



**Exploring agency risks and governance  
between institutional investors and fund  
managers in private equity**

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# Abstract

In this study, the relationship between Fund Managers and Investors in private equity is explored. This relationship is fairly under-researched in the literature, and the purpose of this research was to launch an exploratory study intended to motivate future research in this field. The study was predicated upon a structured framework established using Agency Theory as a theoretical basis to conceptualise the underlying relationship. Agency Theory was used to formulate key themes upon which to structure and research key areas of the agency relationship. These were: selection; alignment of interest, governance mechanisms and agency conflicts. The research design was incorporated in the context of a Development Finance Institution as a single-case study, with six private equity funds as multiple embedded units within the context. In particular, the relationship was explored to understand how investors and fund manager of private equity are selected; how alignment of interests are achieved through incentive structures and partnership agreements; how agency conflicts manifest, and how decisions are made via key governance structures in the Fund. Furthermore, a number of agency predictions were validated in the context of the relationship.

Keywords: Private equity, DFI, agency theory, agency conflicts

# Declaration

I declare that this research project is my own work. It is submitted in partial fulfilment of the requirements for the degree of Master of Business Administration at the Gordon Institute of Business Science, University of Pretoria. It has not been submitted before for any degree or examination in any other University. I further declare that I have obtained the necessary authorisation, and consent to carry out this research.

Name : Geshie Naidoo

Signature : \_\_\_\_\_

Date : 07 November 2012

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First and foremost, I would like to convey special thanks to the Development Finance Institution (DFI) who provided me with access to the Fund Managers within their private equity investment portfolio. I am forever grateful for your philosophy on information sharing, and trust that I have abided by all conditions set forth by your research policy.

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I am reminded of the comment made by many of the Fund Managers during my interview with them, that they do not ordinarily agree to participate in academic research, given the sensitivities as well as the nature of the industry in which they operate. I thank you once again for agreeing to participate.

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South Africa, Gauteng, November 2012

Geshie Naidoo

# Table of Contents

<b>ABSTRACT .....</b>	<b>I</b>
<b>DECLARATION .....</b>	<b>II</b>
<b>ACKNOWLEDGEMENTS .....</b>	<b>III</b>
<b>TABLE OF CONTENTS .....</b>	<b>IV</b>
<b>CHAPTER 1: INTRODUCTION TO RESEARCH PROBLEM.....</b>	<b>11</b>
1.1 RESEARCH PROBLEM.....	11
1.2 RESEARCH MOTIVATION .....	11
1.3 EVIDENCE OF RESEARCH PROBLEM .....	12
1.4 RELEVANCE OF RESEARCH TO SOUTH AFRICA.....	12
1.5 PURPOSE OF RESEARCH.....	13
<b>CHAPTER 2: LITERATURE REVIEW .....</b>	<b>14</b>
2.1 AGENCY THEORY.....	14
2.1.1 <i>The genesis of Agency Theory.....</i>	<i>14</i>
2.1.2 <i>Limitations of Agency Theory.....</i>	<i>16</i>
2.1.3 <i>Concluding remarks of Agency Theory.....</i>	<i>17</i>
2.2 SELECTION CRITERIA.....	18
2.2.1 <i>Selection criteria used by Investors to select Fund Managers .....</i>	<i>18</i>
2.2.2 <i>Selection criteria used by Fund Managers to select Investors .....</i>	<i>19</i>
2.3 ALIGNMENT OF INTERESTS .....	20
2.3.1 <i>Compensation.....</i>	<i>20</i>
2.3.2 <i>Contracts and Partnership Covenants.....</i>	<i>21</i>
2.4 AGENCY CONFLICTS .....	22
2.5 GOVERNANCE MECHANISMS.....	23
2.5.1 <i>Legal Structures within Funds.....</i>	<i>24</i>
2.5.2 <i>Investment Committees and Advisory Committees .....</i>	<i>24</i>

2.5.3	<i>DFI's role in private equity governance</i> .....	24
2.5.3	<i>Best practice governance models</i> .....	25
2.6	PULLING TOGETHER THE LITERATURE REVIEW .....	26
<b>CHAPTER 3: RESEARCH QUESTIONS</b> .....		<b>27</b>
<b>CHAPTER 4: RESEARCH METHODOLOGY</b> .....		<b>28</b>
4.1	RESEARCH DESIGN .....	28
4.2	SCOPE OF RESEARCH .....	29
4.3	UNIVERSE/POPULATION .....	29
4.4	SAMPLING .....	29
4.5.	RESEARCH INSTRUMENT/MEASUREMENT .....	30
4.5.1	<i>Reliability</i> .....	31
4.5.2	<i>Validity</i> .....	31
4.5.3	<i>Pre-testing</i> .....	31
4.6	DATA ANALYSIS .....	31
4.7	RESEARCH LIMITATIONS .....	32
<b>CHAPTER 5: RESULTS</b> .....		<b>33</b>
5.1	THE DFI UNDER RESEARCH.....	33
5.1.2	<i>Investment strategy of the DFI</i> .....	33
5.2	FUND P.....	34
5.2.1	<i>Investment Strategy</i> .....	34
5.2.2	<i>Selection criteria</i> .....	35
5.2.3	<i>Alignment of interests</i> .....	36
5.2.4	<i>Governance, disclosure and regulation</i> .....	38
5.3	FUND S .....	39
5.3.1	<i>Investment strategy</i> .....	39
5.3.2	<i>Selection criteria</i> .....	40
5.3.3	<i>Alignment of Interests</i> .....	40

5.3.4	<i>Governance, disclosure and regulation</i> .....	43
5.4	FUND V.....	45
5.4.1	<i>Investment Strategy</i> .....	45
5.4.2	<i>Selection criteria</i> .....	46
5.4.3	<i>Alignment of Interests</i> .....	47
5.4.4	<i>Governance, disclosure and regulation</i> .....	49
5.4	FUND A.....	50
5.5.1	<i>Investment strategy</i> .....	50
5.5.2	<i>Selection criteria</i> .....	51
5.5.3	<i>Alignment of Interests</i> .....	52
5.5.4	<i>Governance, disclosure and regulation</i> .....	55
5.6	FUND N .....	56
5.6.1	<i>Investment strategy</i> .....	56
5.6.2	<i>Selection criteria</i> .....	57
5.6.3	<i>Alignment of Interests</i> .....	58
5.6.4	<i>Governance, disclosure and regulation</i> .....	61
5.6	FUND T.....	63
5.7.1	<i>Investment strategy</i> .....	63
5.7.2	<i>GP’s selection strategy</i> .....	64
6.2.7	<i>Fund T</i> .....	64
5.7.3	<i>Alignment of interests</i> .....	65
6.2.7	<i>Fund T</i> .....	65
5.7.4	<i>Governance, and regulation</i> .....	67
5.7	CONCLUDING REMARKS .....	68
<b>CHAPTER 6: DISCUSSION OF RESULTS</b> .....		<b>69</b>
6.1	RESEARCH QUESTION 1: WHAT ARE THE SELECTION CRITERIA DEPLOYED BY INSTITUTIONAL INVESTORS WHEN SELECTING FUND MANAGERS? .....	69

6.1.1	<i>Investor selection criteria</i> .....	69
6.2	RESEARCH QUESTION 2: WHAT IS THE SELECTION CRITERIA DEPLOYED BY FUND MANAGERS WHEN SELECTING INSTITUTIONAL INVESTORS? .....	71
6.2.1	<i>Adverse selection when the fund manager is the principal</i> .....	71
6.2.2	<i>Concluding remarks on selection criteria according to the Fund Managers</i> .....	71
6.3	RESEARCH QUESTION 3: HOW DO AGENCY CONFLICTS MANIFEST IN THE RELATIONSHIP BETWEEN INSTITUTIONAL INVESTOR AND FUND MANAGERS? .....	76
6.3.1	<i>Areas of agency conflicts identified across funds</i> .....	76
6.3.2	<i>Management fees paid to the fund manager</i> .....	76
6.3.3	<i>Capital contribution made by the fund manager</i> .....	78
6.3.4	<i>Fees charged by affiliate companies to investee companies</i> .....	78
6.3.5	<i>Funds manager’s Black Economic Empowerment credentials</i> .....	79
6.3.6	<i>Fund structure: ‘Trust’ versus a ‘Limited Partnership’ Structure</i> .....	79
6.3.7	<i>Investor staff that join the employment of private equity funds</i> .....	80
6.3.8	<i>Commitment by the fund manager to ESG issues</i> .....	81
6.3.9	<i>Valuations and sales of investee companies by the fund manager</i> .....	82
6.3.10	<i>Fund manager wanting to extend the life of fund</i> .....	84
6.3.11	<i>Departure of Key Persons from the fund manager</i> .....	84
6.3.12	<i>Investors and fund managers that co-invest alongside each other</i> .....	85
6.4	RESEARCH QUESTION 4: WHAT ARE THE TYPICAL GOVERNANCE MECHANISMS IN FUNDS, AND HOW DO THESE REDUCE AGENCY CONFLICTS? .....	86
6.4.1	<i>Typical governance structures within funds</i> .....	86
6.4.2	<i>Investment Committee (IC)</i> .....	86
6.4.3	<i>Conflicts Committee</i> .....	91
6.4.4	<i>Limited Partnership Advisory Committee</i> .....	93
6.4.5	<i>Audit and Risk Committee</i> .....	97
6.5	RESEARCH QUESTION 5: HOW IS THE ALIGNMENT OF INTERESTS CREATED BETWEEN INSTITUTIONAL INVESTORS AND FUND MANAGERS? .....	99

6.5.1	<i>Alignment of interests between Investor and Fund Manager</i> .....	99
6.5.2	<i>Concluding remarks on alignment of interests between Investors and Fund Managers..</i>	100
<b>CHAPTER 7: CONCLUSION</b> .....		<b>105</b>
7.1	PULLING IT ALL TOGETHER.....	105
7.2	RECOMMENDATION TO STAKEHOLDERS BASED ON RESEARCH FINDINGS .....	106
7.3	RECOMMENDATIONS FOR FUTURE RESEARCH AND THE MANAGERIAL IMPLICATIONS THEREOF .....	107
<b>REFERENCE LIST</b> .....		<b>109</b>
<b>APPENDICES</b> .....		<b>112</b>
APPENDIX 1: GENERAL PARTNER: INFORMED CONSENT LETTER .....		112
APPENDIX 2: LIMITED PARTNER: INFORMED CONSENT LETTER.....		126
Table 1:	Sources of data .....	30
Table 2:	Respondents .....	30
Table 3:	Fund P premium drivers.....	35
Table 4:	Fund P fees.....	36
Table 5:	Fund P alignment of interests .....	37
Table 6:	Fund S premium drivers .....	40
Table 7:	Fund S fees .....	41
Table 8:	Fund S alignment of interests .....	41
Table 9:	Fund V premium drivers.....	46
Table 10:	Fund V fees.....	48
Table 11:	Fund V alignment of interests.....	48
Table 12:	Fund A premium drivers .....	51
Table 13:	Fund A fees .....	53
Table 14:	Fund A alignment of interests.....	53
Table 15:	Fund N premium drivers .....	57

Table 16: Fund N fees .....	58
Table 17: Fund N alignment of interests.....	59
Table 18: Fund N partnership covenants.....	60
Table 19: Fund T premium drivers .....	64
Table 20: Fund T fees.....	66
Table 21: Fund T alignment of interests .....	67
Table 22: Selection criteria .....	72
Table 23: Value contribution area .....	72
Table 24: Investment Committee representation .....	87
Table 25: Investment Committee meeting frequency.....	88
Table 26: Decision making criteria.....	89
Table 27: Fee summary.....	100
Table 28: Premium driver summary .....	103
Table 29: DFI preferences.....	103
Table 30: Alignment of interests summary.....	104
Figure 1: Embedded multiple units of analysis.....	29

*“A predominant concern for an economy, discussed since the time of Adam Smith, is to assure that production is conducted in the most efficient manner, taking advantage of the benefits of specialization, appropriately conserving scarce factors, and so on. But even if we could figure out, or were willing to let the market figure out, the most efficient way to produce the goods, there would be the problem of ensuring that each individual performs his or her agreed-on task. If information flowed costlessly and perfectly...the stockholder could be confident that managers were operating the corporation as if it were their own. But in real life full information rarely is freely available to all parties, and so the problem becomes how to structure an agreement that will induce agents to serve the principal’s interest even when their actions and information are not observed by the principal.*

*Whenever one individual depends on the action of another, an agency relationship arises.”*

**(Pratt and Zeckhauser, 1991)**

# Chapter 1: Introduction to Research Problem

*The purpose of this chapter is to describe the need for the research undertaken in this study, as well as the objective of such research. In addition, the relationship between the research problem and the research objectives is clearly articulated, together with the scope of the studied defined.*

## 1.1 Research Problem

**T**he relationship between Institutional Investors and Fund Manager in private equity bears close resemblance with the quotation on the preceding page. In private equity, institutional investors invest with fund managers who act as financial intermediaries between entrepreneurial firms and institutional investors. Institutional investors often have diversified investment mandates from their shareholders which prevent them from developing expertise in any unique asset class. However, Fund Managers possess time, specialised skills and networks for sourcing, screening, carrying out due diligence, investing and monitoring investments into firms.

The outsourcing of underlying investments into entrepreneurial firms via Fund Managers solves the problem of institutional investors from having to worry about agency problems relating to investments in disparate portfolio companies, sometime across geographies. However, the relationship between institutional investor and fund managers presents a different kind of agency problem governed by the classical assumptions of self-interest, risk aversion, goal divergence and information asymmetry.

## 1.2 Research Motivation

The agency problem arising between institutional investor and fund manager in private equity institutions is of particular interest, and selected to be further studied, for the following reasons:

- There remains a shortage of research covering the agency problems that exist between institutional investors and fund managers, owing in large part to the lack of information available to researchers (Phalippou, 2007). Instead, agency problems between fund managers and portfolio companies are well documented in the literature (Millson and Ward, 2005).

- Internationally, multilateral development finance institutions (MDFIs) are increasingly embracing private equity as a new vehicle for infrastructure investing, highlighting a renewal of understanding of fund management practices, risks and opportunities (Chowdhury, Orr, and Settel, 2009).

### 1.3 Evidence of Research Problem

Evidence supporting the existence of agency problems between the institutional investor and fund manager in private equity institutions is numerous in the literature:

- Agency problems exist between institutional investors and fund managers in private equity, giving rise to agency costs. Harris (2010) argues that while contracting is used extensively in the private equity industry to reduce and control agency costs, contracts are complex, costly to negotiate, and not sufficient to anticipate and mitigate all agency problems which may arise.
- Phalippou (2009) and Harris (2010) covered in section (2) of the literature review both highlight the areas where potential for agency conflict is rife: (1) fundraising; (2) capital call; (3) capital contributions; (4) management fees; (5) carry fees; (6) claw back; (7) transaction fees; (8) risk profile; and (9) valuation

*(The availability of specific examples of where agency problems have resulted in governance breakdown or poor performance of funds is lacking in the literature. Due to private equity being an unlisted asset class in South Africa, there is no obligation of transparency and disclosure to the general public, other than existing investors. Therefore, information is not easily accessible to researchers who may be interested in empirically validating the existence and impact of inherent agency problems upon such relationships.)*

### 1.4 Relevance of Research to South Africa

The agency problem between institutional investor and fund manager in private equity institutions is of particular relevance to South Africa (SA), given that:

- Private equity fund raising from institutional investors has increased from R3.8 billion in 2009 to R11.1 billion in 2010 (KPGM and SAVCA, 2011), owing in large part to the global

recovery since the 2008 global economic crisis, but also to the increasing investment opportunities in SA and the rest of Africa's fast growing economies.

- Changes to SA's regulatory environment allowing pension funds to invest up to ten percent of their assets by value in private equity schemes. With 16.3 percent of total fund raising emanating from pension funds and endowment companies during 2010, this development is expected to further increase their contribution to the asset class (KPGM and SAVCA, 2011).

## 1.5 Purpose of Research

The purpose of this research was to:

- To explore from the literature the building blocks of agency theory and how it can be applied to the relationship between institutional investor and fund manager in private equity institutions.
- To explore six case studies using the building blocks of agency theory as a framework to structure the exploratory research.
- To launch an exploratory study intended to motivate future research in this field.

The findings of this research will contribute to the existing body of knowledge in terms of unpacking the specific agency problems, governance mechanisms, selection criteria, and alignment of interests that commonly occur in private equity.

## Chapter 2: Literature Review

*The literature review will present an overview of previous research findings that are related to key areas of particular relevance to the research questions. The literature review is broken down into five main areas: (1) Agency Theory; (2) Investment criteria used by Institutional Investors and Fund Managers; (3) Alignment on interests in private equity; and (4) Governance mechanisms. The purpose of the literature review is to ultimately arrive at a framework will be used to influence and drive the format of the 6 case studies described in Chapter 4.*

### 2.1 Agency Theory

#### 2.1.1 The genesis of Agency Theory

**A**gency theory was first proposed by Jensen and Meckling (1976) as an extension to risk sharing theory explored by economists during the 1960s and early 1970s. The theory is based upon conflicts of interest between contracting parties. Four interesting predictions arise out of Jensen and Meckling (1976, p. 5):

Firstly, that the agency relationship between principal and agent arise out of a contract:

*“We define an agency relationship as a contract under which one or more persons (the principal(s)) engage another person (the agent) to perform some service on their behalf which involves delegating some decision making authority to the agent.”*

Secondly, that goal conflicts arise between principal and agent:

*“If both parties to the relationship are utility maximisers, there is good reason to believe that the agent will not always act in the best interests of the principal.”*

Thirdly, that incentives and monitoring can be used to create better alignment of interests:

*“The principal can limit divergences from his interest by establishing appropriate incentives for the agent and by incurring monitoring costs designed to limit the aberrant activities of the agent.”*

And forth, that monitoring costs are incurred in typical agency relationships:

*“In addition in some situations it will pay the agent to expend resources (bonding costs) to guarantee that he will not take certain actions which would harm the principal or to ensure that the principal will be compensated if he does take such actions.”*

Since 1976, various authors have written widely on the topic of Agency Theory. Decades later, Eisenhardt (1989), and Waterman and Meier (1998), summarise the three primary assumptions underlying Agency Theory. Firstly, that that *'goal conflict'* exists between principals and agents. Secondly, that there is hidden information before and after contracting (with the agent holding more information), which results in an *'information asymmetry'* between them. Thirdly, that there are different *'risk preferences'* between principal and agent.

Jensen and Meckling (1976) define *'agency costs'* as the sum of: (1) the monitoring the expenditures (by the principal); (2) bonding expenditures (by the agent); (3) the residual loss (reduction in principal welfare). The premise behind *'agency costs'* is that the principal can limit divergences from his interest through the use of incentives for the agent and by incurring monitoring costs (in both the principal and agency domain) in order to limit certain unwanted activities of the agent.

Kren and Tyson (2009) describe how the elements of Agency Theory, first postulated by Jensen and Meckling (1976), can be captured under the umbrella of *'subjective'* and/or *'objective'* control systems, that can be used to structure systems and procedures for establishing common goals or alignment of interests. In an *'objective'* control system, the focus is on having less base pay, and more bonus pay based on profitability or ROI performance measures. Alternatively, a *'subjective'* control system determines rewards on the quality of manager's decisions rather than on the outcomes of such decisions. Given that a *'subjective'* control system is based on the quality of a manager's decision-making, under a *'subjective'* control system, all actions of managers are monitored.

The implications for organisations that implement a subjective control system are twofold. Firstly, the total number of agents recruited by the principal would have to be minimised according to resource limitations, owing to the need for the principal to closely monitor all actions of the agent. Secondly, the principal would have to invest in *"advanced information technology"* and monitoring capabilities.

Prowse (1998) reiterates two kinds of agency problems which frequently occur within agency relationships. These are *'sorting problems'* and *'incentive problems'* (alternatively, referred to as *'adverse selection'* and *'moral hazard'* in the literature). *'Adverse selection'* arises during the selection of suitable agents by the principal, given that the agent knows more about its own capabilities than the principal. *'Moral hazard'* refers to problems that arise in the course of an

agency relationship in which the agent acts in self-interest, taking actions at the expense of investors.

Today, agency theory is cited extensively in the literature to describe relationships occurring within the various disciplines: accounting, economics, finance, law, political science, organisational behaviour, and even sociology. The relationship between Institutional Investors and Fund Manager bears close resemblance with the definition of an agency relationship defined above. However, the predictions made by Agency Theory would have to be tested on a case by case basis, in order to generalise the applicability of Agency theory as an umbrella theory across relationships at large.

### **2.1.2 Limitations of Agency Theory**

Opponents of agency theory argue that it is not enough to identify and align goal divergence between principal and agent. Heath (2009) identifies three potential problems with agency theory from the perspective of the business ethicist: (1) firstly, that it treats all motivation as self-interested; (2) secondly, that it pre-supposes shareholder primacy; (3) and thirdly, that it encourages the evasion of moral responsibility. Heath (2009) stresses the importance and need of a fiduciary relationship between shareholder and manager, given that managers control information.

Eisenhardt (1989) asserts that agency theory by itself presents a partial view of the world, ignoring other complexities in organisations such as impression management, innovation, vertical integration, compensation, strategic alliances, and Board relations. Furthermore agency theory is too biased toward economic restrictive assumptions of efficient market and a single view of economic actors being that of self-interest (Eisenhardt, 1989).

Harris (2010) concludes in his critical review of private equity that contract design alone will not be enough to anticipate and mitigate managerial abuse of discretion. Donaldson (2008) asserts that the solution to hedge fund opacity is ethical (parallels exist between hedge fund and private equity funds from a structure point of view – they are both alternate forms of investments and open to the abuses of information asymmetry and divergent goals advocated under agency theory).

The literature that uses Agency Theory as a framework to describe relationships often assumes a unidirectional relationship between principal and agent. In other words, the role of principal

or agent can only be assumed by the same actor in the relationship. Pratt and Zeckhauser (1991) explain that in many contexts, the agency relationship may be reciprocal. If we map this insight back to private equity, we can appreciate that the risk of *'adverse selection'* applies equally to Fund Managers as it does to Investors. Assume under certain situations, there were to be surplus of investor capital, or a deficit of quality Fund Managers in the marketplace, then under these circumstances, it stands to reason that the Fund Manager would have more selection power in choosing investment partners, hereby subjecting himself to the risk of *'adverse selection'*, given that Investors hold more information about their respective profiles.

The current literature on Agency Theory magnifies the defaulting potential of the agent, with little or no mention of how principals could equally deviate from partnership terms and covenants in practice. The default by principal Investors in private equity is not inconceivable, and evidence is cited from the literature of situations that may trigger contractual default by principal investors in private equity:

*"An investor may choose not to honour its capital commitment for any number of reasons. First of all, an investor may have liquidity issues... Secondly, as the outlook for certain types of funds has worsened, an investor may become weary of "throwing good money after bad"... If the defaulting limited partner's unfunded capital commitment outweighs the capital already invested, or if the venture capital fund has already experienced significant losses, then the decision to walk away from a fund investment becomes easier"* (Rand and Weingarten, 2002, p. 1-2).

And finally, a discussion on Agency Theory would not be complete without mention of governance. Agency theory forms the backbone to corporate governance (Millson and Ward, 2005). *'Governance mechanisms'* can reduce the agency costs of the separation of ownership and control (Jensen and Meckling, 1976). In other words, the prevalence of governance mechanisms reduces the likelihood of self-serving decision-making, resulting in the protection of investors.

### **2.1.3 Concluding remarks of Agency Theory**

From the literature presented, there are many elements to Agency Theory which are of relevance to this study: *'information asymmetry'*, *'adverse selection'*, *'goal conflicts'*, *'moral hazard'*, *'monitoring'*, *'agency costs'*, *'subjective'* versus *'objective'* control systems, and *'governance*

*mechanisms*'. Hence if the predictions of Agency Theory are valid for private equity, then there are a number of implications that we can expect to manifest.

The limitation of Agency Theory research highlights the need to consider other intangible forms of alignment of interests. The fiduciary relationship between shareholder and manager is important in any agency relationship, given that managers control information. And the commitment by both principal and agent to ethical behaviour is essential if both parties are to conform to generally accepted governance standards. Shareholder supremacy assumes that the agency relationship is unidirectional, which is not the case, given the evidence cited from the literature of situations where principals may default contractually. Neither is the selection of suitable partners in an agency relationship, a unidirectional process, given that when there is deficit of capital, and/or good quality Fund Managers, it makes sense to assume that Fund Managers would possess more selection power to carefully select the Investors that they wish to invite into prospective funds.

In line with the emergent themes identified from the literature on Agency Theory, the remainder of this chapter is structured around the following Agency Theory themes: (1) Selection; (2) Alignment of interests; (3) Agency conflicts; and (4) Governance mechanisms. These emergent themes will also form the basis of the remainder of this study, including:

- The research questions formulated in Chapter 3
- The structure of the results presented in Chapter 5.
- The structured questionnaire shown in Appendix 1 and 2, as well as

## **2.2 Selection criteria**

### **2.2.1 Selection criteria used by Investors to select Fund Managers**

The decision for an institutional investor to invest in PE funds is a function of two basic decision making parameters: (1) fund selection; and (2) country selection. Hence the specific drivers of selection criteria for private equity investing by institutional investors can be aggregated according to 'Country' and 'Fund Manager' groupings. Prior research in this area is presented here to establish the key investment criteria used by institutional investors. Firstly, the Fund manager selection criteria are discussed, followed by country selection criteria.

Groh and Liechtenstein (2010) identifies from previous literature, the following selection criteria typically used to rank the level of importance placed by Investors on selecting Fund Managers in private equity: (1) *'track record'*; (2) *'strategic investment focus'*; (3) *'match of team background and strategy'*; (4) *'reputation of team or individuals'*; (5) *'locals in team'*; (6) *'local market experience of team'*; (7) *'turnover of team'*; (8) *'independence of team'*; (9) *'deal flow/access to transactions'*; (10) *'commitment of other well-reputed LPs'*; (11) *'fee structure'*; (12) *'balanced incentive structure among the team'*; and (12) *'alignment of interest between LPs and GPs'*.

Hochberg, Ljungqvist and Lu (2007) find that the main driver that makes a fund successful with their portfolio companies is the *'quality of networks'*. Sorensen (2007) (cited in Phalippou, 2007) find that the main driver that makes a fund successful with their portfolio companies is *'experience'*. A study by Zarutskie (2006) (cited in Phalippou, 2007) shows that the main driver of a venture capital private equity fund's success rate is *'previous scientific training'*, and for early-stage funds, having *'past industry experience'* is important while having *'prior venture capital investing'* experience is not. Gompers, Kovner, Lerner and Scharfstein (2006) (cited in Phalippou, 2007) prove that a strong positive relationship exists between the degree of *'specialisation'* by individual venture capitalist at a firm and its overall success rate.

There literature that is available on social, political and economic determinants that shape private equity markets, are considerably more vast than that available for fund manager selection determinants (Groh and Liechtenstein, 2010). The authors pull from a number of literature sources to arrive at an amalgamated list of determinants. These are: (1) *economic activity*; (2) *state of the capital market*; (3) *taxation*; (4) *investor protection*; (5) *human and social environment*; and (6) *entrepreneurial opportunities*.

### **2.2.2 Selection criteria used by Fund Managers to select Investors**

The selection of Investors by Fund Managers is a contrarian view, in that it would rely upon two factors relating to demand-supply dynamics not usually considered in literature on private equity: (1) that there is a surplus of capital in the private equity market all chasing the same Fund Managers; and/or (2) that there is a deficit of good quality Fund Manager in the industry.

The literature on selection criteria used by Fund Managers is limited. (Söderblom, 2011, p. 268) uses the following factors in a questionnaire designed to solicit information from LPs: (1) Capital; (2) governance structure competence; (3) financial competence; (4) network for deal-flow; (5) network for other LPs; and (5) brand status. Funds raised by successful and

established GPs tend to be oversubscribed and prior investors tend to receive privileged access (Phalippou, 2007). This would imply that ‘personal relationship’ is an important factor when selecting Investors for established Fund Managers. It also confirms the view that established Fund Managers have more selection power than otherwise expected.

## 2.3 Alignment of Interests

Prowse (1998) outlines the mechanisms used to align the interests of participants in the private equity market. Two areas of alignment are mentioned. The first is *‘performance incentives’* which includes *‘reputation’* and *‘compensation’* of the Fund Manager. In order to retain and build credibility in the private equity market through word of mouth via Investors, the *‘reputation’* of Fund Manager serves as a strong alignment of interest mechanism. And in order to ensure that Fund Managers act in the best interest of the Fund and Investors, the *‘compensation’* incentive structure of the Fund Manager serve as an important mechanism to align interests.

The second area of alignment is *‘direct means of control’*, which includes *‘partnership covenants’* and *‘Advisory Board’*. The basic premise behind the *‘partnership covenants’* is that partnership agreements give Investors restricted and direct control over the Fund Managers activities. Whilst within the *‘Advisory Board’*, Investors maintain the right to vote on matters of strategic importance. Advisory Board could also be viewed as a governance mechanism in Fund, used to reduce agency conflicts. Governance mechanisms are discussed later.

The literature is generally in favour of a higher carried interest and lower management fees as a means to create better of alignment of interests. On the one hand, there is a view that an investor’s capital contribution at risk is the greatest incentive for creating the alignment of interests (ILPA, 2011). Alternatively, Baks and Benveniste (2010) point to contract structuring that closely monitors sources of misalignment within fee income (deal fees, monitoring fees, consulting fees, etc.) earned by Fund Managers, as well as an industry move toward de-emphasising management fees as a compensation channel in favour of higher carried interest.

### 2.3.1 Compensation

Phalippou (2009) dissects the fee structure of typical private equity funds. These comprise of a (1) *annual management fee*; (2) *organisation expenses (fundraising fee)*; (3) *carried interest*; (4) *claw-*

*back provision; (5) portfolio company fees (transaction fees, advisory fees, monitoring fees, and directorship fees).*

Annual management fees are received annually and fixed, allowing for flat fees, a declining percentage of managed capital, or as a percentage of committed capital (Harris, 2010). Portfolio company fees are the most controversial fee components discussed at length in the literature. According to Agency Theory, these are the fees which may be earned as Fund Managers act on information otherwise hidden to Investors. The problem with *portfolio company fees* is that these fees are taken directly out of the portfolio company by the Fund Manager, and this action is not visible to the Investors, owing to the *information asymmetry* problem in the agency relationship between Investor and Fund Manager. There is uncertainty as to when these fees are charged by Fund Managers: “*These fees are quite opaque. Contracts specify neither the amount, nor when such fees will be charged*” (Phalippou, 2009, p. 150).

Metrick and Yasuda (2010) define the largest component of variable revenues in a typical fund as the *carried interest*. The other two components arise from *portfolio company fees*. The purpose of these fees is to compensate funds for time and effort spent in working with portfolio companies. Transaction fees are fees charged to the portfolio company, and can be anywhere in the region of 1-2% of the transaction value. Monitoring fees typically range between 1% and 5% of EBITDA, with this number being at the lower end of the range for smaller companies and vice versa. In most cases these fees are shared, with 80% going to Investors, while the Fund Manager retains 20%.

### **2.3.2 Contracts and Partnership Covenants**

Sahlman (1990) explains that there are typically two levels of contracts in private equity. Firstly, at the lowest level, there are contracts governing the relationship between Fund Manager and portfolio companies. Secondly, there are contracts governing the relationship between Investor and Fund Managers. Both forms of contracts share common characteristics, notably:

- Staging of capital commitments and preserving the option to abandon;
- Aligning the compensation structure directly to value creation; and
- Maintaining ways that force managers to distribute investment proceeds.

In addition, Sahlman (1990) concedes that both forms of private equity contracts address three fundamental problems:

- Sorting problems: deals with how to select the right Fund Managers and underlying portfolio investments;
- The agency problem: deals with how to minimise the present value of agency costs; and
- The operating-cost problem: deals with how to minimise the present value of operating costs, including taxes.

The literature is polarised on the role played by contracts in reducing agency conflicts and aligning interests between Investors and Fund Managers. (Harris, 2010, p.34) gives a critical assessment of the role played by contracts in private equity:

*“Private contract attempts to resolve these issues by aligning manager and investor interest and heading off agent misbehaviour... Given these agency problems, which are not resolved by contract design, one might expect that there may be more disputes between investors and fund managers, particularly in down markets.”*

Others like (Torrance, 2007, p. 681) provide a different view on the role played by contracts in governing relationships and reducing conflicts of interest in private equity: “

*“The relatively long-term commitment to a fund creates a long-term reliance on specialist managers’ expertise, with the law of contract at the core of regulating the anticipation of conflicts of interest. The desired institutional form of financial intermediation over the long-term is the legally binding contract.”*

## **2.4 Agency Conflicts**

Harris (2010) point out that investors in limited partnerships have not fully been able to reduce agency misconduct through partnership agreements, highlighting that these are often complicated documents and costly to negotiate. Harris (2010) argues that while partnership agreements in private equity are designed to create alignment of interests and avoid misconduct, the accompanying provisions often present agency problems of their own. The provisions commonly used to protect Investors in limited partnerships are: distribution provision; liquidation provision; and compensation provision. The resultant agency problems arising from these provisions are summarised briefly below:

- *Distribution provision:* The provision that requires Fund Manager to distribute the proceeds from the disposal of investments to Investors, may lead to Fund Managers manipulating the timing of their exit from investments.
- *Liquidation provision:* The limited duration of a private equity fund (typically 10 years) may result in Fund Managers devoting less of their time to an existing fund toward the end of life, as Fund Managers focus on the raising of new funds.
- *Compensation provision:* The earning of guaranteed management fees may result in Fund Managers increasing their investment risk-profile as they deem the management fee to serve as an “*insurance policy*” against the risk of poor performance as well as failure to receive the incentive-based portion of compensation. Hence, management fees undermine the incentive-based portion of compensation.

Kirkland and Ellis (2009) summarises the conflicts of interest forming part of a broader consultation report issued by the International Organisation of Securities Commissions (IOSCO). The report articulates that conflicts of interest between Fund Managers and Investors are rife across all four stages of a fund’s life-stage, stating that conflicts could arise during: (1) fundraising stage; (2) investment stage; (3) management/monitoring stage; (4) exit stage.

Phalippou (2009) identifies and provides detailed explanation in areas where potential agency problems may arise in buyout funds. These include: (1) compensation contracts (management fees, carried interest, portfolio fees, and extra fees or costs); (2) methods used to calculate returns; (3) opaqueness of fee contracts (leading to investors underestimating the impact of fees); (4) fund-raising prospectuses that may be misleading for investors; and (5) contract clauses that provide incentives that can distort the optimal timing, leverage, and size of investments.

## 2.5 Governance mechanisms

Private equity funds are subject to the agency division of ownership and control. The governance context of private equity funds refer to the set of institutional mechanisms that influence how decisions are made within the boundaries of the fund.

### 2.5.1 Legal Structures within Funds

Private equity funds in SA are generally structured as partnerships, trusts, or companies (BG, 2011). When compared with international counterparts, the prevailing legal structure is the Limited Partnership. The difference in legal structure has implications from an Agency Theory perspective. Investors in Limited Partnerships have unlimited liability, meaning that they are not involved with the fund's day-to-day operations. Investors in Limited Partnerships are "*passive contributors of capital*", and receive only income and capital gains from their investment in the partnership (CAI, 2008).

### 2.5.2 Investment Committees and Advisory Committees

The main governance mechanisms used in private equity funds are Investment Committees, and Limited Partnership Advisory Committees. The literature does not distinguish between different manifestations of governance mechanisms for Limited Partnerships and Trusts. CAI (, 2008, p. 1) explains that governance mechanisms are covered within partnership agreements:

*"The agreement covers economic and contractual terms, specifies fees, governance mechanisms, and stipulates provisions that define the agreement between the GP and LPs."*

While the Investment Committee is a vital decision-making governance mechanism in private equity funds, its treatment is lacking in the literature, with more focus given to Advisory Committees. For instance, the '*Private Equity Principles of the Institutional Limited Partners Association*' (ILPA, 2011), does not explain the structure and functions of the Investment Committee governance mechanism. Sahlman (1990) refers to "*special advisory committees*" with focus primarily targeting the Advisory Committees in funds. However, the EVCA handbook (EVCA, 2012) does mention briefly mention the Investment Committee as part of its publication.

### 2.5.3 DFI's role in private equity governance

Institutional investors are widely cited in literature the as being major contributors to corporate governance in private firms such as private equity funds. According to Nielsen (2007), institutional investors invest would favour private firms with governance mechanisms that tend to reduce agency costs. Furthermore, when institutional investors commit to an investment, there is likely to be further improvements in corporate governance. Settel,

Chowdhury and Orr, (2009) appraised the role played by DFIs in supporting private equity in emerging markets. Within their study, the Asian Development Bank's (ADB) reason for investing in private equity is quoted (Settel, Chowdhury and Orr, 2009, p. 71):

*“...to be an active investor, with an active approach to corporate governance and environmental standards.”*

According to the authors, DFIs offer *“essential mentorship to Fund Managers as they commence operations”*. DFIs see play a major role in providing deal flow to private equity funds in which it invests. Many of the DFIs that participated in the study (Settel, Chowdhury and Orr, 2009), cited that other DFIs are their *“primary co-financing partners”* in private equity.

The authors identify two predominant models used by DFIs for private equity investing. From an Agency Theory perspective, these would have a profound effect on the governance mechanisms deployed within the agency relationship. These are briefly summarised:

*“Direct involvement model”*: this model entails a close partnership between Fund Managers and DFIs, in order to jointly set the fund strategy and make investment decisions. A seat on the Advisory Committee is a minimum requirement. Under certain circumstances, the DFI will sometimes take an equity stake in the General Partner and share in the profits. DFIs take an active role in order to ensure that new Fund Managers adopt industry best practices, and that its own corporate governance and environmental standards “trickle” down” into underlying portfolio investments.

*Hands-off model*: this model involves passive investments by DFIs with Fund Managers who are trusted in the marketplace. Some DFI will also limit operational involvement in the fund's Investment Committees, citing the risk of jeopardising their relationship with Fund Managers as the reason. However, DFIs are still able to provide “deal flow” and “political risk cover” to Fund Managers under these circumstances.

### **2.5.3 Best practice governance models**

Various best practice models in literature are becoming increasingly important for Investors in private equity. Investors are no longer only interested in performance and Fund Manager's behaviour and conduct. Conformance to various governance standards are becoming mandatory globally (ILPA (2011), EVCA (2012), (UNEP, 2011), and (IGCC, 2012)).

According to Harris (2010), fund managers may redirect resources between funds for its own benefits (conflict of interest or moral hazard), hide information from investors (information asymmetry), possess different risk profile (risk averse), and have may use focus on new fundraising activities at the expense of investors (goal divergence). Hence these agency problems give rise to agency costs which may lessen the overall investment returns earned by institutional investors as a result of certain decisions taken by the fund manager.

## **2.6 Pulling together the literature review**

There are two reasons why agency theory is relevant for this study. Firstly, it provides useful predictions and a framework within which to structure and further explore the relationship between Fund Managers and Investors in private equity. Secondly, it provides the themes along which to formulate the research questions and analyse findings: selection criteria, agency conflicts, governance, and alignment of interests. These themes will be used to structure the content of the remaining Chapters in this research.

## Chapter 3: Research Questions

*Agency Theory discussed in Chapter 2 provides the themes along which to formulate the research questions in this research. Questions are structures along each theme: selection criteria, agency conflicts, governance, and alignment of interests. These themes will be used to structure the data collection discussed in Chapter 4, and to present the data in Chapter 5.*

### **Research question 1:**

- What are the selection criteria deployed by Institutional Investors when selecting Fund Managers?

### **Research question 2:**

- What is the selection criteria deployed by Fund Managers when selecting Institutional Investors?

### **Research question 3:**

- How do agency conflicts manifest in the relationship between Institutional Investor and Fund Managers?

### **Research question 4:**

- What are the typical governance mechanisms in funds, and how do these reduce agency conflicts?

### **Research question 5:**

- How is the alignment of interests created between institutional investors and fund managers?

## Chapter 4: Research Methodology

*The research methodology will present the method of study chosen to answer the research questions. The research methodology is broken down into 8 sections: (1) Research design; (2) Scope; (3) Universe /Population; (4) Sampling; (5) Research Instrument/Measurement; (6) Data Analysis; (7) Research Limitations.*

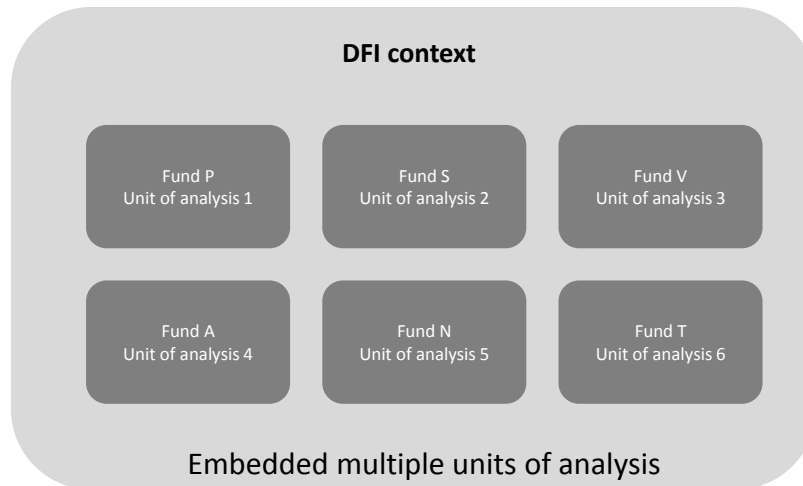
### 4.1 Research design

The aim of this study was to investigate the nature of the agency relationship between an Investor and Fund Managers in a private equity setting. The context of the study was a DFI, and a series of six case studies was chosen for research. According to Yin (2003), the conditions for using a case study approach was suitable for this research, given that:

- The focus of this study was exploratory in nature;
- The behaviour of the Investor and Fund Managers could not be manipulated;
- The DFI contextual conditions were relevant to this study

According to (Baxter and Jack, 2008, p. 556): “...It enables the researcher to answer “how” and “why” type questions, while taking into consideration how a phenomenon is influenced by the context within which it is situated. For the novice research a case study is an excellent opportunity to gain tremendous insight into a case. It enables the researcher to gather data from a variety of sources and to converge the data to illuminate the case” (Baxter and Jack, 2008, p. 556).

This research took the format of a single case study (the DFI) with multiple embedded units (the private equity funds). This allowed the various private equity funds (sub-units to be) to be studied in the context of a DFI. As diagram of the research design is shown in figure 1.



**Figure 1: Embedded multiple units of analysis**

## 4.2 Scope of research

Within the private equity industry, there are essentially two levels of investment. The first level of investment takes place whereby Investors invest in private equity through intermediary Fund Managers with specialisation in private equity. The second level of investment takes place whereby fund managers invest the capital raised from Investors, into entrepreneurship or underlying investee companies. The research is applicable to the agency relationship between Investor and Fund Manager in private equity. The relationship between Fund Manager and the portfolio company is not within the scope of this research.

## 4.3 Universe/population

There were 18 private equity funds in total within the DFI's investment portfolio at the time of this study.

## 4.4 Sampling

The study made use of a purposive sampling technique. The purposive sample technique is appropriate for the collection of a small sample when collecting qualitative data. Each sample, each of 6 private equity funds, was carefully chosen based on certain criteria. A diverse sample was obtained, based on the sector of focus, experience of fund managers, and size of

funds under management. However, the sample is by no means representative of the entire population.

The intention of the sample selection was to provide rich data on an explorative account of agency issues between an Investors and Fund Managers in private equity. It was expected that the cases chosen in the sample would contribute to a richer understanding of how agency relationships manifest in private equity relationships.

## 4.5. Research instrument/measurement

The case studies will triangulate information from multiple data sources. Given the sensitivity around the cases, access to information proved a challenge as one would expect. However, sufficient sources were tapped in order to provide rich insight and adequately answer the research questions. To aid with data collection, two questionnaires were developed from the literature and Agency Theory themes discussed in Chapter 2. The instruments used in this study are shown in Table 1 and 2.

Embedded case study within DFI	Sources of data
Fund P	LP & GP Questionnaire 2011 annual report
Fund S	LP & GP Questionnaire
Fund V	LP & GP Questionnaire partnership agreement
Fund A	LP & GP Questionnaire
Fund N	LP & GP Questionnaire; partnership agreement
Fund T	LP & GP Questionnaire
DFI	Portfolio Management Report, March 2012; PE Strategy Report, 2012

**Table 1: Sources of data**

Unit of analysis	Respondents
Fund P	Respondents #P1, Fund P
Fund S	Respondents #P1, Fund P
Fund V	Respondents #P1, Fund P
Fund A	Respondents #P1, Fund P
Fund N	Respondents #P1, Fund P
Fund T	Respondents #P1, Fund P
DFI	Respondents #1, DFI
	Respondents #2, DFI
	Respondents #3, DFI
	Respondents #4, DFI

**Table 2: Respondents**

### **4.5.1 Reliability**

The researching is open to subject bias, in which the LPs and GP might provide unreliable information to avoid being shown in a bad light by not practicing essential control functions within their investment and operations processes. There is no risk of observer error, as there will be only one researcher in this study.

### **4.5.2 Validity**

Everything to the best of the researcher's capability will be done to limit the invalidity of research findings. It should be noted that one of the limitations of case study methodologies is that the results from a single study can never be statistically representative of the entire population. There is minimal risk, if any, of the following factors from being relevant to this study: testing; mortality and ambiguity about causal direction.

### **4.5.3 Pre-testing**

All formats of the structured interview questions and questionnaires were tested and refined with private equity experts from the industry, prior to rollout. These included a number of Portfolio Managers and Analysts from the DFI who agreed to participate in this study.

## **4.6 Data Analysis**

The unit of analysis in a case study is the case itself. Given the exploratory nature of the research using Agency Theory to develop themes, the key findings of all six case studies were presented in Chapter 5. The method of thematic analysis was used to analyse the qualitative feedback obtained from respondents. The questions were structured around the Agency Theory Themes established in the literature review in Chapter 2. This analysis of the result easy given that the responses were already given against the respective Agency Theory themes: Selection, Alignment of interest, Governance mechanisms, and Agency conflicts.

During analysis in Chapter 6, the questionnaire responses were supplemented with data triangulated from other sources such as partnership agreements, annual reports etc. Insights obtained from earlier interviews were connected with later interviews, in order to recognise if respondents should be contacted for follow up meetings.

## 4.7 Research Limitations

The problem with case studies from a research and analysis perspective can be summarised as: *“Analysing data is the heart of building theory from case studies, but it is both the most difficult and the least codified part of the process”* (Eisenhardt, 1989, p.539). Furthermore, the limitation of case studies is that it can be lengthy, there is a concern that case studies lack rigor, and probably the most written about limitation is that case studies lack generalisation ((Neale, Thapa, and Boyce, 2006).

It is possible to have response bias if most respondents are from a particular institutional investor, in this case the DFI. However, given that the scope of the case specifically targets private equity investing in the context of a DFI, this risk was reduced. The risk on non-response bias is was not applicable, since respondents are selected by the researcher and interviewed accordingly. Hence, new respondents could have been substituted in place of those who were not available for whatever reason. Another limitation of this study is that it used Funds based in South Africa (Johannesburg) who invest mainly in South Africa, and the greater African region. Hence there would have been response bias relevant to the unique business and cultural setting in Africa. For this reason, findings should not be generalised to other economies without caution.

# CHAPTER 5: RESULTS

*The purpose of this chapter is to present the results of each of the six case studies developed as part of this research. Each case study is constructed along the emergent themes constructed in the Literature Review.*

*No analysis is performed in this chapter, with only sparse commentary added to clarify the context in which the information is presented. Chapter 6 will deal with the aggregate synthesis of findings across all six case studies.*

**T**he rationale for the emergent themes was established within the Literature Review chapter, and provides a framework for discussing agency relationships between institutional Investors and Fund managers. These are: investment strategy; selection criteria; alignment of interests; and governance mechanisms. Alias names are used to protect the identity and confidentiality of the DFI, Fund Managers as well as the specific funds being studied.

## 5.1 The DFI under research

### 5.1.2 Investment strategy of the DFI

The DFI has been investing in the private equity asset class since 1999. The DFI's investment strategy is to invest mainly with established Black Fund Managers targeting investments in their 'start-up', and 'development and growth' phases across sectors of social and economic infrastructure (healthcare, education, water, energy, transportation, mining), although other sectors are also targeted if opportunities are available to the DFI. The DFI focuses funds that will invest not just in SA, but also the greater African region.

To date, the DFI has committed an estimated ZAR 6bn into 18 funds holding approximately 70 underlying portfolio investments. The existing portfolio is divided up into Pan-African Funds (ZAR 4.5bn) and SA funds (ZAR 1.5bn). All private equity funds are managed and monitored within the Portfolio Risk Management cluster within the DFI's Investment Banking Division. Each Portfolio Manager and Analyst within the cluster is responsible for a number of private equity funds. Portfolio management activities range from site visits to Fund Managers, to occasional visits to portfolio companies. In addition, quarterly and annual reports are sources on a quarterly basis from Fund Managers on financial performance as well as environmental

assessments pertaining to the overall fund, and in some instances, the portfolio investments themselves.

## 5.2 Fund P

### 5.2.1 Investment Strategy

#### 5.2.1.1 Fund Structure

During 2008, the DFI committed US\$ 100m to Fund P which is managed by an award winning Fund Manager. The legal structure of the fund is that of a Trust structure. The Board of Trustees has to approve all investment decisions recommended by the Investment Committee. The Fund Manager currently manages its first fund, Fund P, with partnership agreement domiciled in SA. During harvest, the Fund Manager anticipates trade sales as an exit strategy.

#### 5.2.1.2 Investment thesis

The Fund's investment thesis is to maintain a minority equity stake in large-scale infrastructure projects, using a combination of development and growth capital. The geographic focus is within SA as well as the wider Pan-African region, mainly in the sectors of energy, telecommunications, water, and natural resource sectors.

According to the Fund Manager believes that the investors are instrumental in generating deal flow for the fund:

*“We see that as one of our strengths. The fact that we have (the DFI) and ABSA mean they can invite us into deals.”*

**(Respondent #P1, Fund P)**

The Fund Manager believes that having the DFI as an investor is crucial for helping it navigate the political risk of doing business in Africa. However, the he conceded that, if it came to taking sides, DFI's support would lean in favour of the respective government:

*“Our investors help us to understand political risk (in other African countries) as well.”*

*“DFIs help to mitigate political risk (in other countries) but would not take our side against the governments’.”*

**(Respondent #P1, Fund P)**

The Fund Manager explained that having pension fund investors within the Fund would eventually help the Fund to off-load portfolio investments during harvest stage:

*“Pension funds for example expect fund life to be longer. We probably would like to sell the infrastructure asset at the life end of the fund to the pension investors who prefer long life”*

**(Respondent #P1, Fund P)**

The Respondent was asked to rank the value-add by the fund to its portfolio investments, the result of which appears in Table 3.

Premium drivers	Rank (1-3)
Financial engineering: making capital structure more efficient through lower capital costs	1
Governance engineering: improve monitoring and performance incentives for managers	2
Operational engineering: improving operations, working capital, marketing, and product mix	3

**Table 3: Fund P premium drivers**

## 5.2.2 Selection criteria

### 5.2.2.1 Investment criteria deemed important for the Fund Manager

The Fund manager of Fund P explained that given the nature of its large-scale infrastructure investing mandate, with long investment horizons, the investment thesis of Fund P is to attract Pension Fund investors across Africa, whose investment horizons are aligned with the underlying assets of the Fund.

### 5.2.2.2 Investment criteria deemed important for Investors

The Fund Manager of Fund P conceded that in light of the opaqueness surrounding private equity, many of pension fund investors in Africa remain averse to the asset class. According to the Fund Manager of Fund P, investors are often attracted to funds that already have other strong anchor investors:

*“American investors would take comfort from seeing a local investor first.”*

**(Respondent #P1, Fund P)**

The Respondent also made reference to shareholder dominance by some investors within the fund as being a possible deterrent to investing with a fund:

*“Small LPs are sometimes intimidated by big LPs. Are the bigger LPs going to control and am I just going along for a ride.”*

**(Respondent #P1, Fund P)**

### 5.2.3 Alignment of interests

#### 5.2.3.1 Key findings relating to incentive structure, partnership covenants, and monitoring

The initial fee structure for Fund P was negotiated between the fund manager and anchor investor. Management fees were agreed upfront during the formation of the fund:

*“Management agreement specifies fees and what is for manager’s account.”*

**(Respondent #P1, Fund P)**

Once the Respondent was prodded for more information pertaining to ‘other fees’ charged, he conceded that fifty percent of all ‘other fees’ charged to portfolio companies are used to offset fund costs (management fee), while the remaining fifty percent flow to the Fund Manager:

*“It’s not massively in our interest to get monitoring fees.”*

**(Respondent #P1, Fund P)**

The Respondent defended his position on charging out ‘other fees’ to portfolio companies, by reasoning that charging more ‘other fees’ charged to portfolio companies would result in greater returns for investors.

The overall fee structure for Fund P is summarised in Table 4.

Types of fees charged by GP	Mark (X)
Fundraising fees charged to fund	X
Underwriting fees charged to investee company	
Arranging fees charged to investee company	
Consultancy fees charged to investee company	
Directorship fees charged to investee company	X
Monitoring fees charged to investee company	

**Table 4: Fund P fees**

According to the Fund Manager, a greater ‘capital contribution’ would lead to greater alignment of interests:

*“The more skin you have in the game, the better.”*

**(Respondent #P1, Fund P)**

A summary of the Fund Manager’s view on how to create better alignment of interests are shown in Table 5:

Structure	Management fee	Carry interest	Monitoring	Capital contribution
Decrease			X	
Keep the same	X	X		
Increase				X

**Table 5: Fund P alignment of interests**

According to the Respondent, certain investors, for example, the IFC, push hard to achieve self-serving terms during negotiation:

*“...sometimes trying to get a stake in the Fund Manager. After the crises [2008 global economic crises], LPs try to squeeze GPs.”*

**(Respondent #P1, Fund P)**

The Respondent conceded that fundraising fees are either paid for by the fund manager, or by anchor investor. If it is paid for by the anchor investor, these would eventually be recovered from the other investors upon closure of the fund:

*“Fundraising fees are sometimes put up by GPs, and other times the anchor LP will fund fundraising activities of the GP, with the expectation of eventually getting reimbursed at a later stage by other participating LPs.”*

**(Respondent #P1, Fund P)**

The Fund Manager of Fund P explained that its fee structure (management and carried interest fees) did not vary across investors, while the risk expectations did vary across, and were contained in side letters that accompany the Fund’s management agreement:

*“We started seeing this in some of the side letters (to the management agreement). If you offer someone everything, everyone wants it. (But) All LPs get to see all side letters.”*

*“It would be very difficult to swing different management fees across LPs.”*

**(Respondent #P1, Fund P)**

The Fund Manager of Fund P shed light on a topic rarely discussed in private equity, i.e., investors that default on capital calls. According to the Fund Manager, in one case when a smaller Limited Partner defaulted, the particular Limited Partner’s shareholding was foregone to the remaining investors of the fund, as per the fund agreement. According to the fund

manager, the likelihood of Investors defaulting on capital calls is not inconceivable, especially if their financial situation changes:

*“I know of times when LPs said to GPs: Listen, don’t think of making a capital call!”*

**(Respondent #P1, Fund P)**

The Fund Manager did not believe that good investment returns overpower agency conflicts that may arise between Investors and Fund Managers within private equity. The Respondent also mentioned that they were often burdened by the monitoring of some investors who were prone to micromanaging their activities:

*“Shit we’ve got this! Especially large investors, we work with them and don’t try to fight them.”*

**(Respondent #P1, Fund P)**

#### **5.2.4 Governance, disclosure and regulation**

According to the fund manager, the private equity industry has sufficient regulation, and regulation only reduces agency problems in the relationship with Investors to a certain extent:

*“To a limited extent, agency problems are better dealt with through alignment of interests than regulation. Regulation is important because you always have ‘fly by nights’.”*

**(Respondent #P1, Fund P)**

The Respondent believed that the adoption of regulation and mandatory codes and standards should be adopted on an ‘apply or explain’ basis, rather than a ‘voluntary basis. When asked about maintaining the fair treatment of all Investor, the fund manager responded:

*“Financially we can’t treat LPs differently. (This is) dealt with through internal controls. LPs get quarterly reports, but they don’t get information of decisions as and when it happens, but they get it in quarterly reports.”*

**(Respondent #P1, Fund P)**

## 5.3 Fund S

### 5.3.1 Investment strategy

#### 5.3.1.1 Fund structure

During 2003, the DFI committed ZAR 100m to Fund S. The Fund Manager of the fund is a wholly-owned subsidiary of an Investment Holding Group established in SA. Over the past decade, the Group's strategy was to no longer pursue the private equity funds business given that it has managed to build a substantial balance sheet with alternate sources of funding. The legal structure of the fund is that of a Trust structure. The Board of Trustees has to approve all investment decisions recommended by the Investment Committee. The Fund manager currently manages only one fund, Fund S, with partnership agreement domiciled in SA. During harvest, the fund manager anticipates trade sale as an exit strategy.

#### 5.3.1.2 Investment thesis

The Fund's investment thesis is to undertake buyouts in mature businesses. The Fund's geographic focus is mainly within SA, but has a single investment in Nigeria. The sector focus excludes agriculture, resources, and property. During the interview, the Respondent generalised the attitude of Fund Managers within in the industry:

*"Fund Managers are mercenaries. Do things now, apologise later."*

**(Respondent #S1, Fund S)**

The Fund Manager believes in independence, and do not support the idea of investors originating leads for the fund:

*"The trustees are independent. That's what you got the Fund Manager to do."*

**(Respondent #S1, Fund S)**

The Respondent was asked to rank the value-add by the fund to its portfolio investments, the result of which appears in Table 6.

Premium drivers	Rank (1-3)
Financial engineering: making capital structure more efficient through lower capital costs	1
Governance engineering: improve monitoring and performance incentives for managers	3
Operational engineering: improving operations, working capital, marketing, and product mix	2

**Table 6: Fund S premium drivers**

## 5.3.2 Selection criteria

### 5.3.2.1 Investment criteria deemed important for the Fund Manager

The Fund Manager of Fund S explained that raising new funds is difficult under current market conditions:

*“Whoever is willing to give you money, (you) cannot be too choosy.”*

**(Respondent #S1, Fund S)**

### 5.3.2.2 Investment criteria deemed important for Investors

The Fund Manager of Fund S explained that Investors are generally attracted to funds with strong anchor investors. The Respondent cited importance of a ‘track record’ to Fund Managers:

*“Based on track record, if you demonstrate returns it shows them that you know what you’re doing. If IRRs of previous fund are bad then you’re in the wrong game.”*

**(Respondent #S1, Fund S)**

## 5.3.3 Alignment of Interests

### 5.3.3.1 Key findings relating to incentive structure, partnership covenants, and monitoring

During the interview the Fund Manager frowned upon the charging of ‘other fees’ to portfolio companies:

*“[The charging of ‘other fees’ to portfolio companies is a] straight no by us! LPs have access to our financials. They would know if this was the case. If there is a conflict of interest, LPs must get involved and sort it out.”*

**(Respondent #S1, Fund S)**

The only fees that were charged by the Fund to portfolio investments were ‘director fees’. However, as explained, these fees were for the full benefit of the Fund Manager. None of this amount flowed back to the fund, as the Respondent explained:

*“Declared upfront – The only fees are management fees, carried fees, and director fees. No portion of Directors fees go back into the fund. We have an agreement that it can be used to cover expenses – Rent, travel and salaries.”*

**(Respondent #S1, Fund S)**

According to the Respondent, management fees and carried interest fees charged were consistent across all investors. And Investors get to dictate the terms of the partnership agreement:

*“LPs tell you what the terms should be. In South Africa it’s pretty standard.”*

**(Respondent #S1, Fund S)**

The overall fee structure for Fund S is summarised in Table 7.

Types of fees charged by GP	Mark (X)
Fundraising fees charged to fund	X
Underwriting fees charged to investee company	
Arranging fees charged to investee company	
Consultancy fees charged to investee company	
Directorship fees charged to investee company	X
Monitoring fees charged to investee company	

**Table 7: Fund S fees**

A summary of the Fund Managers view on how to create better alignment of interests is shown in Table 8:

Structure	Management fee	Carry interest	Monitoring	Capital contribution
Decrease				
Keep the same	X		X	
Increase		X		X

**Table 8: Fund S alignment of interests**

‘Reporting’ requirements varies across Investors. Different partnership covenants are negotiated across the different Investors of the fund:

*“Some have side letters e.g. Sanlam get an annual profit share of the Fund Manager because they were one of our founding members.”*

**(Respondent #S1, Fund S)**

The Fund Manager explained how Investors might potentially trigger an ‘event of default’ as per the partnership agreement, through the disclosure of confidential information to third parties. The Respondent cited that such an event would, however, be to the detriment of any future relationship with the particular Investor:

*“...for example if an LP representative was sitting on our fund’s IC and the IC of another fund was considering investing in a competitor to one of our portfolio companies, and if he/she were to show the financials of our investment to the other fund, that would be anticompetitive and cause chaos.”*

*“[In this case we could pursue the] legal route, but then your relationship with the LP is fucked!”*

**(Respondent #S1, Fund S)**

According to the Fund Manager, Investors could hypothetically sell their partnership stake in the Fund, provided there were no serious conflicts of interests between the prospective buyer, and existing Investors:

*“Unless there is a serious potential conflict of interest between fund manager and new buyer, if they are dodgy. However 95% [of the decision to allow the investor to sell] sits with LP unless the new LP is a dodgy car sales LP.”*

*“If an LP wants to get out, they will get out. As a fund manager it’s difficult to frustrate an LP, if you frustrate an LP by blocking them, they will be on your case.”*

**(Respondent #S1, Fund S)**

The valuation method used by the Fund Manager was established with all Trustees on the outset of the fund. However, the Respondent did mention that any future asset sales would require further endorsement by all Investors.

Given that the Fund Manager’s main shareholder is an Investment Holding Group that is also co-invested in underlying portfolio investments alongside the fund, in order to avoid future conflicts of interests, independent parties would have to be used in order to ensure that valuations reflected fair market value:

*“When we exit we will use an investment bank and external auditors [not same as KPMG auditors] to audit. We do DCF valuations ourselves.”*

**(Respondent #S1, Fund S)**

The respondent explained that the DCF method of valuation is the primary method used to value portfolio investments of the fund, while the multiples method was often used as a check:

*“If you have highly depreciated assets, it doesn’t make sense [to use the ‘net assets’ method for valuation].  
[Therefore] Cash flow is [the] primary method of valuation.”*

**(Respondent #S1, Fund S)**

When asked whether any conflicts have arisen between Investors and the Fund Manager due to valuations, the Fund Manager responded:

*“We really haven’t had [any]. They trust the fund manager because interests are aligned to get highest valuation. They obviously trust us.”*

**(Respondent #S1, Fund S)**

When asked about the approval process involving the selling of investments between funds, the Fund Manager eluded to it becoming an issue, only if they were to raise a second fund:

*“Valuation would become a huge issue, especially if there were different LPs. Conflicts would become a big issue. It’s almost like an arbitration type of event. Then you would need independent valuers.”*

**(Respondent #S1, Fund S)**

According to the interviewee, good investment returns would overpower any agency conflicts that could arise between Investors and Fund Managers within private equity. The Fund Manager did not believe that any of the Fund’s investors micromanaged their functions within the Fund, adding that the partnership agreement clearly stipulated the role of each party.

### **5.3.4 Governance, disclosure and regulation**

When the fund was formed ten years earlier, ESG awareness and requirements were not as heightened as it is today. The interviewee commented on the insincerity behind Investors who claimed that ESG were important considerations for assessing performance:

*“This [ESG] is a very recent focus. Our fund started 10 years ago. No matter what any Fund Manager [may] tell you, the main focus is [always] returns.”*

**(Respondent #S1, Fund S)**

However, the Respondent conceded that if ESG were to become important for its current Investors, then the fund would have no option:

*“Look you’ve gotta be pragmatic in this business. Your room to manoeuvre is limited because of what your investors want. It’s like going to the bank and telling them what to do. It’s not going to happen!”*

**(Respondent #S1, Fund S)**

The Fund Manager did not believe that it should produce an integrated annual report:

*“Not relevant. No integrated report, way too small [for that]. [We] just have financials.”*

**(Respondent #S1, Fund S)**

The interviewee was of the view that the industry had sufficient regulation, and that too much regulation would be harmful to the overall industry:

*“You don’t want an industry that is over regulated, [or else] you choke the industry. Things like hedge funds need more regulation. They [the hedge funds] are crazy. [However] in SA not enough funds allocated to hedge funds. Fund Managers are cowboys. They’re chasing returns.”*

*“Any institution [investing] in third party funds need to be regulated. You can’t give money to cowboys [and] then they blow it. You can’t let the guys run havoc with other people’s money.”*

**(Respondent #S1, Fund S)**

The Respondent viewed corporate citizenship as important for attracting new Investors to a fund:

*“Everyone that invests other people’s money has to be a good corporate citizen.”*

*“LPs don’t want us to get into trouble with the law.”*

**(Respondent #S1, Fund S)**

The Fund Manager believed that regulation was an effective tool for reducing agency conflicts, and for this reason, should be adopted on an ‘apply of explain’ basis.

When asked how the Respondent maintained the fair treatment of all Investors, the Fund Manager responded:

*“No specific investor gets special treatment as opposed to others. All LPs get same information. All LPs sit on IC. All [also sit] on Fund Board of Trustees.”*

**(Respondent #S1, Fund S)**

## 5.4 Fund V

### 5.4.1 Investment Strategy

#### 5.4.1.1 Fund Structure

During 2009, the DFI committed ZAR 200m to Fund V. The legal structure of the Fund is that of a Limited Partnership, and is domiciled in SA. The Fund Manager is currently managing its second fund, with the DFI having also invested in its first fund as well. The Fund provides mezzanine funding to mature businesses. The typical form of exit for mezzanine funding would be a refinancing of the remaining debt contained in the portfolio investment upon harvest.

#### 5.4.1.2 Investment thesis

The Fund's investment thesis is to invest in mature businesses, using mezzanine financing structures. The Fund's geographic focus is within SA (65%), as well as Africa (35%). The Fund invests in all sectors of the economy, and is domiciled in SA. The preferred method of exit is through the refinancing of debt. All details of the investment criteria are incorporated into the partnership agreement. Any waivers are approved by the Advisory Committee. The interviewee did not believe that the Investors had a role to play in the origination of deal-flow:

*“The Advisory Board’s role is to oversee compliance with the fund. It needs to handle conflicts of interest that may arise. It oversees financials. Does not oversee deal flow. We have a limited partnership structure. If LPs become too involved they could be at risk of compromising their limited liability.”*

**(Respondent #V1, Fund V)**

The investment strategy of the Fund resonates well with the distribution and exit horizons of the Investors:

*“To the extent that LPs commit to 5 year lockup and 5 year divestment period, they are bound to illiquidity during that period. Pension funds cannot contribute more than 2.5% to PE investing. So [the] illiquid portion is private equity, and many other asset classes are more liquid.”*

**(Respondent #V1, Fund V)**

The Respondent was asked to rank the value-add by the fund to its portfolio investments, the result of which appears in Table 9.

Premium drivers	Rank (1-3)
<i>Financial engineering: making capital structure more efficient through lower capital costs</i>	1
<i>Governance engineering: improve monitoring and performance incentives for managers</i>	2
<i>Operational engineering: improving operations, working capital, marketing, and product mix</i>	3

**Table 9: Fund V premium drivers**

## 5.4.2 Selection criteria

### 5.4.2.1 Investment criteria deemed important for the Fund Manager

According to the Fund Manager of Fund V, the Fund focussed purely on institutional investors with a minimum committed contribution of at least ZAR 100m. Smaller Pension Funds were only accepted under the banner of an Investment Consultant, who could be an Independent Actuarial Firm that advises Pension Funds on portfolio management. ‘Credit worthiness’ was not a significant consideration, since most institutional investors were large institutions with good reputations.

The interviewee conceded that ‘financial position’ of the investor was the most important selection criteria. According to the Respondent, only if a prospective Investor were to have a “dubious” reputation, then only would the Fund Manager consider other selection criteria such as reputation, track record, corporate governance, company brand; or personal relationship.

The Fund Manager elaborated upon the risk of having too many investors:

*“Many LPs will impose industry standards. If there are [less] LPs, we may be able to get away with less monitoring oversight. [However there is] less ability to “arbitrage” monitoring oversight.”*

**(Respondent #V1, Fund V)**

Alternatively, attracting the right amount of investors was seen as important for new funds:

*“Some LP’s make commitments to funds but funds may not close if it does not achieve critical mass.”*

**(Respondent #V1, Fund V)**

Finally, the Fund Manager mentioned that it would be cautious about existing investors with micromanaging tendencies, when deciding on which investors to invite into subsequent fund:

*“The one way is to avoid inviting them into successive funds”*

**(Respondent #V1, Fund V)**

#### 5.4.2.2 Investment criteria deemed important for Investors

The interviewee explained that investors were attracted to funds with strong LP anchors. The Fund Manager also referred some investors who were less active shareholders than others, relying upon standard-setters to lead the way in shareholder activism within an investment:

*“Some LPs will impose certain standards that the rest of the LPs will piggy back on.”*

(Respondent #V1, Fund V)

#### 5.4.3 Alignment of Interests

##### 5.4.3.1 Key findings relating to incentive structure, partnership covenants, and monitoring

According to the Fund manager, all fee related income was disclosed upfront with investors. And fees that were charged to portfolio companies would have to flow back into the fund. However, within the Fund Manager’s structure, an affiliate called the ‘Capital Markets Division’ is allowed to originate debt for portfolio companies, and charge advisory as well as underwriting fees directly to investee companies. As the Fund manager explained, these fees flow directly to the affiliate, not the fund:

*“We do have another division in the Group that does debt-raising. They don’t have to push fees back into the fund. If the Capital Markets Division contracts with third parties for capital-raising then this must go to the Advisory Board given the potential conflict of interest.”*

(Respondent #V1, Fund V)

The Respondent explained that increasing the size of subsequent funds raised was an appealing prospect, from a fee perspective, but also to take advantage of other investments opportunities in the industry:

*“...can earn larger management fees and carry interest and can take advantage of more opportunities.”*

(Respondent #V1, Fund V)

According to the Fund Manager, while fee structures are standard across the industry, some investors will try to negotiate. The respondent elaborated upon the composition of ‘fundraising fees’, explaining that these accounted for ‘out of pocket expenses’ and recovered post-fundraising from the fund. ‘Out of pocket expenses’ could comprise of fees paid to legal

firms, tax consulting firms, hotel, and travel costs. The same management fee, carried interest fee and risk expectations applied to all investors of the Fund.

The overall fee structure for Fund V is summarised in Table 10.

Types of fees charged by GP	Mark (X)
Fundraising fees charged to fund	X
Underwriting fees charged to investee company	X
Arranging fees charged to investee company	X
Consultancy fees charged to investee company	
Directorship fees charged to investee company	X
Monitoring fees charged to investee company	X

**Table 10: Fund V fees**

The fund manager implied that the turnaround time for closing a fundraising effort was a major source of competitive advantage for Fund Managers in the industry:

*“In addition, time taken to raise a fund is the biggest bottleneck. To develop a better reputation, one hope you will be in a position to improve turnaround time.”*

**(Respondent #V1, Fund V)**

According to the interviewee, increasing the capital contribution from Fund Managers would create better alignment of interests:

*“Increasing capital contribution from the Manager will create more alignment of interest. However this depends on the financial strength of the GP.”*

**(Respondent #V1, Fund V)**

A summary of the Fund Managers view on how to create better alignment of interests are shown in Table 11:

Structure	Management fee	Carry interest	Monitoring	Capital contribution
Decrease				
Keep the same	X	X	X	
Increase				X

**Table 11: Fund V alignment of interests**

The Fund Manager explained that while one partnership agreement governed the relationship with all partners, some investors had side letters in place. However, the presence of side letters did not make a material difference. For example, the PIC may of asked that BBBEE Codes be included as part of the investment requirements. ILPA and other industry standards

generally govern the way in which fund agreements are drafted, leaving little or no room for deviation.

Investors looking to sell their partnership interest would first have to offer their stake to existing investors prior to approaching the secondary market:

*“There are provisions in partnership agreements. There is a pre-emptive clause where LPs will be first offered the right to purchase.”*

**(Respondent #V1, Fund V)**

All valuation performed on investee companies require the endorsement of the Advisory Committee. According to the Fund Manager, no disputes have yet arisen with any of the Fund’s investors.

If portfolio investments were to be sold between funds under management, then the approval of the Advisory Committee would be sought on matters relating to the timing of sale, valuation, and approval of such a transaction.

The Fund Manager did not believe that strong investment performance could overpower all agency problems that may arise. When asked how the Fund Manager dealt with Investors who tended to micromanage them, he responded frankly:

*“The one way is to avoid inviting them into successive funds”*

**(Respondent #V1, Fund V)**

#### **5.4.4 Governance, disclosure and regulation**

The Fund Manager explained that it was more important for investors to report on fund performance and portfolio performance, as opposed to reporting on fees earned from portfolio companies:

*“LPs ask for more detail on portfolio performance.”*

*“Environmental and Social questionnaires as required mainly by DFIs can be taxing.”*

**(Respondent #V1, Fund V)**

When asked about regulation in the private equity industry, the Fund Manager responded:

*“It’s not easy for ‘fly by nights’ to prosper. Existing regulations avoid ‘fly by nights’ from entering the industry”*

*“Regulation that kills ‘fly by nights’ from entering the industry would be the right balance.”*

**(Respondent #V1, Fund V)**

However, regulation alone would not be enough to help reduce agency problems:

*“Carried interest, and co-investment by GP are effective in reducing agency problems. It would be ambitious to think that regulation alone can deal with agency problems.”*

**(Respondent #V1, Fund V)**

When asked about the fair treatment of all investors, the Fund Manager responded:

*“The partnership agreement provides a level plain-field for all LPs. The fundamental basis is the partnership agreement.”*

**(Respondent #V1, Fund V)**

## **5.4 Fund A**

### **5.5.1 Investment strategy**

#### **5.5.1.1 Fund structure**

During 2009, the DFI committed US\$ 20m to Fund A. The legal structure of the Fund is that of a limited partnership, with an entity domiciled in Mauritius for offshore investment exposure, as well as an entity domiciled in SA for local investment exposure. This is the first private equity fund managed by the Fund Manager. The fund’s investment criteria were established together with the anchor investor. All decisions relating to portfolio investments and exit criteria are undertaken by the Fund Manager. According to the Fund Manager, there is no reliance on the Advisory Committee to provide leads for deal flow.

#### **5.5.1.2 Investment thesis**

The Fund’s investment thesis is to invest directly in agricultural and food businesses in their growth and mature life-stage phases. The Fund’s geographic focus is within Sub-Saharan Africa. The Fund Manager foresees trade sale as well as IPOs as a means of potential exit from

portfolio investments upon portfolio harvesting. During the interview, the Fund Manager summarised the approach it uses for investing:

*“[There is an upfront] ‘100 days’ plan ahead of investment and agreed with management”*

*“Our philosophy [is], if you’re a private equity fund in Africa [that is] investing in growth [then] you can’t not focus on development.”*

(Respondent #A1, Fund A)

The Respondent was asked to rank the value-add by the fund to its portfolio investments, the result of which appears in Table 12.

Premium drivers	Rank (1-3)
<i>Financial engineering: making capital structure more efficient through lower capital costs</i>	2
<i>Governance engineering: improve monitoring and performance incentives for managers</i>	3
<i>Operational engineering: improving operations, working capital, marketing, and product mix</i>	1

**Table 12: Fund A premium drivers**

## 5.5.2 Selection criteria

### 5.5.2.1 Investment criteria deemed important for the Fund Manager

During the interview, an interesting question was raised by the Fund Manager when asked how it went about selecting investors:

*“Beggars can’t be choosers. Don’t get too picky. [We] might get choosy in future. [An] interesting question would be does it change with life stage of fund manager?”*

(Respondent #A1, Fund A)

The Fund Manager conceded that they did not require the help of investors for operating the Fund. The interviewee explained that there was always the risk of unforeseen investment requirements from DFIs or listed companies that could result in disapproval for a particular transaction:

*“Investment restrictions from DFIs that you are not initially aware of...you might want to do a deal and a DFI or listed company might say no.”*

(Respondent #A1, Fund A)

### 5.5.2.2 Investment criteria deemed important for Investors

According to the respondent, investors are attracted to funds with strong investor anchors. The ability of Investors to be able to monitor their investment in a Fund was also raised by the Fund Manager as being another ‘selection criteria’ of importance for investors, adding:

*“It [monitoring oversight] comes with this space. If I were giving someone my money, I’d also want monitoring oversight.”*

**(Respondent #A1, Fund A)**

### 5.5.3 Alignment of Interests

#### 5.5.3.1 Key findings relating to incentive structure, partnership covenants, and monitoring

The Respondent explained that all fee related income earned from investee companies is disclosed upfront to investors. In addition, 2% management fee and 80-20% carry rule was described as being the industry standard. The Fund Manager responded to the charging of ‘other fees’ to underlying portfolio companies:

*“The fund manager can charge all kinds of fees – Advisory, monitoring, consulting. The market is moving away from 80-20%. Now, 100% [of all fees] go into [the] fund.”*

*“Technically you can make extra money this way. But you’re taking value away from investors by taking cash flow.”*

**(Respondent #A1, Fund A)**

According to the Respondent, if they were to become a superior Fund Manager compared to other players in the industry, increasing the size of subsequent funds raised would be the most appealing factor when considering the raising of subsequent funds. The interviewee did not think that increasing the existing management fee or carried interest percentage was an attractive option:

*“We’re growing as a fund manager, so more funds is better. Successive funds, we’d like to be bigger to take advantage of opportunities in Africa.”*

*“Fees go down as committed capital becomes invested, but overheads stay same. So you want to be raising that next fund.”*

**(Respondent #A1, Fund A)**

Once costs are recovered for services provided to portfolio companies, the Fund Manager is entitled to share in 20% of all surplus funds, while the remaining 80% flows into the Fund to offset future management fees. This varies from other funds, in which all fees go back to the fund (Fund S and Fund V), or 100% of surplus of fees go to the Fund Manager (Fund P):

*“Costs are recovered from the total amount, with the remaining going into the fund, and this surplus being shared 80/20 between investor [80%] and fund [20%]. And this offsets the management fee at next drawdown.”*

**(Respondent #A1, Fund A)**

The Respondent conceded that the management fee, carry fee and risk expectations were consistent across all of the Funds investors. The existing fee structure of the Fund is summarised in Table 13.

Types of fees charged by GP	Mark (X)
Fundraising fees charged to fund	X
Underwriting fees charged to investee company	
Arranging fees charged to investee company	
Consultancy fees charged to investee company	X
Directorship fees charged to investee company	X
Monitoring fees charged to investee company	X

**Table 13: Fund A fees**

The Fund Manager was not indifferent to the existing fund structures used by investors to create alignment of interests. These are shown in Table 14.

Structure	Management fee	Carry interest	Monitoring	Capital contribution
Decrease				
Keep the same	X	X	X	X
Increase				

**Table 14: Fund A alignment of interests**

The Fund Manager of Fund A explained that reporting requirements typically differ between investors. The Fund Manager was complimentary about DFI investors, citing that they are less concerned about a DFI’s ability to honour capital calls:

*“Normally it’s not a catastrophe. You need to manage the process from day 1. Plus or minus 90% of PE LP commitments in Africa are DFIs.”*

**(Respondent #A1, Fund A)**

The Fund Manager mentioned that they could start fundraising for another fund, provided that 75% of all committed capital of the existing fund was fully invested, and that the Key Persons of the new fund were different from the existing fund. According to the Fund Manager, this requirement is sufficient to prevent the “cherry-picking” phenomenon from occurring.

The fund used the IPEV guidelines to perform valuations on portfolio investments which are rolled up to give the overall Fund valuation. The valuation methodology requires upfront endorsement by the Advisory Committee from all participating investors. According to the fund manager, fund valuations are not audited, however the fund does make use of an external auditor. And valuations do not require the approval from the Advisory Committee.

The Fund Manager contrasted DFI investors with commercial investors, citing their difference in preferences for returns:

*“DFIs are very focused on development and ESG. Less focused on financial returns, while other LPs less focused on development and ESG, and more on financial returns.”*

**(Respondent #A1, Fund A)**

During the interview, the Fund Manager was strongly opposed to the selling of portfolio companies between funds should they in future have a second fund under management:

*“If you sell for too high in Fund 1, you disadvantage LPs in Fund 2, and vice versa. I wouldn’t do it. If you’re a long-term fund manager, someone’s going to get upset and this could damage future ability to raise funds.”*

**(Respondent #A1, Fund A)**

The Fund Manager did not believe that strong investment returns overpowers agency conflicts of interests:

*“Certainly with DFIs, if you make a load of money and you rip out a rainforest, they won’t be happy.”*

**(Respondent #A1, Fund A)**

The interviewee explained that it is better to upward-manage investors, than to allow Investors the time and opportunity to micromanage the activities of the fund:

*“Work with them. We accept it comes with this space. You communicate with them, they won’t micro-manage – [it] keeps them quite happy. Keep them updated. [We believe in] regular reporting. Speaking regularly [with investors] keeps them quite happy...we kind of micromanage them!”*

(Respondent #A1, Fund A)

#### 5.5.4 Governance, disclosure and regulation

The Fund has a formal risk management plan for all investments, and risk assessments are performed on a continual basis, and shared with the Advisory Committee:

*“(We) report fully on portfolio companies. (We) tell everything, don’t hide anything.”*

(Respondent #A1, Fund A)

According to the interviewee, a formal IT governance framework/methodology was deployed to manage the data in its operations. Strikingly different from the other funds, was the fact that the fund deployed an online access tool for investors, in order to access Fund related documents.

*“[We] launched a website with passwords for all LPs. But LPs still prefer emails.”*

(Respondent #A1, Fund A)

As the Respondent pointed out, not all investors wanted to be active participants on the Advisory Committee:

*“We try to see everyone once a year at least. Some investors, but not all, are on advisory committee. Some don’t want to be. DFIs like to be.”*

According to the Fund Manager of Fund A, many overseas Fund Managers are resisting increased regulation, stating that there was a cost to complying with regulation, as long as it was relevant. The Respondent did not believe that increased regulation would be any more effective in reducing agency problems:

*“Not sure what [the] problems are. I think money is smart. LPs are sophisticated investors and smart. Fees ‘over and above’ [are] now being done away with. LPs talk to each other, they work together. The money regulates.”*

(Respondent #A1, Fund A)

However the Respondent did agree that increasing regulation should be adopted across the industry on an ‘apply or explain’ basis.

## 5.6 Fund N

### 5.6.1 Investment strategy

#### 5.6.1.1 Fund structure

During 2010, the DFI committed ZAR 200m to Fund N. The legal structure of the fund is that of a limited partnership, domiciled in South Africa. This is the second of funds managed by the Fund Manager. The DFI was also invested in the first fund. The Fund's investment criteria were negotiated with investors during the fundraising process. All decisions relating to portfolio investments and exit criteria are undertaken by the Fund Manager. The Fund Manager maintains independence stating that there is no reliance on the Advisory Committee to provide leads for deal flow, given the nature of mining investing:

*“We invest in a high risk area where institutional investors don't want to typically go.”*

**(Respondent #N1, Fund N)**

#### 5.6.1.2 Investment thesis

The Fund's investment thesis is to partake in venture capital transactions in the mining sector. The Fund invests directly in mining sector projects in their early stages, where risk equity capital is required in order to determine feasibility of stated reserves. The Fund manager foresees trade sale as a means of potential exit from portfolio investments upon portfolio harvesting. The Fund Manager prefers to invest in projects that have internal expertise, given that there are only four investment professionals in the Fund.

*“Generally we like companies that got expertise in-house. There are only 4 of us on investment side plus one back-office man.”*

**(Respondent #N1, Fund N)**

The Respondent was asked to rank the value-add by the fund to its portfolio investments, the result of which appears in Table 15.

Premium drivers	Rank (1-3)
Financial engineering: making capital structure more efficient through lower capital costs	3
Governance engineering: improve monitoring and performance incentives for managers	1
Operational engineering: improving operations, working capital, marketing, and product mix	2

**Table 15: Fund N premium drivers**

During the interview, the Fund Manager explained the technical nature of mining investments:

*“Holes are drilled and money goes into the ground.”*

*“Financial engineering is more for the Fund and Investor, not the portfolio company, because we like to screw them over.”*

*“The way we make money is we have a value-add curve - understanding the metallurgy, market and costs.”*

**(Respondent #N1, Fund N)**

## 5.6.2 Selection criteria

### 5.6.2.1 Investment criteria deemed important for the Fund Manager

The Respondent stated that ‘personal relationships’ was the most important selection criteria for selecting investors, especially within its second fund:

*“It took us 3 years to find LPs for our new fund. It’s very high risk and in the mining game most investors don’t like that. The majority of our investors are DFIs.”*

**(Respondent #N1, Fund N)**

The Fund Manager of Fund N stressed that it was difficult to solicit interest for mining private equity funds from prospective investors in SA, owing to the low risk-appetite for venture capital type transactions in the mining sector. From a selection point of view, DFIs and North American investors appear to have the biggest appetite for early stage mining transactions:

*“We wrote a placement memorandum and this we distributed to DFIs. Sanlam, Coronation and Allan Gray go into established stocks. They just don’t go into exploration. In North America, there is a ‘strong body’ that go into exploration. Toronto stock exchange has in excess of 200 junior mining stocks.”*

**(Respondent #N1, Fund N)**

### 5.6.2.2 Investment criteria deemed important for Investors

During the interview, the Fund Manager commented on the overall state of their relationship with investors, stressing the need for openness and transparency with investors:

*“We have a clear cut relationship with our investors.”*

(Respondent #N1, Fund N)

### 5.6.3 Alignment of Interests

#### 5.6.3.1 Key findings relating to incentive structure, partnership covenants, and monitoring

According to the Fund Manager, all fee related income was disclosed upfront with investors. ‘Fundraising’ and ‘Directorship’ fees were the only fee components charged to portfolio companies. When asked about the charging of ‘other fees’ to portfolio companies, the Fund Manager responded:

*“We don’t charge consulting fees. All director fees charged are passed straight back to the investors.”*

(Respondent #N1, Fund N)

The existing fee structure of the fund is summarised in Table 16.

Types of fees charged by GP	Mark (X)
Fundraising fees charged to fund	X
Underwriting fees charged to investee company	
Arranging fees charged to investee company	
Consultancy fees charged to investee company	
Directorship fees charged to investee company	X
Monitoring fees charged to investee company	

**Table 16: Fund N fees**

According to the Fund Manager, if they were to become a superior Fund Manager compared to other players in the industry, increasing the size of subsequent funds raised would be the most appealing factor when considering the raising of subsequent funds:

*“Increasing the size of the fund gives you more fees. But the moment you’re above a certain amount, they [investors] cut you down. [So] charging higher management fees and getting higher carry is not going to happen!”*

(Respondent #N1, Fund N)

The Fund Manager conceded that there was not “much of a choice” when it came to changing the existing management fee and carry interest structures of funds in the industry. Monitoring was felt to be over burdening, given that the Fund Manager is managing a mining fund, and that environmental issues dominate the agenda especially for DFI investments. Hence, the Respondent felt that there was room for less monitoring oversight from investors. And while the he conceded that while it was desirable to increase their capital contribution of the Fund, owing to the expected return envisaged, there was little chance of this from happening.

The Fund Manager conceded that there is not “much of a choice” when it came to changing the existing ‘management fee’ and ‘carried interest’ structures of the fund. According to the Fund Manager, the Investors in the Fund held most of the power when it came to negotiating the terms of the fund:

*“Investors tell you what your fee structure is going to be.”*

**(Respondent #N1, Fund N)**

A summary of the Fund Managers view on how to create better alignment of interests are shown in Table 17:

Structure	Management fee	Carry interest	Monitoring	Capital contribution
Decrease			X	
Keep the same	X	X		
Increase				X

**Table 17: Fund N alignment of interests**

The Fund manager referred to the level of transparency in the way in which terms were negotiated within the Fund:

*“We all sat down in this room with the lawyers and everyone.”*

*“All LPs get exactly the same terms.”*

**(Respondent #N1, Fund N)**

During negotiation, the Fund Manager’s attempt at trying to negotiate a longer duration for the fund was not successful:

*“We wanted 10 years - they [investors] cut us back to 8yrs”*

**(Respondent #N1, Fund N)**

The interviewee pointed to the rationale for ensuring that sufficient effort is placed on negotiating initial agreements with investors:

*“Once you’re closed, you’re closed with the current agreement”*

**(Respondent #N1, Fund N)**

A number of comments were made by the Fund Manager regarding various partnership covenants forming part of the existing partnership agreement with investors. These are presented in Table 18.

Partnership covenants to mitigate against agency risks	Comments
Restrictions on co-investment with other funds	“They also encourage us to invest with them.”
Limits on personal investments by GPs	“We have to tell them about it. We have to be very careful about this one.”
Restrictions on partnership interest sale by GPs	“If we sell it, all GPs will have to sell at the same time.”
Restrictions on additional fundraising ability	“Can only after a certain amount of time and must be 75% invested.”
Limits on investments in other assets	“Cant invest outside of a very strict mandate.”
Restrictions on partnership interest sale by LPs	“Covered in the agreement. Have to offer to other LPs first.”

**Table 18: Fund N partnership covenants**

Given the nature of the industry and investor composition of the Fund, investors to the Fund are naturally concerned with the funds ability to report on environmental issues:

*“On Advisory Committee – Monitoring oversight is primarily related to environmental and social issues of which they are extremely conscious.”*

The valuation methodology used by the Fund was endorsed by the Advisory Committee. All LPs represented on the Advisory Committee are required to approve valuations. Valuations are performed by the Fund Manager and audited by PWC. When asked to comment on how conflicts around valuations were resolved with investors, the Fund Manager responded:

*“Haven’t had [any conflicts around valuations as] yet. There are clauses in the agreement on how to resolve disputes.”*

**(Respondent #N1, Fund N)**

During the interview, the fund manager eluded to one of the ways in which its agency relationship with investors were affected:

*“In our first fund, the most ‘picky’ guy was the insurance company and the second most ‘picky’ was the DFI. They like to pick on you. What are you doing?!”*

**(Respondent #N1, Fund N)**

While no formal limitations existed with regards to valuations, approvals and the timing of the sale of portfolio investments, the fund manager conceded that it did consider the sale of a particular portfolio investment from its first fund, to its second fund. However, it did not go into too much detail regarding the proposed transaction to the Advisory Committee:

*“There was one investment we thought of carrying on to the second fund, but we no longer considered it.”*

**(Respondent #N1, Fund N)**

The fund manager did not believe that good investment performance had the ability to overpower agency problems, adding:

*“Probably not - but everybody likes to make money.”*

**(Respondent #N1, Fund N)**

While the Respondent commented on how some investors appeared to be “picky” during its first fund, there did not appear to be any investors so far in its second fund that tended to micromanage its functions:

*“We haven’t had this [micromanaging] situation [yet]. We will cross that bridge when we get there.”*

**(Respondent #N1, Fund N)**

#### **5.5.4 Governance, disclosure and regulation**

The Fund adheres to the IFC exclusion policy, as required by investors. According to the Fund Manager, investors who do not wish for the fund to pursue certain investments either for ethical reasons or for mandate purposes, have the option to be excluded from specific mining investments.

*“Investors can exclude themselves from a certain investment if they want. Investors are then excluded just for that investment.”*

**(Respondent #N1, Fund N)**

However, it is not evident to what extent investors are excluded from transactions, nor is there clarity on how this policy would affect the relationships with excluded investors from an agency perspective.

The Respondent explained that while risk assessments are performed on a continual basis, there is no formal risk management plan in place for the overall investment portfolio and operations:

*“No – we’re in a hell of a high risk business. We have to assess risk by having a look at technical issues.*

*[We] do it intuitively.”*

*“It’s called experience.”*

**(Respondent #N1, Fund N)**

The Fund Manager does not deploy a formal IT governance framework/methodology as part of its management practices. Much of the information is stored in hard copy, although the fund manager concedes that it prefers soft copies of all data.

*“We don’t publish any details. Only send quarterly reports to LPs. In annual reports – we only report on overall fund financials, and would report on each investment. We sign NDAs with investee companies. Only if LPs push, then only will we disclose full detail [of investee companies]. IFC has rules disclosing to the fucking world at large of what we do.”*

**(Respondent #N1, Fund N)**

The interviewee mentioned that many of the fund’s investors are primarily concerned with performance relating to portfolio investments:

*“Why’s the thing gone fucking wheels-up? We have to tell them: listen guys - its high risk”*

**(Respondent #N1, Fund N)**

When asked about reporting, the Fund Manager responded:

*“Try not to. That’s when you get all queries – What do you mean by this.”*

*“If we are expected to report more frequently we will do it. But we tend to report just when they want us to.”*

**(Respondent #N1, Fund N)**

A general comment was made during the interview regarding investors' growing sentiment toward charging management fees for funds under management:

*"I think LPs, more and more worldwide, are getting more 'sticky' with the management fees charged."*

**(Respondent #N1, Fund N)**

When asked about the prevalence of regulation in the industry, the fund manager responded:

*"Adequate. Governance [is] by IFC standard procedures and rules. One of our investors is particularly sticky about bribery and corruption."*

*"Can't cut corners anymore: not in this game!"*

**(Respondent #N1, Fund N)**

Finally when asked how the Fund Manager ensured the fair treatment of all investors, the Fund Manager responded saying that it had no choice in the matter.

## **5.6 Fund T**

### **5.7.1 Investment strategy**

#### **5.7.1.1 Fund structure**

During 2009, the DFI committed ZAR 100m to Fund T. The legal structure of the fund is that of a limited partnership, domiciled in South Africa. Fund T is a black-empowered private equity fund management team formed as a joint venture by three experienced private equity executives from two investment firms in SA. The fund's investment criteria were negotiated with investors during the fundraising process, and formulated in the LP agreement. All decisions relating to portfolio investments and exit criteria are undertaken by the fund manager. The fund manager's ability to exercise investment decision making that is independent from investors is questionable given that the CEO of one of its investors are represented on the IC:

*"Some don't deem [the CEO of one of our investors as] independent, but we do."*

**(Respondent #T1, Fund T)**

### 5.7.1.2 Investment thesis

The fund’s investment thesis is to partake in buyout and growth transactions in all industry sectors with the exception of the mining sector. Twenty percent of investment capital is reserved for investments in sub-Saharan Africa. The fund manager foresees trade sales and re-MBOs as a means of potential exit from portfolio investments upon portfolio harvesting. Preference is given to companies that are in the mature stage of their business life cycle.

The fund manager ranks its value-add to portfolio investments according to Table 19.

Premium drivers	Rank (1-3)
<i>Financial engineering: making capital structure more efficient through lower capital costs</i>	1
<i>Governance engineering: improve monitoring and performance incentives for managers</i>	2
<i>Operational engineering: improving operations, working capital, marketing, and product mix</i>	3

**Table 19: Fund T premium drivers**

Up until the time of this interview with the fund manager, the fund had been slow to find suitable investments, and remained under-invested:

*“[We] only made second investment [up until now]. [We have] mainly been focussed on the first asset up until now.”*

**(Respondent #T1, Fund T)**

## 5.7.2 GP’s selection strategy

### 6.2.7 Fund T

When asked about how decisions are made regarding the selection of investors for a new fund, the Fund Manager of Fund T responded:

*“In the current environment you take what you can get. Funding has dried up. Things are being regulated. The market has shrunk. In the US you have more choice. In SA the choice is limited.”*

*“Whoever gives us money, we will take it!”*

**(Respondent #T1, Fund T)**

When selecting prospective investors, the fund manager conceded that ‘financial position’ was the most important selection criteria followed by ‘LP reputation’.

When asked about the channels used to select prospective investors, the Fund Manager of Fund T cited “anyway possible” as a means. Other means cited were personal relationships, cold calling, and through the use of networks like trustees and asset consultants.

The Fund Manager explained that during the Investors’ due diligence process, a fairly good idea of what is important to a particular Investor is gauged:

*“During their DD (due diligence) we get to understand what their big buttons are. For example, [for] PIC, empowerment is very important, [and for another DFI, ESG is very important.”*

**(Respondent #T1, Fund T)**

### ***Investor selection criteria according to Fund T***

Given that the managing partners of the fund have been long in the industry, gaining substantial experience in the process, the fund manager explained that it did not need to use the fund for a further ‘learning curve’.

Furthermore, according to the Fund Manager, there is a definite link between reputable investors and stringent governance requirements, and Investors are attracted to funds with other strong Investors on board:

*“If you have some Mickey Mouse guys, it means nothing!”*

**(Respondent #T1, Fund T)**

## **5.7.3 Alignment of interests**

### **6.2.7 Fund T**

#### ***Key findings relating to incentive structure, partnership covenants, and monitoring***

The Fund Manager conceded that all fees were disclosed upfront with investors. During the time of this interview, the Fund Manager had only made one portfolio investment. In the Fund Manager’s words, the management fees earned from investors are just enough to pay for the main expenses:

*“Our management fees basically pay for salary and rent.”*

**(Respondent #T1, Fund T)**

The fund manager explained that there is little attractiveness in charging ‘other fees’ to investee companies for services rendered, given that 80% of these fees would have to go back to the investors. There was also no incentive to charge such fees:

*“So [the benefit to the GP of charging fees] is marginal, [and the GP is] not incentivised to charge fees. I think it should be fifty-fifty between LP and GP.”*

**(Respondent #T1, Fund T)**

The Fund Manager explained that ‘arranging fees’ are “sometimes” charged to portfolio companies. ‘Fundraising fees’ were considered as recoverable costs once a fund is closed with investors. The Fund Manager estimated, from a Manager’s perspective, the critical mass of a commercially viable fund to be in the region of ZAR 500m.

The existing fee structure of the fund is summarised in Table 20.

Types of fees charged by GP	Mark (X)
Fundraising fees charged to fund	X
Underwriting fees charged to investee company	
Arranging fees charged to investee company	X
Consultancy fees charged to investee company	
Directorship fees charged to investee company	X
Monitoring fees charged to investee company	X

**Table 20: Fund T fees**

According to the Fund Manager, if they were to become a superior fund manager compared to other players in the industry, ‘charging higher carried interest’, followed by increasing the size of subsequent funds raised, would be the most appealing factors when considering the raising of subsequent funds.

Increasing the carried interest was seen by the fund manager to be “a better incentive” to create alignment of interests between Fund Managers and Investors. However, while the fund manager viewed ‘charging higher carried interest’ as “attractive”, he explained that he did not believe that this could be achieved.

In the Fund Manager’s words, some investors are “quite onerous”. Hence, the fund manager conceded that less monitoring would be more desirable. Other changes to the existing fund structure, that were highlighted by the fund manager in order to create better alignment of interests is shown in Table 21.

Structure	Management fee	Carry interest	Monitoring	Capital contribution
Decrease				
Keep the same	X		X	
Increase		X		X

**Table 21: Fund T alignment of interests**

The Fund Manager explained that any contractual differences among investors stem mainly from differences in reporting requirements:

*“If we negotiate terms with an LP, other LPs can demand the same terms, provided that their contribution is equal [to] or more [than the LP in question].”*

**(Respondent #T1, Fund T)**

Side letters also exist across the various investors:

*“[We have] side letters with four partners. [We] do negotiate different covenants [across investors].”*

**(Respondent #T1, Fund T)**

The fund manager conceded that there were no disputes to date with any of its investors. The most onerous investors in the fund are pension funds and DFIs, who are primarily concerned with regulatory and reporting requirements.

When asked about whether investment performance had the potential to overpower agency problems, the fund manager responded:

*“Ultimately yes – they all kick and scream but if you deliver 35-40% IRR they are happy.”*

**(Respondent #T1, Fund T)**

And when asked about investors who tend to micromanage, the Fund Manager responded:

*“LPS are your bread and butter. We have to do whatever we have to [in order to] keep them happy.”*

**(Respondent #T1, Fund T)**

#### **5.7.4 Governance, and regulation**

The fund focusses on sustainability related themes and the IFC exclusion policy in response to investors. The fund manager conceded that there has been no conflict with regards to exclusion policies across its many investors:

*“Yes, [it is a] requirement, and we think it is important for doing business!”*

**(Respondent #T1, Fund T)**

When asked how the confidentiality of LPs, investee companies and the overall fund is maintained within its operations, the fund manager responded:

*“[Information is] tightly held. Three of us have access to information and we deploy a professional firm to do reporting.”*

**(Respondent #T1, Fund T)**

When the Fund Manager eluded to the small size of its administration function, which tended to be strained ad-hoc information requests from Investors:

*“Yes – Regulatory [reporting is taxing]. Anything out of the ordinary (can be taxing], because we are a small business.”*

**(Respondent #T1, Fund T)**

According to the fund manager, private equity regulation should be adopted on an ‘apply or explain’ basis, and more regulation is required:

*“[If you have more regulation] you will get more investors.”*

**(Respondent #T1, Fund T)**

## **5.7 Concluding remarks**

Quotations and insights deemed to be important from an agency perspective were presented in this Chapter. The intention was not to analyse the data to any extent, but rather to share with the reader the wealth of insights gathered during the interviews with the Respondents. The detailed analysis and commentary of data in support of the research questions follows in Chapter 6.

# Chapter 6: Discussion of Results

*The purpose of this chapter is to elaborate on the results presented in Chapter 5 in terms of the research questions presented in Chapter 3. This Chapter will analyse the research findings in the context of the DFI, its private equity funds, as well as the literature review discussed in Chapter 2. Where research findings confirm, contrast, or add new dimensions to the literature, these will be highlighted for future research considerations discussed in Chapter 7.*

## **6.1 Research question 1: What are the selection criteria deployed by Institutional Investors when selecting Fund Managers?**

### **6.1.1 Investor selection criteria**

Agency theory predicts that ‘*adverse selection*’ is a risk when it comes to the selection of Fund Managers by Investors, given that the Fund Manager, who is the agent, possesses more information about its own skills, knowledge and experience, which are not commonly available to Investors. Hence the agency problem of adverse selection is equally applicable to the selection of Fund Managers by Investors, in the same way that it is applicable to the selection of portfolio investments by Fund Managers in private equity.

A number of selection criteria obtained from the literature was presented to the DFI respondents in order to identify the selection criteria of importance, used when performing due diligences on prospective private equity funds. While Respondent #1 and Respondent #2 cited all of the criteria presented to it as being important, they highlighted the following selection criteria as those being most important:

#### ***Macro selection criteria of importance according to the DFI respondents***

##### ***Economic activity***

- Economic activity is an important barometer for deal flow. Measures of economic activity could include international GDP growth, changing market trends, rising middle class etc.

##### ***State of the capital market***

- State of the capital markets provides an indication of how easy it would be to raise additional finance from other sources of finance (banks, buyout and mezzanine funds, etc.)

***Human and social development***

- The DFI requires skills not just in prospective Fund Managers, but also in existing and prospective employees in order to “write deals”. This consideration is particularly important if the DFI is considering the use of expertise in other African countries where skilled human resources are scarce.

***Entrepreneurial opportunities***

- The business environment is important for Funds looking to invest in fast growing economies in Africa. Policy reform by governments in support of entrepreneurial opportunities, are factors worth considering prior to investing in Funds targeting certain economies.

***Micro selection criteria of importance according to the DFI respondents***

***Track record***

- Investors are attracted to fund managers that have demonstrated high investment returns within prior private equity funds.

***Locals in team (Black Fund Managing Partners)***

- SA has BBBEE policies aimed at encouraging local participation in business. As a DFI, it is important to support the development of Black Fund Managers, and to fast track investment opportunities in Funds where this is a likely prospect.

***Commitment to other well-reputed LPs***

- Reputable local Investors often serve as a catalyst to attracting both local and international investors. During due diligence, the DFI will often try to ascertain who the other prospective investors are that are considering investing with the same Fund Manager.

***Commitment to good agency and governance***

- It is essential that Fund Managers are able to demonstrate commitment to the establishment of decision making structures within the fund in order to facilitate the principles of good governance – transparency, independence, fairness, etc.

## **6.2 Research question 2: What is the selection criteria deployed by Fund Managers when selecting Institutional Investors?**

### **6.2.1 Adverse selection when the fund manager is the principal**

Private equity funds are usually raised by way of a private placement, in which prospective institutional investors are approached by fund managers to invest in a particular fund. As discussed in Chapter 2, a major shortcoming of Agency Theory is that it assumes a unidirectional selection process between principal and agent, and that only agent can do harm within a relationship. As seen in Chapter 2, most of the literature covering the relationship between Investor and Fund Manager show that many partnership agreements between investors and fund managers often cater for the default of limited partners (Rand and Weingarten, 2002; Phalippou, 2007).

Hence, the classical agency problem of adverse selection is as much relevant to the scenario in which the fund manager may not have all relevant information about a prospective institutional investor. For example, the institutional investor may currently be sued by one of its customers or suppliers, or its current financial position may be deteriorating, or it is about to embark upon some form of corporate action. All of these factors could jeopardise future capital commitments to the fund, investor expectations, or even the overall agency relationship between fund manager and investor.

### **6.2.2 Concluding remarks on selection criteria according to the Fund Managers**

In discussing the results obtained from the six case studies, the responses from the various Fund Manager respondents of each fund provide valuable insights into not just how they view selection of prospective investors, but also what they perceived to be important selection criteria of Investors to be when choosing to partner with a particular Fund Managers.

A summary overview of how the six funds collectively viewed the importance of selection criteria established from the literature is shown in Table 22. Collectively, the sample of six

funds viewed ‘financial position’ as the most important selection criteria, followed by ‘LP reputation’ and ‘Personal Relationship’.

Selection criteria	Importance ranking (1-6)						Average
	Fund P	Fund S	Fund V	Fund A	Fund N	Fund T	
LP reputation	3	2	--	3	--	2	2.50
Track record	2	2	--	4	--	--	2.66
Financial position	1	3	1	1	--	1	1.16
Corporate governance	4	2	--	5	--	--	3.66
Company brand	6	2	--	6	--	--	4.66
Personal relationship	5	1	--	2	1	--	2.55

**Table 22: Selection criteria**

A summary overview of what essential value-add attributes the six funds collectively expect from Investors, are shown in Table 23 respectively. Collectively, all six sample funds expected high value-add from investors with regards to the provision of ‘capital’. Correspondingly, this result validates the claim by four funds (which is a majority of the six cases) that ranked ‘financial position’ as number ‘1’ in terms of its selection criteria. It makes sense that if at least four funds rank ‘financial position’ as the most important selection criteria, then at least four or more (all six in this case) would rank the provision of ‘capital’ as highly important from a value-add perspective.

Three funds ranked the ‘network for other LPs’ as a ‘high’ value-add attribute. This result also validated the second most important selection criteria of ‘LP reputation’, as it makes sense that highly reputable LPs would easily attract other LPs to co-invest alongside them. Three funds were in favour of some ‘branding status’ and ‘learning curve’ value-add from investors. Two of the six funds, Fund V and Fund T, stated that they did not have any expectations from Investors with regards to additional value-add other than the provision of capital, citing that they had adequate experience on the industry to manage private equity funds by themselves as a reason.

Value contribution area	Type of value contributor	Number of case respondents			
		None	Low	Some	High
Financial:	Capital	0	0	0	6
Governance:	Structures	1	0	2	2
Operational:	Network for deal flow	2	1	1	1
Operational:	Network for other LPs	1	0	1	3
Reputational:	Brand status	0	0	3	2
Other:	Learning curve	1	1	3	0

**Table 23: Value contribution area**

The ‘selection criteria’ and ‘value contribution area’ gives insight into how important Fund Managers deemed the importance of certain criteria established in the literature review. However, from an agency perspective, a number of other valuable ‘selection criteria’ insights were gained during the case studies, and provides a rich understanding of the thought processes as well as perceptions held by the six Fund Managers contributing to this study. These are collectively summarised across the six case studies.

### **Collective summary of selection insights gained from Fund Managers in the six case studies**

#### ***Financial position and LP reputation are the most important selection criteria***

- Fund Managers want strong ‘financial position’ to support the provision of ‘capital’, and good ‘LP reputation’ to support the ‘network for other LPs’.

#### ***Alignment of Investor investment horizons and underlying assets is important***

- Fund P is attracted to Investors whose investment horizons are aligned with the underlying assets of the fund.

#### ***Demand-supply dynamics of the market impacts selection strategy of Fund Managers***

- Fund S hinted to the supply-demand dynamics of investment capital in the market as being a major determinant of how Fund managers would have to adapt their selection strategies. This was confirmed by Fund A and Fund T. (Collectively, these Fund Managers expressed concern over the short supply of new investment capital available in the market, reiterating this view through citations such as “...funding has dried up...” and “Beggars can’t be choosers...”).

#### ***Preference is for smaller amount of Investors in a fund***

- Fund V is weary of having too many investors in a fund, citing that the more the number of investors, the greater industry standards and monitoring requirements imposed on a fund. Fund V selects on the basis of Investors participating on a minimum ‘committed contribution’ of at least ZAR 100m, or alternatively, on recommendations of smaller pension fund investors made by independent actuarial firms.

#### ***Credit worthiness of institutional investors is not as relevant for private equity***

- Fund V explained that credit worthiness does not apply to investor selection in private equity, owing to the fact that most institutional investors are large institutions with good reputations.

***Turnaround time of Investors is important for closing funds***

- Fund V mentioned that Investors should be committed to quick turnaround on the closing of new funds, so that funds may attract and keep the critical mass of investors and capital required.

***There are benefits as well as pitfalls to having DFI investors on board***

- There were mixed views on the benefits posed from having DFIs as investors on board. For instance, Fund 'A' made reference to DFIs, Pension Funds, and listed companies that often have stringent requirements from an ESG perspective, which could lead to the disapproval of certain transactions. However, Fund N cited that the majority of their investors are DFIs, adding that most commercial investors are not attracted to high-risk early-stage mining ventures.

***Understanding more about Investor risk appetite preference will assist with selection***

- Investors are more attracted to certain funds than other. For example, Fund N stated that DFIs and North American have appetite for high-risk early-stage mining investments. Hence, from a 'selection' point of view, it is reasonable to assume that Fund Managers that are highly specialised within specific industry sectors may filter out unlikely Investors through the process of elimination prior to targeting likely candidates during private placement.

***Good investors are prone to having open and transparent relationships***

- Fund N highlighted the need for investors who are prone to holding a "clear cut relationship" with the Fund Manager.

***Investor due diligence process can be used as a barometer for how Investors will behave***

- According to Fund T, understanding what Investor's "big buttons" are during due diligence could provide late, but nonetheless, important insights for the Fund Manager from a selection point of view.

***Some investors tend to micromanage with onerous reporting requirements***

- According to Fund V, the way to avoid Investors who tend to micromanage the Fund Manager is to not invite these Investors into subsequent funds.

**Collective summary of selection criteria important to Investors according to Fund Managers**

***Anchor investors provide other investors with a level of comfort***

- All six funds stated that prospective investors are attracted to funds with strong investor anchors. In addition, Fund N mentioned that American investors take comfort from seeing a local investor first. Investors don't want to invest in funds that have "Mickey Mouse guys" without any reputable investors!

***Local investors provide foreign investor with a level of comfort***

- Foreign investors take comfort from seeing a local investor first.

***Large investors may intimidate smaller investors***

- Small investors may be drawn away from investment opportunities owing to perceived intimidation by larger dominant investors within a fund.

***Track records of Fund Managers are important***

- Investors are attracted to fund managers that have demonstrated high investment returns within prior private equity funds.

***Larger investor usually set the standards***

- Some Investors rely on other Investors to set standards that it can "piggy back on".

***Monitoring capability is important for investors***

- Investors expect to have monitoring oversight in the funds within which they invest. This has a number of implications on the way in which Investors may assess the Fund Managers ability to generate information and reports for the various decision-making governance structures with a typical fund.

## **6.3 Research question 3: How do agency conflicts manifest in the relationship between Institutional Investor and Fund Managers?**

### **6.3.1 Areas of agency conflicts identified across funds**

During the interviews with the four portfolio managers from the DFI, various agency issues and agency conflicts were highlighted based on the individual interview responses. Agency issues spur agency conflicts as Fund Manager's actions are hidden from Investors, due to the nature of the agency relationship. Some of these were specific to the sample of funds presented, while others were relevant to other funds within the DFI's private equity portfolio. Some were also considered generic to the total portfolio of funds under management:

Eleven areas were identified in this study where agency issues and conflicts of interests were highlighted, by the DFI during interviews. There are:

- Management fees paid to the fund manager
- Capital contribution made by the fund manager
- Fees charged by affiliate companies to investee companies
- Fund manager's Black Economic Empowerment (BEE) credentials
- Fund structure: 'Trust' versus a 'Limited Partnership' structure
- Investor staff that join the employment of private equity funds
- Commitment by the fund manager to ESG issues
- Valuations and sale of investee companies
- Fund manager requesting an extension of fund life
- Departure of Key Persons from the Fund Manager
- Investors and Fund Managers that co-invest alongside each other

Following is a discussion of each agency issue identified in the context of the DFI and the six sample funds studied.

### **6.3.2 Management fees paid to the fund manager**

Many of the fund managers made reference to looming changes in the global private equity industry, owing to added scrutiny around the structure of management fees earned by fund

managers. The global financial economic crises of 2008 meant that the valuations of many private equity funds globally were revised downwards, due to the global slowdown in economic growth. The effect of valuation downgrades implied revaluation losses for institutional investors, who themselves have stringent reporting obligations to their own shareholders, on the investment performance of various asset classes. Despite valuation downgrades, and a general halt in investment activity, fund managers continued to draw the full portion of annual management fees, further impacting the cash flows of funds and returns for investors negatively. Globally, the world is seeing a shift in financial regulation, specifically in the way in which agents are expected to account to shareholders on matters of risk, return, and compensation.

*“Fees are generally negotiated as one of the most contentious issues during negotiation, and are negotiated on a case by case basis.”*

**(Respondent #1, DFI)**

*“Fee structure – this is usually the most contentious issue. That’s where they get uptight. They don’t want to disclose completely!”*

**(Respondent #2, DFI)**

Adding to the strain of the 2008 financial crises, Respondent #1 hinted to fund managers in the DFI’s overall portfolio who were slow to take advantage of recovered markets with new investment opportunities post 2008, making particular reference to a fund manager not part of the sample in this research:

*“Management have not been investing for a year, but they are still drawing management fees.”*

**(Respondent #1, DFI)**

This concern relating to the agency relationship was confirmed by Respondent #2, calling for lower management fees:

*“We want this [management fees] to be lower. For example, with fund T, we are getting irritated. They haven’t made investments yet, but we are still paying fees. We feel like we’re carrying passengers!”*

**(Respondent #2, DFI)**

Respondent #2 also alluded to management fees not being a big enough incentive to promote investment performance by the fund manager:

*“When people chase management fees, and get cushy, that is precisely the problem!”*

(Respondent #2, DFI)

### 6.3.3 Capital contribution made by the fund manager

Capital contribution has been identified by the DFI as a potential area where *hidden action* by the Fund Manager due to informational asymmetry could arise. For instance, the respondent argued that there is no guarantee that the Fund Manager is always exposed for the said one percent contribution, as well as the source of this contribution:

*“There is no guarantee that the fund manager is using its own money for the one percent exposure as there are no checks in place to guarantee [that] this [is happening]. Does the contribution come from surplus [...] management fees, or portfolio company fees that are destined for ploughing back into the fund?”*

(Respondent #1, DFI)

### 6.3.4 Fees charged by affiliate companies to investee companies

Respondent #1 referred to a *conflict of interest* identified during the DFIs due diligence process regarding Fund V. The particular fund manager uses an affiliate ‘Capital Markets Division’ to originate debt for underlying investee companies of the fund. This practice has the potential for the fund manager to pursue *hidden actions* by pursuing debt origination, advisory, and arranging at a time when it is not really required by the underlying investee company, without the investors knowing about this action when it occurs. In addition, Fund V is a mezzanine fund, whose mandate is precisely to provide debt to investee companies. The respondent mentioned that new terms are being drafted by the LPs and will be re-negotiated with the Fund Manager as an amendment to the existing partnership agreement. Under the proposed amendment, any fees earned by the fund manager’s affiliate will comprise of:

- Cost overhead of the advisory services provided
- A return for the affiliate division
- Surplus fees flowing directly into the fund

According to Respondent #1, the amendment will clearly allow for unique cases whereby the affiliate may retain all fees, provided the transaction is at *“arm’s length”*.

### 6.3.5 Funds manager's Black Economic Empowerment credentials

Respondent #1 conceded that the DFI insisted that funds maintain staff representation that is reflective of the demographics of the SA population. This assertion was reiterated by Respondent #2 of the DFI:

*"We are big time supporters of first time fund managers, especially BEE [fund managers]."*

*"The only thing I can fault [fund N] on is their BEE profile."*

**(Respondent #2, DFI)**

Fund V has had a high turnover of investment professionals. The DFI became concerned about the fund's ability to meet empowerment objectives. Eventually the DFI started to put pressure on the fund manager to employ Key Persons in order to obtain a more balanced team:

*"In [fund V], there has been an issue with [the] turnover of BEE staff, so we insisted on BEE in key-man positions."*

**(Respondent #2, DFI)**

According to Respondent #2, the Fund Manager was not willing to compromise on this request, resulting in them having to mobilise the support of PIC and the Eskom Pension Fund in favour of the matter. However, another European DFI was very vocal about this request, and not willing to back the DFI, PIC and the Eskom Pension Fund on their request. Eventually the request triumphed over its protractors, given that there was majority support for the request at an Advisory Committee level. Empowerment objectives are high up on the DFI's agenda, and the DFI sees private equity investing as a means to catalyse the development of Black Fund Managers in the local industry:

*"[The DFI] has taken a stake in the [name of fund] in order to setup the [governance] structures, given that it was an empowerment fund [that would be] developing home-grown talent [within the private equity industry]."*

**(Respondent #1, DFI)**

### 6.3.6 Fund structure: 'Trust' versus a 'Limited Partnership' Structure

The DFI is invested in private equity via two prevailing legal structures: trusts and limited partnerships. From the sample of funds chosen in this research, Fund P and Fund S take the form of a 'trust' legal structure. Various respondents explained the rationale for the DFI wanting to invest via a 'trust' legal structure:

*“For example we wanted to be on [the] investment committee of [fund P] because they were a first time fund manager.”*

*“Yes – Fund P. The reason we put in an investment committee member is to protect our investment.”*

**(Respondent #1, DFI)**

*“Trust structure is used when the fund manager don’t have a track record. Under a trust structure we are able to allocate people to the fund to help, and become involved in operations.”*

**(Respondent #3, DFI)**

Being invested via a *Trust* legal structure implies that the DFI has more exposure and influence over the operational activities within the fund’s operations. Choosing to invest via a *Limited Partnership* legal structure implies that the fund manager would not be able to partake in operational activities of the fund. If the DFIs mandate is partly to promote and catalyse the development of first time Fund Managers in the private equity industry, then it comes as no surprise why it would be important that the DFI play an active role in ensuring the adequate skills transfer occur via participation on investment committees. The decision of which legal structure to deploy when invest in private equity poses an agency conflict, not just between investors and fund manager, but also between investors (principals) who may have conflicting views on which legal structure to deploy. Based on the results of the research interviews, it was not apparent as to which legal structure was more prone to agency conflicts between Investors and Fund Manager. While the use of a *Trust* legal structure for private equity is not as common in other economies such as the US and Europe, nevertheless, this insight requires further research, especially from the perspective of the South African context.

### **6.3.7 Investor staff that join the employment of private equity funds**

Respondent #1 raised a concern about one of the DFI’s staff members who was involved in underwriting the investment in Fund P, but recently resigned from the employment of the DFI in order to join the employment of fund P:

*“There should be a cool-off period after leaving the employment of LP in order to join the GP. If you are a key decision-maker, then [you and] I raise a fund, I support this fund, and two years later I join [the employment of your fund].”*

**(Respondent #1, DFI)**

During the time of this interview, two of the DFIs staff members had resigned from the DFI in order to take up senior positions within the private equity industry. However, only one of these joined a fund in which the DFI was an existing investor:

*“With [one of our staff members] leaving to join a fund that he underwrote, there are questions arising from a conflict of interest [perspective]. Should there be a cooling-off period if deal-makers were to leave [the employment of the investor]. Or there should be provisions barring you from leaving the principal and joining the agent. It’s wrong for an LP staff member to favour an investment with a Fund Manager, and shortly thereafter leave to join [the same fund manager]. I think it raises questions of morality.”*

**(Respondent #2, DFI)**

Based on the results of the research interviews, it was not apparent as to how this move has affected the existing agency relationship between the DFI and the impacted Fund Manager on the whole. This is certainly an area for further research.

### **6.3.8 Commitment by the fund manager to ESG issues**

ESG issues are becoming major concerns within the investment community as investors strive to showcase responsible investing to shareholders and consumers. Commitment to a positive environmental and social development impact is high up on the DFI’s agenda:

*“If upfront you are in a development impact fund, then you know what you are getting up to. You know your development return will be high!”*

**(Respondent #1, DFI)**

While many of the fund managers stated during the interviews that they conform to the IFC exclusion rules, ‘conflicts of interests’ relating to environmental and social impact could still arise. For example, Fund N mentioned that should an investor not wish to be part of a specific investment, they will be excluded from it. However, this will not deter the Fund Manager from pursuing the identified opportunity, should the remaining commercial investors see the potential for high investment returns. It is not clear how this will affect the agency relationship between the DFI and the Fund Manager should a like situation arise:

*“ESG are very big issues... This could damage your reputation. But if you have European DFIs [on-board as other investors in the fund], they could improve our monitoring [ability when it comes to reputational risks].”*

(Respondent #1, DFI)

However, there were also pockets of sound agency practiced by Fund Managers within the DFIs private equity portfolio. During the interview, Respondent #2 made reference to one such occasion:

*“The fund manager did on one occasion ask if we have an issue with investing in a particular African country. We then told them to check with the Department of Foreign Affairs [given that we are a DFI].”*

(Respondent #2, DFI)

### **6.3.9 Valuations and sales of investee companies by the fund manager**

Four scenarios were ascertained from the case studies researched, on how ‘asset sale’ transaction could present conflicts of interests, and how these have typically manifest in the agency relationship between investor and fund manager.

The valuation of investee companies is central to the four scenarios described. The buyer of an investee company will want to pay the lowest possible price, while the seller will seek to drive up valuations. And herein the conflict of interest arises, when the same party is found to have links to both sides of a transaction.

#### **Sale of assets to fund managers in their personal capacity**

The first insight obtained was from the Fund Managers of Fund N, who expressed a desire to the Fund’s Advisory Committee, to purchase the equity of a particular investee company from the fund during exit stage. According to Respondent #2, the Advisory Committee declined the proposed transaction by the Fund Managers, citing conflict of interest as the reason. However, Respondent #2 complimented the Fund Managers of Fund N on their openness relating to their disclosure of the proposed transaction to the Advisory Committee:

*“They were honest and open about wanting to have bought the portfolio investment in Fund I.”*

(Respondent #2, DFI)

#### **Sale of assets between funds managed by the same fund manager**

The second insight obtained was from Fund A, who claimed that as a Fund Manager, it is not in anybody’s interest to purchase as asset from the fund under management, citing:

*“If you sell for too high in Fund 1, you disadvantage LPs in Fund 2, and vice versa. I wouldn’t do it. If you’re a long-term fund manager, someone’s going to get upset and this could damage future ability to raise funds.”*

(Respondent #A1, Fund A)

### **Sale of assets by an institutional investor to the fund**

The third insight obtained was from Fund P, who went on to elaborate in detail as to how decisions were taken within the structures of the Fund, in order to deal with the proposed transaction:

*“When [one of the fund’s investors] took the decision to exit its own direct equity infrastructure portfolio, after serious deliberation, the fund decided to buy the [investor’s] portfolio from them. In this case then, the [Fund P] was the buyer, and [the investor] were the sellers, yet the [investor] was sitting on the [Fund P’s] decision-making committee. When it comes to that kind of situation, it’s a question of declaring as interest and recusing yourself.”*

(2011 Annual Report, Fund P)

### **Sale of an asset by the fund manager to its Holding Group**

The fund manager of Fund S failed to mention during its interview that a recent dispute had occurred between the fund manager and investors relating to the valuation of a particular investee company, in which the fund manager’s Holding Group had co-investment alongside:

*“The Group [that holds the majority of equity in the Fund Manager of Fund S] has co-invested alongside the fund. Upon exit [of the fund’s investments by the Fund Manager] the Group is proposing a price that is giving a lesser return [than our benchmark] to the fund. The investors disagree [with the proposal].”*

(Respondent #3, DFI)

This insight was obtained during the interview with Respondent #3 from the DFI, in which the respondent explained that the Holding Group was putting pressure on the managing members of the fund (who are also employees of the Holding Group) to push down the valuation of a specific portfolio investment. The reason for this was so that the holding group would be able to buy out the remaining shares in the company at a discount. The respondent explained that the financial implications of this action would adversely affect the returns to the fund, disadvantaging investors. According to the respondent, this situation (referred to as ‘moral

hazard' in agency theory) still remain unresolved and is awaiting further resolution by the Board of Trustees (as at the time of this research).

### 6.3.10 Fund manager wanting to extend the life of fund

The literature make reference to the extension of fund life as a lucrative proposition by fund managers given that management fees could still be earned during this period. Alternatively, a fund manager could request the extension of a fund's life in order to realise the upside on a particular investee company. According to Respondent #2 from the DFI, Fund N had a remaining investment at the end of fund life, and wanted to ride this investment in order to increase the carry potential that could be earned by both investor and fund manager. The DFI was cautious of the decision to extend the life of the fund unless a cost benefit analysis proved that it was feasible to do so:

*The fund manager was for extending Fund I, but the Trustees declined [the request]. By this time, Fund II was already in place. I'm sure we signed up for Fund II [as well] because Fund I did so well."*

(Respondent #2, DFI)

Respondent #4 from the DFI explained how one of its other fund (not part of the research sample, and exhibiting poor investment performance), attempted to extend the life of the Fund. According to the respondent, the DFI was even less satisfied with the Fund Manager's attitude:

*"When [the DFI] said "yes" to [the fund], it was the right thing to do politically. If [the fund] were to raise a second fund, we would say "no". I mean this guy [the Key Person of the fund] pitches up [at the DFI] and gives a report by 'word of mouth'. I mean that's arrogant!"*

(Respondent #4, DFI)

### 6.3.11 Departure of Key Persons from the fund manager

Respondent #2 of the DFI explained how important Key Persons are when investing in private equity as an asset class, and to what extent it poses a risk from an agency perspective if a Key Person event were to be triggered as per the partnership agreement:

*"[Keymen in a fund are] very important [for investors]. For example, two guys at [Fund N] are keymen. If any of these two left [Fund N], [then] that would trigger a keyman event... People will invest with certain GPs because they know they trust certain behaviours, track record, [and] reputation."*

*It's for these things, and to protect our investment. So if you go, I want out as well, or to salvage what I can!"*

**(Respondent #2, DFI)**

Investors also need assurance that there is a succession plan in place for new Key Persons, should the existing member resign from the fund. For example, in another fund not part of the research sample, there is only one Key Person in the fund, who is a retired private equity executive, with no successor in place. To add to the magnitude of this agency problem, the Fund Manager is also requesting an extension to the fund's life in order to capture value in the underlying investee companies, prior to exit. The DFI is only willing to consider this proposal on the basis that no further management fees are paid during the extension period, and that the only compensation for the fund manager going forward, will be any carry interest realised upon harvest. At the time of this research, no formal decision had been reached on this matter.

### **6.3.12 Investors and fund managers that co-invest alongside each other**

This agency issue results in a potential conflict of interest if an investor and the fund finds itself on opposite sides of an investee company's capital structure. Under these circumstances, the investor and fund manager may disagree as to how a recapitalisation of a struggling investee company is to be financed:

*"It could very easily happen that whilst pondering an equity-based transaction in, say, the power generation sector, the Fund Manager becomes aware that investors like the [an international DFI] or [an international insurance and asset management company] are looking at providing debt to the business. This in itself does not necessarily represent a position of conflict. But at a later stage, if a recapitalization of that business becomes necessary, because, for example, the business in question is not doing well, then there is potential for conflict based on disagreement between the debt holders and the equity holders as to who is responsible for providing the additional funds. In such a case, as always, the Fund Managers would want what is best for the fund, and would look to the Conflicts Committee for an amicable solution."*

**(2011 Annual Report, Fund P)**

Many of the sample funds chosen for the case studies have investors that are either direct lenders or direct providers of equity finance, and in many instances, such investors would co-invested alongside the fund. However, Fund P is unique when compared with other funds in

the sample in that they have established a Conflicts Committee as an extension of the Board to recommend (not approve) to the Board resolutions to conflicts. According to the Fund Manager, it becomes easier if the potential conflict areas are identified upfront, and the risk of that conflict periodically monitored and reviewed.

## **6.4 Research question 4: What are the typical governance mechanisms in funds, and how do these reduce agency conflicts?**

### **6.4.1 Typical governance structures within funds**

During the interviews with the six case study funds, various governance structures were identified and investigated in order to better understand more about the composition, but also how effective decisions are made within the fund's operational structures. Four decision-making committees were identified for the purposes of further discussion. These were:

- Investment committee (IC)
- Limited Partners Advisory Board (LPAC) (or 'Board of Trustees' for a 'Trust' legal structure)
- Conflicts Committee
- Audit & Risk Committee

Fund P was found to have a Conflicts Committee (CC) and an Audit and Risk Committee, two governance structures not commonly associated with funds in the private equity literature.

Following is a discussion of each governance structure in the context of the DFI and the six funds studied, as well as how these structures function to reduce agency conflicts between investors and fund managers.

### **6.4.2 Investment Committee (IC)**

#### **6.4.2.1 Structure**

The Investment Committee is established as a sub-committee of the board of directors of the General Partner (limited partnership fund), or the board of Trustees (trust fund). The Investment Committee is a vital governance structure used in private equity in order to make investment recommendations to either the General Partner or the Board of Trustees, who are

the ultimate decision makers within the operational structures of funds. In the case of Fund N (limited partnership):

*“The General Partner will establish an investment committee as a sub-committee of the board of directors of the General Partner (the “Investment Committee”), which will consider investment and divestment proposals and make recommendations to the General Partner thereon. All investment and disinvestment decisions of the Fund will be made by the General Partner.”*

**(Partnership Agreement, Fund N)**

Fund P (a fund with a Trust structure) explained that the recommendation made by its Investment Committee is not binding:

*“The IC is the investment arm of the Board, with its mandate stipulated in terms of the Trust Deed. The Trust Deed provides that the Board is not empowered to take any investment decisions without having received a recommendation from the IC in that regard. However, the Board is not obliged to follow any such recommendations.”*

**(2011 Annual Report, Fund P)**

All of the six funds studied were found to have a formal IC structure in place. A summary of the IC’s representation is shown in Table 24:

Fund name	Size of fund	Structure	Fund manager representative	Investor representative	Independent representative	Total
Fund P	US\$ 630m	Trust	1	6	2	9
Fund N	US\$ 568.56m	LP	3	0	2	5
Fund V	ZAR 1847.40m	LP	2	0	2	4
Fund T	ZAR 600m	LP	5	1	2	8
Fund S	ZAR 303m	Trust	3	4	1	8
Fund A	US\$ 151m	LP	3	0	1	4

**Table 24: Investment Committee representation**

Given that Fund T is a Limited Partnership, the fund manager’s ability to exercise investment decision-making that is independent from investors is questionable given that the CEO of one of its investors are represented on the IC:

*“Some don’t deem [the CEO of one of our investors as] independent, but we do.”*

**(Respondent #T1, Fund T)**

In all six funds studied, representatives serving on the IC are generally senior and experienced investment professionals in the industry. Some independent members are compensated for their services rendered to the investment committee while others do not receive any form of

compensation. The fund manager of Fund A conceded that its independent appointee earns a “small fee”, and does it “for the love of Africa”.

The frequency of times that the IC meet per annum vary across the funds studied, and is shown in Table 25.

Fund name	Frequency of meeting	Source
Fund P	6 times annually (during 2011)	(2001 Annual Report, Fund P)
Fund N	At least four times annually	(Respondent #N1, Fund N)
Fund V	At least twice annually	(Respondent #V1, Fund V)
Fund T	On an ad hoc basis	(Respondent #T1, Fund T)
Fund S	On an ad hoc basis	(Respondent #S1, Fund S)
Fund A	At least twelve times annually	(Respondent #A1, Fund A)

**Table 25: Investment Committee meeting frequency**

The terms of chairperson differs across funds. In the case of Fund P (Trust fund), the Chairperson is appointed by the Board of Trustees out of a recommendation received from the Investment Committee. In this case, the Chairperson appointed is from one of Fund P’s investors, and also a serving trustee on the board of trustees. Alternatively, for Fund N (limited partnership), the partnership agreement stipulates that the IC has to be chaired by an independent IC representative. In addition, fund N’s partnership agreement stipulates the composition of the Investment Committee to include Key Persons and maintain a degree of specialisation through the appointment of mining expertise from the industry:

*“The members of the Investment Committee will consist of all the Key Persons, as well as two independent members who have appropriate expertise in the mining sector.”*

**(Partnership Agreement, Fund N)**

#### **6.4.2.2 Decision-making**

The order of importance given by the funds to a range of investment criteria is shown in Table 26. Overall, the funds rank ‘investment returns’ as the most important investment criteria influencing decision-making within the investment committee, followed by ‘compatibility with the fund’s risk appetite, and ‘compatibility with the fund’s investment strategy’, both sharing equal importance. Respondent #N1 representing Fund N declined to rank the decision making criteria deployed by its investment committee, stating that ‘potential for growth within the remaining lifespan of the fund’, investment returns’, and ‘development impact’ were all “very important” for the fund. Respondent #A1 representing Fund A, who also declined to rank the decision making criteria, stated that “all go hand-in-hand”.

Decision making criteria (ranking 1-5)					
<i>Compatibility with the fund's risk appetite (average across funds = 2.25)</i>					
Fund P: 1	Fund S: 3	Fund V: 2	Fund A: --	Fund N: --	Fund T: 3
<i>Compatibility with the fund's investment strategy (average = 2.25)</i>					
Fund P: 4	Fund S: 2	Fund V: 1	Fund A: --	Fund N: --	Fund T: 2
<i>Potential for growth within the remaining lifespan of the fund (average = 3.75)</i>					
Fund P: 3	Fund S: 4	Fund V: 3	Fund A: --	Fund N: --	Fund T: 5
<i>Investment returns (average = 1.75)</i>					
Fund P: 2	Fund S: 1	Fund V: 3	Fund A: --	Fund N: --	Fund T: 1
<i>Development impact (average = 4.60)</i>					
Fund P: 5	Fund S: 5	Fund V: 4	Fund A: --	Fund N: 5	Fund T: 4

**Table 26: Decision making criteria**

When comparing the role of the Investment Committee in a trust fund structure studied versus a limited partnership structure, there are striking differences in the way investment decisions are made. In a trust fund, one observes that investment recommendations made by the Investment Committee are not binding until approved by the Board of Trustees. Conversely the Partnership Agreement of Fund V explain the independence of decision-making, in that it is all investment decision made by its Investment Committee governance structure are binding:

*“The Advisory Board will not have any power to approve or disapprove of Portfolio Investments or to manage the Partnership or any Portfolio Investments. The decision to make Portfolio Investments rests solely with the General Partner, which may take into account the advice given by the Advisory Board in making such decision.”*

**(Partnership Agreement, Fund V)**

The partnership agreement of Fund N in case explains how decisions are made by its investment committee:

*“A quorum of the Investment Committee shall be all of its members present in person or participating by electronic means or by proxy... The Investment Committee will make decisions by 75% or more in number of the members of the Investment Commitment members attending the meeting in question. Any resolution of the Investment Committee signed by 75% or more in number of the members shall be valid and effective as if it had been adopted by a duly convened meeting of the Investment Committee.”*

**(Partnership Agreement, Fund N)**

All of the funds stated that meeting minutes are either distributed to investors, or available upon request by the investors. However, Fund T was an anomaly in this regard, who when asked whether or not meeting minutes were distributed to investors, cited:

*“No! Because they’re not entitled to it! We won’t distribute IC documentation. It’s our IP (intellectual property)”*

**(Respondent #T1, Fund T)**

#### **6.4.2.3 Concluding remarks on Investment Committee**

The Investment committee typically comprise of members from the General Partner, as well as independent investment professionals from industry who are paid fees by the fund to provide independent expertise to the investment process. In the case of Trusts, the Investment Committee may also be represented by Investors in the fund. Recommendations by the Investment Committee are taken unanimously, in the case of a Trust fund, the Board of Trustees reserves the right to ‘approve’ or ‘decline’ any transactions recommended by the Investment Committee. Conversely, in the case of a Limited Partnership fund, the investment decisions made by the Investment Committee are binding on the fund.

The Investment Committee is a governance structure in private equity that plays a critical role in originating new assets for the fund. The representation of independent investment professional (and in the case of Fund N, the appointment of an independent professional as Chairperson of the Investment Committee) ensures that the fund is able to maintain independence, reducing potential conflicts of interests, reassuring investors from an agency perspective. In the case of a Trust in which the Board of Trustees are required to make the final decision to invest based on a recommendation by the Investment Committee, there is the downside of having to deal with more red tape in getting investments through. Finally, the role played by the investment Committee is central to the overall investment process, in that it supports the segregation of duties from those who identify and structure investment opportunities, to those who make investment recommendations, and ultimately from the General Partners or Board of Trustees who give final approval on investments.

### 6.4.3 Conflicts Committee

#### 6.4.3.1 Structure

Of the six cases studied, Fund P was the only fund to have what it calls a Conflicts Committee. The Conflicts Committee is represented by four of the Fund's trustees. The committee met four times during the 2011 financial year. The fund manager explains the rationale for the Board of Trustees constituting a dedicated committee tasked with dealing in resolving conflicts of interests:

*"...the great majority of investors in the fund are also invested in Africa through other financial vehicles, either their own, or through alternate or additional partnerships or subsidiaries. This raises the question of conflict of interest and how to deal with it."*

**(2011 Annual Report, Fund P)**

From an agency perspective, the role played by this committee is important in understanding how specific conflicts of interests are reduced by the fund, as well as the assurance the process gives to existing but also potentially new investors. Usually, the resolutions of conflicts are part of the functions executed by the Advisory Board of a fund. But in the case of Fund P, the Conflicts Committee is established as an extension of the Board of Trustees tasked with resolving conflicts as and when they arise in the fund:

*"The CC [Conflicts Committee] is the conflict resolution arm of the Board. All determinations made by the CC are recommendations subject to the approval of the Board. However, the Board is not obliged to follow the relevant recommendation."*

**(2011 Annual Report, Fund P)**

#### 6.4.3.2 Decision-making

The committee advises and makes recommendations to the Investment Committee and Board of Trustees who is responsible for implementation. Hence the Conflicts Committee plays an advisory role to the Investment Committee and Board of Trustees. Potential conflicts of interest are raised via a "declaration of interest register", which is made available within various governance structure (Investment Committee and Board of Trustees) of the fund. According to the fund manager, should a conflict of interest arise within the structures of the Investment Committee or the Board of Trustees that the fund is not aware of, the responsibility is upon the respective individuals to declare these. When a conflict of interest is

declared by a particular member of the Investment Committee or the Board of Trustees, they recuse themselves from further decision-making. The Board of Trustees appoints the Chairperson of the CC upon recommendation of the CC, who happens to be the Chief Investment Officer of the Fund Manager.

In its 2011 Annual Report, Fund P makes reference to several situations that explains how the Conflicts Committee is able to serve as an effective governance mechanism in reducing conflict of interests from an agency perspective:

*“It is the role of the Conflicts Committee to ensure that areas of potential conflict of interest are identified proactively. When such conflicts are brought to its attention, the Conflicts Committee knows how to deal with them and recommends appropriate action. This could take the form of recusal; declaration of conflict, or other measures, though never in such a way as to be counterproductive.”*

**(2011 Annual Report, Fund P)**

To understand how the Conflicts Committee have been effective in reducing conflicts of interests and hence agency conflicts between investors and the fund manager, two examples explain this result. The first example points to a declaration of interest declared by an investor sitting on the Conflicts Committee, resulting in the individual recusing himself from further decision making:

*“When [one of the fund’s investors] took the decision to exit its own direct equity infrastructure portfolio, after serious deliberation, the fund decided to buy the [investor’s] portfolio from them. In this case then, the [Fund P] was the buyer, and [the investor] were the sellers, yet the [investor] was sitting on the [Fund P’s] decision-making committee. When it comes to that kind of situation, it’s a question of declaring as interest and recusing yourself.”*

**(2011 Annual Report, Fund P)**

The second example points to a declaration of interest made by an investor who was a debt-provider to the same project in which the fund was an equity provider. In this instance, there was no need for the investor to recuse himself from the discussion, but instead, the investor was in a position to contribute constructively to the overall discussion once the interest was openly disclosed:

*“...there have been transactions where [one of the fund’s investors] were the debt-providers and the [fund] were the equity-providers, and the bank had a lot of knowledge about the deal; knowledge that could add value to the outcome. In such a case, it is likely that although the bank is honour-bound to*

*declare an interest, it need not necessarily recuse itself from the ensuing debate, but should, instead, participate, and so contribute the value that it is capable of adding.”*

**(2011 Annual Report, Fund P)**

### **6.4.3.3 Concluding remarks on Conflicts Committee**

The Conflicts Committee is a formal structure used by Fund P, an extension of the Board of Trustees, mandated to proactively be on the look-out for conflicts of interests, and to decide on how best to deal with interests declared within various structures of the fund. The Conflicts Committee makes recommendations to the Investment Committee and the Board of Trustees, who then become responsible for the implementation thereof. However, the Investment Committee and the Board of Trustees are not obliged to accept the recommendations made.

From an agency perspective, the Conflicts Committee ensures the formalised and proactive disclosure of conflicts of interests, increasing the levels of disclosure and transparency for overall governance within the fund. Given that the Fund Manager of Fund P manages a US\$ 630m fund, and its intention is to in future increase the quantum and size of funds under management, the establishment of governance mechanisms such as a Conflicts Committee is indicative of the level of disclosure and transparency governance mechanisms that the fund manager is striving toward.

### **6.4.4 Limited Partnership Advisory Committee**

#### **6.4.4.1 Structure**

The role of the Advisory Committee is best described as:

*“...not to directly govern, nor to audit, but to provide a sounding board for guidance to the GP [General Partner] and a voice for LPs when appropriate”*

**(ILPA, 2011)**

As with any other committee constituted within typical private equity funds, one would expect there to be different constituencies of the Advisory Committee across funds, given that every circumstance would not be the same. The case of Fund N is used to outline the typical governance structure of an Advisory Committee, together with key functions as described in the Partnership Agreement.

The particular fund comprises of two Parallel Entities, with six investors in its Mauritius partnership and three investors in its SA partnership. The DFI in this study holds 79.20% of the equity in the SA partnership fund. Each investor holding at least 15% of the total fund's capital commitments is allowed to appoint a representative to serve on the Advisory Committee (not less than three and not more than 7 in the case of Fund N).

The Advisory Board is expected to meet not less than two times per calendar year. Each partnership will have its own single Advisory Committee. Each single Advisory Committee decides on its own Chairperson, and the Chairperson does not have a casting vote. However, there is also a combined Advisory Committee at the fund level which comprises of representatives from each single Advisory Committee (with total representatives for the combined Advisory Committee not exceeding ten). The Chairperson of the combined Advisory Committee is elected by the single Advisory Board of whichever partnership (SA or Mauritius) has the higher of capital commitments.

A quorum for the Advisory Committee is 75% in number of its representative members. Decisions taken by the Advisory Committees are made by majority vote, based on the number of representatives present at the meeting where the decision is made. The provision of information by the General Partner to the Advisory Committees is important if the respective Advisory Committees are to properly discharge its duties and make decisions pertaining to the fund. Conflicts of interests are reviewed and voted upon only by the Advisory Committee of the relevant partnership and no decisions are taken at the combined Advisory Committee level.

The role of the Advisory Committee, according to the partnership agreement, is quoted:

*“...to review from time to time the Fund's adherence to the Good Governance Standards...to review from time to time the Fund's adherence to its Investment Objectives and Investment Guidelines, to provide clarification of such Investment Objectives and Investment Guidelines in the case of ambiguity or uncertainty...to approve on a case by case basis any deviation from or waiver to the Investment Guidelines...to approve any changes of the auditors...to notify the General Partner of a breach of its duties under the Agreement...to approve the establishment of any Parallel Entity (other than the Mauritius Fund)...to approve any changes to the Investment Percentages in the event of fluctuations in the Rand/USD exchange rate upon the request of the General Partner...to approve valuations of Investments...to review Operating Expenses...to review payments of the GP Profit Return...to*

*approve break costs...to review, on an annual basis, the policy for the allocation of the GP Profit Return amongst the Key Persons... to resolve conflicts of interest between the Fund and the General Partner (and its Associates)...to approve any transaction...*

**(Partnership Agreement, Fund N)**

According to Respondent #1 from the DFI, the bigger the size of commitments made to private equity funds, the more senior level the representative is, that the DFI seconds to serve on the Advisory Board:

*"[It] depends on the size of fund. Very senior [members of our staff are allocated to the Advisory Boards] for big commitments."*

**(Respondent #1, DFI)**

This method of nominating and appointing senior executives to serve on Advisory Committees by the DFI is problematic according to a Portfolio Analyst who complained about the lack of feedback provided by senior executives who attend the Advisory Board meetings within funds:

*"Sometimes [there is] the executive who attends the Advisory Board meeting, but don't report back to us Portfolio Managers. But this is our system [internal process] issue."*

**(Respondent #2, DFI)**

According to the respondent, there is an information gap between senior executives who attend the Advisory Board meetings and the portfolio managers and analysts who manage the operational relationship with the Fund Manager. The frustration shown by the respondent during his response can be attributed to the informational gap, but also the vulnerability that this risk poses to continuity and coherence in the management of the overall relationship.

#### **6.4.4.2 Decision-making**

The Advisory Board would be required to make decisions on strategic issues impacting the fund. In understanding how decisions are made, it is necessary to understand how resolutions are adopted, and how members of the Advisory Board mobilise support from other investors should they wish to pursue a specific agenda.

To understand a case in how decisions are made on strategic issues impacting the fund, evidence is referenced from Respondent #1 of the DFI when asked to explain how authority

would be granted in a hypothetical case to a General Partner who intended on selling his partnership interest in the fund:

*“[The matter is] discussed at the Advisory Board. But then the Advisory Board will have to present the request to the institutions whom [that] they are representing. Once institutions agree to that, then the Advisory Board will adopt a resolution to approve the change.”*

**(Respondent #1, DFI)**

To understand a case in how support is mobilised from other investors, a quotation is referenced from Respondent #2 of the DFI in order to better understand co-operation and co-investment dynamics among three prominent investors in the local private equity industry – the DFI being studied; the IDC, and Eskom Pension Fund.

*“Usually we would go in with another DFI. We typically want the comfort of an IDC, Eskom [Pension Fund], [and] PIC...Because if PIC hears that [the DFI in question] made a commitment, this gives them comfort.”*

**(Respondent #1, DFI)**

And finally an example is given on how this manifested in practice. Respondent #1 of the DFI told of Fund V having had a high turnover of Black investment professionals up until the time of this study. The DFI became concerned about the fund’s ability to meet empowerment objectives. Eventually the DFI started to put pressure on the fund manager to employ Key Persons in order to obtain a more balanced team. According to Respondent #2, the fund manager was not willing to compromise on this request, and that they eventually had to mobilise the support of PIC and the Eskom Pension Fund to vote in favour of the proposed resolution.

#### **6.4.4.3 Concluding remarks on the Limited Partnership Advisory Committee**

Based on the cases studied, the Advisory Board was shown to be an effective governance mechanism that can reduce agency conflicts. The Advisory Board does this in various ways. For instance, members of the Advisory Board are able to bring back to their institutions the particular conflicts of interest that are prevalent in a fund, and consequently vote toward a resolution in a way that is reflective of how their respective institution views a particular matter relating to governance.

However there are also the downside risks. For instance there could be informational asymmetry resulting from appointing different people who serve on the Advisory Board, and those who may be involved in the day to day management of the portfolio. As Respondent #1 of the DFI conceded, senior executives who serve on the Advisory Board may not always provide adequate feedback to Portfolio Managers as and when needed. In addition, the functions of a typical Advisory Board as shown in the case of Fund N are too broad, which could result in dilution of its efficacy, jeopardising critical monitoring oversight, particularly those relating to conflicts of interests and overall risk management the fund.

## 6.4.5 Audit and Risk Committee

### 6.4.5.1 Structure

Of the six cases studied, Fund P was the only fund to have an Audit and Risk Committee. The Audit and Risk Committee is a sub-committee of the Board of Trustees of Fund P, and is considered the audit, risk, and compliance arm of the Board of Trustees. The Audit and Risk Committee has specific functions pertaining to the fund relating to the financial, strategic and operational risks of the fund. The governance structure also makes decisions around the allocation of expenses and endorses valuations put forth by the Fund Manager. All determinations made by the Audit and Risk Committee are subject to the approval of the Board of Trustees, who is not obliged to follow these recommendations. Nominations for the Chairperson are recommended by the Audit and Risk Committee, and then appointed by the Board of Trustees.

The fund manager is committed to the establishment of sustainable structures which could be scaled to benefit its future business growth, in particular the raising and managing of additional funds for investing in Africa. The function of the Audit and Risk Committee are broadly split into a series of financial functions (financial statements, and internal and external audits), and risk functions (strategic risk, operational risk, valuation risk, and contractual risks).

The role of the Advisory Committee, according to the 2011 Annual Report of the fund manager, is quoted:

*“This function is overseen by the Fund’s Audit and Risk Committee, which has two main functions.*

*One is on the financial side...including internal and external audits, financial statements and everything associated with that. On the risk side, the committee is concerned with both strategic and*

*operational risk...to monitor the performance of both the manager and the management agreement.*

*[The fund manager] is a service provider and its services are subject to on-going scrutiny."*

**(2011 Annual Report, Fund P)**

From an agency perspective, the main function of the Audit and Risk Committee is essential to reducing agency conflicts that may arise in the area of asset valuations. Evidence in support of this is quoted:

*"The most important task, of the ARC is the valuation of the investments, accompanied by a realistic appraisal of the risks facing those investments. It is essential to make sure that those risks are properly addressed and mitigated through the investment process, and this includes a comprehensive assessment of the value of these investments on an annual basis."*

**(2011 Annual Report, Fund P)**

#### **6.4.5.2 Decision-making**

Apart from the structure and functions of the its functions, understanding the type of decisions taken by the Audit and Risk Committee and how these decision assist in reducing agency conflicts between investors and fund manager is important in order to validate agency theory predictions of the role played by governance mechanisms in reducing agency conflicts.

If we consider the allocation of expenses in private equity as a contentious issue, albeit that the treatment of expenses are covered at length in partnership agreements, there is always the risk that unrelated expenses are passed on to funds, which ultimately affects investor returns. And we know from the literature that partnership agreements are long winded and complex for many investors, diluting the monitoring capability of contractual terms for investors.

Evidence is given on how decisions taken by the Audit and Risks Committee regarding the allocation of expenses, and the endorsement of valuations performed by the fund manager. Firstly, the allocation of expenses is explained:

*"On the audit side, there is the question of the allocation of expenses. Often a decision has to be made as to whether an expense should be allocated to the Fund, or whether it is legitimately the manager's expense. Internal auditors are employed to ascertain this, and to provide the relevant comfort to the Audit and Risk Committee."*

**(2011 Annual Report, Fund P)**

Secondly, the endorsement of valuations is explained:

*“When the Fund Manager attaches a value to a pool of assets, it is the responsibility of the Audit and Risk Committee to endorse that valuation; to confirm that the right methodology has been employed; that approved conservative inputs and assumptions have been made, and that the numbers being attached to the asset are realistic.”*

(2011 Annual Report, Fund P)

#### **6.4.5.3 Concluding remarks on the Audit and Risk Committee**

In Limited Partnership funds studied, the Advisory Committee would typically take on these responsibilities performed by the Audit and Risk Committee in Fund P (that is a trust structure). However, given the size and future expansion aspirations of Fund P, the Fund Manager has decided to establish formalised governance structures dedicated to ring-fencing the management of certain functions of existing but also future funds under management.

While there is greater integrity of valuations when it is endorsed by the Audit and Risk Committee, the existing representation of the committee raises questions around the independence of the committee, a point of clarification not elaborated upon in the Fund’s 2011 Annual Report. Without an independent opinion on portfolio valuations, investors would still not be certain if whether portfolio valuations are free from conflicts of interest.

Given that the Fund Manager of Fund P manages a US\$ 630m fund, and its intention is to in future increase the quantum and size of funds under management, the establishment of governance mechanisms such as the Risk and Audit Committee could become a scalable function with limited future disruption to its overall business operations, as the number of funds, portfolio investments, and investors increases.

### **6.5 Research question 5: How is the alignment of interests created between institutional investors and fund managers?**

#### **6.5.1 Alignment of interests between Investor and Fund Manager**

From an agency perspective, there are three areas where alignment of interests can be created in typical agency relationships. These are incentive structures, contracting, and

monitoring. The literature on how best to align interests between Investor and Fund Managers in private equity is divided. On the one hand, there is a view that an investor's capital contribution at risk is the greatest incentive for creating the alignment of interests (ILPA, 2011). Alternatively, Baks and Benveniste (2010) point to contract structuring that closely monitors sources of misalignment within fee income (deal fees, monitoring fees, consulting fees, etc.) earned by Fund Managers, as well as an industry move toward de-emphasising management fees as a compensation channel in favour of higher carried interest.

### 6.5.2 Concluding remarks on alignment of interests between Investors and Fund Managers

The range of compensation options across the 6 case studies researched show a variety of fee structures manifesting in practice. The combined responses across the six case study funds are presented in Table 27.

Types of fees charged by GP	Mark (X)						Tot.
	FP	FS	FV	FA	FN	FT	
Fundraising fees charged to fund	X	X	X	X	X	X	6
Underwriting fees charged to investee company			X				1
Arranging fees charged to investee company			X			X	2
Consultancy fees charged to investee company				X			1
Directorship fees charged to investee company	X	X	X	X	X	X	6
Monitoring fees charged to investee company			X	X		X	3

FP = Fund P, FS= Fund S...

**Table 27: Fee summary**

In all the six case studies, Fund Managers stipulated that all fees charged were declared upfront with Investors during the Fund's formation. "Fundraising" fees raised by Fund Manager during the fundraising stage typically comprise of fees for 'out of pocket expenses' and recovered post-fundraising from the fund. 'Out of pocket expenses' could comprise of fees paid to legal firms, tax consulting firms, hotel, and travel costs.

Excluding 'fundraising' fees, a portion of all other fees raised by the Fund Manager from portfolio companies usually flow back into the fund to offset future management fees due. However, the six cases reveal striking differences in the portion of fees that are required to flow back into each fund, and the amount that Fund Managers are allowed to retain for their own gain.

- In the case of Fund P, fifty percent of all fees ('directorship' fees) raised on portfolio companies flow back into the fund, the remaining fifty percent being for the Fund Manager's gain:
- In the case of Fund S, one hundred percent of all directorship fees charged to portfolio companies are for the Fund Manager's gain. None of these flow back into the fund, as the Fund Manager explained:

*"Declared upfront – The only fees are management fees, carried fees, and director fees. No portion of Directors fees go back into the fund. We have an agreement that it can be used to cover expenses – Rent, travel and salaries."*

**(Respondent #S1, Fund S)**

- In the case of Fund V, all fees that are charged to portfolio companies have to go back into the fund. However, 'underwriting' and 'arranging' fees raised by an affiliate division of the Fund Manager flow directly to the affiliate division of the Fund Manager. As the Fund Manager explained:

*"We do have another division in the Group that does debt-raising. They don't have to push fees back into the fund. If the Capital Markets Division contracts with third parties for capital-raising then this must go to the Advisory Board given the potential conflict of interest."*

**(Respondent #V1, Fund V)**

- In the case of Fund A, 80% of all fees recovered from portfolio companies after cost, flows back into the fund, the remaining twenty percent going straight to the Fund Manager. The Fund Manager commented on the risk on cash flows, and the changing trend in the industry:

*"The fund manager can charge all kinds of fees – Advisory, monitoring, consulting. The market is moving away from 80-20%. Now, 100% [of all fees] go into [the] fund."*

*"Technically you can make extra money this way. But you're taking value away from investors by taking cash flow."*

**(Respondent #A1, Fund A)**

- In the case of Fund N, 'directorship' fees were the only fee component charged to portfolio companies by the Fund. However, in the case of Fund N, the Fund Manager

conceded that all ‘directorship’ fees earned from portfolio companies flowed into the fund:

*“We don’t charge consulting fees. All director fees charged are passed straight back to the investors.”*

**(Respondent #N1, Fund N)**

- In the case of Fund T, 80% of all fees recovered from portfolio companies after cost, flows back into the fund, the remaining twenty percent going straight to the Fund Manager. Furthermore, the fund manager explained that there was little attractiveness in charging ‘other fees’ to investee companies for services rendered, given that 80% of these fees would have to go back to the investors. There was also no incentive to charge such fees:

*“So [the benefit to the GP of charging fees] is marginal, [and the GP is] not incentivised to charge fees. I think it should be fifty-fifty between LP and GP.”*

**(Respondent #T1, Fund T)**

From the 6 case studies, only one fund (Fund N) claimed that all fees (‘directorship’ fees in this case) were returned to the fund. This was the second of funds under management by the Fund Manager and the DFI was also invested in its first fund. Fees earned by Fund Managers from portfolio companies should not be frowned upon, especially if these are stipulated in partnership agreements, declared to investors as and when they arise, and value is added to portfolio companies in the provision of the said services by the Fund Manager.

Agency theory predicts that ‘hidden information’, as a result of fees earned from portfolio companies that are not declared to Investors could lead to goal incongruence, in which the Fund Manager and affiliates are incentivised to siphon off cash flow indirectly from a Fund via its underlying portfolio investments, without detection from the governance and monitoring mechanisms used to safeguard Investors. This action would negatively impact the cash flows and thus the valuation of funds under management.

Clearly a fee structure (involving fees earned from portfolio companies) that is transparent, and disclosed to all Investors (via Advisory Boards), creates the best alignment of interests between Fund Manager and Investors. However, this was not the case with the cases studied, as there was no way the Investors would be able to detect these fees on the Fund’s quarterly financial statements given that the flows could be earned directly by Fund Managers or affiliates.

Of concern, is that some of the funds mentioned that there was no “incentive” to charge these ‘other’ fees and thus incur value-adding services to portfolio companies, given that up to eighty percent of fees earned are required to flow back into the Funds. While the research has unearthed these insights, it is still unclear how to best achieve alignment of interests with regards to the ‘other’ fees component.

Fund Managers were asked to rank the appeal of a range of options, should they were to become an outstanding fund manager capable of delivering superior returns in the market. The combined responses across the six case study funds are presented in Table 28.

Premium drivers	Importance ranking (1-3)						Av
	FP	FS	FV	FA	FN	FT	
Charge higher management fee %	2	2	--	--	--	--	2.00
Charge higher carried interest %	3	1	--	--	--	1	1.66
Increase size of subsequent funds raised	1	3	1	1	1	2	1.50

**Table 28: Premium driver summary**

The collective view of the six Fund Managers interviewed show that the most appealing variable to increase would be the size of subsequent funds that are raised, followed by charging a higher carried interest portion on funds that exceed the hurdle rate. Increasing the size of subsequent funds raised would imply that the quantum of management fees would also rise (assuming the management fee % remained the same). According to agency theory, the majority of the Fund Managers favour a “subjective control system’ in which the “efforts” and “skills” of Fund Managers are rewarded, regardless of the performance outcome of the fund under management (Kren and Tyson, 2009). Hence the collective view of the six case study Fund Managers validate the prediction of subjective control system of Agency Theory.

Respondents from the DFI were asked to rate the effectiveness of levers commonly used in the industry to create alignment of interests. The results of these are shown in Table 29.

DFI preferences	Importance ranking (1-4)				Av
	R #1	R #2	R #3	R #4	
Management fees	--	--	4	2	3.00
Carried interest	--	2	3	3	2.66
Clawback provision	--	--	1	4	2.50
Capital contribution	--	1	2	1	1.33

**Table 29: DFI preferences**

The collective view of the respondents from the DFI revealed that most of them were in favour of ‘capital contribution’ as being the most effective in element for creating the alignment of

interest. This result did not come as a surprise, given that many of the DFI's funds are run by first time Fund Managers, who normally battle to raise equity funding of their own. Given that these Fund Managers often find it hard to raise the capital contribution required by Investors during fundraising, in the event that they were able to raise the funds, this would increase the Fund Manager's "skin in the game".

The Fund Managers were asked for their view on improving the alignment of interests between Investors and Fund Manager. The combined responses across the six case studies are presented in Table 30.

Structure	Management fee %	Carry interest %	Monitoring	Capital contribution %
Decrease			P,N (2)	
Keep the same	P,S,V,A,N,T (6)	P,V,A,N (4)	S,V,A,T (4)	A (1)
Increase		S,T (2)		P,S,V,N,T (5)
Total responses	6 funds	6 funds	6 funds	6 funds

**Table 30: Alignment of interests summary**

Most of the Fund Managers responding on behalf of the six funds were in favour of increasing the 'capital contribution' in order to create better alignment of interests between Investors and Fund Managers. This finding is aligned to the majority view shared by the DFI respondents who rated 'capital contribution' as being the best means of creating alignment of interests between Investors and Fund Managers.

# Chapter 7: Conclusion

*The purpose of this chapter is to highlight the key findings obtained in this research. The research findings are integrated into a single framework, summarising the exploratory research insights gained across the study. Recommendations are made to the affected stakeholders based directly upon the research findings. And finally, recommendations are given to future research and managerial implications.*

## 7.1 Pulling it all together

In this research project, the agency relationship between Investors and Fund Managers were explored. Six case studies were conducted on six private equity funds belonging to the investment portfolio of an international DFI operating in South Africa. Data was triangulated from a variety of sources in support of the research questions: structured questionnaires; partnership agreements; annual reports; portfolio monitoring report; and strategy documents.

Agency theory provided the emergent themes that provided the focus areas governing the exploration process of the relationship between Investor and Fund Manager. The themes focussed on were – agency conflicts; selection criteria; alignment of interests; and governance mechanisms. The structured questionnaire was developed along key themes and assumptions established from an examination of agency theory in the literature. The results of the findings were presented along the agency themes used to structure the study, and the findings were discussed in the context of the research questions formulated for this study.

The finding in this research is by no means representative of the industry, and cannot be extrapolated at large to the general population of Investor and Fund Managers. Nevertheless the findings provide depth and rich insight into how the chosen six private equity funds and the DFI investor view certain aspects of their mutual relationship from an agency theory perspective.

Based on the exploratory findings of the research, a number of Agency Theory assumptions were validated. That is, the selection process within the relationship between Investor and Fund Manager is reciprocal, and that its application depends on factors such as demand-supply dynamics in the market, which includes both capital as well as the prevalence of quality Fund managers from which to choose. Governance mechanisms can reduce agency conflicts, provided that the decision-making committees established have a clear mandate, meetings are

formalised, and there is a fair degree of independent representation. With regards to the alignment of interests, based on collective responses from six case studies, Fund Managers want the best of both worlds in that they lean more in favour of a ‘subjective control system’ (which implies greater management fees), while at the same time some desire less monitoring from Investors. Hence the Fund Managers view of how best to align interests proved paradoxical from an Agency Theory perspective. Perhaps a further study with more statistical rigor is required in order to further test the merits of this prediction.

## **7.2 Recommendation to stakeholders based on research findings**

While Agency Theory is complex, and refers to many aspects that govern the relationship between Principal and Agent, it’s easy to reduce the theory to information as the commodity which ultimately supports all other assumptions of the theory. Information is valuable commodity in private equity, and at the heart of Agency Theory. For if information was perfect, then there would be no opportunity for agency issues to manifest from *adverse selection* and *goal divergence*. The six case studies revealed some interesting insights from an informational perspective, with managerial implications.

The DFI could work toward fixing any communication gaps prevalent between senior executives who serve on Advisory Boards and Portfolio Managers who monitor the day to day relationship with Fund Manager. The DFI should shift focus away from paper-pushing reporting, and spend more time on scrutinising adherence of its Funds to actual contractual arrangements and governance compliance. Portfolio Managers within the DFI could better familiarise themselves with the contractual aspects of the relationship, and seeking to better understand partnership covenants, and trying to understand where loopholes can be exploited. A better attempt should be made at understand the quantum of value that is being taken from portfolio companies by Fund Manager affiliate companies, and the potential impact this may have on fund cash flows and potential valuation. Hence, asking to know when the frequency and timing of fees may go a long way to understand the real motivations behind these. At an a portfolio level, the DFI should develop a bird-view of the variation in partnership covenants across contracts, in order to better understand the actual motivations behind these, and whether they are directly responsible for Fund Manager actions. The DFI

should try to model the right balance between funds requiring a direct-involvement model versus a hands-off model, given the implication on agency costs arising from being more directly involved with operations of the Fund. Similarly, the right balance between first time funds and commercial funds should be ascertained in order to offset some of the mandatory agency costs (like mentorship of first time fund managers, and time spent attending Investment Committee meetings.) that the DFI incurs.

For Fund Managers, the list is shorter though not any less important. Fund Manager's should implement lasting governance structures that could easily be scaled for more funds as its business prospers. They should attempt to upward manage Investors in the Fund, and ensure that all value-added services provided to investee companies are communicated to Investors, whether for fees or not. And finally, as the demand-supply dynamics of the market changes and more Investors and capital come to market, successful Fund Managers will have more choice to avoid those investors who are onerous and increase agency cost.

### **7.3 Recommendations for future research and the managerial implications thereof**

The motivation behind the exploratory research undertaken is to inform and encourage valuable areas for future study. This study is based on six case studies in a DFI context. While the predictions of agency hold for this particular study, the results cannot be extended to other institutional settings. The study could be replicated for a commercial bank, insurance company, or any other investor community in order to determine the validity of Agency predictions.

The sample size of the study could be increased substantially in order develop more representative findings to a more heterogeneous Investor community. Similarly, studies could determine if there are similarities among investor groupings. Other studies could attempt to determine if there is causality between agency conflicts and performance. Studies could also investigate causality between governance and performance in private equity funds. Another interesting area to consider would be to conduct research into the determinant variables of agency costs, with the aim of establishing a model for quantifying agency costs arising from the total economic perspective, which includes opportunity costs. Last but not least, future research could attempt to answer the open question left from this study: How to develop

effective mechanisms to reduce the agency conflicts resulting from *moral hazard* that cannot be easily contracted away.

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# Appendices

## Appendix 1: General partner: Informed consent letter

I want to thank you for agreeing to volunteer your valuable time to my research project that I am doing as part of my MBA. I am conducting research into agency relationships between institutional investors and fund managers in private equity. Our interview is expected to last about 2 hours, and will help us better understand how agency relationships manifest in private equity. Your participation is voluntary and you can withdraw at any time without penalty. All data will be kept confidential, and under no circumstances will the names of interviewees be published or revealed to an external party. If you have any concerns, please contact me. My details are provided below:

**Researcher name:** Geshie Naidoo

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**Phone:** +27 83 680 4625

**Signature of participant:**

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**Signature of researcher:**

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## GP questions

### Section 1: GP's INVESTMENT STRATEGY

#### GP's business strategy

- (1) What is your strategy:

Elements of PE strategy	Description
Fund preference (VC, development, buyout)	
Number of funds	
Sectors	
Investment geography	
Domicile geography	
Direct/indirect emerging market exposure	
Target business life-stage (early, growth, mature)	
Exit strategy (IPO, secondary market)	

- (2) In the long term, do you still see yourself as a fund manager or more of an investment holding company?
- (3) In the long term, do you see yourself undertaking a public listing after establishing a track record?

#### Investment thesis

- (1) Who decides on:

Decision making area	Responsibility
Investment criteria	
Portfolio investments	

Decision making area	Responsibility
Exit criteria	

- (2) Do you think that the LPAC should assist in generating deal flow leads for you?
- (3) What specific services and value add do you offer to investee companies?
- (4) Does your investment strategy resonate with the distribution and exit horizon expectations of LPs?
- (5) How would you rank the concentration of your value-add across your investment portfolio?

Premium drivers	Rank (1-3)
Financial engineering: making capital structure more efficient through lower capital costs	
Governance engineering: improve monitoring and performance incentives for managers	
Operational engineering: improving operations, working capital, marketing, and product mix	

## Section 2: GP's SELECTION CRITERIA

### Selection criteria

- (1) How are decisions made regarding the selection of LPs for a new fund:

Selection criteria	Rank (1-6)
LP reputation	
Track record	
Financial position	
Corporate governance	
Company brand	
Personal relationship	

- (2) How do you solicit interest from prospective LPs for new fund raising efforts?
- (3) How would you rank the value expected from your LPs across the following areas:

Value contribution		Rank (NONE, LOW, SOME, HIGH)
Financial:	Capital	
Governance:	Structures	
Operational:	Network for deal flow	
	Network for other LPs	
Reputational:	Brand status	
Other:	Learning curve	

- (6) Are you receiving this value?
- (7) What information do you obtain about prospective LPs during your due diligence process?
- (8) Is there a potential for deficient information from LPs that might lead to adverse selection?
- (9) Do you believe that LPs are attracted to funds that already have other strong LP anchors?
- (10) Will you trade-off a reputable LP for less monitoring oversight?
- (11) Do you believe there to be a link between reputable LPs and more stringent governance requirements?

### Section 3: ALIGNMENT OF INTERESTS

#### GP compensation

- (1) Can the quantum of consulting fees charged be greater than the management fee for any given year?
- (2) If you were a superior fund manager, how would you rank the attractiveness of the following options:

Premium drivers	Rank (1-8)
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Premium drivers	Rank (1-8)
Charge higher management fees	
Charge higher carried interest	
Increase the size of subsequent funds raised	
Charge higher consulting fees to investee companies	
Less monitoring oversight from LPs	
Autonomy to increase the life of fund up to a capped duration	
Autonomy on dealing with conflicts of interests between funds	
Autonomy to increase the capital contribution on existing fund	

- (3) Are all fee related income disclosed when they are incurred, or simply agreed upfront with investors?
- (4) Which do you believe to be better structure for improving alignment of interests:

Structure	Management fee	Carry interest	Monitoring	Capital contribution
Decrease				
Keep the same				
Increase				

- (5) How do you decide on the total fee structure with LPs?
- (6) What is your current fee structure comprised of:

Types of fees charged by GP	Mark (X)
Fundraising fees charged to fund	
Underwriting fees charged to investee company	
Arranging fees charged to investee company	

Types of fees charged by GP	Mark (X)
Consultancy fees charged to investee company	
Directorship fees charged to investee company	
Monitoring fees charged to investee company	

(7) Does your management fee, carry fee, and risk expectations vary across LPs?

### Partnership covenants

- (1) Do you negotiate different partnership covenants across LPs?
- (2) What terms typically differ between LPs:

Terms	Mark (X)
Fees	
Distributions	
Clawback	
Reporting	

- (3) Explain if you would you be willing to trade-off covenants for better fee structures with LPs?
- (4) How will you remedy the following breaches in the event of occurrence:

Terms	Remedy
LP not honouring the confidentiality of information	
LP failing to honour capital calls within contractual time frames	

- (5) Who has authority to grant LPs the right to sell their partnership interest in the secondary market?
- (6) Please comment on the existence and level of importance of the following covenant classes:

Partnership covenants to mitigate against agency risks	Mark (X)	Rank (HIGH, MEDIUM, LOW)
Single company investment limits		
Limits of gearing and use of debt		
Restrictions on co-investment with other funds		
Rules about the reinvestment of profits		
Limits on personal investments by GPs		
Restrictions on partnership interest sale by GPs		
Restrictions on additional fundraising ability		
Restrictions on GP's outside activities		
Rules for the inclusion of other GPs		
Limits on investments in other assets		
Remedy for LP default on capital calls		
Restrictions on partnership interest sale by LPs		
Rules for frequency and content of reporting by GP		

**Asset valuation**

(1) Which valuation methodology do you use:

Valuation methodology	Mark (X)	Comment
Price of recent investment		
Multiples		
Net assets		
Discounted cash flows or earnings of the underlying business		
Discounted cash flows from the investment		

- (2) Does your valuation methodology require endorsement from the LPAC?
- (3) Do you use the same valuation methodology for investee companies and the fund?
- (4) Has the appointment of an independent firm for valuations been approved by the LPAC?
- (5) Which independent firm has been contracted to perform valuations?
- (6) Are all LPs (or LPAC) required to approve valuations?
- (7) How do you resolve disputes with LPs around valuations?

**Other**

(1) Which LP group increases the chances of agency conflicts from arising:

Investor grouping	Rank (HIGH, LOW)	Comment
Pension funds		
Insurance companies		
Banks		
DFIs		
Asset managers		

Investor grouping	Rank (HIGH, LOW)	Comment
PE funds of funds		
Sovereign funds		

- (2) What limitations are placed on selling investments between funds (valuations, approval, and timing)?
- (3) Elaborate on the BBBEE HR and ownership policies you have as a result of requirements from your LPs?
- (4) Do you think that good investment performance overpowers all agency problems?
- (5) How do you deal with specific LPs who may be inclined to micromanage your functions?

## Section 4: GOVERNANCE MECHANISMS

### Environmental, social, and governance (ESG)

- (1) Do you focus on sustainability related themes and what are they?
- (2) Are your sustainability related themes in response to LP requirements?
- (3) Do you have an exclusion policy for investing in portfolio companies and what is it?
- (4) Is your exclusion policy in response to your LP requirements?
- (5) How do you deal with conflicting exclusion policies across LPs?

### Investment Committee (IC)

- (1) Who is represented on the IC:

IC representation	Mark (X)	Number of people
GPs		
LPs		
Independent appointees		

- (2) How are decisions made?
- (3) How would you rank the level of importance of the following decision-making criteria:

Decision making criteria	Rank (1-5)
Compatibility with the fund's risk appetite	
Compatibility with the fund's investment strategy	
Potential for growth within the remaining lifespan of the fund	
Investment returns	
Development impact	

- (4) How often does the IC meet and who chairs it?
- (5) Is the role of the IC formally documented in any of the fund's founding documents?
- (6) What is the level of experience and seniority of appointees serving on the IC?
- (7) Are the minutes of each meeting distributed to LPs?

#### Internal Audit (IA) & Audit Committee (AC)

- (1) Do you have an IA function that maintains and reports on the internal controls for risk?
- (2) Do you have an independent AC, and who is it comprised of?
- (3) Does the IA function co-operate with the AC?
- (4) Does the AC oversee the integrated reporting process?
- (5) Who is the external auditor that has been mutually agreed to and appointed?

#### Governance of risk

- (1) Do you have a formal risk management plan for your investment portfolio and operations?
- (2) Explain whether risk assessments are performed on a continual basis?
- (3) Is your risk management plan based on a framework/methodology, and what is it called?
- (4) How often do you provide risk disclosures to the LPAC and LPs?

**Governance of information technology (IT)**

- (1) How would you explain the state of your management information systems (MIS):

Decision making criteria	Rank (POOR, FAIR, AVERAGE, GOOD, VERY GOOD)
Data clarity	
Data security	
Data availability	

- (2) Do you deploy a formal IT governance framework/methodology?
- (3) To what extent is the IT governance strategy aligned with fund reporting requirements by LPs?
- (4) What controls are in place to maintain the confidentiality of LPs, investee companies, and the fund?

**Monitoring of disclosure and integrated reporting**

- (1) How important is the following category of information in your disclosure to LPs?

Category	Rank (LOW, MEDIUM, HIGH)
Fund performance	
Portfolio performance	
Fees earned from portfolio investments	

- (2) What information do LPs typically query in your reports?
- (3) To what extent do you find ad-hoc information requests from LPs taxing?
- (4) Do you disclose 'over and above' the minimum requirements?
- (5) To what extent does LPs require disclosure of the following fees:

Types of fees charged by GP	Mark (X)

Types of fees charged by GP	Mark (X)
Fundraising fees charged to fund	
Underwriting fees charged to investee company	
Arranging fees charged to investee company	
Consultancy fees charged to investee company	
Directorship fees charged to investee company	
Monitoring fees charged to investee company	

(2) Which do you think is more serious an agency risk:

Information risk	Mark (X)
Information deficiency: Fundraising stage leading to 'adverse selection'	
Information asymmetry: Investment, management and exit stages leading to 'moral hazards'	

### Compliance with laws, rules, codes and standards

(1) What regulations, rules, codes and standards have you adopted in your fund management business:

Regulations, codes and standards	Mark (X)	LP requirement (X)
<b>South African</b>		
King Code of Governance Principles (King III)		
Codes of Good Practice for BBBEE		
New Companies Act		

Regulations, codes and standards	Mark (X)	LP requirement (X)
<b>International</b>		
IFRS & GAAP Accounting Standards		
International PE and VC Valuation Guidelines		
IPEV Investor Reporting Guidelines		
EVCA Handbook		
PE Principles		
Responsible Investment in PE		
A Guide on Climate Change for PE Investors		
Ethics of PE & VC		

(1) What are your views regarding regulation:

Level of regulation	Mark (X)
PE industry need less regulation	
PE industry has sufficient regulation	
PE industry need more regulation	

(2) To what extent do you believe these to be effective in reducing agency problems?

(3) Do you think that these should be adopted on a “voluntary” or an “apply or explain” basis?

(4) What is the right balance between “kill the goose that lays the golden egg” and “good agency”?

#### Governance of stakeholder relationships

(1) What communication mechanisms do you use to communicate:

Key stakeholders	Face to face	Video conferencing	Telephone	Formal Reports

Key stakeholders	Face to face	Video conferencing	Telephone	Formal Reports
LPs				
Portfolio Company				
Investment Committee				
LPAC				
Regulators				
Receiver of Revenue				

(2) What information is required from your stakeholders?

(3) What is the frequency of your communication:

Key stakeholders	On-going basis	At least 2 times annually	At least 4 times annually
LPs			
Portfolio Company			
Investment Committee			
LPAC			
Regulators			
Receiver of Revenue			
Auditors			

(4) How do you ensure the fair treatment of all LPs?

## Appendix 2: Limited partner: Informed consent letter

I want to thank you for agreeing to volunteer your valuable time to my research project that I am doing as part of my MBA. I am conducting research into agency relationships between institutional investors and fund managers in private equity. Our interview is expected to last about 2 hours, and will help us better understand how agency relationships manifest in private equity. Your participation is voluntary and you can withdraw at any time without penalty. All data will be kept confidential, and under no circumstances will the names of interviewees be published or revealed to an external party. If you have any concerns, please contact me or my supervisor. Our details are provided below:

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**Signature of researcher:**

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## LP Questions

### Section 1: LP's INVESTMENT STRATEGY

#### LP's PE strategy

(1) What is your PE strategy:

Elements of PE strategy	Description
Fund preference (VC, development, buyout)	
Sectors	
Investment geography	
Domicile geography	
Direct/indirect emerging market exposure	
Sustainability requirements	
Exclusions	

(2) In future, will you invest in a follow up fund with the same GP?

(3) In future, will you invest with the same GP if they pursue a listing?

(4) How large is your current exposure to PE funds:

Elements of PE strategy	Amount
Total approved (ZAR)	
Total committed (ZAR)	
Number funds	
Portion of assets (%)	

#### Investment thesis

(1) How would you describe your rationale for investing in PE:

Investment rationale		Split (%)
Strategic:	Acquiring other business in lending and/or consulting	
Financial:	Investment returns as part of a diversification strategy	
Developmental:	Develop GPs, market failure, and multiplying LP investment	

(1) Who decides on the investment criteria?

(2) How do you decide to invest in a fund:

Investment rationale		Mark (X)
Budget:	Financial allocation for PE fund investments	
No budget:	Invest on a reactive and opportunistic basis	

(1) What institutional capacity interventions do you provide to the GP:

Value contribution		Rank (NONE, LOW, SOME, HIGH)
Financial:	Capital	
Governance:	Structures	
Operational:	Network for deal flow	
	Network for other LPs	
Reputational:	Brand status	
Other:	Learning curve	

(2) Do you serve on investment committees, and if so, why?

(3) Why is it important that your investment in the fund be kept confidential?

## Section 2: LP'S SELECTION CRITERIA

### Selection criteria

(1) How are decisions made regarding the selection of GPs for a new fund:

Selection criteria	Rank by importance (1-5 for each criteria grouping)
<b>Micro criteria</b>	
Economic activity	
State of the capital market	
Taxation	
Human and social development	
Entrepreneurial opportunities	
Economic activity	
<b>Micro criteria</b>	
Track record	
Strategic investment focus	
Match of team background and strategy	
Reputation of team and individuals	
Locals in team (BBBEE)	
Local market experience of team	
Turnover of team	
Independence of team	
Deal flow/access to transactions	
Commitment of other well-reputed LPs	
Fee structure	

Balanced incentive structure among the team	
Alignment of interest between LPs and GPs	
Quality of networks	
Experience	
Previous scientific training (VC funds)	
Specialisation of PE firm	
Commitment to good agency governance	

- (2) How does selection criteria help reduce the likelihood of agency problems?
- (3) Which selection criteria will you in future incorporate into your selection process?
- (4) How important is it that other reputable LPs are also investing in the fund?
- (5) Do other reputable LPs reduce your agency costs (standardised contract terms, portfolio monitoring)?

### Section 3: ALIGNMENT OF INTERESTS

#### GP compensation

- (1) To what extent have you negotiate the overall fee structure proposed by the GP?
- (2) To what extent does each of the following structures create better alignment of interests:

Elements of compensation structure	Rank (1-4)
Management fee	
Carry fee	
Clawback provision	
Capital contribution	

- (3) Do you think that the capital contribution entrenches enough “skin in the game”?
- (4) Which do you believe to be better structure for alignment of interests:

Structure	Management fee	Carry interest	Monitoring	Capital contribution
Decrease				
Keep the same				
Increase				

- (5) How do you ensure alignment between investment horizons and management fees earned by the GP?
- (6) Does the trade-off between ‘investment returns’ & ‘development impact’ lead to misaligned interests?
- (7) How do you think GPs could be rewarded for balancing ‘investment returns’ & ‘development impact’?
- (8) Do you think that other commercial LPs will buy into this concept?

### Partnership covenants

- (1) Please indicate which agency problem is prevalent in your partnership:

Areas where agency conflicts occur in PE	Mark (X)
<b>Financial agency areas</b>	
Management fees	
Carry fees	
Capital calls	
Mandatory distributions	

Areas where agency conflicts occur in PE	Mark (X)
Capital contributions	
Clawback provisions	
Asset valuation	
Risk appetite	
Investee Gearing	
<b>Non-financial agency areas</b>	
Fee disclosure	
Resource allocation	
Investment allocation	
Prospectus disclosures	
Contract negotiation	
Conflicting strategies	
GP co-investment	
Preferential selection	
Conflicting obligations	
LP strategy	
LP power	
Micromanaging GP	
Exit timing	

Areas where agency conflicts occur in PE	Mark (X)
Secondary market	

- (1) How have you structured the top 5 agency risks?
- (2) Did any conflicts arise during contract negotiation, and how were these resolved?
- (3) Please comment of the existence and level of importance of the following covenant classes:

Partnership covenants to mitigate against agency risks	Mark (X)	Rank (HIGH, MEDIUM, LOW)
Single company investment limits		
Limits of gearing and use of debt		
Restrictions on co-investment with other funds		
Rules about the reinvestment of profits		
Limits on personal investments by GPs		
Restrictions on partnership interest sale by GPs		
Restrictions on additional fundraising ability		
Restrictions on GP's outside activities		
Rules for the inclusion of other GPs		
Limits on investments in other assets		
Remedy for LP default on capital calls		
Restrictions on partnership interest sale by LPs		
Rules for frequency and content of reporting by GP		

- (1) Explain if you would be willing to trade-off covenants for better fee structures with GPs?

- (2) Who has authority to grant GP the right to sell their partnership interest in the secondary market?
- (3) How is the Keyman Provision structured?
- (4) How important is the fund's domicile regulatory and legal environment for enforcing contractual rights?
- (5) What is the risk on the agency relationship if key LP staff were to leave your employment?

#### Limited Partners Advisory Committee (LPAC)

- (8) How are decisions made?
- (9) How would you rank the frequency of issues addressed by the LPAC:

Issues addressed by LPAC	Rank (HIGH, MEDIUM, LOW)
Ensuring that the fund's ethics are managed effectively	
Resolving all material conflicts of interest relating to the fund	
Approving all valuation policies and methodologies for the fund	
Facilitating the exchange of information between GP and LP	
Integrating ESG requirements into the overall fund	
Acting as a sounding board for the GP on all governance matters	

- (10) How often does the LPAC meet and which LP chairs it?
- (11) Is the role of the LPAC formally documented in any of the fund's founding documents?
- (12) What is the level of experience and seniority of appointees serving on the LPAC?
- (13) Do you believe that the chairperson is impartial to all LPs?
- (14) Is there potential for more dominant LPs to cause conflict with other LPs in the LPAC?

## Section 4: GOVERNANCE MECHANISMS

### Environmental, social, and governance (ESG)

(1) How important are the following governance areas in your decision to invest with the GP:

Governance area	Rank (HIGH, MEDIUM, LOW)
Ethical leadership and corporate citizenship	
Investment committee	
Advisory committee	
Audit committee and Internal audit	
Governance of risk	
Governance of information technology (IT)	
Compliance with laws, rules, codes and standards	
Governance of stakeholder relationships	
Integrated reporting and disclosure	

- (2) Should the GP have the same sustainability related themes and exclusion policy?
- (3) Explain if the GP has an ESG policy to identify risks during investment, ownership and exit?
- (4) How do you ensure that the GP continue applying its ESG policies post investment in the fund?
- (5) Explain why it is important that other LPs are equally committed to your ESG requirements?

### Compliance with laws, rules, codes and standards

(2) What regulations, rules, codes and standards do you require for adoption by the GP:

Regulations, codes & standards	Mark (X)	LP requirement (X)
<b>South African</b>		
King Code of Governance Principles (King III)		
Codes of Good Practice for BBBEE		
New Companies Act		
<b>International</b>		
IFRS & GAAP Accounting Standards		
International PE and VC Valuation Guidelines		
IPEV Investor Reporting Guidelines		
EVCA Handbook		
PE Principles		
Responsible Investment in PE		
A Guide on Climate Change for PE Investors		
Ethics of PE & VC		

(5) What are your views regarding regulation:

Level of regulation	Mark (X)
PE industry need less regulation	
PE industry has sufficient regulation	
PE industry need more regulation	

(6) To what extent do you believe these to be effective in reducing agency problems?

(7) Do you think that these should be adopted on a “voluntary” or an “apply or explain” basis?

(8) What is the right balance between “kill the goose that lays the golden egg” and “good agency”?

**Monitoring of disclosure and integrated reporting**

1. How effective are the following mechanisms in reducing agency costs:

Mechanisms that can reduce agency costs	Rank (HIGH, MEDIUM, LOW)
LP monitoring capability	
LPAC	
Monitoring capability of other reputable LPs	
Monitoring capability of debt holders in underlying portfolio investments	
Contractual partnership covenants	
Level of GPs commitment to good agency governance	

- (2) What are your reporting requirements – type, frequency, channel, and format?  
 (3) To what extent is the GP willing to resolve information queries from LPs?  
 (4) How willing is the GP in providing information on an ad-hoc basis upon request by LPs?  
 (5) To what extent is the GP willing to disclose ‘over and above’ the minimum requirements?  
 (6) To what extent is there full disclosure of the following fees:

Types of fees charged by GP	Rank (HIGH, MEDIUM, LOW)
Fundraising fees charged to fund	
Underwriting fees charged to investee company	
Arranging fees charged to investee company	
Consultancy fees charged to investee company	
Directorship fees charged to investee company	

Types of fees charged by GP	Rank (HIGH, MEDIUM, LOW)
Monitoring fees charged to investee company	

- (7) How do you know that the agency costs of your monitoring efforts are justified?
- (8) What additional information would you like to be privy to, and will the GP agree to this?
- (9) Which do you think is more serious an agency risk:

Information risk	Mark (X)
Information deficiency: Fundraising stage leading to 'adverse selection'	
Information asymmetry: Investment, management and exit stages leading to 'moral hazards'	

- (10) Is there any specific information that the GP should disclose during their process?

Transparency during fund stages	Description
GP's fundraising stage	
GP's contractual stage	
GP's investment stage	
GP's management stage	
GP's exit stage	

### Overall impression of agency relationship with GP

- (1) How would you rank the following characteristics of 'good agency' in your relationship:

Agency' characteristic	Description	Maturity (scale 1-5)
Discipline	Commitment to universally accepted codes and standards	
Transparency	Adequate mandatory and voluntary disclosure	
Independence	Impartiality of functions and monitoring mechanisms	
Accountability	Ownership of all parties for failure and successes	
Responsibility	Maturity and competency in carrying out duties	
Fairness	Balance of competing interests between GP and LP	
ESG Responsibility	Responding to issues of ethics and corporate citizenship	