Annex E
Recommendations for CMIC Operations Manual

Introduction

This Annex sets out specific recommendations to inform revision of the Operations Manual of the Mexican Capital Investment Corporation (CMIC) to be in line with U.S. and international best practices.

The Operations Manual should cover the following two core topics with specific guidelines for handling specified sub-topics:

1. Investment Process
    - Sourcing methods
    - Evaluation of fund managers and due diligence process
    - Investment approval and execution process
    - Key documentation terms

2. Portfolio Monitoring and Management
    - Monitoring and management methods
    - Valuation
    - Divestment
    - Information Technology

Investment Process

Sourcing Methods

As a “best practice,” deal flow is sourced by both “top down” and “bottom up” mapping of promising investment strategies and fund opportunities conducted by internal research teams, re-funding of fund managers previously supported, and industry networking.

The use of a public “request for proposals” (RFP) process, together with a private equity “gatekeeper” consultant, may be a best practice for smaller institutions during the program’s ramp-up phase. The reasons for this are: (a) the RFP process helps the program quickly identify fund managers interested in investing in the target geographic area or sector specified in the RFP; (b) the RFP process helps the program quickly educate the fund manager industry on the existence and selection standards of the program; and (c) use of a gatekeeper helps the program to quickly establish an institutional quality fund manager selection process, and to expand its network of fund manager contacts. Use of the RFP process and/or gatekeeper should be discontinued once their value-add is outweighed by their attendant costs and/or process constraints.

Evaluation of Fund Managers and Due Diligence Process

The Operations Manual should specify criteria to be used in evaluating whether to invest in a specific fund. Key criteria to be included, based on international “best practice” include the following:

- relative performance of fund manager in prior funds (compared to competition);
- absolute performance of fund manager in prior funds;
- clear and credible investment strategy;
- investment strategy has been consistently applied by fund manager in prior funds;
- key fund manager principals have worked together previously;
- key fund manager principals have managed a prior fund through the entire investment cycle;
- fund manager has demonstrated proprietary deal flow;
- fund manger has demonstrated network among international strategic investors;
- fund manager has demonstrated back-office capability;
- fund manager has strong local presence in the target geographic area;
- fund manager has strong command of local language, culture;
- extent to which the fund is offering “market” terms; and
- extent to which fund indicates willingness to accept the program’s special terms.

According to international best practice, due diligence to be performed in connection with the selection of funds for support should include the following:

- review private placement memorandum;
- obtain and review detailed questionnaire;
- interview fund principals;
- interview full management team;
- interview past portfolio company managers;
- perform reference checks;
- verify prior fund cash flows by:
  - spreading the cash flows;
  - performing a detailed review of audited financial statements;
  - performing a detailed review of the valuation methodology used;
  - checking attribution to current fund manager principals; and
  - checking unrealized valuations against comparables; and
- negotiate key investment terms prior to commitment.

Templates serve to provide consistency and transparency in the selection process. It is recommended that the following templates be included in the operational manual for use by staff in order to enhance the efficiency of the screening/evaluation/due diligence process:

(a) template screening memorandum;
(b) template investment recommendation memorandum;
(c) template evaluation criteria checklist;
(d) template cash flow model; and
(e) database of funds, team members, portfolio companies.

Investment Approval and Execution Process

The investment approval process in private sector investment managers/advisors generally takes place at the investment committee level. Public sector program investments typically require a decision of the Board of Directors in addition to investment committee approval. In any case, the investment committee is responsible for detailed review and analysis of opportunities, and should follow a standard approval process that is set out in the Operations Manual.

As a matter of "best practice," the following approval process is used to approve investment commitments:

- internal staff makes the initial "screening" decision regarding interest in a fund opportunity, and after diligence makes an investment recommendation;

- an investment committee, comprised primarily of businesspersons with experience and expertise in private equity funds, approves (or disapproves) the investment recommendation; and

- if necessary, to the extent a separate governance body (e.g. Board of Directors) exists to confirm that the program's activities are strategically consistent with its overall mandate, such body also approves (or disapproves) the investment recommendation.[1]

Once a decision has been made, senior management and legal counsel approve final investment documentation, and the investment execution process typically takes from 1 to 3 months to complete from approval of the commitment.

Key Documentation Terms

As a matter of "best practice," the following terms are key to fund investment negotiations:

(a) ability of the limited partners to suspend the fund's ability to make investments by a supra-majority vote;

(b) ability of the limited partners to terminate the fund by a supra-majority vote;

(c) ability of the limited partners to remove the general partner "without cause" by a supra-majority vote;

(d) ability of the limited partners to suspend investments and/or terminate the fund based on a "key man" event;

(e) limited partner right to "claw back" general partner carried interest distributions; and

(f) ability of program to participate on the advisory board of the fund; and

(g) structuring (tax and ERISA) issues.

<u>Portfolio Monitoring and Management</u>

The areas of portfolio monitoring and management that were reviewed for international best practices include monitoring and management methods; valuation of portfolio; divestment strategies, and the use of information technology systems.

[1] Note that approval by the Board of Directors is required only where the membership of the Board is substantially different from the membership of the investment committee.

Monitoring and Management Methods

Monitoring and management of portfolios is a critical function of funds of funds, and one which investors look at carefully in assessing possible investments in FoF managers. There is general consensus on best practices for portfolio monitoring, but the extent to which various systems are put in place varies depending primarily on size of programs and resource constraints.

Global private equity programs and development finance institutions that focus on private equity tend to use dedicated internal staff (i.e. professionals other than those that primarily originate investments) to perform many of these functions. Smaller programs including those that focus primarily on seed and venture capital tend to be more resource constrained, and generally use the same professionals to both originate and monitor investments.

As a matter of "best practice," the monitoring and management of the program portfolio is performed primarily by dedicated internal staff, supplemented as necessary or useful (particularly in respect of matters involving fund relationships and valuations) by investment professionals that are primarily engaged in originating investments.

Dedicated internal staff perform the following functions related to portfolio management: accounting; legal; data verification and input; database management; fund compliance monitoring; producing and analyzing portfolio reports; and managing information technology.

As a matter of "best practices," the key portfolio monitoring and management functions to be performed include the following:

(a) confirming compliance of each proposed investment by each fund with that fund's investment guidelines, diversification requirements, and other contractual restrictions;

(b) confirming compliance by each fund with contractual provisions regarding management fees and fund expenses;

(c) confirming compliance by each fund with all reporting requirements, including in respect of scope and timeliness;

(d) inputting into a database on a contemporaneous basis all key data regarding each fund, including fund terms, portfolio company profiles, capital calls, distributions, and other cash flows;

(e) verifying data provided by funds, including against monthly program bank statements, quarterly fund financial statements, and quarterly or semi-annual fund valuation reports;

(f) ensuring database integrity through separate accuracy reviews of all data inputs by a person other than the individual that input the data;

(g) producing regular program portfolio performance reports, including current valuations, actual cash flows, and portfolio IRR;

(h) producing regular forecasts of program portfolio cash flows and performance using financial model;

(i) collecting benchmark data, and analyzing program portfolio performance against benchmark data;

(j) maintaining and following written monitoring and management procedures; and

(k) ensuring that no single individual has the authority or ability to approve, execute, and report any program transaction.

Large private sector global private equity programs tend to be the most rigorous in monitoring and managing their portfolios. Smaller programs perform most of the same functions, but generally omitting those functions that would likely require larger organizations (i.e. the functions set forth in clauses (e), (f), (h), (j), (k) above).

In addition to the list above of best practices, the following methods are also used to manage and monitor the portfolio:

(a) produce regular (monthly and/or quarterly) written, monitoring reports on each fund, which reports are reviewed by senior management;

(b) monthly internal meetings to review the program portfolio;

(c) attend each fund's advisory board meetings, supplemented by quarterly meetings with each manager;

(d) perform search media databases (e.g. Lexis/Nexis) on a regular basis for news regarding fund managers and portfolio companies;

(e) in respect of troubled funds, consider meeting with management of key portfolio companies of the fund to independently assess status;

(f) require that each fund supported provide the following reports:

  (i) quarterly unaudited, and annual audited, fund financial statements;

  (ii) quarterly and annual capital account statements;

  (iii) quarterly investment activity reports, e.g. investments made, realized;

  (iv) quarterly performance summaries for each portfolio company; and

  (v) for emerging managers, consider obtaining annual budgets for the fund, and audited annual investment manager financial statements.

Valuation

The use of internationally accepted standard valuation guidelines for valuing portfolio companies has emerged as a best practice among investment managers in recent years. Most favor the use of the new International Private Equity Valuation Guidelines (IPEG) produced by EVCA, BVCA and AFIC. Where U.S. investors are involved, investment managers may choose to use the standards issued by the Private Equity Industry Guidelines Group (PEIGG), which are endorsed by the Institutional Limited Partners Association (ILPA).

Divestment

Recovery of capital contributions is generally expected to occur through fund liquidations, after 6 or more years. Of the firms surveyed for this report, all expect to hold their fund investment through liquidation. Four of the survey respondents indicated that the average holding period (time from contribution to return of capital) was more than 8 years; two other programs indicated 5 to 7 years.

Information Technology

An effective, user-friendly information technology (IT) platform is essential to performing institutional quality portfolio monitoring and management. Several specialized software products exist for this purpose.[2] However, in most instances, firms create customized IT platforms, either building it themselves using programs such as Excel or Access, or modifying a purchased software package. The cost of purchasing/developing an IT system is about US$100,000. In addition, internal staff hours are spent on ensuring proper customization and training. Firms typically spend about US$25,00 a year on operations and maintenance, though this amount varies with smaller firms spending less than $25,000 per year.

As a matter of "best practices" information technology systems manage the following information:

(i) status/performance of each fund (e.g. capital committed, drawn down, invested, realized, distributed; IRR and multiples);

(ii) aggregate roll-up of status/performance of program portfolio;

(iii) program portfolio diversification (e.g. by vintage year, investment strategy, sector);

(iv) program portfolio annual cash flows, actual and projected;

(v) compliance of each fund with contractual requirements;

(vi) contacts manager/directory of fund contacts;

(vii) forward calendar of fund manager fundraising cycles; and

(viii) customized reports derived from filtering, grouping, subtotaling database entries.

[2] Vendors include Burgess/Private I, Sungard/Investrans, Analytyx, and Venture Complete