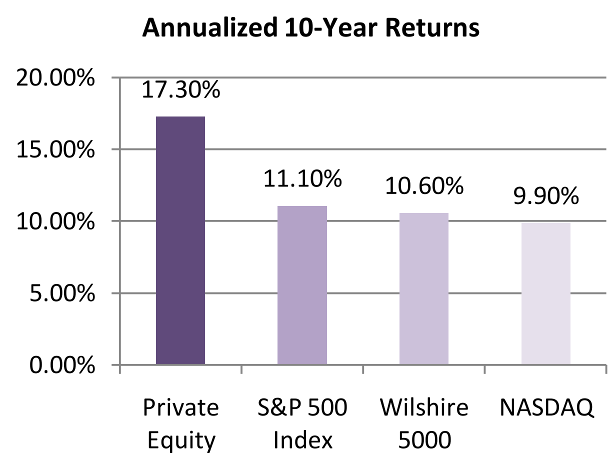
Henshaw

Primer Supplement on Private Equity Considerations

Introduction to Private Equity: Over the last ten years private equity ("PE") has increasingly become a significant portion of most institutional portfolios. The private equity asset class is defined as investments in private companies or partnerships that invest in them. Since 1995, investors have committed more than US$1.8 trillion to private equity funds.[1] Since 2000, the number of endowments, foundations, corporate and public pension plans committing to the PE asset class has steadily increased to over 80% of all such institutions in North America. Similarly, allocations to PE as a percentage of total portfolios has also steadily increased, with an average allocation in North America increasing to over 9% in 2007.[2] Progressive University endowments such as those of Yale, Harvard and Princeton allocate as much as 20% of their endowment portfolios to PE.[3]

Attractive Investment Returns: There are two primary reasons why financial institutions invest in private equity. First, PE returns have historically outperformed those of public equities by a large margin. As shown below, data from Venture Economics indicate that PE has delivered more than a 17% annualized return from 1995-2006, outperforming public equities by more than 600 basis points per annum. Prior studies show similar outperformance.



Diversification Benefit: Secondly, PE is not highly correleated to public equities, making it an excellent diversifier when added to a portfolio of stocks and bonds. Despite its attractiveness, prior to investing, it is important to note that private equity has liquidity constraints and not be suitable for investors who do not seek to match asset and liability durations. Given these two core considerations, adding PE to a diversified portfolio is becoming increasingly common. Based on various studies, adding an allocation of PE to a portfolio increases return while reducing risk. Fort Washington's study generated the following results:

	Annualized Return	**Annualized Std. Dev.[4]**	**Correlation**	**Sharpe Ratio[5]**
S&P 500 Index	11.1%	17.8%	1	0.62
Lehman Brothers Gov't/Credit Index	7.0%	4.7%	-0.24	1.49
Private Equity Pooled Average	17.3%	24.0%	0.67	0.72
Portfolio 1: (60% S&P 500 + 40% LB G/C)	9.9%	10.4%	0.98	0.95
Portfolio 2: (60% S&P 500 + 40% LB G/C + 5% PE)	10.2%	10.0%	0.98	1.02
Portfolio 3: (60% S&P 500 + 40% LB G/C + 10% PE)	10.5%	9.7%	0.98	1.08

[1] Venture Economics, VentureXpert database.
[2] Report on Alternative Investing. Goldman Sachs & Co and Frank Russell Company.
[3] The Directory of Alternative Investment Programs, Asset Alternatives, Inc.
[4] Standard Deviation is a statistical measure generally regarded as a measure of risk. The higher the Std. Dev. the greater the distribution of possible returns around the expected return.
[5] Sharp Ratio is a measure of the reward to volatility; ratio of portfolio excess return to standard deviation.

33 St James's Square, London, SW1Y 4JS,
Tel: +44 (0) 20 3178 6570, Fax: +44 (0) 20 3178 6571
Email: info@africanfundoffunds.com

A similar study by Harvard Business School Professors Paul Gompers and Josh Lerner found that adding PE to a portfolio shifted the entire efficient frontier toward higher return with lower risk. Increasing returns while lowering risk is the fundamental reason why PE has become so popular with the institutional investor community.

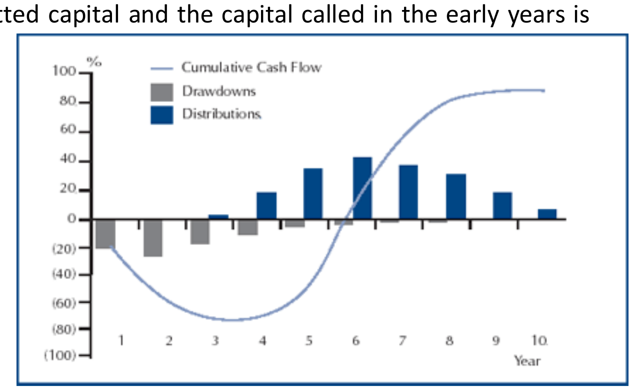
What is the Appropriate Allocation to PE?: Most consultants consider that a meaningful allocation to any asset class should be at least 5% of the portfolio. The average public pension plan in North America has a 7% allocation to PE, roughly double that of just 10 years ago.[6] Some pension plans, such as the State of Michigan's or the State of Washington's having allocations of as much as 15% and 17% respectively. The average private/corporate pension plan and university endowment has an 8% allocation to PE.

The "Yale Effect": The so-called "Yale Effect" has many progressive institutions trying to emulate Yale and other Ivy League endowments' highly successful portfolio performance due in part to their large allocations equal to as much as 20% to PE. Many investors, including large pension plans have recently initiated allocations to PE. For example, the San Diego City Employees Retirement System recently approved a new allocation of 5% if its US$4.7 Bn portfolio. The Public Employee Retirement System of Idaho and the Indiana Teachers Retirement Fund recently increased their allocations from 5% to 10%.

Over-Commitment and Target Asset Allocation: Once PE dollars are committed, drawn and returned over time, actual exposure becomes a moving target. Initiating a portfolio or scaling one can be a daunting task – one that consumes a significant amount of time and attention for a relatively small portion of the portfolio. While there are various approaches to reaching target asset allocations, it cannot be done overnight and requires some level of over-commitment and regular monitoring. By over-commitment, we mean that a 5% allocation may require commitments of 1.5 to 1.9 times the target level (since the commitment is drawn and returned over time) to reach the desired exposure.

Acceleration: Using fund of funds, commitments could be accelerated since fund of funds tend to commit their capital over two to four vintage years. Thus, commitments to fund of funds could be front-loaded to achieve similar results. For example, using a fund of funds, an institution could make the first two or three years of commitments to a fund of funds if it was to invest over two to three vintage years. In addition, since fund of funds are typically open for a period of up to one year after the first close, commitments to fund of funds may achieve some prior vintage year diversification. Finally, using secondaries, the portfolio could further accelerate exposure by gaining access to prior vintage year funds hat are nearly drawn. While timing is often a question, a disciplined commitment plan allows for "dollar cost averaging" into the asset class over a reasonable time horizon. Using a fund of funds allows for larger up front commitments and potentially, access to prior vintage year funds. Secondaries can also accelerate exposure to the extent it is believed secondaries will achieve the desired returns.

Addressing the J-Curve: Two things fundamentally cause the J-Curve. The principal driver is that management fees in a fund are charged based on a fund's entire committed capital and the capital called in the early years is only a portion of the fund's committed capital. Thus in the early years, management fees and organizational expenses represent an unusually large portion of the contributed capital.



Lemons: The second major driver of the J-curve is best explained in the following way: the lemons ripen early, particularly with early stage funds, eg., venture capital. Troubled companies tend to be written down or off much more quickly than successful companies develop. Most

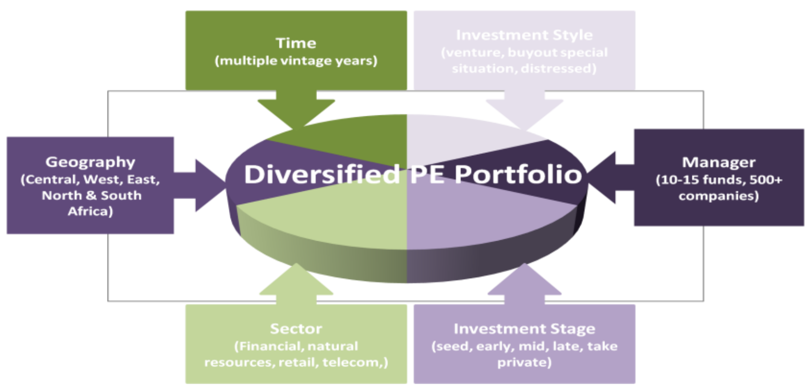
[6] NACUBO, Private Equity Analyst

GPs expect that successful companies take four to seven years to reach their positive outcome. Troubled companies, on the other hand will surface more quickly as it becomes apparent that their business models or management teams are not working. Thus while good companies tend to be held at cost, bad ones are written down according to the accepted accounting principles of the industry. For these two reasons it is typical to see the NAV of the commitments made by and LP investors decline in the early years to below cost and then accelerate quickly in later years thereby generating the offsetting returns which achieve the superior long-term results the industry has become known for.

Solutions: There are several ways to address this J-Curve effect, although it is inherent to the asset class. These include: 1) effectively managing fees, 2) purchasing secondary interests in private equity funds at a discount, and 3) managing the portfolio between buyout and venture capital such that there are likely to be some winners ahead of or consistent with some of the "leons" in the early years. Other techniques include mezzanine investing or other current income approaches. Despite the foregoing, at Henshaw we believe achieving the best possible long-term economic returns outweighs the concerns about managing interim accounting valuations.

Building and Managing the Private Equity Portfolio: A fund of funds is advantageous for both investors with small private equity allocations and for investors with large allocations. Although fund of funds adds an additional layer of fees, the fees can be far less that costs of managing the portfolio in-house.[7] In addition, using a competent professional manager brings the necessary expertise, discussed below, to effectively access, select and manage the underlying relationships and the direct co-investments, which in turn drive up returns and effectively reduce the layered fee effect. Because fund of funds are such an efficient private equity investment vehicle, commitments to fund of funds have increased nearly 10 fold from 1995 to 2007. The benefits that drive the efficiency of a fund of funds are multiple and include the following:

Diversification: Private equity investors exchange the lack of liquidity for a historically higher return premium over public equities. However, there are elements of risk dependent on variables such as economic cycles, capital markets and industry sectors, some of which can be eliminated or significantly reduced by investing in a diversified portfolio. Diversifying across investment style, fund manager, investment stage, sector, geography and time (vintage year) realizes the full potential of the asset class while reducing the exposed liability associated with any one of these risk dimension is important.

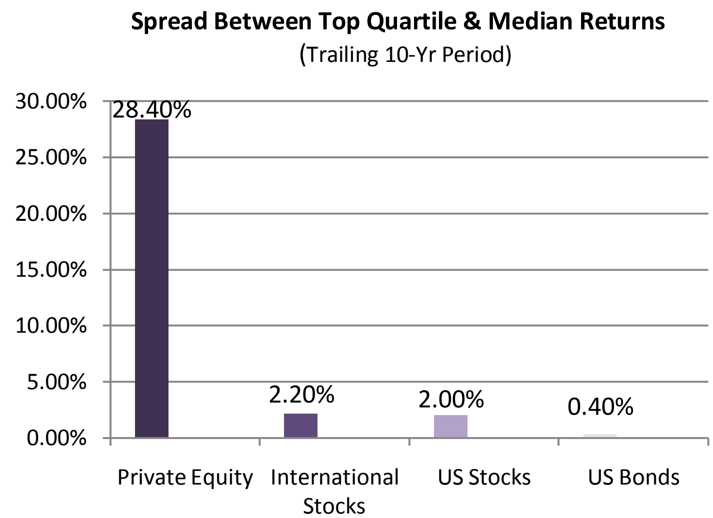


Scaling Up & Down: For investors allocating smaller amounts to the asset class, it is difficult to create a diversified portfolio across these dimensions because many quality PE partnerships, if they can be accessed at all, require US$5 Mn to US$10 Mn minimum commitments. Thus building a well diversified portfolio would require US$50 million. Using a fund of funds provides leverage for the smaller investors. For large investment amount, a fund of funds allows for an efficient single allocation to a manager with the expertise, resources and relationships to build a diversified portfolio by making smaller allocations to select partnerships that have limited access or require specialized knowledge and skills to evaluate properly. This scaling down is typically used for emerging manager or geographic focused strategies.

[7] Private Equity Fund of Funds: State of the Market.

33 St James's Square, London, SW1Y 4JS,
Tel: +44 (0) 20 3178 6570, Fax: +44 (0) 20 3178 6571
Email: info@africanfundoffunds.com

Manager Selection: Much more so than with publicly traded securities, where markets are much more efficient and information asymmetry is less prevalent, manager selection matters a great deal in the realized return. The manager selection could mean the difference between achieving exceptional returns and performing below expectations for the asset class.



Top Quartile Effect: According to PSN/Effron and Venture Economics, the spread between the median performance and the top quartile performance in PE funds is much more significant for PE that for public securities. The key drivers for the difference in returns is the difficult to acquire skills, expertise, and experience as well as the high involvement by the PE manager in identifying, managing and existing the private company investments. When the fund of fund manager identifies those funds with managers who have demonstrated these unique skillsets, the size of the commitment must be enough to impact overall portfolio performance. Sizing the fund of funds becomes important in ensuring that the overall returns remain well above the median. To small a fund and access to the best funds will be difficult. Too big a fund and over diversification drives returns toward the median.

Access: Moreover, the best performing GPs or PE fund managers can choose with whom they do business. The best seek long-term investors who will be with them through subsequent fund-raisings, do not require a lot of hand-holding, where there is stability of personnel and relationships, and who can add real value to their own investment program through the LP's network, ideas, and co-investment capabilities. The greater the value-added provided by the LP, the greater the allocation received in oversubscribed funds. In the case of fund of funds, which typically have deeply experienced PE investment personnel, this offers exceptional access over time.

Skillsets: Finally, it is critical to apply consistent criteria to all fund investment opportunities, including re-investment in GPs with whom one already has relationships. At a very high level of detail, the key criteria in evaluating PE fund GPs include: portfolio fit, industry and sector expertise, focus and reputation, track record, strategy, integrity and commitment, composition of team skillset and length of time together, team rapport, deal flow and acceptable contract terms. Identifying the next generation of leading funds, particularly in a highly dynamic market like Africa require expertise, judgment, knowledge of the personnel within the formerly leading managers and their movements, as well as the emerging sectors and strategies likely to capitalize on the evolving inefficiencies in the macro-economic and microeconomic environments addressed by each fund evaluated. In evaluating new managers during due diligence, multiple face-toface meetings with the partners, extensive review of the track record and investment strategy, review of the existing and potential investments and extensive reference checks are required. Most of all, there must be a general comfort level with the strength of the tea, personal incentives and motivations or the partners, their operating philosophy, specific areas of expertise and how the strategy fits with the rest of the portfolio from risk/return as well as cash-flow perspectives.

Actively Managing the Portfolio: Once an investment is made, many private equity investors take a passive approach, waiting to see of the GP can deliver. This is often due to time and staff constraints, as well as lack of expertise to intervene. There are a number of areas in which a fund of funds manager can continue to add value to the portfolio such as:

- Holding GPs accountable to their strategies and monitoring for style drift;
- Supporting portfolio companies through connections between other GPs, underlying companies and limited partners;
- Advising GPs, including serving on Advisory Boards, on potential conflicts and decisions which help develop the firm's investing capacity;
- Acting as "idea testers" on the efficacy and viability of underlying portfolio company strategy and/or execution.
- Active involvement in the co-investment process and deal idea generation;
- Assistance in assembling optimal, complimentary value-adding co-investors;
- Effectively managing cash and public securities in the portfolio prior to and post distribution.

Monitoring and Reporting: Monitoring investments in a diversified PE portfolio can be complex. There are quarterly and annual reports and partnership tax returns for each partnership as well as quarterly and annual conference calls and meetings with the GPs. A strong fund of funds manager constantly reviews reports, attends meetings and conference calls and effectively aggregates and communicates information to investors via quarterly reports and meetings with its investors. The fund of funds manager also consolidates and simplifies monitoring and administration of capital calls and distributions. Additionally, questions about the portfolio, individual funds or companies can be directed to a single point of contact. At Henshaw we believe in going several steps further in the monitoring process, such that during trips through Africa, we enhance the overall information assembly by augmenting data sources including: meetings with Ministry of Finance, Central Banks, commercial banks, accounting and legal firms, Government Officials, underlying portfolio companies, competitors and MNCs active in the space. The purpose is to constantly update and refresh the information context in concert with the dynamism of the changing environment. This is reflected in our own communications with our investors.

Conclusion: PE is a very attractive asset class for long-term investors seeking to match long-dated assets and liabilities. In order to squeeze the most return out of the exposure however, significant attention to detail is required. A specialized Fund of funds with the in-house dedicated expertise can eliminate or at least minimize many of the "identifiable" risks associated with asset class. "Exogenous" risks such as currency devaluations, government interventions, or major global price movements in a given sector, are difficult to hedge against, particularly in Frontier emerging markets where the financial tools, like deep currency hedging markets are non-existent or too expensive for example. Nevertheless, as EMPEA data show, even in more volatile markets the overall returns have exceeded listed benchmarks over long-dated period studies. Henshaw welcomes the opportunity to assist you in your search for yield within this asset class.