

Growing Pool of EM Fund of Funds Diversifies

During the last two years, funds of funds focused on emerging markets private equity have burst onto the scene with over US\$8 billion raised, dwarfing the approximately US\$3.5 billion previously raised between 2000 to 2005 (see Exhibit 1). This rush of capital has brought with it increasing product diversification driven by the entry of new funds of funds managers. Whether motivated by the need for access in best in class managers, or looking to gain broader exposure, Limited Partners now benefit from a range of choices: from multi-regional or pan emerging markets funds of funds that enable portfolio construction from a bigger pool of managers, to regional or country funds that can claim deep knowledge of a particular market. Funds of funds investing in developed markets are providing yet another option by increasing their allocations to emerging markets or to a region such as Asia or Central & Eastern Europe (CEE). These managers argue that a global benchmark is more important than emerging markets dedication. Behind these various product offerings are divergent views on how to tap the emerging markets private equity opportunity.

market with a new fund, likely to target US\$1 billion and that is again focused on Brazil, Russia, India and China. Managing Director Patricia Dinneen commented, "There is so much room to grow in our target countries, but it is a complex marketplace. We think our approach mixes the best of a regional fund in terms of focusing on a pool of managers whom we can truly know well and the best of a global approach whereby we are getting exposure to four different high-growth markets. We will always stay at a size where we can be confident of how the investments are working at the company level. We view our managers as conduits to companies we would like to own."

In 2007, **PCG International (PCGI)**, an affiliate of the Pacific Corporate Group, had its first close of US\$600 million on a global emerging markets fund of funds. According to Gene Pohren, a Managing Director, "The human resource requirement to manage the emerging markets opportunity is substantial. We maintain a forward calendar of 1000 funds that we think are worth considering.

We then narrow that pool to 100 or 150 funds where we maintain consistent contact. We focus on the upper decile and want to invest in the top 2%."

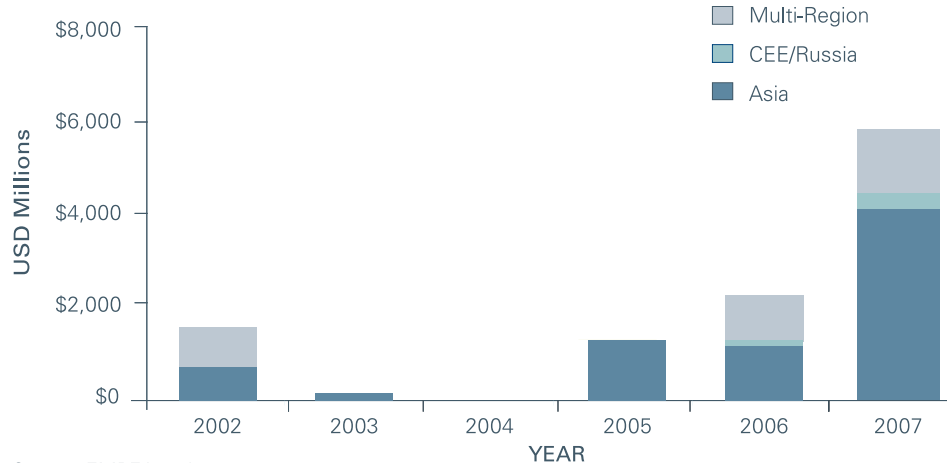
Pohren believes that global scale is critical for achieving the best portfolio construction. He commented, "We are looking for the best 20 managers. We think that when you get to the seventh or eighth manager in Asia, that group will not compare as favorably as the number one manager in Russia or Latin America."

Like PCGI, **EM Alternatives** was launched with capital from California Public Employees Retirement System (CalPERS). The group is targeting US\$1 billion of commitments through separate accounts to be invested in

the global emerging private equity markets. Managing Partner Ernest Lambers sees commonality in the emerging markets thesis. "If an LP wants rest of world exposure, we think they should compare as many managers as possible. It is important to go beyond Asia as the number of truly quality managers is still relatively limited, and the dynamics that have driven growth can also be found elsewhere."

Lambers cautions that the emerging markets universe is still young and forming. "I am concerned about the amount of capital formation targeting emerging markets, and we remain very selective.

Exhibit 1: Total Funds Raised by EM PE Funds of Funds



Source: EMPEA estimates.

Multi-Regional Funds

Fund managers offering a multi-regional scope argue that, while there is an emerging markets private equity thesis that requires specific knowledge about and resources for these regions, a broad mandate is crucial for portfolio construction.

The **Siguler Guff BRIC Opportunities Fund** made perhaps the biggest splash in 2006 when it was oversubscribed at a final closing of US\$615 million. With more than 90% of their capital invested in a diversified portfolio of funds, Siguler Guff is back in the

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There is too much search for exposure. We may lag behind others in terms of getting capital out," Lambers said.

Despite this caution, new players continue to enter the global emerging market funds of funds space. Maria Kozloski, now heading the funds of fund business of global real estate firm **J.E. Robert Companies**, stated, "Funds of funds are used by LPs for specialized strategies and emerging markets are definitely a specialized segment of the business." **EMP Global** recruited Managing Director James Seymour to develop a pan-emerging markets product. Seymour commented, "We now have the baseline data on such a large pool of quality managers, so it is possible to benchmark funds and build a quality portfolio." Other managers with multi-regional funds include **Morgan Stanley**, which has a global emerging markets fund of funds with a target of US\$650 million, and **CAM Private Equity Partners Group**, which has an Asia-dedicated vehicle, is also coming to market with a pan-emerging markets fund of funds. With backing from **AlIG**, **CornerStone Partners** is managing the Global Frontier Fund with a 75% focus on newly emerging economies ranging from Vietnam to Croatia and 25% on Brazil, Russia, India and Mexico.

Regional-Focused Funds: Asia

More than two-thirds of the capital commitments made in 2006 and 2007 has gone to Asia regional funds of funds. These managers, many of them back in the market raising successor funds for Asia, argue that a regionally dedicated approach is needed to keep up with the maturation of the Asian private equity market, the fast pace of change and the volume of fund managers warranting consideration.

Founded by a group of former **GIC** managers, **Axiom Asia** was oversubscribed at a closing on US\$440 million in 2007. They are currently 50% committed and expected back in the market next year. According to co-founder Chihtsung Lam, "The Asia fund of funds phenomenon has only taken off in the last two years. The big flow of exits took place in the second half of 2003, so we now have four years of performance to measure GPs against."

Lam believes a regional focus is key. "There are over 1000 managers in Asia, and we count more than 200 that are institutional quality. Out of those we prioritize about 20." Lam continued, "For a lot of LPs, it is the old 80-20 rule. If you look at emerging markets and ask where the growth for private equity relationships is, I would say Asia represents the 80. In order to have those relationships in Asia, you need a fund of funds that is truly focused on the local scene."

Partners Group is a Swiss asset manager investing in global private equity markets. They are also developing a series of funds of funds dedicated to emerging markets and have had an initial focus on Asia. They closed their first Asia Pacific fund in 2005 with US\$378 million and were reportedly three times oversubscribed. Partners Group has invested this fund in 21 fund managers and is

raising a successor product. Chris Rubeli, a Partner with the firm, believes strong returns are sustainable in the region. "We have seen our Asian buyouts returning 3 to 5 times capital with IRRs in the range of 50% to 100%. Looking forward, this may come down a bit because of more capital flowing in, but we think Asian private equity looks very healthy."

Asia represents the most competitive market for regional funds of funds. **Squadron Capital** is raising a US\$300 million fund on the back of a successful six-year Asian track record. In 2007, **Asia Alternatives** closed its regional fund of funds with US\$515 million, far beyond their target of US\$350 million. They are back in the market with a second fund. **Pantheon** is one of the most experienced players in the market and is now investing their fourth Asia fund of funds with almost US\$600 million. Large banks and insurers have also entered this space, including **HSBC** (US\$700 million in 2002), **Goldman Sachs** (US\$618 million in 2006) and **Axa Private Equity** (US\$512 million in 2005).

Regional-Focused Funds: Central & Eastern Europe/Russia

While it has dominated fundraising to date, Asia is not the only region getting attention, as two regional funds focused on Central and Eastern Europe (CEE) and Russia closed in 2007.

Swiss firm **Alpha Associates** recently announced a closing of US\$439 million. Their first fund of funds was closed in 1998 with approximately US\$180 million. According to Alpha Associates' CIO Petr Rojicek, "CEE is a niche market and requires a lot of local attention. Using EVCA data, we see more than a hundred funds across the CEE region and Russia, and two to three new meaningful entrants each year. Out of this pool, we see about 50 investable funds." Access to CEE private equity funds is becoming more difficult. Last year, Enterprise Investors, one of the largest funds focused on CEE investments, had the first by-invite only fundraising. Rojicek commented, "Access will become increasingly difficult, but we offer a way of gaining the best exposure."

Finland-based **Amanda Capital** is a fund of funds investing in the CEE/Russia region, with a greater focus on Russia. Petteri Ankila is the CEO and manages a US\$160 million fund of funds that closed in 2006. Ankila thinks a fund of funds for his region is appealing to LPs because they do not want excessive manager risk on top of substantial country risk. "Russia also presents reputational risk, but with a fund of funds LPs can stay one layer away from the manager selection and be assured that our team is looking out for their interests," Ankila said.

Ankila argues that Amanda Capital is building a portfolio that differentiates the risk exposure from what LPs can find on the listed markets. According to Ankila, "Some of the top fund managers in Russia are touching sectors such as oil and gas that carry a lot of political risk. Our LPs don't want that risk because they can play it

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Exhibit 2: Funds of Funds Managers and Their Location Focus

Manager (Sample)	Location Focus
Multi-Regional/Global	
CAM Private Equity	EM
EMAlternatives	EM
EMP Global	EM
CornerStone Partners/Global Frontier Fund	EM
JER Companies	EM
Morgan Stanley Alternative Investment Partners	EM
Northgate Capital	EM
Partners Group	EM
PCG Asset Management	EM
Siguler Guff & Co	Brazil, China, India, Russia
Storebrand Alternative Investments	EM
Regional Managers	
Adeq Group	Asia-Pacific
ALPHA Associates	Central & Eastern Europe
Amanda Capital	Central & Eastern Europe
Asia Alternatives Management	China, India, Japan, South Korea, and other Asia
AXA Private Equity	Asia-Pacific
Axiom Asia Private Capital	Asia-Pacific
Belmont Global Advisors	Asia-Pacific
Breeze Ventures Management	Eastern Europe, Russia & CIS
CIBC Emerging Europe Ventures	Poland, Hungary, Czech Republic, other CEE
Corporacion Mexicana de Inversiones de Capital	Latin America
Deutsche Bank Capital Partners	Asia-Pacific
Emerald Hill Capital Management	Asia
Evergreen Partners Ltd	Middle East/Africa
Goldman Sachs Private Equity Group	Asia-Pacific
Grupo Guayacan	Latin America
Hansa Investment Funds	Central & Eastern Europe
Henderson Private Capital	Asia
Horizon21 Private Equity	Asia-Pacific
Horsley Bridge Partners	Asia
HSBC Private Equity (Asia) Ltd	Asia-Pacific
IDEA Capital Funds	Central & Eastern Europe
Industry Funds Management Pty Ltd	Asia-Pacific
ING Investment Management	Asia-Pacific
JP Morgan Partners	Latin America
Lombard Odier Darier Hentsch Group	Latin America, Caribbean
Monaco Capital Partners	Asia
Nokia Growth Partners	China, India and other Asia
Pantheon Ventures	Asia-Pacific
Partners Group	Asia-Pacific
Pomona Capital	China, India, and other Asia
Portfolio Advisors	Asia
Quay Partners	Asia-Pacific
RCG Capital	Asia-Pacific
Rumson Capital Advisors	Asia
Search Investment Group	Australia, China, India, Japan, South Korea, other Asia
WestAM	Asia
Westscheme Ventures	Asia-Pacific
Wilshire Associates	Asia-Pacific
Country Managers	
Capvent	India
Evolve Capital	India
ICICI Venture Funds	India
Jade Alternative Investment Advisors	China
Lok Capital	India
Sagres Advisory	China
Thomas Weisel Asset Management	India
Tianjin Municipal Government	China
Global Managers with EM Exposure	
Adams Street Partners	Global
Auda Advisors	Global
HarbourVest Partners	Global, South America, Australasia, Africa, CEE
Invesco Private Capital	Global
Northsea Capital	Global
Parish Capital	Global
SVG Capital	Global
Unigestion	Global

better on the exchanges. Our portfolio strategy is to tap private consumption growth in the middle classes because that is the exposure you don't get on the exchanges and where there premium returns can be found."

Country-Focused Funds: China & India

Sponsors of country-focused funds of funds argue that their markets have grown so fast that the best managers are hard to qualify and access is becoming an issue for LPs. They also say that co-investment, which most of the funds of funds offer, is hard to manage without a country focus. To date, the only markets to draw country-focused funds of funds are China and India.

Jonas Lindblad is a Founding Partner of **Jade Advisors**, a US\$150 million fund of funds focused on Chinese private equity. In 2007, Jade had a first closing of US\$62 million. Lindblad argued, "LPs or fund of funds operating on a fly-in basis find the China market challenging with respect to access as well as manager identification. Our due diligence looks different from some of our peers. We compensate for the lack of long track records by weighting skills in a China context." Lindblad sees a lack of synergies with global and even regional fund of funds and asked, "What synergies can be exploited by covering countries as diverse as Australia and China? We believe that an increasing number of LPs will shop around for managers with a higher degree of specialization rather than outsourcing their entire emerging markets exposure for the sake of convenience."

The Indian market has seen several country-specific funds of funds recently formed. After investing in India funds for some time, **Thomas Weisel International** is now raising a fund of funds in the range of US\$150 million. **ICICI** is reportedly raising a US\$500 million India fund of funds. Dubai-based **Evolve Capital** has sponsored an India fund of funds team led by Managing Director Paresh Thakker. The Evolve India Fund closed in 2007 with US\$250 million. Thakker described some of the factors specific to the India market. "So many funds are actually investing in PIPE transactions, but we want managers that have sustainable value-adding strategies. This business is really about due diligence and being plugged in. When evaluating fund managers you have to ask whether they are rationalizing their decisions or do they really have credibility on the street." According to Thakker, "Our LPs are a mix of institutions or family offices and they see our platform as a way of accessing co-investment opportunities they simply could not manage from overseas."

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Swiss investment advisor **Capvent** opened an India office in 2003 and invested close to US\$100 million in a portfolio of funds. They are now in the market with an India focused fund of funds. According to Partner Tom Clausen, "When we opened our Indian office there were about 50 private equity professionals active in India. Today we count as many as 2000. Due diligence in India is not just about tracking funds, but finding the right people and getting the inside stories." Clausen continued, "In emerging markets you don't get to look at all the data points that are available in developed markets. You have to go out and create those data points around what you know about people. In India, the various business communities can be closed off to outside investors. Reference lists tend to be narrow. You need to independently verify how good a fund manager is at creating value and assess this over time."

Global Funds of Funds with EM Exposure

At the other end of the spectrum, some US and European fund of funds managers are going to emerging markets and believe that global benchmarking is the key to success.

Global fund of funds **HarbourVest** has one of the deepest track records investing in emerging markets private equity. Starting in 1990, the firm has invested between one-quarter and one-half of five multi-billion non-U.S. funds of funds in Asian and other emerging markets, accounting for nearly US\$2 billion in commitments. In 2005, HarbourVest raised its first separate companion fund of US\$527 million dedicated solely to Asia and emerging markets to invest alongside the nearly US\$3 billion HarbourVest International Private Equity Partners (HIPEP) V Euro program. It is anticipated that a subsequent HIPEP VI program will be offered in 2008 that further segments Asia from other emerging markets.

HarbourVest's Hong Kong-based Partner, Philip Bilden, established the firm's Asia presence in 1996 and described their global strategy: "We start out with preliminary regional allocations across markets, but we are fully aware that we may not find managers in certain emerging markets that meet our criteria. We are seeking the highest performing managers with globally competitive risk-adjusted returns." Bilden also raised a concern. "Many LPs seem to be pursuing geographic exposure at the expense of optimal manager selection and are not being paid for risk. The proliferation of country-focused funds of funds with limited experience is a sign of excess supply meeting institutional demand, and this worries me."

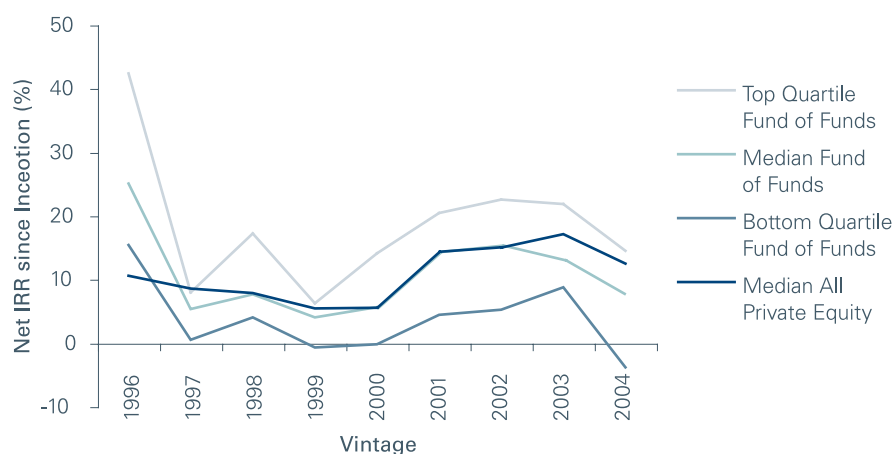
André Jaeggi is a Managing Partner with Swiss firm **Adveq**, a global fund of funds manager with most of its past exposure in the US and Western European private equity markets. He commented, "We have always considered that private equity money does not know frontiers. We don't consider Asia an emerging market anymore. What we now see in Asia is a set of managers that are on par with the best of Europe or the United States. We benchmark managers on a global basis." For Jaeggi, a fund of funds has to focus on manager selection rather than geographies or cycles. "If you want to play the emergence of a market then you are better off playing the stock market. If you want to find the best managers of private equity then a fund of funds makes a lot of sense."

Despite the view that money knows no borders, Adveq recognized that their LPs do have allocation strategies. They have launched a US\$200 million Asia fund of funds and will soon be back in the market with a successor Asia fund of funds. According to Jaeggi, "We do provide segmentation of our products according to what our LPs want, but internally we are globally oriented. We are very careful

not to compromise on our principles. Private equity is not an allocation game, it is an opportunity game."

Unigestion is another Swiss fund of funds that has moved about 10% of their capital into Asia. Marc-Antoine Voisard, Head of European and Asian Investments, finds it still challenging to build a pure Asian fund of funds. "A good fund of funds needs twelve to fifteen funds over three years. If I were mandated to only invest in Asia, I would not be sure that the quality of my fund number fourteen or fifteen would be as good as my one or two. By investing not only in Asia but also in Europe and the US, we have a better understanding of the relative value of Asian funds." Voisard believes that the universe of funds worthy of review in Asia is less than 25, not a big enough pool in his mind to warrant a specific vehicle.

Exhibit 3: Fund of Funds Performance Vs. All Private Equity



Source: Private Equity Intelligence Ltd (Preqin) 2007.

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Solomon Owayda, CIO for **SVG Capital**, concurs that there is a danger of quality deterioration. SVG Capital has historically focused on the US and Western Europe but is now establishing an Asia vehicle. "SVG has invested opportunistically in Asia since the 1980s, and we have seen the good and the bad. Given the growth, improvements in transparency and the deeper track records we have increased our Asian and other emerging markets exposure. But, I would say that LPs should look for a fund of funds manager that knows how to say 'No'. We are certainly seeing a lot of junk from these markets." Owayda argued that it is important in this environment to have a smaller fund size; the SVG Asia fund will be in the US\$200 to US\$250 million range.

P.V. Wang, a Partner with global fund of funds **Adams Street Partners**, is responsible for Asian commitments. Since 2003, Adams Street has been investing in emerging markets, mostly in Asia. According to Wang, "We don't have an allocation strategy. We have a bottom-up strategy based on a global bar." Emerging market managers now consist of approximately 10% of their active GP relationships. Wang said Adams Street is highly selec-

tive. "Take Japan for example. We like the macroeconomics and the ecosystem for private equity, [but] despite the top down attraction we have not invested in a Japan-dedicated manager because of various bottom up issues relating to the 10 to 20 groups we considered."


Adams Street has taken the plunge in China, backing several funds including CDH since 2004. CDH is now the largest fund in China, having recently closed on US\$1.6 billion. Adams Street has faith in CDH's ability to manage the large fund. Wang said, "We think CDH is pushing the frontiers of private equity in China, and we like that. First movers have a competitive edge."

Looking Forward

The variety of fund of funds products reflects a divide in thinking about how best to tap the emerging markets opportunity. However, the menu of options may just fit the variety of LP needs.

In 2006, CalPERS invested US\$600 million with PCGI, US\$100 million with EM Alternatives and US\$50 million with Asia

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mainstream

Many report that private equity is now considered a mainstream asset class. What does it mean to be mainstream? More funds, more investors, more complications.

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Alternatives. CalPERS is reportedly interested in limiting the number of relationships with fund managers, and fund of funds have become increasingly important to achieve that.

Other LPs have the opposite need: to expand relationships as they move into emerging markets private equity. Drew Smith of Advantus Capital manages the alternative investment portfolio for Minnesota Life and recently invested in Alpha Associates' regional CEE & Russia fund of funds. According to Smith, "We find exposure to emerging markets leaking into all aspects of our portfolio. We decided to be pro-active about emerging markets, and funds of funds are important for our strategy. When expanding to a new area like CEE, we like funds of funds as a jump start on our network creation."

Data shows that the choice of a fund of funds manager can have a strong impact on returns, so LPs should not be focused on exposure alone. According to Prequin's global data on returns, the differential between top quartile and median funds of funds manager-

s has been in the range of five points over the last four years. The differential between top and bottom quartiles has been between 10 to 25 points.

Eric Johnson, who covers emerging markets for **Cambridge Associates**, believes that the up-front design of emerging markets funds of funds may have a substantial impact on returns. According to Johnson, "Although this market segment is very new and there is limited historical experience to go on, LPs should look at how the fund of funds' portfolio construction, including its geographic focus and investment allocations between venture, growth and buyouts, may influence its returns."

While a significant number of funds of funds managers have been successful, others have been suspended or abandoned. Nevertheless, the rush of capital to this market segment continues, and funds of funds promise to be a much bigger part of the emerging markets private equity scene. •

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