

**Confidential**



**Buyout Evaluation**

**LLR Equity Partners II, L.P.**

**TEACHERS' RETIREMENT SYSTEM OF THE STATE OF ILLINOIS  
BUYOUT PARTNERSHIP EVALUATION**

**LLR EQUITY PARTNERS II, L.P.**

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**TEACHERS' RETIREMENT SYSTEM OF THE STATE OF ILLINOIS  
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LLR EQUITY PARTNERS II, L.P.**

**Introduction**

The Teachers' Retirement System of the State of Illinois ("TRS") Annual Tactical Plan identified buyouts as an area of interest for the 2003/2004 fiscal year. TRS Staff has been monitoring buyout fund formation and believes that LLR Equity Partners II ("Fund II") is an attractive investment opportunity.

**Evaluation Process**

TRS Staff met with LLR Partners ("LLR") in Springfield on January 12, 2004. The LLR Private Placement Memorandum and Private Equity Manager Questionnaire materials were reviewed in detail. A supplemental question list was sent to LLR, and the supplemental questions were addressed during a meeting conducted in LLR's Philadelphia office on Wednesday, April 28, 2004.

The onsite investigation focused on the organization, investment team, compensation, strategy, process, deal flow, investment evaluation and analysis, documentation, monitoring, and liquidity. TRS Staff also met additional LLR key professionals and reviewed LLR's investment process, including a review of LLR's transaction and monitoring documentation.

**Findings**

TRS Staff believes that LLR Equity Partners II, L.P. is an attractive investment opportunity given that:

- The Fund is a good complement to the System's other buyout managers. Fund II will focus on companies in the Mid-Atlantic region. As of December 31, 2003, less than six percent of the total market value of the private equity portfolio was in portfolio companies located in the Mid-Atlantic region.
- This is the second buyout fund raised by the Principals. The first fund was a vintage year 1999 buyout fund. As of December 31, 2003, three of the companies have been sold for proceeds of \$64.5 million, resulting in a 65% gross IRR and a 2.8x multiple on invested capital. The unrealized investments have a market value of \$200 million, resulting in a 25% gross IRR and a 1.5x multiple on invested capital. The combined realized and unrealized gross IRR is 35% and the multiple on invested capital is 1.7x.

Taking into consideration the TRS strategic and tactical plans, as well as the evaluation of LLR as a buyout manager, TRS Staff recommends that the System make a commitment to LLR Equity Partners II, L.P. of \$25 million. The recommendation is subject to review and approval of the partnership documents by TRS legal counsel.

## **Investment Strategy**

LLR's strategy emphasizes capital preservation while generating attractive returns. LLR is able to successfully deploy capital in all market cycles, opportunistically at critical points in economic and/or industry-specific cycles, and frequently with a contrarian point of view. LLR achieves capital preservation through enhanced control features in growth equity investments, receiving a senior preferred position and/or investing in a preferred position with significant equity value subordinated to LLR.

LLR has a strong reputation in the Mid-Atlantic region, which stems from successfully working with many of the leading growth companies in the region over a period of 25 years. There are few competitors with LLR in the Mid-Atlantic region. LLR is frequently asked to co-invest with other private equity firms that are headquartered outside of the Mid-Atlantic region. The Mid-Atlantic region possesses substantial economic strength, accounting for 12% of the nation's population and 13% of its employment base and has been the recipient of 13% of the U.S. private equity and buyout investments since 1999. Since 1999, non-resident investment firms have supplied 88% of the \$30.8 billion in growth equity and buyout capital invested in the Mid-Atlantic region.

Within the Mid-Atlantic region, LLR will solely focus on middle-market companies. LLR will make investments of \$10 million to \$30 million in middle-market growth companies that fall between the early stage of venture capital and the mega buyout ends of the private equity spectrum. LLR believes both ends of the market are saturated with competitors, reducing the potential for generating adequate equity returns. The middle market presents attractive opportunities and a better environment for structuring deals with downside protection. LLR does not focus exclusively on any one industry. LLR looks for the best deals across a wide range of industries.

### *Industry, Geography and Other Diversification*

- The Fund will focus on middle-market investments in the Mid-Atlantic region.
- The Fund will diversify by industry sector.
- The ownership position will range from 25% to 75%.

### **Transaction Sourcing**

LLR uses multiple strategies to source transactions that meet its investment objectives. The core component is the business networks of the four Principals. Each of the four Principals has been conducting business and regularly interacting with the investment committee in the Mid-Atlantic region for over 25 years. The Principals access their networks to identify new transactions and companies that may be seeking capital.

LLR also employs a direct marketing approach that targets both private companies and orphaned public companies in the Mid-Atlantic region. LLR contacts these businesses through a systematic calling effort. The LLR message is reinforced through a direct mail campaign of deal

announcement cards and annual letters, as well as formalized email campaigns four times per year to their contact base, which has more than 3,000 contacts.

## **Investment and Portfolio Management Process**

### *Decision Process*

LLR follows an approval process that places each potential investment under a great amount of scrutiny. The approval process consists of a series of formal meetings of the firm to review the merits and risks of each transaction and to provide direction to the deal team. This process provides the partners with information needed to negotiate the most optimal transaction terms while providing multiple points at which a proposed transaction may still be rejected. Once an exhaustive review of an opportunity has been completed, the Principals must unanimously approve each investment.

### *Due Diligence*

LLR employs a comprehensive due diligence process on all investment opportunities under consideration. The process was developed internally by the investment professionals based on their prior experience and input from experts at other private equity firms, accounting firms, and law firms.

Each due diligence project is staffed with two partners, a primary and concurring, and at least one associate and two analysts. The project is managed by a partner and associate who utilize their own relationships in the professional services community to augment its expertise. These relationships include accountants, lawyers, technical consultants, investment bankers, recruiters, and other industry experts.

Key elements of the due diligence process include management interviews, reference calls and background investigations, review of historical and projected financial performance, customer satisfaction reference calls and interviews, market and industry research, technology assessment, and legal and audit reviews. There are two primary objectives of this process: first to identify all meaningful business risks to determine whether the opportunity warrants an investment, and second to become intimately knowledgeable with all facets of the business in order to identify issues to monitor and arrears in which LLR can add value.

### *Active Management*

LLR works closely with the management teams of the portfolio companies. Before an investment is made, a Principal, an Associate, and an Analyst work spend a considerable amount of time with the senior management team. After an investment is made, LLR will not hesitate in changing the management team if the company is not performing as well as expected.

### *Monitoring and Reporting*

LLR has one or more board seats in all investments.

TRS Staff also reviewed LLR's reports to limited partners and found them to be of institutional quality.

### *Exit*

LLR balances many factors when determining the exit of an investment. Key factors considered include business performance, business outlook, market conditions, management's desires, availability of viable buyers, and expected rate of return. LLR reviews these factors on an ongoing basis and when these factors are most optimally maximized, LLR, together with management, will initiate the process to exit an investment.

LLR's primary exit strategy is a sale to a strategic acquirer or to a complementary business looking to enter a new market. LLR's Principals have significant business experience selling businesses and LLR leverages both that knowledge and its business contacts to maximize the purchase price in the sale process. LLR does not rely upon the IPO market, though it will opportunistically pursue an IPO if market conditions are favorable.

### **Organization and Management Team**

LLR was founded in 1999 to make middle-market private equity investments in companies headquartered in the Mid-Atlantic region. LLR is led by four Principals, Ira Lubert, Seth Lehr, Howard Ross, and Mitchell Hollin, who each possess, on average, over 20 years of experience in the investment and professional services communities. The Principals were responsible for managing LLR Equity Partners, L.P. ("Fund I") and are supported by a team of seasoned investment professionals who possess a broad range of transactional, financial, and managerial investment skills.

### *LLR Investment Professionals*

LLR has a total staff of twelve full-time people that will be dedicated to the Fund, as seen in the following chart. Please refer to *Appendix A* for biographies of key professionals.

<b>Position</b>	<b>Total</b>
Managing Directors	4
Associates	3
Analysts	3
Administrative	2
<b>Total</b>	<b>12</b>

### **Historical Performance**

This is the second fund for the Principals working together as a team. The first fund was a vintage year 1999 buyout fund. As of December 31, 2003, three of the companies have been sold for proceeds of \$64.5 million, resulting in a 65% gross IRR and a 2.8x multiple on invested capital. The unrealized investments have a market value of \$200 million, resulting in a 25% gross IRR and a 1.5x multiple on invested capital. The combined realized and unrealized gross IRR is 35% and the multiple on invested capital is 1.7x.

## Terms and Conditions Summary

Fund Size	Targeting \$335,000,000 of commitments
Management Fee	2.0% on commitments
Profits Allocation	80% Limited Partners, 20% General Partner
Hurdle Rate	8%
Clawback Provision	Yes
Term of Partnership	10 years, with two one-year extensions
Investment Period	Six years, subject to expenses, management fees, and follow-on investments
Organizational Expenses	\$750,000
Key Man Provision	Yes
LP Advisory Board	Yes
Third Party Fees Paid	There are no third party fees being paid
GP Investment	\$10,000,000

LLR has closed on commitments of \$305.1 million. They are looking to have a final closing during the second quarter of 2004 on \$335 million.

### Key Concerns

#### *LLR Equity Partners II, L.P. Concerns*

- *Specific Focus:* Fund II will focus exclusively on companies located in the Mid-Atlantic region. Even though the focus is only on companies located within one region, the Principals have extensive experience and relationships within the region. The System's current private equity portfolio has little exposure to the Mid-Atlantic region so Fund II is a good complement to the System's other buyout funds. TRS Staff believes the investment team has the appropriate contacts and experience to take advantage of investment opportunities in this region of the private equity market.

### Legal Review

Staff asked Gardner Carton to review the proposed documentation associated with the LLR investment opportunity. Gardner Carton is in the process of negotiating the terms of the agreement with LLR's legal counsel.

### Summary

TRS Staff believes that LLR Equity Partners II, L.P. is an attractive investment opportunity given that:

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the total market value of the private equity portfolio was in portfolio companies located in the Mid-Atlantic region.

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## LLR Professional Staffing and Biographies

### Managing Directors

#### **Ira M. Lubert**

Mr. Lubert is the Principal and founder of the Independence Capital Partners fund family, which consists of LLR Partners, Quaker Bioventures, Lubert-Adler Partners, and LEM Capital. Mr. Lubert is the former managing director and co-founder of TL Ventures, a family of Safeguard Scientifics affiliated early-stage venture capital funds with over \$1 billion in assets under management.

He received a B.S. in Human Development from Pennsylvania State University.

#### **Seth J. Lehr**

Mr. Lehr is a former Managing Director and group head of the investment banking division of Legg Mason. At Legg Mason, Mr. Lehr was responsible for more than \$3.5 billion of merger and acquisition, private placement, and initial public offering transactions. Mr. Lehr was also the Co-founding Partner of The Middle Market Group, a spin-out from Lehman Brothers that was acquired by Legg Mason.

He received a B.S. in Economics and a M.B.A. in Finance from the Wharton School of Business of the University of Pennsylvania.

#### **Howard D. Ross**

Mr. Ross was a Senior Partner at Arthur Andersen LLP, which he joined in 1973 after graduating from college. At Andersen, Mr. Ross was Partner-in charge of the Growth Company Practice in the Greater Philadelphia market for 15 years.

He received a B.S. in Economics from the Wharton School of Business of the University of Pennsylvania. Mr. Ross is a Certified Public Accountant and a member of the AICPA and PICPA.

#### **Mitchell L. Hollin**

Mr. Hollin was Co-founder and Managing Director of Advanta Partners, a \$100 million private equity firm affiliated with Advanta Corporation. Prior to working at Advanta, Mr. Hollin joined Patricof & Co. Ventures in 1988. The firm is now known as Apax Partners.

He received a B.S. in Economics and a M.B.A. in Finance from the Wharton School of Business of the University of Pennsylvania.

## LLR Equity Partners II, L.P. Investor List

<b>Investor Name</b>	<b>Type of Investor</b>	<b>Commitment Amount</b>
Pennsylvania Public School Employees	Public Pension Fund	\$75,000,000
Smaller institutions and individuals	Institutions and Individuals	\$73,200,000
Family Offices	Individual Investors	\$30,000,000
JP Morgan Fund of Funds	Private Equity Manager	\$30,000,000
Kodak Pension Fund	Corporate	\$30,000,000
Pennsylvania State Employees	Public Pension Fund	\$25,000,000
LLR Partners	General Partner	\$15,000,000
City of Philadelphia Pensions	Public Pension Fund	\$10,000,000
Thomas Jefferson University	University	\$10,000,000
Sovereign Bank	Financial	\$5,000,000
William Blair	Financial	\$1,900,000
<b>Total</b>		<b>\$305,100,000</b>