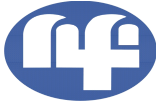

Mexico Investment Catalyst Fund: Analysis and Recommendations

FINAL REPORT

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EXECUTIVE SUMMARY

The Mexican government established in 2006 a new fund of funds (FoF) program, known as the Mexican Capital Investment Corporation (*Corporación Mexicana de Inversión de Capital,* or CMIC), to catalyze the growth of the venture capital and private equity (VC/PE) industry in Mexico. Its founding shareholders are Mexican development banks: Nacional Financiera (NAFIN), Banco Nacional de Comercio Exterior (Bancomext), Banco Nacional de Obras y Servicios Publicos (Banobras), and Fondo de Capitalización e Inversión en el Sector Rural (FOCIR). Each of the founding shareholders has contributed its existing VC/PE fund portfolio to CMIC, valued in the aggregate at approximately $135 million, to be managed by and the proceeds thereof reinvested by CMIC. In addition, NAFIN expects to invest an additional $250 million through CMIC over the next five years, and the FoF is open to additional commitments from the other founding shareholders.

CMIC's mandate includes coordinating public and private sector efforts to build the Mexican VC/PE industry; supporting the creation of new VC/PE funds, new VC investment schemes, and the development of an entrepreneurial culture in Mexico; and providing capital to high growth potential sectors and companies. Moreover, it seeks to catalyze the growth of VC/PE as a commercially viable industry in Mexico, and to stimulate public and private investment through the institutionalization of the industry.

CMIC contracted a study with funding from the US Trade and Development Agency to analyze its planned organizational structure, investment policies, and procedures in light of international best practices.[1] The Consultant conducted an extensive 72-question survey of eleven private and public FoF programs and managers, interviewed another 20 industry participants, undertook secondary research on several public sector emerging markets FoF programs, and drew upon their own expertise and experience as current and former managers of public and private sector FoF programs, to perform the analysis and suggest how CMIC might further harmonize its structure, policies and procedures with international best practices.

Both the goal of building a national VC/PE industry and the strategy of using a public sector FoF program to facilitate this goal, have ample international precedent. The economic benefits of a vibrant VC/PE industry are well documented in a variety of developed and emerging markets countries: VC/PE investment can have a substantial impact on growth, employment, and wealth distribution. Most developed countries, many emerging markets countries, and a wide variety of multi-lateral and other development institutions, operate FoF programs. So there is a significant body of experience and data available to guide CMIC in its efforts.

Three fundamental principles – "first principles" – arise from this body of international experience and data. First, to develop a national VC/PE industry of a scale large enough to have a meaningful impact on the national economy, the industry must attract private capital, from local institutional investors as well as international investors. Mexico receives only approximately 0.002% of the VC/PE capital invested globally; it will take

[1] The study was conducted by a consortium comprised of Cimarron Capital Partners, PCG International, and Millennia Consulting.

much more than the $385 million that CMIC plans to invest in Mexican VC/PE to materially improve that statistic.[2] Second, the path to catalyzing private sector investment in an industry lies in the objective demonstration that such investment yields, relative to comparable investment opportunities, superior risk-adjusted returns. As economies ranging from the United States to Israel to Singapore and much of Asia today have experienced, investors will flock to markets which they believe will deliver attractive returns.

Third, and of great practical importance to CMIC and its stakeholders, international experience suggests that achieving superior risk-adjusted returns through investment in VC/PE funds targeting Mexico will prove a difficult challenge. While average historical rates of return for VC/PE funds in the US range from 13% to 20%,[3] existing data for emerging markets indicate much lower returns (4% for emerging markets as a whole, 10% for Asia, and -3.6% for Latin America).[4] To state the point differently, if a commercial investor set out to invest $385 million over five years in a diversified portfolio of VC and PE funds targeting Mexico, with no mandate other than generating superior risk-adjusted returns, the available data suggests there is a significant risk that it would fail to meet its objective.

Thus, international experience indicates that achievement of the Mexican government's goal of stimulating economic development through the CMIC funds of funds program will require a steady, disciplined, focused emphasis on structures, policies and procedures that facilitate investment performance. While CMIC has already taken an impressive number of steps to incorporate international best practices, based on its analysis of CMIC's current structure, policies and procedures in light of international best practice, the Consultant makes the following recommendations:

Make generating a positive demonstration effect the top CMIC priority

- *Prioritize mandates and objectives*
- *Find and publicize the path to smart investing in Mexico*
- *Focus on investment performance*

In order to achieve its goal of growing the VC/PE industry in Mexico, CMIC needs to catalyze private sector investment. To do this, it must find and publicize the path to smart investing in Mexico: who are the best managers, which are the best investment strategies, what are the most efficient investment structures. This task alone will be a challenge -- given the dearth of experienced, successful Mexico-oriented fund managers and investors, particularly in the venture capital space -- and will require organizational focus, a dedicated team, and conducive policies. To the extent other CMIC mandates and objectives detract from such an investment environment, they will make achievement of the critical goal of catalyzing private VC/PE capital more difficult. The CMIC Board and stakeholders can greatly enhance CMIC's prospects for success by clarifying the priority of CMIC's multiple mandates and objectives, and by focusing the organization first and foremost on achieving superior risk-adjusted investment performance.

[2] 2004 Price Waterhouse Coopers Global Private Equity Report.
[3] Venture Economics' US Private Equity 20 year Horizon Returns, Pooled IRR, 12/31/05
[4] Cambridge Associates Private Equity Indexes. Published in EMPEA Newsletter Q2 2006.

Identify, develop, and invest with top managers

- *Invest to greatest extent possible with top fund managers*
- *Use disciplined research and allocation planning*
- *Limit sector investment restrictions*
- *Invest in regional funds*

To maximize the prospects for achieving superior returns, CMIC should invest whenever possible with experienced, successful fund managers. International experience demonstrates that manager quality correlates more strongly to success in VC/PE investing than in any other asset class. Stated differently, CMIC's probability of generating a return that will attract private sector interest in Mexico will be reduced to the extent that it invests in a fund managed by a team that does not have a track record of success investing third party capital under similar investment conditions utilizing similar investment strategies. Since there is not currently a deep pool of VC/PE fund managers with successful experience investing in Mexico, CMIC will need to devote substantial energy and resources to identifying and building relationships with teams that have successful track records investing under analogous conditions (e.g. proprietary investing in Mexico, fund investing in US or Latin America). And, to the extent such managers are not currently investing in Mexico, CMIC will need to be creative in using its capital to attract such managers.

Several implications follow from these general principles. First, CMIC will need to research the capabilities and interests of a broad range of investment professionals, and trends in investment strategies, both in Mexico and the region, through constant literature review and heavy networking. Second, such research needs to be collected in, and made accessible through, reports collected in a database, which database will over time represent valuable proprietary know-how. Third, a formal asset allocation planning process should be used to catalyze forward planning and collective consideration of emerging investment opportunities. Fourth, CMIC should strive to make itself an investor with which top managers seek to work, due to its professional investment decision process, and the commercial orientation of its investment policies. In particular, CMIC should avoid restricting its fund managers from investing in promising sectors that are acceptable on reputation risk grounds to other public sector investors, as well as forcing its fund managers, as the price of CMIC support, to invest in sectors that they would not otherwise pursue. Stated differently, it is better to work with the best possible manager, and allow a few investments in sectors that CMIC believes already have sufficient access to private capital, than to work with a lesser manager. Similarly, to develop relationships, CMIC should support top managers (in particular, of regional funds) on the basis of a business understanding confirmed by due diligence that they will seek promising investments in Mexico and/or a sector that CMIC seeks to promote, without requiring such investment, should such opportunities fail to present themselves.

Build an exceptional FoF management team and process

- *Clarify, and expand functions of the Fund Administrator*
- *Centralize investment decision-making in the Fund Administrator*
- *Invest in staff quality/development, and management information systems*
- *Create process-oriented culture*

CMIC will need to build an exceptional team of investment professionals in order to invest its $385 million effectively. To the extent CMIC seeks to deploy additional Mexican government capital, and/or to manage capital for other public and private sector investors, the importance of developing such a team increases. CMIC has wisely, and consistent with international best practice, housed the FoF's investment professionals in a separate legal entity known as the "Fund Administrator," such that the structure of CMIC resembles a commercial FoF program. But the role of the Fund Administrator in respect of CMIC is currently much more limited than that of a commercial FoF manager, because the investment committee is not housed within the Fund Administrator, but rather is a committee of CMIC itself (and Fund Administrator professionals constitute only two of its five members).

Such an arrangement is disadvantageous, from the perspective of enabling efficient and effective decision-making with respect to CMIC's existing capital, and of attracting additional investors to CMIC. Specifically, because currently the Fund Administrator and the CMIC investment committee share responsibility for CMIC's investment decisions, there is insufficient individual accountability (i.e. the investment committee can fault the Fund Administrator, and the Fund Administrator can fault the investment committee, for poor investment decisions). Moreover, given the substantial overlap between the composition of the Fund Administrator and the investment committee, on the one hand, and between the investment committee and the Board, on the other hand, the decision-making structure creates unnecessary redundancy. Moreover, the lack of clarity as to which individuals are responsible for the success or failure of CMIC's fund investments will hamper efforts to attract additional investors to CMIC, who will want to know (just as CMIC wants to know when it considers investing in a fund) whether CMIC's track record is attributable to the team that proposes to invest their capital.

We recommend that CMIC move the investment committee functions, as well as the individuals (at least the independent directors) currently serving on the investment committee, into the Fund Administrator. The Fund Administrator would thus have complete responsibility for recommending to the Board (and screening out) potential fund investment opportunities, on the basis of commercial merit. The function of the Board in turn would be to accept or reject the recommendation of the Fund Administrator investment committee, based on political considerations of CMIC strategic direction (as opposed to commercial merit). This decision-making structure, of a Board of political appointees approving an investment recommendation made by investment professionals, has ample international precedent, including among many of the world's largest public pension funds.

CMIC should devote significant resources to recruiting, developing and incentivizing the individuals (staff and independent directors) that will be charged with the technical evaluation of investment opportunities, and to supporting the investment team with a robust

management information system. The investment evaluation and monitoring process and procedures used -- which should incorporate the international best practices set forth in detail in this Report -- should be clear, consistently followed, and periodically reviewed. Establishing a process-oriented investment culture is critical to mission success: not only must the CMIC investment team generate attractive FoF returns (which international experience demonstrates requires a strong emphasis on process), but it must be able to explain to local and global investors how it did so.

Consider making future investments through distinct, discrete life, FoF vehicles

CMIC is structured as an evergreen investment entity. While the current structure is satisfactory for the current shareholder composition (i.e. all agencies of the Mexican government), it will hinder the attraction to CMIC of additional public or private sector investors. International experience demonstrates that investors, including development institutions, prefer to invest in FoFs structured as discrete life funds, typically with a twelve year (extendable for up to three years) term and capital commitments made by investors at the outset. Regardless of whether CMIC seeks additional investors, it may wish to consider making investments beginning approximately in 2008 through discrete life vehicles, as this will facilitate commercial investor behavior by its stakeholders.

CMIC Board should focus on governance and support

- *Board should focus on policy, not day to day operations*
- *Monitor investments based on international standards for FoF reporting*
- *Audit best practices compliance*
- *Provide ongoing education to all Directors and stakeholders on VC/PE industry*

To facilitate the operation of CMIC based on best commercial practices, the CMIC Board should limit its role to defining strategic objectives and policies, and maintaining support for the mission and approach of CMIC within the Mexican government and the general public. To the extent the CMIC Board contains individuals with the ability and interest to contribute to the day to day management of CMIC (e.g. independent directors serving on the investment committee), they should do so as part of the Fund Administrator rather than the CMIC Board.

As stated above, the Board can greatly enhance CMIC's prospects for success by clarifying and prioritizing its mandates and objectives. Most likely, this will also require Board members to build a political consensus within the Mexican government around those priorities. To be effective in building, and maintaining, such consensus, the Board should invest significant energy and resources in educating itself, and CMIC's broader universe of stakeholders, on best practices and trends in the global VC/PE industry in general, and among public and private FoF programs in particular. Since the Board plays a critical, on-going role in maintaining political support for CMIC's strategic objectives, this internal and external education process should also be on-going

Consistent with international best practice, the Board should exercise its governance responsibilities through a regular program of reviewing and approving annual strategic plans,

budgets, senior management performance plans, internal and external auditor reports, and portfolio performance reports. This process serves four main functions. First, the Board must act to ensure that the Fund Administrator has the resources and personnel to execute its responsibilities. Second, to facilitate the efficient operation of the CMIC program, the Board must confirm to the Fund Administrator in a timely manner that broad tactical plans are generally consistent with strategic objectives.

Third, through its high level review of Fund Administrator execution, the Board must monitor implementation of the policies and procedures that the Fund Administrator has identified, based on international experience and its own learning curve, as important to success. Fourth, the Board must, through regular Board reviews, provide an important check against systematic fraud and mismanagement. In all these functions, the Board governance process should strive to support, empower, and encourage – rather than distract – the Fund Administrator in becoming the premier VC/PE fund investor in Mexico, and among the best regional programs.

Help others prepare the VC/PE investment environment

- *Provide substantial support to activities that build an environment conducive to VC/PE investing*
- *Do so by funding and facilitating the efforts of other organizations, rather than undertaking such activities directly*
- *Staff and resources to implement such VC/PE industry "infrastructure development" activities should be maintained separate from the FoF investment team and program*

Public sector support for activities that develop a culture of entrepreneurship and VC investing in Mexico – from advocacy for legislative changes, to the education of investors and entrepreneurs, to the formation of institutions and mechanisms that foster successful investing -- are critical to building a robust Mexican VC/PE industry. Moreover, as the focal point of the Mexican government's VC/PE experience and expertise, it makes sense for CMIC to support these industry "infrastructure development" activities. However, to avoid creating a negative demonstration effect on private investors, CMIC must implement its support for such industry development activities in a manner that does not impair its prospects for building a successful FoF investment program. Specifically, CMIC's support for industry development activities should not divert management time, focus, and resources from CMIC's investing activities.

Several implications follow from the above principles. First, since the industry development activities are important, and CMIC was established to consolidate the Mexican government's VC/PE industry activities, CMIC should devote substantial resources to the development of legal and institutional "infrastructure" that will facilitate VC/PE investment. Second, because in practice it has limited resources, particularly human resources, CMIC should avoid undertaking industry development initiatives internally, but rather should catalyze and support such initiatives being undertaken by other organizations. In particular, CMIC should target its support on the establishment and operation of active industry associations, which then undertake initiatives with funding and input from CMIC. Whether

with industry participants, other Mexican government agencies, or other development institutions, the key operational concept is partnering. Third, the staffing, funding and management of CMIC's industry development activities should be kept separate from its FoF investment activities, so that the investment team can devote their full energies and resources to the difficult task of building and operating a world class FoF program.

I. INTRODUCTION

A. Background

As part of its efforts to build the venture capital and private equity (VC/PE) industry[5] in Mexico, the Government of Mexico has established a new catalyst investment fund that combines resources from the country's four leading development banks. Functioning primarily as a fund of funds (FoF), the Mexico Capital Investment Corporation (CMIC) invests in VC/PE funds, which in turn invest directly in operating companies.

The current shareholders of CMIC are Nacional Financiera, SNC (NAFIN), Banco Nacional de Comercio Exterior (Bancomext), Banco Nacional de Obras y Servicios Publicos (Banobras), and Fondo de Capitalización e Inversión en el Sector Rural (FOCIR). To launch the FoF, each shareholder has contributed its existing portfolio of VC/PE investments to CMIC to manage. As the largest shareholder, NAFIN has been tasked with leading the design of CMIC and launching an independent fund administrator to manage aspects of CMIC's operations.

Establishment of CMIC was part of a larger government initiative to promote development of the VC/PE industry in Mexico. Notwithstanding the tremendous growth of the global VC/PE industry over the past two decades, and its increasing emphasis on emerging markets, Mexico, and Latin America in general, receives a disproportionately small percentage of global VC/PE investment. In 2004, private equity investment worldwide reached US$115 billion, but 52% of this total was invested in North America, 30% in Europe, 15% in Asia, and only 1% in Latin America.[6] Within Latin America, the one percent of global private equity investments went primarily to Brazil (45%), Argentina (29%), Mexico (18%), and Chile (9%).

VC/PE investment has in several countries proven to be an impressive engine of wealth and job creation. For example, in the United States, which has had a VC/PE industry for 40 years, it is estimated that companies receiving venture financing between 1970 and 2003 accounted for 10.1 million jobs and $1.8 trillion in revenue in 2003, representing approximately 9.4% of total U.S. jobs and revenues.[7] Significantly, these companies grew even during sluggish economic times, registering 6.5% and 11.6% gains in jobs and revenues respectively between 2000 and 2003 while national employment fell 2.3% and U.S. company revenues rose only 6.5%.[8] Another study indicates that the average U.S. venture-backed firm generates more than 100 jobs and grows annual sales by 66% within five years of receiving venture financing.[9]

The Government of Mexico recognizes the potential benefits of increased VC/PE investment in Mexico, and has been taking steps to promote VC/PE. A 2003 study financed

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[5] Throughout this report, we use the term "venture capital/private equity" to refer to the full range of investments in this asset class, from seed and early stage through buyouts.
[6] Price Waterhouse Coopers Global Private Equity Report 2005
[7] NVCA "Venture Impact 2004: Venture Capital Benefits to the U.S. Economy"
[8] ibid.
[9] Megginson, William L. "Entrepreneurial Finance & Venture Capital" in Introduction to Corporate Finance. South-Western College Publishers: 2001.

by the U.S. Trade and Development Agency and conducted under the auspices of NAFIN (2003 Study) reviewed the current barriers to VC/PE in Mexico and recommended an action plan for building the industry. Those recommendations included addressing regulatory hurdles, supporting a series of activities to build a culture of venture capital and entrepreneurship, facilitating entrance of local institutional investors, and also providing ongoing capital as a catalyst for attracting additional investment. Among the steps the Government of Mexico has taken to implement the study recommendations, the CMIC was established to invest in privately managed VC/PE funds operating in Mexico.

B. The Challenge

The goal of the CMIC, as set forth in its constituent documents and preliminary business plan, is to promote the development of a strong, sustainable VC/PE industry in Mexico. Stated differently, the CMIC seeks to demonstrate to Mexican and foreign investors that VC/PE investments in Mexican companies generate attractive risk-adjusted returns, so that these investors will also provide VC/PE capital to Mexican companies. CMIC intends to advance this objective by providing capital to professional, private sector VC/PE fund managers, who will invest the capital on behalf of CMIC and other, private sector, fund investors, into diversified portfolios consisting (in whole or in part) of companies operating in Mexico. CMIC seeks to emphasize in particular the provision of VC and other capital to small and medium-sized businesses in Mexico.

The goal and approach of CMIC is similar to that of many other public and quasi-public institutions. As will be discussed further in this study, many governments have created FoFs to catalyze VC/PE investment in specified geographic regions and/or sectors. As reflected in the survey of several such institutions conducted as part of this study, there is widespread agreement among these programs that having a "positive demonstration effect" – showing that VC/PE investment in the target areas or sectors delivers superior returns – is key to mobilizing additional investment from the private sector.

CMIC's goal of delivering superior risk-adjusted returns on its investments in VC/PE funds operating in Mexico to create a "positive demonstration effect" represents a major challenge (as do the similar goals of other public institutions targeting other emerging markets jurisdictions). The statistical evidence, although fragmented and incomplete, is sobering. Based primarily on data supplied by large development finance institutions and the Emerging Markets Private Equity Association (EMPEA), Cambridge Associates has developed an Emerging Markets Private Equity Index. According to the Cambridge Associates index, 10-year returns for all emerging markets as of December 2005 are 4.06%, while for Asia they are 3.67%, for Central and Eastern Europe and Russia they are 10.25%, and for Latin America, they are negative: -3.62%.[10] Moreover, a 2004 report produced by the European Commission suggests that successful early stage venture investing is

[10] Data from the *Cambridge Associates LLC Proprietary Index* taken from the quarterly newsletter of the Emerging Markets Private Equity Association, Vol II, Issue 2, Q2 2006. (www.empea.net). The Cambridge Associates Index is based on pooled end to end returns, net of fees, expenses and carried interest.

particularly challenging: 5 and 10 year returns on early stage investments in companies operating in the European Union have been 2.3% and 8.3% respectively.[11]

Despite these rather sobering average returns, investment in VC/PE has the potential to generate substantially higher returns which have a significant positive impact on economic development, as discussed above. In the US, where the industry is the most mature, average 5 and 10 year returns on venture capital are 22.8% and 25.4% respectively, according to the 2006 European Commission report.[12] In terms of later stage private equity investments, the Cambridge Associates PE index for the US is 13.37% and for Western Europe is 21.13% for ten year returns.

It is important for CMIC and its stakeholders to approach the goal of demonstrating successful VC/PE investment in Mexico with the clear-eyed understanding that this is a difficult mandate. The point here is not to discourage the undertaking – indeed, the goal is too important not to undertake – but rather to stress that success will likely require excellence in all phases of CMIC's operations. CMIC's commission of this international best practices survey clearly reflects its appreciation of this challenge, as do other steps it has taken to ensure CMIC can operate in an independent, commercial manner. Such appreciation, of the difficult challenge posed by CMIC's mandate, will also serve as a key starting point for CMIC's consideration of the findings and recommendations set forth in this study, most of which are designed to take CMIC's existing good processes, policies and structures and further strengthen them, consistent with international best practice.

Notably, how quickly CMIC and its stakeholders move to incorporate excellence into its processes, policies, structures, and operations will likely have a substantial impact on CMIC's prospects for success. Although its shareholders are already respected for their work as investors in VC/PE funds in Mexico, CMIC itself is newly formed and just now establishing its reputation in the global VC/PE marketplace, among fund managers and especially among international investors in VC/PE funds. The marketplace is quick to form judgments, however, such that CMIC has at best 2 to 3 years to establish its "brand" as a serious institutional investor with which top fund managers want to work and smart investors want to follow. If CMIC succeeds in establishing such brand, its mandate will become progressively easier to implement. A negative initial image in the marketplace, on the other hand, could take years to overcome. It is therefore critical from the outset that CMIC convincingly project itself as a sophisticated investor committed to superior investment performance.

Finally, as CMIC's stakeholders recognize, operating a successful public sector FoF, while challenging, is not enough to develop a strong and sustainable VC/PE industry in Mexico. While CMIC plans to invest about $400 to $450 million over the next five years, this amount is still small given the size of the Mexican economy and need for risk capital. CMIC anticipates that these investments with public sector resources will help to develop, lead, and educate the marketplace, catalyzing further private sector investment, perhaps as much as ten times the original CMIC investment over the next five years. Yet as the 2003

[11] European Commission, "Profitability of venture capital investment in Europe and the US," Economic Paper Number 245. March 2006.
[12] ibid.

Study assessed in detail, there are regulatory and other hurdles to the dramatic expansion of private sector VC/PE investment. One of the most significant such hurdles is the current legal prohibition on investment by the Mexican pension funds in the VC/PE asset class. To truly "move the needle" in expanding VC/PE in Mexico, this large base of potential local institutional investors will need to be tapped. Thus, whether it is CMIC or some other governmental entity that spearheads efforts to address the legal and other hurdles to private investment in Mexican VC/PE, such obstacles will need to be removed in order for the goal of establishing a large, sustainable VC/PE industry to be achieved.

C. Study Methodology

To aid in the design of CMIC and ensure its operations, policies, and investment strategies are in line with international best practice, the CMIC Board, through NAFIN, obtained funding from the U.S. Trade and Development Agency (USTDA) to hire a consortium of consultants comprised of Cimarron Capital Partners, PCG International, and Millennia Consulting.

The terms of reference for the study called for the consultants to undertake the following seven tasks: (1) review of international experience in six countries; (2) analysis of options and implications for operations; (3) development of a financial model; (4) interviews with investors and fund recipients; (5) analysis of implementation options and products; (6) analysis of business plan, operations manual, and policy manual for the fund of funds; and (7) report writing.

For the review of international experience, the methodology included a scan of available information to identify experiences of greatest relevance to Mexico, and the development and distribution of a comprehensive survey that facilitated systematic collection of information on practices employed by a range of firms. The initial scan and additional secondary research looked at experiences with funds of funds and similar investment vehicles in over ten countries including the U.S., United Kingdom, Finland, Netherlands, Germany, New Zealand, Israel, Singapore, India, China, and Canada, as well as regional firms working in Latin America, Europe, Asia, and pan-emerging markets.

The survey (attached as Annex A of this report) was sent to 17 firms. Nine surveys were completed and follow-up interviews were conducted to ensure complete information from each of those cases.[13] Respondents represented a range of firms from both the public and private sectors, investing in developed and emerging markets, with total capital under management ranging from $40 million to $21 billion.

In order to facilitate the compilation of practices according to common characteristics and place findings into an appropriate context, the survey respondents were grouped into three categories selected according to the most dominant feature(s) the respondents have in common: (1) Seed and Venture Capital (SVC) Programs, in which more than 50% of program investment commitments are made to SVC funds; (2) Development Finance

[13] Two additional programs provided survey responses that were either substantially incomplete or late, so they are not incorporated into the aggregate analysis of the survey responses. However, their input is included as relevant in the findings of the report.

Institution—Private Equity (DFI-PE) Programs, which are publicly owned and funded, with an economic development mandate, and operate exclusively in emerging markets; and (3) Private Developed Market (PDM) Programs, which are comprised of independent, private sector investment advisory firms that manage capital provided by other investors (principally public and private pension funds), and invest predominantly in buyout funds located in the United States and Western Europe.

A degree of overlap exists among the categories and some respondents could be classified in more than one group. For example, an organization categorized as DFI-PE may also invest in venture capital funds and a firm categorized as SVC may also invest in private equity (though the majority of its investments are at the seed and venture level). However, for purposes of comparison each firm was placed in the category that best captured the scope and size of its operations.

Four "case studies" drawn from the survey results are presented in Annex B. The first three summarize the practices identified by respondents in each category, noting common practices and areas of difference. The fourth draws conclusions on "best practices" based on the survey responses and the Consultant's collective experience. These case studies are drawn on in the discussion of international experience throughout the Report.

A list of "international best practices" by FoF function, as well as a detailed discussion of the methodology used by the Consultant to identify a practice as "best", can be found in the fourth case study entitled "Best Practices". Review and evaluation of the findings and recommendations set forth in the body of this Report will be greatly assisted by an initial review of this case study.

The analysis required under Task II involved the collection and review of existing documentation on the Mexican FoF, analysis and comparison of current practices in Mexico with international experience, and dialogue with CMIC Board and staff regarding initial analysis and findings. Two site visits to Mexico were conducted to collect information, present initial findings, and discuss preliminary analysis.

A financial model has been developed under Task III that allows CMIC and its management firm to analyze the impact of various strategic and investment decisions on the financial projections of the FoF using sensitivity analyses. The model incorporates recommendations of the consultant related to organizational structure and investment strategies.

Information collected from CMIC and the review of international experience was augmented through twenty interviews conducted under Task IV. Interviews were conducted with international investors who could potentially co-invest with or in the FoF in the future, fund managers that have received funding from the new FoF or one of its shareholders, industry leaders in Mexico, and all current Directors of the CMIC Board (both shareholders and independent directors).

Following completion of Tasks I – IV, additional analysis was conducted and recommendations refined regarding investment strategies (including in respect of industry

sectors, asset class, risk profile), governance structure, operational and management procedures, fee structures, policies, staffing considerations, and forecast returns (Task V). In addition, research was conducted on international best practices related to building a culture of entrepreneurship and venture capital and recommendations developed for these activities given the current context in Mexico.

A sample business plan has been provided, building on CMIC's existing preliminary plan, and the consultants have commented on the CMIC operations and policy manual (Task VI). This Report constitutes Task VII.

The structure of the rest of this Report, other than the section describing the financial model, is generally as follows: (1) describe CMIC's current approach to the main issues and functions relating to a general topic, e.g. governance, staffing; (2) describe "international best practices" in respect of those issues and functions, as derived from the survey and research described above (and listed in the fourth case study); and (3) make recommendations regarding possible changes to CMIC's current approach, based on international best practices.

II. GOVERNANCE AND ORGANIZATIONAL STRUCTURE

A. Current Approach in Mexico[14]

In establishing CMIC, the Government of Mexico has sought to design a governance and organizational structure that allows the fund to operate with independence and in line with private sector practices, despite its current public sector ownership. Rather than continue to manage VC/PE investments under the umbrella of one of the state development banks, the Government created a new legal entity using the standard corporate form of a "Sociedad Anonima" (S.A.). The *Corporación Mexicana de Inversión de Capital, S.A. de C.V.* (Mexican Capital Investment Corporation, or CMIC) is a private Mexican corporation, held by four government-owned development institutions—NAFIN, Bancomext, Banobras, and FOCIR.

In order to facilitate professional fund management, a separate management firm was also established as a private corporation, known as *Administradora, S.A.* (the "Fund Administrator"). The Fund Administrator, which provides investment management services to CMIC, is currently owned by the initial shareholders of CMIC. However, it will operate as an independent entity with its own governance procedures, offices, and funding, to allow for the possibility of: (i) managing investment pools other than CMIC (ii) eventual spin-out of the Administrator management team, to manage investment pools other than CMIC through a different fund management company; and (iii) eventual sale of the Fund Administrator to the private sector. In addition, the use of a separate fund management firm allows CMIC the option of contracting a different fund manager.

[14] The description of the current approach in Mexico, in this section of the report and others, is drawn from a review of documentation provided by CMIC, including the corporation's bylaws, regulations governing the Board and various Board committees, and preliminary business plan.

The structure of CMIC is that of an evergreen investment corporation, with an initial life of 20 years extendable on an ongoing basis. The corporation was capitalized by contributions of the four founding shareholders of their existing investment portfolios. An initial share price was set in the corporation's bylaws at 500 Mexican Pesos. Each shareholder thus owns a number of shares corresponding to the value of the assets it contributed to the CMIC, as determined by agreement of the shareholders. Based on the preliminary valuation of the portfolio as of December 31, 2005, the expected initial distribution of shares among the founding shareholders is as presented in Table 1 below.

Table 1: Contributed Portfolio and Initial Distribution of Shares

	FoF Portfolio	Value of investment (US$ millions)	Initial percent of ownership
NAFIN	Sincas (8)	25.90	
	Fondos (16)	48.81	
	Subtotal	**74.71**	**55.44%**
BANCOMEXT	Sincas (1)	0.58	
	Fondos (5)	11.77	
	Subtotal	**12.35**	**9.17%**
BANOBRAS	Fondos (1)	**7.60**	**5.64%**
FOCIR	Fondos (2)	0.62	
	Cap. Riesgo (28)	18.56	
	Crédito (29) *	20.91	
	Subtotal	**40.09**	**29.75%**
TOTAL		**134.75**	**100.00%**

As additional capital is committed to CMIC, additional shares will be issued to the contributing investor and the proportion of ownership will therefore change for all shareholders. Each time a new VC/PE fund investment is approved by CMIC, its shareholders are given the opportunity to contribute additional capital for that investment. No initial commitment on the amount of new capital to be contributed is required, but shareholders are expected to make decisions on new capital commitments at the beginning of each year, based on budget projections presented by the Fund Administrator. To date, only NAFIN has committed new capital for the four investments approved as of July 2006. NAFIN has committed to invest up to $64 million in 2006. This will bring NAFIN's stake in the FoF to about 70% by the end of 2006, assuming (as anticipated) that no additional capital is contributed by other shareholders this year. NAFIN has also made an internal allocation to invest up to $50 million in 2007 and $136 million over 2008, 2009 and 2010, for a total of $250 million over the next five years.

All shareholders participate in the governance of CMIC through its Board of Directors. In addition to the four founding shareholders, the Board is comprised of four independent directors selected by the Board following detailed criteria designed to avoid any potential conflict of interest and strive for true director independence. While the shareholder institutions may designate alternate representatives to the Board, the independent directors are appointed as individuals and are expected to attend at least 70% of Board meetings. Terms are for one year, but are renewable without limitation. An independent operations

auditor (*comisario*) was also appointed by the Board and must be invited to attend all Board meetings.

All eight members of the Board have an equal vote, with the Board President having additional weight to break a tie vote if needed. The Board President is always appointed by the shareholder with the largest ownership stake in the CMIC. The articles of incorporation of CMIC anticipate the possibility of foreign investors becoming shareholders but notes that any foreign shareholders need to formally commit before the Secretary of Foreign Relations that it will be considered as a Mexican national with respect to shares in this company,

Decisions on investments are made by a committee of the CMIC comprised of 3 CMIC Board Directors and 2 representatives of the Fund Administrator (the "Investment Committee"). At least one of the Board members must be an independent director. Committee members are appointed by the Board and have no set term. Decisions are made by simple majority, but must include the vote of at least one independent director.

The role of the Investment Committee is to analyze, evaluate and recommend investments to the CMIC Board, which is the only body authorized to approve investments. The Investment Committee is charged with developing a strategic investment plan with short and long term goals, as well as policies and procedures that guide investment. This plan needs to be approved by the Board and should include an asset allocation plan that identifies priority investments, sets acceptable risk parameters, seeks to balance risk and return, establishes a system for risk management, and establishes a system for management of the portfolio that will maximize profitability given specified risk and liquidity levels as well as strategic objectives.

The CMIC Board has an audit committee comprised of three members of the Board, of which one must be an independent director. Audit committee members are appointed by the Board using detailed criteria established to ensure independence and avoid any potential conflict of interest. Quorum is achieved with a simple majority. Committee resolutions pass with a simple majority of members present, but must include the vote of at least one independent director.

As currently structured, the main roles of the Fund Administrator in respect of the CMIC are to: (i) cast two of the five votes on the CMIC Investment Committee; (ii) perform the sourcing and due diligence in respect of investment opportunities, and present such opportunities to the Investment Committee; (iii) perform portfolio monitoring and maintenance in respect of the CMIC portfolio; and (iv) engage in various outreach and VC/PE industry development activities, as further described in Section III.A. The Fund Administrator's Board is currently comprised of the four CMIC shareholders but not the independent directors**.** Board members are appointed by an assembly of shareholders for renewable one year terms. The Board President is appointed by the majority shareholder of the Fund Administrator. Regular meetings are held quarterly. Voting is done with a simple majority of those present, with the exception of certain decisions such as the creation of Board committees, appointing a CEO, and approving compensation packages, which require the vote of a majority of all Board members. The independent "comisario" must be invited to all meetings.

B. International Best Practice

Objectives; Organizational Structure

Funds of funds are a common vehicle through which investors direct capital to VC/PE funds, and constitute one of the largest categories of global institutional investors, with 120 firms managing funds of around $130 billion in 2005.[15] Funds of funds represent about 10% - 15% of the total capital invested in the primary equity market.[16] When reviewing international best practices of relevance to Mexico, it is important to look at the range of experiences in both the public and private sectors, including captive and third party-managed fund investment programs, as well as to consider generally the perspectives of fund managers and fund investors.

In addition to vehicles formally structured as "funds of funds", there are many private investment management firms that invest capital in funds on behalf of institutional investors on a for-profit basis, as "investment advisers." These firms may have the authority to make investment decisions on behalf of investors (i.e. discretionary management), or may simply make investment recommendations to investors (i.e. non-discretionary management). In either case, these firms need to demonstrate superior performance, as compared to both other third party investment advisors as well as internal investment staff, which many institutional investors maintain, in order to attract and retain clients. Whether managing a fund of funds, or managing a "special account" on either a discretionary or non-discretionary basis, the third party investment management firms generally perform the full range of investment functions, including sourcing, researching, and evaluating investment opportunities, and monitoring, managing, and analyzing the fund portfolio. The experience of these private investment advisory firms is thus also relevant to FoF international best practices.

The objectives of private funds of funds are driven primarily by the objectives of the institutional investors they serve. Institutional investors (typically, pension funds, insurance companies, foundations and endowments) primarily invest in VC/PE for superior returns. Of direct relevance to the CMIC, institutional investors typically invest in VC/PE funds through a funds of funds (as opposed to investing directly) for any or all of the following reasons: (i) to obtain access to VC/PE funds managed by top tier fund managers that are otherwise closed to new investors; (ii) to obtain greater diversification (by stage, geography, sector) than it could by investing on its own (given the size of minimum investment commitments required by most funds); and (iii) to invest with greater administrative efficiency or lower costs than could be achieved through building internal capacity.[17]

Private funds of funds are typically structured as discreet life entities, often as limited partnerships, generally for a period of 12 years (with up to two 1-year extensions). Investors

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[15] Almeida Capital. "The Fund of Funds Market: A Global Review" AltAssets 2005. www.altassets.net
[16] Private Equity International. (2005). "A Guide to Private Equity Fund of Funds Managers" London: Investoraccess Ld.
[17] See, e.g., "The Economic Logic of Fund of Funds: A Primer on How the Industry Works", in "*Private Equity Fund-of-Funds: State of the Market*" (Dow Jones, 2006 Edition)

seeking to invest in funds of funds prefer this organizational structure because it provides a pre-determined time frame for investments, which facilitates resource planning, monitoring of fund manager performance, and realization of investments. The discipline is in place to realize the portfolio within the fund term, and investment returns are generally distributed as received and not re-invested. In discreet life funds of funds, a set amount of capital is committed by investors at the outset of the fund, thus allowing managers to plan and implement an investment strategy that fits the size of the fund. Moreover, fund investors typically insist as a condition to their commitments that the fund achieve a minimum size that is appropriate to the market opportunities and the fund's investment strategy.

Governments and governmental institutions that invest in VC/PE funds (other than through pension funds) tend to have a primary strategic mandate, often to promote private sector VC/PE investment into a target geographic area or sector where it is not otherwise abundant. There are many such public sector programs: in addition to global and regional multilateral development institutions, many countries and even states within countries have been established to promote local VC/PE industries.

Like the private sector programs, the public sector programs are focused on investing in funds to generate attractive profits, because they view such "positive demonstration effect" as advancing the strategic mandate of promoting private sector VC/PE investment. However, to the extent the public sector program acts as a "pioneer" investor, committing capital to fund managers, investment strategies, or geographic areas that do not have a proven track record for generating attractive profits, the program takes on a higher degree of risk than most private sector programs.

The public sector programs are typically established as either departments of larger public institutions, or as government owned corporations. Where resident in a larger institution, the program is usually managed by internal staff consisting largely of civil servants. Where the program is established as a government corporation, the program is often (but not always) managed by internal staff, which are typically comprised of professionals hired from the private sector employees, but may also include civil servants.

None of the public sector programs (whether established as departments of larger institutions or as public corporations) reviewed by the Consultant seek to manage third party capital. There are, however, several examples of fund management teams that managed public sector VC/PE funds (as opposed to funds of funds) who went on to manage successor funds that were privately owned and funded, including Actis (which spun-out from the Commonwealth Development Corporation) and Enterprise Investors (which managed the Polish American Enterprise Fund). These data points indicate that, to the extent the management team for a public sector program seeks to spin out as a private investment advisor, it should conduct its activities to the greatest extent possible in the same manner as a private sector fund of funds manager, including in its objectives, structure, and governance.

Board Governance Functions

In private sector fund management companies (including funds of funds managers and investment advisory firms), the governance body functioning as the Board of Directors

(often a Board of Members) tends to consist of the firm principals, who are also the senior executives of the firm. In the public sector programs established as government owned corporations, the Board of Directors is generally not engaged in the day-to-day management of the program. In both cases, the Board generally engages in the following governance functions:

- approve an annual strategic plan;
- approve an annual budget;
- approve performance plans for senior management;
- hire and fire senior management;
- receive regular reports on actual vs. budget expenditures;
- receive regular reports from internal and/or external auditors;
- receive regular reports on the performance of the program portfolio; and
- receive regular reports of the programs development/outreach activities.

In the public sector programs established as a department of a larger institution, the Boards of Directors tend to engage in less oversight of the fund investment programs, delegating several of the above duties to senior management.

Investment advisors may be given full discretion or levels of discretion to commit a client to investments. But among public sector institutions that have a Board of Directors, it is common for the Board to review and approve the investment recommendations of the investment committee. (In private sector management firms, the composition of the Board of Members and investment committee are generally very similar, so that no separate Board approval is required).

In funds of funds and "special accounts" managed by private sector management firms on a discretionary basis, the investment decision is made by the advisory firm's investment committee, and the institutional investor has no input (other than approving the general investment guidelines within which the investment manager must function) in the selection of investments or day to day management of the program. To the extent investors do have decision-making authority in a fund of funds, for example to approve deviations from investment guidelines or to suspend further investments, such investors vote in proportion to the size of their investments in the fund of funds. Where private sector firms manage accounts on a non-discretionary basis, investment recommendations are typically approved by the client (e.g. pension fund), which approval may be provided by an officer or the Board of the client. Such Boards, as with the Boards of public sector programs, are often comprised of several government appointees, each of which has one vote.

Investment Committees

In private sector firms, the investment committee is the crucial forum for ensuring sound investment decisions. The investment committee is typically comprised of the firm's principals, who are senior investment professionals, and who use the committee as a formal venue for discussing and approving investment recommendations made by staff. Likewise, among public sector funds, the investment committee is often comprised primarily of businesspersons with experience and expertise in investing in VC/PE funds, and the

committee serves as the forum for discussion and approval **of** the investment recommendations of staff.

In the public sector programs, Board members (who are typically political appointees) are not usually members of the investment committee. However, to the extent the investment committee is comprised of individuals without extensive experience in evaluating and selecting VC/PE fund managers, it is critical that the staff or other advisors to the committee have not only the expertise but also the practical ability to screen out non-meritorious investment opportunities.

In both the private and public sector cases, successful investing depends on top staff, supported by proven advisors and professionals, to perform the underlying due diligence and analysis and to guide the investment committee through the rationale for an investment recommendation.

In the political environment that surrounds most public sector development institutions, the role of the staff, investment committee and/or Board often involves communicating to stakeholders how specific investment recommendations relate to the program's mandate, including the practical implications of generating a positive demonstration effect on fund investment selection. This communication is greatly facilitated, and investment decisions thereby enhanced, if Board members (and, to the extent they are not seasoned VC/PE fund investment professionals, investment committee members) receive regular information and training on best practices and trends in the global VC/PE industry.

Independent Directors

While the use of independent directors is a best practice in governance for corporations in general, private VC/PE investment firms are usually controlled by their principals without independent directors. Of the nine firms surveyed for this report, only two (both public sector programs) use independent directors. However, the private investment advisors surveyed report that many of their public sector clients (e.g. pension funds) utilize independent directors.

Where independent directors are utilized, there is evidence that the following are "best practices":

- independent board directors represent more than half of the board membership;
- independent board directors serve multi-year terms (at least 3 years, with the possibility of further extensions) to balance fresh perspective with continuity, institutional knowledge, and established working relationships;
- independent directors serve for staggered terms, so the terms of all the independent directors do not expire in the same year; and
- the qualifications for independent directors include sound business judgment and the extensive knowledge of and experience with private investing.

C. Reflections and Recommendations for Mexico

As described above, the Mexican Government has established CMIC to provide for the independent, professional management of its investments. Indeed, CMIC seeks to operate at such a high level of professionalism and independence from political influence that eventually institutions other than the Mexican Government will invest into CMIC.

The current governance and organizational structure established for CMIC and the Fund Administrator follows many aspects of international best practice in respect of public sector programs. However, to ensure the greatest chance for success in achieving the mandate of the CMIC, as well as achieve CMIC's goal of attracting additional investors to the FoF and/or having the Fund Administrator manage third party capital, several changes to the current structure are advisable.

The structure of an independent evergreen investment corporation operated separately from government agencies but owned by the public sector is in line with other public sector programs. This structure allows the government to be flexible and patient in its investment strategy depending on resource availability and market development. Moreover, CMIC's governance structure of providing each of its founding shareholders an equal Board vote despite differences in ownership stakes is not without precedent among public sector programs. This is also the case for example in the U.S. Overseas Private Investment Corporation (OPIC) where the sole shareholder is really the U.S. Government, but the Board is comprised of representatives of several federal agencies, each with an equal vote in decision-making. A similar approach to governance is often utilized by public pension funds, where the Board consists of representatives from various governmental agencies. Finally, the fact that the investment committee is a committee of the CMIC and not of the Fund Administrator is analogous to many public sector programs, which do not utilize a separate legal entity to manage their investments.

However, it is important to note that the public sector programs that utilize such a governance and organizational structure do not manage any third party capital. Although some public sector investors active in the region could possibly be interested in investing in CMIC, given its structure as an evergreen corporation controlled by appointees of the Mexican Government, CMIC will likely find attracting most outside investors difficult. Similarly, it will be difficult for the Fund Administrator to demonstrate that any positive track record of the CMIC is clearly attributable to it under the current structure, which demonstration will likely be required in order for the Fund Administrator to manage privately funded successor programs.

The decision of most investors to invest in the CMIC, or in a successor fund managed by the Fund Administrator, will likely be based on many of the same considerations as are taken into account by investors in the evaluation of opportunities to invest in a single VC/PE fund: does CMIC or the successor fund offer a clear and compelling investment strategy, an experienced fund management team that can demonstrate it has successfully managed a prior VC/PE fund investment program and is properly incentivized, and "market" terms and conditions, including a discrete life vehicle, with a defined pool of capital, and rights of investors to terminate, suspend, and remove fund managers? Moreover, as a fund of funds,

the Fund Administrator will need to demonstrate that it can manage capital better and more efficiently than investors themselves.

In order to attract third party capital to CMIC, the organizational and governance structure would need to be modified to be in line with international best practices for private funds of funds. Indeed, many of these modifications will also improve the efficiency and effectiveness of the CMIC in investing public sector funds. Key elements that investors would look for in making decisions on investing into the FoF include:

- Alignment of interest with fund manager and other investors;
- Size and focus of the fund; and
- Demonstrated capability of fund manager to carefully invest third party capital.

In terms of alignment of interests, investors want to see clear independence of fund managers, clear guidelines on potential conflict of interests, avoidance of any preferential obligations to any of the other investors, and capital at risk on the part of the senior officers of the fund management team. Investors also seek to ensure that the other investors in the fund of funds have interests in alignment with their own. They want to know that there are like-minded investors who will tend to approach any problems that may arise in a similar way. Political independence of investors and clarity of objectives is thus important.

Investors are interested in analyzing the size of the fund relative to the size of market opportunities, to gain a sense of confidence that a fund of funds will be able to implement its investment strategy and invest efficiently. A traditional fund with a pre-determined capital level over a discreet life period facilitates this analysis for investors. Furthermore, investors need to have a clear picture of the focus and strategy of the fund.

The capability of the fund manager would be determined by investors based on its demonstration of, among other factors: sound due diligence practices; unbiased decision-making based on specific criteria; deep market knowledge and connections to deal flow; appropriate supervision and monitoring of portfolio; reliable reporting; and most importantly, past performance. It is therefore critical, if the Fund Administrator seeks to manage private capital, that all of these factors reside within or are directly attributable to the Fund Administrator team. Under the current structure, any success enjoyed by CMIC will be attributable to personnel of both the Fund Administrator and CMIC, because a substantial portion of the investment committee is comprised of individuals who are not part of the Fund Administrator management team.

Specific Recommendations

In order to adapt the current structure of CMIC and the Fund Administrator to meet international best practices, thus allowing optimal management of existing resources as well as attracting co-investors, we recommend the following specific changes:

1. *Establish separate legal and financial entities structured as discreet life funds of funds*

Maintaining the current structure of the evergreen investment corporation for the current investors is reasonable and serves the current objectives of the public sector investors. The plan of reinvesting profits rather than distributing them to shareholders is sound to allow for ongoing capitalization of the investment corporation, alongside any additional capital commitments.

Bringing in additional investors to the Mexican FoF, as planned by CMIC, is recommended not only to increase the amount of capital being invested but also to provide greater long term institutionalization of the FoF and minimize the potential for political interference over time. In order to do so, organizational and governance structures will need to be in line with international best practices, namely discreet fund life; capital commitments made by all investors up front; and voting based on shareholder interest.

We recommend CMIC organize a companion fund of funds entity as soon as it has put in place its team and procedures, has demonstrated the ability to effectively deploy capital, and can appeal to other investors (likely public sector programs operating in the region). This entity would be operated by the Fund Administrator alongside the first FoF, would allow the new investors to have representation on the Board, and could be structured as a limited life vehicle with up front capital commitments, a more defined investment strategy, and "market" investor protections. This recommendation has been incorporated into the financial model discussed in Section VIII below and presented in Annex D.

In this Report and the financial model, the existing Mexican FoF is referred to as **FoF1**. The second, suggested for launch in 2008 as the above conditions are achieved, is referred to as **FoF2**. A third FoF, referred to as **FoF3**, modeled for launch in 2012, could potentially attract private as well as public institutional investors.

2. *Within CMIC and Fund Administrator, modify terms of independent directors*

The decision to use independent directors on the Board of CMIC was a positive one in line with best practices. In order to ensure independence as well as continuity, CMIC should consider lengthening the terms for independent directors to three years. Terms should be renewable, and staggered. Given limited experience within Mexico with the VC/PE industry, CMIC has selected independent directors with extensive business expertise and sound judgment, but not necessarily experience with investing in VC/PE funds (which is not the same as making or facilitating equity investments in individual companies). Thus ongoing education of independent directors and other Board members on this particular industry and especially global trends and practices will be useful in their ability to serve effectively.

3. *Structure Fund Administrator in such a way as to allow for possibility of future privatization and management of third party capital*

CMIC has structured the Fund Administrator to permit its eventual privatization. Utilizing a core team of investment professionals to manage CMIC's investments is consistent with international best practices, and in this respect the establishment of an independent Fund Administrator for CMIC is sound. However, the full potential of having an independent team of investment professionals manage CMIC's investments will not be realized unless the level of its responsibility and discretion for making investment decisions is clarified. Under the current structure, the merits of investment opportunities are formally discussed and decided in a body of CMIC (the investment committee), on which the Fund Administrator has minority representation. Moreover, it is unclear that under the current structure the Fund Administrator has the authority and practical ability to decline to present non-meritorious fund opportunities to the investment committee. In order for the Fund Administrator to establish a clear "track record", upon which it may be privatized and/or manage third party capital, it must be evident to investors that the Fund Administrator team had the primary responsibility for CMIC's investment decisions, and that the individuals, networks and processes behind those investment decisions are all resident in the Fund Administrator.

Although the organizational and governance structure of CMIC and the Fund Administrator in many ways reflects best international practices for public sector programs, the following changes would both enhance its effectiveness as a public sector institution and lay the proper foundations for achieving in the future the goals of attracting third party capital to the FoF or allowing the Fund Administrator to manage successor funds as a private manager:

(1) Move Investment Committee function, and copy the independent director structure, into the Fund Administrator. Thus, the same individuals will act as the investment committee under this modified structure as in the current structure, but all investment decision-makers will be part of the Fund Administrator. The purpose of this recommendation is to ensure the track record of each FoF entity is clearly attributable to the Fund Administrator, and that the technical expertise is being developed and resides in the "manager" of the FoF. The board of CMIC can still approve FoF1 investments, as in public sector programs and pension funds, but should confine its oversight to strategic fit and program mission issues. In respect of CMIC's subsequent participation as a limited partner to FoF2 and FoF3, the CMIC Board's role should be limited to approving the upfront capital commitments to and the constituent documents (including general investment guidelines) of each vehicle. If the Government of Mexico seeks eventually to privatize the Fund Administrator, or to have it manage third party capital, it will need to be clear to potential investors that the Fund Administrator team is responsible for the FoF track record

(2) Ensure that the Fund Administrator is staffed with experienced, senior investment professionals, and provide on-going resources for the training and development of

Fund Administrator staff, including the Investment Committee representatives (see Section V).

(3) Ensure that there is clarity between CMIC and the Fund Administrator on the investment objectives for FoF1, as well as subsequent vehicles, including specific guidance on performance targets and tolerance for risk to achieve developmental objectives, which investment guidelines should be set forth in writing (see Section III).

(4) Utilize clear, written fund manager selection criteria and process (see Section IV.A);

(5) Utilize clear, written portfolio management, monitoring and analysis procedures (see Section IV.B);

(6) Engage in a regular process for reviewing the efficacy of the items 3, 4 and 5;

(7) Maintain throughout the CMIC and Fund Administrator a firm dedication to transparent operations based on compliance with agreed procedures;

(8) Make substantial investment in IT capability, to provide real time information, and to demonstrate over time that the management team and its processes yielded superior performance.

III. INVESTMENT STRATEGY AND OBJECTIVES

A. Current Approach in Mexico

The Mexican FoF was established with a clear commitment to pursue an investment strategy that both generates profitable returns and serves to catalyze growth of the VC/PE industry in Mexico, which would in turn spur the entrepreneurial economy. The objectives of CMIC as specified in its preliminary business plan are as follows:

- Develop the growth of venture capital industry in the country under principles of viability and profitability;
- Coordinate government and private efforts in matters related to venture capital;
- Provide temporary capital through specialized funds for projects/and or viable businesses with high growth potential and in the expansion stage;
- Stimulate public and private investment through institutionalization of venture capital;
- Support creation of new venture capital funds;
- Promote a venture capital culture between investors and businesses;
- Promote the development of new venture capital investment schemes; and
- Support legal and financial initiatives that will strengthen venture capital for the benefit of small and medium sized enterprises in Mexico.

While the CMIC's functions primarily consist of defining policies and approving investments, all other functions are to be realized through the Fund Administrator, whose core functions are the following:

- Identify Fund investment opportunities; these should be presented to the Investment Committee and to the CMIC Board;

- Monitor investments;
- Participate in fund administration activities (Board of Directors and Investment Committee) where it takes part as representative of the CMIC's interests;
- Administer the CMIC's financial resources that have not yet been invested;
- Administer venture capital programs and public investments;
- Design and operate the appropriate release mechanisms for venture capital investments (Over the Counter, OTC Market);
- Promote modification to legal framework; and
- Organize events, forums, seminars, etc. to promote venture capital culture in the country.[18]

General investment polices have been established by CMIC and include the following:

- Support funds where fund managers have proven experience.
- Support funds with an investment strategy oriented to sectors previously defined, trying to keep a diversified portfolio;
- Funds must have a minimum capital goal of US$12 million.
- In the case of international funds, at least the equivalent of double the contributions from the CMIC must be invested in Mexico.
- Minority participation from the CMIC of up to 35% participation in funds larger than US$30 million, with a limit of US$30 million; and up to 35% participation in funds smaller than US$30 million, with a limit of US$10.5 million. (These percentages can be revised downwards after the 5th year.)

The investment guidelines also dictate that the CMIC cannot take part in funds where investment is directed to polluting enterprises, armament and explosive businesses, speculative real estate, or gambling, among others. It further specifies that investments should be focused in sectors that have been defined as strategic priorities in the government's National Development Plan, and in those funds that support regional development, seeking to direct investments to the sectors that are most attractive considering Mexico's competitive advantages. The priority sectors have been defined as aerospace, agribusiness, automotive, commerce, construction, leather products, energy, export-oriented maquiladoras, chemicals, software and information technology, textile and clothing, and tourism. Specific sectors excluded from investment include the financial and real estate sectors. The rationale for limiting the sectors in which CMIC invests was to focus public sector investments where greatest economic impact was needed and not to sectors where the private sector was likely to invest whether the public sector was also investing or not.

Within the context of this strategy, the FoF guidelines specify that investments should be made only where profitable returns "at market rates" can be expected and where transparent analysis has been conducted. The FoF is to invest only in fund managers with proven experience. Nevertheless, CMIC recognizes that its goal of promoting the development of a local VC industry will likely require it to invest with first time fund managers. In these cases, CMIC is to assess the aggregate experience of the individual team members within the fund management firm, and to impose special conditions on investment

[18] Objectives and Functions taken from CMIC Preliminary Business Plan.

(such as obtaining at least 5% of the fund manager's portion of fund returns) to compensate for the additional risk.

In terms of asset allocation, the FoF intends to diversify its portfolio by sector, stages of investment, and size of companies supported. CMIC aims to invest in funds representing a range of investment stages (seed, venture, growth/expansion, buyout) and investment strategies (equity and mezzanine). However, it recognizes that each has varying risks and return implications and has not yet defined a specific asset allocation plan.

B. International Best Practices

It is widely accepted in the global VC/PE industry that fund manager quality is the most important determinant of fund investment success, or at least the most important determinant within the control of the investor. The primary investment strategy of most institutional investors (and indeed the reason why many of them choose to invest through a professionally managed fund of funds) is to invest with the best fund managers, irrespective (other than in matters of reputation) of the fund manager's specific underlying strategy. Nonetheless, consistent with this primary objective, most institutional investors attempt to construct an optimal fund investment portfolio, from the standpoints of risk, return and cash flow, through the use of a formal, annual, asset allocation planning process. Many public sector programs also seek to invest with the best possible managers, at least with a large portion of their investment capital, on the theory that such an approach is critical to generating a "positive demonstration effect." Most public sector programs also use some form of allocation planning, although not always as a formal, annual process.

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

- 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.

In order to ensure the asset allocation plan is grounded in local market realities, fund administrators conduct extensive research on the market including mapping the fund managers active in the geography or sectors of interest to the fund managers. The depth of such research varies depending on the size of firms and available resources. For example, a large private sector global private equity fund of funds manager monitors about 600 funds and tracks the top 100 funds and top 200 fund managers on an ongoing basis. This allows the firm to have a good sense of the market landscape and identify the best fund managers.

Asset allocation plans provide a useful tool for providing a clear strategy for 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.

Ultimately it is the quality of proposals received from fund managers that will inform whether or not the asset allocation plan is on target, and inform adaptation of the plan in subsequent years. This is particularly true in circumstances where the VC/PE industry is at an early stage of maturity. FoF managers need to be patient in order to avoid forcing capital into allocations where the immediate opportunities are not very attractive and instead wait until the best managers for a given allocation/objective are in the market. Generally, allocations are considered as ceilings rather than minimum restrictions.

Although successful private and public sector programs also research the growth prospects of various industry sectors, they do so in order to make informed decisions about the credibility of fund manager strategies, rather than to lead fund managers to invest in certain sectors. Stated differently, successful programs react to investment strategies put forth by experienced fund managers, rather than find investment managers to implement investment strategies that have been designed by the investors. Experience has shown that the key to developmental VC/PE 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.

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.

The Israeli government program, Yozma, established a fund of funds in 1993 with US$80 million. The program is widely considered among the most successful governmental efforts to catalyze a VC industry: by 2000, its interests in nine VC funds were auctioned and privatized, over half of the $10 billion raised by Israeli VC funds in that prior decade was managed by Yozma related firms, and its funds had invested in over 200 start-up companies.[19] Today Israel has a vibrant VC industry. Notably, the program was specifically intended to "create a competitive industry with critical mass by integrating and learning from foreign limited partners and integrating Israeli venture capitalists into an international network."[20] Specifically, Yozma invested in 10 funds managed by Israeli managers, providing $8 million to each fund (40% of total fund capital), on the condition that each fund raise at least $12 million in private capital, including a substantial investment from an established foreign VC fund or other financial institution. The program thus paired Israeli managers with foreign venture capitalists in order to provide the Israeli firms an opportunity to learn, and to provide an external quality check on the Israelis applying for the government funds. The Yozma program also provided a strong upside incentive, for 5 years the private funds had a call option on government shares at cost plus 5-7 percent interest – a lucrative incentive for both the Israeli and foreign partner.[21]

Likewise, the FoF established by the Government of Singapore, also considered to be among the most successful public sector programs in catalyzing a domestic VC/PE industry, focused strongly on creating linkages with international fund managers and investors. The Government established its Technopreneurship Investment Fund (TIF) in 1999 with US$1 billion, divided into three subfunds: (1) a broad-based $500 million FoF to attract foreign venture capital firms to Singapore through investment in such funds, (2) a "strategic" FoF that invested in VC funds around the world – regardless of intention to invest in Singapore – in order to establish relationships and seek knowledge transfer; and (3) an early stage fund that invested locally both directly and through local VC funds.[22] Government funding played

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[19] Lerner, Josh, David Moore and Stuart Shepherd. (2005). "A Study of New Zealand's venture capital marklet ad implications for public policy," LECG Limited, 43.
[20] Avnimelech, Gil, Morris, Teubal, and Kenney, Martin, "Building Venture Capital Industries: Understanding the U.S. and Israeli Experiences" The Hebrew University, 2006, at 32; Avnimelech, Gil and Morris Teubal, "Evolutionary Venture Capital Policies: Insights from a Product Life Cycle Analysis of Israel's Venture Capital Industry" The Hebrew University, 2003.
[21] Ibid.
[22] Lerner, Moore, and Shepherd (2005), 45; Kenney, Martin, "Scattering Geese: The Venture Capital Industries of East Asia – A World Bank Report", University of California – Davis, 2002 at 112.

a major role in the growth of the VC industry in Singapore, as demonstrated by the fact in 2000 approximately one fifth of the VC funds operating in Singapore had their origins in government financing.[23] Moreover, the cumulative amount of funds managed in Singapore has doubled from S$9 billion in 1998 to S$17 billion in 2005, and the number of VC firms investing in Singapore doubled from 82 in 1998 to 160 in 2005.[24]

Importantly, the Singapore and other successful public FoF 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" invested locally, the strategy over time will "pull" international fund managers into the local industry, to great effect.

C. Reflections and Recommendations for Mexico

Mexico is pursing a positive investment strategy in line with international best practices by aiming to meet its developmental objectives through a fund of funds vehicle intended to invest profitably. Finding an appropriate balance between its performance and strategic objectives will be key to success of the initiative. The investment strategy pursued by CMIC needs to seek to achieve its strategic objectives, but should do so in a way that permits funds to address strong market opportunities and enhances the potential for strong rates of return. All of the firms surveyed for this report noted that performance was their top objective, even when they also had strategic objectives.

While the definition of priority sectors is useful for informing the FoF on potential opportunities, best practices suggest that the FoF should minimize limitations on the sectors in which the funds it supports can invest, so that such funds can respond to the best opportunities presented by the market. As discussed in the introduction to this study, generating a positive demonstration effect for VC/PE investing in Mexico, given the nascent state of the industry, will be a tremendous challenge. CMIC should therefore avoid tying the hands of its professional fund managers unnecessarily. Excluding funds that invest in the financial sector and real estate, for example, is unnecessarily restrictive, as these are attractive opportunities in Mexico. (Furthermore, other development finance institutions are investing in these sectors in Mexico, suggesting that public sector support may indeed be needed). Although CMIC may not want to invest in a fund that focuses exclusively on certain sectors that are already of great interest to private investors, allowing its funds to make some investments in the most promising sectors will facilitate fundraising and improve returns. Public sector investment programs are most effective and generate the largest economic impact when they are able to invest where the greatest market opportunities exist within the framework of their asset allocation plans. By demonstrating excellent financial

[23] Ibid.
[24] Speech by Mr. Teo Ming Kian, Chairman, Singapore Economic Development Board, at the Asia Pacific Venture Capital and Private Equity Association Roundtable on 24 January 2006.

returns, CMIC will attract other institutional investors to the VC/PE asset class in Mexico. And by supporting the companies in Mexico that are growing most rapidly, regardless of sector, CMIC will be selecting for those businesses that are creating the most jobs. Finally, over time, by producing strong financial returns CMIC will prosper, ensuring its ability to support the higher-risk, emerging sectors in Mexico.

In order to develop an asset allocation plan, the Fund Administrator will need to conduct deep bottom-up research and analysis on actual opportunities in Mexico. Such a study was beyond the scope of this assignment and is a task that is best carried out by the Administrator directly. The research function is needed from the outset but can grow and mature over time. A strategy that could be effective for the Administrator is to contract advisors to conduct market research, and then build the capacity in-house over time, adapting the process learned from the advisors.

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 Consultant: (a) reviewed the actual allocation of capital in other parts of the world, (b) examined through interviews and anecdotal evidence the current economic and sectoral 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. Table 2 summarizes the distribution of investments by asset class for different regions of the world.

Table 2
Allocation of VC/PE Capital Globally by Stage (in percents)[25]

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 Table 2, 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.[26] 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

[25] 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.
[26] National Venture Capital Association/Thomson Financial, "Q2 2006 Fundraising Data". Downloaded online at www.nvca.org)

markets and 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 VC/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. Whereas in developed economies there is more emphasis on buyouts, in emerging markets – especially if investing with a developmental focus – there is more of an emphasis on expansion.

In Mexico today, the vast majority of capital deployed by local funds 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. International funds, on the other hand, that are active in Mexico have demonstrated an appetite for large buyouts of established companies and divisions. 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 the 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 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 a growing number of funds with a proven track record are emerging as reasonable candidates for CMIC investment.

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 Table 3. 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.

Table 3
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 Table 3, 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.

IV. OPERATIONAL PROCEDURES AND INTERNAL POLICIES[27]

A. Current Approach in Mexico

Investment Process

The Fund Administrator has established an investment process based on the prior experience of the shareholders in their VC/PE operations. Deal sourcing is done through a combination of networking and outreach. Since NAFIN and other shareholders have played a leadership role in fostering the VC/PE industry in Mexico, and have widely advertised the formation of the FoF in Mexico, local fund managers know to approach the FoF with opportunities.

Due diligence begins with an evaluation of fund managers through a series of personal meetings and reference checks. A formal process of documentation review is then undertaken. Staff of the Fund Administrator is responsible for sourcing and evaluating fund opportunities, and presenting recommendations to the Investment Committee, whose decisions are then presented to the Board for final approval.

Guidelines have been established that define terms for FoF investments in funds including the following:

- Capital will be contributed pari passu with other investors
- CMIC must participate on the fund's Investment Committee and Advisory Committee

[27] More detailed description of recommendations related to operational procedures and internal policies are included in Annex E (Recommendations for Operational Manual) and Annex F (Recommendations for Policy Manual).

- Fund managers should invest at least 15% of committed capital of the fund within the first two years
- CMIC expects distributions in line with best practices
- In small funds, investors should have the right to request liquidation of the fund if key personnel are changed. Any change of senior personnel should be approved by a 75% majority of investors
- Fund managers can be removed by a 75% majority of investors for failure to comply with legal obligations

Portfolio Monitoring and Management

The Fund Administrator has responsibility for portfolio monitoring and management. Valuation of the portfolio is to be done using guidelines established by BVCA, EVCA, or AFIC. Specific systems for monitoring and management have not yet been established, though staff has begun to monitor the existing portfolio contributed by the current shareholders using existing processes in place by NAFIN.

B. International Best Practice

Investment Process

The key aspects of the investment process reviewed for international best practice are deal sourcing; evaluation of fund managers and due diligence process; investment approval and execution process; and key documentation terms. Since there is substantial agreement on standard practices in these arenas, our description of these practices is taken primarily from the nine respondents surveyed for this report. Additional detail and specific recommendations for adopting best practices in the Operations Manual of CMIC are included in Annex E.

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.

Three of the nine programs surveyed used a public "request for proposals" (RFP) process to source deal flow, at least during the ramp-up phase of the program. These programs were neither global private equity programs nor programs housed in larger institutions with extensive "on the ground" personnel. Thus, there is evidence that use of an 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

As a "best practice," funds of funds define specific criteria used in evaluating whether to invest in a specific fund. These criteria are made public including posting on websites, to ensure a transparent evaluation and selection process. Key criteria relate to the specific previous experience and qualifications of fund managers, as well as demonstrated ability to attract and manage deal flow.

Due diligence is performed based on a consistent structure, involving review of a pre-established list of documents and verification of information provided by potential investee funds. Generally, this involves use of a detailed questionnaire, review of the private placement memorandum, interviews with full management team and past portfolio companies, reference checks, verification of fund cash flows, and negotiation of key investment terms prior to making a commitment.

Standard templates are used in order to enhance the efficiency of the screening/evaluation/due diligence process. Typical templates used include template screening memorandum, template evaluation criteria checklist, template cash flow model, and database of funds, team members, and portfolio companies.[28]

A timely process of response to prospective fund managers is also important. Firms often have a weekly meeting among investment officers to decide whether new funds are worth pursuing or not. Funds that have contacted the firm receive responses within a short time frame, with a clear indication of the reasons for the decision and the next steps in the process, if the decision was to move forward with due diligence on the fund.

Investment Approval and Execution Process

Investment approval 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.

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

[28] Templates are often available for download on firm's websites. For example, the US Overseas Private Investment Corporation has forms available at: http://www.opic.gov/investment/apply/index.asp

- 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.[29]

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," funds of funds tend to consider a certain set of terms as key to fund investment negotiations. These include structuring (tax and ERISA) issues as well as the ability of the limited partners to do the following:

- suspend the fund's ability to make investments by a supra-majority vote;
- terminate the fund by a supra-majority vote;
- remove the general partner "without cause" by a supra-majority vote;
- suspend investments and/or terminate the fund based on a "key man" event;
- "claw back" general partner carried interest distributions; and
- participate on the advisory board of the fund.

Portfolio Monitoring and Management

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.

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

[29] 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.

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.

Key portfolio monitoring and management functions revolve around ensuring compliance of funds with agreed terms and requirements. As a matter of “best practice” funds of funds monitor compliance of each proposed investment by an investee fund with that fund’s contractual restrictions such as investment guidelines, and confirm compliance of funds with all contractual provisions and reporting requirements.

Databases are maintained on a regular basis with information on each fund, including fund terms, portfolio company profiles, capital calls, distributions, and other cash flows. Integrity of databases is maintained through separate accuracy reviews by a person other than the individual that input the data. As resources allow, best practice among larger firms includes the verification of data provided by funds, including against monthly program bank statements, quarterly fund financial statements, and quarterly or semi-annual fund valuation reports.

Regular portfolio performance repots, including current valuations, actual cash flows, and portfolio IRR, as well as regular cash flow forecasts are produced as part of best practice monitoring and management functions. Reports also compare performance against industry benchmarks.

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).

Careful monitoring allows FoF managers to identify discrepancies resulting from differing valuation methods. For example, two investee funds could have different valuations for the same portfolio company.

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.[30] 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$75,000 – US$100,000, though it could be less particularly if programmed in Excel or Access. In addition to costs of external consultants, internal staff hours are spent on ensuring proper customization and training. Firms typically spend about US$25,000 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:

- status/performance of each fund (e.g. capital committed, drawn down, invested, realized, distributed; IRR and multiples);
- aggregate roll-up of status/performance of program portfolio;
- program portfolio diversification (e.g. by vintage year, investment strategy, sector);
- program portfolio annual cash flows, actual and projected;
- compliance of each fund with contractual requirements;
- contacts manager/directory of fund contacts;
- forward calendar of fund manager fundraising cycles; and
- customized reports derived from filtering, grouping, subtotaling database entries.

Risk Management

Risk management is considered an important function by fund of fund managers. The extent to which firms carry out these functions depend on the size of the firm and resources available. Larger firms have a dedicated compliance officer on staff.

As a matter of "best practice" risk management involves written procedures and formal processes regarding key issues such as conflict of interest and money laundering. Written codes of ethics are shared with all staff, together with clear procedures for reporting and handling infractions.

Regular internal audits ensure compliance with investment process and procedures, portfolio monitoring and management, and risk management procedures. To ensure internal controls, firms organize work with separation of duties where conflicts of interest may arise. 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.

[30] Vendors include Burgess/Private I, Sungard/Investrans, Analytyx, and Venture Complete. A listing of over 20 such vendors can be found in the report *Private Equity Fund of Funds: State of the Market* (Dow Jones, 2006 Edition), Exhibit 4.9 "Guide to Vendors who Market Accounting/Reporting Systems."

A key factor in minimizing risks involves ensuring 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. Formal processes and written procedures, as well as existence of confidential mechanisms for staff to report concern are commonly used to manage risk.

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 the categories of management, measurement, and oversight.[31] A listing of the standards is included in Annex F.

C. Reflections and Recommendations for Mexico

Investment Process

The investment process put in place thus far by the FoF follows several aspects of international best practice, and appears to be in line with practices of other Mexican investors (private as well as public). The due diligence process is sound, though could be further formalized and transparent, with all information required of candidate funds provided to them up front, along with a timeline for completing each step of the process. Relationships are important, but processes should be transparent in assessing fund managers. The more the outside world understands the discipline used in selecting investments, the greater will be the respect given to the FoF.

In order to increase efficiency of the due diligence process, especially if pace of investments increases, additional staff should be brought into the due diligence process. Currently the evaluation and due diligence functions are handled almost entirely by the senior staff manager. As discussed further in Section VII below, staff should be highly professional and trained in VC/PE.

At the staff level, several members of the team should be engaged in meeting the management team of prospective funds, conducting site visits, and sharing tasks of due diligence. This provides more than one perspective on the opportunity and several points of reference for evaluating fund managers. Investment officers, serving as an internal investment committee, should participate in the decision-making.

In terms of generation of deal flows, the FoF seems to be taking the right steps. Even though the goal is to evaluate those opportunities presented by the private sector, a FoF manager cannot just wait for such opportunities to present themselves. With a clear picture of what the portfolio should look like based on an asset allocation plan, FoF managers should actively go out and to find appropriate candidates, scanning the environment to gain a good understanding of opportunities that exist. By building a relationship with these candidates the FoF will improve the likelihood it will have the chance to invest in the better funds. It is a top down and bottom up approach. The Fund Administrator has been doing this and should continue activities that provide it with visibility as well as the opportunity to get to know

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

fund managers in the market. An RFP can be used to jump start evaluation of strategies with which the Fund Administrator/Investment Committee is not already fully familiar, and to surface international fund managers that are interested in Mexico.

The investment terms set by the FoF in its investment guidelines are generally in line with best practices. However, some may need to be reviewed. For example, participation of the FoF on the investment committees of their investee funds differs from current international practice. While many DFI investors did previously participate on investment committees, this trend has changed. Many investors do not want other investors (particularly public sector programs) that are not properly incentivized and may not have the requisite experience in direct VC/PE investing to participate on investment committees; as a result, requiring FoF participation on the investment committee of a portfolio fund may have an adverse impact on the ability of the fund to raise capital.

Portfolio Monitoring and Management

As the Fund Administrator establishes its portfolio monitoring and management system, it should strive to follow the various specific elements summarized above under international best practices and listed in detail in Annex E. However, the current size and resources of the FoF have to be taken into account. As the FoF grows and resource constraints are minimized, some of the more sophisticated elements could be adopted. Internationally, most firms perform many of same monitoring and management functions, but the level of sophistication and dedication of staff evolves as firms grow and resource constraints change. Whatever the specific methods employed, clear written guidelines and procedures are needed to guide staff in performing these critical functions.

Monitoring reports should include a comparison of the FoF's performance with international benchmarks. In the case of CMIC, benchmarks should be drawn from both developed and emerging markets. The FoF will want to demonstrate how it compares to several other regions and countries within Latin America; but in addition, investors will want to know how returns compare to US, European and Asian benchmarks.

A good IT system is essential for portfolio management, and should contain all of the key parameters listed above. Staff should review several existing platforms to determine whether adapting a purchased software or hiring a developer to design a custom system is the best option. The key will be that the system provides the reports needed and is user-friendly so that it can be maintained by staff. Data entry and report generation should be simple in a good system taking up a minimal amount of staff time and facilitating greater access to the information that supports portfolio monitoring and management.

Risk Management

The Mexican fund of funds can adopt many of the basic risk management practices considered best practice and build complexity into the system as resources allow. Written procedures regarding conflict of interest, and organizational structures that ensure separation of duties should be put in place. Financial auditors can be asked to review compliance with contractual terms. In addition, an annual internal audit by an independent consultant could

provide the Board with assurances that guidelines and procedures are being followed appropriately.

As the Fund Administrator seeks to manage third party capital, it will need to be careful to ensure it does not have special obligations to founding shareholders that may lead to a conflict of interest in managing the funds of other investors.

V. STAFFING AND MANAGEMENT CONSIDERATIONS

A. Current Approach in Mexico

Staff Composition

The Fund Administrator has proposed an initial staff of 10, which could grow to 12 with the addition of two additional investment officers as needed. Staff will include a Managing Director, a Deputy Manager for Investment, 4 Investment Officers, a Deputy Director for Administration, two Administrative Consultants, and one secretary.

The Administrator plans to outsource the following functions: legal services, IT support, accounting and tax services, payroll, risk management, and audit.

Division of responsibilities among staff include the following:

- Managing Director – Responsible for overall management of the operations, definition of strategy and policies, promotion of the industry, design and oversight of activities to grow the industry, participation on Investment Committee and CMIC Board.

- Deputy Manager for Investments – Responsible for everyday management of the portfolio, including deal sourcing, due diligence, participation on governance committees of investee funds.

- Investment Officers – Analyze opportunities, negotiate terms with funds, participate in governance committees of funds, monitoring and managing portfolio of assigned funds

Compensation

The Fund Administrator has proposed salaries based on comparison with salaries paid by PE fund managers operating in Mexico. In addition to base compensation, the Fund Administrator will pay a bonus of 20% over annual salary for investment officers, deputy managers, and the managing director.

B. International Best Practices

Staff Composition

Highly qualified professional staff has proven essential to quality fund of funds investing. A review of staffing configurations of a number of investment firms suggests that an internal staff of 9 to 14 persons, of which 7 to 10 are investment and other professionals, represents appropriate staffing for a fund investment program that is larger than USD$300 million (and invests in SVC funds).

Investment firms, particularly smaller ones managing up to about $300 million in capital tend to be organizationally flat, in that at least half of the internal staff consists of senior investment professionals. Where resources allow, investment origination and portfolio monitoring and management functions are handled by distinct staff. Even in such cases, origination staff may have some role in portfolio management, such as participation on fund advisory boards or review of reports. Of firms surveyed for this report, 50% assign junior level staff to the tasks of data entry and compliance checking. Each staff member is generally responsible for tracking six to eight funds.

Certain functions, such as legal counsel, tend to be handled in-house when possible, but outsourced in smaller programs. As a matter of "best practice," program managers should negotiate business terms, while legal counsel should be engaged to review documentation and ensure that documents reflect the agreed business terms. To the extent resources are available, it is helpful to have a full time in-house lawyer, supplemented by external counsel. It is not uncommon to have separate counsel for partnership matters, tax matters, regulatory matters, and transaction matters (to the extent the fund is making direct investments). Smaller programs, which tend to be more resource constrained, generally outsource the legal function entirely.

Compensation

In order to maintain quality staff, investment firms pay competitive salaries, often with some form of incentive bonus. The *2005 Private Equity Analyst-Holt Compensation Study* provides data on the average compensation paid at global private equity funds of funds institutions. This data is for large firms, primarily PDM-PE. The typical profile of the respondents was US$1.8 billion in assets under management, 14 investment professionals, of which 5 were firm principals, and 25 total employees. The following chart sets forth the information on PDM-PE compensation from the above study, alongside data regarding compensation in the DFI and SVC categories derived from the survey. Accordingly, the average base salary, cash bonus, and carried interest paid in 2005 among the respondents are as follows:

Table 4: Average Compensation among Fund of Funds Programs

	PDM-PE Programs[32]			DFI-PE Programs[33]		SVC Programs[34]	
	Base Salary*	Cash Bonus**	Carried Interest***	Base Salary*	Cash Bonus**	Base Salary*	Cash Bonus**
Senior Mgmt	$333,000	100%	30%	$150,000 to $300,000+	1% to 10%	$200,000 to $300,000+	1% to 25%
Senior investment professionals	$185,000 to $265,000	100%	20%	$100,000 to $300,000+	1% to 10%	$100,000 to $200,000+	1% to 25%
Junior investment professionals	$90,000	100%	30%	$50,000 to $150,000+	1% to 10%	$50,000 to $100,000+	1% to 25%
Other professionals	$180,000 to $300,000	100%	No carried interest paid	$50,000 to $200,000+	1% to 10%	$50,000 to $150,000+	1% to 25%

* Base salary stated in US Dollars
** Cash bonus stated as percentage of base salary
*** Carried interest stated as percentage of base salary and bonus

Compensation information collected through surveys conducted for this report revealed similar though slightly lower pay scales for smaller seed and venture capital focused firms and for private equity programs managed by development finance institutions. Compensation within the DFI-PE programs consists almost exclusively of base compensation, and ranged from US$150,000 to over $300,000 for senior management, US$100,000 to $300,000 for senior investment professionals, and US$50,000 to $150,000 for junior investment professionals.

Base compensation for seed and venture capital focused programs (managing between US$40 and $400 million in committed capital) seem to be in a similar range, with $200,000 to more than $300,000 for senior management, US$100,000 to $200,000 for senior investment professionals, and US$50,000 to US$100,000 for junior investment professionals.

In respect of incentive compensation, private firms (and public corporations) managing up to $400 million tend to pay cash bonuses, which could amount to anywhere from 1% to 25% of base compensation.

[32] Data for Private Sector programs operating in Development Markets (PDM-PE Programs) is based on 2005 Private Equity Analyst-Holt Compensation Study, since it provides a richer data set than the survey conducted for this study.
[33] Data on Development Finance Institutions Private Equity programs (DFI-PE) is based on survey conducted for this study; none of the survey respondents paid carried interest to the management team.
[34] Data for Seed and Venture Capital Programs (SVC) is based on the survey conducted for this report; one respondent pays carried interest to senior management that could amount to 25% to 50% of base compensation; the other two respondents do not pay carried interest to the management team.

Typically the amount awarded as incentive compensation to individual employees is determined by senior management, within budget parameters, in some cases approved by the Board or a compensation committee. Incentive compensation is generally awarded based on management's assessment of the employee's individual performance, either against written individual performance targets (which include managing the program within annual expense budgets) or on an ad-hoc basis. In addition, the performance of the program portfolio overall can impact incentive compensation.

Decisions on hiring and firing of investment professionals are generally made by the CEO/CIO.

Professional Development

All programs surveyed invest in professional development of their staff. It is common to provide staff (not just senior management but investment officers) with opportunities to attend private equity industry conferences. This is considered vital to maintain staff knowledge about private equity best practices and emerging global trends. Where possible, firms also support staff in undertaking other types of training.

C. Reflections and Recommendations for Mexico

International experience shows that high quality professional staff is one of the most important elements to successful fund management. Building a strong team will be essential for the Fund Administrator. Current staff members are highly competent but the staff is small. Therefore recruitment of additional personnel is needed.

In order to attract the right staff, competitive compensation packages are needed. The Fund Administrator will likely be competing with banks, fund management firms, and other investment institutions operating in Mexico for talent. While the current salary structure was based on a comparative analysis of Mexican fund managers, the range chosen for the Administrator may be low, in particular for the investment officers, whose salaries at the Fund Administrator are more in line with junior investment officers than senior investment officers within private sector fund management firms.

In terms of staff structure, the Administrator should consider creating more of a flat structure, with larger teams of senior level staff involved in due diligence, negotiation, and portfolio monitoring. Given the current size and scope of the FoF, outsourcing as proposed seems reasonable. It will be critical that the Fund Administrator have fully independent legal counsel and administrative functions performed by persons experienced in the private equity industry, and that operations are managed entirely separately from the current public sector agencies of the shareholders.

Ongoing professional development is a common practice in international firms, and is particularly important given the level of maturity of the Mexican market. Investment officers as well as senior management and investment committee members should attend conferences and networking events at the local regional and global level, in order to keep updated with current trends and best practices in the industry.

VI. FINANCIAL MODEL

The task of developing a financial model for the FoF included the following:

- Evaluate the existing assets of the 36+ funds based on existing financial and tax treatment data provide by NAFIN.
- Include evaluation criteria and a methodology for evaluating future assets.
- Provide a preview of the life of the fund (approx. 20-30 yrs) and not focus solely on forecasting returns from existing funds.
- Forecast recommended future investments, with the concurrence of NAFIN, and segregate them by industry sector, asset class, risk profile, dollar amount to be invested in each market segment.
- Benchmark and forecast future returns for each segment, and expected holding periods for each future investment.
- Include consideration of future investments, resources, and fund size that will allow for enough resources for investment, liquidation and returns.
- Make assumptions on timing of the receipt of monies from the existing funds as they are liquidated.
- Contain assumptions about new funds to be supported by the FoF.
- Perform sensitivity analyses for different interest rates, macro-economic performance, asset allocation and management structure scenarios.

The model was created in an interactive Excel spreadsheet and is included as an annex to this report on a CD-Rom. The spreadsheet contains a page with assumptions that drive the model and financial statements, and a sensitivity analysis based on varying investment and liquidity assumptions. The recommendations regarding governance structure, discussed in Section II above, were taken into account in the financial model. Specifically, this implied assuming that the Administrator would manage a series of concurrent funds of funds as follows:

(1) *Fund of Funds 1* (FoF1) containing the original contributed portfolio, under the conditions and governance structure currently established by CMIC. For this FoF, the assumptions on the value of the portfolio are based on data provided by current shareholders in July 2006, with figures based on December 2005, which totaled US$176 million. In addition, it was assumed that NAFIN would contribute US$114 million in new capital to this FoF (based on current and expected commitments for 2006 and 2007). In the model, dividends from this portfolio are held in cash accounts for reinvestment. The evergreen nature of FoF1 provides a means of capturing the cash assets of CMIC investors to reinvest in new vehicles, potentially alongside other investors.

(2) *Fund of Funds 2* (FoF2) models investments under a new legal entity established in January 2008 using a governance structure following the guidelines recommended in Section II of this report. This would be a discreet life fund that could attract third party capital. As such, capital commitments would be made at the outset of the fund by all participating investors. For purposes of the model, it

was assumed that this could be a $300 million fund, with capitalization supplied by NAFIN (US$136 million), other current shareholders (US$64 million), and multilateral financial institutions ($100 million). If dividends from investments in FoF1 remain in cash accounts rather then being redistributed to shareholders, then the current shareholders of CMIC could use those resources to invest in the new entity.

(3) Fund of Funds 3 (FoF3) assumes that in about six years (by 2012) the Administrator will have built up sufficient capacity and track record to launch a third FoF that could potentially attract private as well as public institutional investors. Like FoF2, it would be a discreet life vehicle. Capitalization is targeted at US$500 million, with $300 million coming from current CMIC shareholders and $200 million coming from other investors.

The assumptions in the model are not intended to be inflexible, but instead an indication of what a likely potential scenario could be considering the report's recommendations and our understanding of CMIC objectives and the international VC/PE market.

The assumptions tab in the financial model includes assumptions on current value of the portfolio and projections for future investments, provided by CMIC. The model permits a user to select variables for the following key items:

- The costs of operating the FoF, including management fees, legal and accounting fees, and other partnership expenses.
- Amounts contributed by CMIC shareholders and third party investors to each FoF.
- Asset allocation percentages by stage or strategy.
- The timing for making and holding investments.
- The impact of environmental changes in interest rates, costs of equity capital, and foreign currency values.

In the model the Administrator is provided a budget for managing the FoF. In practice the Administrator is reimbursed its actual costs. It is reasonable to assume the cost of this service to CMIC will approximate the amount of a typical management fee for a FoF Manager, or 1% of committed capital, reduced in out years based on cost of assets less liquidations.

Benchmarks are shown for US as well as emerging markets. Benchmarking data for emerging markets has begun to be collected in recent years. The lack of consistent and comprehensive data in many markets creates some difficulties. In an effort supported by large development finance institutions and the Emerging Markets Private Equity Association, Cambridge Associates has developed an Emerging Markets Private Equity Index. According to December 2005 data, the Cambridge Associates index shows the 10-year return horizon for all emerging markets to be 4.06%, while for Asia it is 3.67%, for Central and Eastern Europe and Russia it is 10.25% and for Latin America it is -3.62%.[35] The Cambridge

[35] Data from the *Cambridge Associates LLC Proprietary Index* taken from the quarterly newsletter of the Emerging Markets Private Equity Association, Vol II, Issue 2, Q2 2006. (www.empea.net)

Associates Index is based on pooled end to end returns, net of fees, expenses and carried interest.

The negative returns for Latin America reflect the significant losses experienced in the beginning of this decade, particularly by large international funds, which were the ones most likely to have participated in Cambridge Associates data collection process. CMIC will want to monitor the Cambridge Associates index as well as new benchmark data that will be available in the future from a new data collection effort specifically for Latin America launched in mid-2006 by the Latin American Venture Capital Association in collaboration with Thomson Financial Venture Economics.

Benchmark data varies in developed markets as well. In the financial model, we use Venture Economics' US Private Equity 20 year Horizon Returns, Pooled IRR, as of December 31, 2005. According to that benchmark, US early and seed investments have a 30 year return of 20.4%, VC has 14.6%, expansion/growth is 13.5%, and buyout is 13.3 percent. In comparison, the Cambridge Associates index for ten year returns for US private equity is 13.37%, for US venture capital (*possibly combining in one category the investments that Venture Economics breaks down into early stage and VC)* is 39.34%, and for Western Europe private equity is 21.13%.

The performance of each FoF is modeled to show capital drawn, current income, capital returned, capital gain, capital loss, cash flow, and internal rate of return (IRR) by sub-asset class and portfolio fund within each sub-asset class. FoF1 is divided into two portfolios, one for the legacy assets contributed by the original CMIC shareholders, and a second for the new contributions of capital from NAFIN.

Proforma financial statements are modeled for each investor. These depict the investment portfolios held by an investor (e.g. NAFIN holds FoF1, FoF2, and FoF3, while New Investor #1 holds only FoF3), and the income statement, balance sheet, and statement of cash flows for each investor account. The model can used to project the IRR to an investor and the value of an investor's account over time, based on a set of assumptions.

The model makes no prediction of financial performance for CMIC and its investors, but provides a tool for testing performance under multiple scenarios. Some variables have greater impact than others. Tax implications can be dramatic for tax paying investors. Since the current FoF is established as an S.A. corporate structure in Mexico, both the fund and the shareholders are taxed. Such double taxation decreases returns to the shareholders and will likely be problematic for third party tax paying investors. The use of a Mexican trust (*fideicomiso)* or offshore vehicle may need to be explored for future FoFs.

Regarding taxes, it is also important to note that the financial model takes into account tax implications based on Mexican tax law, but does not serve as a detailed tool for annual tax planning. This is a task that the Administrator will need to contract a Mexican fiscal and legal advisor to conduct based on the actual financial situation of the FoF.

VII. ACTIVITIES TO SUPPORT GROWTH OF THE INDUSTRY

A. Current Approach in Mexico

In the establishment of CMIC, the shareholders acknowledged that growth of the industry and success of their investments required efforts to build a culture of entrepreneurship and venture capital in Mexico and create an appropriate environment for the industry. As noted above, CMIC's objectives include promoting a VC culture between investors and businesses, promoting the development of new venture capital investment schemes, and supporting legal and financial initiatives that will strengthen venture capital for the benefit of small and medium sized enterprises in Mexico. The Fund Administrator's functions listed in its preliminary business plan include promoting modification to the legal framework and organizing events, forums, seminars, etc. to promote venture capital culture in the country.

Specific activities to be carried out to meet these objectives have not yet been defined, but CMIC is considering taking on activities currently managed by its shareholders. Two programs likely to be taken on by CMIC are the technology venture support with the National Council for Science and Technology (*Consejo Nacional de Ciencia y Tecnologia*, CONACYT) and the angel investor program currently spearheaded by NAFIN.

B. International Best Practices

Research on public sector efforts in several countries in the 1980s and 1990s to attract VC/PE indicates many such efforts were not successful due to policy makers misperception of VC as a 'pool of capital" as opposed to an "industry" requiring explicit attention to capabilities, institutions, and strategies.[36]

Support for "the development of a private equity culture among institutional investment managers" and supporting business angel networks were both included as recommendations devised from a ten-country study conducted by OECD in 2003.[37]

Successful public sector initiatives directing capital through funds of funds discussed in previous sections (e.g. Israel, Singapore, US) were complemented by a variety of programs and policies to support growth of the industry alongside the capital investment.

While support for growth of the industry is important alongside investments, it is important to note that internationally, technical assistance funds have not been found to generate expected impact when they are not directed toward specific goals with the marketplace.

[36] Avnimelech, Gil and Morris Teubal, "Evolutionary Venture Capital Policies: Insights from a Product Life Cycle Analysis of Israel's Venture Capital Industry" The Hebrew University, 2003.
[37] OECD (2004) "Science Technology Industry – Venture capital: trends and policy recommendations" cited in Lerner, Josh, David Moore and Stuart Shepherd. (2005). "A Study of New Zealand's venture capital market and implications for public policy," LECG Limited. (www.lecg.com)

C. Reflections and Recommendations for Mexico

Clarity of objectives is important in determining which non-investment activities CMIC should undertake and what form its involvement should take. Part of CMIC's goal is to build a "culture" that supports VC and entrepreneurship. To change culture, we need to understand what it is and what change is desired. Based on international experience, culture in this context can be defined as attitudes and knowledge that influence behavior about venture investing. The culture that is desired is one in which risk and return are understood, people are inclined to invest, and entrepreneurs are inclined to take risks with business ventures.

The Fund Administrator will have its hands full performing the job of a first rate Fund of Funds manager. But the performance of the CMIC portfolio can be materially enhanced through the careful promotion of the VC/PE industry in Mexico. The Fund Administrator should limit the amount of time its staff spends on these activities and instead should provide leadership by supporting the work of other worthy organizations. The Consultant recommends a technical assistance budget of $500,000 to $1 million per year, assessed against the accounts of the original CMIC shareholders. This resource should be deployed through a competitive process, staffed by one full time person, in a manner that directs resources to the most effective organizations, and in a manner that enhances the prestige of CMIC.

There is a wide range of activities that could be useful in Mexico, on many levels: for investors, entrepreneurs, and the business/regulatory environment.

For institutional investors, CMIC will be demonstrating the best methods for investing in VC/PE funds. As it achieves success, CMIC will attract other Mexican institutions to the asset class. Of all possible culture-building activities, this is the most important for CMIC to accomplish.

Individual (or "angel") investors provide most of the capital for start-ups. But for many individuals with capital, the lack of familiarity with VC/PE inhibits their willingness to invest in young companies. NAFIN has launched an ambitious program to encourage angel investing and the formation of angel investor groups. This initiative can be sustained and expanded through a program of training and networking. Excellent models exist, particularly in the U.S., such as the Minnesota-based Regional Angel Investor Network, and Angel Capital Association. CMIC could help underwrite a comprehensive program through its technical assistance budget.

Entrepreneurs often fail to attract capital because they misunderstand the needs of investors. Many programs already exist in Mexico to train entrepreneurs. These could be enhanced with input from the portfolio of CMIC VC/PE fund managers. CMIC could direct resources from its technical assistance budget to those programs that do the best job of introducing entrepreneurs to the concepts of world-class business venturing.

CMIC can accelerate the adoption of new ideas by helping investors and entrepreneurs connect. Again through its technical assistance budget, CMIC can support events, such as venture forums, that facilitate interaction and learning.

The general business and regulatory environment in Mexico requires attention, and CMIC can add its weight to removing key obstacles to investment. At the Board level, CMIC can adopt positions that reflect the needs of a VC/PE industry regarding taxation, the judicial system, intellectual property protection, transparency in accounts, etc. In particular, CMIC needs to support those who spearhead the efforts to remove the current prohibition on investment by Mexican pension funds in the VC/PE asset class. While international investors will undoubtedly need to play a substantial role in expanding VC/PE investing in Mexico, ultimately the strength of any VC/PE industry depends on the involvement of local institutional investors. Worldwide, pension funds constitute the largest pool of capital that can be directed into VC/PE investments. Institutional investors are the largest source of venture capital investments in the U.S., accounting for approximately 40 to 50 percent of investments in venture capital funds during the last two decades.[38] In Latin America, pension funds in the largest economies in Latin America control $145 billion in assets.[39] Thus, a legal framework that prohibits or is unduly restrictive of investments by pension funds acts as a barrier to this source of investment.

Currently, in Mexico, pension funds are not allowed to invest in this asset class. Similar restrictions existed in other Latin American countries but have been removed in recent years. In Brazil, pension funds have been playing a major role as investors in VC/PE funds over the last several years. Chilean pension funds have been involved in this asset class for about ten years and despite some setbacks in the first phase of their investments, continue to be a source of capital for the industry. Colombia and Peru have both recently modified their legal frameworks to allow pensions funds to invest in venture capital and private equity. Other emerging markets, including Korea and South Africa, have also been proactive in promoting pension fund involvement in order to catalyze resources for this industry.

VIII. DEVELOPMENT IMPACTS

Establishment and growth of the CMIC is expected to produce positive development impacts in Mexico. Enhanced efficiency via consolidation of public sector investments through the fund of funds vehicle and adoption of international best practices will allow the Mexican government to strengthen its impact on the growth and maturity of the private equity and venture capital industry in Mexico, and thus contribute to increased capital invested into growing Mexican enterprises. To the extent that CMIC demonstrates successful financial results and contributes to changes in government policy that would allow Mexican pension funds to invest in venture capital and private equity, the development impacts would be even greater.

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[38] Nuechterlein, Jeffrey D. "International Venture Capital: The Role of Start-up Financing in the United States, Europe and Asia." Economic Strategy and National Security: A Next Generation Approach. Ed. Patrick DeSouza. Westview (A Counsel on Foreign Relation book), 2000: 6.

[39] Zellner, Mike. "Jubilacion Activa", Latin Trade Vol.9,No.1 (Enero 2001): 47.

The improved market access and efficiency that can be generated within the fund of funds will make it easier for Mexico to attract both Mexican and international investors that could potentially include, among others, insurance companies, pension funds, private equity funds, other multilateral and bilateral agencies. As noted in the desk study conducted for USTDA, the FoF operating in line with international best practices "should be able to a) generate higher returns, b) reduce operating costs by avoiding duplicate agency functions, c) improve operational efficiency by standardizing investment criteria and d) improve its risk management procedures by learning from the experiences of other countries and their development agencies."

The timing of Mexico's efforts is consistent with a global trend toward increased investment in VC/PE in emerging markets by international investors and fund managers, thus supporting the proposition that CMIC could attract additional global capital to Mexico. A 2006 report on VC investment trends among US firms noted, "We can't ignore the fact that the top venture capitalists in the country, who once boasted about never leaving Silicon Valley to do a deal, are making quarterly trips outside of the country. Venture capitalists will continue to focus most of their energies at home, but kicking the tires overseas will become a more prevalent activity for the majority of U.S. firms."[40]

A vibrant venture capital and private equity industry in Mexico can be expected to produce positive development impacts, such as those recorded in other countries. As mentioned in other sections of the report, VC/PE has proven an effective means of generating economic growth and contributing to job creation. In the U.S., where the industry is the most highly developed, a U.S. venture-backed firm generates on average more than 100 jobs and grows annual sales by 66% within 5 years of having received venture financing.[41]

According to a 2004 report on the impact of VC/PE in the U.S., companies that received venture financing between 1970 and 2003 accounted for 10.1 million jobs and $1.8 trillion in revenue in 2003, representing approximately 9.4% of total U.S. jobs and revenues.[42] In the United Kingdom, a 1999 study found that 10% of the private workforce was employed by firms financed with private equity and those firms grew at an annual compounded rate of 24%, which is three times faster than firms in the FTSE100 and 70% faster than the FSTE 250.[43]

Venture capital has been shown to have an impact on innovation. Research on these linkages found that, even after taking into account causality concerns and differing variables, "venture capital, even though it averaged less than three percent of corporate R&D from 1983 to 1992 [in the US], is responsible for a much greater share – perhaps ten percent – of

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[40] Deloitte NVCA Global VC Investment Survey. July 2005. www.nvca.org
[41] Wiliam L. Megginson, "Entrepreneurial Finance & Venture Capital" in Introduction to Corporate Finance. South-Western College Publishers: 2001.
[42] NVCA "Venture Impact 2004: Venture Capital Benefits to the U.S. Economy"
[43] Kenney, Martin, Kyonghee Han and Shoko Tanaka. (2002) "Scattering Geece: The Venture Capital Industries of East Asia: A Report to the World Bank." Citing British Venture Capital Association 1999 study.

US industrial innovations in this decade."[44] A 2000 OECD report recommended that all countries consider efforts to grow venture capital as it was identified as a key driver of the success of entrepreneurial high-tech firms.[45]

Venture capital and private equity financing can reach any sector where high growth enterprises exists. In Mexico, it can be expected that growth of the VC/PE industry will impact many of the same sectors that have received greatest benefit in other countries, as well as those sectors with particular growth potential.

According to a 2005 Deloitte NVCA Global VC Investment Survey, the main targets of venture capitalists worldwide are the technology sectors – with 60% of firms surveyed prioritizing software, over 50% seeking communications and networking as priority sectors, and 40% targeting the semiconductor and medical device sectors. Sectors gaining increasing attention are the energy/environment sector and consumer businesses, which were identified as current priority target sectors by 12% and 19% respectively, but as targets for the next five years by 21% of firms.[46]

In Mexico, VC/PE firms may seek these same sectors, but given the economic and market realities specific to the country, different sectors will receive attention from investors. Mexico's proximity to the US and its participation in the North American market through NAFTA provide unique opportunities. Current fund managers operating in Mexico note that substantial opportunities exist related to NAFTA, for example in the transportation, logistics, and services sectors. Companies that find synergies with cross-border activities also have high growth potential.

Consumer services, in particular retail, health care, and housing, are current targets of VC/PE investments in Mexico. The domestic market for consumer goods has grown in Mexico in response to increased access to credit. This has been combined with growth of the labor pool, which companies can draw upon.

Technology, communications, and media are also identified by some existing Mexican fund managers as opportunities for VC/PE, but these sectors are less dominant in the economy today than they are in other countries with high levels of VC/PE activity. However, efforts to support entrepreneurial growth in technology sectors, discussed in Section VI, in conjunction with growth of the VC/PE industry, could contribute to an increase in technology ventures in Mexico.

[44] Korum and Lerner (200) "Assessing the contribution of venture capital to innovation, Rand Journal of Economics, 31. Cited in Lerner, Josh, David Moore and Stuart Shepherd. (2005). "A Study of New Zealand's venture capital marklet ad implications for public policy," LECG Limited (www.lecg.com)
[45] OECD, "A New Economy? The changing role of innovation and information technology in growth," Paris: OECD, 2000.
[46] Deloitte NVCA Global VC Investment Survey. July 2005. www.nvca.org