Important Information about Private Equity Funds

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We have prepared this document to help you understand the characteristics and risks associated with investing in private equity funds to assist you in making a more informed decision when buying or selling these securities. This document is compiled for your information and is intended to be a conversation starter between you and your Baird Financial Advisor or other appropriate experts, such as your tax or legal advisors. Your Baird Financial Advisor is available to address your questions and discuss the features, characteristics, costs, and risks of any particular investment. Investing in private equity funds can be speculative and involve significant risks. As a result, private equity investments may not be suitable for all clients.

Characteristics of Private Equity Funds

Private equity funds are pools of actively-managed capital that invest primarily in private companies with the intent of creating value in the companies in which they invest by improving operations, reducing costs, selling non-core assets and maximizing cash flow. Through a private equity fund, investors combine or pool their capital that enables the manager of the fund to make investments in various companies.

Private equity funds are typically structured as limited partnerships or limited liability companies that are professionally managed by a general partner who sources and vets potential investments and has the discretion to make investments for the fund. Private equity funds usually have an investment objective or strategy that may focus on companies in certain sectors, industries, geographic regions, size ranges or stages of development or operations, or on certain types and sizes of investments. Private equity funds may focus on making venture capital investments in early stage companies, investments in growth equity in more established companies, leveraged buyouts and change of control transactions, or investments in distressed companies and turnaround or special situations. Although private equity connotes equity investing which offers funds a significant upside potential, private equity funds may also provide debt financing, including senior, mezzanine, subordinated or convertible debt. Many private equity funds provide operational and other assistance to their portfolio companies.

Unlike mutual funds, private equity funds are generally exempt from registration as investment companies under the Investment Company Act of 1940, although some private equity funds may be so registered. In addition, interests in private equity funds are commonly issued in private placements rather than in public offerings so as to avoid registration under the Securities Act of 1933. In order to rely on such exemptions, private equity funds often limit the number and type of persons that may invest in them. Most private equity funds are only available to persons or entities who meet certain qualification and minimum investment requirements. Often, only high net worth persons and institutional investors are eligible to invest. Limited partner or other equity interests in a private equity fund are not listed on an exchange or otherwise transferable. In limited circumstances, some private equity funds will repurchase interests from investors, but an investment in a private equity fund should be regarded as illiquid.

Some private equity funds are structured as funds of private equity funds. These funds of private equity funds are often more widely distributed and, as a result, are registered as investment companies. A fund of private equity funds invests in other private equity funds with different strategies rather than investing directly in individual companies but may also make co-investments in portfolio companies and investments in listed private equity firms.

Private equity funds raise capital by selling limited partner interests to investors. Often the investors make an initial capital commitment and then contribute capital when called by the general partner when an investment is identified. The typical capital commitment period during which the general partner may issue a capital call may last for eight to ten years or perhaps longer. A private equity fund may have a life beyond that. Private equity funds make investments in various companies with the goal of selling or otherwise exiting a company at a profit after a period of time. The proceeds from the exit are distributed to the limited partners. The general partner may also receive a portion of the proceeds as its carried interest after the limited partners have realized a certain rate of return. The general partner also receives an ongoing management fee and transaction fees. Often the fees paid by the private fund to its general partner include a management fee (often ranging from 1% to 2.5%) and a carried interest entitling the general partner to a percentage of the distributions made to the limited

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partners (often ranging from 15% to 30%) usually after the limited partners have received a threshold preferred return on their capital (often ranging from 6% to 10%). The general partner may also receive fees associated with each transaction involving a portfolio company. Funds of private equity funds typically charge an ongoing management fee plus the managers of those funds of funds may receive a performance allocation (often ranging from 5% to 10%). These management fees and performance allocations are in addition to the management fees and carried interest that the underlying private equity funds charge, so with a fund of private equity funds investors essentially are charged two layers of fees. Investors in a fund of private equity fund make their initial investment and are not usually required to make future capital contributions.

In connection with a private equity fund or fund of private equity funds, potential investors receive a Private Placement Memorandum ("PPM"). The PPM discloses material information about the offering such as strategy, terms and risks to allow investors to make an informed decision. If the investor decides to become a limited partner, the investor will be responsible for completing and signing a subscription booklet, which assists the manager of the fund in determining whether the investor is eligible to invest in the fund. The investor will also be required to sign the fund's partnership or LLC operating agreement. The partnership or operating agreement sets forth the terms of the investment, the fees charged and the rights and requirements of the limited partners, among other provisions.

Common Terminology for Private Equity Funds

- **Capital Commitments.** The amount of capital that each limited partner agrees to contribute to the fund when and as requested by the general partner. Most private equity funds impose a minimum subscription amount or capital commitment threshold in order to become a limited partner.

- **Capital Contributions.** The amount of capital that is contributed to the fund when and as requested by the general partner in connection with investments to be made by the fund.

- **Investment Period.** The period during which the general partner is permitted to make new investments on behalf of the private equity fund in portfolio companies. Subsequent to the termination of such period, the limited partners typically are released from further obligations with respect to their unfunded capital commitments, except necessary to cover expenses, liabilities and obligations of the fund, including management fees; fund then existing commitments and complete investment by the fund in transactions that were in process as of the end of the investment period; and effect follow-on investments in existing portfolio companies.

- **Fees.** May include start-up or organizational costs, placement fees, servicing fees, management fees, carried interest, and transaction fees. Fund of private equity funds may also be charged fees by the underlying private equity funds in which they invest.

- **Carried Interest.** Sometimes called a performance allocation or incentive fee, it is a share of the profits from a private equity fund's investment that is paid to the general partner as a performance incentive. The performance incentive is typically not paid until the limited partners realize a threshold rate of return. The remaining profits are paid to the fund's investors.

- **Hurdle Rate or Preferred Return.** A minimum rate of return which must be achieved by the limited partners before the general partner can receive its carried interest.

- **J Curve.** Refers to a diagram where a curve initially falls, but then rises to higher than the starting point. It is used to illustrate the historical tendency of private equity funds to experience capital outflows and negative returns in early years and cash flow distributions and investment gains in future years as its portfolio companies mature.

- **Internal Rate of Return.** The rate of return commonly used by private equity funds to measure their performance. Specifically, it is the discount rate at which the net present value of costs (or capital contributions) equals the net present value of the benefits (or distributions) of the investments.

- **Portfolio Company**. A company in which the private equity fund invests.

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- **Term.** The life or duration of the private equity fund. The term of a private equity fund is often 10 to 12 years with potential extensions of a few additional years.

Understanding the Risks

Risk is inherent in any investment product or strategy. Certain of the common risks and other important considerations associated with investment in private equity funds are highlighted below. These and other risks are disclosed in the applicable PPM for the fund in which you may be considering. You are strongly encouraged to review the prospectuses or other disclosure documents associated with any product for a more fulsome discussion of additional risks and other important considerations before making any invest decision. Additional information regarding investment risks generally and other important consideration is also available at www.bairdwealth.com/retailinvestor.

- **Substantial Commitment Requirements.** Most private equity funds require a significant commitment which can be drawn at the general partner's discretion as provided in the limited partnership agreement. Investors should therefore be prepared to have sufficient funds available to meet those capital calls, which can be significant in size and frequency during the initial years of the fund.

- **Lack of Liquidity.** Investments in private equity funds should be regarded as illiquid. They are not listed on an exchange, traded in the secondary market and are generally not transferable. In addition, investors should not expect to receive distributions from a private equity fund for a number of years because distributions are typically made when the fund exits a portfolio company.

- **Fees.** There are potentially significant fees that investors in private equity funds bear. These fees include start-up or organizational costs, placement fees, management fees, administrative service fees, portfolio company transaction fees, and the carried interest (or performance allocation or incentive fee).

- **No Control Over Investments or Governance.** Private equity funds are regarded as blind pools. Investors may understand the types of companies and investments that a private equity fund proposes to make but do not know the specific investments it will make. In addition, investors in private equity funds are passive and rely on the general partner to make investments and exit those investments. Investors do not have a say in what investments are made and when they are sold. Typically, the governance rights for limited partners in private equity funds are minimal, making it very difficult to replace the general partner.

- **Investment Risks.** Given the risks associated with private equity investments, an investor can lose all of his or her investment. Private equity investing is very risky. Many investments made by a private equity fund in portfolio companies are not profitable; however, a few can be very profitable. The risk of loss is generally higher in venture capital funds, which invest in companies during the earliest phases of their development or in companies with high amounts of financial leverage. By their nature, investments in privately held companies tend to be riskier than investments in publicly traded companies. Generally, there will be no readily available market for a substantial number of a private equity fund's investments, and hence, most of the fund's investments will be difficult to value and to exit. Some private equity funds may not be diversified by sector, industry or geography, and may be concentrated in relatively few portfolio companies. Moreover, because the general partner will generally have a potentially significant carried interest or performance allocation that is triggered after the limited partners earn a hurdle rate of return, the general partner may be inclined to take greater risks in order to earn the carried interest or performance allocation.

- **Leverage**. Private equity funds may make use of leverage by incurring or having a portfolio company incur debt to finance a portion of the fund's investment in a given portfolio company. Leverage generally magnifies both a private equity fund's opportunities for gain and its risk of loss from a particular investment. The use of leverage will also result in interest expense and other costs to the private equity fund that may not be covered by distributions made to the fund or appreciation of its investments. Leverage often imposes restrictive financial and operating covenants on a company, in addition to the

burden of debt service, and may impair its ability to finance future operations and capital needs. The leveraged capital structure of portfolio companies will increase the exposure of a private equity fund's investments to any deterioration in a company's condition or industry, competitive pressures, an adverse economic environment or rising interest rates and could accelerate and magnify declines in the value of the fund's investments in the leveraged portfolio companies in a down market. In the event any portfolio company cannot generate adequate cash flow to meet debt service, a private equity fund may suffer a partial or total loss of capital invested in the portfolio company, which could adversely affect the returns of the fund. Moreover, the companies in which a private equity fund will invest generally will not be rated by a credit rating agency.

- **Dependence on Key Personnel.** The success of any private equity fund is highly dependent on the general partner and its management team who are valuable in identifying, vetting and structuring investments, improving the performance of portfolio companies and determining the appropriate time to sell those investments. The loss of one or more key individuals may have a material adverse effect on the performance of the fund.

- **Conflicts of Interest.** There may be conflicts of interest between the general partner and investors. The general partner may make riskier investments than would otherwise be appropriate in order to generate high returns and earn its carried interest. The general partner or its affiliates may have other funds that compete for similar investments as the private equity fund in which you invest and may create other such funds. Allocations of investment opportunities between the private equity fund and other funds managed by the general partner or its affiliates are made in the sole discretion of the general partner and its affiliates. Managing multiple funds may make it difficult for the general partner to devote its full time and attention to managing the private equity fund in which you invest. Additionally, the general partner or its affiliates may make co-investments or side-by-side investments with the private equity fund. The general partner may also cause the private equity fund to invest in a portfolio company in which the general partner or its affiliates may have an investment or cause a portfolio company to enter into a transaction with another company in which the general partner or its affiliates may have an investment.

- **Limited Information.** Private equity funds often do not provide much information about their investments and the performance of their portfolio companies, other than annual or semi-annual financial statements, an annual Schedule K-1, and possibly quarterly reports.

- **Lack of Regulation.** A private equity fund is typically not registered as an investment company under the Investment Company Act of 1940 and the general partner may not be registered as an investment adviser under the Investment Advisers Act of 1940. Moreover, an offering of interests in a private equity fund is not registered under the Securities Act of 1933. Accordingly, private equity funds are generally not subject to much regulation and investors may not have the protections afforded by such laws.

- **Tax Considerations.** Private equity funds are usually taxed as partnerships and investors will receive an annual Schedule K-1 showing their pro rata share of the fund's gains, losses, income, credits and distributions. An investment in a private equity fund will complicate an investor's tax return and increase tax preparation costs. Please consult your tax advisor before investing in a private equity fund.

Understanding the Risks Specific to a Fund of Private Equity Funds

In addition to the risks associated with investing in a private equity fund, as described above, an investment in a fund of private equity funds involves further risks, including the following:

- **Investments in Underlying Funds.** Because a fund of private equity funds invests in underlying private equity funds, the performance of the fund of funds is dependent on the performance of the underlying funds in which the fund of funds invests, and the investment decisions made by the managers of those underlying funds over which the general partner of the fund of funds has little control. Some of the underlying funds may compete with each other for investment

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opportunities and may have overlapping or economically offsetting investments. It is likely that the underlying private equity funds in which the fund of funds invests will not be regulated as investment companies. Moreover, the interests in the underlying private equity funds will be illiquid. The general partner of the fund of funds will rely on valuations provided to it by the managers of the underlying private equity funds. Such valuations are inherently subjective.

- **Multiple Layers of Fees.** Investors in a fund of private equity funds will bear directly the various fees and expenses of the fund of funds, and the general partner of the fund of funds may receive a carried interest. Additionally, investors in the fund of private equity funds will bear indirectly the various fees and expenses of the underlying private equity funds in which the fund of funds invests, and the manager of the underlying private equity funds may receive a carried interest. This will result in higher fees and expenses than those applicable to an investment in a private equity fund.

- **Uninvested Capital.** At times a fund of private equity funds may not be able to make investments in underlying private equity funds and may have relatively large cash positions that are invested in money market and other short-term instruments.

More Information

Before investing in a private equity fund or a fund of private equity funds, you should discuss the merits and risks of the investment with your Baird Financial Advisor to make sure it is consistent with your investment objectives, financial needs, liquidity expectations and risk profile.

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