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# LPE Focus

## Extract from Issue Five



- This interview with Brooks Zug, senior managing director and a founder of HarbourVest Partners, is an extract from LPE Focus Issue Five which was published on 16 June 2010.

### Analysts

**Louisa Symington-Mills**  
United Kingdom  
+44 20 7678 1670  
louisa.symington-mills@rbs.com

**Mark James**  
United Kingdom  
+44 20 7678 7433  
mark.e.james@rbs.com

250 Bishopsgate, London, EC2M 4AA,  
United Kingdom

<http://www.abnamroresearch.com>

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**In this section, we interview Brooks Zug, co-founder of HarbourVest Partners, in which we discuss current regulatory reforms affecting private equity, the outlook for the private equity fund of funds industry and the listed fund HarbourVest Global Private Equity Ltd.**



### **Biography**

Brooks Zug is a senior managing director of HarbourVest Partners, LLC and a founder of the firm. He is responsible for overseeing primary, secondary and direct investments. He joined the corporate finance department of John Hancock in 1977, and, in 1982, co-founded Hancock Venture Partners, which later became HarbourVest Partners. He serves as an advisory committee member for a number of US and European private equity partnerships, including funds managed by Accel Partners, Advent International, Doughty Hanson, Permira, Silver Lake Partners, and TA Associates. Brooks is also a director of HarbourVest Global Private Equity Limited. Brooks is a past trustee of Lehigh University and a current overseer of the Boston Symphony Orchestra. He received a BS from Lehigh University in 1967 and an MBA from Harvard Business School in 1970. Brooks received the Chartered Financial Analyst designation in 1977.

**Brooks, thank you agreeing to be interviewed today. Perhaps you could start by giving a brief update on HarbourVest?**

You're welcome, and I would be happy to provide a quick update. As you know, HarbourVest has been around for nearly 30 years, and today we have more than 230 employees located in Boston, London and Hong Kong. Our London subsidiary will celebrate its 20th anniversary in the autumn. We continue to focus on primary partnership, secondary and direct investments across markets and private equity strategies on behalf of our more than 300 investors from around the world.

To date, we have committed more than US\$30bn to private equity investments. This capital has been committed from our funds of funds, secondary funds and direct funds. We pride ourselves on creating both comprehensive and specialised solutions for our clients. As we have done throughout our 28-year history, over the last 18 months, we have continued to follow our consistent and focused due diligence process across strategies to seek the strongest opportunities with the most attractive risk/reward profiles.

History has shown that the years during and following a market downturn can provide strong vintage year returns and so we continue to commit and deploy capital, ensuring vintage year diversification for our investors. Also, since the beginning of 2008, we have successfully expanded our relationships with several top-tier managers that were looking to diversify their client bases. We are committed to capitalising on opportunities created by market dislocation.

With respect to resources and personnel, we are very pleased to be establishing a subsidiary in Japan. HarbourVest has been committed to Japan for more than 20 years, and today we have several investments with general partners in Japan and manage significant capital commitments from over 20 Japanese limited partners and trust banks.

During 2009, we promoted three principals to the position of managing director, and we now have 21 managing directors with an average of 17 years at HarbourVest. We are proud that so many of our professionals have chosen HarbourVest for a long-term career.

**HarbourVest is one of the oldest private equity funds of funds groups – do you think this long operating history had a bearing on the group's ability to weather the credit crisis?**

We firmly believe that our history has strongly influenced our ability to weather the crisis. We've been doing this for almost 30 years and our senior team of managing directors has been working together for an average of 17 years. Something I constantly emphasise, though, is that we must always keep in mind that private equity is a long-term investment that experiences market cycles like every other asset class. During the history of our firm, we have navigated many economic and

market cycles and although the outlook remains unclear, we are confident about the future of private equity and the future of HarbourVest.

So, how have we responded to the credit crisis? Put simply, we have continued to rely on our time-tested investment process and strived to capitalise on the opportunities available at the appropriate moment. As with the majority of our peers, we saw the value of our portfolios drop – by between 15% and 30% from year-end 2007 through the first quarter of 2009. With a rebound in the public markets, we have been able to recover a good portion of value through year-end 2009, and we expect that this trend will continue.

During the same period of time, private equity capital raised worldwide dropped from about US\$400bn in 2007 to one-quarter of that amount in 2009. Private equity investments by general partners also dropped, from about US\$800bn in 2007 to an eighth of that in 2009. This all resulted in most general partners focusing on either helping their portfolio companies cut costs or helping them restructure their debt. Concurrently, liquidity was nearly non-existent as the IPO window and credit markets closed and strategic acquirers conserved their cash. HarbourVest is and always has been a patient investor. It is not in our DNA to deploy capital at any cost, given that we are determined to provide vintage year diversification and raise new funds only when the prior program is fully invested, rather than on a set schedule. Additionally, because of our long history, the HarbourVest portfolio includes many mature investments that were poised for liquidity prior to the downturn.

As the public markets improved and the liquidity window began to open over the second half of 2009, we have seen increased realisations and distributions across our portfolio. Not only are we deploying new capital in the market, we are harvesting investments – which illustrates the benefits of consistently investing across cycles. During the second half of 2009, HarbourVest funds had exposure to a total of 29 IPOs, and, during the first five months of 2010, an additional 37 companies have gone public. These include companies held via primary partnerships and secondary investments, as well as two companies held in our direct portfolio (Select Medical Corporation and Adesa, Inc.). A number of additional companies have filed to go public in 2010.

**Table : Recent liquidity events in HarbourVest managed funds**

IPOs	M&A activity	
Company	Company	Acquirer
A123 Systems, Inc.	Accelerant, Inc.	Ethicon, inc.
Adesa, Inc.	Axygen Scientific, Inc.	Corning Incorporated
Amadeus Global Travel Distribution SA	Birds Eye Foods	Pinnacle Foods
Ancestry.com	Buytheway Inc.	Korea Seven
Archipelago Learning, LLC	CoreValve Inc.	Medtronic, Inc.
Avago Technologies, Inc.	Data Domain, Inc.	EMC Corporation
Brenntag Group	Datatel, Inc.	Hellman & Friedman, JMI Equity
Calix, Inc.	Fovea Pharmaceuticals SA	Sanofi-Aventis
CETIP S/A	Healthvision, Inc.	Lawson Software
Dollar General Corporation	Jet Aviation Group	General Dynamics
Kabel Deutschland GmbH	PennFoster Education Group, Inc.	The Princeton Review
LogMeln, Inc.	Pure Digital Technologies	Cisco Systems, Inc.
MaxLinear, Inc.	Sanyo Electric	Panasonic
Médica	Stiefel Laboratories, Inc.	GlaxoSmithKline plc
Medidata Solutions, Inc.	Synetrix Holdings Limited	The Capital Group Plc
Myer Pty Ltd.	United Malt Holdings	GrainCorp, Ltd.
Promethean Ltd.	Unity Media SCA	Liberty Global Inc.
Select Medical Corporation	Ventor Technologies Ltd	Medtronic, Inc.
Sensata Technologies, Inc.	Zappos	Amazon.com, Inc.
Solarwinds, Inc.		
TeleNav, Inc.		

Source: HarbourVest Partners

While the “golden age” of buyouts is behind us, the industry could be poised for growth. Deal pace has picked up, and high yield debt became available again. Purchase price multiples are moving back up. They are not yet at 2007 levels, but they are higher than any of us would have anticipated, partly because public markets recovered more quickly than many of us had expected, and public comparables therefore increased. I believe that the resizing of the market will continue, but I don’t think it’s going to be as extreme as most people thought a year or two ago. From “peak” to “trough”, new capital raised went from about US\$400bn worldwide to about US\$100bn between

2007 and 2009. I believe it will recover to an average of US\$200bn to US\$300bn over the next few years. What this means for HarbourVest, as a fund of funds manager, is that we need to continue to be highly selective in our investments, choosing those only with the most attractive profiles for our portfolios.

**Funds of funds have fallen under a particularly intense spotlight over the past couple of years, partly due to issues we've seen with managing cash flows and commitments, but also as investors have become increasingly sensitive to fees. Is the criticism warranted?**

Obviously, we don't believe that HarbourVest warrants criticism, but not all funds of funds are the same. We maintain a dialogue with our investors, especially through a very active group of clients who make up our funds' advisory committees. Over the course of our history, our fees have generally been equal to or lower than the majority of our fund of funds competitors. For example, we have a long history of offering a fee structure where the fee scales up over the first few years of fund's life, which we believe is most appropriate because it aligns fees with investment pace. Another example of our responsiveness to investor feedback is the fee structure of our latest innovation, HarbourVest Senior Loans Europe Limited, where the management fee is charged on net invested assets only.

With respect to managing cash flows and commitments, HarbourVest follows a prudent commitment strategy and selective use of credit lines. This can be seen through our funds and through HVPE, neither of which faced liquidity challenges over the past year. I believe this highlights one of our key strengths – a conservative approach to fund management and risk.

But, back to fund of funds generally. Some of the fund-of-fund managers in the market today are relatively new entrants to the space (particularly relative to HarbourVest). In some cases, that means that they haven't weathered a full market cycle or they don't have access to some of the strongest general partners. In other cases, it could mean that they don't have an established process (for both investments and operations). Some people discount HarbourVest's experience, but ultimately we believe it is vital to our success. We have built a cohesive, deep team that has been through market cycles and seen almost everything there is to see – from wars and sovereign crises to unique deal structures, GP management issues, tax complications and major regulatory changes. Our team is able to apply its collective experience and work tirelessly to find a solution that best serves our investors. A fund of funds manager should provide returns to its investors, regardless of strategy; after all, that's why investors commit their capital to us. There are many benefits of fund of funds, and I could talk for a long time about them. I think they can be summarised as follows: efficiency, simplicity, diversification, access, equal treatment, and, most of all, experienced professional management.

Funds of funds are sometimes accused of not adding enough value to justify their fees. I believe that our job is to select the managers and partnerships that will outperform the public markets and our private equity peers over the long term. Success and value-add are proven through performance. Additionally, what critics often forget is that a fund of funds commitment is essentially hiring an outsourced private equity manager. A fund of funds manager is providing an experienced investment team to source, evaluate, select, and monitor investments as well as an experienced operations team to manage cash, fund capital calls, receive distributions, manage stock distributions, review and summarise quarterly reports, prepare consolidated reporting, and more. An investor needs significant resources – people, time, technology, and money – to manage all of these responsibilities in-house. For some investors, an in-house program makes sense, but for many, a fund of funds allows them to access private equity simply and efficiently.

So, to answer the question, is the criticism warranted? The answer is no for HarbourVest, but as I said before, not all fund of funds managers have the experience and performance of HarbourVest. The key is to select the right manager to meet your individual objectives, just as it is when HarbourVest is selecting managers for our fund of funds portfolios.

**How do you respond to critics who call fund of funds managers “index” managers?**

There are certainly some examples out there that can justify this accusation, but I would say that this is not based on the approach to manager selection or by the performance of certain longstanding managers. As I mentioned earlier, the key is to select the managers that are most

likely to outperform both public markets and private equity indices while building a balanced and diversified portfolio that is therefore more likely to weather up and down market cycles. In order to achieve upper-quartile returns, most fund-of-fund managers make commitments to less than 25% of the funds in the market, negating the “index” effect. HarbourVest typically invests in only approximately 6% to 7% of funds in the market over an investment cycle. I don’t think you can fairly call 7% representative of an index.

**And what about broader challenges, and specifically the growing regulatory focus on the alternative investment fund industry from both the US and Europe... do you know yet what the impact on HarbourVest is likely to be?**

We take an active interest in the proposed regulatory changes. Because HarbourVest is both an investor and a manager, we have a fundamental interest in the eventual shape of the regulation that is currently being debated both in Europe and in the US. With respect to the AIFM Directive, HarbourVest has been proactively engaged in lobbying for nearly a year, both through our membership in trade groups such as the EVCA, BVCA, ILPA, EMPEA, and LPEQ, and through direct dialogue and correspondence with Brussels politicians. As I speak, one of our London-based executives is in Brussels to engage on the AIFM Directive. But it is too early and unwise to make plans at this stage as the eventual shape of the AIFM Directive remains unclear.

Two things are certain, however: the first is that whatever the eventual regulation, it will not prevent another financial, market, or economic crisis in the future. Second, it will change business and investment models: costs of operation will rise; returns may fall as a consequence of the currently proposed reduced sphere of fund and manager choice; a second wave of extreme market volatility and price depression may result if investors are required to divest of current holdings that may become ineligible under the new regime; and some managers may withdraw from either investing in or raising money from Europe. On the other side of that coin, European investment in emerging markets may be sharply curtailed and innovation may be stymied as smaller businesses find themselves unable to support the costs of compliance that may result from private equity investment.

With respect to listed investment companies, we are disappointed that Brussels continues to believe that additional regulation is necessary. No one should underestimate the potential and long-term ramifications of the AIFM Directive as currently drafted.

By contrast, the US approach has generally been less controversial. That is not to say that HarbourVest is not focused on the areas where we believe there is room for improvement, but the proposals have been less politically motivated. HarbourVest is registered with the SEC and has been since the early 1980s, both in our current form and as our predecessor firm, Hancock Venture Partners, Inc. As such, we are already in compliance with the principal specifications of the Restoring American Financial Stability Act, which requires registration with the SEC and managers to maintain records and reports. With respect to the Volcker Rule, it is certainly possible that HarbourVest may be a beneficiary of the proposed prohibition on banks sponsoring and investing in private equity funds.

**Time for a crystal ball moment – what’s your prediction for how the fund of funds industry will develop over the next 10 years? Who will be the winners and who will be the losers?**

Well, I have to start out by saying that I certainly wish I had a crystal ball, but I don’t, and it is very difficult to predict anything in good or bad markets. The past 18 months have been a roller coaster, and I don’t think anyone could have predicted what’s happening now in both public and private markets. One day experts say we’re on the road to recovery, and then a currency crisis hits Europe; we just never know what’s going to happen next.

With respect to the fund of funds industry in general, we do expect some managers to slowly disappear as the industry undergoes a contraction. This could result in smaller funds, fewer managers and fewer investors (or LPs) as some decide that they can invest on their own or even abandon the asset class, venture capital in particular. We have already seen fundraising levels drop, with less than half of the capital raised in 2009 than in 2005, 2006 and 2007. We expect the industry to downsize, illustrated by less capital raised and invested. Those investors who have committed to private equity for the long term are going to look for the survivors, hopefully because

the capital being put to work now could generate strong returns. Historically, market downturns have benefited those investors and managers that have “stayed the course” and continue to invest. This is the time when there is less capital, less competition and lower prices. It is the managers with money to put to work at lower valuations that have the best opportunity not only to survive, but also to succeed.

I expect the “survivors” to be the large, established fund of funds managers with economies of scale, as well as those focused on niche areas. We have already seen two significant changes in the fund of funds industry in 2010: Affiliated Managers Group’s acquisition of Pantheon Ventures from Russell and the April merger of Gartmore and Hermes.

**Moving back to listed funds, before we talk about HarbourVest Global Private Equity I wanted to take the opportunity to ask about HarbourVest’s most recent fund offering, HarbourVest Senior Loans Europe. The strategy is quite a departure from the fund of funds operations that HarbourVest is known for – isn’t it?**

HarbourVest Senior Loans Europe Limited invests in the senior secured loans of mid-sized private equity-backed companies. It is a slight departure from our strategy, but a natural extension of our core business, our experience, and our investment expertise. HarbourVest has always been an innovator. We started as a primary fund of funds and direct venture investor, moved into the secondary asset class in 1986, and then began to make credit investments in 1992. We make deals across the corporate capital structure and are well versed in complex deal negotiation and corporate structuring. Investing directly into senior loans is an entirely instinctive step for us. We are also focused on responding to what our existing and prospective investors are seeking and to capitalise on potential opportunities as a firm.

**How important was it that this fund be offered in a listed, closed-end structure?**

That decision evolved out of discussions during 2009 with potential investors. The asset class and particular attributes of the investment strategy opened the opportunity to investors other than those that typically invest in time-limited private partnerships. We are already familiar with the listed environment through our existing vehicle, HarbourVest Global Private Equity, and it was a clear option to offer a listed version of the senior loans strategy. So we decided to test that theory and presented the case to around 20 UK-based institutions in December 2009 and January 2010. Our assessment seemed to be on track and in February we decided to move ahead and HSLE listed on the Main Market of the London Stock Exchange on 26 May 2010. This particular strategy pays dividends and intends to return capital after two years; it does not employ leverage at the fund level, does not use currency hedging, and has a single asset class investment focus.

We made a decision only to market the company’s placing to U.K.-based institutions, and it is, therefore, no surprise that the company has attracted a number of prestigious institutions, including pension funds, insurance companies, wealth and asset managers, many of which are new investors with HarbourVest. It is too early to predict how the company will trade, but right now the investment team is busy identifying and analysing loan opportunities.

**You touched just now on trading, and this would seem a good moment to move our discussion to HarbourVest Global Private Equity, or HVPE. Liquidity has been an issue for HVPE since launch, but you’ve recently implemented a package of corporate actions to improve it... can you talk through each one, and the expected benefit?**

Before touching on the steps taken to improve liquidity, it might be useful to quickly describe why we believe the shares have been illiquid since offering. Our shareholder base is very high quality, but concentrated mostly in the hands of sophisticated, long-term institutional investors, which is not typical for a listed private equity company. As you may recall, in order to create a fully invested, diversified portfolio from the outset, at its founding, HVPE exchanged shares for existing seasoned HarbourVest fund interests. As a result, these shares were held by a small number of large US investors that owned approximately 60% of the company. These shareholders, primarily state pension funds and endowments, have not needed liquidity and have not sought to sell. Given this shareholder base, the company has had fewer UK asset managers and wealth managers as investors. These types of shareholders are typically represented on LPE registers and tend to generate marginal underlying liquidity.

In order to help increase liquidity, the company sought to diversify the shareholder base, provide a trading platform that would be more attractive to UK-based LPE investors, and increase the company's visibility and profile in the UK marketplace. To accomplish these objectives, the company established a three-point liquidity plan.

First, the company sought a dual listing on the Specialist Fund Market of the London Stock Exchange, which took place on 12 May 2010. Second, in order to diversify the company's shareholder base, HVPE's joint corporate brokers executed a secondary placing of shares held by existing shareholders. In May 2010, 4.8 million shares were placed at US\$5.75 per share. Third, in order to enhance the number of shares traded and promote ongoing trading liquidity, the company added an innovative feature to the offering and provided put rights to eligible purchasers of the shares in the secondary placing and thereafter, for a certain period, in the market. The put right allows holders to sell HVPE shares back to the company in 18 months for the lower of the US\$5.75 secondary placing price or estimated Economic NAV at 31 October 2011. The put right provides downside and liquidity protection to the buyer, while providing the potential for upside returns. At the same time, for HVPE shareholders, if the puts are exercised in 18 months, it will most likely be at a level below NAV and therefore accretive to NAV per share. The company has allocated up to US\$40 million to repurchase nearly seven million shares if the puts are exercised. Since 4.8 million put rights were attached to the shares in the secondary placing and subsequent trading, approximately 2.2 million of put rights remain, which are available to buyers of the shares in the market, subject to appropriate registration with the company.

**Are you able to give an idea of the number and type of investors that took up shares in the secondary placing?**

The 5.8 million shares were placed with eight new and one existing shareholder. The majority of these shareholders fit the profile of those we set out to attract and include several established U.K. asset managers and wealth managers. We were also very pleased to see the support of existing shareholders throughout the process.

**I appreciate it's only been a few weeks since these corporate actions happened, but are you pleased with the effect so far?**

This liquidity plan is the beginning of a process. Since the secondary placing, trading has remained subdued in a difficult market. Following the secondary placing, the shares traded as high as US\$5.95, but then fell back to US\$5.50. At this level, eligible buyers would have a potential US\$0.25 gain per share since they would receive a put enabling them to sell shares back to the company at US\$5.75 in 18 months.

Importantly, the secondary placing has enabled the company to "clear the market" of shareholders who wished to sell at that time and positioned the company to build a more typical LPE investor base over time. We will continue to work with our brokers to enhance interest in the company and liquidity in its shares.

**Moving on to performance, HVPE saw a strong NAV gain over its financial year to 31 January 2010 of 13.7%. Can you talk about the key drivers of this return?**

We started the 2009 financial year from a resilient position as HVPE was not distracted by any balance sheet challenges that might have required it to take any action such as selling portfolio assets or issuing new shares at a discount. So, from a stable foundation, HVPE's NAV benefited from strong performance in the underlying portfolio and from currency appreciation as the euro increased 8.2% relative to the US dollar during year. Approximately 21% of assets are denominated in euros. While our portfolio is quite diverse, with no underlying holding representing more than 3.2% of NAV, a number of our larger companies experienced liquidity events. Six of our Top 25 companies at 31 July 2009, or almost 25%, have had liquidity events over the last 10 months as at the end of May 2010. Key transactions include the sales of Birds Eye Foods, Datatel and a portion of Shenzhen Development Bank, as well as the IPOs of Avago Technologies, Brenntag Group and Amadeus Global Travel Distribution.

While performance over the last year was strong, our primary goal is to generate strong performance over a full market cycle. In this regard diversification is key, and HVPE's NAV is split

38% in venture and 59% in buyout. While the venture portion of HVPE's portfolio underperformed over the last year, it strongly outperformed buyout in the previous year. If you consider cumulative strategy performance over the two-year period from 31 January 2008 to 31 January 2010, venture outperformed buyout overall. Within the buyout portion, medium buyouts, where HVPE has a relative concentration, recorded the strongest performance.

**And what are your expectations for performance over the coming financial year?**

It's probably best to speak in general terms rather than make specific predictions regarding the HVPE portfolio. Obviously, the public markets have been quite unsettled in recent weeks. At the same time, the private equity market is seeing positive trends. First-quarter valuations showed continued improvement as underlying company performance and market benchmarks improved to 31 March 2010. Distributions have also been encouraging year to date.

The extent to which these positive trends continue will depend, in part, on the pace of economic recovery, interest rates, equity markets and currency movements. The ability of private companies to pursue planned IPOs will obviously be important in determining both future valuations and distributions. Certainly, in the short term, the falling euro and lower equity markets could put pressure on the NAVs of US dollar-denominated funds in the second quarter of 2010, but some of the negative market impact may be offset by ongoing earnings momentum.

At the same time, the current environment continues to offer opportunities. We believe venture will be an attractive asset class in the current cycle, and post-recession vintage years have historically generated strong performance. For all of these reasons, we are optimistic about the long-term potential of private equity markets and HVPE.

**Last year many of the private equity portfolio managers we spoke to felt that 2010 would be the year for new opportunities... but now we're in 2010, and not much has changed, 2011 is being held as the next 'big' vintage opportunity. What's your view?**

I mentioned earlier that I expect private equity fundraising worldwide to recover from its low of US\$100bn in 2009 to about US\$200bn to US\$300bn per year over the next few years. Today, investment activity is picking up, a big driver of which is more confidence. There is more debt available than there was 12 to 18 months ago. The banks are willing to lend, and while it's not at the same multiple of EBITDA that they offered before, they are becoming aggressive again. Additionally, investment periods for many private equity funds are coming to an end. There are a number of buyout (as well as venture) funds that were raised three or four years ago with four- or five-year investment periods. That capital either needs to be put to work before the end of the investment period or the general partners must extend the investment period with permission from the limited partners.

Today's deal prices are certainly more attractive than they were in 2007, but they are increasing. Some point to the estimated US\$400bn of capital overhang in the buyout market as part of the reason why prices are at current levels. While the overhang may put continued pressure on pricing and result in aggressive bidding in the marketplace, we believe the amount is not that far out of line with historical norms. The rebound in the public markets is also keeping pricing levels up. At the same time, investor appetite for private equity appears to be growing again. We are beginning to see some realisations and liquidity, and I think we'll receive more distributions this year than we had anticipated, partly because of the sponsor-to-sponsor transactions. As transaction activity increases and buyers seek to put more money to work, sellers may turn out to be older private equity funds that are near the end of their life and looking for liquidity. This could result in the distributions created by sponsor-to-sponsor deals matching or at least approaching the level of drawdowns this year.

Also, I think there are fewer concerns about risk in the marketplace today than there were 18 to 24 months ago. One thing is for sure: it will take longer to see the returns than it has historically, and even if the multiples at the end of the day are comparable to historical multiples (and I'm not sure they will be), the length of time it takes to get the money out will undoubtedly reduce IRRs. We believe that IRRs will still be attractive relative to the public markets, but they will not be the IRRs generated on deals done from 2002 to 2004.

Finally, the business of private equity has become truly global, and I think it will be even more so in the years ahead. China, India, the major markets of Latin America and other emerging markets, which have not traditionally been big players in private equity, will aim to take a larger and larger share of capital. These are the markets where I expect to see 5%, 6%, 8%, 10% growth rates, and some of these countries currently have surpluses and positive balance of payments. They also don't have the credit availability (individuals, corporations, banks, governments) that the US does, and I think these markets could sustain the growth of the world markets in the years ahead. Alternatively, I believe that the US and Europe will see significantly lower growth than in the last decade. This could have a profound effect on the private equity markets and the opportunities available. All investors should be looking around the world for the best opportunities to capitalise on the current market.

**In our view lack of shareholder confidence in underlying valuations continues to be a major factor in the wide discount levels still in evidence across the listed private equity sector. What's your approach to valuations at HarbourVest, and how do you establish whether the GP values you receive are appropriately conservative?**

As you point out, private company valuations remain somewhat subjective, even when utilising objective data such as public market inputs. However, under US GAAP, the requirement is that valuations at each quarter end represent "fair market" value, as best as can be estimated. They are not meant to be subjectively "conservative".

HarbourVest representatives sit on approximately 80% of the advisory boards of the partnerships in which we have invested, which enables us to monitor discussions on valuation metrics and how they are being applied. Our reporting and performance team closely reviews the quarterly reports submitted by the general partners to ensure consistency in valuation policies and look for any nuances that should be further questioned. If deemed appropriate, we would adjust manager valuations to reflect our best estimate of "fair value".

**Logically it should be possible to draw parallels between listed private equity pricing and pricing in the secondaries market, but at the moment the gap between the two seems wide as, going by anecdotal evidence, discounts on secondaries have contracted substantially so far in 2010. Is this something you've also identified through HarbourVest's secondaries business?**

While secondary pricing is clearly asset specific, we have seen discounts narrowing in the secondary market, particularly for partnerships which are more fully funded and where investors have seen positive valuation and distribution events in the underlying portfolio. This trend is consistent with past cycles, where discounts began to narrow approximately two quarters after the valuation trough which occurred in the second quarter of 2009. Following the trough, pockets of liquidity in funded portfolios became more visible. From 2009 to 2010, there has also been a shift in the type of funds offered for sale, which has affected the headline discount number. In 2009, as investors sought to reduce over-commitments, they sought to sell lightly funded assets with high levels of unfunded commitments. These assets sold for a higher discount on the low level of assets actually invested. In 2010, many more highly funded assets are coming to market, so the discount on invested assets is lower.

Unfortunately, while there has been some narrowing of the listed discounts, we have not seen the same level of recovery in the LPE space. This could be explained partly by the fact that the portfolios of listed assets have remained constant over time and have not shifted as in the secondary market. Likewise, the benefits of increased distributions do not flow immediately to LPE investors in current cash flow. As you know, pricing in the LPE market is set in part by supply and demand for a finite pool of assets, and more LPE investors must return to the market to increase demand and close the gap. Discounts have also started to reflect subjectivity, which was not the case at the market trough. In other words, analysts and investors apply very different and specific discounts according to the individual company, which of course sounds obvious, but in the depths of the downturn, the deep discount shadow was applied unilaterally.

**And what, in your view, will the catalyst – or catalysts – be for discount contraction in the listed sector?**

If you look at LPE discounts over time, it's not unusual for the sector (excluding 3i) to trade at a 10% to 15% discount on a normal basis. This was certainly the case from 1997 through 2004, although there was a period during 2005 to 2007 when the sector traded at a small premium. Today's discounts are still 20% or so below "normal" levels. To close this gap, I think we need to see a number of positive events happen, including an improved public market environment, sustained improvement in NAVs, a re-opening of the IPO window and enhanced distributions. This is a sector that performed very poorly from a stock price perspective during the fourth quarter of 2008 to the first quarter of 2009, so it's not surprising that investors remain cautious on the sector in the current uncertain environment. However, in an improving environment, we could begin to see discounts narrow further towards historic levels. Again, I don't think all listed private equity companies will be beneficiaries of this.

**Finally, what's on the agenda for HVPE – and HarbourVest – over the remainder of 2010?**

We spoke earlier about HVPE's liquidity plan, and we are hopeful that HVPE will begin to see increased trading in the shares as we move forward. The recovery of the public markets during 2009 provided a catalyst for HVPE's NAV growth, and we expect this to continue throughout 2010, assuming ongoing positive economic trends. The increasing NAV, combined with beneficial cash flow trends, has significantly strengthened HVPE's balance sheet and increased financing flexibility. The diversification of the HVPE portfolio, which features 38% venture exposure and lower levels of large buyout exposure relative to its peers, leaves it well positioned to grow in an improving market. In addition to HVPE's recent investment in HSLE, over the course of 2010, we will consider additional opportunities for HVPE to invest in new HarbourVest funds, to purchase existing fund interests for cash or stock, and to co-invest alongside HarbourVest funds.

With respect to HSLE, the immediate focus is to identify and invest in senior secured loans and to build a strong rapport with our new shareholders. We believe HSLE presents an exciting opportunity for us as a firm.

HarbourVest's plan remains unchanged in that we will "stay the course". We are establishing a new presence in Japan and have hired an experienced investment professional, Tatsuya Kubo, to represent us in an important market. We continue to evaluate all of the investment opportunities that we can, including inside and outside of the U.S. and in emerging markets, and seek the primary partnership, secondary, and direct investments that offer the strongest potential to generate returns. We are very pleased to see increasing realisations and distributions across markets, strategies, industries, and vintage years. We are hopeful that this trend will continue as the private equity industry gets back to what it does best: helping companies grow in order to provide returns to investors.

**Thank you.**

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