



December 31, 2007

Dear Investors and Friends,

Below please find the December progress report of the BayStar Capital III Investment Fund ("The Fund" or "BayStar Capital III").

### **FUND OVERVIEW**

As a multi-strategy investment fund, BayStar Capital III provides timely and innovative financing solutions for small to mid-capitalization private and public companies. The Fund's investments focus on credit-protected base returns coupled with significant equity growth potential, and are driven by a proven strategy of recognizing future value-creating events associated with a company's business enterprise. BayStar Capital III intends to generate pure alpha with little correlation to any market index performance. The operational and financial performance of our specific portfolio and investment determines our periodic returns.

### **Cash-Rich Fund Retains Advantage**

December's subprime mortgage turmoil victims – including Morgan Stanley and Bear Stearns - demonstrate that major companies continue to be constrained in their ability to raise capital. As mounting data points to the likelihood of a U.S. recession, smaller capitalization firms - dependent on U.S. economic conditions – are in need of capital infusions. Positively, the increase in the number of companies (now with more favorable valuations) who need harder-to-get capital, coupled with the decrease in the number of firms chasing deals, allows us to aggressively price new transactions to the Fund's favor.

### **PORTFOLIO NEWS: BayStar Capital III investment files S-1**

GlassHouse Technologies, an information-technology services provider and (BayStar Capital III investment) filed their S-1 with the Securities and Exchange Commission on December 18, 2007 announcing plans for an initial public offering. Goldman Sachs, JP Morgan Securities, Banc of America Securities and Thomas Weisel Partners are underwriting the IPO. In July, 2007, the Fund invested in GlassHouse with the following terms:

- Protected base return of 12% (10% coupon + fees) ; 36 month term
- Convertible at 20% discount to IPO; 22.5% warrants for six years provide additional upside
- Subordinate to senior debt

Additionally, the BayStar Capital III Fund signed a term sheet for a \$7.5 million convertible loan with a medical device company. The financing will provide growth capital to support the launch of a ground-changing device for acute and chronic nerve injuries. We expect that the device will be approved by the FDA in the coming months. The financing is structured as a senior secured convertible debenture with a 10% coupon with full convertibility, substantial warrant coverage, and full ratchet and anti-dilution protection. The debt will be secured with a first lien on all assets and intellectual property of the company.

### *20/20 Hindsight*

BayStar Capital III continues to stay on a positive track by reviewing multiple investment opportunities and by selecting only those that fit our investment model to bring significant value to the Fund and its investors. We believe there has been too much money chasing bad deals due to the acceptance of unrealistic valuations without adequate fundamental research. We continue to monitor structured transactions within our criteria<sup>1</sup> on a daily basis, which provides a rewarding 20/20 hindsight view on our decision to pass on many deals presented to us. Our research has shown us that as of December 31, 124 “structured private placement investments” were completed by publically-traded companies in calendar year 2007. On average, as measured from the time of investment, issuers' share prices have declined by

almost 13% with the highest gain at 335% and the largest loss at 96%. In our view, this wide swing, highlighted by a standard deviation of over 47%, underscores the importance of fundamental research and analysis, and the ability to walk away from a deal that does not make sense in terms of structure, fundamentals, valuation and risk management with respect to an entire portfolio of investments.

### **LRG CAPITAL GROUP NEWS**

**The LRG Special Opportunities Fund** strategy commenced operations on January 2007 with successful inception-to-date returns of 41.05%. The Fund takes advantage of opportunities born from the rigorous investment analysis performed on prospective BayStar Capital III portfolio companies and market sectors. This analysis often identifies favorable opportunities that fall outside the parameters of the BayStar Capital III mandated strategy, mostly due to structure or issuer needs, and are best positioned in a separate strategy. We monetize these opportunities through the active trading of long/short common equity positions, but will also include a range of instruments that gain exposure to opportunities beyond those reflected solely through stock price. Stock specific volatility, market sector inefficiencies, and macro relative value are examples. All opportunities use fully liquid instruments and have shorter time horizons than those presented in BayStar Capital III.

Due to its continued success, **LRG Capital Commercial Ventures** made an additional investment in the **Arque Orion Group** ([www.arqueorion.com](http://www.arqueorion.com)), which operates regional wealth management and securities brokerages in Japan. The firm expects December to beat November 2007 as their best revenue month since inception (calculated on a trade date basis) and expects its combined revenue for calendar Q4 to surpass Q3 by 39%. If December revenue projections are reached, Arque Orion will have achieved a monthly revenue growth rate of 1650% in 14 months.

We continue to see benefits from our strategic alliances in the Middle East with **Nakheel** ([www.nakheel.com](http://www.nakheel.com)), **RetailCorp** ([www.retailcorp.ae](http://www.retailcorp.ae)) and **Seven Tides** ([www.seventides.com](http://www.seventides.com)) in Gulf Cooperation Council (GCC) countries, where we are co-developing restaurants, leisure complexes and retail centers. In addition, LRG Capital is one of the largest investors in **Island Global Yachting** ([www.igymarinas](http://www.igymarinas)), the world's premier owner, developer and manager of luxury marinas and yachting lifestyle destinations. IGY has more than \$400 million of equity, with 15 world-class marina locations under ownership or management. This month, IGY and Nakheel signed an exclusive agreement whereby IGY is now the exclusive provider of design, development and management services for all Nakheel marina properties, including its signature developments - The Palm Islands, The World, and Dubai Waterfront, the largest waterfront development in the world. We believe these activities will continue to drive new investment opportunities and strong strategic/ financial co-investors to BayStar Capital III.

We are confident about our investment strategy, our team and the companies we have chosen for the BayStar Capital III Investment Fund. Our success is closely associated with your continued support and investments. We look forward to working with you.

<sup>1</sup> Assumptions: Public companies with market capitalization between \$50M and \$500M. Transaction value: greater than \$4M over last 12 month period. Healthcare, IT, Telecommunications, Oil and Gas Exploration and Media industries.