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Private Equity Fund of Funds Sponsored by DFI's

Private Equity and venture capital Fund of Funds have experienced a significant growth around the world. Increasingly they are being created to accomplish development agendas by harnessing proven private sector tools to nurture growth businesses and drive employment growth. We have surveyed the Fund of Funds industry and uncovered a surprisingly large number of initiatives in almost all other regions of the world, except Africa.

The Evidence: Over the past 5 years, a range of fund of funds have been created to foster economic development not only in emerging markets but also in many developed markets. **Appendix 1** lists 2 dozen different fund of funds programs that have been raised over this period to achieve regional developmental goals. All of these funds have been initially sponsored by development agencies and or government entities and almost all have been allocated to independent 3rd party management entities.

Key Points

- In all cases the first vehicle was established by development and public sources of capital to support local fund managers and establish a track record at the FoF level.
- In the cases where the entity was established before this period and they are now raising 2nd or 3rd funds, the managers were able to attract private sector capital.
- A 3rd party management company was selected in all cases to strategically build that capacity and arms-length independence precisely in order to attract private sector capital in the future.

Africa Relevance

- Africa has no Pan-African independent Fund of Funds manager. Development institutions need to prepare in advance for the recovery to come in 2 years, when an entity like Henshaw Capital Partners will by then be able to attract far more capital when the capital markets are more conducive and reaching for yield once again.
- Without vehicles in place now, validating the concept, establishing a track record, and marketing to tomorrow's investors, years will have been squandered.
- Now is the time, more than ever to establish this type of vehicle.

Fund of Funds as a Driver of Economic Development: A growing awareness exists of the role that fund of private equity funds play in leveraging in incremental capital into a region. That role as a "leveraging platform and subsequent capital allocator to the most efficient uses", is now best understood within the Asian markets.

Asian Growth: Between 2004 and today over $6 Billion in private equity fund of funds have been raised in predominately first time funds. In our survey of the market, as many as a half dozen new funds are about to be launched by institutions such as IDFC and ICICI in India. These funds are either country specific, i.e., India or China, or regional in nature, accounting for approximately 25% of the capital being committed to private equity. Of the balance of funds being committed to Asia PE Funds, 59% has over the past two years come from Asian investors[1]. The growth of the FoF industry is seen as critical in facilitating both local and US/European first-time investors' access to what is considered an opaque and complex regional market, much like Africa. A common theme in the launching of the industry was initial commitments from knowledgeable local investors including public and quasi public entities. That commitment galvanized subsequent round closings from "already-interested fence-sitters" who had neither the resources, personnel nor expertise to evaluate individual funds.[2] Over time, the percentage share of total funds committed to Fund of Funds vs the underlying direct Fund has declined, as end investors have become more knowledgeable through their Fund of Fund investments and the PE industry's growing success. This catalyzing and

1 Asia Private Equity Review, various issues between 2006 and 2008, Asia Alternative Management LLC.

2 KPMG, "Private Equity: Implications for Economic Growth in Asia Pacific, 2006.

subsequent declining relative roll of FoFs was also evident in Europe over the past 15 years.[3] Today, the value-added of Fund of Funds in attracting further private equity capital to the region is being replicated on a smaller scale in both Latin America and the CIS, where our analysis has uncovered a handful of Fund of Funds in each market, either already raised or currently in the market. As you know, there are no independent Pan-African Fund of Funds managers in Africa. Henshaw Capital Partners is pioneering this effort.

Risk Mitigation through Fund-of-Funds: The logic behind seeding a FoF vehicle is that such entities offer a well-document risk mitigation tool for attracting new capital to a regional or sectoral private equity & venture capital industry. The evidence on risk-reduction is clear. Recently, Weidig and Pierre-Yves Mathonet, analyzed the historical performance of private equity, buyout and venture capital funds, across Europe and the US.[4] They analyze the data for 300 US funds and 200 European funds over 15 years and ran 50,000 fund of funds simulations. The core findings of these studies are that **risk is very substantially mitigated through FoF vehicles**.

To summarize:

1. **Risk**: Private Equity is a risky asset, but private equity investments are not necessarily so.
2. **Variety**: Every type of private equity vehicle has a different risk profile.
3. **Diversification**: Diversification is essential in private equity, because it materially reduces risk.

    a. Any single direct company investment has a 30% probability of total loss across their sample set.
    b. A fund (or a portfolio of direct investments) has a very small probability of total loss.
    c. A fund-of-funds (or a portfolio of funds) has a negligible probability of incurring any loss at all.

Though not perfectly correlated with an emerging or frontier market as is common across Africa, the data they derive for European venture capital and buyouts over the past 15 years is instructive as less debt was used in the underlying deals than was common in the US, and exits in the earlier period were more structured trade sales than IPOs--both key features of private equity across Africa particularly within the SME segment. The salient conclusions, net of fees, of the study are as follows[5]:

Variable	Average Buyout Fund	Buyout Fund of Funds	Explanation
Average Multiple	1.6	1.7	The average FoF has a higher return than the statistical average direct fund
Median Multiple	1.5	1.7	FoF generate returns well above the median fund.
Standard Deviation	0.8	0.2	FoF statistically deviate much more tightly around a 1.7X return than do underlying direct funds.
Worst 99th Percentile	-75%	25%	The worst FoF performers still generate positive returns
Worst 95th Percentile	-32%	37%	As worst performing percentiles are relaxed, FoF returns improve faster than single funds.
Probability of a loss	21%	0%	FoF have a materially lower risk of losing money
Average loss given a loss	-23%	-1%	And if money is lost it is negligible in

3 Javier Echarri, EVCA Secretary General, « The Economic Impact of Private Equity : Bratislava Presentation », 2005.

4 Tom Weidig and Pierre Yves Mathonet, January 2004, “The Risk Profiles of Private Equity: Private Equity is Risky, but Private Equity investments are not necessarily so.” And Weidig T and Born B., 2008 “The Risk Profile of Fund of Funds.” Working paper.

5 Todd Moss, Vijaya Ramachandran and Scott Standley, 2007, “Why Doesn’t Africa Get More Equity Investment? Frontier Markets, Firm Size and Asset Allocation of Global Emerging Markets Funds.” Center for Global Development.

			comparison to a single fund.
Probability of total loss	1%	0%	The venture capital probability of total loss is much higher, but that is not relevant for out purposes.
Risk-Return Ratio	0.8	3.1	The amount of risk investors take on to achieve equivalent returns is **4x greater** with a single fund than with a FoF.

Building African Liquidity: A related study examines the determinants of asset allocators to African listed exchanges.[6] In this paper the authors examine both market-related and market-failure explanations for the relatively low allocation to African stock markets by FIIs over the past 10 years. A number of important conclusions were derived:
1. **Small Market Size:** Because there has been very little regionalization in market structures in Africa over the past 40 years, most mid-sized firms have remained mid-sized.
2. **High costs:** Because there has been a dearth of investment in infrastructure in Africa, the average company has much higher indirect operating costs than those in other emerging markets or developed markets.
3. **Low levels of new Supply on Exchanges:** Because of these two factors, the number of new listings on stock markets across Africa has trailed other higher growth emerging markets like India, China, Russia, Brazil, etc.
4. **Investment Choice:** As a result, investors basically have the limited choice of energy, finance, communications, or infrastructure type companies whether listed in Kenya, Nigeria, Egypt, or South Africa.

Fortunately, these constraints: A) are reflected in entry pricing in today's private equity market in Africa, and B) are being explicitly addressed by market forces.

1. **Infrastructure**: Between larger national budgets driven by external commodity demand, unprecedented Chinese & Indian infrastructure-for-commodity deals, increasing DFI focus on infrastructure, and a myriad of new infrastructure private equity funds raised or in the market[7], there is an unprecedented amount of capital building to address this specific issue. The resulting productivity gains for other private companies will be reflected in margin expansion and eventually corporate valuations.

2. **Private Equity**: Many of the private equity fund managers we are speaking with have very explicit strategies to "buy and build". In order to achieve economies of scale and/or scope in the underlying portfolio company's operations, the managers are looking to buy into the top 1-3 niche leaders and then "Bolt-on" acquisitions to achieve synergies in product portfolio, new distribution for existing products, as well as achieve overhead and balance-sheet efficiencies. This building of scalable businesses into regional niche leaders is explicitly targeting the IPO route for exit because the up-front investments will be larger and the consequent company size will be much larger.

These trends will over time, materially influence the overall investment landscape and contribute to greater liquidity flows to the listed markets in a gradually positive feedback loop. These are predictable trends, assuming the macroeconomic and political environment continues to improve and that the best private equity managers continue to build higher productivity emerging champions. For those SME Funds seeking to address this opportunity, an independent fund of funds manager that can act as a bridging channel to other fund managers on a deal by deal basis can materially help shape the growth dynamic of the SME sectors. This has a high development impact potential.
Conclusion: China, India, Mexico, New Zealand, Australia, Norway, Italy, Greece, Spain, Portugal, France, Turkey, Illinois, California, Oregon, Ohio, Indiana, Kentucky, Utah and others see the clear benefits to supporting the formation of specialized fund of funds to foster economic development in their regions. Certainly a market like Africa merits such an entity. The logic in the first instance is that such a vehicle offers a scalable dedicated platform to ensure capital is allocated quickly and efficiently to the better SME fund managers. That platform then builds the dedicated resources to drive value-added down through the Fund Manager to the underlying portfolio company. In the second instance, such a platform it the best vehicle to enable first time capital to flow into the region or sector when risk appetite resumes. For first time investors seeking exposure to a volatile or emerging investment space, a Fund of Funds with a proven track record offers an attractive risk mitigation tool to subsequently test the returns and learn more about the market as evidenced by the 2 dozen initiatives Appended, and the general evolution of the Asian markets.

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6 Todd Moss, Vijaya Ramachandran and Scott Standley, 2007, "Why Doesn't Africa Get More Equity Investment? Frontier Markets, Firm Size and Asset Allocation of Global Emerging Markets Funds." Center for Global Development.

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Appendix I: Additional Examples of Fund of Funds Targeting Regional Development

Fund	Size	Mission	Sponsor	Manager	Contact	Status
BC Renaissance Capital Fund (2008)	CAD90Mn	Invest in VC/PE funds investing in British Columbia companies	British Columbia Ministry of Economic Development	Kerney Venture Partners	Todd Tessier VP Investments Todd.tessier@gov.bc.ca +1 250 356 7411	Invested in 6 Funds
Ontario Venture Capital Fund (2008)	CAD270Mn	Invest 80% in VC/PE funds investing in Ontario-based companies	Ontario Government & 3rd party investors	TD Capital Private Equity Investors	Michael Flood Managing Director Michael Flood@tdcapital.com +1 416 308 4159	Beginning investment program
The Ohio Capital Fund (2006)	US$150Mn	Invest solely in PE funds investing at least 50% of capital into Ohio companies	Ohio General Assembly & Legislature	Buckeye Venture Partners	Herb Brown Senior Vice President Herb.brown@wslife.com +1 513 361 7600	Invested in 25 funds
NEO Venture Capital Fund (2008)	US$150Mn	Invest in Funds focused on companies in NE Ohio	The Cleveland Foundation, State Fund for Our Economic Future, NorTech	Buckeye Venture Partners	Herb Brown Senior Vice President Herb.brown@wslife.com +1 513 361 7600	Invest in 12 VC & Pee funds
Fonds France Investissement (2007)	EUR 630Mn	Invest solely into funds investing in French SME businesses	Caisse des Depots de France…now open to third parties	CDC Enterprises	Vanessa Giraud Director of Investments Vanessa.giraud@cdcenterprises.fr +33 1 58 50 7171	Invested to date in 8 funds
Neotec (2006)	EUR 130Mn	Invest solely into funds investing in Spanish expansion stage businesses	EIF	JV with CDTI as manager	Jean-Philippe Burcklen Head of Venture Capital j-p.burklen@eif.org +352 42 66 88 1	Invested to date in 5 funds
Instabul Initiative (2008)	EUR 200Mn	Invest solely into funds investing in Turkish expansion stage businesses	EIF	JV with Turkish Tech Foundation & Development Bank of Turkey	Jean-Philippe Burcklen Head of Venture Capital j-p.burklen@eif.org +352 42 66 88 1	Initiating program
Portugal Initiative (2008)	EUR 111Mn	Invest solely into PE funds investing in Portuguese expansion stage businesses	EIF	Partnering now	Jean-Philippe Burcklen Head of Venture Capital j-p.burklen@eif.org +352 42 66 88 1	Initiating program
NEXT (2004)	EUR 37Mn	Invest solely into PE funds investing in the Lombardy region of Italy	Local banks, and regional & city authorities	FinLombarda	Marco Nicolai Managing Director Marco.nicolai@finlombarda.it +39 02 760 441	Invested in 5 funds to date
IDeA Capital Fund of Funds I (2007)	EUR 681Mn	Promote the formation of alternative investment firms in Southern Europe	De Agostini Group, various Government Agencies from Italy, Spain, Greece	IDeA Capital Advisors	Franco Mosca Managing Director & Head of Fund of Funds fmosca@ideasgt.com +39 02 290 663 1	5 funds to date, 8-10 over next 12 months
Illinois Private Equity Fund of Funds (2005)	US$143Mn	Support the development of regional PE fund Managers investing in Illinois,	Illinois Municipal Retirement Fund, State Universities Retirement System of Illinois, Public School Teachers' {ension & retirement Fund of Chicago each contributed US$25 MN, as cornerstone investors.	Muller & Monroe	Irwin C. Loud CIO Irwin.loud@m2am.com +1 312 782 7771	Fully invested in 12 funds. Now raising Fund II.

Fund	Size	Mission	Sponsor	Manager	Contact	Status
Tri-State Growth Capital Fund I (2005)	US$30MN	Invest solely into PE funds investing in Ohio, Kentucky &Indiana	Local pension funds, development authorities & banks	Fort Washington Capital Partners	Steve A. Baker Managing Director Private equity Steve.baker@fortwashington.com +1 888 244 8167	Fully invested in 11 Funds
Tri-State Growth Capital Fund II (2007)	US$40MN	Invest solely into PE funds investing in Ohio, Kentucky &Indiana	Local pension funds, development authorities & banks & 3rd parties	Fort Washington Capital Partners	Steve A. Baker Managing Director Private equity Steve.baker@fortwashington.com +1 888 244 8167	Planned 5-10 funds over next 18 months
California Emerging Venture Fund IV (2006)	US$300Mn	Fourth vehicle that invests solely into PE funds investing in California	California Public Employees Retirement System	Grove Street Advisors	Frank Agnella General Partner fga@grovestreetadvisors.com +1 781 263 6100	5 so far
Northwest Emerging Ventures III (2008)	US$400Mn	Third vehicle that invests solely into PE funds investing in Oregon and Pacific Northwest	Oregon Public Employees Retirement Fund	Grove Street Advisors	Frank Agnella General Partner fga@grovestreetadvisors.com +1 781 263 6100	Planned 4-6 over next 2 years
Utah Fund of Funds I (2006)	US$100Mn	Invest in fund managers who will actively source investment opportunities or set up a presence in the state of Utah	State of Utah Government	Utah Capital Investment Corporation	Jeremy Neilson Managing Director Jeremy@utahfundoffunds.com +1 801 521 3072	Fully invested in 15 funds
Utah Fund of Funds II (Raising)	US$200Mn	Invest in fund managers who will actively source investment opportunities or set up a presence in the state of Utah	Utah State Government and 3rd party investors; Final close Q2, 2009	Utah Capital Investment Corporation	Jeremy Neilson Managing Director Jeremy@utahfundoffunds.com +1 801 521 3072	Planning 5-10 investments over next 12 months
Tianjin Binhai New Area Investment Guidance Fund (2008)	CNY 2Bn	Invest in funds focused on expansion and start-ups businesses in the Tianjin Binhai New Area of Northern China	Chinese State Council, China Development Bank, TBNA Authority	TBNA Fund Management	Jingwei Ni Manager Njw7cn@vip.sina.com +86 10 6830 6688	3 funds thus far
New Economy Development Fund (2004)	EUR 105Mn	Invest primarily in innovation technology companies in Greece, seed, expansion, buyout	Hellenic Government & Greek development institutions, & now 3rd parties	Westport Private Equity subsidiary-TANEO	Eleni Kolofotia Investment Director ekolofotia@taneo.gr +30 210 338 7110	10 thus far
Argentum Fund (2001)	EUR 300Mn Listed & Evergreen	Mandate to invest in private equity funds investing in companies based in or with a presence or business activities in Norway	Initially, Norwegian Ministry of Trade and Industry. Now 3rd parties via new share subscriptions	Argentum Fondinvesterin ger	Harald-Ingve Flgtvedt CFO hig@argentum.no +47 5554 7000	14 funds to date; recycle proceeds into new funds
Mexican Fund of Funds I (2006)	US$440Mn	Invest in PE funds investing in Mexican early, expansion and buyout opportunities	Government of Mexico, NAFIN, BANOBRAS, BANCOMEXT and FOCIR	Corporacion Mexicana de Inversiones de Capital	Eduardo Mapes Director of Investments emapes@fondodefondos.com.mex +52 55 5663 2707	4 funds to date
IFM Australian PE Fund IV (2007)	AUD665Mn	Fourth vehicle that invests solely into PE funds investing in Australia and New Zealand	Local development agencies and 3rd party Superannuation schemes. Fund I	Industry Fund Services	Judith Smith Head of Private Equity jsmith@ifm.net.au +61 3 9923 7188	4 to date, 10- 12 over next 12 months

			initially sponsored by Australian and New Zealand Development Agencies			
New Zealand Venture Investment Fund I (2003)	NZD 160MN	Invest in venture capital and private equity funds focused on New Zealand expansion stage businesses	New Zealand Government	New Zealand Venture Advisors	Francesa Banga CEO Franceska.banga@nvzif.com +64 9 951 0170	Fully invested and working on Fund II