Annex F
Recommendations for CMIC Policy Manual

Introduction

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

While there is no standard practice regarding contents of a policy manual, inclusion of the following topics in CMIC's Policy Manual would be consistent with best practices regarding documentation of guidelines and procedures: (1) Investment Strategy and Guidelines; and (2) Risk Management Practices.

Investment Strategy and Guidelines

Guiding Principles

The policy manual regarding investment strategy should set out clear overarching principles and goals that serve to guide investment decisions. These should emphasize the importance of overall fund performance as the primary objective, which is to be achieved through investments that also seek to achieve an economic developmental impact as specified in CMIC's stated objectives.

The investment strategy should take into account that international experience has shown that the key to developmental venture investing is to invest where the greatest opportunities for positive returns exist, i.e. where significant market inefficiencies exist, where existing or emerging markets are sufficiently robust, where the pool of talented entrepreneurs is prepared to accept venture investors as partners, and where venture capital fund managers have the demonstrated skill to exploit these opportunities. Investments made in such an environment have the potential to generate strong positive returns and as a by-product produce the desired economic impact. Developmental venture financing has not been successful, however, where investments were made into funds focused on specific sectors or companies targeted as priorities for economic impact but where a sound plan for generating returns was not evident, or the fund's establishment was instigated by the public sector rather than the private market.

While the definition of priority sectors is useful for informing the fund of funds (FoF) on potential opportunities, best practices suggest that the FoF should not limit in any way the sectors in which it invests, so that it can be responsive to the opportunities presented by the market.

Research and Planning

The policy manual could set out guidelines and specific steps to be followed in conducting annual or biannual asset allocation planning, as well as the market research needed to inform those plans.

The research function includes in-depth mapping of active players in the industry, as well as an assessment of market opportunities where CMIC may strive to allocate resources. Research can be undertaken by outside advisors, while the Administrator builds up its capacity to conduct extensive research internally.

Key factors that are generally considered in determining the level and focus of capital commitments in an allocation plan include the following:

- known opportunities to invest with top fund managers;
- forecast of program net cash flows;
- assumptions regarding the growth of the program portfolio;
- comparison of current program portfolio performance and diversification against long term targets;
- assumptions regarding the risk return and cash flow profiles of different investment strategies based on historical data;
- assumptions regarding attractiveness of different investment strategies, geographic areas, sectors based on macroeconomic analysis; and
- assumptions regarding terms of fund investments.

Policies should ensure that asset allocation plans are not rigid requirements but rather a framework that reflects an investment strategy and guides investments. While a fund of funds should set out to seek the opportunities that match its asset allocation plan, it also must exercise flexibility since the ultimate goal is to invest only in the most promising opportunities. If the asset allocation plan calls for investing in a particular sector or investment stage but no strong fund managers present themselves in that sector or stage, then best practice would call for the FoF not to make investments in that area. Generally, allocations are considered as ceilings rather than minimum restrictions.

In instances where a FoF wants to invest in a new sector, geography, or sub-asset class, international experience has shown that an effective way to launch the process is to conduct a request-for-proposals (RFP). Through issuance of an RFP, a FoF signals its appetite, and the market responds. This could be accompanied by aggressive market outreach to identify firms that should receive the RFP and to inform the market about the opportunity. But in essence, this strategy allows for a directed effort to target a particular market segment while relying on the market to identify and present opportunities within that segment – be it a particular sector, geographic area, etc. The investment strategy criteria for such RFPs should be sufficiently broad to permit a diversity of approaches to addressing the strategic objective of the RFP. If managers must contort their investment strategies in order to qualify for funding, better managers may be discouraged from applying.

This same principle applies to investment restrictions imposed on funds. The more a fund manager must deviate, in order to obtain public funding, from what it believes to be the optimal strategy for generating strong investment returns – for example, by avoiding promising sectors, limiting regional investments, or committing to invest a specified amount in less promising sectors, the less attractive such funding is to top managers, and the less attractive to private investors are the funds that are supported subject to these restrictions.

Another strategy that has been used successfully in non-OECD countries – notably Israel and Singapore – is to intentionally lure international fund managers with the objective of promoting knowledge transfer and international investor interest to their countries. These programs used their capital commitments to regional and international funds, managed by top international fund managers, to create linkages between international VC/PE and their local industries. These programs did not impose "hard" covenants on fund managers to invest minimum amounts in their countries – good fund managers will not accept such conditions because it may cause them to make investments that are not otherwise meritorious – but rather obtained "soft" commitments from the fund managers, to establish offices and hire staff in their countries, to undertake the types of sourcing activities likely to result in a pipeline of deal flow. Indeed, the programs looked for international fund managers that were already developing local deal flow on their own initiative. Even if not every capital commitment to such funds results in "2X program capital" investment locally, the strategy over time will "pull" international fund managers into the local industry, to great effect.

Asset Allocations

The policy manual may set out specific criteria for the investment strategy including the asset allocation plan, which should be updated on an annual or biannual basis. In order to provide CMIC with a possible range of options for what an asset allocation plan might look like based on international experience, the consultants: (a) reviewed the actual allocation of capital in other parts of the world, (b) examined through interviews and anecdotal evidence the current economic and sectorial trends in Mexico as well as the current VC/PE landscape in Mexico, and (c) took into consideration the FoF's strategic objectives.

Internationally, a small portion of total investment is directed to early stage and venture capital while the majority of resources are invested in expansion and buy-out stages. In terms of number of investments, there may be more investments at earlier stages but they represent a smaller proportion of invested capital. The table below summarizes the distribution of investments by asset class for different regions of the world.

Allocation of VC/PE Capital Globally by Stage (in percents)[1]

Stage	N.Am	Europe	Asia	DFIs
Early Stage/VC	11	7	2	6
Growth/Expansion	23	23	35	61
Buyout	51	70	63	3

As shown in the table, the greatest proportion of investment into early stage and venture capital takes place in North America (U.S. and Canada), where in 2004 it constituted 11% of total investment, as compared to only 7% in Europe. The U.S. is the only country where up to 25% of total capital invested in VC/PE is invested in early stage and venture capital.[2] No global aggregate data exists for emerging markets, but in Asia the allocation to early stage and VC is only 2%, according to the PWC 2005 Global Private Equity Report. According to a sample of four development finance institutes (DFIs) that focus in emerging markets that were surveyed for this report, an average of 6% of their capital is invested in this stage.

These figures represent percentages of capital invested and not of funds supported, so the number of early stage and VC funds receiving investment may in fact be larger than other stages, but the amounts invested are less. Furthermore, it is important to note that trends indicate a rise in VC activity in several emerging markets. For example, in India and China, there are many more VC funds operating in 2006 than existed five years ago.

Buyout is the largest stage category of PE capital in North America and Europe, as well as Asia. The Development Finance Institutions in our survey invest only 3% on average on pure buyout funds, but invest substantial capital in large infrastructure and mezzanine financing. Indeed, there are very few purely buyout funds in emerging markets.

In Mexico today, the vast majority of capital has been directed to the growth/expansion stage. Of about 20 funds operating in Mexico, about four are focused on venture capital. These VC funds are primarily comprised of state level funds created at the initiative of the government although they are privately managed. The Consultant is aware of only one active privately sponsored VC fund in Mexico. Some business leaders surveyed for this study believe there is a substantial market for buyouts of smaller firms, particularly for the purpose of expansion.

In considering how CMIC's objectives might influence an asset allocation plan, the Consultant took into account the goals of CMIC to invest across a range of investment stages, support growth of the industry (which implies investing in first time fund managers), and exceed benchmark performance for the fund as a whole. This

[1] Source for North America, Europe, and Asia is PWC 2005 Global PE Report. For Development Finance Institutions (DFIs), it is based on 4 responses to the survey collected for this report.
[2] National Venture Capital Association/Thomson Financial, "Q2 2006 Fundraising Data". Downloaded online at www.nvca.org)

implies that CMIC will likely want to invest in early stage and VC financing in order to help grow that asset class and support small and medium sized businesses. Support of later stage PE funds also fits within CMIC's mission and the market landscape in Mexico, since this segment of the industry continues to need public support and yet a growing number of funds with a proven track record is emerging to support reasonable investments by CMIC.

In summary, specific considerations for various investment levels included the following:

- *Seed and Venture* – Good opportunities to support early stage investments are currently limited in Mexico, with only a few funds currently operating at this stage. Yet, these fund managers contend that many opportunities exist at this stage and the Mexican economy would be buoyed by increased investment in promising early stage opportunities. Since the development of each stage requires that there be exit opportunities, which in this case would most likely come from the next PE stage, allocation to this stage may grow over time as the PE market matures. Other considerations include the fact that seed and venture funds globally entail greater risks as well as the potential for higher returns. At the same time, Mexico may be able to attract VC fund managers from the large early stage market in the US, who may be interested in expanding to Mexico.

- *Expansion and Buyouts* – This is the stage where most PE activity has taken place in Mexico to date. Current fund managers and other business leaders see tremendous potential in this arena for Mexico, in particular where sectors can take advantage of NAFTA and the growing Mexican consumer base to expand and consolidate brands on a national and global level. More experienced fund managers exist at this stage in Mexico and it is also a stage that tends to attract more international well-established funds (although, as noted above, the amount of VC/PE investment in Mexico as a whole is quite small, given the size of its economy).

- *Mezzanine, Infrastructure and Distressed Debt* – Mezzanine investment, which implies using subordinated debt with equity kickers, is really a financing structure rather than a stage of investment. Mezzanine, infrastructure and distressed debt investments tend to provide more current yield than traditional PE/VC investing. There do appear to be good opportunities for mezzanine funds in Mexico.

- *Cross Border Investments* – Increasingly, U.S. and European funds are studying the merits of investing in Mexican firms. These represent a pool of experienced managers who could augment the work of Mexico-domiciled managers. At the same time, they may provide a path to North American and European markets, relationships, and capital for entrepreneurs in Mexico. There appears to be an opportunity to attract funds of this type, and to

generate sufficient competition to give the FoF the chance to select from a pool of seasoned managers. These are identified not by stage, but by strategy, and may range in focus from seed through buy-out.

- *First-time Funds* – New fund management firms tend to have lower returns than established firms. However, given that the VC/PE industry in Mexico is still young and that CMIC's objectives include promoting growth of the industry, investment in first time fund managers will likely be a part of its strategy. Since these funds have higher risks, the allocation for first time funds should be small. Other institutions that invest in first time funds seek to minimize risk by conducting extensive due diligence on the individuals comprising the fund manager, to require a significant capital commitment of such individuals to the fund, and to impose greater investor controls on issues such as fund expenses and management fees.

Based on the above analysis, a suggested range to be considered for the allocation of funds across stage categories is presented in the table below. CMIC will need to determine the precise allocation based on internal planning and research. Over time, the allocations will likely shift. For example, as the market matures and other activities help grow opportunities at earlier stages, CMIC could allocate larger percentages to those early stages. This suggested asset allocation plan has been worked out in the financial model submitted together with this report. The financial model has the ability for the FoF to modify the allocation plan and see the implications on returns.

Potential Range for Allocation by Stage in Mexico

Stage	Potential Range
Early Stage/ Venture Capital	5 – 10%
Growth/ Expansion	50 – 70%
Buyout	20 – 40%

In addition to an allocation plan by stage of investment such as presented in the table, CMIC's asset allocation plan could also set investment targets for other types of investments that cut across stages, such as investments in international and cross border funds, or first time funds. Since such allocations depend on internal policies and objectives, no range has been suggested for these allocations.

Risk Management Practices

Risk management is considered an important function by fund of fund managers. International best practice in risk management involves written procedures and formal processes regarding key issues such as conflict of interest and money laundering. Written code of ethics are shared with all staff, together with clear procedures for reporting and handling infractions. It is recommended that these written procedures and guidelines could be included in the CMIC policy manual.

In addition, the policy manual should set out guidelines for the use of regular internal audits to ensure compliance with the investment process and procedures, portfolio monitoring and management, and risk management procedures. To ensure internal controls, clear specification of separation of duties to avoid conflicts of interest could be included in the manual. For example, the same staff responsible for approving disbursements does not also write checks. Financial audits also review compliance with the management contract and looks for any conflicts of interest and separation of duties.

A key factor in minimizing risks involves ensuring that the interests of the fund manager are in line with the interests of the investors. This includes avoiding any special alignment between the fund manager and any one shareholder or group of shareholders.

According to firms surveyed for this report, the risk management procedures that fund of funds managers incorporate into operations include the following:

(a) dedicated Compliance Officer to oversee and monitor program compliance with external legal and regulatory regimes, as well as internal process and procedures (*generally employed only by large firms)*;

(b) written compliance calendar setting forth key dates for compliance filings, compliance reviews, etc.;

(c) formal process and written procedures to identify potential conflicts of interest among employees, consultants, Board and Investment Committee members and funds supported;

(d) a written code of ethics;

(e) confidential forum for employees to raise concerns regarding program investment process, management practices;

(f) written Anti-money Laundering policy;

(g) written Disaster Contingency Plan;

(h) written Recordkeeping policy regarding records maintenance and retention;

(i) regular training on program policies for employees (typically, upon hiring and then semi-annually or annually);

(j) regular internal audits regarding program compliance with investment process and procedures (typically, on an on-going basis);

(k) regular internal audits regarding program compliance with PMM process and procedures (typically, on an on-going basis); and

(l) regular internal audits regarding program compliance with program risk management policies regarding conflicts of interest, anti-money laundering, and other legal and regulatory requirements.

In the US, a Risk Standards Working Group was formed in 1996 with members from a variety of public and private sector organizations to develop risk management guidelines for investment managers and institutional investors. The group developed 20 standards organized into three categories as follows:[3]

I. Management

1. Acknowledgement of fiduciary responsibility
2. Approved written policies, definitions, guidelines, and investment documentation
3. Independent risk oversight, checks and balances, written procedures and controls
4. Clearly defined organizational structure and key roles
5. Consistent application of risk policies
6. Adequate education, systems and resources, back-up and disaster recovery plans
7. Identification and understanding of key risks
8. Setting risk limits
9. Routine reporting, exception reporting and escalation procedures

II. Measurement

10. Valuation procedures
11. Valuation reconciliation, bid/offer adjustments and overrides
12. Risk measurement and risk/return attribution analysis
13. Risk-adjusted return measures
14. Stress testing
15. Back testing
16. Assessing model risk

III. Oversight

17. Due diligence, policy compliance and guideline monitoring
18. Comparison of Manager strategies to compensation and investment activity
19. Independent review of methodologies, models and systems
20. Review process for new activities

[3] The Risk Standards can be downloaded online at http://www.cmra.com/html/the_risk_standards.html