

SOUTHERN AFRICA PRIVATE EQUITY ROUNDTABLE

October 2010

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PRIVATE EQUITY (PE) FUNDS

GLOSSARY

Carried Interest – share of the gain on the Fund paid to the Manager

Blind Pool – where there is limited visibility on the portfolio to be acquired

Exit – realisation of the holdings in an investee

General Partner (GP), PE Manager– management company that raises PE funds

Gross IRR – IRR of the investee portfolio only. Net IRR is the return to Investors (see below)

Hurdle rate – an annual percentage return received by Investors before the GP gets the carried interest

Private Equity (PE)– generic term for investing in private companies of which Venture Capital, MBOs and Development Capital are subsets

Interim IRR – IRR of the Fund measured on activity to date, eg actual cash flows +NAV

Investee – portfolio company of a PE Fund

IPEVC – International PE and Venture Capital Group, established main valuation guidelines

IPO – Initial Public Offering (or listing) on a recognised stock exchange

IRR = Internal Rate of Return, the discount rate/%age return where NPV is zero

Limited partner (LP) – Investor - surrenders decision making in return for limited liability and (usually) tax breaks

MBO – management buy out

Net IRR – the IRR actually received by the investor, after all costs of management and fund expenses

Net Present Value – the present value of future cash flows when discounted at a set rate

SME – Small and Medium-sized Enterprises

Systemic risk – risk to the financial markets or system, as opposed to a participant, which cannot be diversified away

Vintage of Fund – the year in which a fund first closes

WHOLE AGENDA – PRIVATE EQUITY (PE) RISK?

SESSION 1:

- PE as an asset class: history, definitions, use, risk and return, summary risk control
- How do PE funds work? Using structures to mitigate risk

SESSION 2:

- How PE is implemented? Using disciplines to control risk
- Manager selection

SESSION 1. Emerging Market Private Equity (EMPE) AS AN ASSET CLASS

1.1 History and background

- Introduction and History, Risk perspective
- Use of PE in portfolios
- Returns

Break to draw breath and answer questions!

1.2. Controlling Risk through the fund structure

- Fund structure
- How they work
- Risk mitigation
- Alignment and conflicts
- J curve

INTRODUCTION AND HISTORY

EARLY HISTORY

- 14th century – Moravian Protestant movement C Europe
- 15th century Florence – de Medici

MORE RECENT HISTORY – 19th century

- Introduction of investment trusts
- Financing of US railroads

MODERN HISTORY – 1975 onwards

- Global expansion from US, then UK, then Europe
- Introduction of limited partnerships 1970/80s
- Emerging market PE from early 1990s

Definition of a private equity investor - someone with deep pockets but very short arms!



WHAT IS PRIVATE EQUITY?

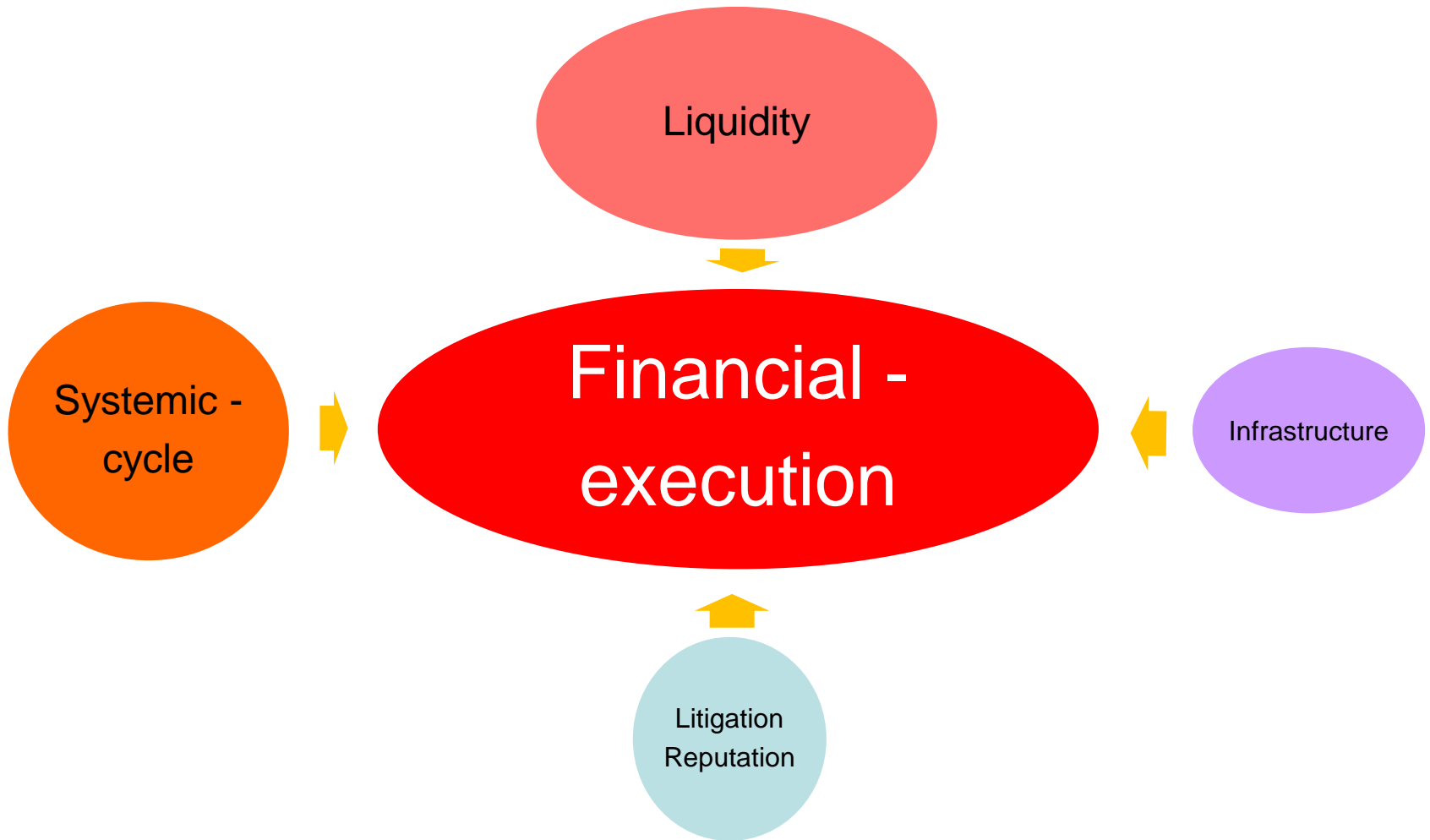
- Equities not traded on public markets
- PE is generic term covering Venture Capital (early stage/start ups), Expansion and Buy Out capital
- Higher growth smaller companies, agility/flexibility
- Higher risk (smaller firms, cyclical exposure, less defensiveness, management depth)
- Can include some large companies as well as SMEs
- Holding periods of 3-7 years
- EM PE is quite a new asset class

OVERVIEW OF GENERAL INVESTMENT RISKS

Common to *ALL* institutional equity investment

- Systemic: ‘uncontrollable externalities’
- ‘Alpha exposure’ to upside and downside
- Strategic: failure to achieve policy objectives (desired exposure)
- Financial/Counterparty: loss of money/underperformance v benchmark due to investment activity and/or fraud, caused by failings in the management (of company or fund), organization/process
- Liquidity: mostly difficult in smallcap or frontier markets
- Reputation: risk accepted in the listed arena?

POTENTIAL ADDITIONAL PE RISK HEAT MAP



PE RISK PERSPECTIVE

What greater risks are we taking (compared to other asset classes)?

1. Liquidity. Cannot realise investment at will. **Medium**
2. Systemic. Cycle – SME sensitivity to economic and market cycles = more volatile returns. **Medium**
3. Financial: execution in PE more difficult. **High**
4. ‘Infrastructure’ (financial, bureaucratic, judicial) can be more difficult for private firms. **Medium/Low**
5. Litigation: legal redress sought by creditors, suppliers, governments etc. **Low**
6. Reputation: damage caused by issues derived from the above. **Low**

WHY BOTHER?

- Exploit market imperfections
- SME growth potential
- Low correlation with other assets
- Returns reflect the risk?

Potential long term high reward for additional risk

RISK!



SPECTRUM OF RISK - INVESTMENT

Judgment

Evidence

CDO's/Junk Private E Listed equities Real Est Corp bonds Gov't bonds

Judgement dependant on:

?! Analysis! analysis and liquidity credit rating security value

HIGH RISK



LOW RISK

SPECTRUM OF RISK - PE

Judgment

Evidence

Start ups

early stage

expansion

MBO

asset backed

Judgement dependant on:

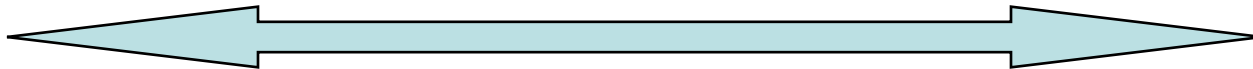
Projections

market and track record analysis

security value

HIGH RISK

LOWER RISK



SPECTRUM OF RETURN – INVESTMENT (net \$ based)

12-25%

7-15%

5-12%

3-7%

2-4%

Private E

Listed equities

Real Est

Corp bonds

Gov't bonds

Return dependant on:

Stage

sector/geography

sector/geog

credit

country

HIGH RISK

LOW RISK



Returns are targeted **net** to investors based on an approximate history of developed markets

SPECTRUM OF RETURN (GROSS) - PE BY STAGE

30-45%

Start ups

25-40%

early stage

20-30%

expansion

17-25%

MBO

12-20%

asset backed

Dependant on:

Projections

HIGH RISK

market and track record analysis

security value

LOW RISK

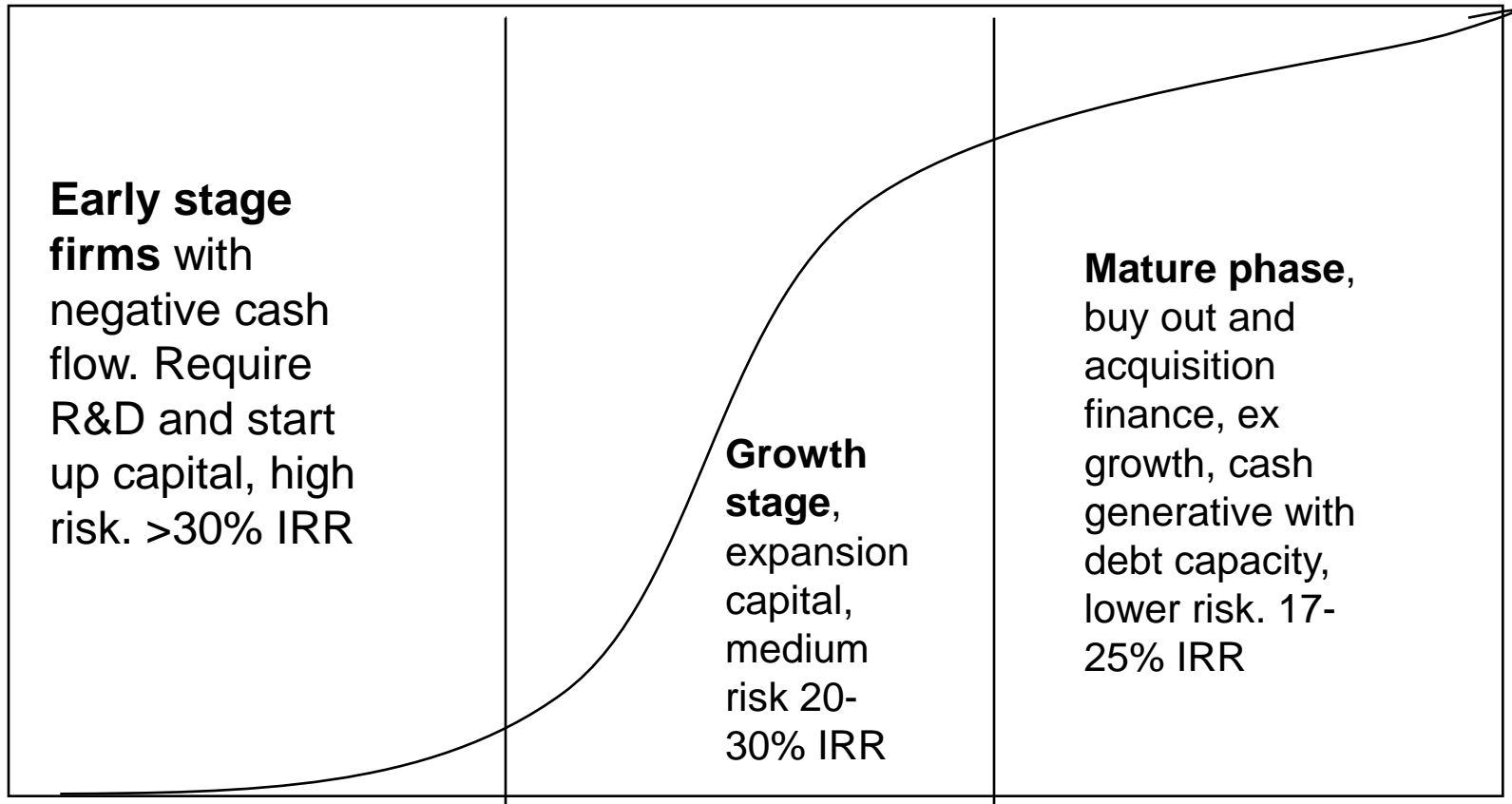


Returns are **targeted gross** portfolio returns before fund costs

COMPANY LIFE CYCLE

High risk

Lower Risk



BROAD DEAL TYPE DEFINITIONS

- Venture
- Expansion capital
- Buy out and acquisition financing
- Mezzanine ('shareholder loans' to SMEs, or unsecured debt to mid sized/large firms)
- Types of investment instrument – equity and quasi-equity or debt/preference all used
- Private Investment into Public Equity (PIPE)

Funds may focus on one area or be quite generalist in deal type or sector

WHY USE PE IN PORTFOLIOS?

- Correlation low with other asset classes
- Long term asset, rather like real estate
- Stabilising effect of less volatile pricing over short term
- Potential higher return

MANAGER SELECTION

- PE requires specialist skills and resource
- For many institutions this is too expensive
- If so, sub contract management required – use fund of funds
- In South Africa PE industry well developed, favourable conditions, good choice of funds
- Rest of Southern Africa, where funds are available, then investment/execution is the key to success

NET RETURNS ACHIEVED BY PE FUNDS

Returns to 31 March 2010	3 year	5 year	10 year
Emerging Markets PE &VC	9.9	13.7	7.7
W Europe VC&PE	(3.6)	13.5	14.0
MSCI EM index (listed equities)	5.5	16.0	10.1
MSCI World index	(5.4)	2.9	(0.0)

- EMPE better than World and close to EM listed indices
- Reasonable result given the Crunch (EMPE was top in 2007)
- Caveat - not a strong benchmark. EMPE is only 307 funds
- **Africa sample size too small to be included in the statistics**
- Wide dispersion of PE returns internationally and between quartiles (EMPE top quartile beats MSCI index)

Source: Cambridge Associates – pooled end to end \$ net returns after all costs

SOUTH AFRICA RETURNS

Gross returns of independently managed funds in SA from inception to end 2009 (net returns not available):

Gross IRR %	5 year	10 year
<10	1	-
10-20	1	-
20-30	1	2
30-40	2	1
>40	1	-

Source : KPMG and SAVCA 2009 SA PE survey

SOUTH AFRICA RETURNS - CONCLUSIONS

Small sample but indicates:

- 2/3 are producing strong index beating returns (>20% gross IRR)
- Top quartile = stellar returns
- Only one may be a failure on present information (<10% gross IRR)
- Longer term recorded returns tend to improve as funds are divested (years 6-10 normally)

EVIDENCE FROM THE IFC

All their PE funds since 2000:

- Diversified global portfolio including >20% in Africa/MENA
- Net IRR to December 2009 = 18% (top quartile)
- SME investments not significantly riskier than large ones, except well below \$2m deal size
- IRR of minority position deals not significantly different from majority held ones
- First time funds produced similar returns to non first time ones

Contrary to traditional view on PE risk

Source: IFC. The Case For Emerging Markets, March 2010

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BUT....

- Although good PE fund returns can result from excellent selection
- WHAT IS THE REQUIRED RISK PREMIUM OVER LISTEDS?
- Is 15-18% net actually good relative to the risk
- What is the premium required to persuade Western LPs to invest in Africa. Different from local risk premium?
- Risk premium for African LPs to invest in West?!! (Due to recent poor returns in West)

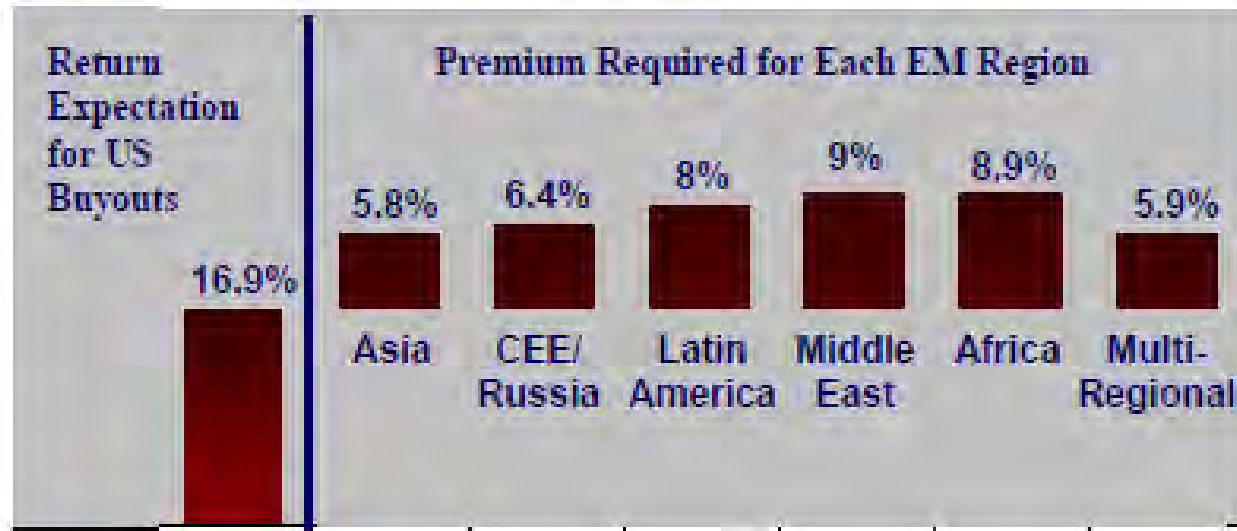
Pre crunch 2006 - 25% net from Africa. Today?

COMPARISON OF REQUIRED PREMIUM, BY REGION

Chart 17

“What returns do you expect from your 2005-2006 US buyout commitments (in IRR, net of fees and carried)?”

“What premium would you require over US buyout returns to invest in a fund in the following regions?”



* Asia ex Japan, Aus & NZ

CURRENCY RISK

- Not of course an issue for domestic investor
- Balance of exporters and domestic businesses good
- Regional funds look to diversification and long term nature of funds to mitigate
- Funds do not try to hedge, due to cost of long term hedges and uncertain cash flows

SUMMARY SESSION 1.1

- PE has additional risks to those of listed equities
- It is still early days for the asset class
- EMPE has an important role in a portfolio
- The risks can be identified and mitigated, to capture higher return
- Often undertaken by sub contract PE Manager
- Risk is concentrated in execution – so selection of right PE Fund Manager is key

SESSION 1. PE AS AN ASSET CLASS

1.1 History and background

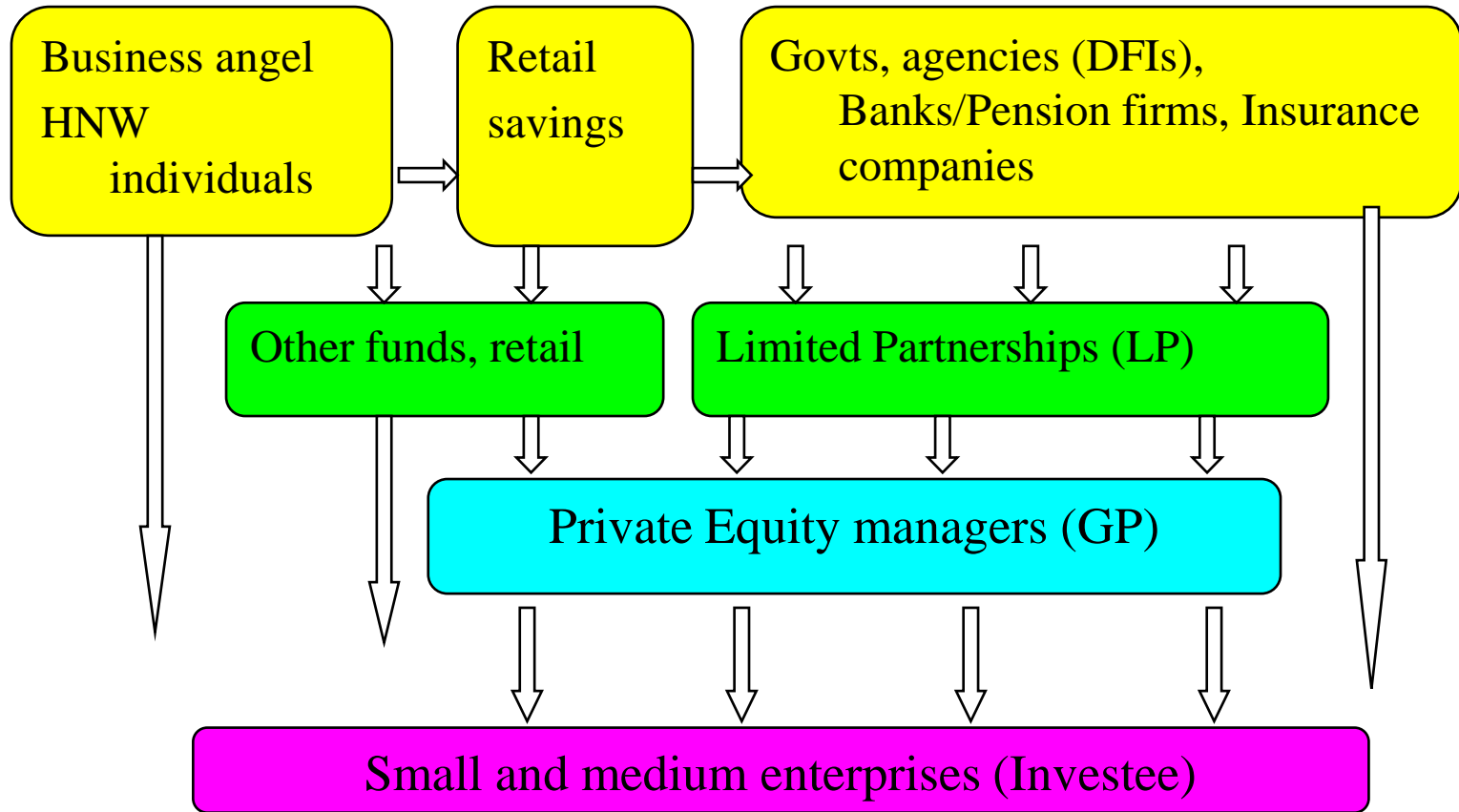
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FLOW OF FUNDS DRIVER

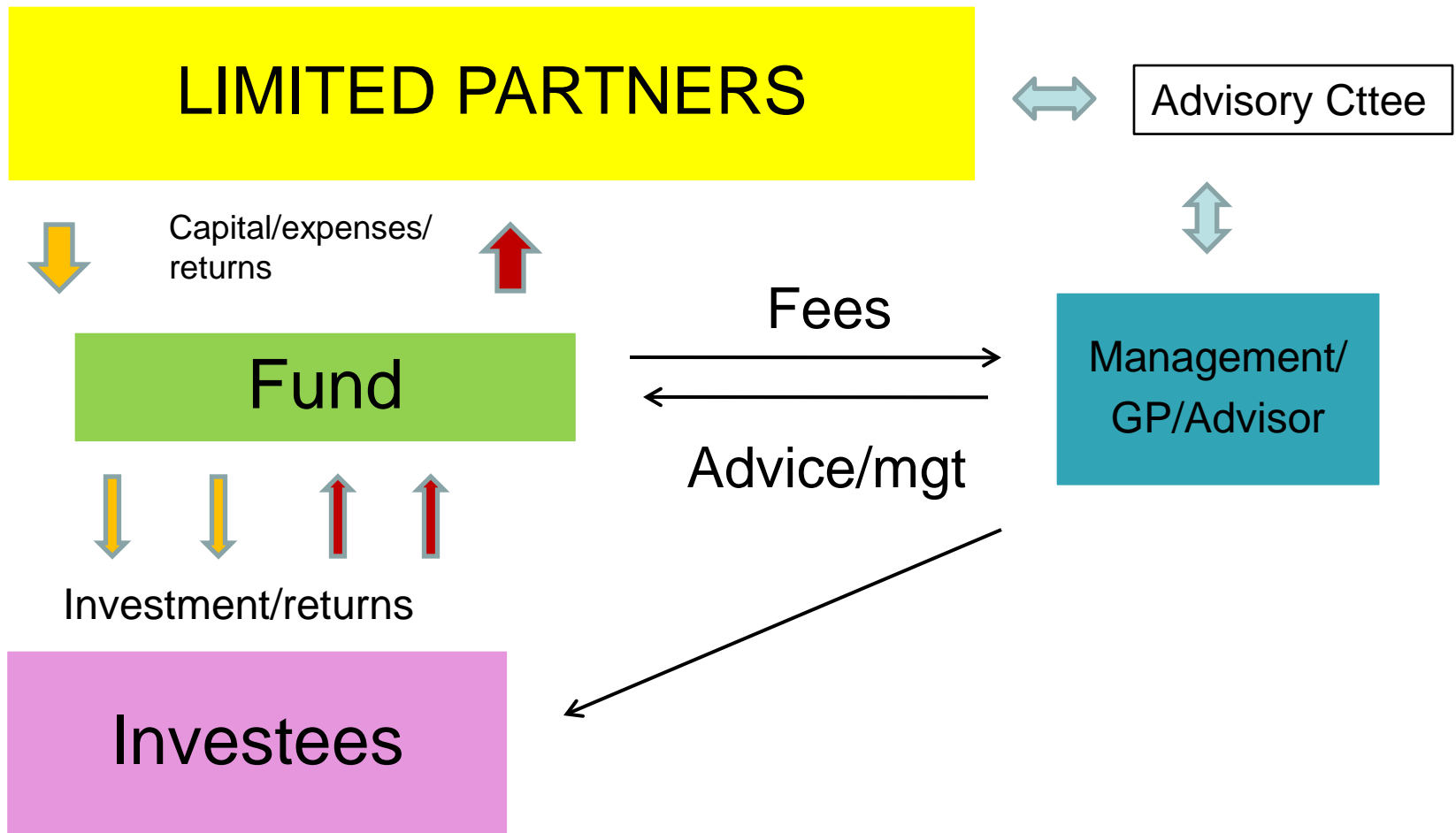


MOST TYPICAL FUND TYPE

LIMITED LIFE LIMITED PARTNERSHIPS FUNDS – proven to be most effective. WHY?

- Investors reluctant to commit money to one Manager for more than 10 years, but happy with successive funds on good performance
- Limited partnership or easily liquidated company structure
- Commitment on which annual fee is paid, but capital drawn down as needed (IRR efficiency)
- Investment only allowed for four or five years
- Thereafter capital to be returned as realisation of investments occur
- Minimum economic Fund size c \$20m and so not suitable for PE deal sizes below c \$200,000 (fund economics)
- Partnership has tax transparency in many jurisdictions so can pool ('commingle') different investor types

STANDARD FUND STRUCTURE



HOW DO PE FUNDS WORK 1

Initiation

- Investors approached by Manager (General Partner/GP) with Private Placement or Information Memorandum
- Negotiate a common shareholder and management agreement
- Initial investors make commitment on a single day = First Closing, but draw down is only as required
- Other investors may join in subsequent closings on 'equivalent basis' for up to a year
- GP expected to invest at least 1%
- Organisational expenses of fund up to 1% paid by fund

HOW DO PE FUNDS WORK 2

Operation

- Draw Downs against Commitment as needed for up to 5 years (Investment Period)
- Normally portfolio of 8-15 investments created over the 5 years
- Capital to be returned by year 10 (Divestment phase)
- This can be extended with partner approval
- The GP can raise sequential fund when current fund is c 75% invested, so they always have capital available
- Structure (or regular fund raisings) is potentially wasteful in GP time, but helps incentive alignment, and reduces blind pool risk

HOW DO PE FUNDS WORK 3

Expenses

Costs

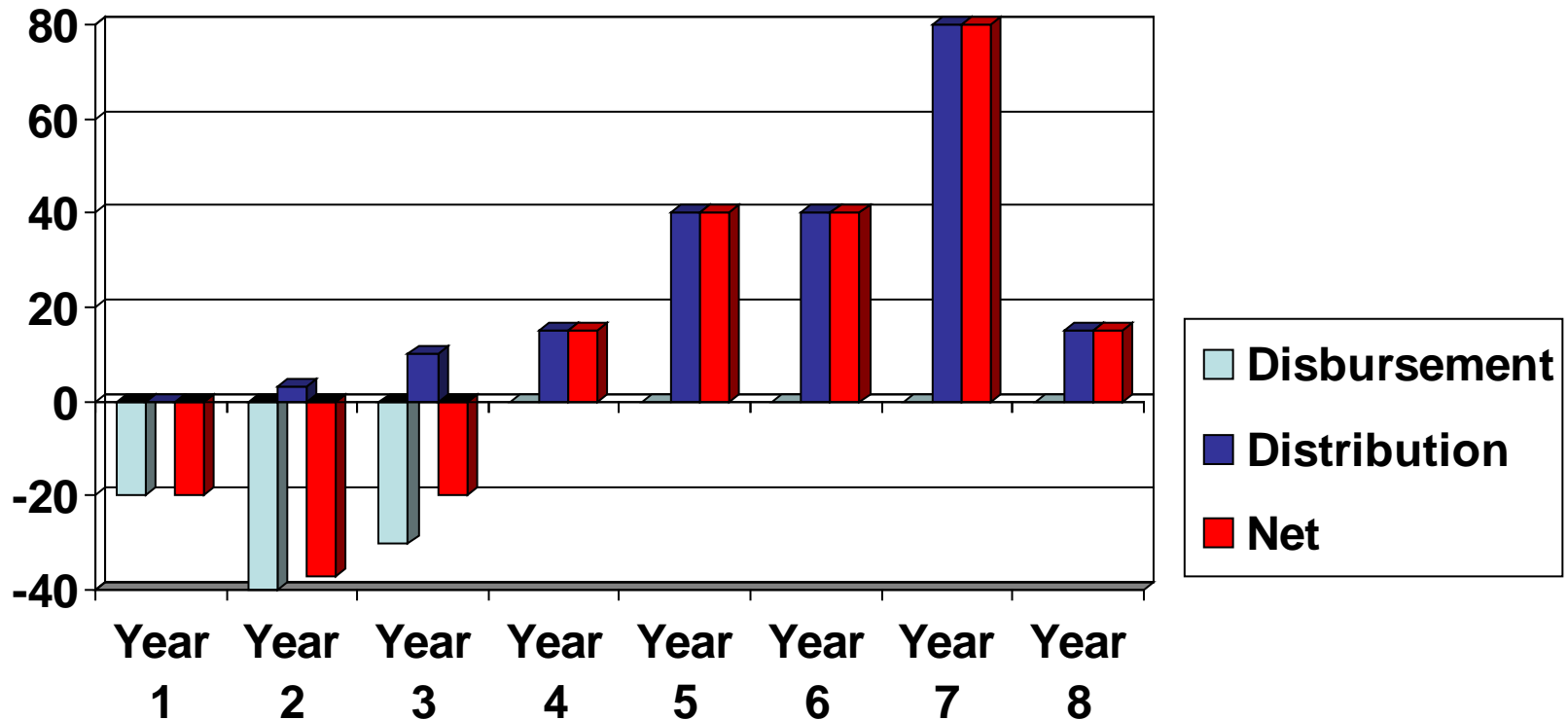
- Management fees paid on Commitment (1.75 to 3% - dependant on size)
- GP may be able to charge investees certain fees, 75-100% of which is shared with fund
- Fund carries all other third party costs, eg legal costs, auditing etc
- GP gets a 'carried interest' (share of gain) of 20% of the returns after Investors received cost and 'hurdle' (6-10% pa) back

HOW DO PE FUNDS WORK 4

Process

- Investment Committee makes investment decisions
- Advisory Committee/Board (of LPs) meets up to quarterly to review conflicts/valuations
- Reporting quarterly
- Valuations at least twice a year, now often quarterly
- Capital or income received returned to Investors immediately (subject to minimums)

TYPICAL FUND CASH FLOW FOR INVESTORS



\$100m Fund, \$90m drawn down, IRR 20%, 2.25 multiple

1.2 HOW DO FUNDS WORK TO MITIGATE RISK AGENDA

- Flow of funds
- The limited partnership structure
- How funds work
- How funds mitigate liquidity, systemic, infrastructure, litigation and reputation risk
- J Curve

STRUCTURE AND PROCESS

Tailor made to mitigate risk

Risk category	Description	Mitigation
Liquidity	No tradability of asset	Fund life structure and process
Cycle	Exposed to economic/financial cycles. Uncontrollable externalities!	Fund life and structure, diversification and other controls
Execution Session 2	Investment process complex/time-consuming	Process and procedures at PE Manager level
Infrastructure	Poor private sector and institutional support	Structure, procedures
Litigation	Suppliers, creditors, third parties	Fund structure, corporate governance
Reputation	Implicated by events in fund portfolio (environmental, social, accidents etc)	Fund structure, delegated management

LIQUIDITY AND CYCLE/SYSTEMIC RISKS

- Closed end fund protects the illiquid assets
- 5 years to invest, 10 year life gives room for manoeuvre
- Cash starts to flow back year 4/5
- Orderly investment/divestment = maximum opportunity to negotiate good entry/exit prices
- Diversification within the fund across sectors/stages (very few sector specific funds in EM)
- 5 years to invest spreads cycle risk across periods, same for exit
- Manager does not sit on cash
- Secondary market (negotiated basis) – IFC announced \$500m fund

But, Investor must accept 'ring fencing' committed funds for long period

LIQUIDITY AND CYCLE – SPECIFIC PROTECTIONS

Investment Policy Restrictions and Protections

Diversification requirements

- Set policy
- Country/sector maximums
- Investment maximums per investee

Other restrictions

- Environmental, Social and Governance
- Banned sectors

Change of policy requires investors consent

Quarterly Reporting

- Investee by investee details
- Valuations either quarterly or six monthly

INFRASTRUCTURE

Private sector facilitation, strength and favourability:

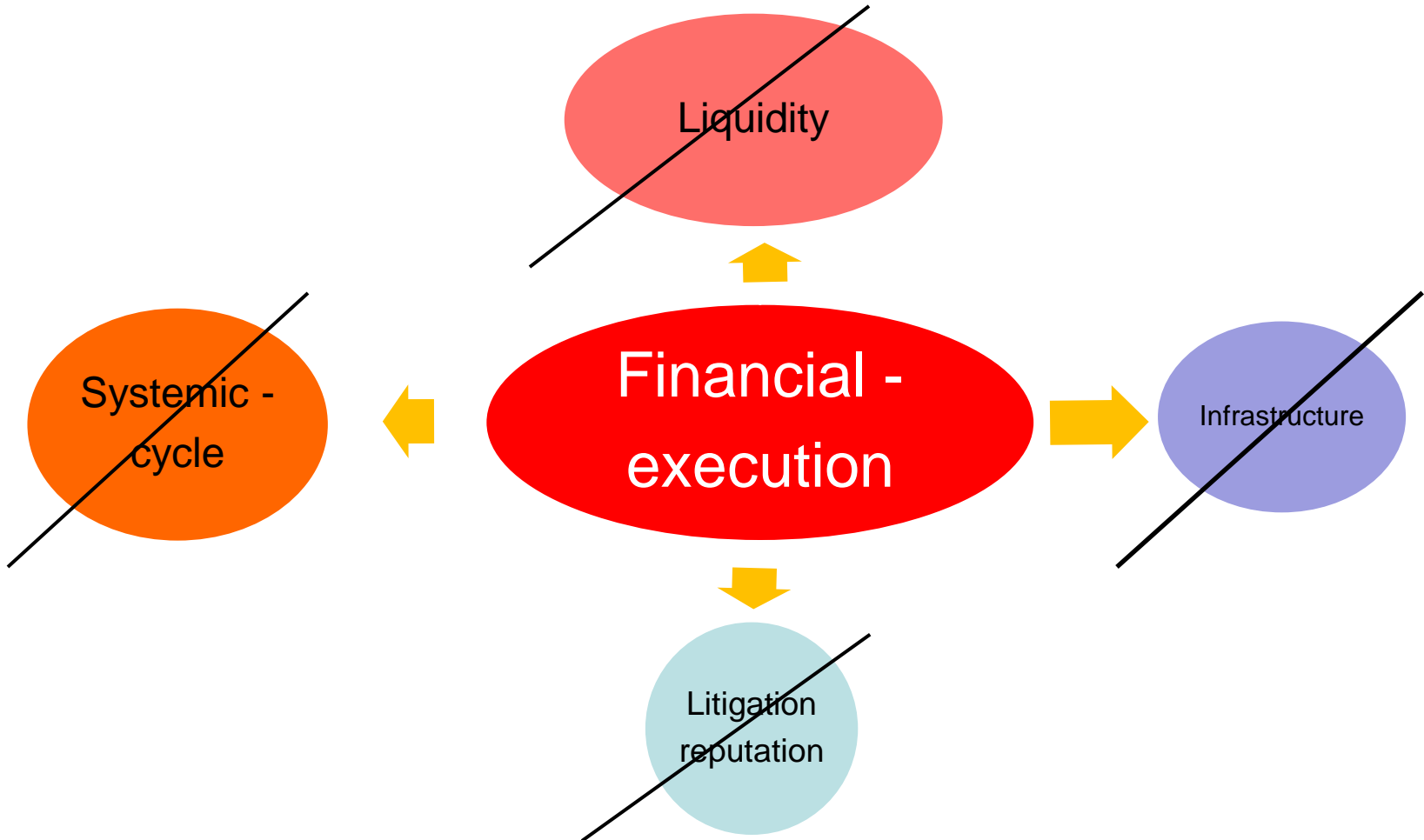
- Ownership protection
- Law of contract
- Judicial redress, efficiency and transparency
- Company's act and legal framework
- Tax incentives, government support
- Limits on state and bureaucratic intervention
- Encouragement of foreign investment
- Availability of debt, liquidity of public market

LITIGATION/REPUTATION

CORPORATE GOVERNANCE

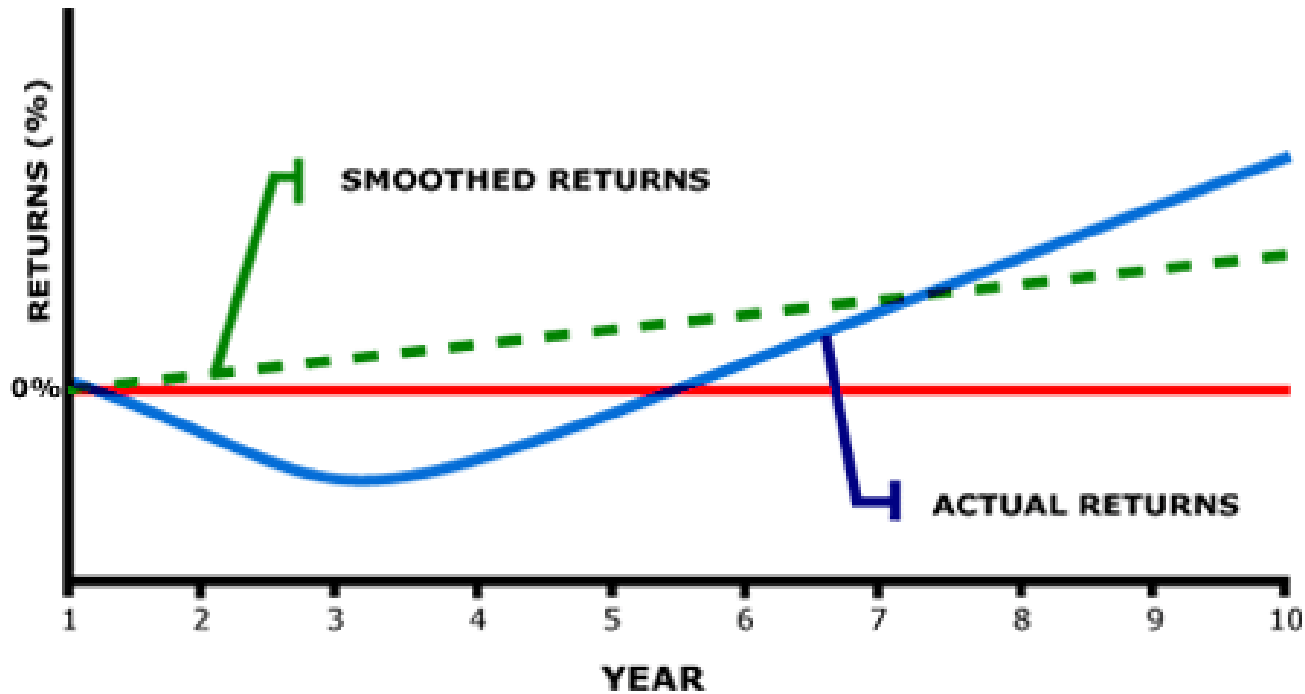
- Delegated investment decisions to avoid investor liability
- GP has Investment Committee that may have independents on it
- GP takes the liability but indemnified except for negligence/fraud
- Advisory Board of Investors controls conflicts, valuations and audit, and change to investment policy
- Ability to fire GP without cause subject to high vote threshold
- 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 environmental, social and governance criteria to be followed

POTENTIAL ADDITIONAL PE RISK HEAT MAP



OTHER MATTERS - 'J' CURVE

IRR measured each year in the life of a Fund



Source: CalPERS

SUMMARY SESSION 1

- Sub contract to professional management is needed – specialist skills
- To commit resource to the investment process, manager needs capital backing and longer term stability
- Fund pools investors interests and diversifies exposure
- Structure works to mitigate risks
- Selection of PE fund manager is key (wide return range between top and bottom quartile)

SESSION 2. IMPLEMENTATION AND RISK MANAGEMENT



WHOLE AGENDA – PRIVATE EQUITY (PE) RISK?

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RISK MITIGATION REVIEW

- Policy and diversification – portfolio construction, diversification and investment limits/allocation
- Liquidity – diversification across vintages/fund type
- Cycle – diversification across vintages
- Fund selection – pre and post investment disciplines and procedures (**this Session**)
- Tax and jurisdiction – offshore locations
- Currency – diversification by country if regional
- Liability – fund structures are limited liability partnerships
- Reputation – delegated decision making

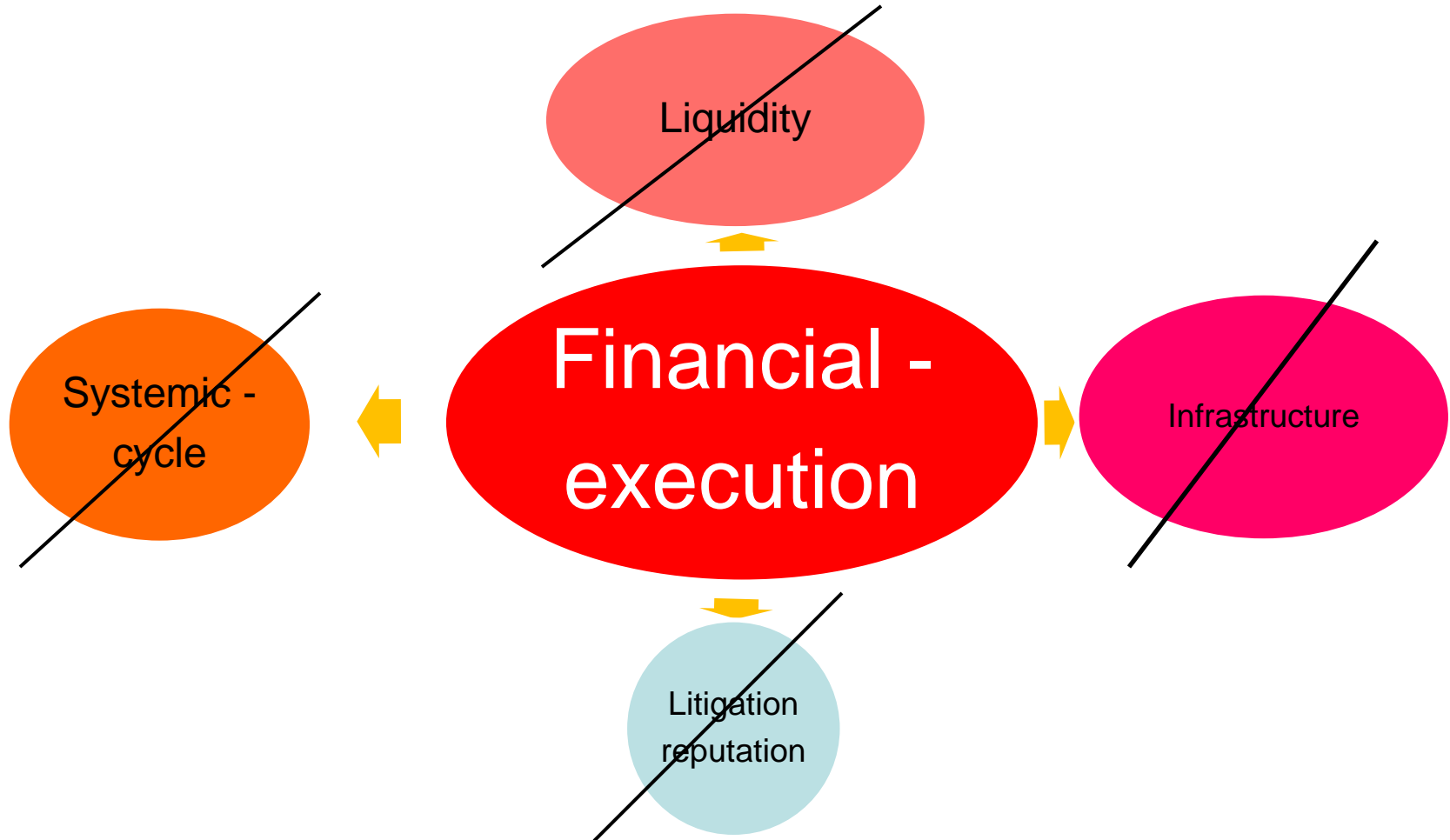
VIEW OF PE RISK CHANGED FROM...



....TO?



POTENTIAL ADDITIONAL PE RISK HEAT MAP – NOW THE HOTTEST BIT!



PE EXECUTION



How PE is implemented?

- Definition of execution/counterparty risk
- The main issues for Fund of Funds
- Alignment and conflicts
- Fund of Fund level risk control
- Main issues for Direct PE
- Direct Investment risk control

PE Fund Manager selection

- Focus on the people side

EXECUTION OR IMPLEMENTATION RISK

Overall Risk definition:

The potential to make poor investment decisions, and to fail to negotiate strong financial packages, add value, secure a good exit, and so not make a risk adjusted return

Applies both at fund of fund and at the portfolio level

THE MAIN ISSUES ENCOUNTERED FOR THE FUND OF FUNDS INVESTOR

Finding:

- Experienced managers with good and long records
- Stable teams with a balance in terms of skills (entry, add value, exit), experience, and incentives
- Teams who adapt to change but still stay with their core competence
- Aligned interests

ALIGNMENT AND INCENTIVES



Principles:

- Some cash exposure from Manager, min 1%?
- Focus that comes from limited life
- Focus from restrictions on other activities
- Manager incentivised by share of gain after all Investors money back plus hurdle
- Investors ultimately have control through 'no fault divorce'

GENERAL ALIGNMENT SOLUTIONS 1

Key alignment issues:

1. Strategy – GP and LPs to share same objectives because:
 - Fees set so manager is viable but not excessively profitable
 - no new funds until this one invested, restrict other activities
 - no 'fault divorce'. Super majority of investors can close the fund without cause
2. Risk sharing
 - Carried interest only after Investor's cost is returned
 - 'Significant investment' in fund from GP
3. Short Termism – discouraged by:
 - All deal income of any sort 100% to the fund
 - Proper step down of management fee after investment Period

GENERAL ALIGNMENT SOLUTIONS 2

3. Staffing flexibility – limited by:
 - key man clause. Breach of contract if key managers leave GP
 - individual carried interest allocation
5. Costs controlled:
 - cap on organisational costs,
 - fund administration cap
 - strict control on Manager charges to the Fund
6. Incentives aligned:
 - economics mostly go to key Managers who deliver for the fund
 - first time funds the sponsor role/backing involves GP ownership
 - later funds should see GP ownership and carry shift to Managers

However, alignment requires the right attitude and sense of responsibility, cannot be achieved by Terms only

TWO DECISION LEVELS

1. Fund of fund level/fund investor level execution

**Manager/fund
selection
FoF level**

Manager qualities,
processes,
Pipeline, fund
structure, terms

2. PE fund level execution

**Investee
selection
PE Fund level**

Investee quality: markets,
competition, product/service
USP, management, reporting,
valuation, deal structuring,
value add

LEVEL 1. ADDRESSING THE FOF RISKS

ITEM	How mitigated?
Liquidity	Secondary purchase market
Systemic/cycle	Country diversification (if possible), investment policy restrictions
Financial	Quality of opportunity, GP record, strength of GP team, fund terms operation and processes etc
Infrastructure	Pooled interests/structure
Litigation	Limited partnership structure
Reputation	Limited partnership structure

SELECTION PERFECTION!

How to assess PE fund excellence

Operational Risk= Management team, competence, balance, incentives, alignment, track record, process and disciplines (50% weight?)

Market Risk= nature of the opportunity, deal flow, pipeline, competition, networks (20% weight?)

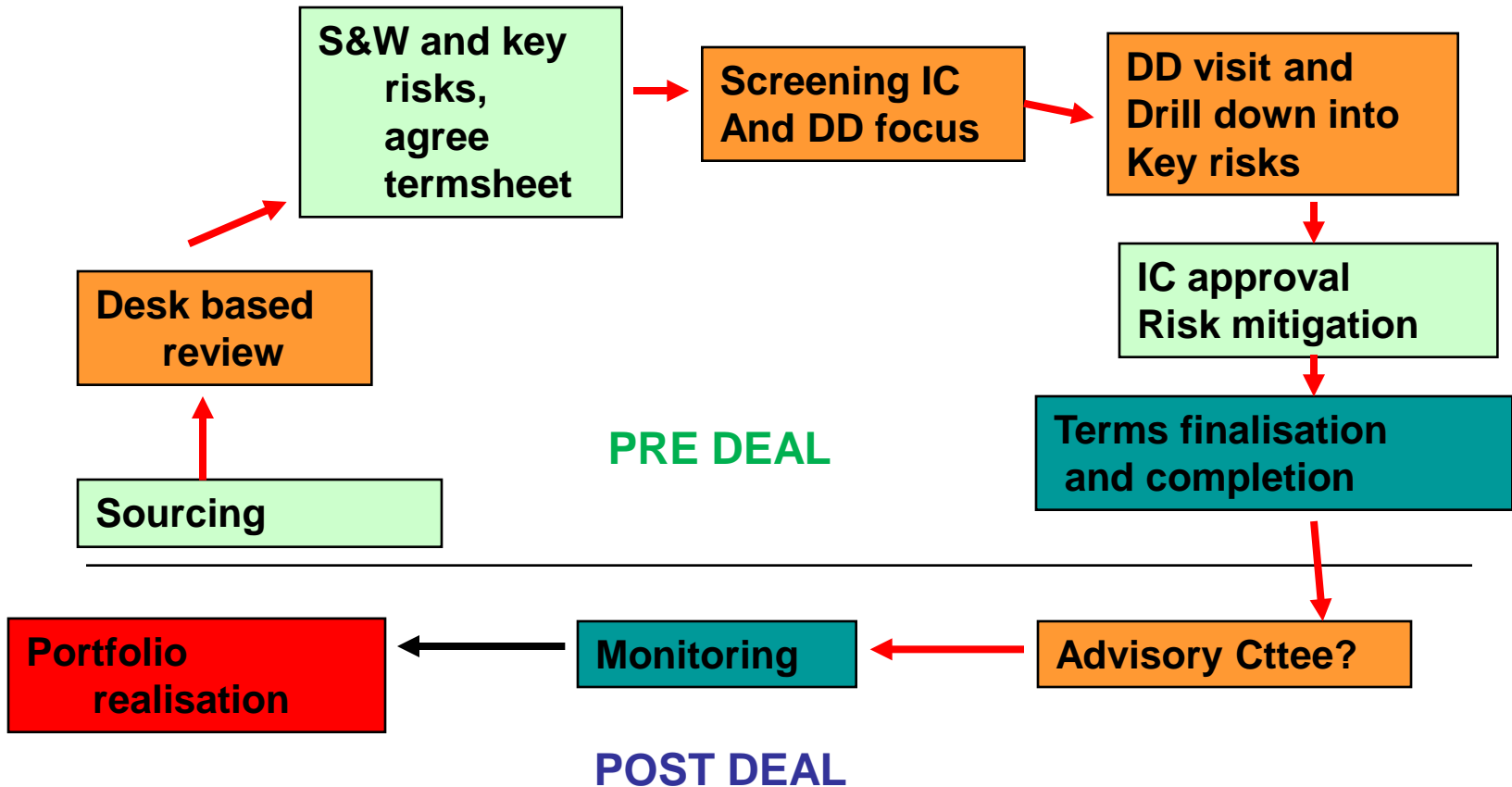
[Infrastructure Risk (country/region) = contract and judicial, liquidity, business, physical, political/economy, exit potential (10% weight?)]

Fund Specific Risk = investment policy/strategy, projected returns, fund terms, conflicts, structure, tax, currency (20% weight?)

PE FUND ASSESSMENT PROCESS

1. PPM or Information Memo received
2. Questionnaire issued by Investor
3. Initial meetings or screening (may occur as stage 2)
4. If passed screening, intensive review of PPM
5. Acquire access to data room
6. Take up initial references
7. Due diligence visit drilling down into data areas, interviewing the partners (individually), meeting other staff
8. May visit investees of a prior fund or pipeline companies
9. Finalise references
10. Go for approval
11. Legal stage

OVERVIEW OF INVESTMENT PROCESS (VERY SIMILAR TO DIRECT)



PE FUND RETURNS - ANALYSIS

Various measures used, as IRR in early years is not indicative (J Curve effect)

- Investment rate – amount of capital paid into fund v commitment
- Divestment rate – amount of capital returned v paid in
- Value of portfolio v paid in (based on IPEVC guidelines)
- Total value of investors interest v paid in = cash back + portfolio value eg Multiple on Cost
- Also look at the rate of loss = written off portfolio as proportion of paid in
- Look at portfolio companies to assess their state of health
- IRRs (gross and net)

Possible to build a good picture of progress even in the early years

CASE STUDY

Pan African fund of 1998 vintage – first ‘free standing’ fund for the Manager

- \$477m raised
- Manager established 4 African offices
- Invested across a range of industries – 9 deals, most successful were telecoms and financial services
- By 2007 90% exited and \$1097m returned
- Equivalent to 2.3 x multiple on cost
- Gross IRR of portfolio 28%
- Net IRR to investors 21%

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FoF level**

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PE Fund level**

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USP, management, reporting,
valuation, deal structuring,
value add

LEVEL 2. ADDRESSING DIRECT INVESTMENT RISK

- Investees are always incorporated entities (limited liability)
- Professional fund manager's process
- Intensive due diligence
- Protective deal structures (downside protection)
- Shareholder protections, minority controls
- Creation of corporate governance structure
- Board and Fund manager review of progress at least quarterly
- Registration of investment instruments with authorities

THE MAIN ISSUES ENCOUNTERED - DIRECT PE

- Finding transparent and dynamic entrepreneurs with sound ideas and able to penetrate growth markets and make a profit!
- Entry value disagreement with the management/sponsor
- Management teams who lie about their exit motivation
- Securing a 'good' exit, limited IPO potential or strategic attraction
- Volatile conditions for smaller companies, eg currency if exporting, commoditised markets and pricing power, cash flow, debt availability
- Conflicts, related party transactions, 'informal' management practice, misunderstandings by entrepreneur who owned 100% before the deal
- Management information delays

Good PE Manager can address all of these to some extent

RISK CONTROL IN DIRECT PE - MANAGER'S ROLE

- Investment process
- Due diligence
- Deal structuring
- Investment protections and agreements
- Corporate governance
- Management information systems
- Added value post investment
- Exit management



THE INVESTMENT PROCESS

- Sourcing of deals
- Screening for the potential best prospects
- Initial approval from Investment Committee
- Detailed negotiation of terms
- Heads of Terms agreed
- Full Investment Committee approval
- Due diligence undertaken
- Completion
- Monitoring, added value and support
- Preparation for exit
- Negotiation of exit (IPO, sale to trade investor, or MBO)
- exit

SIX KEY FACTORS FOR SUCCESS OF INVESTMENT

1. Due diligence
2. Negotiating a good deal
3. Securing investor protection
4. Securing good flow of management information from investee
5. Adding value to the investee
6. Exit management

1. DD - SOMETHING HIDDEN UNDERNEATH?



2. NEGOTIATING THE DEAL



3. INVESTMENT PROTECTION



4. MANAGEMENT INFORMATION

Like pulling teeth!

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search ID: mly/n793

5. ADDING VALUE (power boost your humble sofa?)



6. EXIT MANAGEMENT



CELTEL CASE STUDY

- In May 2000, Investment \$50 million by group of PE funds
- Pan-African mobile GSM telecommunications provider, founded in 1998
- Deregulation, privatization and expansion plan in Africa

Lead investor and PE group:

- Restructured board, new external directors, improved corporate governance
- Advised on and helped to mould strategy
- Provided additional capital to support the acquisition of KenCell from Vivendi
- Supported management in disputes with regulators
- Regularly advised Celtel on acquisitions and financing strategies
- Key role in finding and developing strategic partners with exit potential

CELTEL CASE STUDY (Continued)

- By exit in March 2005, the Celtel had almost 4 million subscribers in 13 countries: niche strategy targeting smaller countries
- Largest mobile network in Africa, from nothing in 1998
- Celtel's licenses covered over one third of the African continent and 28% of the population
- EBITDA of \$200 million by end 2004
- Average revenue per user was \$252
- Celtel employed 5,000 people, 99% of which in Africa
- Acquired by Kuwaiti telecoms company MTC for \$3.4 billion
- The sale resulted in initial PE investors receiving 4.3x invested capital and 37% IRR


PRE INVESTMENT CONTROLS DEAL STRUCTURING

Principles of deal structuring:

- Alignment with management motivations, 'partnership'
- Management/sponsor must have money on the table
- Focus on the exit incentives
- Upside exposure, but downside protection (self liquidation)
- Income orientation in mature companies
- Use of debt to match cash generation potential and security

Every deal unique, no 'one size fits all'

MANAGEMENT MOTIVATION SPECTRUM



Management Motive	exit type/ proximity	deal structure
Lifestyle/ Family	trade sale unlikely. Sale to sponsors	self liquidate debt proportion large
Mixed/uncertain	possible trade sale	debt/equity/warrants/ convertible/pref
Capital gain Orientated	trade sale/IPO likely	Equity and/or preference

PRE INVESTMENT CONTROLS

CORPORATE GOVERNANCE

- Board structure
- Independent directors, and/or appointment from the Fund Manager
- Board routines, set and regular meetings, agenda
- Conflict declaration
- Clarification of roles and organisation structure
- Establishment of full management information system, rapid reporting
- Appointment of main stream auditor

POST INVESTMENT CONTROLS

- Ensuring governance provisions are adhered to
- Conflicts supervision and resolution
- Assisting with implementing strong financial controls
- Strategic advice and assistance on all aspects of the business
- Input to and authorisation of capital expenditure or acquisitions
- Advice and encouragement towards an exit
- Often includes help with strategy, opening new markets, finding JV partners or even potential acquirers

CONCLUSION - EXECUTION

- For a Fund of Fund there are two levels of execution
- Disciplined process needed for both fund and direct investment selection
- Fund Manager/GP role is key
- Specialised tools for managing risk in direct investment
- A well managed PE programme will be of great benefit to an institutional portfolio
- The asset class is old enough for the lessons to have been learned
- Risks exist but they are manageable

PE EXECUTION

How PE is implemented?

- Definition of execution risk
- Alignment and conflicts
- Fund of Fund level risk control
- Direct Investment (Fund level) risk control

PE Fund Manager selection

- Focus on the people side

PE MANAGER SELECTION

Its all about people!



TYPICAL PE MANAGER

- Initially often a division of a financial institution
- However does not always fit well with other investment activities
- Usually becomes a separate 'partnership' organisation
- Needs skilled transaction orientated professionals
- Work in teams but individually motivated
- Needs a mix of skills, financial, accounting, and business
- If successful tends to become focussed just on managing successive PE funds
- Best model in an emerging economy is generalist investor

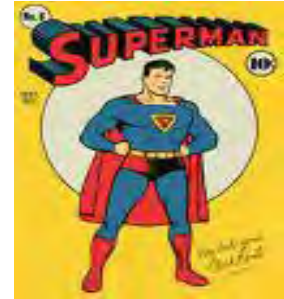
MAIN TEAM JUDGEMENT CRITERIA

Key criteria for selecting right PE fund team:

- Individual capabilities and track record
- Team dynamics
- Incentives and alignment
- Process and discipline



TEAM v INDIVIDUAL, GENERALIST v SPECIALIST



Individuals

- People judgment, analytical, relational, deal doers
- Commercial but not greedy, self motivated but team player, deal orientated but long term 'partner' to investee
- Integrity and network of relationships in business community

Team

- Tend to have individuals/small teams doing everything, from sourcing though to aftercare/exit
- Therefore assessment is key – does the team have depth
- Team 'players' essential, with balance of skills (not all accountants!)
- In Emerging Markets relationship-forming skill is a necessity – poor legal redress
- Team must have spread of financial, and operational skills

GP ORGANISATION CRITERIA ?

- Flat structure - hierarchy is for large organisations, PE is project driven
- Open and inclusive structure, partnership or similar
- Multi disciplinary skill use
- Dynamics – must not be bunch of individualists
- Creative tension OK, but internal competition and politics is wasteful
- Minimal distraction from other clients

INCENTIVES

Alignment principles:

- Focus on team should be share of capital gain alongside Investors (carried interest)
- Pay competitive but not higher than other financial services
- Management company operates close to break even/small profit
- Carried interest should be well spread amongst the key partners and principals

MANAGER SELECTION CONCLUSION

- PE is a people business
- The ideal GP structure is unusual
- Many of the skills involved are specific to PE
- Selecting the best in class PE investment managers is key
- Retention, incentives, alignment
- Ultimately partnership attitude within GP, and with LPs is fundamental

WE'VE ARRIVED!



CONTACT

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DEFINITION OF THE 'J' CURVE

'The tendency for PE Funds to display falls in net asset value per share and Interim IRR in the early years of a limited life, draw down vehicle, followed by a recovery in the later years'.

Drivers:

- Blind pool with fees 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 (typically 3-5 years at least)
- Provisions taken at once if underperformance occurs – 'the lemons ripen early'

J CURVE AND VINTAGE

