

# **WATER STREET HEALTHCARE PARTNERS, LLC**

**Water Street Healthcare Partners, LLC  
333 West Wacker Drive  
Suite 2800  
Chicago, IL 60606  
<http://www.waterstreet.com>**

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**This Investment Adviser Brochure ("Brochure") provides information about the qualifications and business practices of Water Street Healthcare Partners, LLC (the "Management Company"). If you have any questions about the contents of this Brochure, please contact us at (312) 506-2900. The information in this Brochure has not been approved or verified by the United States Securities and Exchange Commission (the "SEC") or by any state authority.**

The Management Company is an investment adviser registered with the SEC under the Investment Advisers Act of 1940, as amended (the "**Advisers Act**"). However, such registration does not imply a certain level of skill or training.

Additional information regarding the Management Company is also available on the SEC's website at [www.adviserinfo.sec.gov](http://www.adviserinfo.sec.gov).

## **MATERIAL CHANGES**

Water Street Healthcare Partners, LLC filed its most recent Form ADV Part 2 on March 31, 2014. This amendment adds a recently formed alternative investment vehicle ("AIV") to the list of Affiliated Advisors and clarifies the description of the business practices of Water Street Healthcare Partners, LLC and its affiliates.

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## ADVISORY BUSINESS

Water Street is a private investment management firm, including several registered investment advisory entities and other organizations affiliated with the Management Company (collectively, "**Water Street**").

The Management Company, a Delaware limited liability company and a registered investment adviser, provides investment advisory services to private investment funds. The Management Company commenced operations in January 2005.

The following are the affiliated advisers of the Management Company (collectively with the Management Company, the "**Advisers**"):

- Water Street Healthcare Management, L.P. ("**GP I**");
- Water Street Healthcare Management II, L.P. ("**GP II**");
- WSHM II AIV, L.P. ("**GP II AIV**"); and

Water Street Healthcare Management III, L.P. ("**GP III**" and together with GP I and GP II, and GP II AIV the "**General Partners**")

The Advisers' clients include the following (collectively the "**Partnerships**," and together with any future private investment fund to which Water Street or its affiliates provide investment advisory services, "**Private Investment Funds**"):

- Water Street Healthcare Partners, L.P. ("**Fund I**");
- Water Street Healthcare Partners II, L.P. ("**Fund II**");
- WSHP II AIV, L.P. ("**Fund II AIV**"); and
- Water Street Healthcare Partners III, L.P. ("**Fund III**")

The General Partners each serve as general partner to one or more Partnerships and have the authority to make the investment decisions for the Partnerships to which they provide advisory services. The Management Company provides certain advisory services to the General Partners.

The Partnerships and any other Private Investment Funds that may be formed by a General Partner (or its affiliates) at a later date or that may otherwise become clients of a General Partner are expected to invest through negotiated transactions in operating entities. The Advisers' investment advisory services to the Partnerships consist of identifying and evaluating investment opportunities, negotiating investments, managing and monitoring investments and achieving dispositions for such investments. Investments are made predominantly in non-public companies, although investments in public companies are permitted. From time to time, the senior principals or other personnel of the Advisers or their affiliates may serve on a portfolio

company's board of directors or otherwise act to influence control or management of portfolio companies held by the Partnerships.

The Advisers' advisory services for Private Investment Funds are further described in the applicable private placement memoranda and limited partnership agreements, as well as below under "Methods of Analysis, Investment Strategies and Risk of Loss." Investors in Private Investment Funds participate in the overall investment program for the applicable Partnership, but may be excused from a particular investment due to legal, regulatory or other applicable constraints.

Additionally, from time to time, the Advisers may provide (or agree to provide) certain investors or other persons the opportunity to participate in co-invest vehicles that will invest in certain portfolio companies alongside a Private Investment Fund. Such co-invest vehicles typically invest and dispose of their investments in the applicable portfolio company at the same time and on the same terms as the Private Investment Fund making the investment. However, from time to time, for strategic and other reasons, a co-invest vehicle may purchase a portion of an investment from a Private Investment Fund. Any such purchase from a Private Investment Fund by a co-invest vehicle may occur shortly after the Private Investment Fund's completion of the investment to avoid any changes in valuation of the investment, and the co-invest vehicle may be charged interest on the purchase to compensate the relevant Private Investment Fund for the holding period.

As of December 31, 2013, the Management Company managed approximately \$1.46 billion in client assets on a discretionary basis. The only person with a 25% or more ownership interest in the Management Company is Timothy A. Dugan.

## **FEES AND COMPENSATION**

In general, the General Partners receive a Management Fee (as defined below) and a carried interest in connection with advisory services. The General Partners or other Water Street entities or affiliates receive additional compensation in connection with management and other services performed for portfolio companies of Partnerships and a portion of such additional compensation may offset in whole or in part the management fees otherwise payable to the applicable General Partner. Investors in the Partnerships also bear certain fund expenses. The following is a general description of fees, compensation and expenses of the Partnerships. Differences exist from Partnership to Partnership, and certain Partnerships may not charge certain fees, compensation or expenses that other Partnerships charge. The Partnership Agreements (as defined below) of the Partnerships describe fees, compensation and expenses in greater detail.

### **Management Fee**

Each Partnership will pay the applicable General Partner a management fee (the "**Management Fee**"), partially in advance and partially in arrears, equal to 2.0% on an annual basis of aggregate the Partnership investor capital commitments ("**Commitments**"), subject to reductions at the end of the investment period and in certain other circumstances, in each case, as specified in the limited partnership agreement of the applicable Partnership (the "**Partnership**

**Agreement").** The Management Fee will be payable until all portfolio investments are distributed or until the General Partner's relationship with the Partnership is terminated for other reasons (as described in the applicable Partnership Agreement). Installments of the Management Fee payable for any period other than a full Management Fee period are adjusted on *pro rata* basis according to the actual number of days in such period.

Unless otherwise approved by the applicable Partnership's advisory board, the Management Fee will be reduced by an offset credit equal to a specified percentage of the Partnership's share of (i) directors' fees paid by portfolio companies to partners or employees of the General Partner or certain of its affiliates; (ii) any net transaction fees, financial consulting fees or advisory fees paid to the applicable General Partner or certain of its affiliates with respect to any Partnership investment; and (iii) any net break-up fees with respect to Partnership transactions not completed that are paid to the applicable General Partner or certain of its affiliates (any such fees that such General Partner or another Water Street entity or person are permitted to retain are herein referred to as "**Supplemental Fees**"). To the extent that such an offset credit would reduce the Management Fee for a given Management Fee period below zero, the credit will be carried forward for future application against payable Management Fees. To the extent any such excess credit remains unapplied upon dissolution of a Partnership, each partner of such Partnership will receive its share of such unapplied excess, unless such partner elects not to receive its share. To the extent that any other Private Investment Fund or any other entity or individual co-invests alongside a Partnership in any portfolio company investment, any Supplemental Fees may to the extent specified in the applicable Partnership Agreement be allocated with respect to such Partnership and the co-investors in proportion to the cost of the investment or potential investment in the portfolio company held (or committed to be held) by each. Such co-investors generally do not pay management fees or carried interest and to the extent any allocation with respect to Supplemental Fees has been made concerning the Partnership and co-investors, and no managements fees are charged to co-investors, the General Partner has no management fees to offset with respect to co-investors and, therefore, may retain the full amount of the Supplemental Fees.

Water Street works with a network of executives that serve as operating partners (the "**Operating Partners**") that are experienced industry executives, generally former Chief Executive Officers, who work in a consulting role that is exclusive to Water Street or as employees of Water Street. Water Street also has a Corporate Resources Group that is comprised of functional specialists, who are Water Street employees with experience in executing key strategic initiatives. The Corporate Resources Group is designed to supplement and/or provide expertise in a particular area for a portfolio company. Operating Partners that are consultants to, and not employees of, Water Street, and members of Water Street's Corporate Resources Group (collectively, "**Consulting Operations Personnel**") provide additional services to portfolio companies. Such Consulting Operations Personnel may receive compensation from Water Street and/or may receive compensation directly from portfolio companies. Payments made by portfolio companies to Water Street with respect to Consulting Operations Personnel or directly to Consulting Operations Personnel do not reduce or offset fees payable to the Advisers. Expenses of the Corporate Resources Group, including compensation, benefits, overhead and travel costs, are passed through to portfolio companies and are either paid directly by Water Street and then reimbursed by portfolio companies or are paid directly by portfolio companies. Under the terms of the applicable Limited Partnership Agreements expenses of the Corporate

Resources Group, whether initially incurred by Water Street directly and reimbursed by portfolio companies, or covered directly by portfolio companies, do not offset management fees payable by Limited Partners of the respective funds. Water Street also maintains full-time employees, also referred to as Operating Partners, that provide general consulting and other services to portfolio companies (other than services provided by the Corporate Resources Group) and such employees do not receive any compensation from portfolio companies, but may retain equity-based compensation received as Consulting Operations Personnel, prior to their full-time employment by Water Street. As of the date of this Brochure, the full-time employees who are Operating Partners include Jim Connelly and Kevin Swan, of which only Mr. Swan has retained equity based compensation received prior to his employment at Water Street.

Supplemental Fees and/or other portfolio company-related fees may also include amounts prepaid in anticipation of future services or otherwise accelerated, which will be offset against the Management Fee to the extent set forth in the Limited Partnership Agreements of the applicable partnership.

As permitted under the Partnership Agreement for each Partnership, the applicable General Partner may waive or agree to reduce the Management Fee. Any such waived or reduced portion of the Management Fee reduces the amount of capital the General Partner would otherwise be required to contribute to the Partnership. The limited partners of the Partnership may be required to make a *pro rata* contribution according to their respective Commitments to fund any contribution that would otherwise be required of the General Partner in connection with any such waiver or reduction as described above and, as a result, the exercise of such waiver may result in an acceleration of investor capital contributions. Waived or reduced Management Fees are not subject to the Management Fee offsets described above.

To the extent that any other Private Investment Fund, any other entity or individual co-invests alongside a Partnership in a portfolio company investment and such portfolio company pays fees and expenses that would otherwise be considered Supplemental Fees, such fees and expenses are allocated to the co-invest entities pro-rata in determining the Supplemental Fees that will offset the Management Fees paid by the Partnership. Since the co-investment entities do not typically pay management fees (or carried interest), the General Partner's Management Fee may be reduced to a lesser extent. The terms of the limited partnership agreements provides the General Partner the ability to charge fees and/or carried interest in its discretion, and the General Partner provides disclosure to a Partnership's limited partners in circumstances when fees and/or carried interest are charged to co-investors.

### **Carried Interest**

The General Partner of each Partnership will receive a carried interest with respect to such Partnership equal to 20% of all profits in excess of an 8% compound preferred return subject to a General Partner catch-up provision, as more fully described in the Partnership Agreement of the applicable Partnership. The carried interest distributed to the General Partner is subject to a potential giveback at specified points in the life of the Partnership if the General Partner has received excess cumulative distributions.

It is expected that any similar future Private Investment Funds will have a similar fee structure.

## **Other Information**

The Partnerships generally invest on a long-term basis. Accordingly, investment advisory and other fees are expected to be paid, except as otherwise described in the Partnership Agreement, over the term of the applicable Partnership, and investors generally are not permitted to withdraw or redeem interests in the Partnership.

Principals or other employees of Water Street may receive a portion of the Management Fee, carried interest or other compensation received by the General Partners or their affiliates.

In addition to the Management Fee and carried interest payable to the applicable General Partner, each Partnership bears certain expenses. As set forth in more detail in the Partnership Agreement for the applicable Partnership, the Partnership bears all Partnership expenses to the extent not paid by portfolio companies, including organizational expenses up to the expense cap specified in the Partnership Agreement, legal, auditing, consulting (excluding fees for consulting services associated with overall strategy that are not performed as part of an investment initiative), financing, accounting and custodian fees and expenses; expenses associated with the Partnership's financial statements, tax returns and Schedule K-1s; out of pocket expenses incurred in connection with transactions not consummated; expenses of any advisory board of limited partners; expenses of meetings with the Partnership's limited partners; insurance; other expenses associated with the acquisition, holding and disposition of its investments, including extraordinary expenses (such as litigation, if any); and any taxes, fees or other governmental charges levied against the Partnership, but not ordinary administrative and overhead expenses of the General Partner incurred in connection with maintaining and operating its offices, including employees' salaries, rent, utilities and other similar expenses specified in the Partnership Agreement. The Partnerships also may bear expenses indirectly from the payment by portfolio companies of similar expenses, including Supplemental Fees. Brokerage fees may be incurred in accordance with the practices set forth in "Brokerage Practices."

Additionally, as described more fully in the Partnership Agreement for the applicable Private Investment Fund, Consulting Operations Personnel may receive fees and other compensation from such portfolio companies in the form of cash and/or equity grants. Such compensation does not reduce or offset Management Fees payable to the General Partners. Consulting Operating Personnel may be permitted to make co-investments alongside a Partnership and, as noted above, typically are not charged fees or carried interest on such co-investments. As noted above, if an Operating Partner that is a consultant holds equity interests in portfolio companies and such person becomes an employee of Water Street, such person may retain the ownership interests obtained prior to their employment.

Water Street and/or its affiliates generally have discretion over whether to charge transaction fees or other compensation to a portfolio company and, if so, the rate, timing and/or amount of such compensation. The receipt of transaction fees may give rise to conflicts of interest between the Private Investment Funds, on the one hand, and Water Street and/or its affiliates on the other hand.



## **PERFORMANCE-BASED FEES AND SIDE-BY-SIDE MANAGEMENT**

As described under "Fees and Compensation," the General Partners may receive a carried interest allocation on certain profits in the Partnerships. Water Street advises a private fund that is not subject to management fees or a carried interest (the "**Co-Invest Fund**"). While this practice could present a conflict of interest in allocating investment opportunities and expenses, Water Street does not believe this arrangement poses a conflict of interest in practice because the Co-Invest Fund co-invests alongside the Partnership at substantially the same time and on substantially the same terms as the Partnership and disposes of such investments in a similar manner.

## **TYPES OF CLIENTS**

The Advisers provide investment advice to Private Investment Funds, including the Partnerships. Private Investment Funds are investment partnerships or other investment entities formed under domestic or foreign laws and operated as exempt investment pools under the Investment Company Act of 1940, as amended (the "**Investment Company Act**"). The investors participating in Private Investment Funds may include individuals, banks or thrift institutions, other investment entities, pension and profit-sharing plans, trusts, estates or charitable organizations or other corporations or business entities and may include, directly or indirectly, principals or other employees of the Advisers and their affiliates.

Fund I has a minimum investment of \$5 million for third-party investors and Funds II and III have a minimum investment of \$10 million for third-party investors, each of which may be waived by the applicable General Partner. Investors in the Partnerships must meet certain suitability and net worth qualifications prior to making an investment. Investors must be (i) "accredited investors" as defined under Regulation D of the Securities act of 1933, as amended and (ii) either "qualified purchasers" or "knowledgeable employees" as defined under the Investment Company Act.

## **METHODS OF ANALYSIS, INVESTMENT STRATEGIES AND RISK OF LOSS**

### **General**

Water Street is a private investment firm focused on making investments in later-stage, middle-market healthcare companies. The Advisers' investment advisory services consist of identifying and evaluating investment opportunities, negotiating investments, managing and monitoring investments and achieving dispositions for investments. Investments are predominantly of non-public companies although investments in public companies are permitted.

The following is a summary of the investment strategies and methods of analysis generally employed by Water Street on behalf of the Partnerships and a summary of certain risks involved with Water Street's investment strategy and an investment in the Partnerships. More detailed descriptions of the Partnerships' investment strategies and methods of analysis and risks are included in the applicable private placement memoranda and Partnership Agreements for each Partnership. The investment strategies and methods of analysis and risks described in this section also generally apply to the Co-Invest Fund.

The Advisers' investment strategy for the Partnerships focuses on the acquisition of controlling interests in middle-market companies and divisions of global healthcare organizations that the Advisers believe have strong growth prospects to serve as potential platform companies. The Advisers focus on investments that require equity capital of approximately \$25 million to \$100 million, although the required capital may be greater or less than such amounts.

The Advisers' investment strategy consists of the following phases: (i) sourcing proprietary investment opportunities through a direct calling program and conducting due diligence; (ii) creating customized transaction structures and innovative capital structures for sellers; (iii) growing portfolio companies through strategic combinations; (iv) maintaining active involvement with portfolio companies in an effort to improve operating performance; and (v) exit planning to position a portfolio company for strategic sale.

There can be no assurance that the Advisers will achieve the investment objectives of the Partnership and a loss of investment may be possible.

### **Investment and Operating Strategy**

*Deal Sourcing and Due Diligence.* The Advisers' deal sourcing program has two components: (i) a sourcing effort focusing on the 200 largest publicly-traded healthcare companies; and (ii) a segment-focused sourcing effort with middle-market companies. The first component serves as a method for the Advisers to propose and discuss creative ways to enhance the operations, market positions and value of certain of the public healthcare company's non-core businesses. The second component focuses on building a dialogue with middle-market companies in pre-selected areas of interest with a goal of partnering with them to seek to grow their businesses. The information gathered through the proactive sourcing program helps the Advisers to: (a) better understand trends and competitive dynamics in a segment by talking to key participants and competitors in that segment; (b) identify businesses that can most likely be combined to create a market leader in the segment of interest; and (c) identify likely strategic buyers of that business once successfully built and developed. Once a potential investment is identified, the Advisers develop an investment thesis and, through a detailed due diligence process, seek to verify such thesis and investigate the major business risks.

*Create Customized Transaction Structures for Sellers.* As part of its strategic dialogue with healthcare companies, the Advisers encourage owners to maintain ongoing ownership stakes in partnership with Water Street as a means of both: (i) providing corporate parents or private-company owners with the opportunity to benefit from future value creation; and (ii) differentiating the Advisers' discussion and proposed transaction from an outright sale. The Advisers expect to frequently structure their acquisitions as leveraged recapitalizations, allowing owners to achieve partial liquidity, while continuing to have meaningful equity stakes and remain involved in the governance of their companies. This structure is preferred for a larger corporation or entrepreneur that is looking for liquidity but also desires a financial partner to enhance the company's growth opportunities and the ability to participate in value creation.

*Grow Portfolio Companies Through Strategic Acquisitions.* The Advisers seek to build market-leading companies focused on adding value to end customers through broader product

and/or service offerings. Post-acquisition, the Advisers encourage and facilitate significant operating investments in the infrastructure of their portfolio companies to better position such companies for future growth and value creation. Portfolio companies also may receive additional and more comprehensive support through Water Street's Corporate Resources Group (a group comprised of functional specialists who support portfolio companies with executing key strategic initiatives, including executive recruiting, corporate development and communications). Portfolio companies may request the services of the Corporate Resources Group to supplement and/or provide for the portfolio company's expertise in a particular area. Members of the Corporate Resources Group are employees of Water Street working substantially on portfolio companies' internal projects. As described above and as permitted under the Limited Partnership Agreement for the applicable Private Investment Fund, expenses of the Corporate Resources Group, including compensation, benefits, overhead and travel costs, are paid by portfolio companies without offsetting fees that are paid to the Advisers. The Advisers also seek to improve the competitive position and financial performance of portfolio companies through transformational strategic acquisitions. The Advisers focus on acquisitions that they believe will: (i) offer customers improved product offerings and/or greater geographic coverage; (ii) leverage production and purchasing power to improve gross margins; (iii) leverage distribution strength into profitable and proprietary licensing or distribution relationships; (iv) consolidate selling and marketing efforts to reduce costs, improve margins and improve customer coverage; and/or (v) enhance investments in research and development.

*Maintain Active Involvement in Portfolio Companies.* Post-closing, the Advisers will establish a detailed governance program that includes a regular calendar of organization planning, strategic planning, corporate development, executive compensation and operations analysis. Additionally, the Advisers seek to implement an authorities matrix that explicitly outlines approval authorities for management and ensures that the board of directors of a company (the "**Board**") gets appropriately involved in decisions of significance for each company. The Advisers will also develop, together with management, a reporting package that is focused on operating metrics that the Advisers believe are critical in monitoring the progress of the company. In most companies, an operating executive from Water Street or an Operating Partner consultant generally serves as a lead director, working closely with company management on operating and strategic priorities. Water Street also seeks to supplement its knowledge, experience and contacts with a network of executives that serve as Operating Partner's that are consultants. Operating Partner consultants are experienced industry executives, generally former Chief Executive Officers, who work in a consulting role that is exclusive to Water Street or as employees of Water Street. Operating Partner consultants may serve as members of the Board or, in special cases, as operating executives of portfolio companies. Operating Partners may be employees of Water Street, such as Jim Connelly and Kevin Swan, or Operating Partners may be independent consultants as described above under "Fees and Compensation - Management Fee." Water Street also may make resources available to portfolio companies through senior advisers, who serve a similar purpose as Operating Partners, but who are not exclusive to Partnerships' portfolio companies.

*Exit Strategy.* The Advisers seek to develop companies with the objective of building businesses that will become compelling and dynamic acquisition candidates for a strategic buyer. The Advisers seek to develop portfolio companies into market leaders that have the financial scale to be meaningful to a strategic buyer and that are run with the discipline and reporting

standards of a public company. The Advisers believe that keeping management focused on the standards required for an independent public company improves the strategic decisions made in the development of the company and best positions the business for sale to a strategic buyer. Although the Advisers will analyze whether a portfolio company is appropriate for public offering, the Advisers' primary exit strategy is a cash sale to a strategic buyer.

## **Risks of Investment**

A Partnership and its investors bear the risk of loss that the applicable Advisers' investment strategy entails. The risks involved with the Advisers' investment strategy and an investment in a Partnership are detailed in the Partnership's private placement memorandum. In general, these risks include, but are not limited to:

*Business Risks.* The Partnership's investment portfolio will consist primarily of securities issued by privately held companies, and operating results in a specified period will be difficult to predict. Such investments involve a high degree of business and financial risk that can result in substantial losses.

*Investment in Junior Securities.* The securities in which the Partnership will invest may be among the most junior in a portfolio company's capital structure, and thus subject to the greatest risk of loss. Generally, there will be no collateral to protect the Partnership's investment once made.

*Concentration of Investments.* The Partnership will participate in a limited number of investments and intends to make most of its investments in one industry or one industry segment. As a result, the Partnership's investment portfolio could become highly concentrated, and the performance of a few holdings or of a particular industry may substantially affect its aggregate return. Furthermore, to the extent that the capital raised is less than the targeted amount, the Partnership may invest in fewer portfolio companies and thus be less diversified.

*Lack of Sufficient Investment Opportunities.* The business of identifying and structuring private equity transactions is highly competitive and involves a high degree of uncertainty. It is possible that the Partnership will not be fully invested if enough sufficiently attractive investments are not identified. However, the limited partners will be required to pay Management Fees during the investment period based on the aggregate amount of all Commitments to the Partnership.

*Leveraged Investments.* The Partnership may make use of leverage by having a portfolio company incur debt to finance a portion of its investment in such portfolio company, including in respect of companies not rated by credit agencies. Leverage generally magnifies both the Partnership's opportunities for gain and its risk of loss from a particular investment. The cost and availability of leverage is highly dependent on the state of the broader credit markets, which state is difficult to accurately forecast, and at times it may be difficult to obtain or maintain the desired degree of leverage. The use of leverage also 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 the Partnership'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 Partnership'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, the Partnership may suffer a partial or total loss of capital invested in the portfolio company, which could adversely affect the returns of the Partnership. Furthermore, should the credit markets be tight at the time the Partnership determines that it is desirable to sell all or a part of a portfolio company, the Partnership may not achieve an exit multiple or enterprise valuation consistent with its forecasts. Moreover, the companies in which the Partnership will invest generally will not be rated by a credit rating agency.

*Restricted Nature of Investment Positions.* Generally, there will be no readily available market for Partnership investments, and hence, most of the Partnership's investments will be difficult to value. Certain investments may be distributed in kind to the Partners.

*Reliance on Portfolio Company Management.* Although the General Partner will monitor the performance of each Partnership investment, it will primarily be the responsibility of each portfolio company's management team to operate such portfolio company on a day-to-day basis. Although the Partnership generally intends to invest in companies with strong management or recruit strong management to such companies, there can be no assurance that the existing management of such companies will be able or willing to successfully operate a company in accordance with the Partnership's objectives.

*Projections.* Projected operating results of a company in which the Partnership invests normally will be based primarily on financial projections prepared by each company's management. In all cases, projections are only estimates of future results that are based upon information received from the company and assumptions made at the time the projections are developed. There can be no assurance that the results set forth in the projections will be attained, and actual results may be significantly different from the projections. Also, general economic factors, which are not predictable, can have a material effect on the reliability of projections.

*Need for Add-On Investments.* Following its initial investment in a given portfolio company, the Partnership may decide to provide additional funds to such portfolio company or may have the opportunity to increase its investment in a successful portfolio company. There is no assurance that the Partnership will make follow-on investments or that the Partnership will have sufficient funds to make all or any of such investments. Any decision by the Partnership not to make follow-on investments or its inability to make such investments may have a substantial negative effect on a portfolio company in need of such an investment. Additionally, such failure to make such investments may result in a lost opportunity for the Partnership to increase its participation in a successful portfolio company or the dilution of the Partnership's ownership in a portfolio company if a third party invests in such portfolio company.

*Non-U.S. Investments.* The Partnership may invest in portfolio companies that are organized or have substantial sales or operations outside of the United States, its territories, and possessions. Such investments may be subject to certain additional risk due to, among other things, potentially unsettled points of applicable governing law, the risks associated with fluctuating currency exchange rates, capital repatriation regulations (as such regulations may be

given effect during the term of the Partnership), the application of complex U.S. and non-U.S. tax rules to cross-border investments, possible imposition of non-U.S. taxes on the Partnership and/or the limited partners with respect to the Partnership's income, and possible non-U.S. tax return filing requirements for the Partnership and/or the limited partners.

Additional risks of non-U.S. investments include: (a) economic dislocations in the host country; (b) less publicly available information; (c) less well-developed regulatory institutions; (d) greater difficulty of enforcing legal rights in a non-U.S. jurisdiction; (e) civil disturbances; (f) government instability; and (g) nationalization and expropriation of private assets. Moreover, non-U.S. companies may not be subject to uniform accounting, auditing and financial reporting standards, practices and requirements comparable to those that apply to U.S. companies.

*Director Liability.* The Partnership will often obtain the right to appoint one or more representatives to the board of directors (or similar governing body) of the companies in which it invests. Serving on the board of directors (or similar governing body) of a portfolio company exposes the Partnership's representatives, and ultimately the Partnership, to potential liability. Not all portfolio companies may obtain insurance with respect to such liability, and the insurance that portfolio companies do obtain may be insufficient to adequately protect officers and directors from such liability.

*Uncertain Economic and Political Environment.* The current global economic and political climate is one of uncertainty. Prior acts of terrorism in the United States, the threat of additional terrorist strikes and the fear of a prolonged global conflict have exacerbated volatility in the financial markets and can cause consumer, corporate and financial confidence to weaken, increasing the risk of a "self-reinforcing" economic downturn. The availability of credit for consumers, homeowners and businesses, including credit used to acquire businesses, continues to be restricted. This may have an adverse effect on the economy generally and on the ability of the Partnership and its portfolio companies to execute their respective strategies and to receive an attractive multiple of earnings on the disposition of their businesses. A climate of uncertainty may reduce the availability of potential investment opportunities, and increases the difficulty of modeling market conditions, potentially reducing the accuracy of financial projections. Furthermore, such uncertainty may have an adverse effect upon portfolio companies in which the Partnership makes investments.

*Market Conditions.* Any material change in the economic environment, including a slow-down in economic growth and/or changes in interest rates or foreign exchange rates, could have a negative impact on the performance and/or valuation of the portfolio companies. The Partnership's performance can be affected by deterioration in public markets and by market events, such as the onset of the credit crisis in the summer of 2007 or the downgrading of the credit rating of the United States in 2011, which, among other things, can impact the public market comparable earnings multiples used to value privately held portfolio companies and investors' risk-free rate of return. Movements in foreign exchange rates may adversely affect the value of investments in portfolio companies and the Partnership's performance. The value of publicly traded securities may be volatile and difficult to sell as a block, even following a realization through listing. The impact of market and other economic events may also affect the Partnership's ability to raise funding to support its investment objective and also the level of profitability achieved on realizations of investments.

*Deterioration of Credit Markets May Affect Ability to Finance and Consummate Investments.* The recent deterioration of the global credit markets has made it more difficult for investment funds such as the Partnership to obtain favorable financing for investments. A widening of credit spreads, coupled with the deterioration of the sub-prime and global debt markets and a rise in interest rates, has dramatically reduced investor demand for high yield debt and senior bank debt, which in turn has led some investment banks and other lenders to be unwilling to finance new private equity investments or to only offer committed financing for these investments on unattractive terms. The Partnership's ability to generate attractive investment returns may be adversely affected to the extent the Partnership is unable to obtain favorable financing terms for its investments. Moreover, to the extent that such marketplace events are not temporary and continue, they may have an adverse impact on the availability of credit to businesses generally and could lead to an overall weakening of the U.S. and global economies. Such marketplace events also may restrict the ability of the Partnership to realize its investments at favorable times or for favorable prices.

*Healthcare Regulation, Reimbursement and Reform.* Various segments of the healthcare industry are (or may become) (i) highly regulated at both the state and federal levels in the United States and internationally, (ii) subject to frequent regulatory change and (iii) dependent upon various government or private insurance reimbursement programs. While the Partnership intends to make investments in companies that comply with relevant laws and regulations, certain aspects of their operations may not have been subject to judicial or regulatory interpretation. An adverse review or determination by any one of such authorities, or an adverse change in the regulatory requirements or reimbursement programs, could have a material adverse effect on the operations of the companies in which the Partnership invests. Recent legislative changes have had, and will likely continue to have, a significant impact on the healthcare industry. In addition, various legislative proposals related to the healthcare industry are introduced from time to time at the United States federal and state level, and any such proposals, if adopted, could have a significant impact on the healthcare industry. The U.S. healthcare industry continues to undergo significant changes designed to increase access to medical care, improve safety and contain costs. Generally, Medicare and Medicaid reimbursement levels have declined; the use of managed care has increased; distributors, manufacturers, healthcare providers and pharmacy chains have consolidated; and large purchasing groups are more prevalent.

In March 2010, the Patient Protection and Affordable Care Act and the Health Care and Education Reconciliation Act (collectively the "**Affordable Care Act**") were enacted. Among other things, the Affordable Care Act seeks to expand health insurance coverage to approximately 32 million uninsured Americans. Many of the significant changes in the Affordable Care Act do not take effect until 2014, including a requirement that most Americans carry health insurance. While expansion of access to health insurance may increase the demand for various healthcare products and services, other provisions of the Affordable Care Act could affect the Partnership and its investments adversely. The Affordable Care Act contains many provisions designed to generate the revenues necessary to fund the coverage expansions and to reduce costs of Medicare and Medicaid. Beginning in 2013, each medical device manufacturer will have to pay a tax in an amount equal to 2.3 percent of the price for which the manufacturer sells its medical devices. The Partnership's portfolio companies may be subject to this tax. Additionally, the Affordable Care Act changed the federal upper payment limit for Medicaid

reimbursement to no less than 175 percent of the average weighted manufacturer's price from 250 percent of the lowest average manufacturer's price for generic pharmaceuticals. The Partnership and its investments could be adversely affected by, among other things, changes in the delivery or pricing of or reimbursement for pharmaceuticals, medical devices or healthcare services.

Congress may withhold the funding necessary to implement provisions of the Affordable Care Act, or may attempt to replace the legislation with amended provisions or repeal it altogether. Due to its complexity, the impact of the Affordable Care Act remains difficult to predict and is not yet fully known. The Affordable Care Act could negatively impact the Partnership and its portfolio companies or could alternatively create new or expand existing opportunities for investment.

*Healthcare Research and Innovation.* The healthcare industry spends heavily on research and development. Research findings (e.g., regarding side effects or comparative benefits of one or more particular treatments, services or products) and technological innovation (together with patent expirations) may make any particular treatment, service or product less attractive if previously unknown or underappreciated risks are revealed, or if a more effective, less costly or less risky solution is or becomes available. Any such development could have a material adverse effect on the companies in which the Partnership invests.

## **Conflicts of Interest**

During the investment period of a given Partnership, all appropriate investment opportunities that meet the investment criteria of the Partnership will be pursued by the Advisers through such Partnership, subject to certain limited exceptions set forth in the applicable Partnership Agreement. Without limitation, the Advisers' principals currently manage several investment vehicles and other investments similar to a given Partnership and those investments in which such Partnership invests. The Advisers' principals and the Advisers' investment staff will continue to manage and monitor such investment vehicles and such investments. Such other investments that the Advisers' principals may control may potentially compete with companies acquired by a given Partnership. Following the investment period of a Partnership, the Advisers' principals may and likely will focus their investment activities on other opportunities and areas unrelated to such Partnership's investments, possibly including successor funds. In addition, the Advisers' principals may spend a portion of their business time and attention pursuing investment opportunities that do not fall within the investment objectives of a Partnership for other investment vehicles and other than on behalf of such Partnership. The significant investment of the Advisers' principals in a given Partnership, as well as the Advisers' principals' interest in the carried interest, operate to align, to some extent, the interest of the Advisers' principals with the interest of the limited partners of such Partnership, although the Advisers' principals have economic interests in such other investment vehicles and investments as well and may receive management fees and carried interests relating to those interests.

From time to time, the Advisers will be presented with investment opportunities that would be suitable not only for a given Partnership, but also for other Private Investment Funds and other investment vehicles operated by advisory affiliates of the Management Company. In determining which investment vehicles should participate in such investment opportunities and



the amount of such participation, the Advisers are subject to conflicts of interest among the investors in such investment vehicles. The Advisers attempt to resolve such conflicts of interest in light of their obligations to investors in the applicable Partnership, Private Investment Funds and other investment vehicles managed by them, and attempt to allocate investment opportunities among a Partnership, other Private Investment Funds and such investment vehicles in a fair and equitable manner. Where necessary, the Advisers consult and receive consent to conflicts from an advisory committee consisting of limited partners of the applicable Partnership and such other investment vehicles.

Because the General Partners' carried interest is based on a percentage of certain net profits, it may create an incentive for the Advisers to cause the Partnerships to make riskier or more speculative investments than would otherwise be the case. Since the General Partners are permitted to retain certain Supplemental Fees (as described under "Fees and Compensation") in connection with Partnership investments, the Advisers could have a conflict of interest in connection with approving transactions and setting such compensation. The Advisers also could have a conflict of interest in allocating investment opportunities and related fees and expenses to the Partnerships and co-investors.

The Management Company may cause its affiliates, including a Partnership, to purchase different classes of debt and/or equity of the same borrower or issuer. These and other investments may be deemed to create conflicts of interest, particularly because the Advisers' principals and/or other employees of the Management Company may take certain actions for affiliates with respect to one class of debt or equity that may be adverse to other affiliates who hold other classes of debt or equity of the same borrower or issuer. In such cases, the Advisers' principals will seek to act in a manner they believe in good faith to be fair to clients under the circumstances.

As a result of the Private Investment Funds' controlling interests in portfolio companies, Water Street and/or its affiliates typically have the right to appoint board members to such portfolio companies, or to influence their appointment, and to determine or influence a determination of their compensation. From time to time, portfolio company board members approve compensation and/or other amounts payable to Water Street and/or its affiliates. Water Street and/or its affiliates may also, from time to time, employ personnel with pre-existing ownership interests in portfolio companies owned by the Private Investment Funds or other investment vehicles advised by Water Street and/or its affiliates. In addition, portfolio companies may from time to time pay certain fees to third party consultants (including consultants introduced or arranged by Water Street and/or its affiliates that may regularly provide services to one or more Private Investment Fund portfolio companies such as Operating Partners that are consultants and not full time employees of Water Street, Senior Advisors and the Corporate Resources Group), and such fees will not offset the Management Fee as described herein. Any of these situations subjects Water Street and/or its affiliates to potential conflicts of interest.

#### **DISCIPLINARY INFORMATION**

The Management Company and its management persons have not been subject to any material legal or disciplinary events required to be discussed in this Brochure.

## **OTHER FINANCIAL INDUSTRY ACTIVITIES AND AFFILIATIONS**

The Management Company serves as the general partner of each of the General Partners, each of which is registered with the SEC under the Advisers Act pursuant to the Management Company's registration. The General Partners serve as general partners of private investment funds and other pooled vehicles or of other affiliated investment advisers and may share common owners, officers, partners, employees, consultants or persons occupying similar positions.

## **CODE OF ETHICS, PARTICIPATION OR INTEREST IN CLIENT TRANSACTIONS AND PERSONAL TRADING**

The Advisers have adopted the Water Street Code of Ethics and Securities Trading Policy and Procedures (the "**Code**"), which sets forth standards of conduct that are expected of the Advisers' principals and employees and addresses conflicts that arise from personal trading. The Code requires the Advisers' personnel to:

- report their personal securities transactions;
- pre-clear any proposed purchase of an initial public offering or a limited offering; and
- comply with policies and procedures reasonably designed to prevent the misuse of, or trading upon, material non-public information.

A copy of the Code will be provided to any client or prospective client upon request to Jeff Holway, the Water Street Chief Compliance Officer, at (312) 506-2900. Personal securities transactions by employees who manage client accounts are required to be conducted in a manner that prioritizes the client's interests in client-eligible investments.

The Advisers and their affiliated persons may come into possession, from time to time, of material nonpublic or other confidential information about public companies which, if disclosed, might affect an investor's decision to buy, sell or hold a security. Under applicable law, the Advisers and their affiliated persons would be prohibited from improperly disclosing or using such information for their personal benefit or for the benefit of any person, regardless of whether such person is a client of the Advisers. Accordingly, should the Advisers or any of their affiliated persons come into possession of material nonpublic or other confidential information with respect to any public company, the Advisers would be prohibited from communicating such information to clients, and the Advisers will have no responsibility or liability for failing to disclose such information to clients as a result of following their policies and procedures designed to comply with applicable law. Similar restrictions may be applicable as a result of Water Street personnel serving as directors of public companies and may restrict trading on behalf of clients, including the Partnerships.

Principals, Operating Partners and employees of the Advisers and their affiliates may directly or indirectly own an interest in Private Investment Funds or certain co-investment vehicles. To the extent that co-investment vehicles exist, such vehicles may invest in one or

more of the same portfolio companies as a Partnership. Operating Partners could also own direct interests in portfolio companies.

Co-investment opportunities may also be presented to certain affiliates of Water Street, as well as third party investors and other persons, and such co-investments may be effected through co-investment vehicles or directly in a particular portfolio company. The Partnerships and other Private Investment Funds may invest together with other private investment funds advised by an affiliated adviser of an applicable General Partner in the manner set forth in the applicable Partnership Agreement. In addition, certain Operating Partner consultants, other consultants, employees of Water Street that are not partners of the General Partners and members of the Corporate Resources Group may be offered the opportunity to co-invest in each portfolio company investment of the Partnerships. The Advisers will determine allocation of investment opportunities in a manner that they believe is fair and equitable to their clients consistent with the Advisers' fiduciary obligations and Water Street's Investment Allocation/Co-Investment Policy. In the case of co-investments, the Advisers may grant certain third party investors the opportunity to evaluate specified amounts of prospective co-investments in a Private Investment Fund's portfolio companies or otherwise have priority in co-investment opportunities. Co-investors described above may, but, typically do not pay management fees or carried interest.

The Advisers and their affiliates, principals and employees may carry on investment activities for their own accounts and for family members, friends or others who do not invest in the Partnerships, and may give advice and recommend securities to other accounts or certain Partnerships or vehicles which may differ from advice given to, or securities recommended or bought for, other Partnerships or vehicles, even though their investment objectives may be the same or similar. The operative documents and investment programs of certain vehicles sponsored by Water Street (the "**Reference Funds**") may restrict, limit or prohibit, in whole or subject to certain procedural requirements, investments of certain other vehicles in issuers held by such Reference Funds or may give priority with respect to investments to such Reference Funds. Some of these restrictions could be waived by investors (or their representatives) in such Reference Funds.

From time to time, the General Partners may borrow funds on behalf of the Partnerships or the Private Investment Funds and contribute such borrowed amounts to the Partnerships (or relevant Private Investment Fund, as applicable) as a special capital contribution for investment, to be returned to the General Partner at a later date. Interest in connection with such borrowing is borne by the Partnerships (or the relevant Private Investment Fund, as applicable) as a Partnership expense, consistent with the applicable Partnership Agreement (or other governing document) and the expense policy described under "Fees and Compensation." In borrowing on behalf of the Partnerships or a Private Investment Fund, the General Partners are subject to conflicts of interest between repaying their obligations and retaining such borrowed amounts for the benefit of the Partnerships or Private Investment Fund, as applicable. The General Partners will effect such borrowings in a manner that they believe to be fair and equitable to the Partnerships or Private Investment Fund, as applicable, and consistent with the General Partners' obligations to the Partnerships and the Partnership Agreement (or other governing document).

## **BROKERAGE PRACTICES**

The Advisers focus on securities transactions of private companies and generally purchase and sell such companies through privately-negotiated transactions in which the services of a broker-dealer may be retained. However, the Advisers may also distribute securities to investors in a Private Investment Fund or sell such securities, including through using a broker-dealer, if a public trading market exists. Although the Advisers do not intend to regularly engage in public securities transactions, to the extent they do so, they follow the brokerage practices described below.

If the Advisers sell publicly traded securities for a Private Investment Fund, they are responsible for directing orders to broker-dealers to effect securities transactions for accounts managed by the Advisers. In such event, the Advisers will seek to select brokers on the basis of best price and execution capability. In selecting a broker to execute client transactions, the Advisers may consider a variety of factors, including: (i) execution capabilities with respect to the relevant type of order; (ii) commissions charged; (iii) the reputation of the firm being considered; and (iv) responsiveness to requests for trade data and other financial information.

The Advisers have no duty or obligation to seek in advance competitive bidding for the most favorable commission rate applicable to any particular client transaction or to select any broker on the basis of its purported or "posted" commission rate, but will endeavor to be aware of the current level of the charges of eligible brokers and to reduce the expenses incurred for effecting client transactions to the extent consistent with the interests of such clients. Although the Advisers generally seek competitive commission rates, they may not necessarily pay the lowest commission or commission equivalent. Transactions may involve specialized services on the part of the broker involved and thereby entail higher commissions or their equivalents than would be the case with other transactions requiring more routine services.

Consistent with the Advisers seeking to obtain best execution, brokerage commissions on client transactions may be directed to brokers in recognition of research furnished by them, although the Advisers generally do not make use of such services at the current time and have not made use of such services since their inception.

The Advisers do not anticipate engaging in significant public securities transactions; however, to the extent that the Advisers engage in any such transactions, orders for purchase or sale of securities placed first will be executed first, and within a reasonable amount of time of order receipt. To the extent that orders for Private Investment Funds are completed independently, the Advisers may also purchase or sell the same securities or instruments for several Private Investment Funds simultaneously. From time to time, the Advisers may, but are not obligated to, purchase or sell securities for several client accounts at approximately the same time. Such orders may be combined or "batched" to facilitate obtaining best execution and/or to reduce brokerage commissions or other costs. Batched transactions are executed in a manner intended to ensure that no participating Private Investment Fund of the Advisers is favored over any other Private Investment Fund. When an aggregated order is filled in its entirety, each participating Private Investment Fund generally will receive the average price obtained on all such purchases or sales made during such trading day.

When an aggregate order is partially filled, the securities purchased or sold will normally be allocated on a *pro rata* basis to each Private Investment Fund participating in such buy or sell order in accordance with the amount of securities originally requested for such Private Investment Funds.

Each Private Investment Fund generally will receive the average price obtained on all such purchases or sales made during such trading day. Exceptions to *pro rata* allocations are permissible provided they are fair and equitable to Private Investment Funds over time.

### **REVIEW OF ACCOUNTS**

The investments made by the Private Investment Funds are generally private, illiquid and long-term in nature. Accordingly, the review process is not directed toward a short-term decision to dispose of securities. However, the Advisers closely monitor companies in which the Private Investment Funds invest, and the Water Street Chief Compliance Officer periodically checks to confirm that each Private Investment Fund is maintained in accordance with its stated objectives.

The Partnerships will provide to their limited partners (i) audited financial statements annually, (ii) unaudited financial statements for the first three quarters of each fiscal year, (iii) annual tax information necessary for each limited partner's tax returns, and (iv) descriptive investment information for each portfolio company periodically.

### **CLIENT REFERRALS AND OTHER COMPENSATION**

The Advisers and/or their affiliates may provide certain business or consulting services to companies in the Partnerships' respective portfolios and may receive compensation from these companies in connection with such services. As described in the applicable Partnership's Partnership Agreement, this compensation may, in many cases, offset a portion of the Management Fees paid by the Partnerships. However, in other cases (e.g., reimbursements for out of pocket expenses directly related to a portfolio company or with the Partnership's advisory board consent), these fees may be in addition to Management Fees. See "Fees and Compensation."

From time to time, the Advisers may enter into solicitation arrangements pursuant to which they compensate third parties for referrals that result in a potential investor becoming a limited partner in an applicable Partnership or other Private Investment Fund. Any fees payable to any such placement agents are borne by the Advisers indirectly through an offset against the Management Fee.

### **CUSTODY**

The Advisers maintain custody of the Partnerships' assets held in the Partnerships' names with Merrill Lynch & Co., Inc., located at 600 California Street, 8th Floor, San Francisco, CA 94108 and JPMorgan Chase Bank, located at 420 W. Van Buren Street, 4<sup>th</sup> Floor, Chicago, IL 60606-3534.

## **INVESTMENT DISCRETION**

The Advisers have discretionary authority to manage investments on behalf of the applicable Partnership. As a general policy, the Advisers do not allow limited partners to place limitations on this authority. Pursuant to the terms of the Partnership Agreement, however, an Adviser may enter into "side letter" arrangements with certain limited partners whereby the terms applicable to such limited partner's investment in the Partnership may be altered or varied, including, in some cases, the right to opt-out of certain investments for legal, tax, regulatory or other similar reasons. The Advisers assume this discretionary authority pursuant to the terms of the Partnership Agreement and powers of attorney executed by the limited partners of each Partnership.

## **VOTING CLIENT SECURITIES**

The Advisers have adopted the Water Street Proxy Voting Policies and Procedures (the "**Proxy Policy**") to address how they will vote proxies, as applicable, for the Partnerships' portfolio investments. The Proxy Policy seeks to ensure that the Advisers vote proxies (or similar instruments) in the best interest of the Partnerships, including where there may be material conflicts of interest in voting proxies. The Advisers generally believe their interests are aligned with those of the Partnerships' investors through the principals' beneficial ownership interests in the Partnerships and therefore will not seek investor approval or direction when voting proxies. In the event that there is or may be a conflict of interest in voting proxies, the Proxy Policy provides that the Advisers may address the conflict using several alternatives, including by seeking the approval or concurrence of a Partnership's advisory board on the proposed proxy vote or through other alternatives set forth in the Proxy Policy. The Advisers not consider service on portfolio company boards by Water Street personnel or the Advisers' receipt of management or other fees from portfolio companies to create a material conflict of interest in voting proxies with respect to such companies. In addition, the Proxy Policy sets forth certain specific proxy voting guidelines followed by the Advisers when voting proxies on behalf of the Partnerships. Clients or prospective clients should contact Jeff Holway, the Water Street Chief Compliance Officer, at (312) 506-2900, if they would like a copy of the Advisers' complete Proxy Policy or information regarding how the Advisers voted proxies for particular portfolio companies. Such information will be provided to such persons at no charge.

## **FINANCIAL INFORMATION**

The Management Company does not require prepayment of management fees more than six months in advance or have any other events requiring disclosure under this item of the Brochure.