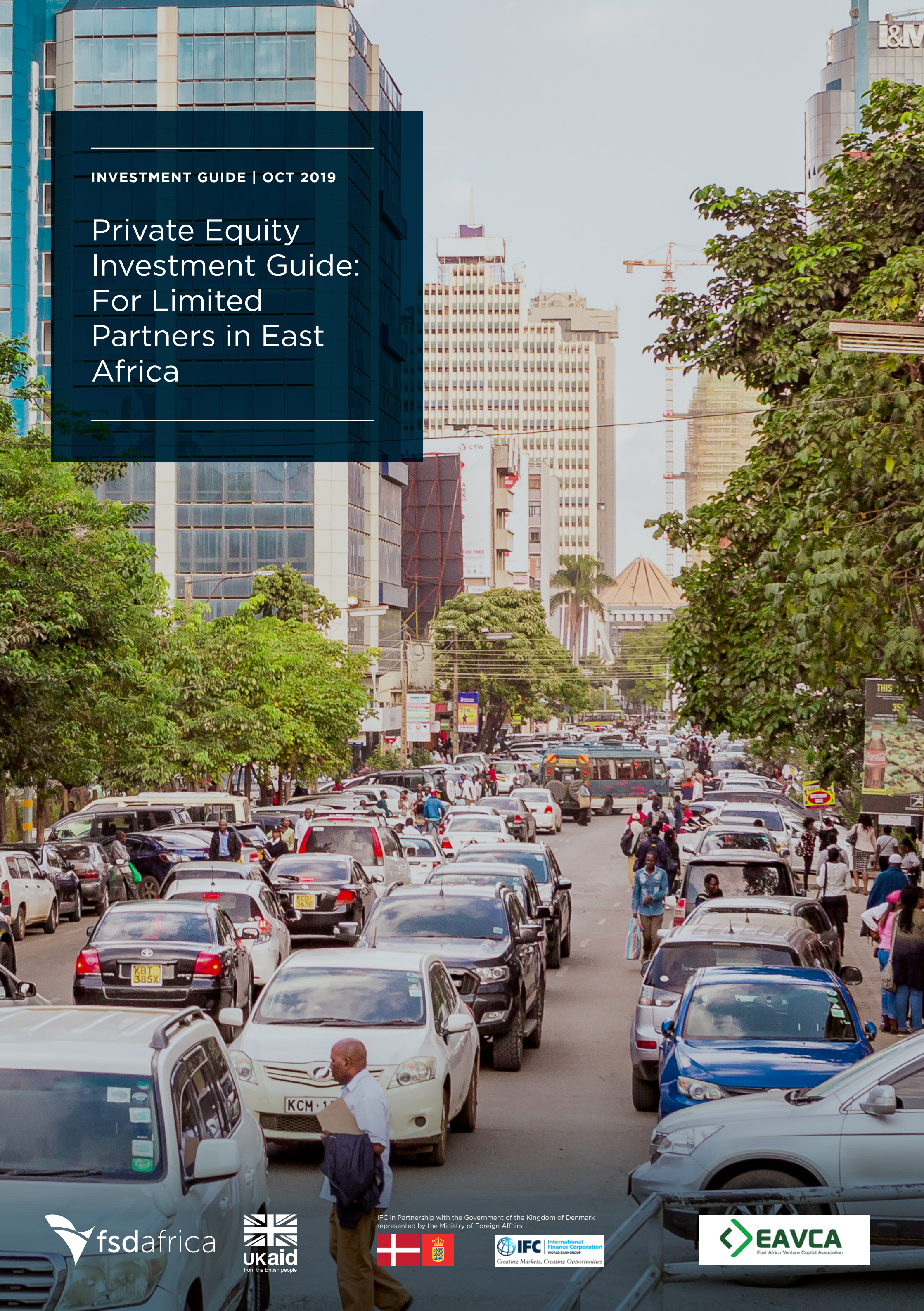
INVESTMENT GUIDE | OCT 2019

Private Equity Investment Guide: For Limited Partners in East Africa



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EAVCA East Africa Venture Capital Association

Private Equity Investment Guide: East Africa

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OCTOBER 2019

Acronyms & Abbreviations

DFI	Development Finance Institutions
EAVCA	East Africa Venture Capital Association
ESG	Environmental, Social and Governance
FSDA	Financial Sector Deepening Africa
FOF	Fund-of-Funds
IC	Investment Committee
IFC	International Finance Corporation
ILPA	Institutional Limited Partners Association
IRR	Internal Rate of Return
IMA	Investment Management Agreement
GP	General Partner
LP	Limited Partner
LPA	Limited Partnership Agreement
LPAC	Limited Partner Advisory Committee
NPV	Net Present Value
PE	Private Equity
PIPE	Private Investments in Public Equity
SAA	Strategic Asset Allocation
SHA	Shareholders' Agreement
SME	Small-to-Medium Enterprises
VC	Venture Capital

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Executive Summary

This Private Equity Investment Guide has been developed with the East African pension fund trustees in mind. It acknowledges that the role of trustee is increasingly complex. When faced with ever more investment products, the complexity lies in assessing whether they are appropriate for their respective pension schemes. While in most cases trustees appoint specialist service providers to assist in the delivery of their fiduciary duty, a trustee remains ultimately responsible for the direction and final decisions of the pension scheme.

As East African trustees contemplate whether to invest in private equity as an asset class or to develop their investment policy documents to allow them to invest in private equity, it should be noted that the average trustee undertakes such decisions in addition to their day-to-day occupations; they do not engage in this nascent asset class as specialists. Therefore, to fully appreciate the challenges and opportunities that will become available when allocating to private equity as an asset class, trustees must also appreciate that such challenges and opportunities will be quite different from those they have been exposed to with traditional asset classes.

The Investment Guide has been created to enable the average trustee to have appropriate background knowledge and understanding of the salient features of investing in private equity. The guide should therefore be used as a learning and reference tool by trustees, empowering them to proactively consider investing in the asset class. In addition, the guide will be useful in the ongoing monitoring and evaluation of their investment decision. Furthermore, the content within this Investment Guide has been collated knowing that the average trustee is not an expert with extensive investment and private equity expertise. Rather, the reference material was compiled to empower trustees to ask the necessary questions and to exercise good judgement in their deliberations when contemplating private equity investments.

The Investment Guide has been organised to provide enough content to enable the average trustee to have sufficient working knowledge of basic concepts, investment principles, governance roles and responsibilities, to guide them in their decision-making as fiduciaries.

In conclusion, this guide marks an important milestone for stakeholders with a key interest in seeing the establishment and growth of private equity as an asset class in East Africa. The partnering firms EAVCA, FSD Africa and IFC acknowledge and thank the RisCura team for the information gathering and documentation, which resulted in publishing this Private Equity Investment Guide.

Section 1

Introduction

This Investment Guide has been compiled to provide practical, industry-led information, with the primary audience being the average East African pension scheme trustee.

It aims to address the following primary areas of enquiry for the average scheme trustee:

Understanding the asset class and where it sits alongside other asset classes	Why and how to invest in the asset class	An overview of the benefits and risks of investing in the asset class

1.1 What is private equity?

- 'Private equity' is the term typically used to describe a long-term investment in private, unlisted companies.
- The investor (in most instances) secures an equity or quasi-equity stake (minority or majority) in the company in return for the investment made. Equity involves the purchase of common shares, while a quasi-equity stake ranges from preference shares, mezzanine debt and other forms of financial instruments that may be recovered as a revenue share, margin share, operating debt or dividends, or other self-liquidating instruments.
- The vehicle for investing is typically a private equity or venture capital fund. A fund manager or sponsor assumes the responsibility of investing on behalf of the fund investors by means of a fund structure (see section 5.1). Fund investors are usually development and other financial institutions, endowment or pension funds, insurance companies and family offices.

» Private equity encompasses a variety of strategies including venture capital, growth capital, private debt, distressed opportunities and leveraged buy-out. The majority of funds in Kenya and Africa are expansionary capital funds, where the capital investment is targeted at the expansion of companies that demonstrate the need for capital to grow their established business models. This is in contrast to venture capital funds that target relatively unproven business models with potential for steep growth on uptake in the market.

1.2 What is private debt?

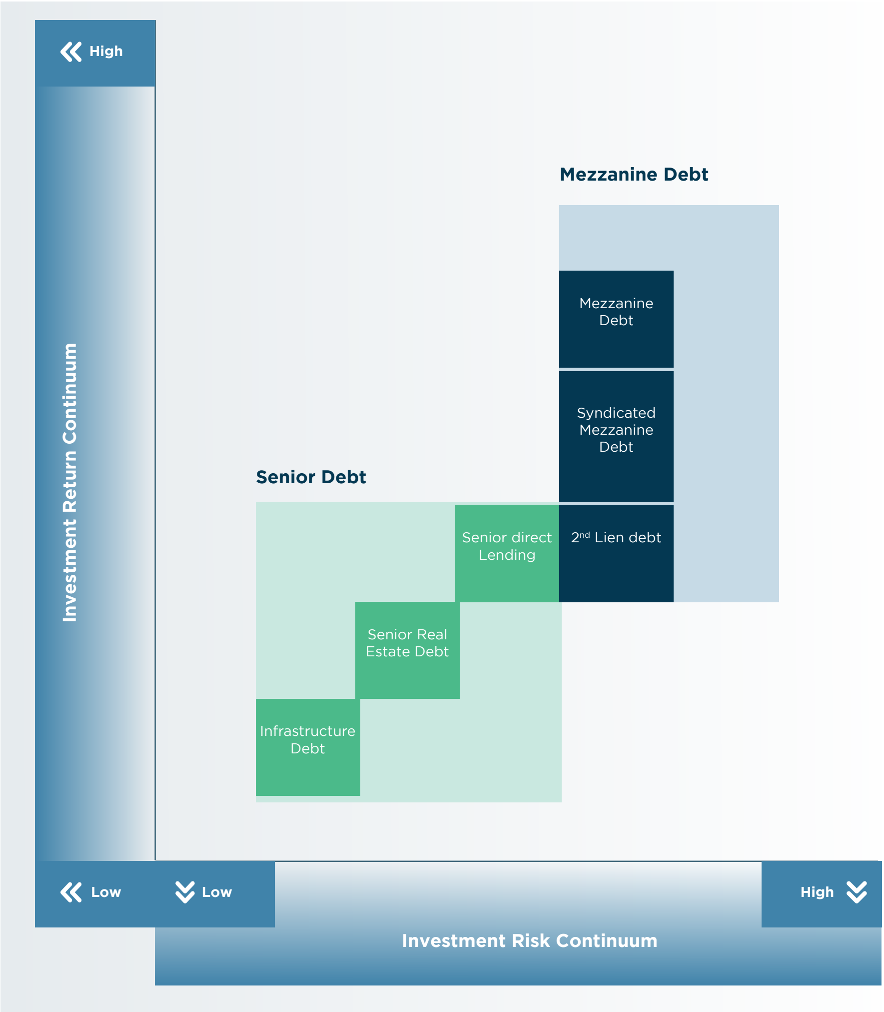
The term 'private debt' generally refers to debt or credit instruments that are not necessarily originated by commercial banks, nor are these instruments publicly traded. Private relates to the fact that the instrument is not traded publicly, as opposed to referring to the issuer of the instrument. Public and private entities can issue non-public debt. Private debt instruments are typically used to finance business growth, providing working capital to investee companies.

Private debt funds come in varied forms and pursue a wide range of investment strategies with differentiated risk/return profiles. Such funds invest in instruments that include, but are not limited to, senior secured instruments, subordinated and unsecured debt instruments, mezzanine debt instruments, preference shares and such other yielding instruments.

The global financial crisis precipitated the growth of the asset class, due to stricter capital adequacy requirements and market dynamics (in general) that led to banks reducing their willingness to hold on to specific types of commercial loans. This has allowed for the growth of private debt/credit funds to enter this space. Demand from institutional investors for private debt as an asset class has grown due to the extended period of low interest rates experienced primarily in the developed markets. As investors have looked to other avenues for higher yield and diversification in their strategic asset allocations, private debt has become increasingly prominent. The asset class presents investors with access to growing unlisted businesses, through an avenue where return profile is more certain in comparison to private equity. Investors should appreciate that the asset class remains nascent in Africa.

The multiple types of private debt strategies and their common risk/return profiles are shown below in Figure 1.

Figure 1: Private debt strategies and their common risk/return profiles



1.3 Private Investments in public equity

A private investment in public equity (PIPE) is a transaction where one or more investors purchase securities directly from a public company by way of a private placement. As a result, such securities purchased through a PIPE transaction would be considered 'restricted securities', where the purchaser of the securities would not be allowed to immediately re-sell the securities to the public.

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Section 2

The Merits of Private Equity as an Asset Class

The risks and rewards associated with investing in private equity as an asset class should be considered within the same risk versus reward framework of any other asset class. For pension funds, private equity would fall into the broader 'Alternative Investment' allocation portion of the pension fund's strategic asset allocation (SAA).

Alternative investments are investments that are not part of the traditional three asset types of listed equity, bonds or cash. Alternative investments can be anything from hedge funds to private equity investments, to real estate, to emerging market investments, that do not fit into one of the traditional asset classes.

Alternative investments provide investors with exposure to markets and investment strategies that cannot be accessed through traditional fixed income and listed equity markets. In addition to attractive risk-adjusted returns, alternative investments allow clients to diversify their portfolios by investment strategy, portfolio manager, industry sector, geography and liquidity needs.

However, these non-traditional asset types each come with a different set of risks compared to their more traditional counterparts. Therefore, when considering the addition of alternative investments into a portfolio, their unique and explicit risks should be considered. Private equity as an asset class has several specific characteristics that are unique to this asset class, which should be carefully judged when establishing a private equity investment policy and programme.

When a private equity investment programme is executed well, the potential for positive externalities and significant returns subsists. By definition, private equity is an active investment strategy (General Partners must be hands-on) in order to deliver on the investment thesis of building better and more valuable unlisted businesses. This active investment endeavour also results in positive externalities, that include job creation, a broader tax base and sustained economic growth.

Investing in a private equity fund (which consists of underlying unlisted portfolio companies) involves a degree of business and financial risk that can result in substantial losses[1]. The performance of prior investments is not indicative of expected future results. This caveat is equally applicable to private equity as an asset class, as it is to other asset classes. Risk factors that a potential investor in a private equity fund should consider prior to investment include, but are not limited to, the factors discussed below.

[1] The cited risks as they relate to private equity are as applicable to public market assets. However, investors must appreciate that private equity introduces illiquidity which, by definition, should not be as material a risk with public market assets under normal trading conditions.

RISK FACTORS TO BE CONSIDERED

Reliance on portfolio company management

Each underlying portfolio company of a private equity fund is managed on a day to day operational basis by each portfolio company's respective management team. Although the private equity fund is responsible for monitoring the performance of each investment, there can be no assurance that the underlying management team of a portfolio company, or any successor, will be able to manage and operate each portfolio company in accordance with the private equity fund's plans. Portfolio companies may lack experienced management as well as a strong board of directors. To counter this, the strategy of the fund manager is to identify areas of value addition within the portfolio companies, which may include the replacement of management and operational staff where needed, as measures used to improve operations and profitability.

If the portfolio companies in which a private equity fund invests are not able to retain managers with enough business experience and skills, these companies may not be successful, and returns to investors may be adversely impacted.

In addition, a portfolio company's operational and strategic direction may be highly dependent on its founder or other executive leadership. The occurrence of an unexpected event that deprives a portfolio company of such leaders may have an adverse effect on the portfolio company and, in turn, on the value of the private equity fund's investment therein.

Lack of diversification

Most private equity funds invest on average in eight to ten businesses, during a three-year period. This results in a large concentration in specific businesses and in a specific phase of the business cycle. Although this risk can be partially managed by investing across multiple funds and vintages[2], residual risk remains.

Illiquid and long-term investments

Although a private equity fund's investment in its portfolio companies may occasionally generate some current income, the return of capital and the realisation of gains – such as dividends and interest income – from an investment, generally will occur upon the partial or complete disposition of such investment. While an investment may be disposed of at any time, it is not usually expected that this will occur until at least a few years after the investment is made.

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[2] Vintage refers to the year a fund is initially formed and/or the year in which it initially draws down on capital. The investment performance of funds can therefore be compared, based on the vintage years of each fund.

Pension schemes should therefore take into consideration the following critical aspects when contemplating investments in private equity funds:

- When plotted against time (depicted below in Figure 2), the pension scheme's cashflows reflect the pattern on initial drawdown(s) on capital and later distributions. This feature receives the often cited 'J-curve' effect synonymous to private equity investing.

Figure 2: Private equity J-curve

- Private equity as an asset class requires investors to invest a pre-agreed amount of capital or commitment, which subsists (in general) over the life of the fund.

Minority or joint venture investments

A private equity fund may hold a minority interest in certain portfolio companies and, therefore, may have a limited ability to protect its position against adverse decisions taken by the majority interest holders.

A private equity fund may pursue investments with strategic investors or joint ventures. Such investments may involve risks in connection with such third-party involvement, including:

- the possibility that a co-investor may have financial difficulties resulting in a negative impact on such investment
- economic and/or business interests or goals that are inconsistent with those of the private equity fund

- the third-party investor may be in a position to take (or block) action in a manner contrary to the private equity fund's investment objectives. In addition, the private equity fund may in certain circumstances, be liable for the actions of a third-party investor.

Manager selection and disparity of returns

Due to the concentration in exposure to specific businesses and a much larger investment universe, private equity funds' returns are much less predictable than those of listed and credit managers, introducing additional risk to the investment portfolio.

The selection of high-quality private equity fund managers is a key driver to the ultimate success of a pension scheme's private equity investment programme. Due to the hands-on or active-management requirement of the asset class, the extent and depth of skills required to assure successful initial due diligence, investment-monitoring and ultimately, an exit, are all equally important. This dynamic presents a clear risk to the ultimate returns generated from investing in private equity as an asset class. This therefore underscores the need and importance for pension schemes to conduct comprehensive and exhaustive due diligence on private equity fund managers prior to making the decision to commit capital. The investment track record of the fund manager and its principal team members is a strong indicator of their ability to choose great investments and exit with returns to investors. This type of due diligence requires pension schemes to either have the experience internally, or to have the access to specialist third-party service providers for advice and consultation. It is also prudent for pension schemes to undertake their due diligence in consultation with, or parallel to, the due diligence investigations conducted by other experienced investors.

Valuation

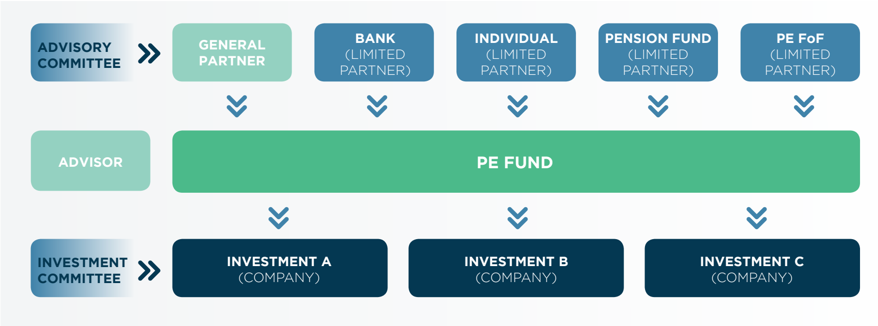
As the assets are not traded on a listed market and transactions in the securities are infrequent, the valuation of the assets is complex and subject to significant judgement. The valuation of the private equity portfolio flows into the fair value of the fund, which is used for transactional purposes and to calculate performance.

2.1 Private equity fund structure

Private equity fund structures differ by region and country according to local legal considerations but are set up to achieve tax transparency for investors, as well as legal liability to protect fund investors.

A typical structure would work as depicted below:

Figure 3: Private equity fund structures

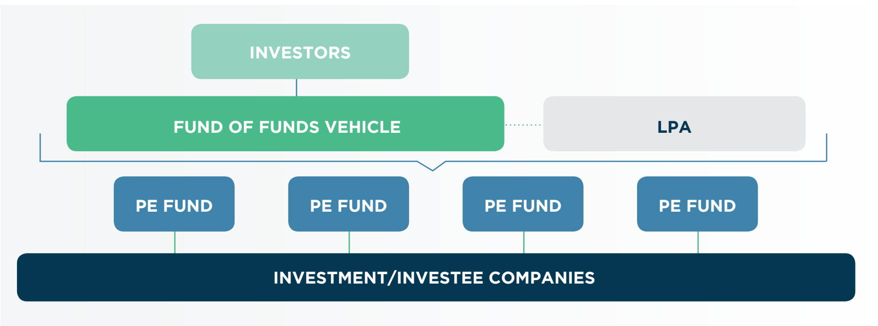


The fund vehicle itself is normally set up as a limited partnership or trust, but in certain countries a company is used. The investors in a limited partnership structure are referred to as Limited Partners, while the investment manager is referred to as the General Partner (GP).

The GP and/or fund manager to the fund performs the fund management duties, and seeks and screens investments, conducts due diligence and prepares investment proposals to the investment committee. The investment committee typically includes members of the fund manager's team as well as external experienced investment professionals, and approves deals. Institutional investors do not form part of the investment decision-making or fund management but may be appointed to an advisory committee, known as the Limited Partners Advisory Committee (LPAC). The LPAC is typically responsible for making sure the governance aspects of the fund are adhered to and no conflicts of interest occur, of either the GP, the fund's investors or other related parties.

2.2 Private equity fund-of-funds structure

Figure 4: Private Equity Fund-of-Funds Structure



The multi-manager, or fund-of-funds (FOFs) option is designed to reduce some of the single manager risks and have experts take over the daily governance, fund construction and manager interaction, on a mandate from the fund.

Private equity FOFs tend to have uniform and in-depth dedicated manager assessment, and both operational management and risk management processes tailored to the intricacies of the sector. This includes appropriately managing cash flows between drawdowns of capital commitments and distributions of investment returns over multiple funds and vintages.

The main disadvantage with investing in private equity via an FOF is the additional fee structure for the service, which can often involve both a management and a performance fee. These fees are in addition to the existing fees that need to be paid to the underlying private equity managers in the portfolio and can reduce the ultimate returns to the investor. In addition, investing via an FOF removes the investor from the direct relationship with the underlying managers.

Fund agreements

For private equity funds established using the traditional limited partnership structure, the key document governing how the fund shall be run, and the relationship between the primary parties (GP and LP), is the Limited Partnership Agreement (LPA).In the case of funds established as companies, the governing agreements are the company's constitution and the shareholders' agreements (SHA) between the investors, the fund manager or sponsor and the company. The LPA (or, in the case of a corporate structure, the SHA) is the foundational document that legally binds the relationship between the investors or LPs within a private equity fund and between the LPs and GP of a private equity fund.

Salient terms and conditions enclosed within the LPA or SHA include:

- Rights, obligations and recourse available to all parties who are admitted to the fund
- The formation, operation and termination of the fund
- Fees, fund expenses and organisational costs
- Removal of the GP or fund manager
- Fundamental commercial issues (such as investment policy of the private equity fund; management and carried interest fees; constitutional and administrative matters; risk and performance reporting requirements and parameters)
- Compliance issues such as environmental, social and governance (ESG) matters and restricted investments (for example, no investment by the fund in businesses involved in production of ammunition or tobacco etc.).

2.2.1 Commitment and drawdown model

The life of these funds is finite and typically around 10 to 12 years. During this period, the fund manager must source transactions, make the investments, grow those companies over a holding period of three to five years and sell them for a profit. Investors will have decided on their allocation to the fund at its inception (commitment). This commitment is legally binding, with the investor obliged to provide the amount committed, as and when the fund manager calls for cash to fund investments for the fund.

The capital allocated to a private equity fund is not paid into the fund on day one but is drawn down into the fund as required to make investments and pay management fees. A normal arrangement is that the private equity fund can draw down capital for new investments during the investment period, but after that cannot make new investments. The investment period is typically the first three to five years.

2.2.2 Fees

In the main, investors in private equity funds will experience two primary fees:

- **Management fees –** to pay for the day-to-day costs of operating a private equity fund.
- **Carried interest –** The proportion of fees earned by a fund manager, upon sucessfully meeting the hurdle rate of their fund performance

Management fees

Management fees are usually charged as an annual percentage of an investor's committed capital during the investment period (generally the first three to five years of a fund). These fees cover the cost of running the fund, most often between 1.5% and 2.5% per annum, with most of the funds charging 2% per annum.

Best practice calls for the GP to provide the prospective LP(s) with a transparent budget (prior to launching a fund), where the LPs can independently adjudicate the reasonability of the proposed fee model.

The extent of the fee depends on the size of the fund and the resources required to implement the fund's strategy. For example, private equity funds targeting the small-to-medium-sized business market segment (SMEs), generally will incur higher costs to service this nascent market segment; as a result, the management fee for such funds will usually be slightly higher than private equity funds that target the mid-market or established large business market segments. SME-targeting funds will usually peg their fees in the region of 2% to 2.5% per annum in comparison to funds targeting more established/mature/later-stage business cycle market segments, charging between 1.5% and 2% per annum. It is now also common practice for fees to step-down as commitment size increases, as well as fees being reduced over time as a fund heads towards maturity.

Carried Interest or performance fees

Performance fees are usually a fixed percentage of the fund's gains (generally between 10% and 20%, but most often 20%). The term 'carried interest' is often used interchangeably with performance fees. The European method of carried interest applies the concept of carried interest being paid out on a whole fund basis (i.e. only once the LPs have received back their entire capital contributed to the fund plus their preferred return). The preferred return is the return rate that a fund must exceed before carried interest payments are made to the GP. It is common to see preferred returns being set in the region of 8% per annum.

For example, in a simplified fund:

- The LP has contributed $100 of capital and the GP $10 (10%) of capital. The LP has also contributed $4 in fees (GPs generally do not pay fees on the capital they commit). If we assume that the fund invested in a single investment and returned either $90 (0.9x capital), $100 (1x capital) $120 (1.2x capital), $125 (1.25x capital), $130 (1.3x capital) or $135 (1.35x capital), the returns would be allocated as follows:

If the fund returns $90

both the Limited Partners' and General Partners' capital is returned in proportion: the LP receives 100/110 x $90, while the GP receives 10/100 x $90. Thus, the LP receives $81.80, while the GP receives $8.20.

If the fund returns $120

normally the capital is returned first, then the LP receives an amount equal to the fees it paid. A preferred return of 8% is allocated to the LP. Thus:

- First capital is returned of $100 to the LP and $10 to the GP. This allocates $110 of the returns.
- Next, an amount equal to the fees is allocated to the LP, thus allocating $4 to the LP.

» If the investment period was 1 year and the fees were drawn down at the beginning of the year, an additional $8.32 needs to be allocated to the LP to ensure that the LP has earned their preferred return of 8% on both the capital and fees amounts. This results in a total of $112.32 being allocated to the LP and $10 being allocated to the GP. As the total return is $120, $10 is allocated to the GP and $110 to the LP.

If the fund returns $150

the performance fees become relevant. If the GP earns 20% performance fee, they will now start sharing in the profit allocated to the LP at 20%. First the GP catches up on its share of the preferred return i.e. 20/80 * $8.32 = $2.08. Thereafter, all profit is shared 80% to the LP and 20% to the GP, which in this case represents $20.48 for the LP and $5.12 for the GP. Below is table detailing all three scenarios.

2.3 Preferred return and waterfall distribution

Table 1: Return and distribution

	Scenario 1	Scenario 2	Scenario 2
Total return	$90.00	$120.00	$150.00
Capital	$81.82	$100.00	$100.00
Fees		$4.00	$4.00
Preferred return		$6.00	$8.32
Performance fees			$20.48
LP	$81.82	$110.00	$132.80
Capital	$8.18	$10.00	$10.00
Fees			
Preferred return			$2.08
Performance fees			$5.12
GP	$8.18	$10.00	$17.20

2.3.1 The difference between private equity management fees and asset management fees (balanced mandates)

Investing in unlisted companies involves a much higher degree of labour-intensity, where information asymmetry must be overcome by the fund manager more so than a manager in a listed equity or debt environment. Within the listed space, the information asymmetry is far less than in the unlisted space, (for example, listed companies must publish annual financial statements, announce any material changes to their business model to the public via the stock exchange, and ensure that minutes of meetings form part of the public record etc). Importantly, by virtue of the equity or debt instrument being listed, price discovery takes place on a daily basis and (in theory) so should liquidity. Within the unlisted space, the fund manager is not afforded these luxuries, but must instead use management skills and experience to find willing buyers, secure a fair price for their investment in the company, and effect the exit in order for a liquidity-event to arise. For this reason, the Trustees must appreciate that the fees charged by private equity managers are likely to be higher than those charged by traditional public market asset managers.

2.3.2 Private equity fund domicile

The fund should be domiciled in a reputable jurisdiction. Common jurisdictions used in the establishment of private equity funds include Mauritius, the Cayman Islands and Guernsey, with Luxembourg vehicles utilised in North African funds. South African partnerships are often used by South African managers.

A key determinant in the selection of the appropriate domicile is the applicable tax regime that would affect the investors. Specifically, where the fund will have international investors and/or development finance institutions (DFIs), preference would be given to those jurisdictions that offer such investors a tax regime that is not considered by the DFIs to constitute “harmful tax practices”. Most private equity funds are structured as limited partnership or limited companies. Key to the legal structure of the fund, is its ability to afford the investors limitation of their liability.

Notes

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Section 3

Understanding the Role and Responsibility of the Limited Partner

3.1 Who are Limited Partners?

- Limited Partners (LPs) are generally the investors in private equity funds established as limited parterships.
- The LPs are not the managers of the fund; the management of the fund is the responsibility and mandate of the General Partner (GP) and/or fund manager.
- To protect an investor's status as a limited partner only liable for the amount invested in the limited partnership, the investors cannot bear any management responsibility whatsoever of a private equity fund. (If the investors participate in investment decision-making or the operations of the fund, they may be liable for the losses of the limited partnership.)
- The limitation of liability of an LP is therefore to the extent of their investment (commitment) in the private equity fund.
- Generally, regulatory authorities deem private equity funds as specialist investment vehicles that are suitable for 'qualified' or 'sophisiticated' investors. Thus, in most countries, the investors deemed to be 'qualified' or 'sophisiticated' would need to be legally defined as such, this definition precluding individuals (in most instances). LPs therefore, are mostly institutional investors, including, but not limited to pension schemes, DFIs, sovereign wealth funds, insurance companies etc. High net worth individuals are increasingly investing through their family offices, which are normally foundations set up for investments and/or charitable activities.

3.2 The role of the limited partner advisory committee

As previously mentioned, LPs do not perform a managerial function within the private equity fund structure. For the views of the investors (LPs) to be collated and expressed within the private equity fund, a governance body is established known as the Limited Partner Advisory Committee (LPAC).

Critically, due to most LPACs being established so as to have a limited number of LP representatives (i.e. not all LPs can sit on the LPAC), the LPAC is therefore to be constituted and to function in a manner that affords and provides for the expression of the views that are representative of the broader LP base of investors in a private equity fund.

Roles performed by the LPAC

Serves as a consultative body, rendering advice to the GP on key matters relating to the fund's investment strategy and business

Providing advice to the GP in scenarios where conflict of interest may arise

Engaging with the GP where certain actions could result in material departures to the structure of the fund as initially envisaged in the LPA,
such as applications to extend the life of a private equity fund; changes to the fees; key man clauses; matters requiring a vote of the LPAC

To meet regularly (at least once a year)

3.3 Structure of the LPAC

While the aspiration of the LPAC is to serve as a representative body that can effectively express the views of all LPs, in function most LPACs are structured to afford larger LPs more seats on the LPAC by virtue of the size of their commitment. The composition of the LPAC is normally proposed by the GP and negotiated with the LPs. Standard commercial terms often include seats for large LPs or LPs that represent a class of LPs, such as pension funds.

This framework does allow for the LPAC to be of limited size, which should result in more efficient decision-making and the outcomes of such decisions (generally) being reflective of the views of the stakeholders with the greatest economic interest in the private equity fund.

Using the size of commitment as the only criteria for membership of the LPAC is increasingly being interrogated. The need to broaden the participation of the LPAC to represent the interests of varied LPs is increasingly being recognised. For example, introducing a framework that allows for LPs from different geographies, types and size, could result in a more balanced representation of all stakeholders' interests.

Ways in which representation on the LPAC can be widened include:

- Affording smaller LPs 'observer' seats on the LPAC
- Allowing for certain seats on the LPAC to be reserved for rotation, which can be used as a means of allowing smaller investors to serve as members of the LPAC
- Reserving a certain number of seats for smaller investors, despite their commitment not necessarily fulfilling the minimum commitment size threshold for the LPAC.

3.4 Capital calls

Capital calls are also interchangeably referred to as 'draw down notices' or 'draw down requests'.

As a private equity fund invests capital over time, the fund does not need all the investors' money at the inception of the fund, and so the fund 'calls' capital over time. Capital calls allow for the efficient deployment of capital, where the GP has identified an investment opportunity in which the capital can be deployed immediately. For the GP, there is incentive to only draw down on capital when there is certainty of deploying that capital. If the GP were to call for the capital, but delay in deploying, the fund performance would suffer as the drawn capital is not earning a return, but rather is being penalised by virtue of management fees charged on this capital. In addition, it should be noted that the LPs are paying management fees for the GP to deploy capital in investment opportunities presenting prospects of a high rate of return, as opposed to the GP calling the capital and the capital is idle/uninvested. Both these scenarios provide context to the necessity for the GP to efficiently invest any capital called.

By virtue of the fund's agreements, the LP has an irrevocable commitment to investing the capital when called. The limitation to this obligation is only under circumstances where capital is being called for any purpose which would constitute a breach of the agreement governing the fund. Not honouring capital calls can result in severe penalties, such as forfeiting a large percentage or the ownership interest in the fund.

The GP will issue a capital call or draw down request to the LPs with between 5 and 15 business days' notice, according to the LPA. The capital could be called to make an investment or pay management fees. When an investor subscribes to a private equity fund, the investor agrees as part of the subscription, that the funds referred to in their commitment will be available when the GP submits the capital call.

Through the fund agreements, investors will prescribe the format and information enclosed within any capital call notice, as well as the minimum timeframe that the GP is to provide for the LPs to meet the capital call. These measures are to ensure that the capital that is called is utilised in accordance with the investment policy of the fund and for the investors to be afforded adequate time to meet the capital call when the request is submitted.

3.5 Establishment costs

The costs associated with establishing the fund include, though may not be limited to, all legal and accountancy expenses. Best practice is for the fund to place a budgetary upper limit on the quantum of establishment cost expenses, with this limit usually set at a percentage of the 'total committed capital' to the private equity fund, (such as establishment costs being set at a limit of 1% of total committed capital). The first drawdown of the fund is normally to reimburse establishment costs and draw down the first period's management fees.

Any fees incurred at the establishment phase of a private equity fund, that are payable to placement agents and/or financial advisers are generally for the GP to pay (i.e. not for the LPs to pay through the fund).

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Section 4

Understanding the Role and Responsibility of the General Partner

4.1 Who are the General Partners?

- The General Partner (GP) is the stakeholder responsible for effecting the investment strategy of the private equity fund.

- The GP (or the designated manager of the GP) is the operational and investment manager of a private equity fund. This is achieved by way of the GP entering into an investment management agreement (IMA) with the fund.
  Through the IMA and in accordance with the investment guidelines of the fund (as approved by the LPAC), the GP constitutes an investment committee (IC). The IC is responsible for all investment decision-making of the fund.

- By virtue of the GP bearing management responsibility for a private equity fund, such management responsibility, by law, precludes the GP from the benefit of limited liability (as enjoyed by the LPs).

- The limitation of liability of an LP is to the extent of their investment (commitment) in the private equity fund.

4.2 Investment guidelines

The investment guidelines of a private equity fund provide the parameters of investment that the GP is to adhere to in the management of the fund. The investment guidelines will enshrine aspects such as:

- Investment objectives and strategy of the fund
- Allowable investment instruments
- Investment limits:
  - Country
  - Industry sector
  - Per company exposures
  - Transaction exposures
- Allowable risk and return objectives
- Restricted Investments

Not all parts of the investment guidelines are binding. GPs prefer a flexible approach to strategy allowing them to take full advantage of the opportunities in the market. LPs may prefer more binding strategies to fit within their investment strategy, strategic asset allocation and the governance requirements of their respective institutions.

The LPAC will typically utilise the investment guidelines as its primary reference document to assess the performance of the fund and the quality of investment and portfolio management abilities of the GP. The GP is not able to make material change to the binding investment guidelines of the fund without prior consultation and approval from the LPAC or the LPs.

4.3 The investment committee

The investment committee (IC) of a private equity fund serves as the custodian of the investment guidelines of a private equity fund. The IC is primarily responsible for:

- Evaluating investment opportunities presented to the IC
- All investment and disinvestment decisions of the fund.

The GP of a private equity fund is not empowered to action any investment or disinvestment decisions without the consent of the IC.

Structure of the IC

- The IC should generally be constituted by a grouping of experienced professionals (complementary in their professionals skills) so as to enhance the quality of evaluation, adjudication and recommendations made by the IC.

- A signficant proportion of the members of the IC are normally independent of the GP and/or fund manager.

- The decision-making of the IC should be by simple majority, with all decisions duly minuted at meetings of the IC.

- All expenses incurred by the members of the IC in the fulfilment of the duties of the IC, as defined within the investment guidelines, should be for the cost of the GP/manager of the private equity fund.

4.4 GP capital commitment

To align the interests of the LP and GP, best practice calls for the GP to commit its own funds alongside the LP. This GP capital commitment demonstrates the willingness of the GP to take investment risk with its own capital alongside that of the LPs. The quantum of the GP capital commitment varies, from as little as 0.5% – the key being to ensure that the GP has committed 'risk capital' alongside the LPs. On average this commitment is around 2.5% to 3%.

4.5 Removal of the GP

Two options exist for the removal of the GP as the manager of a private equity fund.

With cause

The first type of removal is 'removal with cause'. This right is almost universal. This gives LPs the right to remove the manager if they commit certain acts. These are usually actions that clearly disqualify the GP from being a manager, including criminal acts.

A GP can be removed with cause, due to:

- a material breach of law or regulation applicable to the fund
- a material breach of key agreements (for example the partnership agreement and management agreement)
- criminal convictions of principal management staff
- change of control of the management company without consent from the LPAC
- an insolvency event for the GP or manager.

A 'with cause removal' results in the loss of all, or most of the benefits that accrued to the manager and GP. These include:

- No further management fee compensation is payable
- Normally no carried interest or performance fees are paid to the manager.

Without cause

The second type of removal is 'without cause removal'. This is typically referred to as the 'no fault' clause and allows a large majority to either replace the manager or terminate the investment period or fund. It can typically only be done by a very large majority, such as from 66% to 90% of the investors. 'Without cause removal' is sometimes done when accusations of cause are raised or for bad performance of the GP. The fund interest of the GP is normally preserved by converting the GP to a special limited partner who then retains the capital and carry that they earned up until the 'without cause removal'. Management fees are also terminated but may remain payable for a fixed period after the removal.

4.6 Key person[3] risk

Successful investment is largely a human capital endeavour, where there is a heavy reliance on the intellect and expertise of key individuals, the loss of which can prove ruinous to the private equity fund. An unexpected loss of a key individual (key person) is a significant risk to the LPs. Generally, there are three primary strategies to mitigate for key person risk:

Inclusion of key person provision in the limited partner agreement

The LPA may include specific provisions that restrict the timing and amount of investor redemptions in the event of a 'key person event' occurring. These restrictions are generally termed 'lock-ups' or 'gates' or 'key person notice' provisions, with the requirement that redemptions may only be made on specific dates.

Obligatory purchase key person insurance

Key person insurance refers to either a life insurance policy or disability insurance policy taken on a key person within the GP. The key person insurance may entail an insurance policy that compensates the investors for financial losses arising from the death or incapacity of a key person. Purchasing key person insurance provides the LPs with comfort, in that funds will be available in the event of a dissolution or transition of the fund during a 'key person event'.

Written key person contingency plan

If a 'key person event' happens, prudence necessitates for the GP to have provided a clear plan detailing the steps that should be taken and the person(s) responsible for the orderly transitional management of the fund, or in an extreme instance, the winding up of the fund.

4.7 Performance reporting

The standard performance measure used in the industry is Internal Rate of Return (IRR). The IRR is the annualised rate at which monies drawdown increases value

[3] Key Persons are generally the founding or most senior members of the GP who are critical to the implementation of the stated investment strategy of the Fund. Without such key people, the successful execution of the investment strategy would be greatly impaired

to equal the monies received or closing fair value. For example, if $100 is invested for one year, and $108 is received at the end of the year, the IRR is 8%. However, if $100 is invested for six months and $108 is received at the end of the six months, the IRR is 16%.

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The IRR can be expressed as either net or gross. The IRR is gross when the effect of management, fund expenses and performance fees have been excluded, while net IRR includes the effect of these. Net IRR is the most relevant performance indicator for investors as it shows the actual returns the investor will be receiving.

Another performance measure used extensively is the ‘times money measure’ – usually denoted by 1x or 2x. This measure is literally a ratio of total monies received or receivable, over total monies paid in. The ratio can be expressed both for realised and unrealised returns, or total returns. Although easy to understand, the major drawback of this measurement method is the fact that it is not sensitive to the time period over which the return is earned. Thus, a ratio of 1.2 can mean that a return of 20% is earned over a six-month period (which is a highly desirable annualised return of 44%) or over a 5-year period (which is a very low annualised return of 3.75%). Definitions for most widely used return measures are enclosed in the ‘Glossary of Investment Return Terminology’(see page 22).

Industry practice and best practice according to the Institutional Limited Partners Association (ILPA) guidelines is that the investors receive quarterly reporting from the manager. This reporting normally contains information that summarises the position of the fund, including a balance sheet, income statement, summary of cashflows and performance indicators. Then certain limited information on each investment is included, such as the cost of the investment, the returns received and current fair value. The information should also include a summary of the latest available financial and operational performances and a summary of how the fair value was calculated. The format and quality of reporting varies between managers. Best practice is adherence to the ILPA guidelines and timely reporting that adheres to the deadlines set in the LPA.

4.8 Private capital strategies – stages of financing

Table 2: Stages of financing

Strategy	Description	Stage
Venture Capital	Financing provided by investors for start-up business ventures.	» Start-up, early stage. » Seed: angel investors. » Primarily equity and quasi-equity investment instruments used.
Senior Debt	Fixed yielding debt instrument that is most senior in the capital structure of a company	» Expansionary finance and working capital finance, generally collateralised.
Mezzanine Debt	Mezzanine debt is a financing instrument situated between the senior secured debt and the equity in the capital structure of a company.	» Rapid growth. » Quasi-equity and debt.
Distressed Opportunities	Distressed opportunities entail investing in situations where companies are undergoing, or likely to undergo bankruptcies, or other extraordinary situations such as restructurings, reorganisations and liquidations. The investor identifies the opportunity to participate in the turnaround of the company.	» Distressed company. » Refinancing. » Financial restructuring.
Leveraged Buy-Out	Leveraged buy-out investment opportunities generally feature an investor(s) purchasing a stake in company using a combination of a minimal proportion of equity with a significant amount of debt.	» Larger enterprises. » Financial engineering. » Lower growth with emphasis on efficiencies and restructuring.

Notes

Notes

Glossaries

Glossary of Investment Return Terminology

Gross IRR	**Gross Internal Rate of Return** The IRR is based upon the performance of the investments (that is, the gross return that makes the net present value of all investments netted against all investment cost to zero), not taking into account management fees or carried interest.
Net IRR	**Net Internal Rate of Return** The weighted IRR, net of management fees and carried interest generated by an investment in the fund. This return considers the daily timing of all cash flows and cumulative fair stated value, as of the end of the reported period.
DPI	**Distributions to Paid-In Capital (ILPA definition)** The ratio of money distributed to Limited Partners by the fund to contributions (capital calls) paid by the investors. The contributions (capital calls) are net of recallable distributions.
RVPI	**Residual Value to Paid-In Capital (ILPA definition)** The ratio of the net asset value of the fund to the total contributions (capital calls) of Limited Partners to date. The contributions (capital calls) are net of recallable distributions.
TVPI	**Total Value to Paid-In Capital (ILPA definition)** This ratio is the DPI and RVPI added together. It is the ratio of total distributions to Limited Partners plus the net asset value of the fund to the total contributions (capital calls) of Limited Partners to date. The contributions (capital calls) are net of recallable distributions.
TMB	**Times Money Back** This ratio is the DPI and RVPI added together. It is the ratio of total distributions to Limited Partners plus the net asset value of the fund to the total contributions (capital calls) of Limited Partners to date. The contributions (capital calls) are net of recallable distributions.

Glossary of Investment Valuation Methods

Listed Investment Securities: Traded on public markets, thus valuation is provided based on last traded market price.

Unlisted Investment Securities (e.g Private Equity):

- One year or less: at cost, but valuer will make adjustment(s) for any recent third-party transactions and assessment of any adverse events that may warrant a change in the value
- More than one year: valuers generally use the methods below.

Discounted cash flow valuation method (DCF)

Separate the cashflows generated by the company into cashflows accruing to:

- Shareholders
- Bondholders/third-party lenders
- Tax authorities etc.

Anticipate trends in the net operating cashflows into the future.
Discount the cashflows using an appropriate discount rate.

Advantages of DCF	Disadvantages of DCF
• Based on the cashflow fundamentals of a company • Discount rate can be used as an efficient tool to factor in risks to sustainable cashflow generation (e.g. beta, equity and liqudity premiums).	• Accuracy decreases quickly as forecasting horizon lengthens • Cash flow forecasting may be difficult for smaller firms and for companies emerging from development phases • Terminal value estimation is extremely critical to the outcome of the valuation • Data paucity for some countries and sectors can impede the accurate or consistent calculation of a discount rate • This valuation method is also sensitive to the discount rate applied.

Comparables or multiples method

Multiples calculations can serve as an efficient yardstick for comparing the valuation metrics across investments. Generally, comparables are utilised in those scenarios that share similar profiles of cashflows, growth potential and risk characteristics.

EV:EBITDA	**Enterprise Value (EV) to Earnings Before Interest and Tax, Depreciation and Amortisation (EBITDA)** • Most often used in private equity • Capital structure neutral • Proxy for cash flow • Enterprise Value = Company Equity Value + (Total Debt - Cash and Marketable Securities) • By adding the company equity value and net debt, a valuer can ascertain the price paid for the acquisition vs. the underlying earning power of the company.
EV/EBIT	**Enterprise Value (EV) to Earnings Before Interest and Tax** • Equates depreciation and amortisation to cash flow items • Generally less used in private equity.
EV/Revenue	**Enterprise Value (EV) to Revenue** • A valuation method that should not be used in isolation • Past revenue is not an accurate predictor of future revenue or earnings power • This valuation method is sometimes the only option for start-up enterprises.
P/E Ratio	**Price to Earnings Multiples** • Popular yardstick used in public equities • Subject to potential distortions due to accounting practices and differing tax regimes.
EV/BV	**Enterprise Value to Book Value** • As a yardstick of equity valuation, book value is accurate for those companies whose assets are tangible, relatively liquid and easily valued (e.g. commercial banks) • It is important to appreciate that the Book Value is subject to accounting treatment and rules, thus greater care should be taken in analysing the accounting policies and audit reports.

Valuation best practice

International Private Equity and Venture Capital Valuations Guidelines, December 2018 Edition
http://www.privateequityvaluation.com/Valuation-Guidelines

Glossary of Private Equity Terms

Buy-out	Acquiring a controlling equity position in a business. Where debt (leverage) is used in the execution of the acquisition of the controlling equity position, the transaction is therefore termed a 'leveraged' buy-out transaction.
Drawdown	The proportional capital called by the GP of the LPs' capital commitment. The drawdown can be utilised to fund new investments and/or to pay management fees and other operating expenses of the fund.
Carry, carried interest	The proportion of profit earned by the GP.
Co-investment	Where the LPs are afforded the opportunity to invest (directly) alongside the fund in a transaction. The GP will still typically exercise the same level of controls and oversight over both the co-investment portion of the investment alongside the portion of the investment in the fund.
Commitment	The amount of capital that LPs have undertaken to invest in the fund. Upon fully executing the LPA, the investors are legally bound to meet the drawdown calls on their committed capital.
Distressed	An investment strategy premised on securing investment positions (debt or equity) of financially and/or operationally poorly performing (distressed) companies, with a view to restructuring the investment and selling the investment position for much greater value, post restructuring.
Distribution	Return of capital and profits to the investor.
Exit	The realisation of an investment made by a fund. Realisation routes include a sale of the business to another company (a trade sale), listing on a public stock exchange (often via an initial public offering) or a sale to another private equity investor.
Expansion or growth capital	Funds invested in businesses with the purpose for such capital invested, to accelerate the implementation of growth and expansion of an investee company.

Fund-of-funds	A partnership (fund) that invests in other funds.
GP commitment	Capital committed to the fund by the GP.
IRR	The discount rate at which the net present value of all cashflows for an investment are equal to zero. This is a measurement of returns for an investor in private equity and takes into account all the cash inflows and outflows from a particular investment and the residual fair market value of the investment.
J-curve	The pattern of returns seen in a private equity/venture capital fund. The early years of a fund typically show a negative return as capital is invested but not yet generating a return. As the fund matures, the return moves into positive territory as portfolio company valuations increase and as exits (or sales) of companies occur.
Preferred return or hurdle	The specified return that the LPs must receive before the GP is allowed to be paid its carried interest. Preferred returns range from 6% to 10% (per annum), with most funds using a preferred return of 8%. Preferred returns are more commonly used in private equity funds and less so in venture capital funds.
Special situations	A category of investment that does not fit into the traditional classification of venture capital, private equity, private debt. Generally, it involves the financing and investment of specialist assets; for example, provision of finance to airplane leasing.

Notes

EAVCA is a member organisation that represents private equity and venture capital fund managers deploying private capital in East Africa. Established in 2013, the Association serves as the intermediary between the private capital industry and the external environment and aims to ultimately play a greater role in mobilising investment flows in the region.

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FSD Africa is a specialist development agency working to build and strengthen financial markets across sub-Saharan Africa. FSD Africa is incorporated as a non-profit company limited by guarantee in Kenya. It is funded by UK aid from the UK government. FSD Africa works to reduce poverty through a 'market systems development' approach, which means addressing the structural, underlying causes of poverty by improving how financial market systems function. At FSD Africa, programming is designed to address systemic challenges within Africa's financial markets, with the aim of sparking large-scale and long-term change. FSD Africa's interventions are designed from the ground up, to ensure that Africa's financial markets better serve those most in need.

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IFC —a sister organization of the World Bank and member of the World Bank Group—is the largest global development institution focused on the private sector in emerging markets. We work with more than 2,000 businesses worldwide, using our capital, expertise, and influence to create markets and opportunities where they are needed most. In fiscal year 2019, we delivered more than $19 billion in long-term financing for developing countries, leveraging the power of the private sector to end extreme poverty and boost shared prosperity. For more information, visit www.ifc.org

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