

Nigeria Private Equity Roundtable

Building an optimal Private Equity Portfolio

Radisson Blu Anchorage Hotel
Victoria Island, Lagos
September, 12 – 13, 2011

Objectives

1. What are some considerations for African pension funds in building an Optimal private equity portfolio?
2. What are the key risks?
3. How can they be managed?

Considerations...

1. PE as an asset class is here to stay. Strategic portfolio constituent since 1997; impact continues to be accretive to all stakeholders.

2. PE as an industry in Africa is growing but polarized

South Africa	—	80%
Nigeria	—	10%
Rest *	—	10%

Angola, Botswana, Ethiopia, Ghana, Kenya, Mozambique, Senegal, etc

Source: Africa Report Sep 2010

Considerations...

5. African PE activity participants

- ✓ International Financial Institutions (IFIs)
- ✓ AfDB
- ✓ DBSA
- ✓ CDC
- ✓ Dutch FMO
- ✓ French PROPARCO
- ✓ Norfund
- ✓ Etc

6. Notable absence – African Pension Funds

Considerations...

7. More room at the “party” for African Pension Funds
 - ✓ DFIs won’t be permanent fixtures – essentially risk testers ahead of more risk-averse institutional investors
 - ✓ DFIs may reduce role or exit the industry as growth rates and economic climates improve

Norfund won’t invest where per capita GDP > \$6,500. (Botswana, RSA??)

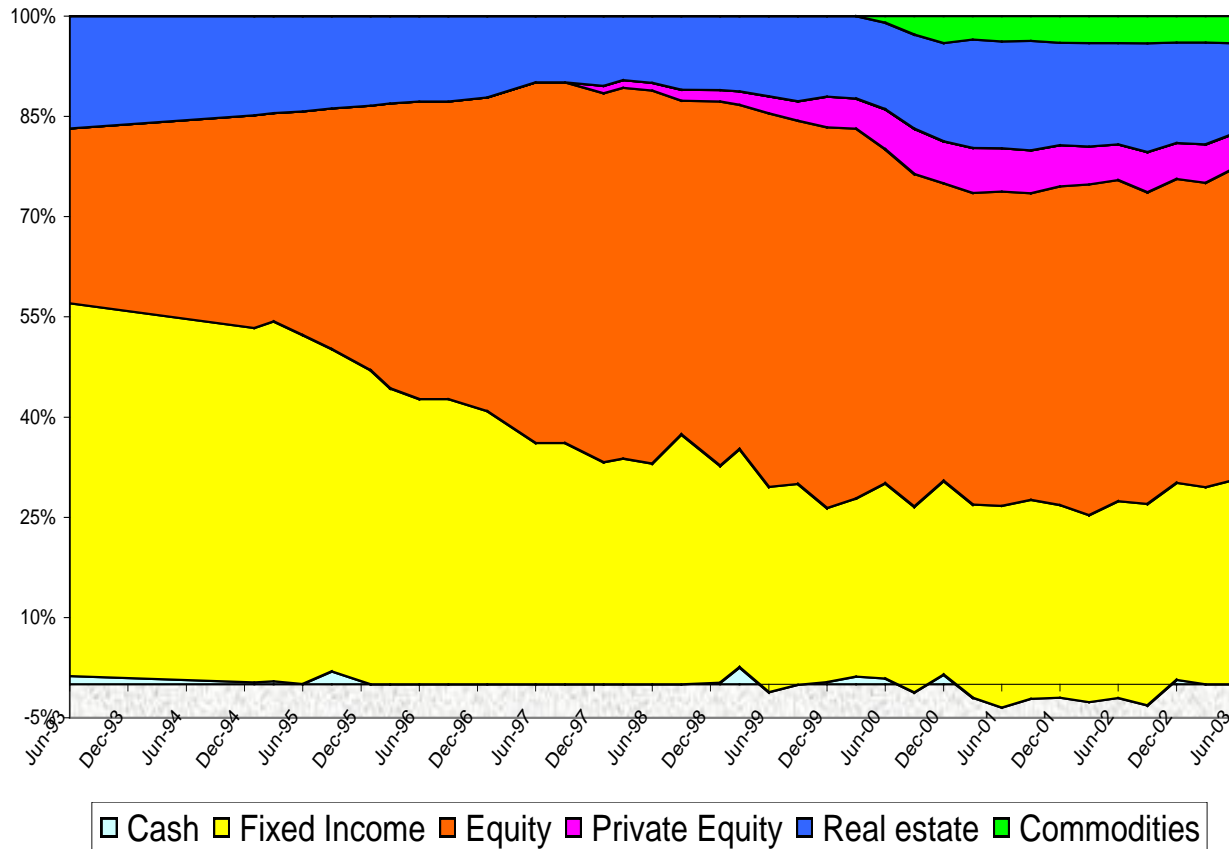
8. Entry of African Pension Funds could ease up the reliance on DFIs and also improve the breadth and depth of the asset class on the Continent

Considerations...

9. Most African nations, rely on healthy International (and intra-African) Trade and a robust Capital market to support and hasten development goals in the areas of:
- ✓ Infrastructure (and Telecommunication),
 - ✓ Supportive financial services sector,
 - ✓ Competitive manufacturing companies,
 - ✓ A pool of talented and skilled managers and workers, etc.

Considerations...

Strategic Portfolio







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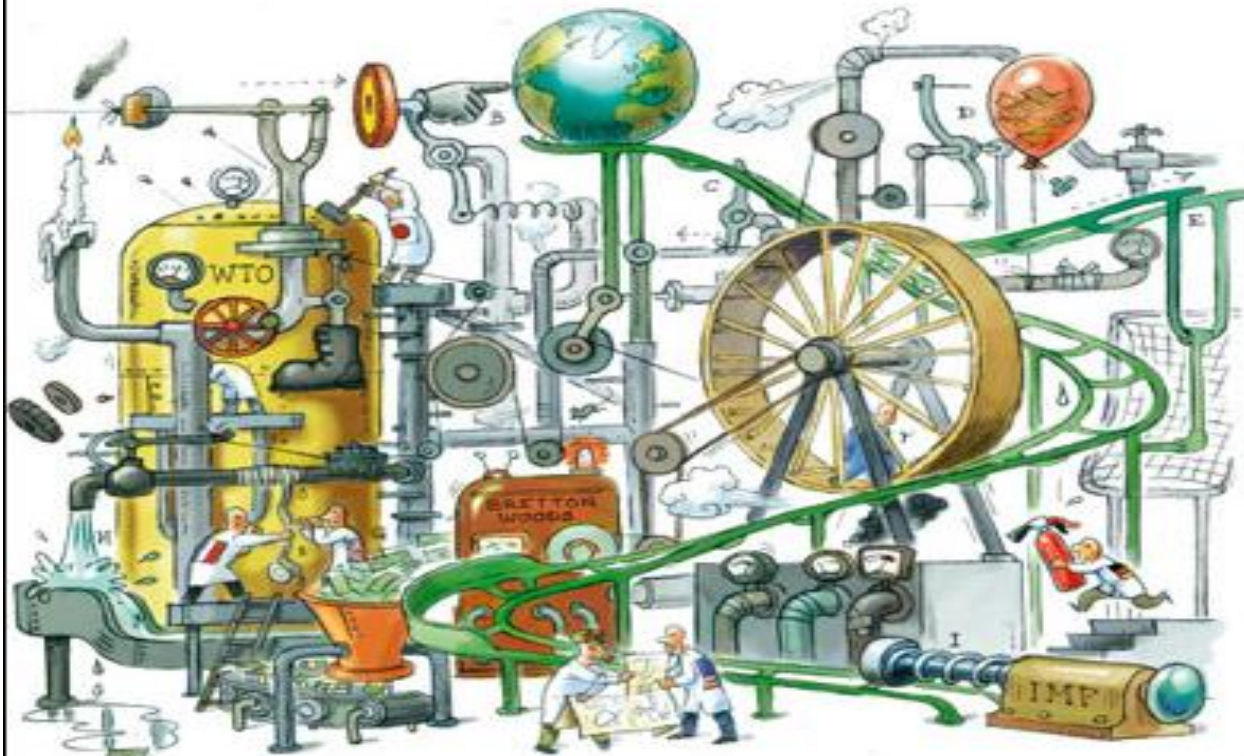
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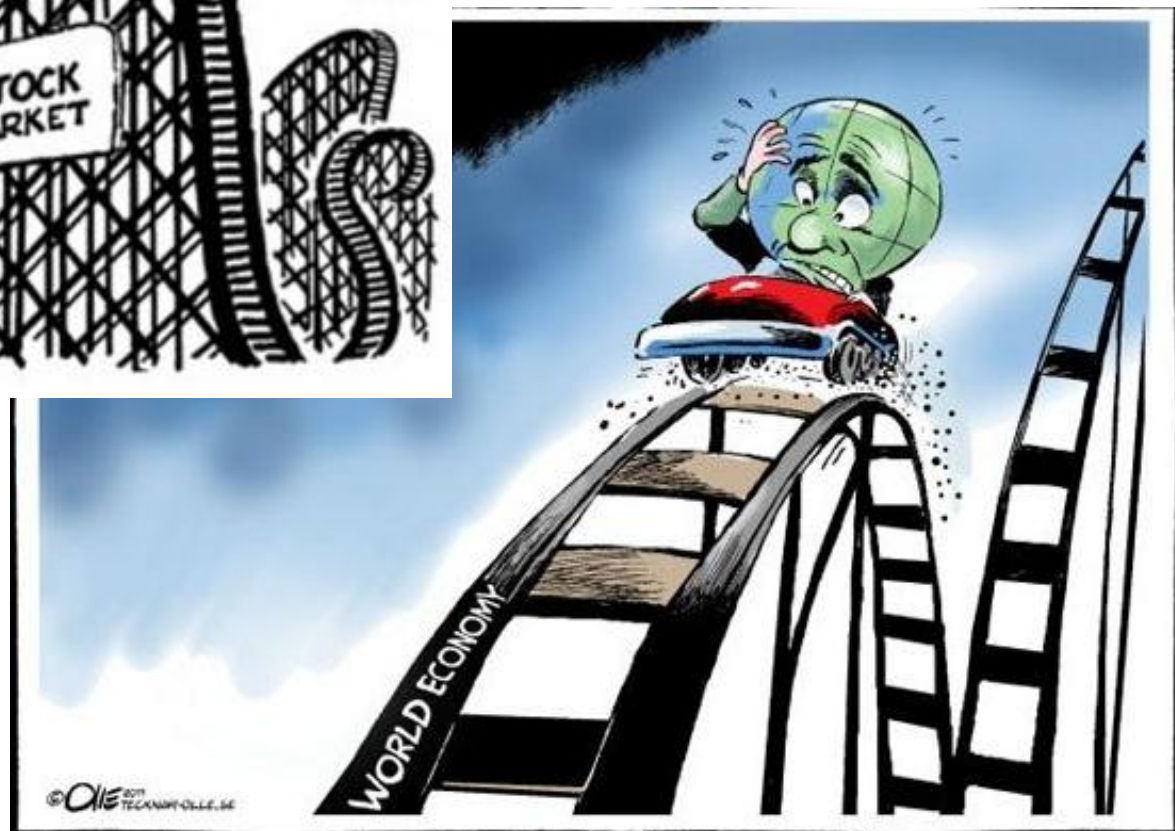
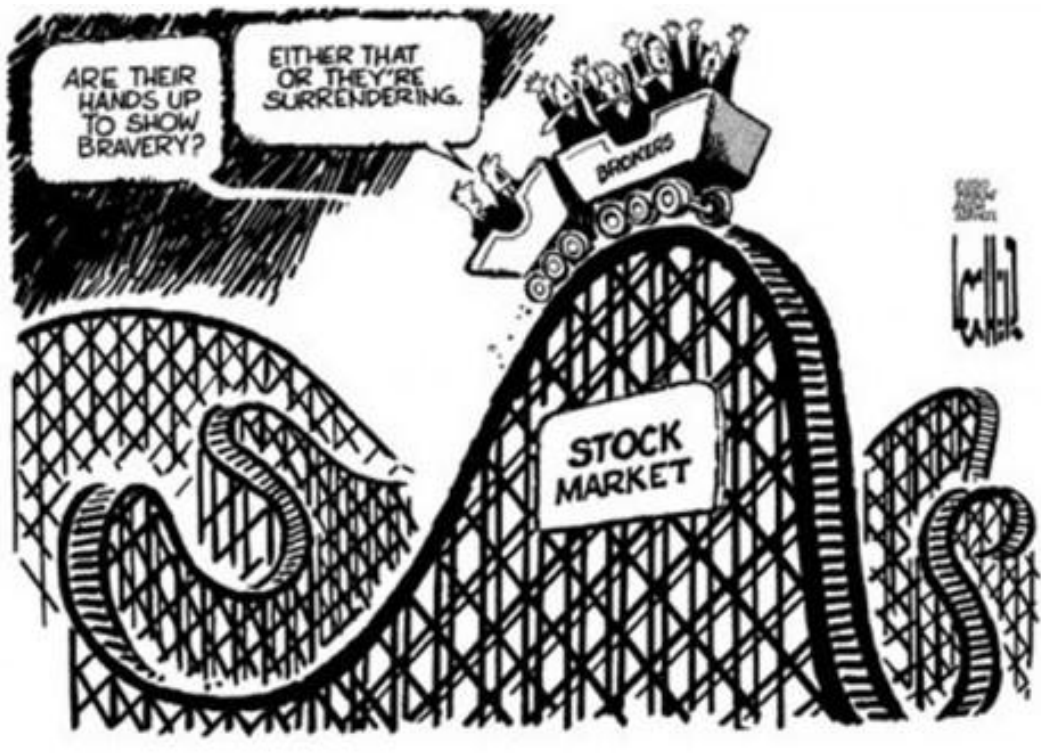
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World on the edge



Albania	ALL650	Croatia	HRK38	France	€5.20	Ireland	€5.20	Latvia	LVL3.65	Nigeria	Naira 600	Romania	RON18	South Africa	R40.00
Austria	€5.20	Cyprus	€5.20	Gibraltar	GIP3.20	Israel	NIS34.40	Lebanon	£19,900	Norway	Nkr 48	Saudi Arabia	Riyal 25	Sweden	SEK50
Bahrain	Dinar 1.50	Czech Rep	CZK150	Greece	€5.20	Italy	€5.20	Lithuania	LTL21.30	Poland	PLN20	Serbia	RSD438	Switzerland	Sfr 30
Belgium	€5.20	Denmark	DKK45	Hungary	HUF1,310	Kenya	KSh5490	Luxembourg	€5.20	Portugal cont.	€5.20	Slovakia	SKK180	Turkey	TRY9
Bulgaria	BGN10.20	Estonia	EEK80	Iceland	ISK400	Kuwait	Dinar 2.80	Malta	€5.20	Qatar	Rial 35	Slovenia	€5.20	UAE	Dirhams 35

Considerations...

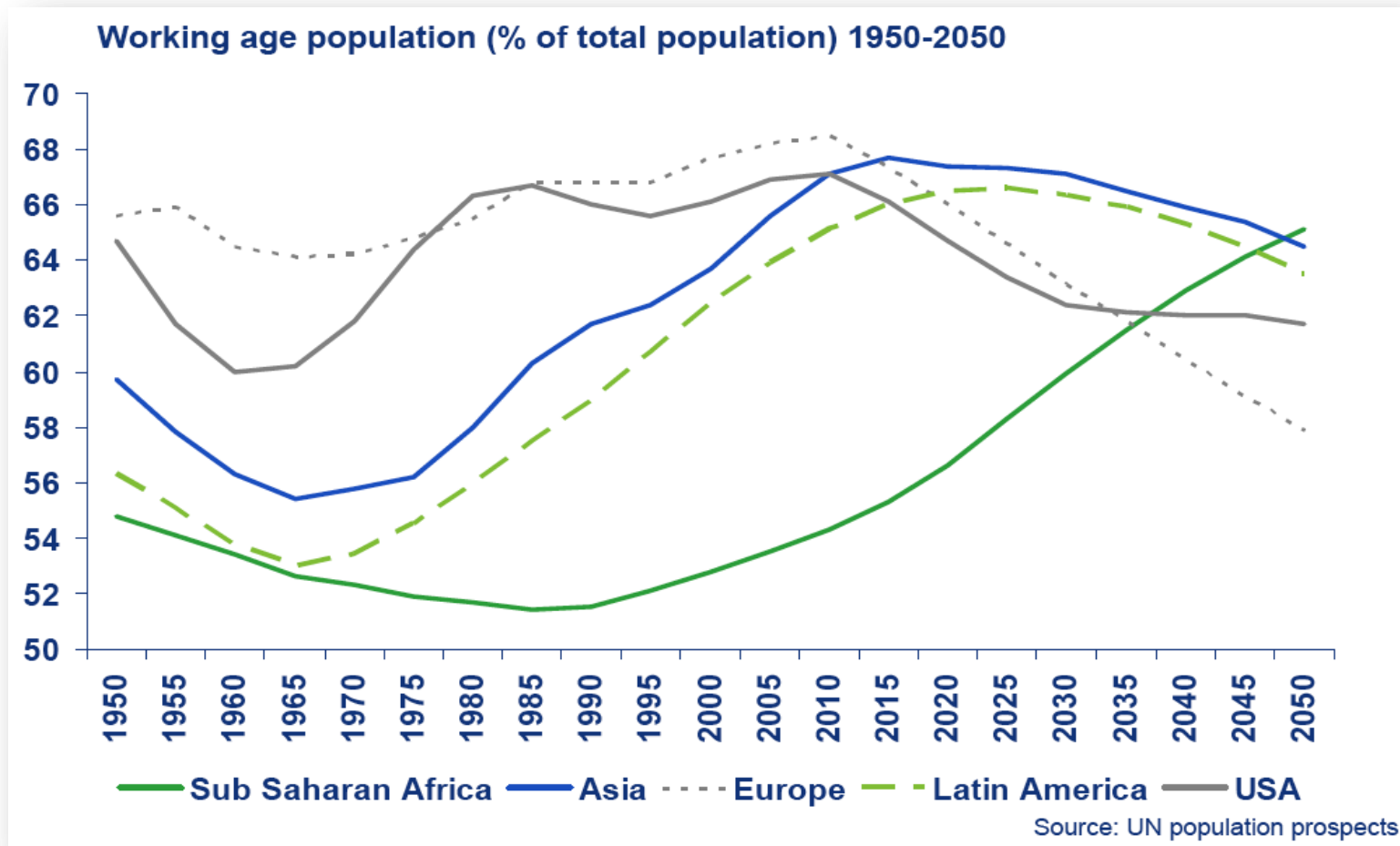
10. The post global financial contagion era (decade) will be one of austerity, de-leveraging, economic restructuring and reconfiguration.
11. Increasing social challenges on various home fronts will compel Development Grants and some Aids from developed / wealthy nations to undergo intense (and hostile) scrutiny and re-alignment

Considerations...

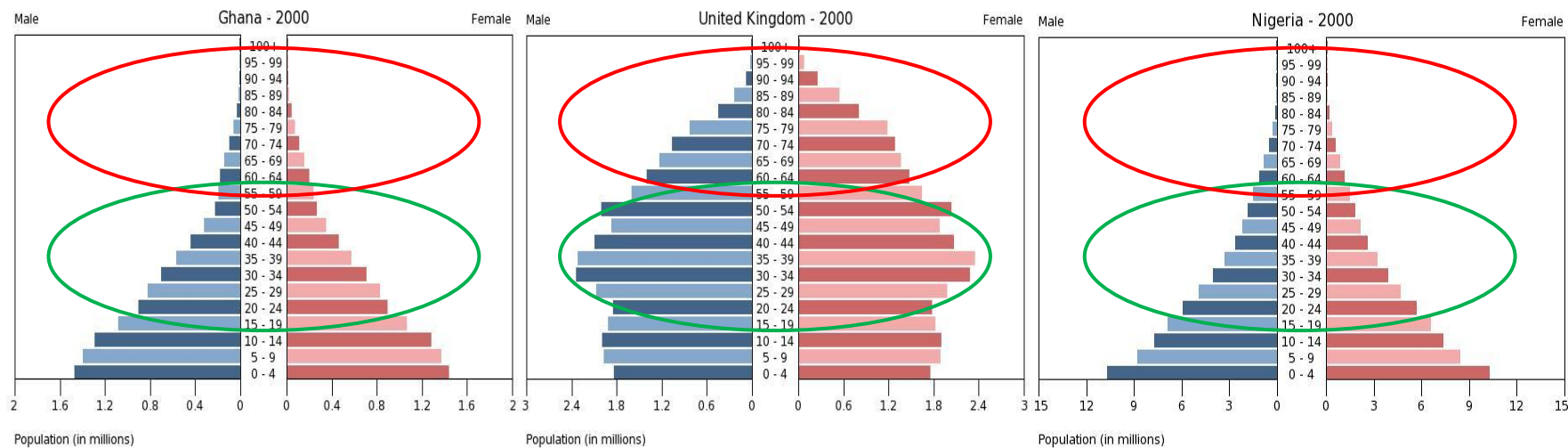
12. Frontier economies fast becoming investment destination of choice – political stability gaining foothold, democratic dispensation developing tap root.
13. Advantage of a rising population that is moving into the consumption mainstream – not middle income as known in the West, but rather home-grown “affordable consumption” class
14. Small but rising affordable consumption class comprises of home-grown and returnees

Considerations...

15. Africa's Demographic Dividend

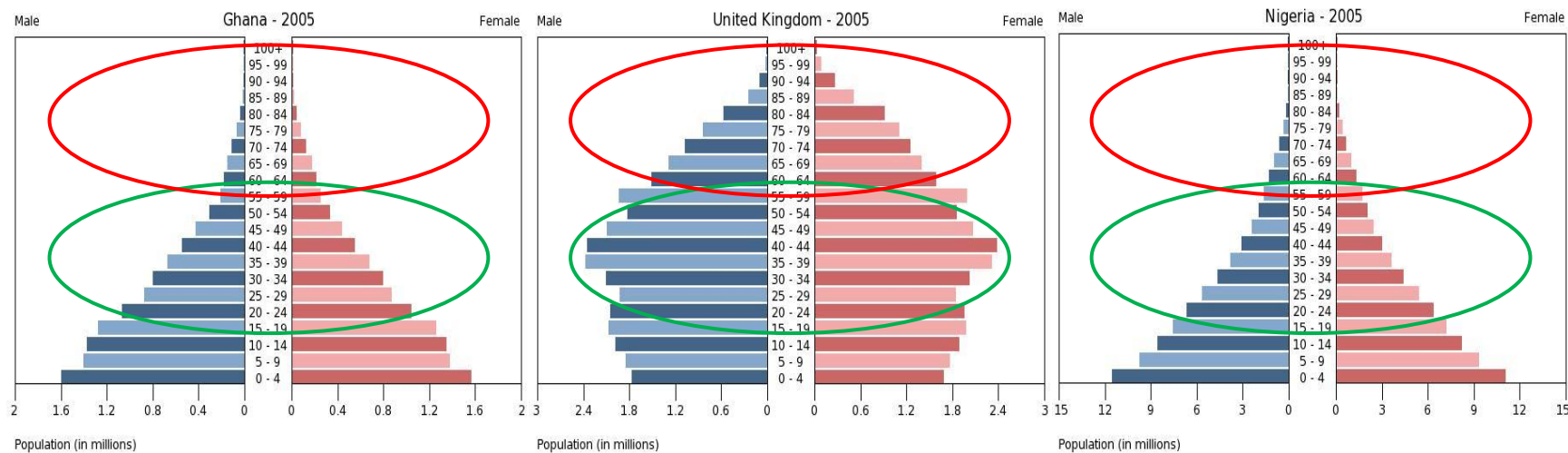


Considerations...



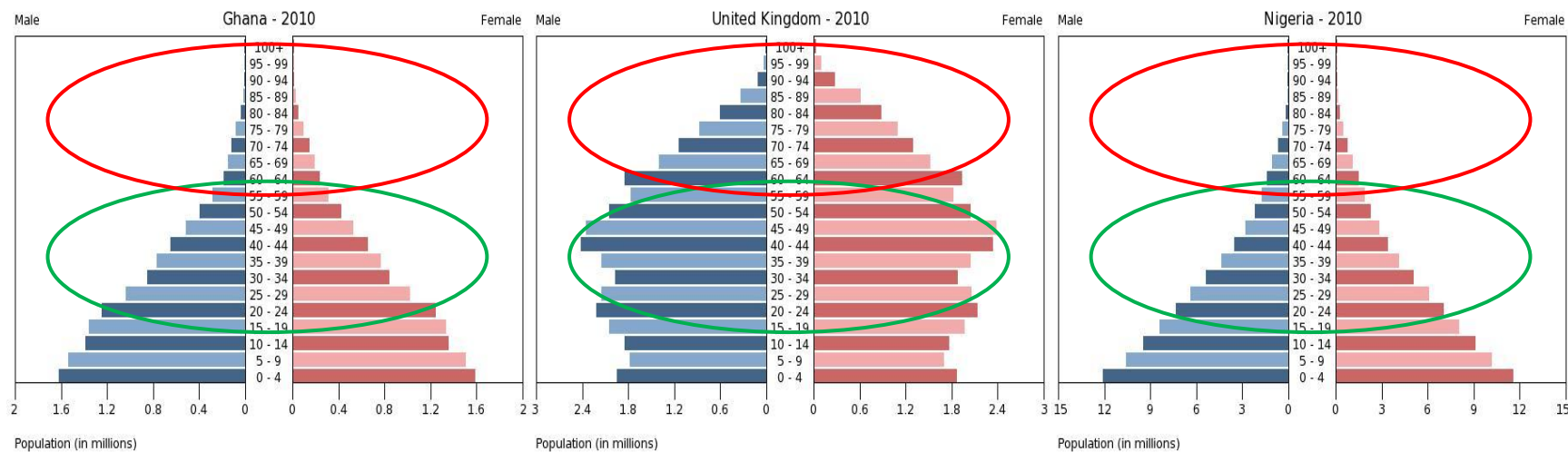
Source: U.S. Census Bureau, Population Division

Considerations...



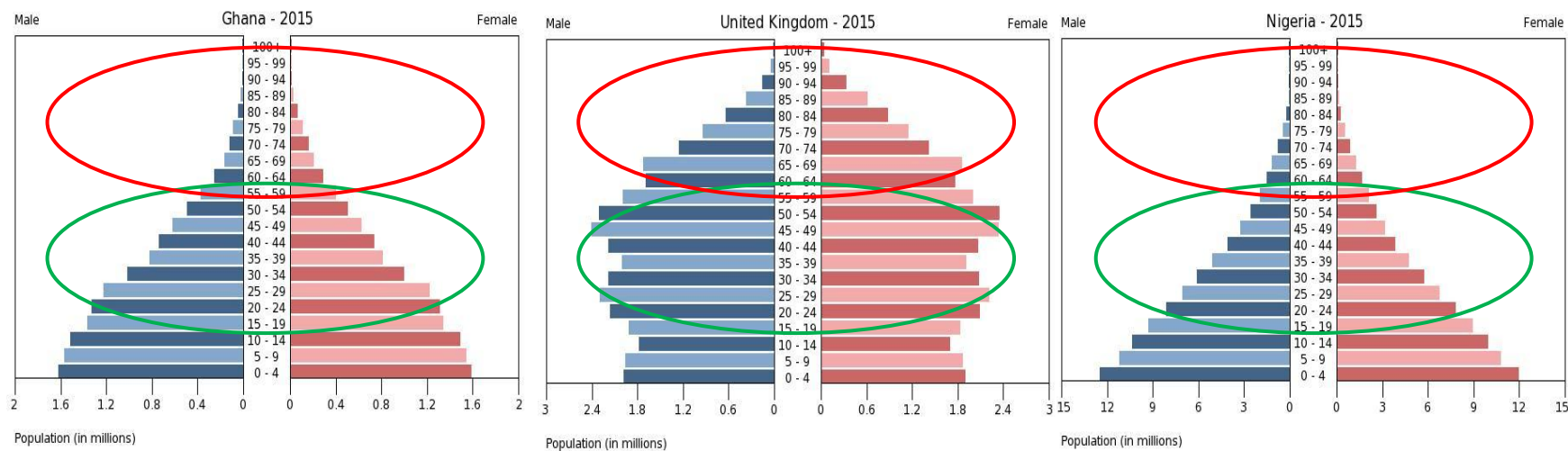
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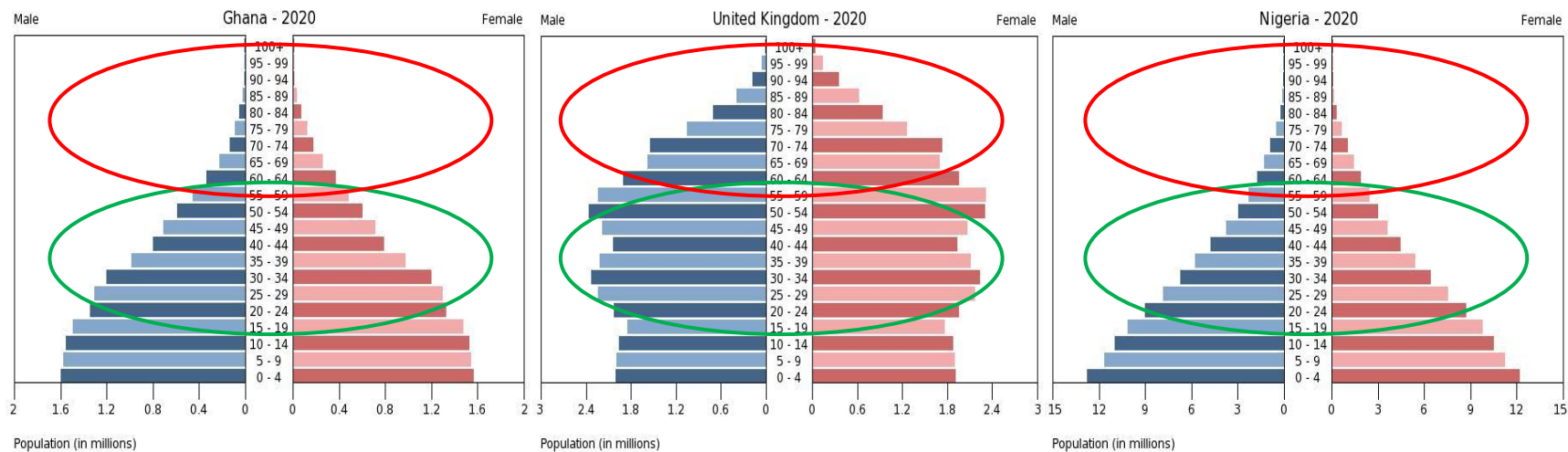
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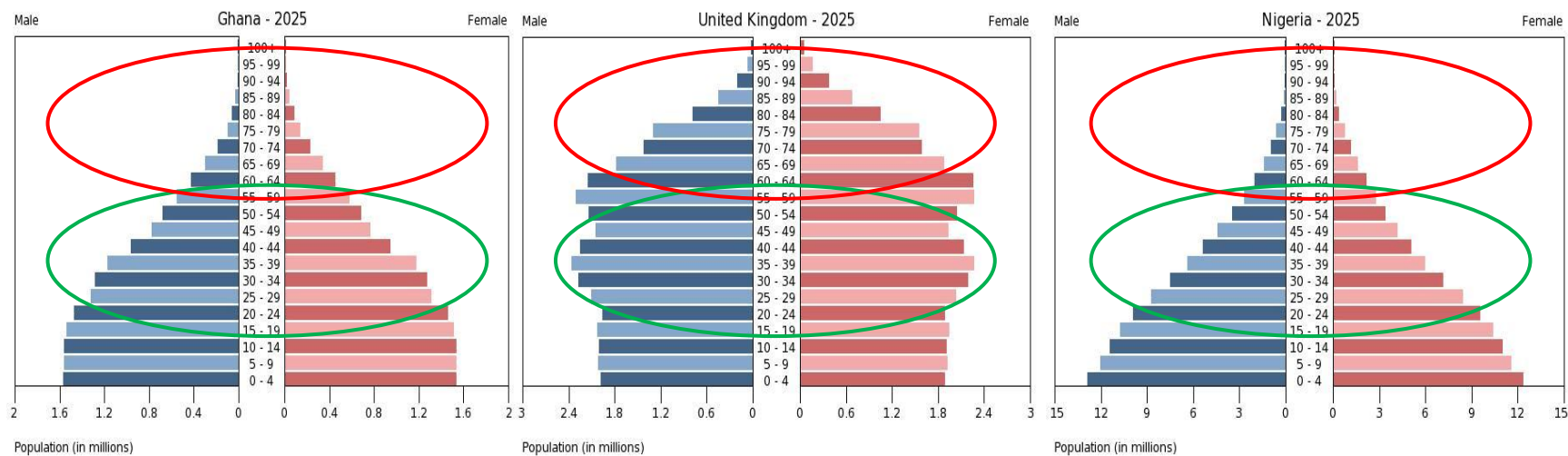
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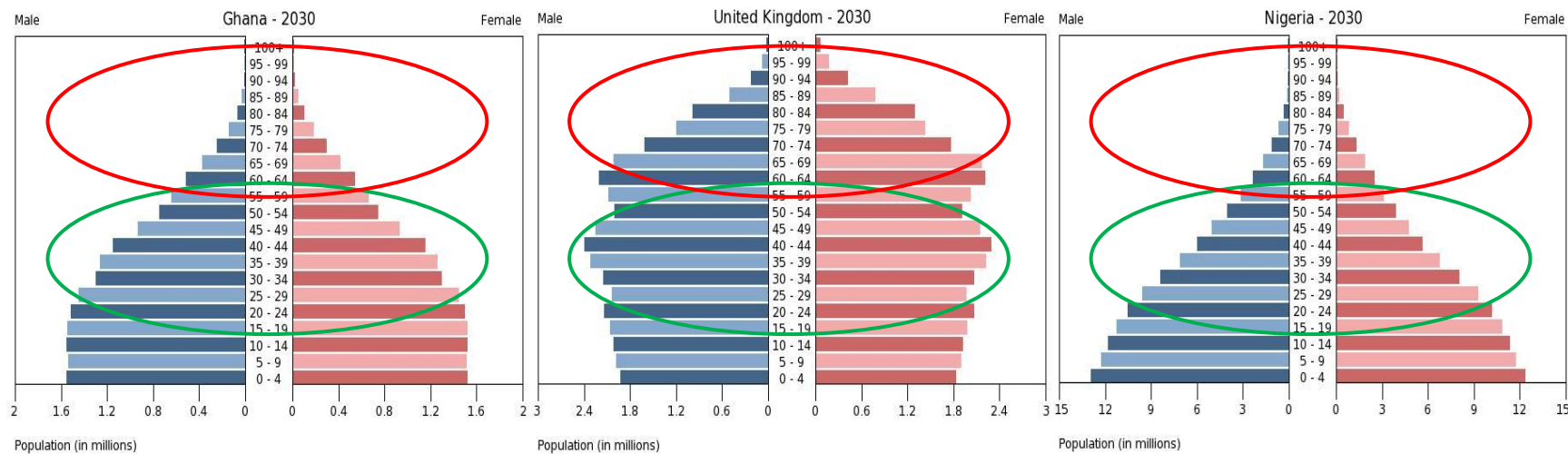
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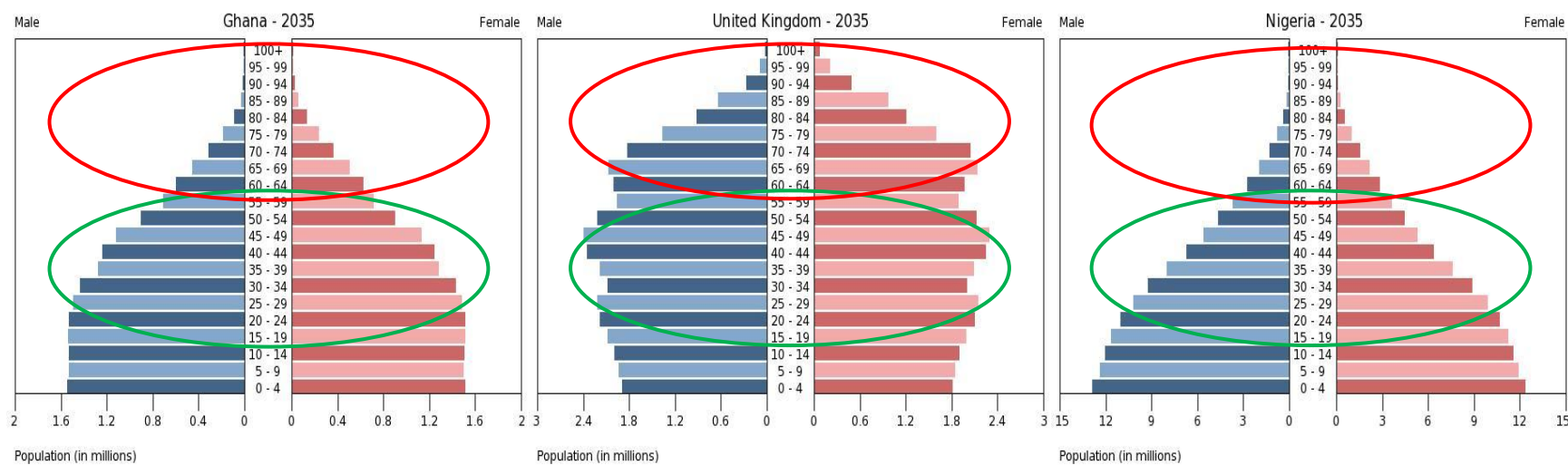
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Considerations...



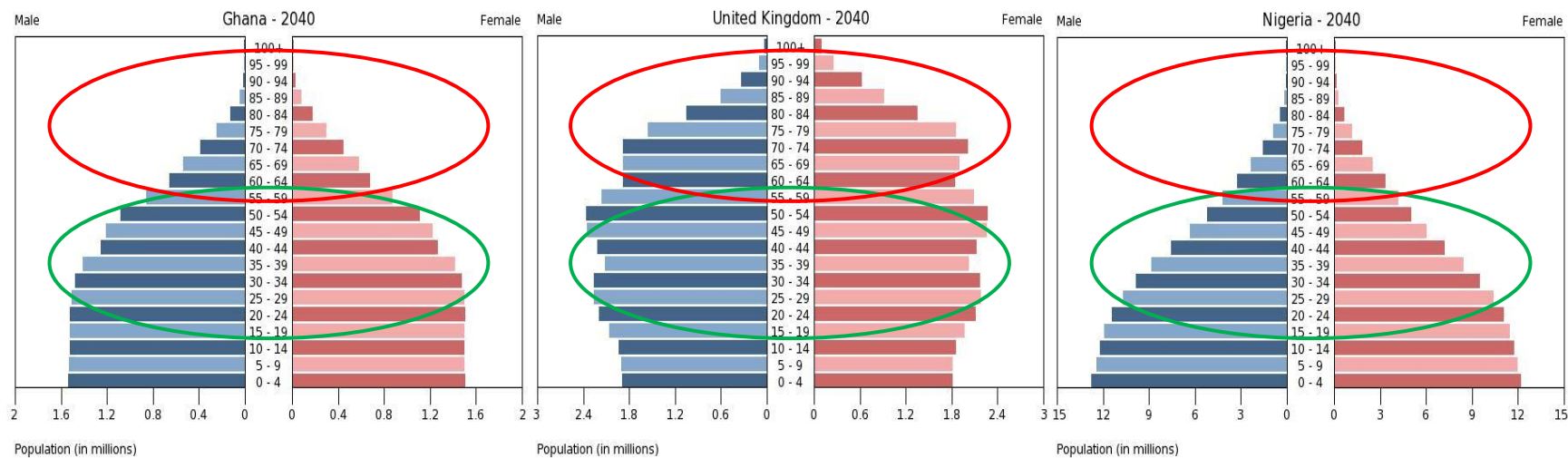
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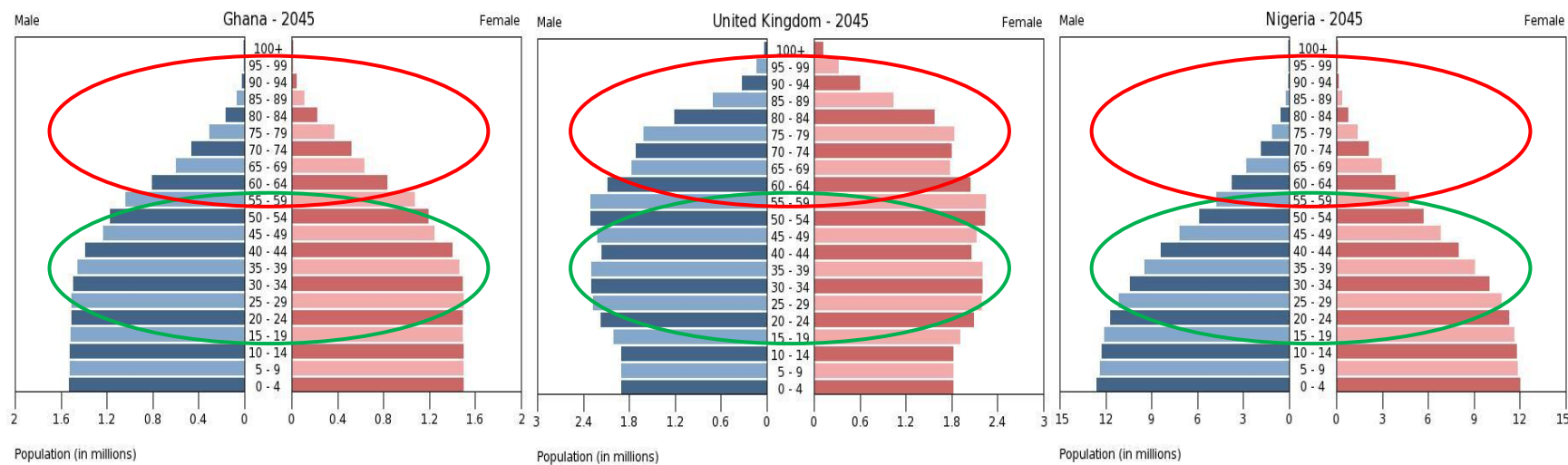
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Considerations...



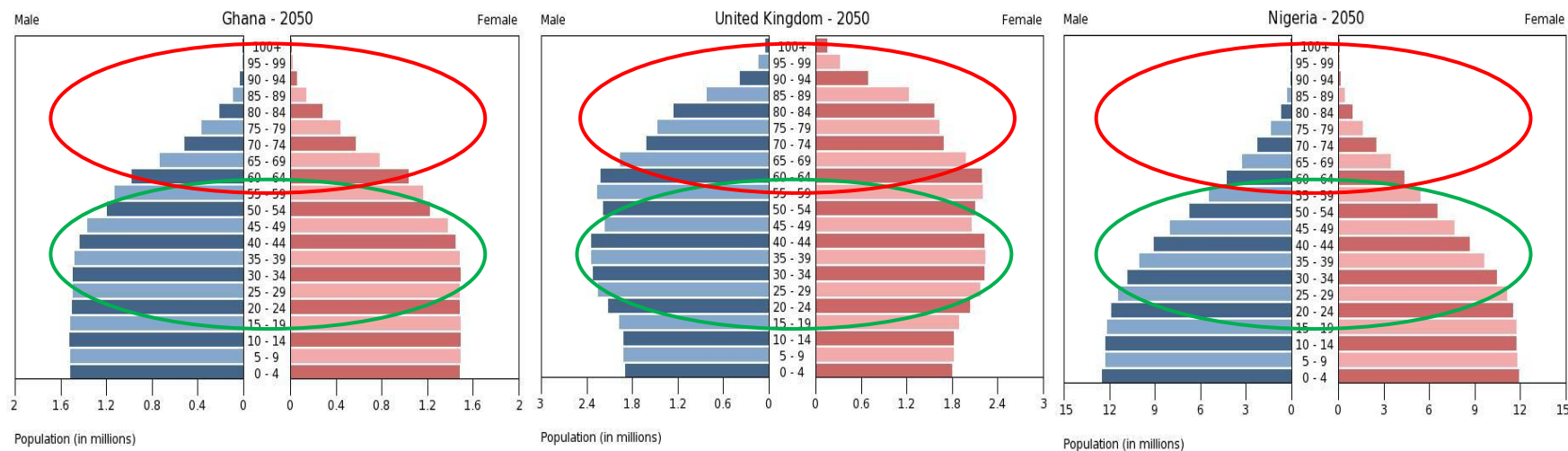
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Considerations...



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Considerations...



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Considerations...

16. Pension Funds penultimate goals —
- Collect contributions
 - Invest for appreciable returns, and
 - Pay benefits when due

However...

17. Strong perception or belief by some that Pension Funds can be a complimentary investment vehicle for development

Considerations...

18. PE Funds can play dual roles as vehicle for
 - Diversification opportunities and options
 - Pursuing broader agenda for development
19. Unfortunately, most African PF Trustees and Managers know very little about PE or are very wary of the asset class and industry

Considerations...

What is PE facial expressions



An Optimal PE Portfolio for PFs

- A. Understanding of PE as an asset class
- B. Board-approved Asset Allocation Policy
 - Asset class, target, {balancing range}, investment guidelines
- C. Should have > 1 PE fund (a FoF is a plus)
 - Diversity
 - Returns
 - Length
 - Geographic footprint
 - Sector (generalist, specialist)

How Stuff Works: Initiation...

- General Partner (GP) approaches prospective Investors (Limited Partners – LPs) with Private Placement or Information Memorandum
- Parties negotiate a common shareholder and management agreement
- LPs make initial capital commitment on a single day - First Closing
- “Calls” or Draw downs are only as required
- Other investors may join in subsequent closings on ‘equivalent basis’ for up to a year – Final Close
- GP expected to invest at least 1%

How Stuff Works: Process...

- “Capital calls” or Draw Downs against Commitments are required for up to 5 years (Investment Period)
- 7-15 investments in individual unlisted companies typically occur during Investment Period
- Capital is mostly returned to investors via distributions on sale, or recapitalization of investee companies by year 10 (Divestment phase)
- This may be extended by up to two 1-year extensions, with approval
- The GP can raise sequential fund when current fund is about 75% invested

How Stuff Works: Expenses...

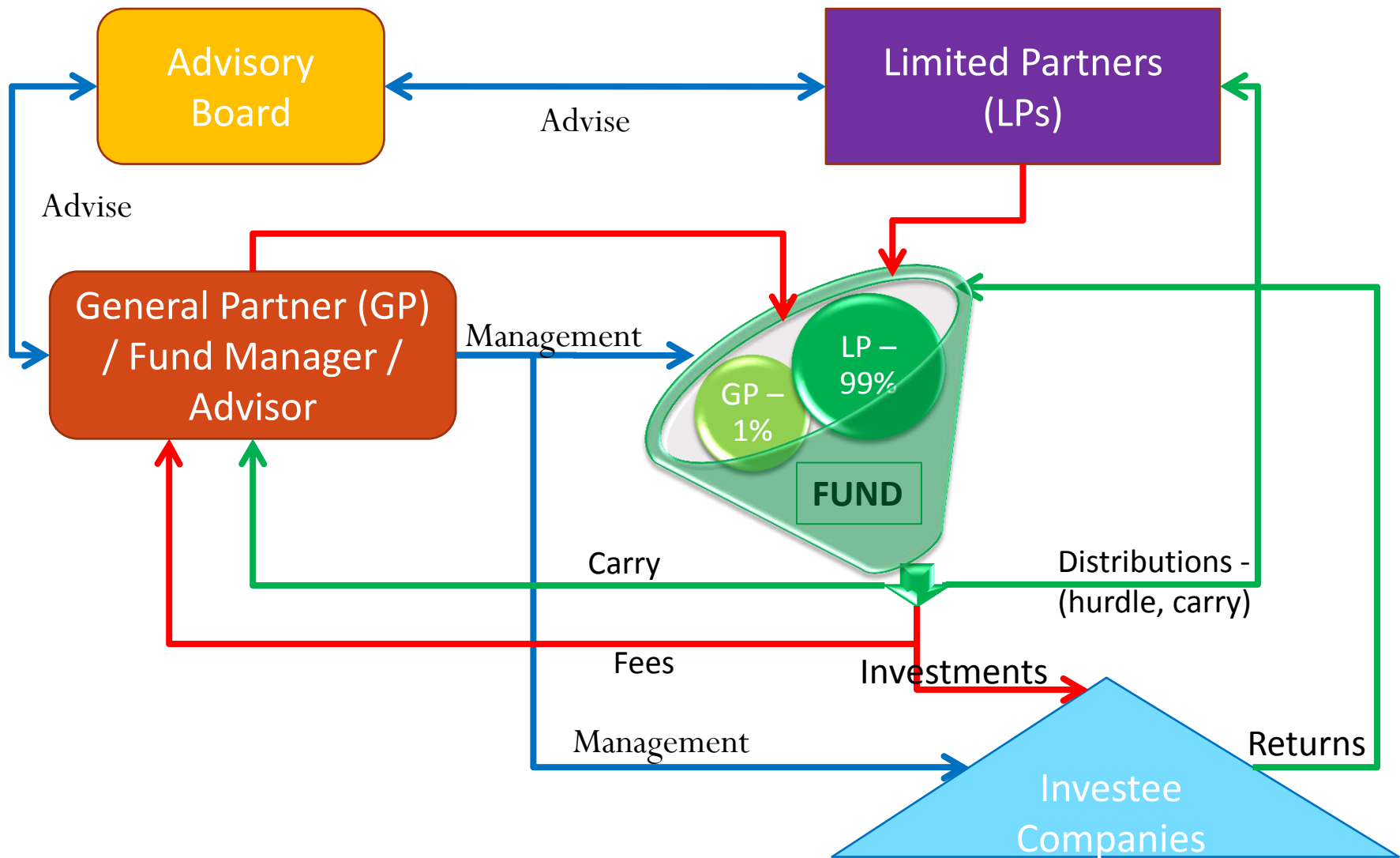
Expenses

- Management fees (MF) paid on Commitment (2–3% pa)
- Some pricing models lower MFs after investment period to % of invested capital instead of committed capital
- Organisational expenses of fund of up to 1% paid by fund
- GP may be able to charge investees certain fees, shared with fund
- Fund carries all other third party costs, eg legal costs, auditing etc
- GP gets a 'carried interest' (share of gain) of 20% of the returns after Investors (LPs) received 'hurdle' (6-10% pa) and 80% carried interest back
- Total expense ratio pa over life of fund (pre carried interest) typically at least 3.5-6%, depending on size of Fund

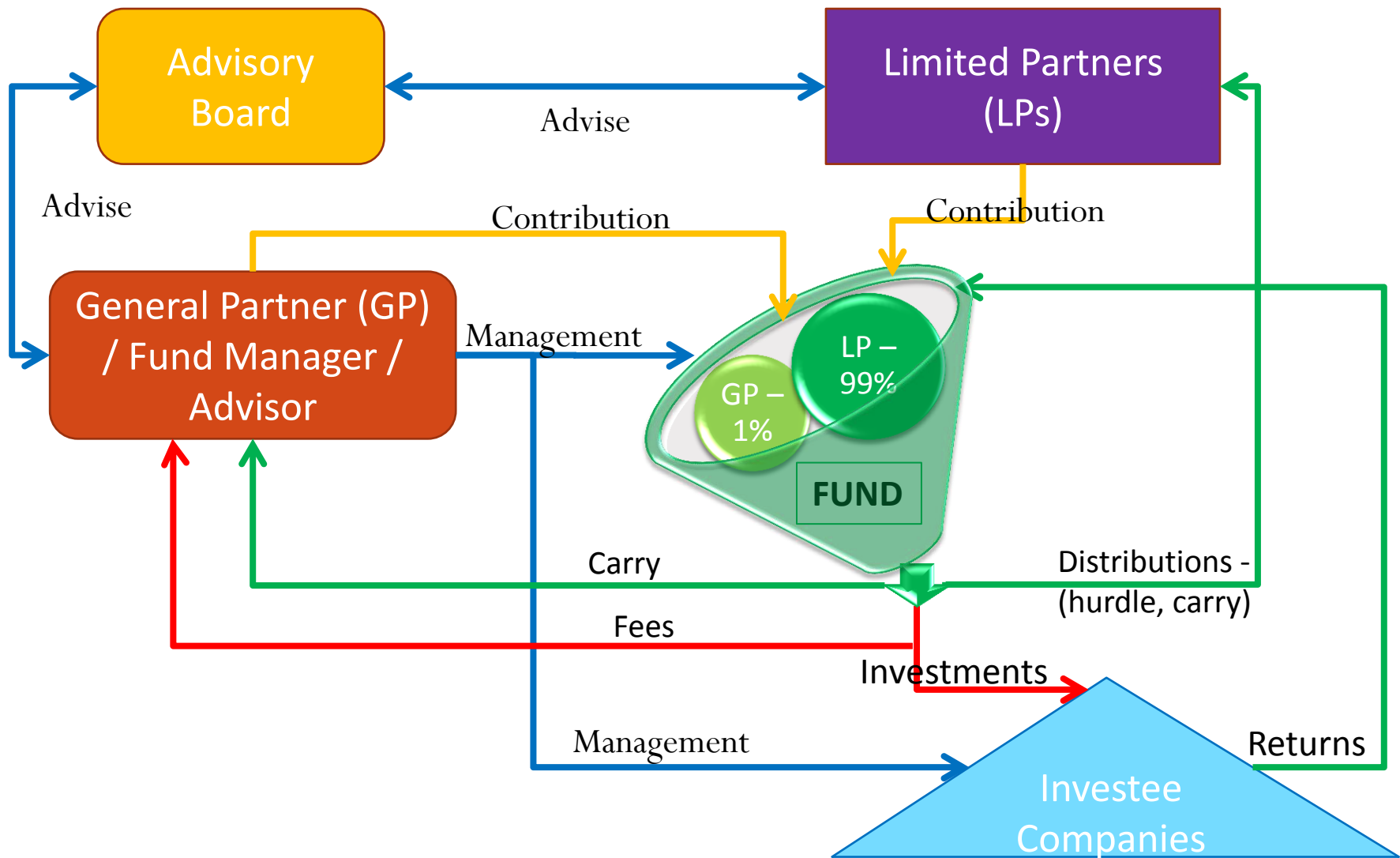
How Stuff Works: Post investment...

- Investment Committee makes investment decisions
- Advisory Committee/Board meets up to quarterly to review conflicts/valuations
- Quarterly Reporting
- Valuations at least twice a year, now often quarterly
- Capital or income received immediately distributed to Investors (subject to minimums)
- Reinvestment of proceeds only acceptable if predefined in initial contract between GP and LPs

Typical Fund Structure...



Typical Fund Structure...



Key Risks...

1. Policy

- Lack of Understanding of PE asset class
- Perceived excess / unacceptable risk
- Undefined Asset Allocation / Investment Guidelines

2. Fund Selection

3. Liquidity

4. Currency

5. Cycle

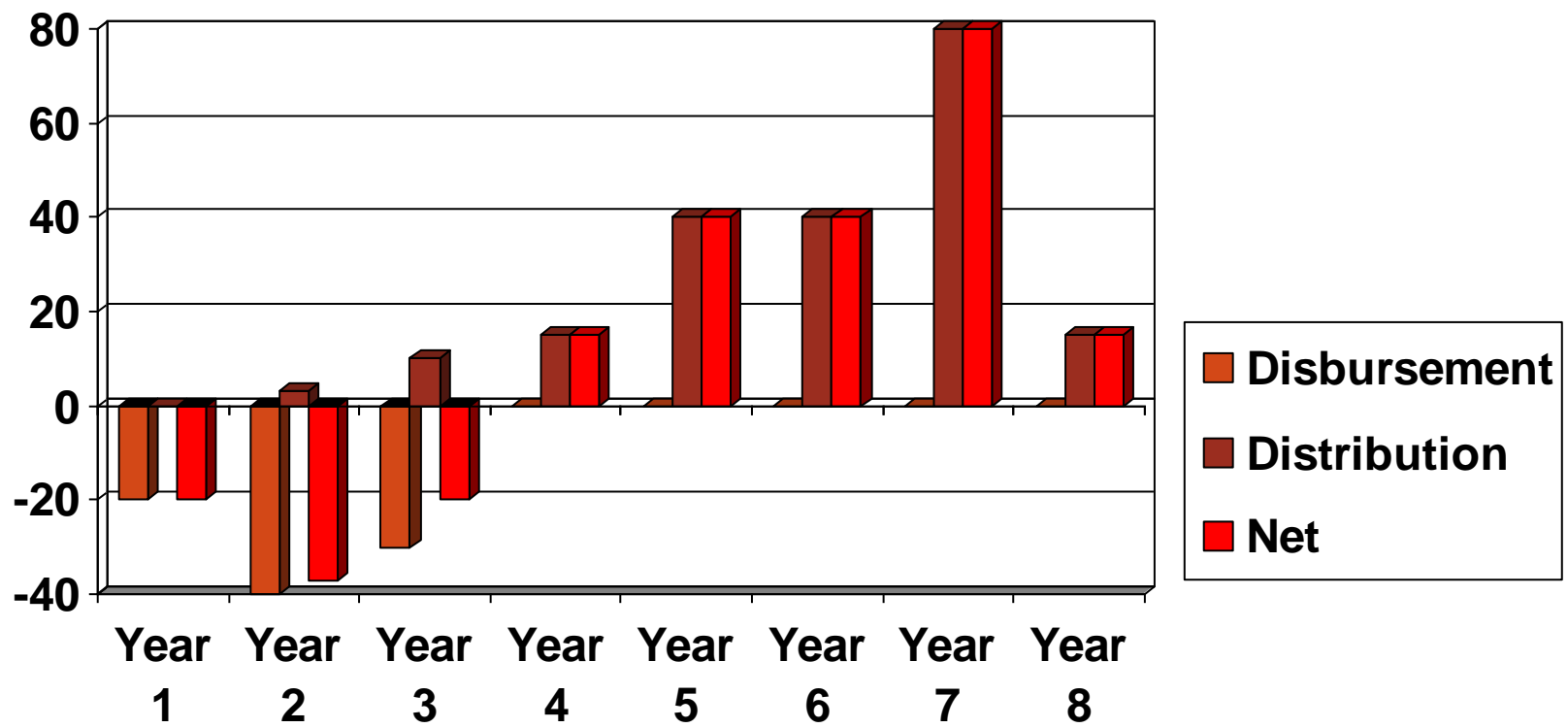
6. Tax and Transparency

7. Infrastructure Support

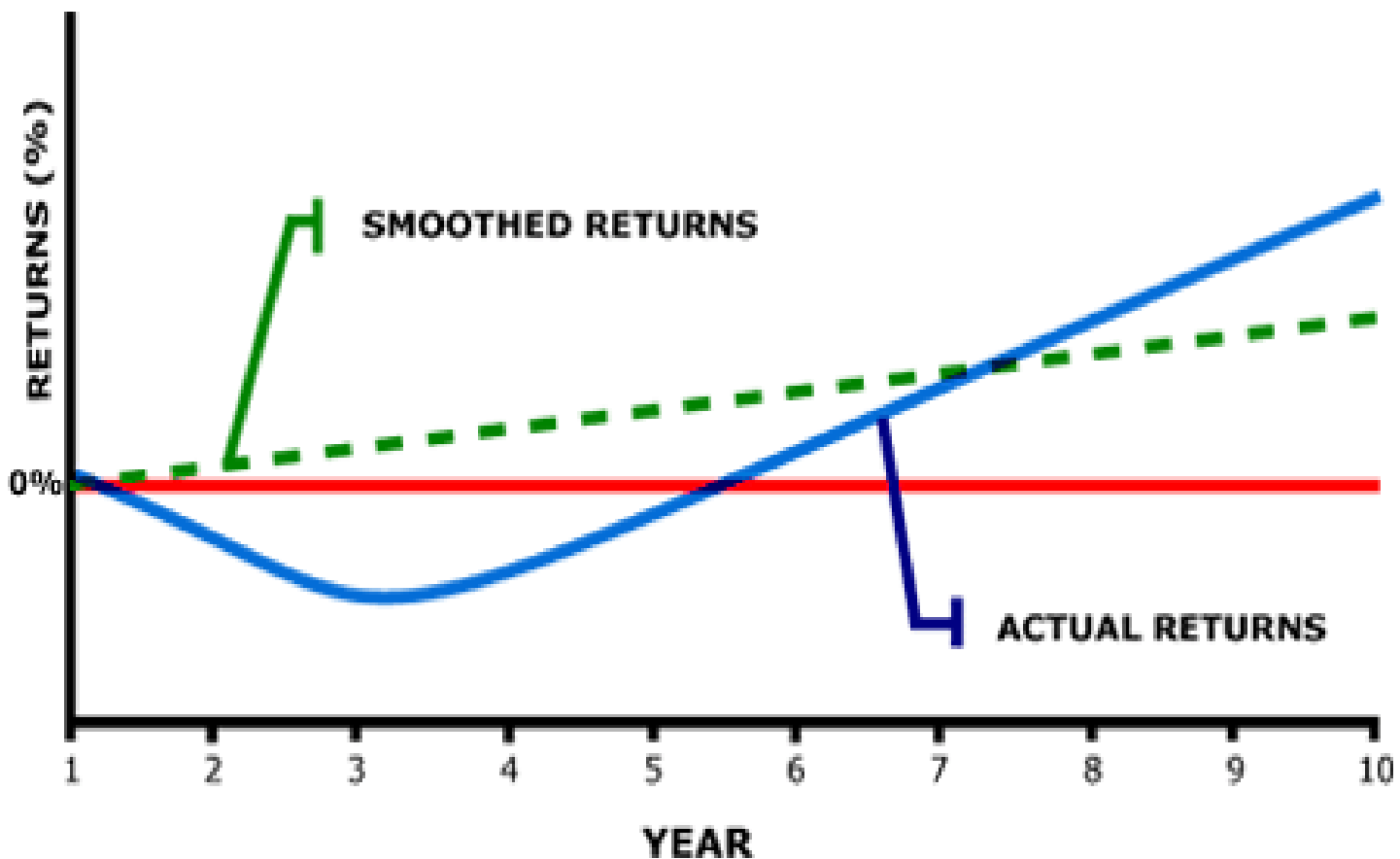
8. Liability and Reputation

Key Risks...J-curve

When a Fund's NAV per share and interim IRR of a PE Fund falls in its early years followed by a recovery in the later years.



Key Risks...J-curve



Key Risks...J-curve

Causes:

- ✓ Fees are charged on commitment from Day 1
- ✓ Organisational (1%) and other expenses carried by the Fund from Day 1
- ✓ Time taken to build a PE portfolio (minimum 3-5 years)
- ✓ Provisions taken at once if underperformance occurs

Broad Segment of Key Risks...

1. Operational Risk

Management team, track record and experience, competency incentives and alignment, process, ability to execute, etc.

2. Market Risk

Nature of opportunity, deal flow, pipeline, competition, network

3. Infrastructure Support Risk

Judicial and contract strength environment, ease, speed and complexity of doing business, liquidity, physical development, political/economic maturity, exit potential

4. Fund Specific Risk

Investment policy, strategy, projected returns, fund terms, conflicts, structure, tax, currency

Managing Key Risks...

Risk Category	Description	Mitigation
Policy	Poor Board knowledge of the asset class, absence of, inadequate or unclear focus to the asset class	Board education and Board-approved AAP & Guidelines <ul style="list-style-type: none"> ▪ Sector/Regional maximums ▪ Fund investment maximums ▪ Return/Hurdle rate minimums ▪ ESG restrictions ▪ Prohibited sectors
Fund Selection	Defects in alignment and transparency with Fund Manager	Clearly defined pre/post investment due diligence and checks
Liquidity	Non or very limited tradability of asset	Fund life structure/process, emergence of secondary market
Currency	Foreign currency denominated draw downs and distributions	Identify currency, diversify, secure projected drawdown plan , plan accordingly

Managing Key Risks...

Risk Category	Description	Mitigation
Cycle	Exposure to systemic external economic or financial cycles	Fund life and structure, and diversification
Execution	Time-consuming investment process complexity	Superior selection of Fund, process and procedures at PE Manager level
Tax and Transparency	Unfavourable tax regime	Focus on Funds in tax-friendly locations (Mauritius, Botswana)
Infrastructure Support	Poor private and institutional support	Fund structure and procedures

Managing Key Risks...

Risk Category	Description	Mitigation
Litigation and Reputation	Suppliers creditors, 3 rd parties Implications by events in Fund portfolio (environmental, social, accidents, etc)	<p>Fund structure, strong corporate governance policies</p> <ul style="list-style-type: none"> ▪ Fund Advisory Board oversees conflicts, valuations, audit and change to investment policy ▪ Delegate investment decisions to IC that has independents ▪ GP takes the liability but is indemnified except for negligence or fraud ▪ Ability to fire GP without cause subject to high vote threshold – no “fault divorce” elect a “no fault” divorce ▪ Other defaults on “key man” retention, breach of investment restrictions, etc ▪ GP restrictions on ability to manage competing funds, over certain types of investment (banned sectors) ▪ Undertaking from GP on ESG criteria to be followed

Pension Fund PE Portfolio Issues

Pre-Investment Issues

1. Objectives (& coverage)
2. Fund size & ticket size
3. People behind the Fund
4. Pipeline
5. Returns, Fees, tax neutrality
6. Usual suspects
7. PowerPoint Presentation

Post-Investment Challenges

1. Capital Calls
2. Valuation
3. Voice & Vote
4. Ongoing communication
5. Touring of investee companies
6. Link Reports to PF Contributions

Pre-Investment Issues

1. Objective of the Fund

- ✓ This has to meet the policy objective and offer a diversification benefit to the portfolio
- ✓ Has to be within the risk/return comfort of the portfolio

2. Size of the Fund & Ticket size.

- ✓ A \$250M Fund elicits a nod quicker than a 10 million fund. Just as a \$2B Fund knits brows easier than a \$450M Fund.
- ✓ Mega Funds means fund raising could be long and closings could be extended, thus delaying commencement of investments
- ✓ Pension Funds will become an insignificant investor.
- ✓ > \$25M tickets eliminates lots of opportunities, especially for regionally focused funds.

Pre-Investment Issues – contd.

3. People Behind the Fund (Managers, Directors etc.)

Very important to investment committee and Trustees. Individual history may be stellar, equally important are:

- ✓ Education
- ✓ Experience - background
- ✓ More Farmers and less Hunters
- ✓ Managers ability to work as a Team for the Fund
- ✓ Managers/Fund's understanding of the investment terrain in the African theater is crucial

Pre-Investment Issues – contd.

4. Pipelines are important

- ✓ Crucial; could be deal spoiler.
- ✓ The PE Fund must be willing to disclose sufficient information about pipeline for PF's comfort.
- ✓ Deeper delving if skeptical of purported pipeline content.
- ✓ Pipeline should contain prospective deals in the soliciting country.

5. Hurdle Rates, Returns and Fees

- ✓ HR = 6-8% (10%)
- ✓ Net IRR = 20 - 25%
- ✓ Fees = 1.50% - 2% (2.5%)

Pre-Investment Issues – contd.

6. Participation of “Usual Suspects”

- ✓ Confirmed commitment of other LPs {DFIs}, a plus.
- ✓ They serve as due diligence pre-cursors for cautious LPs like Pension Funds

7. Power Point Presentation

- ✓ Presentation of objectives, rates, returns, fees, team, deal pipeline and past experience are crucial.
- ✓ Such presentation should be planned for at least 2 levels – Management & Analysts and Investment Committee.

Post Investment Issues

1. Capital Calls

- ✓ The standard 10-day pay up window becomes challenging in a bureaucratic institution like a PF

2. Valuation – 3rd party valuation preferred

- ✓ Valuation illustrates the pro/regress of investments.
- ✓ Basis of valuation of investee companies at entry and at various reporting stages being debated.
- ✓ Independent 3rd party valuation may offer a comfort.

Post Investment Issues – contd.

3. Lack of “Voice and Vote”

- ✓ Millions in commitment + prolonged non-discretionary investment period = Expectation for some voice and vote in governance/advisory boards.
- ✓ Concern reverberates loudly among minority investors (e.g Pension Funds in the early years of venturing into this Asset class of investments.
- ✓ A seat or two for minority LPs on a rotating basis could alleviate this legitimate concern.

Post Investment Issues– contd.

4. Don't confuse face-time with bothersome handholding

- ✓ Maintain dialogue and communications with the PF Allies on a periodic basis.
- ✓ Backed up with timely quarterly and annual statements.
- ✓ Check drawdown / capital calls against Agreement (amount, purpose, timing and payment window).
- ✓ Face time goes a long way in keeping PF adequately informed, focused and strengthens capabilities.

Post Investment Issues– contd.

5. Periodic Touring of Investee companies

- Request for a
 - ✓ tour some of their investee companies,
 - ✓ talk to their management
 - ✓ check underneath the hood and kick the tires
- Alleviates the “Black box” fear/perception
- Adds credibility to PE’s verbal and documented assertions.

Post Investment Issues– contd.

6. Its all about the Pension Fund Contributions

If portfolio /investee companies are domestically domiciled, seek more information from GP on:

- ✓ Company realignment and Sustaining Success
- ✓ Job Creation/Stabilization
- ✓ Social Security Contributions
- ✓ Returns to the Pension Fund

Evaluation of portfolio

IRR may be weak in first 3 or 4 years in (J curve effect), but necessary overall

1. Investment Rate = Paid-In Capital / Committed Capital
2. Realization Multiple = Distributions / Paid-In Capital
3. Investment Multiple = Total Portfolio Value (RV+D) / Paid-In Capital
4. Residual Multiple = Residual Value / Paid-In Capital
5. Rate of loss = written off portfolio as % of Paid-In Capital
6. Review of portfolio companies to assess state of business/financial health
7. SI-IRR (gross and net) when relevant

Conclusion...

1. Key considerations

- Staying power of PE industry and asset class
- Immense opportunity for African PF to meet investment goals while achieving development agenda as well

2. Key risks

- Policy, Fund selection, liquidity, currency, cycle, execution, tax, infrastructure, liability/reputation and J-curve

3. Mitigating measures

4. Pre/post investment issues

5. Evaluation of PE portfolio

Thank you

Questions?