. Neuberger Berman managed approximately \$18 billion in alternatives as of June 30, 2011, and \$198 billion across all asset classes.

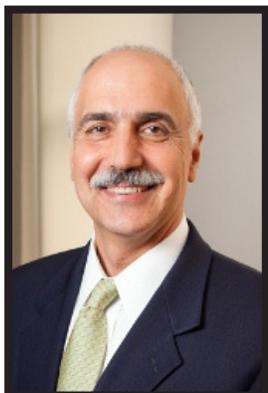
Satyan Malhotra President, Caspian Private Equity



Mr. Malhotra is the President of Caspian Private Equity that manages fund-of-funds as well as direct investment portfolios. Caspian Private Equity was spun out of Caspian Capital Management in 2008. Mr. Malhotra also serves as the President of Caspian Capital Management, where the team has been managing alternative investment strategies since 1994. In addition to Caspian, Mr. Malhotra is on the Boards of many companies. Prior to joining Caspian, Mr. Malhotra was a Senior Manager with the Global Risk Management Solutions practice of PricewaterhouseCoopers LLC. In that capacity, he worked with leading banks, corporate treasuries, mortgage companies, funds and energy/commodity trading firms on a variety of risk management, performance and valuation initiatives. Mr. Malhotra has an MBA in finance from Virginia Tech., a BA from University of Delhi and a Financial Risk Manager (FRM) certification from the Global Association of Risk Professionals (GARP). He is currently working towards a CIBE from Columbia Business School.

Excellence in Co-Investment / Biographies of Participants

Solomon Owayda Managing Director, Siguler Guff



Solomon Owayda is a Managing Director at Siguler Guff. He joined the Firm in 2009 as a senior member of the investment staff and has 23 years of experience investing and managing institutional alternative investment portfolios.

Prior to joining Siguler Guff, Mr. Owayda spent 12 years at SVG Advisers, an international private equity firm, where he was Chief Investment Officer of the advisory business. He was on the investment committee for several SVG vehicles, served on many advisory boards and helped establish the firm's secondary business. Prior to that, Mr. Owayda was the Director of Private Equity at the California Teachers' Retirement System, where he was responsible for committing over \$2 billion to domestic and international funds. While at CalSTRS, he also helped establish the Institutional Limited Partners Association (ILPA) and served as the group's Chairman until leaving the pension fund in 1997.

Mr. Owayda holds a B.S. from Marquette University and an M.B.A. from the Sheldon B. Lubar School of Business at the University of Wisconsin-Milwaukee. He also attended the American University of Beirut. Additionally, Mr. Owayda was an Adjunct Assistant Professor of Finance at the Edward S. Ageno School of Business at Golden Gate University.

Moderator / David Snow Founder, Privcap



David Snow has been covering the global private investment market as a journalist for 12 years. He is Founder and CEO of Privcap, a media platform delivering high-quality content to investors in private partnerships. Privcap's mission is to provide context around important private investment opportunities and practices. Until November 2010, David was Editor in Chief of PEI Media, the leading provider of news and information for the global alternative investment industry, with offices in London, New York, Singapore and Hong Kong. He remains Editor at Large of PEI. David played a key editorial role across PEI's editorial products, events and business strategies, including the launch of news services for the private equity, real estate and infrastructure asset classes. Among PEI's titles are Private Equity International, PERE and Infrastructure Investor. David began his financial-media career at what is now Thomson Reuters, where he became Editor of Buyouts magazine. In 2000 he joined an affiliate of Guggenheim Partners to launch a news service for accredited investors. He has a Master of International Affairs from Columbia University and undergraduate degrees in Political Science and Chinese Studies from the University of California at San Diego. He grew up in Honolulu, Hawaii. www.privcap.com

Excellence in Co-Investment / Full Program Transcript

The following is a transcript of the conversation featured in Privcap's video program, "Excellence in Co-Investment."



David Snow: Hello and welcome to Privcap. My name is David Snow, the founder of Privcap. Privcap gives you valuable context for private capital opportunities and practices.

Today, we are talking about a very hot topic—co-investment. Increasingly, investors are seeking to deploy capital not just into funds, but directly, and often alongside their own managers, into deals. We're going to learn about the right way to do this, and the wrong way to go direct.

Luckily, joining us is a very seasoned, all-star cast of experts who are experts at co-investment and I am very pleased to introduce them today. Welcome.

From Neuberger Berman, we have Michael Kramer; from PineBridge Investments, Scott Gallin; from Caspian Private Equity, Satyan Malhotra; and from Siguler Guff, Solomon Owayda. Gentlemen, welcome.

So it is safe to say that there has been a very noticeable trend in the private equity market over the past several years, and that is an increasing desire on the parts of the institutions that back private equity and private capital funds to go directly into deals, often called co-investment, called direct investment. So I think a good place to start our conversation is talking about why it is that this trend is taking place, setting aside the right or the wrong way to do it, but just talking about why is it you think that investors are increasingly seeking to go directly into deals.

So maybe, Solomon, as a former LP and someone who advises LPs, you can give a bit of background as to why you think this is taking place.

Video Time Stamp 1:43

Solomon Owayda: I've been in this business for the last 22 years, and when I started in the late 80s, it really was in the infancy—there was no asset class known as private equity. It was called alternative investments.

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So you start by learning, you start by doing things with others. When I was at the pension fund [CalSTRS], we used the GPs so that we can start investing with these private companies, so that we can have higher rates of return. As things progress, as now private equity is becoming more and more accepted, it's a natural thing to do, a natural progression, so that you start with GPs, investing with general partners, and then move to the next step of doing co-investments alongside your general partner. And then, some people do it, go directly, and skip the GPs.

At the end of the day, you want the high rates of return, you're learning as you go, and in 20 years, this is just becoming a natural progression of doing things on the co-investment side.

Video time stamp 2:43

David Snow: So Satyan, are there right reasons and wrong reasons to co-invest if you are an investor?

Satyan Malhotra: I think the negatives would be if you were not compliant with your mandate. For example, if you have a co-investment mandate that requires return or requires GP relationship or cost-savings, and you are doing something that is away from the mandate, I think that would be a negative reason. If you look at how Caspian is structured, Caspian itself is primarily focused on getting higher yields of return. For us, every other reason is essentially a tertiary reason.

So I think the right reasons would be: to be compliant with your mandate.

David Snow: Scott, from an investment-philosophy point of view, how would you characterize co-investment as being within a broader, let's say, private capital mandate?

Scott Gallin: I think first and foremost, it starts with a commitment to the asset class. Solomon alluded to the evolution many investors go through—first aligning themselves with those that they think are the best GPs and then learning to do more with them, and then perhaps graduating to do direct on their own. That's certainly one reason—to gain more exposure to an asset class that over the last couple of decades has at least had the perception to outperform some of the broader indices.

But I also think that if you are an experienced investor, and if you have a broad set of relationships, co-investing gives you an opportunity to leverage those relationships, to see the best deals, to pick and choose which opportunities you want to participate in and then as you get more sophisticated, to leverage the relationships to perhaps, move up and down the balance sheet, and find ways to deploy capital with a variety of risk profiles.

Video time stamp 4:26

David Snow: Michael, how have you seen the desire to co-invest evolve over time?

Michael Kramer: Sure—co-investing has been around for quite a while, and it started out, really, as a niche industry—a niche part of the industry, I would say. The only active participants years ago were really some of the larger pension funds, institutional funds like CalSTRS. Then there was an emergence of what we call the pro-rata or syndication market where a general partner will announce a deal and go out to their limited partners and offer up on a pro-rata basis—or according to their proportional investment—with a very summary amount of information, if they want to participate in some limited fashion. That part of the market is still there.

Private equity is cyclical. So as the buyout market kind of got a bit more exuberant, people really jumped in with both feet—somewhat, sometimes a little indiscriminately, some good deals done, some bad deals done. And then after the crisis, people really pulled in their horns and things went cold turkey for about a year to 18 months. We were able to deploy some limited amount of capital, and there were very attractive deals to be done during that time period, but a limited number.

Now, subsequent to that, you have seen the re-emergence of the co-investment market, a greater appetite among investors to participate in co-investment, but I think there is a greater appreciation that it needs to be done in a more professionalized and systematic fashion.

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Video time stamp 6:20

Resourcing & Outsourcing

David Snow: Obviously, it takes resources, it takes time, it takes people to establish a co-investment program. You don't simply say yes or no to a deal. There is a responsibility to actually assess the deal, to perform due diligence. So Scott, I'm wondering if you can give a sense as to the kinds of people needed, possibly, within an institutional investor to even process and to do the work required of an effective co-investment program?

Scott Gallin: Sure, and while this may sound like an obvious answer, what we look for when we hire are people who think like an investor, which is obviously very different from people who think for example like an investment bank or a consultant. Typically, if you are looking for a pre-MBA hire, that is going to be someone with a leverage-finance background or perhaps financial-sponsors covered—somebody who has been around deals and understands some of the mechanics, particularly around financial modeling.

Then when we think about people who are post-MBA, who should be with us for a long time and eventually graduate to the partner ranks, we want people who understand that it is not about doing due diligence, and making a commitment, but it's also about serving on boards, being a constructive member of the board, being creative when it comes time to solve a problem. And so that is what we look for.

One other note is that I spent a lot of the time during the course of the year teaching at Columbia business school, and what I spend most of the class trying to get people think about is making the investment decision and then trying to live with it and make it a great investment. So that mindset is what we look for when we hire, and it is also what I am trying to impart on folks who are sitting in my classroom.

Video time stamp 8:01

David Snow: Well, there is also an aspect of compensation, right? If a person is compensated, where their own capital is put at risk over a long period of time, they are going to want have a much keener interest in how that capital is deployed. Do you think a lot of these institutions that say they want to co-invest don't get the tie-up of personal capital as being part of the equation?

Scott Gallin: Well, some of the institutions that do co-investment don't do it from a fund that has a typical GP structure, where that's even possible. I guess there are instances where a group that is doing co-investment could require a commitment, but I think the best construct to do that is the traditional fund model. So, folks that go out and raise a co-investment fund can create a carry structure, can create that long-term incentive.

And the way we are set up, every member of our team, every investment professional, has carry at stake, because to your point David, we want them to think about every decision as they are making as a commitment of their own resources, and that way, even the most junior person, if they come across something in their diligence that spooks them, we want to have a discussion before we commit capital and get tied up to what could be a three-to-seven year hold.

Video time stamp 9:05

David Snow: Michael, to the extent that certain institutions see an opportunity to co-invest, but choose to outsource some of the functions that are involved in the co-investment process, what kinds of functions are they outsourcing, what are the range of solutions that they are going for?

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Michael Kramer: I think, broadly speaking, outsourcing in an increasing trend. That just relates back to the point I made earlier that things become more professionalized and systematic. It can range, across the whole spectrum, starting with the dealing sourcing. Sometimes people want access to the deal flow. Other times, an institution has their own deal flow, and just wants help evaluating it.

Due diligence is always part of the process. It can be portfolio construction, portfolio allocations. These can also be done in fully discretionary or semi-discretionary manner, and within in Neuberger Berman, I'd say we

have different mandates that encompass the full spectrum with varying degrees of involvement at different parts of the deal process.

David Snow: So if you are going to hire a group, pay a group, to do some of this work for you, they are going to charge you a fee of some sort whether it is a straight fee or whether it is some sort of a success fee. Satyan, I'm wondering if you can describe some of the options that are out there for fee-structures, and maybe for the benefit of any investors watching this, talk about some of the points of negotiation that they might keep in mind when they are looking for an external partner?

Satyan Malhotra: Sure, and I think it's line with what Michael was saying. It all depends on what level of involvement you want from the outsource entity or the team that you are going to set up. If it is in house, it is obviously going to be cheaper, but you may not have the benefit of getting the right talent because you have to get the right budget approved to higher the resources, and most of these resources, like Scott mentioned, have to come from the street.

It's a different morale where you outsource, and if you outsource even there if it's a non-discretionary model, you are looking at on the low-end, at least 25 basis points and some sort of an agreement on the upside, which is a carry.

I think if you participate in full-grown funds, that is you allocate to co-investment focused funds, then it could be upwards with 1-and-10 or 2-and-20. That would depend on what type of performance that can be delivered.

I'll tell you from our experience, our funds, we position them to give returns, which are in line with the other growth and/or other small managers. So if the underlying allocator is expecting that kind of a return, for us to be able to hire and sponsor the right team and motivate the team, we think a comparable fee structure is possible. As far as negotiation is concerned, I would spend my dollars focused on the return aspect. A lot of times, when you focus on costs, you forget that you get what you are paying for. In the end, if you really want the return to be the driver for your portfolio, you should be comfortable paying the right amounts of money.

Video time stamp 12:22

David Snow: I guess I'll throw the question out to anyone—Satyan mentioned getting the incentive structure correct. What should investors keep in mind as they think about working with an external partner as far as how that partner is paid?

Scott Gallin: I think there a couple of things. You alluded to this earlier—obviously, you want the team that is making those decisions to have an alignment of interests and I think the strongest way to have that is to have the investors on the frontlines putting their own capital at risk in the deals. The other thing I would say is focus, and you have people around this table—this what we do for a living. I don't think you can dabble in co-investments. I

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think that you have to have a team that has the experience to do the due diligence, to serve on boards, and to dig in because not all of these deals are going to go straight up. There are going to be tough times no matter how tight your process is, so I think the alignment comes through selecting the right people who have the right skill set to navigate through good times and bad.

Video time stamp 13:25

David Snow: How did you do it at CalSTRS when you were there? I mean, CalSTRS—not an organization that can spend a limitless amount of money on staffing for investments, so how did you get co-investments done despite those resource constraints?

Solomon Owayda: Well, when I was at CalSTRS, that was many, many moons ago, so things have progressed since then. I think this applies to the current public pension funds or corporate pension funds or others who are doing co-investments. I mean at the end of the day, there are certain things that you can do yourself, and there are certain things that you should farm out.

How many of us in here do our own root canals, you know, you don't do that. You just go to an expert to do it. Even if you are a dentist, you go to somebody else to do your own root canal. In this area, there are certain things that are required that you need to have. Partly, as you look at the infrastructure that you have, first of all, can you source the deals that you want to source. Once you source them, can you really analyze them? Can you go out and make the decision-making. So all of these are required.

Again, I don't want to pick on CalSTRS—I don't work there anymore. But when I was at a public pension fund, that is what we looked at. Do we have the staff to do what we want to do and secondly, does the staff have the knowledge?

The second point will be the decision making—do you have the decision-making? Do you have to go [with] every deal, go to a board, which might take weeks.

And thirdly, at the end of the day, especially now when we read about a lot of public pension funds, there is a lot of scrutiny about travel, about what they can do and what they cannot do. Are they really going to be able to do the right job and in some cases, the answer is yes. But if the answer is no, farm it out. Can you really do the right job? Would you be able to travel within a day's notice to go and do the due diligence? Because these co-investments have a life of their own. If you travel, can you really travel within 24 hours? You are fooling yourself if you think yes I can, but then you have to get approval. A lot of times when you go out and visit different portfolio companies, you might have a private jet. Are you allowed to do that if you are a public pension fund?

We do a lot of investing in the BRIC markets at Siguler Guff, so at the end of the day, can somebody who managing a fund in the US, can they travel within a short period of time to Brazil or to China and do the right amount of due diligence? You really cannot just go overnight, visit, shake hands and fly back say, "Ah, that is a good investment."

So you need to have the right staff, and if you don't, go out and hire someone who does. We have offices in China, we have offices in Brazil, so we can help our LPs who come with us in our fund of funds. We co-invest and a lot of times they come with us because they can see the kind of deals that we are doing.

Video time stamp 16:19

Satyan Malhotra: I think you this when we looked at the Harvard Management Company and there was a whole hue and cry on the incentive structure. And that's the whole point—you're talking about Harvard, which is supposed to be on the forefront of all business decisions. Here we are asking pension funds in the US to approve a budget for a private jet, so it's going to be a little different.

Solomon Owayda: You talked about alignment of interests. At the end of the day, you are not allowed to invest your own money in a deal. When I was at CalSTRS, I was offered to co-invest alongside a transaction, which I thought was great. So I went to get the proper approval, they said, "No, you can't do that!" I think they should have let me,

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because I would have had my own money, I would have been really incentivized to do the right thing. But you cannot do that. So the alignment of interests will not be there, and that is critical when you do those co-investments. The alignment must be there.

Scott Gallin: The last couple of minutes have been framed in the context of a CalPERS or a CalSTRS, but I think it is also important to note that for some, co-investment or aligning themselves with a co-investment manager, is another way to play in private equity, because as co-investors we are standing in a stream where we have deals passing us by. There are deals that should have the same return characteristics as any deal that a GP is doing because of course, by definition, they are being done by the same GPs that are marketing their products to the LP's.

So it is not just a question of the large public pensions needing this as a tool to deploy more capital. It is also a way to, I think, add an additional amount of diversity to one's approach to private equity.

Video time stamp 17:56

Sourcing & Vetting Deal Flow

David Snow: Let's talk about functionally how co-investment works, or rather how all of you have seen it work. So, you are an LP, you are invested in the funds in a series of GPs, and how do the opportunities come to you, and how should you even react when invited to be part of a deal that one of your GPs is doing on a direct basis? Satyan, what are some different ways that process works?

Satyan Malhotra: The way we look at the market is, it really is on a spectrum of takers and seekers. What we call [seekers] are co-investment specialists that are staffed to be able source the right kind of deals, and takers are really the co-investment participants that are taking the excess capacity.

If you are only taking excess capacity, then obviously you have lesser say and a lesser stake in the deal. The thing to be careful about here is that if you try to be on the seeker spectrum, you have to have the rights interests, you have to have the alignment of interests, you have to have the carry to be motivated, and so on. Whereas, if you are in the taker bucket, you probably won't pay for that, but at the same time, there could be a huge amounts of adverse selection.

There could be a large amount of correlation with your core portfolio, because to have a taker mentality means you are not staffed to go beyond the GPs that you have supported. So in the end, I think, you have to find the right balance as to what is the institution's objective and if the institution is willing to farm out and focus on net returns. We would obviously champion the seeker model which we think will add a lot more alpha to the portfolio.

David Snow: Solomon, you mentioned the need to do due diligence. What's wrong with simply saying, well my GP already did due diligence and since I have already given him the ability to invest on my behalf, why do I need to get on a private jet and fly out and kick the tires of some company when someone else is doing it?

Solomon Owayda: Great point, but at the end of the day, you are building a portfolio. So when we do co-investments, in addition to investing at a Siguler Guff, we invest in funds, and then we co-invest alongside these managers. At the end of the day, they are building a portfolio and so are we. Sometimes the risk-return could be different, the duration could be different. So we look at it as, does that meet the risk-return profile that we have.

I'll give an example of a transaction that, if it's the first [co-investment] transaction we want to do, and one of the GPs are showing us a deal, that is a risky investment. It could return 20 or 30 times your money, but there is a big chance that you are losing all of your money, and that is the first deal I want to do, probably I will not do it. But if I have already built a portfolio of 10 or 12 co-investments, and they are all doing extremely well - I have a nice rate

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of returns, three times or four times in some cases—would I throw in yet another investment, a small amount that could have thirty percent, I might consider it.

So what you look at is, one, the risk profile, second is the duration—are we meeting the same time frame that they have, in most instances we are but we might not be in some cases. And thirdly, when I’m building a portfolio, if I have right now five health care transactions and somebody shows me yet another one, I don’t want to be over-allocated to health care, I don’t want to be over allocated to technology, I don’t want to be allocated to certain areas. Same thing when I build a portfolio, if I have, again, I’ll give the example of the BRICs market, if I’ve done four deals in Brazil and another deal is in Brazil I might say, it’s time to do a deal in India or a deal in China. So the building of the portfolio becomes very, very critical when you’re looking at things like that.

Video time stamp 21:37

Michael Kramer: GPs are human. They’re not infallible right?

David Snow: What? You can’t say that!

Michael Kramer: Even a signing pitcher will miss the strike zone. What we find is, that tends to happen when people really... their style starts to drift. They start seeking bigger deals than they’ve done historically, or really more commonly, the types of deals or the types of industries where they haven’t had success in the past. So the fundamental bet that has been made on that GP, the given investment, the given co-investment, is not consistent with their strength and the reason you may have made a GP investment in the first place.

Video time stamp 22:21

David Snow: What are some good reasons to say no to a deal? In most cases, should LPs be saying no?

Scott Gallin: Well again I think there are a couple of points, and I would agree with what Solomon and Michael have already said about reasons why, from a portfolio-construction or a risk-reward analysis, you might say no. Another thing to think about as well is, when you say no, what are the tools you’re employing to say no? If you’re more of the taker, it’s probably very difficult to say no because you could very easily make the argument, “I don’t know as much as the GP who is presenting the opportunity to me.”

By contrast, if you are more of a seeker and looking more actively at deals, the one transaction that GP A is showing you may be less compelling from a return perspective, from a risk perspective, than the three or four other deals you’re looking at. And we all know, everybody, regardless of how you’re staffed, you have finite resources. And so you might have to pick your battles and chose to do work on deal B, C, or D at the expense of A. So a lot of times the reasons for saying no, if you’re the seeker, have nothing to do with the validity or the opportunity that is being presented to you. It’s where you chose to focus your time.

Solomon Owayda: It’s also important, David, in how you say no and how quickly you say no.

Scott Gallin: Yes.

Solomon Owayda: You cannot just string the GPs for a long period of time and then at the eleventh hour say no. And as Scott said, it’s great to say, “I looked at this. I like what your doing. It just does not fit in with what we’re



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trying to do.” They don’t mind it. They mind it if you say yes, yes, yes, and then at the eleventh hour you say no. So it becomes really important, the timing. Because, as you said, you’re working as a team. You’ve heard me say that before, is that you are a partner, as a GP, LP, it’s a partnership, so let’s work together. And in a co-investment you really need to maintain that and accentuate it.

Satyan Malhotra: It also depends on which spectrum you’re dealing with, going back to taker and seeker and when to say no. I think if you’re part of a consortium where the deal is getting syndicated, it’s a lot easier to say no. If you are [part] of the core capital that is going to get the deal, then you might as well move quick and if you’re not going to be involved, you should say it quick. Because otherwise you’re going to string them along and next time they’re not going to be there.

Scott Gallin: And our model of co-investment has always given us the opportunity to be more flexible with what securities we take. And I fully agree—the quick no is one of the most important things you can do. . .

Solomon Owayda: As they say, the second best thing is the quick no.

Scott Gallin: We’ve said on occasion “We don’t really love the equity.” This discussion, so far, has been framed as co-investment being equity. We’ve said “We don’t like the equity but if you need somebody to provide you capital that’s maybe more senior, for example mezzanine, that we would love to take a look at and we can very much be a good partner at that tranche.” And so the no doesn’t have to be no investment, it could be, no to what your saying, but I’d love to help you somewhere else in the capital structure.

Video time stamp 25:13

David Snow: I’m interested in learning a bit more about where the deal flow comes from. Is there a trend that you’ve seen in the reasons why a GP might make a certain opportunity available for co-investment, and are they often good reasons?

Solomon Owayda: I’m not going to use the word “relationship”—it has been used and abused. But I think building a good rapport with the GP makes a huge difference. Knowing from the beginning when you talk to a general partner that I’m trying to build a co-investment program, I have the investment in a fund, and also I’d like to find these deals within certain criteria. So that rapport that is built or that relationship that’s built with the GP, now you all of a sudden get to see more deals coming through.

Most of the deals that we do are with GPs that we are already invested with. Or—and I use that word “or” in here because a lot of the time we use co-investments to see [if we] should put money with the GP the next time around. We like the way they do due diligence. We like the way they source deals. We like the way we think they’re going to add value so on and so forth. Then we see that’s a good GP we’re going to put money in the future.

So all of a sudden you’re building those GP-LP relationships—they know that you are going to act quickly. You know that you are going to say yes or no, and for good reasons and also quickly. Then amazingly, the deal flow starts coming in. And the deal doesn’t also come because. . . they don’t have enough money coming in. A lot of times, they seek us because they believe we also add value. And let’s not fool ourselves, they hope we’re going to invest in their fund the next time around, it’s not just the good looks. So... why are you laughing?

David Snow: We’re going to edit that out.

Solomon Owayda: No we’re not!

Video time stamp 26:59

David Snow: Any other thoughts on reasons why co-investment opportunities come about, other than not having enough money and needing to go pass the hat?

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Satyan Malhotra: I think it's also teasers. To be honest with you, one of the things that we did see on the secondary market also was stapled transactions. We see a lot of this because we have both a fund of fund business as well as a co-investment dedicated fund. And a lot of times GPs know that we don't them and that they are new commodity, at least, for our book. One of the best ways for us to get to know them and underwrite them, similar to what you are saying, is to participate in some sort of a silver of a co-investment up front. Now, we have to be very careful here because you don't want the two different portfolios to be driven by any adverse selection. So you are not saying or promising anything, but it does give you a seat at the table, which is different from having good looks or relationship or whatever you are talking about.

Michael Kramer: I think another thing that has been driving some of the deal flow—club deals used to be very, very popular. I think those have fallen out of favor both among limited partners, where they would get exposure across multiple funds, and general partners. Club deals are great when everything is going well. As soon as there is a little hiccup, you have four bosses at the table and it's very difficult to move as nimbly, and exert the control that they need to really move the company forward. Co-investors are a great way to sort of fill that void where you can come in, and fill a significant amount of capital in the transaction, but where there will be a clear lead, and you can see those controlling governance elements as opposed to having multiple people, sort of at each other.

Solomon Owayda: One thing that I have seen, David, and I'm not sure if others have seen it or not, is... now with fundraising, especially in the last two years, being difficult, many GPs were running out of money, and they do not want to put the last X million in one or two transactions. So they are putting in less equity, and they are coming to us as an LP. We have a small buyout fund, and we see that. They are showing us more transactions until they raise the next fund or they have a first close on the next fund. So we become a great LP to them, where we can bridge that extra equity that they need rather than syndicating that deal with some of their competitors. And knowing that when we give them that equity, the chances are extremely high that we are going to invest in their next fund.

Michael Kramer: Another type of deal that we are seeing, a fair amount of post-investment, co-investment opportunities either where there is follow-on acquisition that is very creative, but the sponsor may not have the adequate amount of money, may be past their investment period, we have done those types of deals. Similarly, we have participated in balance sheet restructurings, coming in and pricing equity in a follow-on with a sponsor that still wants to retain control, but can't put all the capital, or needs the capital to be priced. I think that's an area where we as dedicated co-investors can really distinguish themselves, you know, a willingness to go to a non-traditional opportunistic situation, maybe play more of a role in valuing the transaction. And as always, you can't string people along, give them a no at the end of the day, but you also have to be able to get to a fast yes so you have to have the right people to be able to do that efficiently and thoroughly.

Video time stamp 30:41

Co-Investing & Fees

David Snow: Let's talk about one of the core reasons that one often hears that LPs want to co-invest, and that is, they believe that they will be reducing fees that they will pay into their private capital program. So let's kind of dig into that—how should a LP evaluate the amount by which their fees will be reduced? And at what point do they say, gee it's just not worth it, or at what point do they say, wow, we are really getting a good deal here, we should really spend the resources and brain damage necessary to set up a co-investment program?

Solomon Owayda: We are a fund of funds. So at the end of the day, we are offering our investors in our fund of funds or in our separate accounts that we're going to invest in funds and we're also going to invest in co-investments. I would say in, if not in 100 percent, then in 99 percent of the transactions that we have done, we do not pay any fee

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or carry. So just a matter of mathematics—you say I've done so much in co-invest, so much in direct, I'm paying so much for the GPs, and I am paying zero for that, so my amalgamated cost is Y.

At a general LP, when they want to analyze should they co-invest or not; it will be what we were talking about before—what are the extra fees that they are paying? Even though they are getting that co-investment free of fee and carry, are they paying extra money for legal? Are they paying extra money for due diligence, are they paying extra money for travel, are they paying more money for sourcing, did they have to pay a brokerage fee, etc, etc. You add up all these fees, and you say, if I have to pay all these fees, would they make sense or not.

So to us at Siguler Guff, it makes sense all the time, almost always. For others, they need to analyze what are the incremental costs that are coming along, and do they outweigh the benefits that we are trying to get in savings of fees.

Video time stamp 32:35

Scott Gallin: I think the other key point that Satyan made before is that nobody likes to waste money, so saving money is always an interesting thought, but what is more important is, quite frankly, does the deal make sense? Is the deal a good use of the capital that you have to deploy, and so saying, “I want to do co-investment to reduce my fees,” is an incomplete analysis, and you really have to think about, is this a good place to deploy the capital, and if it's not, it doesn't matter how much you are averaging down your cost of an affiliation with a particular GP. It should be all about risk-adjusted returns and is this the best place, given the other opportunities that I have as a portfolio manager, to deploy capital?



David Snow: Satyan, what are the right kinds of fees to pay, how should LPs think about paying a fee—an incentive fee, for example—to get involved in a co-investment situation? At what point should they say, that is not appropriate for the opportunity you are offering me?

Satyan Malhotra: Well, I think, first of all, if your mandate is to get yield, to get rate of return, then you should be open to all ideas. I mean, that is at least our starting point. Then you have to look at the mandate. For example, I guess in Solomon's case, if a co-investment program is part of a fund of fund program, so when he goes into a GP-LP relationship with the un-

derlying fund, the funds knows that he is not comfortable paying a promote. Whereas, if it's a non-LP in a current fund, maybe the LP is a little more open.

We see a lot of transactions from fundless sponsors; these are, you know, old GPs that have left their firms or are in between firms, or frankly, it's a great business model for them because there is no clawback, there is no make-whole clause so they can go around doing one or two discrete deals a year, and be very happy. We tend to stay away from them. I think, in the end, the reason we stay away from them is because we always find that there is a governance issue there. Not necessarily because a deal might not make sense, because at the end of the day, you also want to be able to control the deal, because as they say, when a deal goes sideways or down, that is when all the issues are going to come up, and that is when the governance and the right protocols come into play.

So for us, the starting point is, we look at all deals, but realistically, it has to be, where is it coming from, what is their alignment and how are they motivated, and how are they governed? That is what is going to drive this relationship over seven to ten years.

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Mike Kramer: Yes, it is all about alignment. We always look through the structure to make sure that the returns that the underlying general partner is getting is no disproportionate to what we would be getting such that the risk-reward trade-off is so different that the total characteristics of the investment are different for us and them.

Video time stamp 35:20

Satyan Malhotra: I'll give you an example. We are always focused on what the particular fee is called. For example, you wouldn't like to pay maybe carry, or you may want to pay it depending on what the hurdles are. Or you don't want to pay management fees. But if you analyze a lot of these transactions, a large chunk of the change is spent on transaction fees. And if you are part of the fund, and you have an agreement with the underlying fund between the GP that they'll give a lot of those transaction fees back, well, that's all well and good, but if you are a co-investor, now that's a different equation for you, because you may not participate or may not benefit in that through the fund structure. So we actually spend a lot of time on transaction fees, and seeing [if] its disproportionate to the underlying deal size, the transaction size, the enterprise value and so on, and have in some cases, been successful to negotiate them down.

David Snow: So the most important thing is to lower your fees so that you can get a private jet? Is that the correct analysis?

Video time stamp 36:20

'The Canadian Model'

David Snow: Let's talk about the direction of the private equity asset class and how co-investment is really changing the game in some parts of the world, starting in Canada. It seems like there are very large institutions in Canada that have, within their private equity programs, become substantially direct investors, having started out as investors primarily backing funds.

So I'm wondering—Scott maybe you can start, do you see I guess what you might call the Canadian model, as spreading throughout the rest of the world. As a starting point, perhaps, for some very large organizations around the world that like private equity, want to get involved, but say you know what, before we get too much down the road with this asset class, we want to make sure that we have a substantial co-investment program.

Scott Gallin: My sense of that model is, it was pretty popular and seemed to be becoming more and more in vogue, through 05, 06, 07, and then it stopped when everything else stopped in 2008. I haven't heard as much these days about new entrants to that market, and I think there are a number of reasons why, not the least of which, require a full analysis and the behavioral finance world of why people have backed away from this asset class.

I think what has to be said is, if you are going to go down that path, you have to staff properly, which may not work, given who your underlying client is. The compensation that is required to get the best talent just may not be acceptable to your stakeholders.

I would also say that from a supply-demand perspective, adding an incremental buyer into the mix when the PPMs go around and people are looking for a transaction to get done—I don't think that makes a big difference, and so my feeling, is generally, that co-investing, and as I said before, standing in the middle of the stream, looking for the best opportunities, still represents a pretty nice way to build one's private equity portfolio. Again, if you want to go direct, that is your prerogative. I would just say that one has to make sure that you build the right team because you can't do this without three or four people.

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Video time stamp 38:25

Solomon Owayda: David, let's take a step backwards about, what are we investing in here with private equity, why the name is private equity—you are investing in things that are not public. You are not investing in equities that are publically traded or in fixed income that is publicly traded—you are investing in private companies. So... at the end of the day, that is our goal, invest in private companies. So if you have the infrastructure to go and find these deals, these companies, and have the staff, as you said Scott, to analyze it—first of all, to source it, to analyze and say, does makes sense or not, and then close it, and have that legal and accounting infrastructure to do that, then you should do it on your own.

If you do not have that, then you use the GP as a conduit. You say, “I do not have the staff to do this, so I'm using you, the GP, so that you can find the deals for me, and then show me the co-investment as we go forward.”

Once you decide to go with a co-investment, you really need to make sure that you are properly staffed, and there is an alignment of interests, because without that, it might not be a very successful program. Canada has been extremely successful in staffing properly. To a certain extent, they have been enabled to compensate the team properly. I'm not sure if it is the right number or not; that is very subjective. You ask the staff, they might say no. You ask the board, they say, oh yeah, way overboard. That I think is better than what you see in the US. And then they have the flexibility of decision-making, and the flexibility of travel to go and analyze the transaction. That is a great start.

Video time stamp 39:56

Scott Gallin: David, I would also add the Canadian model has I think been successful, but what's interesting is that most of those players are targeting the larger deals because quite frankly, they have a large amount of money they need to deploy. We have used a word earlier—adverse selection. There are times when the big buyouts make a lot of sense, and there are times where that is the last place you want to be. And so it's not only about staffing, it goes back to, what is your strategy, and what are you trying to accomplish? If you have a belief that the large-cap buyout is the place to go, you can build a successful business. We have seen some folks in Canada do that. It is probably a lot harder to deploy the amount of money you have set as a target if you are trying to do it in the middle-market because you are have to do an exponentially higher number of deals.

Solomon Owayda: There are fixed costs involved. You have to pay the lawyers almost the same amount of money if it is a small deal or a large deal.

Video time stamp 40:49

The GP Role In The Long Term

David Snow: I think it is agreed that if you are going to build a co-investment team, and start a co-investment function, it needs to be well resourced, you need to be a real investor. But given that, Satyan, do you think that going forward, just the role, the understanding of what a GP does, and how a GP fits into the overall goals of an institutional investor, is changing, that people will see a GP more as a starting point or as a partner to do a variety of things, as opposed to simply being blind-pool fund manger?

Satyan Malhotra: If you look at what the GP's role is, it's more than just sourcing a deal. If you were to look at investments, we are focused in this discussion primarily on the investment period. What about the exit? What about the whole management of the company? So yes, I look at the Canada model. They are doing a lot of these investments; it's mainly large deals because they're partnering with somebody and that person is bringing the expertise to the table. At the end of the day, once you've made the investment, you have to run the company for six to seven years, have the right operating bench strength, and find an exit.

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So if they are willing to staff up on that area also, I think, honestly, once they build their track record, they will become a GP themselves because it's a pretty lucrative model. I think that part of the model, it's difficult to see it evolving drastically because you are going to need GP relationships at the end of the day. Structurally though, some of the agreements and constructs are going to change as we are seeing them right now. We've got a lot of the large pension funds taking a direct ownership interest in the underlying large GPs. Some of it for short-term gain purposes where they're going public. But some of them for deal-flow purposes.

We're actually also seeing, in the VC world, new constructs are coming up where it's a series based model. You've got a different series for each investment they make. They don't charge any management fees, and they are basically only compensated on carry. So I think it's correct to say that over time we're going to see some evolution in terms of the relationship between the GP and LP, especially because capital is scarce, at least currently. But a drastic evolution of the relationship, that would be questionable.

Video time stamp 42:58

Solomon Owayda: David, I'm going to say something controversial, and you know I always do that.

David Snow: Please. Bring it on.

Solomon Owayda: There is a misalignment of interest between what a lot of times the GP's doing and the limited partner, especially the very large pension funds, whether they are US or Canadian. And this is the exit that you were talking about. There's no need for a pension fund to exit, especially if the transaction is doing well. A GP must exit because that's how they make their carry and they can go out and raise another pool of capital. So maybe, and you've heard it here first, there's room for something different, which is, especially for public pension funds that really do not need to sell—they are really investing for their pensioners who are going to retire in maybe twenty, thirty years—could there be some sort of permanent capital where rather than buying a company, selling it in five years by another GP to be sold by another GP, to be that money sitting at a public pension fund and they can hold it for the next twenty or thirty years. I'm going to call that the Berkshire Hathaway model. What's wrong with having somebody to do it? And if somebody takes this idea, we need to give credit to David.

David Snow: Sure, I'll take a placement fee. Thank you.

Video time stamp 44:10

Michael Kramer: I think there are certainly merits to that, but when you do back a GP, you're sort of betting on three things. One, that they can pick a good deal... that they can manage the company well. They are good buyers and then they're also good sellers. Ideally, you want to have both. Holding onto a portfolio company indefinitely in the Berkshire model may work for certain investments, but some sponsors are very good sellers. They know how to hit that window and others will try and milk it for the extra dollar at the end of the day, and it may not be the best decision. When you're working with a sponsor, particularly when you're working in a co-investor capacity, when you don't have the ability to influence exit timing, I think you'll want to make sure that you understand the incentives that the general partner has and you also want to know that they're a good seller, they have a good sense of timing.

Video time stamp 45:06

Scott Gallin: I think, David, above all else—and... your idea is very, very intriguing to me - but if you're going to do this, if you're going to be part of that group that thinks they'll evolve more into the Canadian model, you have to be committed to it for the long term. Because we've talked about relationships for sourcing, keeping the right talent. If three or four or five years in, the economy changes or the winds change with your stakeholders and you

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exit, all of the credibility, all of the goodwill, all of the human capital that you have developed will be gone within twelve months and then you'll see really bad returns. So if you're going to do it, my advice would be to know that it's a twenty- to thirty-year bet.

Satyan Malhotra: I mean the long-term model, to be honest, you're seeing that in the infrastructure play because there, they do realize that it's more of a cutting-coupon cash flow rather than monetizing through an exit. So there the GP is partnering with a large endowment or a pension fund, with a view that they're going to hold the asset for a longer duration. So I think, it depends on what the underlying objective of the institution is. And Canadians, especially as you know, are very active in going after the infrastructure component.

David Snow: In fact, I think your idea—the giant pool of permanent capital—there's an OMERS-managed giant fund for infrastructure.

Video time stamp 46:26

Solomon Owayda: And by the way, infrastructure's a great example but it also works for private companies. When a mattress company is sold five times and the last time around goes belly up, if it was not over-leveraged, it would not have gone belly up. As they say, if a company does not have leverage, it would never go bankrupt. So every time you're selling it, there's carried interest taken, there's fees due to the bankers, more fees to the debt holders, etc, etc. So those fees are eating away from the equity, so that's what I mean by permanent capital that's just holding it for a longer period of time, especially if it's a company that makes a lot of sense.



Scott Gallin: Yes, it's eliminating the deadweight costs.

David Snow: So you're proposing a permanent capital mattress fund? Is that what you're saying?

Satyan Mahler: It's called "Stick The Money in Your Mattress Fund."

Solomon Owayda: I like that—we're up to something here David.

Video time stamp 47:17

The GP-LP Pendulum of Power

David Snow: Is it overly simplistic to say that as the pendulum of power swings back towards the LPs, there tends to be more co-investment opportunities. And as it swings back to the GPs, there tends to be less. Or is it not quite that straightforward?

Mike Kramer: I don't think it's that straightforward. Private equity is a cyclical industry. I think we have to preface that and recognize that it is going to swing and the balance of power between the LPs and GPs is going to vary as the cycles vary. Even though balance of powers implies a bit of an adversarial relationship, where you should really be thinking more in the context of a partnership.

I think broadly speaking, coming out of the financial crisis people were looking for really two things: liquidity, which they couldn't get, and information, which they could get. So one of the benefits of that period was greater communication, greater transparency, greater information flow and I think that's a secular change. I think that's

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also driven by, you see more and more of these entities, particularly the larger ones, going public. I think it's fair to say that in up-cycles, it may be harder to get co-investment flow but what that will really do is separate the wheat from the chaff. It's really the marginal players that will get shaken out during those periods and as long as you're committed and dedicated and professional, over the course of the cycles, you'll be rewarded for that.

Solomon Owayda: I agree. It's not a method of cycles because the co-investment comes for various reasons. You see the shift happening when the syndicated deals stop being syndicated as much and being offered to LPs when LPs are saying show me more deals. So I'm not sure if it's a relationship of the pendulum of power.

Satyan Malhotra: I'll give you an interesting example. We've looked at a large GP and we've looked at the transactions they've done since the year 2000, so you've got almost eleven years of data here. Almost 60 percent of the transactions were less than 50 percent equity. Now this is not a thing that happened since 2007 onwards, this is something that's been happening for a while because I think GPs are also getting smart. At the end of the day, if you have to diversify your portfolio and do the right kind of trades and you can put on some sort of leverage if it's available, you would take on more transactions.*

David Snow: I'd like to thank the four of you for bringing greater transparency to the private equity industry. This is a big topic. It's fascinating but I think we can pause for now and hopefully we will be returning to the subject of co-investment and of course the overlap between the interests of the GP and LP going forward. And when Privcap does that, I hope that I can invite you all back to the table and we can have another conversation.

So thanks to all of you and thank you for watching. See you next time.

* Caspian has analyzed multiple GP portfolios and transactions. For example, over the last decade, in 60 percent of the transactions of a larger GP's portfolio, the share of the equity contribution by the GP was less than 50 percent of the total equity contribution. So, in effect, even the larger GPs are co-investors.

Excellence in Co-Investment: Research Brief / Caspian Private Equity’s ‘Seekers vs. Takers’

New York-based Caspian Private Equity manages funds of funds as well as direct-investment portfolios. The firm’s president, Satyan Malhotra, was a participant in the Privcap video program, “Excellence in Co-Investment.”

Below is some data from Caspian that supports Malhotra’s view that, in the co-investment strategy, it may be better to be a “seeker” of direct investment opportunities than a “taker.”

The Taker-Seeker Spectrum

An institutional investor that “takes” most deals offered by its GPs can find itself getting the same, or worse, returns but with an elevated risk. The graphic below shows the tough choices investors must make when determining the best model for co-investment.



Excellence in Co-Investment: Research Brief / Caspian Private Equity's 'Seekers vs. Takers'

Piggybacking: Not the Key to Outperformance

Performance information from three anonymized large-funds shows which deals were offered to LPs as co-investments, and how those co-investments performed relative to the overall fund. If an LP in these funds were to participate in every co-investment offered, the results would have dragged down, or at least not helped the overall gross investment performance with that GP.

Fund Performances vs. Co-Investment Performances				
Fund		Co-Investments		
Fund	ROI	Investments	ROI	%Par+
A	1.72x	6	1.37x	83.3%
B	1.01x	6	1.03x	50.0%
C	1.61x	7	1.19x	57.1%

As of December 31, 2010

Some additional notes to the charts above

- Results show that simple dartboard investing will not produce alpha
e.g., \$1 allocation across few or all does not improve returns but introduces volatility/uncertainty
- Deal selection and sizing is key to producing alpha
- Not all opportunities are shown to all investors
- Some large GPs have started introducing fees/promote.
This is above the transaction costs they already charge portfolio companies.

Excellence in Co-Investment: Research Brief / Caspian Private Equity's 'Seekers vs. Takers'

Gatekeeper Outsourcing: Generally Leads to Taking Excess Capacity

A sampling of co-investment portfolios shows a heavy skew toward large deals

Co-Investment Fund I - Summary Information		
	Deals	Co-Investments
	%	%
Mega-Large	71.4%	75.3%
Small-Mid	28.6%	24.7%
Total	100.0%	100.0%

Co-Investment Fund II - Summary Information		
	Deals	Co-Investments
	%	%
Mega-Large	73.3%	83.0%
Small-Mid	26.7%	17.0%
Total	100.0%	100.0%

The above information for Funds I and II is as of Q3 2010. Additional information available upon request.

Co-Investment Fund III - Summary Information		
	Deals	Co-Investments
	%	%
Mega-Large	63.6%	75.3%
Small-Mid	22.7%	17.9%
Growth/Other	13.6%	6.8%
Total	100.0%	100.0%

Additional information available upon request.

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About Privcap

Investors in the private-capital asset classes have a new source for market intelligence, commentary and best practices: Privcap.com.

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Privcap also offers audio podcasts and articles providing valuable context for anyone with an interest in the private capital industry. The site is free but requires a quick registration.

This document brings together all the supporting content attached to this Privcap video program. You may watch the program in its entirety and access all of the content herein at **www.privcap.com**

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