

Managing a Fund – Best Practices

*MIF-BABSON SME Private Equity and
Corporate Governance Program*

Summary Presentation

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Agenda

- **Fund economics – “Making both ends meet”**
- **Staffing – “Building the right team”**
- **Investment Process – “A process based way to operate, not individually driven”**
- **Alignment of interests with investors – “Partners, for the good and for the bad”**
- **Hints and questions – “For discussion and reflection”**

*This presentation is intended to be used as “food for thought”
for discussions among the participants of the Program*

Fund Economics

- **The challenge: to finance the effort of a long fund raising process, and keep fund's economics sound post-closing**
- **Lessons learned – pre-closing:**
 - **Budget conservatively for a long fund raising time**
 - **Retain mostly young professionals, agree on fixed salaries increasing after closing for senior professionals**
 - **Don't commit to overinvest capital in the fund – use it for fund raising**
 - **Design the fund as a firm effort, not of a couple of individuals**

Fund Economics (cont.)

- **Lessons learned – post-closing (management fees/recurring expenses):**
 - **Keep costs low!**
 - **Compensate mostly with carried interest**
 - **Don't downplay importance or underinvest in back office – it pays in the long run**

Fund Economics (cont.)

- **Lessons learned – post-closing (performance fee/carried interest):**
 - **Divide carry from the beginning**
 - **Be generous in carry for main professionals, but make vesting schedules for the long term**
 - **Leave part of the carry for future allocation, to reward exceptional/unexpected performance along or at the end of fund's life**

Staffing

- **The challenge: to select the right combination of skills and long term commitment at a “possible” cost**
- **Skills to be included in the experiences of fund’s staff:**
 - **Principal investor (preferably active, e.g. VC/PE)**
 - **Line management**
 - **Transaction (M&A/business development)**
 - **Consulting**

Staffing (cont.)

- **Caveats for each “skill”:**
 - **Principal investor:** most useful, includes some of other skills below
 - **Line management:** very useful skill, but sometimes they want to “run” the portfolio companies, or delegate the transaction to lawyers
 - **Transaction :** also very useful, mainly in structuring deals, but often without a long term vision (not used to “clean the mess after the party”)
 - **Consulting:** like salt – a little is good, too much a disaster!

Staffing (cont.)

- **Assess candidly commitment of all professionals (including oneself!) to the VC/PE asset class/activity:**
 - Many people are allured by the multidisciplinary type of activity
 - Most don't have the long term commitment
 - Such assessment is possible only with senior people – juniors cannot judge their own commitment due to lack of experience, so plan for turn over
- **Most difficult task of a venture capitalist – even more difficult than selecting investments (lower diversification!)**

Investment process

Challenges: how to select and structure good investments?

- How high should the target return on paper?
- How to measure and mitigate risks?

How to be effective in the selection process?



Investment process (cont.)

Stages



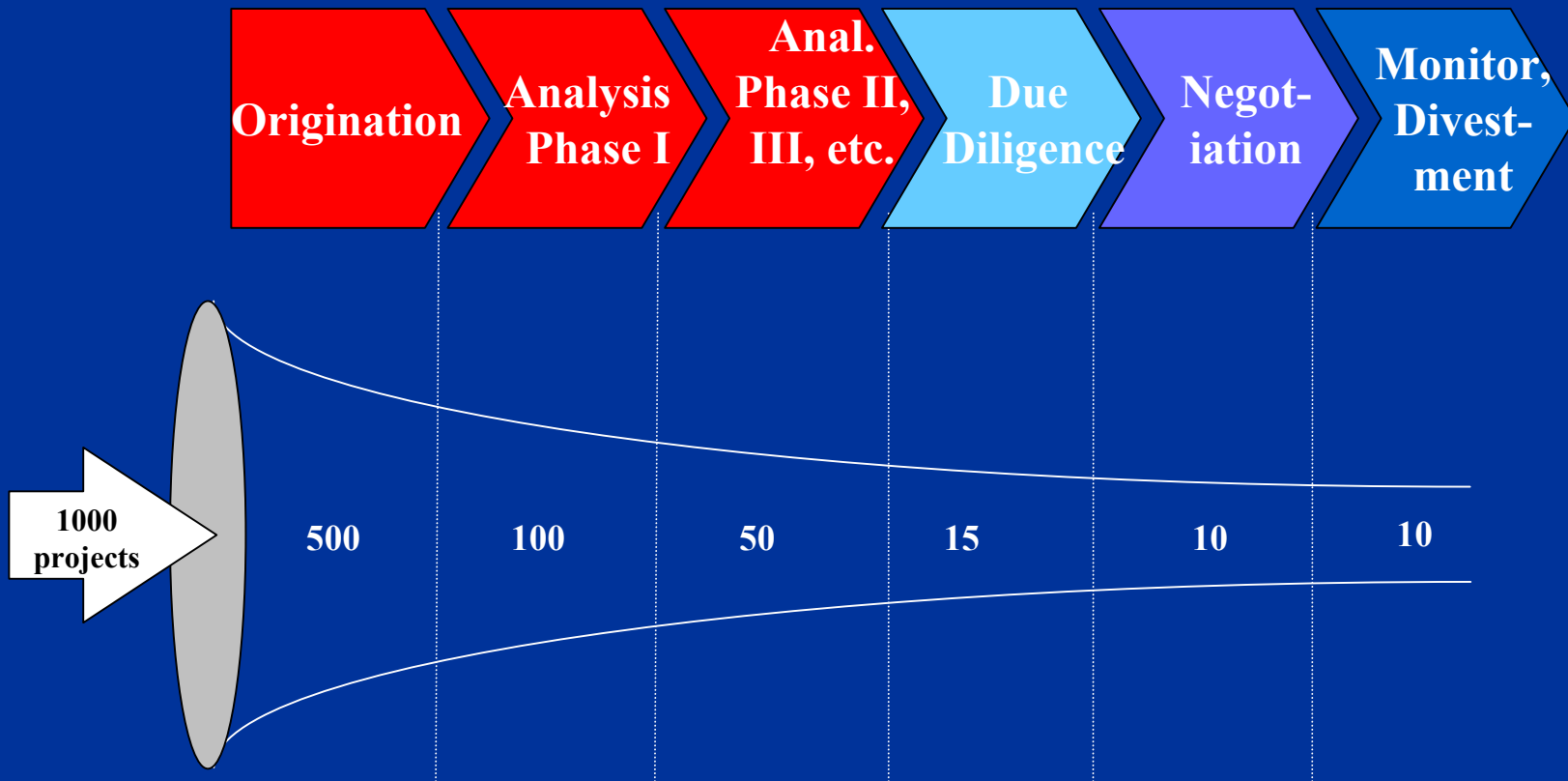
- **Two important analysis tools (to be detailed ahead): “Risk vs. Return Model”, Portfolio Allocation**

Investment process (cont.)

- **All steps in the process are documented (in a summarized way)**
 - **Reunion Minutes**
 - **Projects/companies Database**
 - **Statistics reports (“Funnel”)**
- **Continuous improvement of proprietary “Analysis Process and Investment Selection Manual”**

Investment process (cont.)

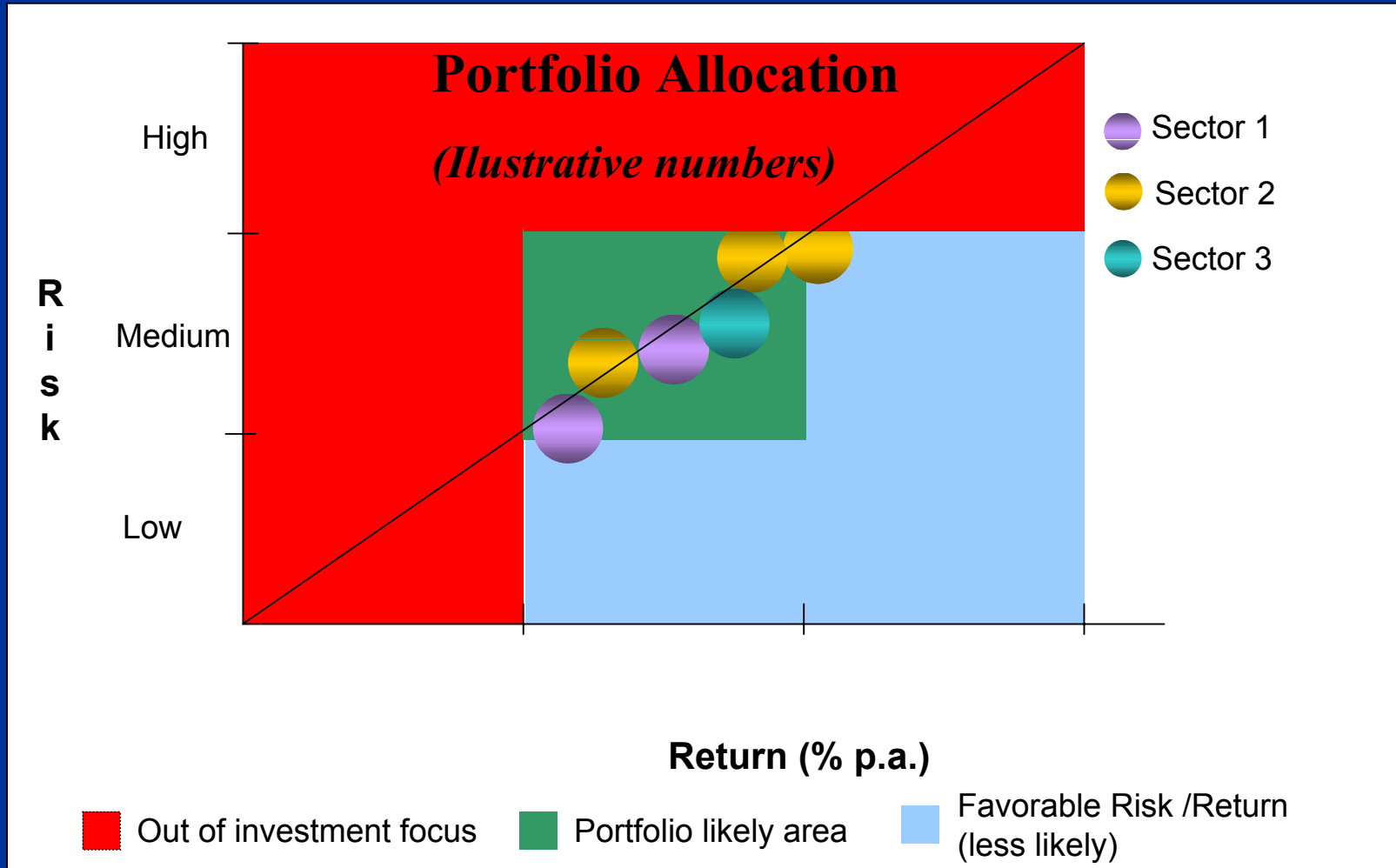
- “Funnel”: Cumulative follow-up of *pipeline (illustrative numbers)*



Investment process (cont.)

- **Risk vs. Return Model**
- **Objective questions to assess types of risk:**
 - **Market**
 - **Company**
 - **Management team**
 - **Technology**
 - **Financial**
 - **etc**

Investment process (cont.)



Alignment of interests with investors

- **Latin American VC fund managers are normally naturally aligned with investors:**
 - **Relatively small funds**
 - **A sizeable dosis of pioneer spirit/ investment in the establishment of the industry exists**
 - **Implication: fund managers are aiming at performance fees/carried interest**

Alignment of interests with investors (cont.)

- **Additional alignment derives from:**
 - **Investment committee participation of investors**
 - **Clauses on investment contract (conflicts of interest, etc)**
 - **Investment of fund manager (in cash or by funding pre-closing or insufficient management fee)**
- **Frequent and transparent reporting to investors is key:**
 - **Report on portfolio companies and investment activity to Investment Committee**
 - **Use Investment Committee to discuss/present strategy of fund and firm**

Hints and Issues

- **Always have a trainee program to breed smart, young trainees rather than hiring only experienced associates**
- **Bring along in portfolio companies independent board members with experience in the sector, recently retired people are the best –contacts are fresh, motivation is high**
- **Obtain economies of scale with lawyers and auditors**
- **Set rigorously weekly meetings with all people involved**
- **Communicate often with investors and Investment Committee members**

Hints and Issues (cont.)

- **General:**
 - VC funds investment themes
 - Issues of market scale/critical mass versus too broad a scope of investment.
 - Are regulations or legal framework a real issue, or are they secondary when compared to the basic skills needed by a VC team?
 - How to communicate to entrepreneurs the benefits of PE/VC?
- **Staffing:**
 - Are there enough trained professionals in the market, or should the industry promote specific training programs?
- **Investment Process: how to communicate the benefits of investing in PE/VC for institutional investors in the region?**

About Stratus

- Stratus is an independent private equity / venture capital firm established in São Paulo, Brazil.
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