



USAID
FROM THE AMERICAN PEOPLE

DUE DILIGENCE CHECKLIST AND USER GUIDE

SUPPORT FOR USAID PRACTITIONERS TO EVALUATE
PRIVATE EQUITY FUNDS AS POTENTIAL DEVELOPMENT
PARTNERS

6 January 2017

This report was produced by Deloitte Consulting LLP with extensive support from the Emerging Markets Private Equity Association (EMPEA). The views expressed in this publication do not necessarily reflect the views of the United States Agency for International Development.

DUE DILIGENCE CHECKLIST AND USER GUIDE

SUPPORT FOR USAID PRACTITIONERS TO
EVALUATE PRIVATE EQUITY FUNDS AS POTENTIAL
DEVELOPMENT PARTNERS

USAID FINANCING GROWTH TASK ORDER
CONTRACT NUMBER: AID-OAA-BC-14-00030
DELOITTE CONSULTING LLP
USAID | OFFICE OF PRIVATE CAPITAL AND
MICROENTERPRISE

6 JANUARY 2017

DISCLAIMER:

This report was produced by Deloitte Consulting LLP with extensive support from the Emerging Markets Private Equity Association (EMPEA). The views expressed in this publication do not necessarily reflect the views of the United States Agency for International Development.

CONTENTS

INTRODUCTION.....	1
Defining USAID’s Level of Engagement with Funds.....	1
THE DUE DILIGENCE PROCESS: A BRIEF GUIDE TO BEST PRACTICES	2
An Overview of the Due Diligence Process	3
Due Diligence Step 1: Establish Due Diligence Criteria.....	3
Due Diligence Step 2: Identify partnership opportunities with private equity funds	4
Due Diligence Step 3: Undertake the due diligence process	5
Due Diligence Step 4: Establish a strong and well-documented internal approvals process	6
Cross-Cutting Considerations for Due Diligence.....	8
DUE DILIGENCE TOOLS.....	9
Expected Level of Engagement and the Due Diligence Process.....	10
MATERIALS TO BE REQUESTED OF PROSPECTIVE PARTNERS.....	11
DUE DILIGENCE QUESTIONNAIRE	16
Due Diligence Questionnaire.....	17
Post-Due Diligence: The Internal Evaluation Checklist.....	23
USERS GUIDE TO DUE DILIGENCE QUESTIONNAIRE.....	25
ANNEX A: LIST OF INTERVIEWED ORGANIZATIONS	33
ANNEX B: NOTABLE QUOTES FROM RESEARCH INTERVIEWS	34
ANNEX C: ADDITIONAL RESOURCES	38

TABLES AND FIGURES

Figure 1: Four Levels of Engagement with Private Equity Funds.....	2
Figure 2: Due Diligence Process and Use of Tools.....	10
Table 1: Materials to Be Requested of Prospective Partners, by USAID Expected Level of Engagement.....	11

INTRODUCTION

USAID focuses on supporting development outcomes in emerging and frontier markets, and the agency recognizes that a healthy financial system and private sector capital flows can often help achieve development goals. To this end, USAID supports private equity and venture capital investment that further development objectives. While USAID undertakes different types of activities involving support to emerging market private equity and venture capital funds—for instance, by providing technical assistance to funds to assist with the design / structuring of that fund or the vetting of potential fund investments, or by providing catalytic grant capital to funds or fund managers, who are then able to raise additional funding from private sector investors—the organization does not provide debt or invest equity directly into funds. Therefore conducting in-depth due diligence on such entities has not historically been core to its mandate and mission.¹

As USAID more actively engages with emerging market private equity and venture capital funds with a development objective (primarily through technical assistance and grant capital), it aims to better understand best practices in assessing and evaluating potential partnership opportunities. It was in this context USAID engaged EMPEA as a subcontractor under Deloitte to conduct research and leverage the knowledge and experience of its network by interviewing institutional investors and collating information supporting best practices in fund due diligence. EMPEA’s network includes development finance institutions (DFIs), impact-focused organizations and commercial limited partners (LPs).

This report represents a compilation of the insights gathered through that process. Following this introduction, Section 2 briefly describes the steps limited partners typically take as they carry out due diligence on funds. Section 3 provides an overview of due diligence tools USAID practitioners can use in preparing for and conducting the due diligence process. Section 4 presents a checklist of materials to be requested of prospective partners, and Section 5 provides a user-friendly Due Diligence Questionnaire and Users’ Guide to support practitioners to conduct and conclude the actual due diligence process.

DEFINING USAID’S LEVEL OF ENGAGEMENT WITH FUNDS

Recognizing that USAID engages with prospective partners at differing stages of their development and with differing objectives in mind, we have differentiated the guidance within all of these tools based on USAID’s expected level of engagement with a fund. This not only provides a framework for understanding how USAID’s strategy with a fund should shift depending on context, but it also recognizes that USAID’s own risk profile and information needs will differ depending on how USAID

Defining Private Equity

For the purposes of this report, **private equity** is defined as investment in the shares or securities (equity) of a company not listed on a public exchange, typically as a long-term holding.

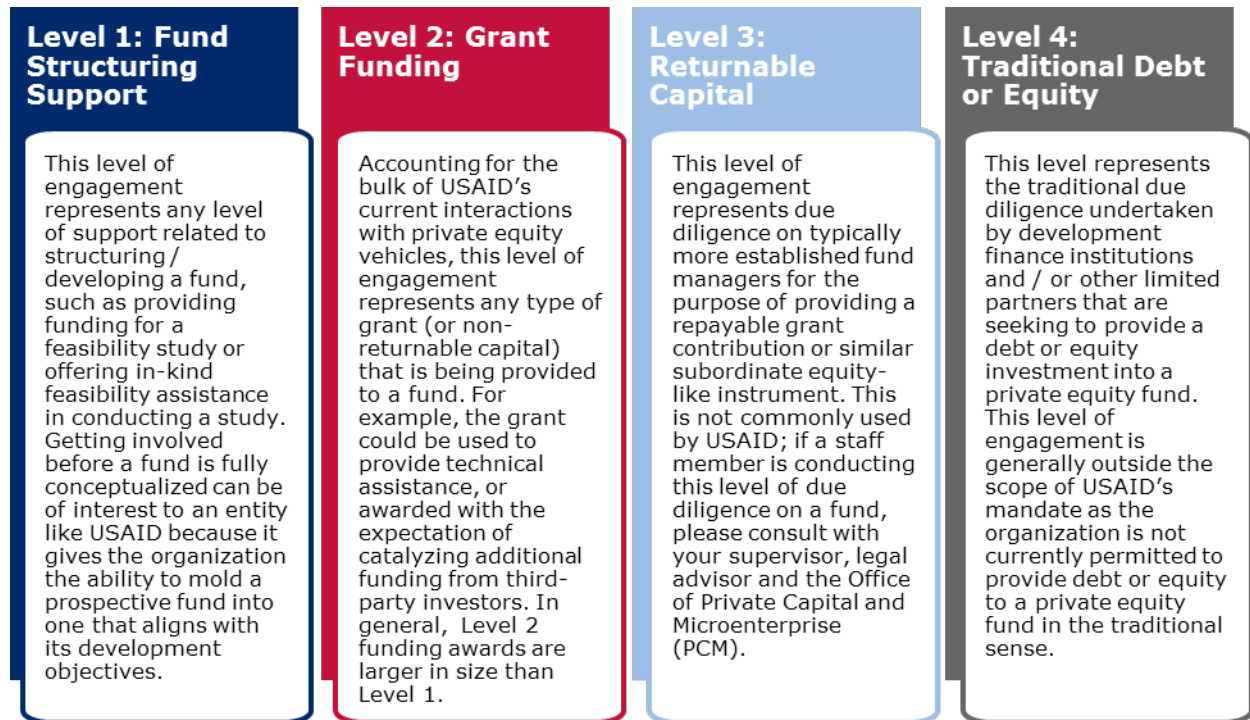
Private equity encompasses a broad range of strategies to support private enterprise, from early-stage to maturity. Early on, private equity can refer to angel investing (investment in a pre-start-up company by a high net-worth individual, often with industry expertise) and venture capital (equity investment in an early-stage company with the potential for exceptionally rapid growth). At the more mature end of the spectrum sits leveraged buyouts (acquisition of a controlling stake in a company predominately financed with debt). In emerging markets, most transactions occur in the middle and are referred to as growth equity or growth capital.

Throughout this document, the term *private equity* will refer to all of these strategies. Also, while the due diligence process for evaluating debt funds in emerging markets will largely be similar, there may be some slight differences not outlined within this document, which focuses exclusively on private equity.

¹ USAID’s Development Credit Authority (DCA) additionally interacts occasionally with emerging market private equity funds by offering credit guarantees on investments made by private lenders into those funds. The DCA team has established a separate and distinct due diligence process for evaluating such guarantees, and therefore the scope of this report is not directly relevant for that program.

expects to engage with a fund. Certainly not all of the items and questions contained within the materials presented in the sections below will be relevant for every due diligence process, so we have defined four general levels of engagement to assist USAID in applying the right tools in the right contexts. These will primarily define the materials USAID would gather from a fund and which due diligence tools would be applied, as described in detail in Section 3.0 *Due Diligence Tools*, below.

Figure 1: Four Levels of Engagement with Private Equity Funds²



THE DUE DILIGENCE PROCESS: A BRIEF GUIDE TO BEST PRACTICES

Many institutional investors are quick to confess that evaluating private equity fund managers—regardless of their maturity, geography or strategy—and choosing which represent the best partnership opportunities is often more of an art than a science. Furthermore, due diligence cannot be viewed as a one-size-fits-all approach. Each institution has its own lens through which to assess funds and therefore every organization’s process will inevitably be slightly different.

However, there are a number of steps that can be taken and policies that can be implemented to help investors ensure they are sourcing quality opportunities, asking the right questions (both from a quantitative and qualitative perspective), requesting the appropriate documents and ultimately getting to know the fund team well in order to make an informed decision. Below is a high-level summary of common themes and strategies that many limited partners have adopted as they undertake due diligence related to private equity funds operating in developing economies.

“At the end of the day, the due diligence process boils down to how comfortable you are with the fund manager and what they are able to accomplish—and the latter is largely based on what they have.”

-- EMPEA Member

² It is worth noting that at levels 1 and 2 especially, USAID is often able to create impact with a relatively small amount of capital.

Note that the majority of the investors EMPEA interviewed are conducting due diligence on funds for the purpose of equity investment, a level of engagement well beyond where USAID will typically carry interactions with funds. In addition, most—but not all—are strongly focused on achieving both a financial and developmental return / outcome, while USAID’s interests will generally be focused more exclusively on development outcomes. These investors largely share a belief that a fund must be financially successful to achieve and maintain a long-term development impact, and therefore the due diligence process focuses on understanding both the financial viability of a fund as well as its potential to affect greater economic and / or social development.

AN OVERVIEW OF THE DUE DILIGENCE PROCESS

The following is a summary of best practices in evaluating a potential partnership with a private equity fund operating in emerging markets, based on conversations with institutional investors active in the industry as well as desk research. These findings are organized in four due diligence process stages, which generally correspond to the steps USAID should take as it prepares to engage with prospective partners:

- Step 1: Establish criteria and filters to assess and evaluate emerging market private equity funds
- Step 2: Identify partnership opportunities with private equity funds
- Step 3: Undertake the due diligence process
- Step 4: Establish a strong and well-documented internal approvals process

These steps and what they entail are described below, followed by a series of cross-cutting activities and considerations USAID practitioners can apply across all steps in the process.

DUE DILIGENCE STEP 1: ESTABLISH INVESTMENT EVALUATION CRITERIA

Emerging market private equity funds operate across a wide spectrum of markets and sectors, and focus on vast array of strategies. In fact, EMPEA data suggest that there are over 600 funds seeking capital in the market today, with some 100 new funds expected to come to market each quarter.

To ensure an organization is best allocating resources and not conducting due diligence efforts on a large number of funds that may not be a good fit, it should create strict parameters around which types of partners it desires to engage, including considerations of geography, sectors and strategies. Other filters might include fund size and team maturity (depth of track record). These criteria should be documented and shared with everyone who will be interacting with potential fund partners and evaluating whether to proceed with activities.

While an organization should quickly pass on any funds that do not fit within its strategy, many institutional investors recommend keeping in touch with fund teams that have made a positive impression. As fund managers seeking capital meet with limited partners in the fundraising process, it is not unusual for them to incorporate advice given to them and over time. As a result, their strategy may evolve to a place where you may desire to form a partnership.

Guiding Principles in Establishing Evaluation Criteria
<ul style="list-style-type: none"> ▪ Clearly establish your organization’s strategy and objectives for interacting with private equity funds from both a financial and developmental standpoint. ▪ Ensure that each individual office, mission or group also has well defined objectives that are in line with and support the broader organization. ▪ Verify that these objectives are well understood by the entire team. ▪ Apply a strict filter—if a fund does not match your investment and development goals, end the due diligence process. ▪ Keep channels of communication open with fund teams that do not meet your criteria in case their strategies develop and evolve over time to become a better fit.

“I have been firm in turning down early-stage GPs in the past; but I don’t say ‘no,’ I say, ‘keep me informed.’ I’ve been surprised by the number of times that I’ve realized after years of getting to know a fund team that I really like them and have seen them working well together. Regardless, you will reach a tipping point in the relationship where you can make a decision on whether or not to move forward—and an informed decision is always a good decision.” –LP

DUE DILIGENCE STEP 2: IDENTIFY PARTNERSHIP OPPORTUNITIES WITH PRIVATE EQUITY FUNDS

An organization should make it clear to the market what it can offer as a partner to emerging market-focused private equity and venture capital firms—particularly when that organization engages with funds across multiple units and in various ways. An entity can advertise its capabilities (as well as restrictions) through a number of channels, including leveraging membership in associations such as EMPEA and by articulating its offering at conferences and events. It is often also helpful to create a dedicated page on an organization’s website to inform interested private equity and venture capital funds on its program (one such example from the Overseas Private Investment Corporation (OPIC) can be found [here](#)), in addition to identifying a clear entry point (i.e., point of contact) for engagement.

From an internal sourcing perspective, many institutional investors combine a top-down and bottoms-up approach—in other words, their process for identifying potential partners is both inbound and outbound. After formalizing what the institution wants to invest in (in terms of strategies, markets and / or sectors), it should undertake a market mapping exercise—either internally or by hiring a consultant—in order to understand the overall investible universe and to begin identifying the best potential partners. Data providers such as EMPEA or Preqin can assist firms in creating lists of potential partners that have raised capital and / or are in the market fundraising. This data is then combined with information gathered through on-the-ground research or conversations held with industry participants met via conferences / events, network introductions, unsolicited requests, etc. to develop a holistic list of funds.

A number of interviewed institutional investors noted that they will rarely turn down a fund manager that has requested a meeting at the LP’s office (unless its strategy is clearly not aligned with the organization’s objectives), as such meetings are always an opportunity to learn.

“Adequate resources must be devoted to the due diligence effort. You don’t necessarily need a six-person team, but if you have a very small group, you should consider bringing in outside help such as a consultant. The problem is that you could end up with a sliver of a view when it comes to the fund manager universe, and with limited bandwidth it becomes very easy to simply take what comes to you rather than being proactive and seeking” –EMPEA Member

In general, consultants are engaged on a limited basis by the limited partners with whom we spoke. However, several investors stressed that an independent perspective can be extremely valuable, particularly in instances where an organization may be subject to (or perceived to be subject to) the influences of external parties. A consultant can support and help defend a transparent and competitive process, validating (or negating) the internal view while also providing additional market intelligence.

Guiding Principles in Identifying Partnership Opportunities

- Clearly advertise your organization’s capabilities and restrictions as a partner to funds.
- Employ a top-down strategy...
- ...in addition to taking a bottoms-up approach to identifying opportunities.
- Embrace an open door policy.
- Consider the use of a consultant if resources are limited and / or additional transparency is needed in terms of defending the decision making process around which funds enter the due diligence process.

DUE DILIGENCE STEP 3: UNDERTAKE THE DUE DILIGENCE PROCESS

The due diligence process can be time-consuming and should not be shortcut. On average, the approval process (for a fund that is not a first-time team) typically takes an institutional investor approximately four to eight months to complete—with some private sector institutions able to reduce the timeframe to two to five months, particularly if there is less of an emphasis placed on evaluating impact. Those DFIs that are willing to support first-time teams note that the process can take on average 12 to 18 months for inaugural efforts. Regardless, nearly all LPs remarked upon the importance of spending an appropriate amount of time and dedicating the right resources to the due diligence process to avoid as best as possible a partnership that proves to be unsuccessful.

Guiding Principles in Identifying Partnership Opportunities

- Embrace the fact that the due diligence process involves multiple steps (see below) and check-in points, and will often be a lengthy process.
- Clearly communicate your due diligence process to any potential fund partners.
- Reference calls are a critical component of due diligence.
- Ensure that you are requesting the appropriate materials and asking the right questions (refer to Section 3 for more information).

While they will differ slightly for each organization, the steps below provide a summary of a typical due diligence process as related to funds.

1. **Review fund strategy.** Confirm that the fund's strategy makes sense given its size and geographic remit, and that it aligns with your organization's objectives and broader goals. Should there be any conflicts or divergence from your strategy, the fund should no longer be considered.
2. **Conduct desk review of initial documentary materials.** After initial meeting(s) or interaction(s) with the prospective beneficiary fund, conduct a thorough desk review of the materials they provide in response to the initial document request (see *4.0 Materials to Be Provided by Prospective Partners*, below). In the case of more mature funds, this may include the Private Placement Memorandum (PPM), a pre-packaged due diligence questionnaire, materials in the data room, any information provided on portfolio companies and the financial / legal documents. The first screen should also include a check on media sources and a few reference calls to verify the team's reputation within their marketplace, confirm that there are no reputational concerns, and affirm that the fund is managed by people with whom you could potentially do business. Many organizations will also search the fund team and investment committee members in relevant databases, such as LexisNexis® WorldCompliance™, and via Google. This assessment should be documented and reviewed internally.
3. **Prepare for an on-site visit.** If a decision is made to advance, evaluators should prepare for an on-site visit. Many LPs will often begin to draft a preparation memo at this step in the process, as doing so tends to trigger questions to bring up during the on-site meeting with the fund. Institutional investors will cross-check their internal due diligence questionnaire (see Sections 3d-e) with the information already provided by the general partner (GP, or fund manager). The fund is then sent a streamlined questionnaire that removes any items already addressed. (A few institutional investors, however, noted that they will re-ask several questions already covered for cross-checking purposes; if the answers differ, it may signal a red flag). Any questions not answered, or not answered sufficiently, will become a key focus during the on-site visit. Reference checks are a vital component of this stage.
4. **Conduct on-site visit.** An on-site visit could last, on average, from two to five days, and typically includes one-on-one meetings with each of the fund team members, as well as with

"It is better to spend a lot of time finding out that a fund manager is not a suitable partner, than to engage with a team that performs poorly and requires significant time and resources to monitor—employing a deep due diligence process is extremely important." –LP

any portfolio companies and references. The on-site visit will focus on any areas that need to be evaluated in greater detail—this could potentially include learning more about the team members and the investment pipeline, how the firm is organized and making decisions, proof that decisions are being documented, a better understanding of how investment holdings are valued, etc. Many organizations will also try to meet with local DFI representatives and other fund managers active in the market during this time to inform a more holistic view of the opportunity.

“The hardest part of the due diligence process is not knowing what you don’t know; and not knowing if there are questions you should be asking but are not. The key to appropriately reviewing the answers to your due diligence questions is to remember that fund managers mean what they write and not what you think they mean—so if there is any ambiguity in what they submitted, it needs to be followed up.” –LP

5. **Conduct internal approvals process.** If the team conducting the due diligence still believes in the fund manager’s team and investment thesis following the on-site visit, they will dive into the internal approvals process to determine if any additional information is needed and make a final partnership decision.

Nearly all of the institutional investors interviewed noted that reference checks are one of the most critical aspects of the due diligence process, as getting to know and feeling comfortable with the team in which you are planning to invest is the primary factor that will influence a decision on whether or not to move forward. Reference checks should be conducted both on the team as well as the shareholders, and are typically done on both a formal and informal basis (meaning based on names provided by the fund but also additional contacts sourced through an organization’s network). Former team members, bankers, advisors, previous LPs in a fund, and CEOs of both current and exited companies are often sought for an interview. In an emerging market context, having ‘boots on the ground’ or the ability to conduct reference checks in person and in the local language is invaluable. When speaking with references, it is important to make it clear that all insights shared will be kept confidential from the fund manager.

A lot of information is needed and a great deal of interaction with a fund team must take place before an organization can make an informed decision to move forward with a partnership—particularly when that organization needs to understand both the financial and developmental potential of a fund. Therefore, it is important to be up front with a fund team at the beginning of the relationship in terms of your organization’s process to ensure that they are not deterred by the volume of the information requested. Quality fund managers may have choice when it comes to funding, and therefore a balance is required in terms of sourcing the information that you need and being considerate of the fund manager’s time. It is advised to be very clear at the onset about what your due diligence and decision making process looks like, and your general timeline.

DUE DILIGENCE STEP 4: ESTABLISH A STRONG AND WELL-DOCUMENTED INTERNAL APPROVALS PROCESS

While the number of internal documents generated and approval / check-points required varies for each institution, having a clear process in place regarding when and how to drive forward a due diligence process and document the findings is considered a best practice. On average, the organizations we interviewed have between two to four internal memos and check-in points. An example of the approvals process from one organization is summarized below:

Guiding Principles in Establishing Internal Approvals Processes

- Institute a transparent documentation process to summarize views on a fund and facilitate internal discussions.
- Engage your legal team and any other potentially interested parties early in the process.
- Establish a clear approvals process with an ultimate decision maker.
- Create and adhere to strict documentation policies, including the establishment of electronic and hardcopy folders for all due diligence materials related to a fund.

1. **Prepare internal fund profile.** After several initial meetings and interactions with a promising fund manager whose strategy appears to be aligned with the organization’s mission, a two- to 10-page internal document is generated summarizing the basic facts about that fund. This memorandum should clearly articulate why the fund fits within the organization’s mandate and may also document any initial concerns. An internal decision is made—either formal or informal—to pursue a greater level of due diligence and incur any resulting costs. Many institutions have established an internal group (e.g., an Evaluation Committee) for internal voting purposes; this body usually consists of the key players within the group conducting the due diligence along with several external perspectives such as representatives from the legal department, external affairs, the policy team (if applicable) and the Chief Investment / Financial Officer’s office to form a broad view. In cases where a decision is made not to pursue a partnership, many institutions will produce a short three- to four-page analysis describing the opportunity and the reasons why it was not further pursued for knowledge management purposes.
- “Even if you are the lead on a due diligence process, it is important that you carry your team along and give your colleagues a chance to reflect on the opportunity and give you input on why a fund fits within your organization’s strategy or not.”*
 –LP
2. **Develop preparation memorandum (draft investment memorandum).** Once cleared to undertake due diligence, many limited partners will draft a preparation memorandum (or draft investment memo), which summarizes the perceived strengths and weaknesses of a fund and outlines any areas that need to be further addressed during an on-site visit. Prior to the visit, many limited partners will again have a check-in (formal or informal) with their team or Evaluation Committee to review the due diligence.
 3. **Develop investment memorandum.** Following an on-site visit, if the team conducting the due diligence still wishes to move forward, it will produce an investment memorandum. This is typically the most extensive analysis of the opportunity and includes information related to the fund manager, the team, the proposed or current portfolio companies, the macro-environment, the competitive landscape, etc. This document normally also includes the legal and tax review of the potential partnership, if relevant.
 4. **Review investment memorandum.** A third check-in with the team or Evaluation Committee is typically held to review the investment memorandum and determine if any additional items need to be addressed before holding a final formal vote. Many investors also consider it wise to engage at least one individual (with an external or risk management perspective) who has not been involved since the beginning of the due diligence process in order to offer a fresh and unbiased perspective.
 5. **Final vote.** While the ultimate decision maker varies by institution (i.e., the Investment Committee, the CEO, the board, etc.), it should be clear at the beginning of the due diligence process how final approval will be obtained. Once approved, a partnership is formed with the fund; however, there may be instances where a deal does not move forward after obtaining final approval (for instance, it is discovered that someone on the fund team was on a terrorist watch list, which was not previously disclosed, a legal issue arises or the fund collapses).

In general, having internal consensus and buy-in before proceeding through each subsequent stage tends to be important to the due diligence process for many limited partners. In addition, engaging and informing all internal groups that may have a view on the opportunity, such as the legal department, at the beginning of a due diligence process might save valuable time in instances where that group may have information that is relevant to evaluating a transaction.

Information management is critical for any organization, and especially so for entities that are large and decentralized. If an opportunity is not pursued, the reasons should be rigorously documented and stored in a way that is easily accessible to anyone else within the organization conducting due

diligence activities. Many of the LPs with whom we've spoken use cloud-based software solutions tools such as Salesforce and Dropbox to store and easily share information.

In the emerging market private equity industry, it is not uncommon for a fund manager that was unsuccessful in its fundraising efforts to re-launch a fund several years later. Having the information of a prior review on hand will be invaluable and may assist in understanding how that fund has changed or evolved since the failed fundraising attempt, if at all. In addition, such a process can also help a firm in reviewing transactions retroactively in order to better understand why certain opportunities were not pursued (for instance, was a fund determined to be financially unviable or was the opportunity simply relatively less attractive versus another transaction being evaluated at the same time). This process can also enhance a limited partner's ability to assess their own performance at manager selection, and learn from their experiences.

"In this industry, due diligence is 50% looking at the team, strategy and track record and the other 50% is an assessment of whether or not you can work with a fund manager for the next 8 to 12 years; and this review has to be done on a personal level. You have to be in contact with the entire team—not just the managing partners—and get a true feeling for the culture of the organization. It's not quantifiable.

This is something you have to learn over time but reference calls are critical as they help to ensure that everything adds up."
—LP

CROSS-CUTTING CONSIDERATIONS FOR DUE DILIGENCE

Following is a summary of additional recommendations offered by the institutional investors EMPEA interviewed, which USAID practitioners should consider as they conduct due diligence on private equity funds in developing countries.

- **Develop the internal capacity to evaluate private equity funds.** Nearly all of the LPs we interviewed acknowledge that the best way to understand how to properly evaluate private equity funds is through in-house experience—and being able to employ pattern recognition to your due diligence process. However, there are ways to get up the learning curve. Several institutions noted that courses conducted by the Institutional Limited Partners Association (ILPA) have been helpful (particularly those courses related to understanding the legal components and documentation for a fund)—and that learning is facilitated not only by the class structure but also through interactions with other limited partners who can offer insights based on their prior experiences.

Separately, a few institutional investors noted that they are focused on providing relevant training to younger members of their team in order to ensure continuity of operations in the event of personnel changes. For instance, some firms require that both a senior and junior person be staffed on a due diligence effort so that the junior team member has ample opportunities to learn on the job.

- **Create a culture focused on learning.** Several institutional investors have instituted regular 'brown bags' or internal 'lunch-and-learns' in order to foster discussions about the industry broadly and the due diligence process specifically; for instance, by having colleagues speak about prior completed deals or by inviting outside representatives to speak with a team about their positive and / or negative due diligence experiences.
- **Ensure your private equity partner understands your role in the capital structure.** In rare instances, USAID may partner with a fund through the provision of a repayable grant contribution or a similar subordinate equity-like instrument. As it takes on a different role and / or occupies a different tier in the capital structure of a fund versus traditional LPs, it is imperative that it communicates these differences with the fund partner, which in turn will need to articulate these variances to other investors.

The experience of DFIs suggests that misunderstandings often arise in cases where there are different types of investors in a fund—and that fund managers do not always understand how different financing structures (i.e., subordinated equity, grants, debt, etc.) can impact the overall fund economics. USAID may also wish to spend time discussing their strategy with other investors, and discuss the pros and cons of using a debt strategy with fund professionals at OPIC.

- **Leverage other investors, particularly the DFIs.**

Beyond providing insights for this project, much of the institutional investor community is keen to assist USAID with developing its capacity to assess and evaluate private equity funds in emerging markets, including sharing information on fund managers and pipelines as well as overall lessons learned. Many of these investors are also happy to share their knowledge and established best practices regarding their internal due diligence processes; for instance, by offering guidance on how to best draft an investment memo. Particularly in cases where USAID is undertaking more intensive due diligence efforts, it should actively consider partnering with LPs—both commercial limited partners and DFIs.

“If I were just beginning to build a private equity / venture capital portfolio in emerging markets today, I would initially lean upon well-established faces and co-invest alongside LPs that know the space very well in order to build up my knowledge base.” –LP

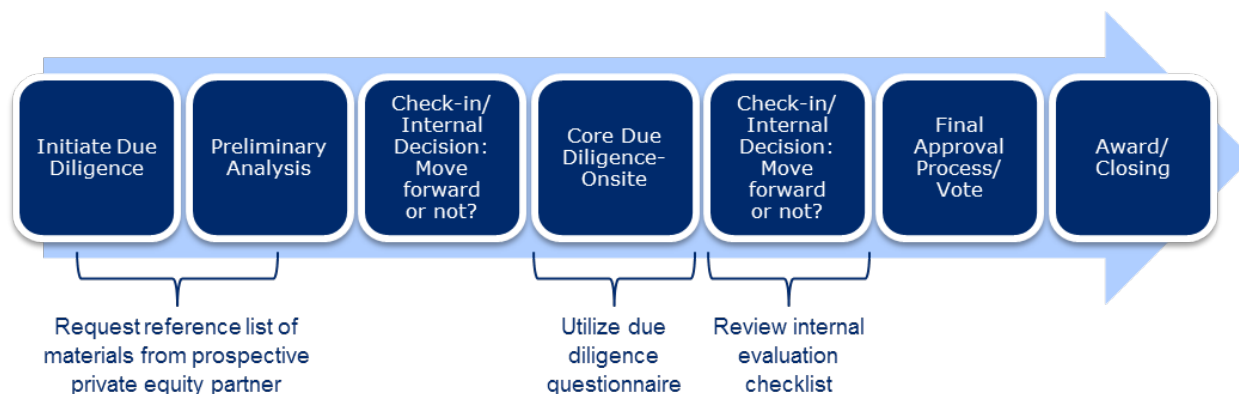
DUE DILIGENCE TOOLS

EMPEA compiled the following items to assist USAID in assessing and evaluating private equity funds operating in emerging markets.

- The **reference list of materials** should be requested of a prospective beneficiary fund in advance of undertaking a formal due diligence effort. The USAID due diligence team may discover that a review of these items will help them determine in a relatively quick manner whether or not a fund has the potential to be a strong partner that is aligned with USAID’s overall goals and objectives. By requesting and reviewing these items (as available) in advance of initiating in-depth discussions with the fund team, including an on-site visit, USAID will be able to allocate its time and resources more effectively.
- The **due diligence questionnaire** represents the core of the due diligence process and is designed to assist USAID in thinking through the key issues that will determine whether or not to move forward with a prospective private equity partner. Some of the questions may be addressed by the list of materials previously requested; however, USAID staff members will want to dig into each of the main topics—background, team, impact and environmental / social / governance concerns, the multiplier effect of capital, compliance and reputational risk, overview of the firm, overview of the fund, fund investment strategy, track record, the investment / monitoring / reporting process, the competitive landscape, alignment of interests and conflicts of interest—in greater depth with the fund team, including potentially during an on-site visit.
- Once the due diligence process has been completed with the fund team, the **internal evaluation checklist** is a list of questions that the USAID due diligence team should ask internally to ensure that all of the key issues have been considered in evaluating a prospective private equity partner. The ability to answer yes to most, if not all, of these questions should give comfort and weigh in favor of considering the fund. There may be instances in which USAID has not directly evaluated a specific question—particularly if the proposed partnership is at a lower level of engagement. In these cases, USAID staff may wish to consult with other limited partners in the fund.

Figure 2 below summarizes the due diligence process and where in the process these tools should be utilized.

Figure 2: Due Diligence Process and Use of Tools³



EXPECTED LEVEL OF ENGAGEMENT AND THE DUE DILIGENCE PROCESS

Given the myriad ways in which USAID partners with funds, certainly not all of the items and questions contained within these materials will be relevant for each due diligence process. To better assist USAID in applying these tools, they are presented in four levels of engagement: (1) fund structuring support; (2) grant funding; (3) returnable capital; and, (4) traditional debt or equity. These are described in detail in Figure 1 on page 2. In those instances in which USAID practitioners may be interacting in ways that do not fit neatly into these categories, they should exercise judgement and apply the level of engagement that most closely resembles the context.

As previously noted, the majority of the investors we've interviewed for the purposes of executing this project—particularly the DFIs and impact-focused organizations—are focused on achieving both a financial and developmental return. These investors largely share a belief that a fund must be financially successful in order to achieve and maintain over time a long-term development impact—and therefore the due diligence process focuses on understanding both the financial viability of a fund as well as its potential to affect greater economic and / or social development. This is especially the case for investors who wish to catalyze additional funding as the private sector will not follow if a fund does not demonstrate profitability and scale. For USAID, the financial success of a fund will likely be important in ensuring that investors who may have committed to that fund, in part because of USAID's role, continue to invest in and support the entity and broader asset class.

USAID staff members conducting a level of due diligence corresponding with a lower level of engagement may not be able to place a great deal of emphasis on evaluating the financial viability of the fund and may instead prioritize understanding and / or shaping its development objectives to ensure alignment with the organization's overall goals. In these circumstances, it is recommended that the USAID due diligence team leverage relationships with the other investors in a fund—particularly DFIs who may have similar development objectives and interests as USAID—to ensure that they are comfortable with aspects such as the historical and projected financials, realized and unrealized valuations, and the firm's track record. The USAID team can refer to the questions associated with Levels 3-4 in their discussions with these other investors.

³ For illustrative purposes only. Practitioners should consult with a supervisor and legal team to understand the relevant, activity-specific due diligence process.

MATERIALS TO BE REQUESTED OF PROSPECTIVE PARTNERS

The following materials, if available, should be provided by the prospective beneficiary to USAID in advance of undergoing a formal due diligence process. An analysis of these materials will help clarify whether or not the fund is aligned with USAID's objectives, and may save time and resources on further due diligence in cases determined not to be a strong fit. More detail on each of these items can be found in the accompanying User Guide to Requested Materials beginning on the following page.

Table 1: Materials to Be Requested of Prospective Partners, by USAID Expected Level of Engagement

	Documentary Support	Level 1: Fund Structuring Support	Level 2: Grant Funding	Level 3: Returnable Capital	Level 4: Traditional Debt or Equity
1.	Fund pitch book / presentation	✓	✓	✓	✓
2.	CVs or biographies for all investment professionals and investment committee members	✓	✓	✓	✓
3.	List of references	✓	✓	✓	✓
4.	Relevant research that supports the fund's investment thesis	✓	✓	✓	✓
5.	Information on current / proposed pipeline	✓	✓	✓	✓
6.	Fund due diligence questionnaire		✓	✓	✓
7.	Latest financial statements for active funds (and any related entities) managed by firm		✓	✓	✓
8.	Private placement memorandum (PPM)		✓	✓	✓
9.	Operating budget covering life of the fund		✓	✓	✓
10.	Employee handbook		✓	✓	✓
11.	Internal policies		✓	✓	✓
12.	Access to data room			✓	✓
13.	Investment committee reports on recent transactions			✓	✓
14.	Latest annual investors' meeting materials			✓	✓
15.	Information related to side letters / special arrangements			✓	✓
16.	Term sheet			✓	✓
17.	Fund Limited Partner Agreement (LPA)				✓

Following are definitions and additional information related to the materials that USAID should request from a prospective partner in advance of undertaking a formal due diligence effort.

1. **Fund pitch book / presentation.** No matter how early stage in concept, a fund manager should have a well thought out and clearly articulated investment strategy, which is often summarized in a fund pitch book or PowerPoint presentation. A typical pitch book would contain information related to the fund's:
 - a. Proposed investment thesis;
 - b. Team (including background and experience);
 - c. Track record (including case studies of completed deals and transparent valuation methodologies);
 - d. Competitive advantage / differentiation;
 - e. Investment criteria, investment process, deal sourcing strategy, and prospective deal pipeline;
 - f. Approach to deal structuring;
 - g. Value creation capabilities / operating expertise;
 - h. Exit strategies; and,
 - i. Timeline and terms, to name a few.
2. **Curricula Vitae (CV) or biography for all investment professionals and investment committee members related to the fund.** All CVs / biographies should include education and employment history with dates, titles and responsibilities. It is important to try to obtain this information for everyone on the fund team and not just the managing partners.
3. **List of references.** The reference list should be comprised of at least three individuals for each principal. Ideal references include prior and / or current portfolio company executives, prior and / or current investors, co-investors, and industry peers. For each reference, the following information should be submitted:
 - a. Full name
 - b. Current employer and title
 - c. Contact details including email address and phone number
 - d. Relationship to individual
 - e. Relationship to the fund

Given that firms are likely to “cherry pick” their references, investors may wish to develop a broader list of individuals who know each team member in both a business and personal capacity to develop a more holistic view. In fact, some limited partners will specifically request to speak with individuals who may have had a mixed or negative experience with a partner / fund team member; for instance, perhaps that person received a tough performance review or was fired by that partner. USAID team members may find it useful to engage in discussions with other prospective investors for the purposes of sharing information related to reference checks and the reputation of the fund team.

4. **Relevant research that supports the fund's investment thesis.** For funds with a specific geographic or sector focus (i.e., infrastructure, climate change or healthcare), any relevant research that supports the fund's investment thesis should be provided. It is important that even early-stage (new) funds still in the concept phase are able to support and verify their investment thesis.
5. **Information on current / proposed pipeline.** Information related to the deal pipeline (or potential portfolio companies) should include the name (or a code name in cases where confidentiality is important), location, business description, method of origination, anticipated investment amount, anticipated stake, exit strategy and current status of the deal. Even early-

stage funds should have an idea of which investments they will be able to make—and how those deals will be sourced (i.e., through proprietary networks versus competitive auctions).

6. **Fund due diligence questionnaire.** Many firms—particularly those that have already raised prior funds—will have an in-house questionnaire filled out in anticipation of the standard questions asked by potential investors during the due diligence process.
7. **Latest quarterly / annual financial statements for active funds (and any related entities) managed by the firm.** The latest balance sheet, income statement and cash flow statement, as well as any accompanying management letters, for all active funds (and any related entities, such as a subsidiary) should be obtained. If contemplating a lower level of engagement with a fund manager, USAID staff members may not necessarily be analyzing these financials directly (and may instead focus more on the development agenda of the fund, while leveraging other institutional investors who can relay their feedback on the financial statements). However, it is important to confirm both the existence of the financial statements and that proper processes are in place around the accounting function of the firm. In addition, it is useful to know whether there is an independent auditor, and if so, who is serving in this role. In the case of earlier-stage funds that may not yet have a professional, independent auditor in place, it is important that the fund manager demonstrates a willingness and intent to engage one. These documents can also provide investors deeper insights into the quality of a fund manager's reporting systems and processes.
8. **Private placement memorandum (PPM):** The PPM (sometimes referred to as the Offering Memorandum) provides a formal description of the fund investment opportunity. A PPM will typically contain a description of the investment opportunity, the terms, fees (particularly those going to the fund manager), capital structure and financial statements, as well as a description of the business and biographies of the management team. PPMs will also include a list of various risks associated with an investment in the fund.
9. **Operating budget covering life of the fund.** An operating budget should be reviewed in order to ensure that the fund manager is well positioned to be financially sustainable over the life of the fund. This is particularly important for smaller funds—some of the DFI representatives with whom we spoke noted that a management fee of 2%-2.75% was often not enough to support funds under US\$25 million in size and that many fund managers in these instances lost money on the operational side and ultimately failed. In the case of smaller funds, a management fee of 3% or higher may be warranted to ensure the fund manager is viable. On the other end of the spectrum, very large fund (e.g., those in excess of US\$5 billion) may need to lower the management fee to maintain an alignment of interest with the fund's limited partners. The best way to evaluate whether a fund's requested management fee is reasonable is to review the operating budget of that fund over its lifespan.
10. **Employee handbook.** An employee handbook or manual should contain all relevant information related to company policies and procedures. Very early-stage funds may not yet have this document in place, though this should not necessarily be viewed as a deal-breaker as long as the fund manager is willing to produce a handbook in line with best practices at the appropriate time. Note that USAID may require specific documentation or a statement regarding adherence to certain employment and labor standards. Users of this guide should consult with a supervisor and/or legal officer to identify specific requirement.
11. **Internal policies.** If available, the fund manager should share all internal policies including a valuation policy, environmental, social and governance (ESG) policy, business continuity / disaster recovery plan, code of ethics / conduct policy, conflict of interest policy, compliance manual and risk management policy. It will often be the case that some of these policies will not be in place with a potential fund partner. This should not necessarily be viewed as a deal-breaker as long as the fund manager is willing to produce these documents in line with best practices at the appropriate time. Note that USAID may require specific documentation or have requirements with respect to ESG compliance. Please consult with your supervisor and legal officer when reviewing a fund's ESG compliance and policy documents.

12. **Access to data room.** The more mature fund managers are likely to operate a data room or data center to store all relevant information related to their latest fund. Participating in a data room ensures that a fund's information is organized, efficiently accessed and up to date. Examples of companies that house data rooms include IntraLinks, iDeals, and Merrill Datasite, to name just a few.
13. **Due diligence / investment committee reports on recent transactions.** Reviewing a fund manager's recent due diligence / investment committee reports will allow you to get a better sense of how they are assessing and weighing the risks around investment opportunities. Asking for these reports will also verify that the fund manager has proper review and documentation policies in place regarding the analysis of potential deals. These documents can also provide investors deeper insights into the quality of a fund manager's reporting systems and processes.
14. **Latest annual general / investors' meeting materials.** Fund managers, particularly those that are more mature, will often hold annual investor meetings to share information and facilitate discussions around the fund's pipeline and current performance. While some of the materials provided will have already been requested (such as the financial statements), such forums tend to offer investors a more detailed view around specific portfolio companies (case studies) as well as greater insights on macroeconomic or sector-specific challenges currently besetting the fund manager. These documents can also provide investors deeper insights into the quality of a fund manager's reporting systems and processes.
15. **Information related to side letters or any special arrangements entered into by the firm that involves the fund and any investors in the fund.** A side letter is a legal document that provides expanded rights or preferences to certain investors. For example, this could include co-investment rights, liquidity preferences, reductions around fees, etc. While several firms utilize side letters and doing so does not contradict regulations, the fund manager should be transparent and forthcoming around providing information related to such arrangements.
16. **Term sheet.** The term sheet is a preliminary, non-legally binding document that outlines the terms and conditions that define the structure of the relationship between a general partner (GP, or fund manager) and the limited partners in a proposed new private equity fund. While the term sheet may not be directly relevant to USAID's role with the fund, it should still be reviewed (or verified with other LPs in the fund) to ensure that it is in line with best practices. The Institutional Limited Partners Association (ILPA) has produced a summary of preferred terms for reference (see Annex A:).
17. **Fund Limited Partner Agreement (LPA).** The LPA is a legal document that sets forth the terms and conditions governing the relationship and the responsibilities of the investors and the GP in a private equity fund, including, for example, the fee structure, including the hurdle rate or preferred return (meaning the minimal return a limited partner must receive from a private equity fund investment before the general partner can begin to share in the profits; typically set at 8%), carried interest (meaning the share of profits from a fund's investments that are allocated to the general partner once the investors have received the hurdle rate; typically set at 20%), the distributions model (also known as a "waterfall," which defines the sequencing of capital distributions to LPs and carried interest payments to the GP), carried interest clawback provisions (in the event that a GP has received more than, say, 20% of the profits, then it would return the surplus to the LP), methods used to value portfolio companies prior to exit, ESG policies and reporting / disclosure requirements. While the LPA may not be directly relevant to USAID's role with the fund, it should still be reviewed (or verified with other LPs in the fund) to ensure it is in line with best practices. The Institutional Limited Partners Association (ILPA) has produced the ILPA Private Equity Principles for reference (see Annex C:).
 - a. Limited partners will often negotiate a number of legal provisions in the LPA to protect themselves in case of a negative turn of events. A few examples are provided below:

- b. Removal provisions: Many institutional investors want the ability to remove a fund manager who is neglectful or causing unnecessary harm to the fund and / or its investments. There are typically two types of provisions: a “for-cause” removal or a “no-fault” removal. A for-cause removal occurs when the fund manager has committed an act (such a criminal felony, gross negligence or fraud) that warrants his / her removal from the fund. The threshold to enact this clause is typically a 50% vote by the limited partners; however, the process is often time-consuming as proving cause can be extremely difficult. A no-fault removal does not require proof that the fund manager has committed an act that warrants removal but requires a higher threshold of votes; typically two-thirds to three-fourths of the LPs in the fund.
- c. Key person clauses: A standard key person provision is a contractual clause that would prevent a fund manager from making any investment decisions in the event that one or more of the key employees fails to perform in his or her role (for instance, by leaving the firm). New investments are only allowed to be made once a replacement is appointed and approved.
- d. No-fault suspension of investment period: In some cases, limited partners are able to negotiate a no-fault suspension (or early termination) of the investment period should something go wrong. The threshold to enact such a clause is typically high; for instance 75% or more of the LPs in a fund.

DUE DILIGENCE QUESTIONNAIRE

When evaluating a prospective beneficiary fund, the following key elements should be reviewed. Note that not every question / item will be relevant for each potential partnership. Guidelines are provided around which points correspond to which level of engagement; however, there will be overlap and USAID staff should evaluate each potential partnership on a case-by-case basis.

As a reminder, brief descriptions of the levels of engagement are summarized below:

- **Level 1—Fund structuring support:** This level of engagement represents any level of support related to structuring / developing a fund, such as providing funding for a feasibility study or offering in-kind feasibility assistance in conducting a study. Getting involved before a fund is fully conceptualized can be of interest to an entity like USAID because it gives the organization the ability to mold a prospective fund into one that aligns with its development objectives.
- **Level 2—Grant funding:** Accounting for the bulk of USAID's current interactions with private equity vehicles, this level of engagement represents any type of grant (or non-returnable capital) that is being provided to a fund. For example, the grant could be used to provide technical assistance, or awarded with the expectation of catalyzing additional funding from third-party investors. In general, Level 2 funding awards are larger in size than Level 1.
- **Level 3—Committing Returnable capital:** This level of engagement represents due diligence on typically more established fund managers for the purpose of providing a repayable grant contribution or similar subordinate equity-like instrument. This is not commonly used by USAID; if a staff member is conducting this level of due diligence on a fund, please consult with your supervisor, legal advisor and the Office of Private Capital and Microenterprise (PCM).
- **Level 4—Traditional debt or equity:** This level represents the traditional due diligence undertaken by development finance institutions and other limited partners that are seeking to provide a debt or equity investment into a private equity fund. This level of engagement is generally outside the scope of USAID's mandate as the organization is not currently permitted to provide debt or equity to a private equity fund in the traditional sense.

USAID staff may wish to refer to some of the questions and items relevant to later levels of engagement as reference points to assist them in their consultations with other limited partners in a fund.

DUE DILIGENCE QUESTIONNAIRE

Question/Data Point		Engagement Level			
		1	2	3	4
I. Opportunity Background					
a.	Summary of the investment thesis / strategy, including developmental impact	✓	✓	✓	✓
b.	Fund statistics: target size, hard cap (or maximum amount of capital that will be raised), fundraising timeline, target number of portfolio companies, legal / tax structure (if in place), key fund terms and target returns	✓	✓	✓	✓
c.	History of firm, if any	✓	✓	✓	✓
d.	List of all prior, current and anticipated investors by name	✓	✓	✓	✓
II. Fund Team					
a.	What is the total number of employees (at firm and fund)?	✓	✓	✓	✓
b.	What is the firm's organizational structure (proposed or actual)?	✓	✓	✓	✓
c.	Background on / resumes of the fund team; each member's name, title, location and role, as well as skillsets based on education and work experience	✓	✓	✓	✓
d.	History of how the fund team came together	✓	✓	✓	✓
e.	Detailed summary of the fund team's track record and experience in the particular countries and / or sectors the fund is targeting	✓	✓	✓	✓
f.	Any financial, health, litigation, personal or other existing conditions of any fund team members that might impact their ability to carry out their duties as related to the fund	✓	✓	✓	✓
g.	Any future plans to hire, and if so, details on position and timing	✓	✓	✓	✓
h.	List of all hires over the last five years including date joined, title when hired and current title		✓	✓	✓
i.	List of all departures (both voluntary and involuntary) over the past five years, including date of and reason for departure. Are any team members expected to depart between now and the end of the fund's life?		✓	✓	✓
j.	Who are the key personnel, and what key person provisions exist?			✓	✓
k.	Clear explanation of succession plans to ensure continuity of management of the firm			✓	✓
III. Impact / Environmental, Social and Governance (ESG) Concerns					
a.	Does the fund seek to make any specific developmental impacts?	✓	✓	✓	✓
b.	How will the fund measure / monitor these impacts, and how frequently?	✓	✓	✓	✓
c.	How do these objectives align with USAID and the specific mission / office's goals? (For instance, in the case of Power Africa, how will the fund contribute to additional megawatts of clean energy generated or an increase in home and business energy connections?)	✓	✓	✓	✓
d.	How willing is the fund manager to track / measure key performance indicators identified as important to USAID?	✓	✓	✓	✓

Question/Data Point	Engagement Level			
	1	2	3	4
e. Does the fund have a robust policy in place around identifying and managing ESG issues? If not, will it consider adopting a policy? Does the policy align with USAID's ESG standards? Will ESG considerations be an inherent part of the investment decision making process?	✓	✓	✓	✓
f. Does the fund adhere to any international standards or frameworks around responsible investment practices (e.g., IFC Performance Standards or the Principles for Responsible Investment (PRI)), or plan to do so?	✓	✓	✓	✓
g. Does the fund anticipate generating any add-on developmental impacts not directly tied to its investment thesis (for instance, helping groups that are disproportionately vulnerable, such as women)?	✓	✓	✓	✓
h. How will the fund disclose any material ESG incidents to investors?	✓	✓	✓	✓
IV. Multiplier Effect of Capital				
a. How critical is USAID's support in ensuring the success of the fund launch / raise?	✓	✓	✓	✓
b. How will USAID's support attract additional investors into the fund?	✓	✓	✓	✓
c. How much additional funding is expected to be generated as a result of USAID's involvement, and by which investors (by name, if known)?	✓	✓	✓	✓
d. Are any other investors capable and willing to undertake the same proposed role as USAID?	✓	✓	✓	✓
V. Compliance and Reputational Risk				
a. Overview of any regulatory bodies that will supervise the firm and / or fund	✓	✓	✓	✓
b. Discuss the firm's proposed compliance policies, including information on procedures and internal controls to prevent the fund from being used to launder money, finance terrorist activities, or become subject to personal gain	✓	✓	✓	✓
c. Has the firm or any of the fund team members ever filed for bankruptcy?	✓	✓	✓	✓
d. Is anyone related to the fund a politically exposed person or listed under any sanctions or terrorist watch lists?	✓	✓	✓	✓
e. Summarize any prior, current or pending litigation, investigation, and / or regulatory actions brought against the firm, fund, fund team members or portfolio companies	✓	✓	✓	✓
f. Summarize any current or past litigation between the firm and investors, or between the firm and portfolio companies	✓	✓	✓	✓
g. Summarize any other potential issues related to reputational risk	✓	✓	✓	✓
h. How will the fund monitor its compliance with laws and regulations?	✓	✓	✓	✓
VI. Overview of Firm				
a. Full legal name and address of the firm	✓	✓	✓	✓
b. The firm's history, including year founded. How has the firm evolved to date?		✓	✓	✓
c. Corporate structure including parent companies and affiliates		✓	✓	✓
d. Office locations; history of location changes and plans for future offices		✓	✓	✓
e. Overall strategy, geographic and sector focus. How has the investment thesis evolved to date? Why?		✓	✓	✓

Question/Data Point	Engagement Level			
	1	2	3	4
f. Total assets under management		✓	✓	✓
g. Overview of all funds raised, including a list of investors in each fund		✓	✓	✓
h. Any relevant recent news related to the firm		✓	✓	✓
i. Overview of all firm products and business lines (including advisory / consulting services, joint ventures and separate accounts). Are there any overlaps or linkages between the fund and the firm's other products or business lines? Do these present any conflicts of interest?			✓	✓
j. Future plans (over the next 5-10 years). Is the firm planning to enter any new business lines? Is the firm planning to exit any existing business lines? Why? Are there plans to launch any new funds? If so, at what size and focused on which strategies, markets and / or sectors? Would doing so violate the terms of existing LPAs? Are there any other significant anticipated changes?			✓	✓
VII. Overview of Fund				
a. Full legal name and address of the fund	✓	✓	✓	✓
b. Target fundraising total and maximum fundraising cap	✓	✓	✓	✓
c. Fundraising timeline, including each actual and anticipated closing date, as well as amounts raised		✓	✓	✓
d. Total commitments received to date; please provide names, contact information and the amount committed by each investor		✓	✓	✓
e. Information related to organizations that have not invested in the fund but are likely to do so, or who have declined to participate in the fund and why		✓	✓	✓
f. Any relevant recent news related to current and anticipated investors		✓	✓	✓
g. Description of any entities / individuals that will participate in the management of the fund including advisors, custodians and administrators		✓	✓	✓
h. Details on any investments made to date		✓	✓	✓
i. Anticipated life of the fund and length of the investment period. What is the process for extending the life of the fund?		✓	✓	✓
j. Legal and tax structure of the fund, including a diagram laying out the relationships among investors, the fund manager, the fund and the portfolio companies, if available			✓	✓
k. Jurisdiction of the fund (e.g., Cayman Islands, Mauritius, Jersey / Guernsey, etc.)			✓	✓
l. Key terms including management fee, carried interest and preferred return for LPs			✓	✓
m. Use of placement agents during fundraising, if at all. If a placement agent is being used, please provide details on how and when the placement agent will be paid, and who will be responsible for this payment				✓
n. Any proposed fee activities for the fund (e.g., monitoring and transaction fees), and management fee offset policy				✓
o. Policy for allocating expenses between the GP and investors (inclusive of start-up costs, placement agent fees, ongoing operational expenses, due diligence costs and legal fees)				✓

Question/Data Point	Engagement Level				
	1	2	3	4	
VIII. Fund Investment Strategy					
a.	Overall strategy, including geographic and sector focus, as well as target stage of companies (e.g., seed / early stage, growth, buyout, private investment in public equities (PIPEs) / take-privates, special situations, etc.) or types of projects (e.g., greenfield versus brownfield).	✓	✓	✓	✓
b.	Why does the firm believe this represents an attractive opportunity set?	✓	✓	✓	✓
c.	Why does the firm believe it is well placed to source and capitalize on these opportunities?	✓	✓	✓	✓
d.	What is the investible market with regard to the firm's strategy?		✓	✓	✓
e.	What are the drivers of deal flow?		✓	✓	✓
f.	What are the risks (macroeconomic, regulatory, political, foreign exchange, etc.) of investing in the fund's strategy?		✓	✓	✓
g.	Allocation designations for regions, markets and / or sectors, including guidelines, limits and restrictions		✓	✓	✓
h.	Potential pipeline		✓	✓	✓
i.	Preference for being a control, minority, joint or sole investor, and how this compares to prior deals done. What controls and rights does the firm typically (or plan to) seek? How will the firm structure its deals to ensure that its controls and rights can be implemented?		✓	✓	✓
j.	Target number of portfolio companies or transactions to be made by the fund		✓	✓	✓
k.	Anticipated deployment velocity (i.e., number of investments to be made per year)		✓	✓	✓
l.	Anticipated range of transaction sizes		✓	✓	✓
m.	Anticipated holding periods		✓	✓	✓
n.	Target and / or maximum leverage guidelines, if any		✓	✓	✓
o.	Anticipated exit strategies		✓	✓	✓
p.	Target returns (gross / net cash multiple and gross / net IRR)		✓	✓	✓
q.	Anticipated role of co-investors in the fund, if any				✓
r.	Process for allocating co-investments, if at all, and general terms				✓
IX. Fund Track Record					
a.	For new or first-time fund managers without prior fund experience, please list any relevant experience of the team members, including any prior investments done on a deal-by-deal basis. How have they performed?	✓	✓	✓	✓
b.	Please detail important lessons learned as a result of prior deal experience	✓	✓	✓	✓

Question/Data Point	Engagement Level			
	1	2	3	4
<p>c. For fund managers with prior fund experience, please provide a list of all investments made by the firm through funds, managed accounts, etc., including information related to:</p> <ul style="list-style-type: none"> i. Structure (equity, senior debt, mezzanine, etc.) ii. Company status (public versus private) iii. Location iv. Deal lead(s); deal team members v. Business focus / sector; description of activities vi. How the investment was sourced vii. Investment thesis viii. Total amount invested ix. Ownership stake x. Investment date xi. Entry multiple / valuation xii. Realized value xiii. Unrealized value xiv. Total value xv. Current investment status xvi. Performance xvii. Exit method(s) and exit date(s) (actual if partial or final; projected if not) 		✓	✓	✓
d. Note which, if any, transactions were led by other fund managers / investors		✓	✓	✓
e. Please provide information on all portfolio companies, detailing annual changes in key financials such as total revenues, operating income, net income and enterprise value.		✓	✓	✓
f. Please provide examples of how the firm has demonstrated pricing discipline (in other words, that the firm has not overpaid for assets)		✓	✓	✓
g. Please describe the role played by the fund manager in terms of sourcing, monitoring and exiting each portfolio company		✓	✓	✓
h. Please outline the value creation initiatives put in place for each portfolio company by the fund manager		✓	✓	✓
i. Describe the conditions behind any investments that were written off, sold or disposed of at a loss			✓	✓
X. Investment, Monitoring and Reporting Process				
<p>a. Please detail your investment process (for both new and follow-on investments):</p> <ul style="list-style-type: none"> i. How will each deal be staffed? Do the professionals involved in an initial investment oversee that deal through exit, or do other team members monitor a portfolio company post-investment? Who will monitor which deals? ii. How do you typically source investments? Please describe your relevant local networks and how proprietary deals are developed, if at all. Please describe your strategy for participating in and winning auctions, if at all iii. How is the deal process documented through each stage (sourcing, due diligence, investment, monitoring and exit)? iv. At what point are investment memos drafted, and how are they approved? What is the role of your investment committee, and how often does it meet? Who currently comprises the membership of the committee? Please include names, affiliations and biographies 		✓	✓	✓

Question/Data Point	Engagement Level			
	1	2	3	4
b. Historically, how many deals reviewed over the life of a fund have moved forward to the investment stage?		✓	✓	✓
c. Please detail your typical level of engagement with a portfolio company post-investment: What information do you require your portfolio companies to report, and with what degree of frequency? What is your approach to monitoring portfolio companies? What is your policy regarding board representation at portfolio companies, if any? Please provide examples, if any, of your firms' constructive engagement with a portfolio company's board and /or management team		✓	✓	✓
d. How frequently does the fund manager report to its LPs? Does the manager have the back-office personnel and / or capabilities to meet investors' demands? Is it capable of fielding incoming requests for information from investors and responding in a timely manner?			✓	✓
e. Please detail your approach to portfolio construction			✓	✓
f. Please detail your approach to portfolio valuation, including your unrealized portfolio			✓	✓
g. Use of third-party consultants, if at all			✓	✓
XI. Competitive Landscape				
a. List of all fund managers and other institutions (e.g., family offices, corporations, etc.) that invest in the same niche as your fund; provide information regarding any anticipated new entrants. What is the total amount of estimated capital currently being directed toward the niche your fund is seeking to target? Is there a sufficient volume of investible companies (i.e., deal flow) to support the volume of capital the fund manager is seeking to raise in light of the total capital available in the market?		✓	✓	✓
b. How do you compare to these other players in the market? What is your competitive advantage?		✓	✓	✓
c. Please describe how any potential future developments related to a target market and / or sector may impact the fund's ability to perform well		✓	✓	✓
d. What types of entities do you expect to co-invest with, if any?			✓	✓
XII. Alignment of Interests				
a. Ownership structure, including percentages, of the firm and fund manager		✓	✓	✓
b. Compensation structure for all fund team members, including detail on base salary, bonus, profit sharing ("carried interest"), equity ownership, and group / individual performance incentives			✓	✓
c. Level of GP commitment to fund			✓	✓
d. Level of executive commitment to fund			✓	✓
e. In cases where the fund manager is a captive, how are the economics split?			✓	✓
f. Are management fees reasonable? Do monitoring and transaction fees constitute an undue source of fixed revenue to the fund manager, thereby reducing the incentives of carried interest?			✓	✓

Question/Data Point	Engagement Level			
	1	2	3	4
XIII. Conflicts of Interest				
a.		✓	✓	✓
b.			✓	✓
c.			✓	✓
d.			✓	✓
e.			✓	✓
f.			✓	✓

POST-DUE DILIGENCE: THE INTERNAL EVALUATION CHECKLIST

Below is a list of questions to consider before signing off on a decision to partner with an emerging market private equity fund—regardless of the level of engagement. In cases where USAID is not directly evaluating a specific question, it may wish to consult with other limited partners in the fund. The ability to answer yes to most, if not all, of the below questions should give comfort and weigh in favor of considering the fund.

Question/Data Point	Engagement Level			
	1	2	3	4
a.	✓	✓	✓	✓
b.	✓	✓	✓	✓
c.	✓	✓	✓	✓
d.		✓	✓	✓
e.		✓	✓	✓
f.		✓	✓	✓
g.		✓	✓	✓
h.		✓	✓	✓
i.		✓	✓	✓

Question/Data Point		Engagement Level			
		1	2	3	4
j.	Have the other institutional investors or LPs in a fund been verified, and are they partners with whom USAID can work?		✓	✓	✓
k.	Is the fund's strategy well suited (and sized) for the market(s) / sector(s) it seeks to target?		✓	✓	✓
l.	Does the fund have a competitive advantage in its target market(s) / sector(s)?		✓	✓	✓
m.	Are relevant risks (i.e., macroeconomic, regulatory, foreign exchange, etc.) well understood by the fund team, and is there a plan in place to address these concerns?		✓	✓	✓
n.	Has the fund manager demonstrated a commitment to internal risk management, including a focus on environmental, social and governance (ESG) issues?		✓	✓	✓
o.	Has the firm and fund been reviewed and cleared of any reputational (including legal) concerns?		✓	✓	✓
p.	Has the fund manager demonstrated the capacity to manage a USAID grant, complying with requirements such as providing information on local procurement, travel and taxation?		✓	✓	✓
q.	Has the fund signed all relevant anti-corruption, anti-money laundering, know your customer (KYC), politically exposed person (PEP), etc. documents?			✓	✓

USERS GUIDE TO DUE DILIGENCE QUESTIONNAIRE

The material below is provided as supporting guidance for users of the due diligence questionnaire. This includes additional information related to each of the categories outlined in the questionnaires, key definitions, and a sampling of potential red flags of which to be aware.

I. Opportunity Background

Any due diligence effort should begin with understanding the fund's investment thesis / strategy, and ensuring that it aligns with USAID's goals and the individual program or mission's specific development objectives. USAID staff should also take note of the overall fundraising objectives and status of any additional investors. Have any LPs committed to the fund or are they in the process of evaluating the opportunity? If so, which LPs are in discussions with the fund manager?

II. Fund Team

Most institutional investors argue that the team is the single most important factor in determining whether or not to pursue a partnership—and this is particularly the case for first-time and early-stage funds.

The due diligence effort should focus on the qualities of each individual employee and understanding how the team formed, including any prior shared work experience. Why are they coming together and do their dynamics make sense? How likely are they to work well together—and to do so over the entire life of the fund? Have they been stress-tested to make difficult decisions with meaningful pools of money? While reference checks will play a key role in answering these questions, it is important to watch the team interacting together in their own offices to get a more granular feel for the firm's culture, and to ensure that each employee shares a similar goal to the rest of the group.

The majority of limited partners with whom we've spoken noted that one cannot put enough emphasis on evaluating the team dynamics, arguing that it's similar to a marriage. The team will be working together for 10 to 12 years, or more, in an industry that can be stressful at times. With a new team, such stresses can create fissures if the dynamics are not strong.

The team evaluation should also seek to confirm the ability to execute on the proposed strategy and deal with any potential issues that may arise. USAID will need to decide whether or not the team possesses all of the requisite skill-sets, or if additional team members need to be engaged. Is USAID willing to spend more time with this team, assist them in building up their capacities, help them pull together their documents and ultimately structure the fund?

Sample positive characteristics:

- Many LPs note that if the team members have known each other for a long time due to shared school or work experiences, or having other strong cross-relationships, they are more likely to stay together in the face of headwinds.
- The local connections to the market(s) the team is targeting appear to be very deep and strong. (The team should demonstrate that they are committed to their local market(s) and not likely to move to another location in the short term).
- A good blend of skill-sets; for example, having some members with a finance background, others with operational / sector-specific expertise, etc.
- While not essential to any fund's success, many LPs have noted that having a mix of employees who are local and others who have experience in more mature private equity markets tends to be a good combination.

Sample potential red flags:

- Lack of a clear understanding of which team members will play which roles (e.g., conflicting views on who is in charge of various aspects of the fund).
- A small early-stage fund employing individuals in different locations.
- A team that has not worked together previously.
- Personal motivations that are not aligned with the fund strategy. For instance, a managing partner of an Africa-focused SME fund who is primarily interested in maximizing as much financial gain as possible (and does not appear to be driven in part by a desire to make a development impact as well) may not be a good fit for the role given the historical performance of this particular niche.
- In the case of later-stage funds, a high volume of recent departures, or a lack of succession planning to replace founders / older partners.

In instances where a fund is targeting investments in sectors that are prone to heavy government intervention, such as infrastructure and power, it is also important to test the team's expertise in that sector as well as its network. With a large influx of capital targeting these sectors, particularly in underserved regions like Africa, several institutional investors noted that teams will sometimes raise funds without a proper understanding of what could happen if things go wrong. Such teams need to demonstrate that they have a plan—and more importantly, networks—in place to manage any potential challenges.

Finally, to reiterate the criticality of the team, in his book *Pioneering Portfolio Management: An Unconventional Approach to Institutional Investment*, Yale Investment Office's David F. Swensen urges, "The character of a private equity fund's investment principals constitutes the single most important criterion in evaluating the merits of an investment. Driven, intelligent, ethical individuals operating in a cohesive partnership possess an edge likely to translate into superior investment results. On the other end of the spectrum, individuals willing to cut corners, operationally, intellectually, or ethically, place an investor's funds and reputation at risk."

III. Impact / Environmental, Social and Governance (ESG) Concerns

An assessment of a fund's investment thesis for change—including its implementation of environmental, social and governance (ESG) best practices—will likely be an extremely important component for USAID in determining whether or not to form a partnership. And this will particularly be the case with first-time funds—does the niche a fund is targeting address an unmet need and ultimately warrant the risk of supporting an unproven track record? Note that USAID has specific requirements around ESG compliance, including environmental review criteria and the consideration of gender impact, among others. Analysts should confer with their supervisor and legal officer for the appropriate set of standards and documentation.

After USAID has made the determination that a fund's developmental goals align with its objectives, the next step would be ensuring that the fund manager has thought through a process for measuring and reporting on its progress. How is the fund holding itself accountable? While the specific key performance indicators (KPIs)—for example, total number of employees, percentage of female employees, tax revenues generated, carbon emissions reduced, etc.—will vary based on the fund and its goals, it is important that the fund manager has identified those that are relevant to its thesis and has established a tracking method. In addition, how willing is the fund manager to measure themselves against USAID's specific KPIs? While there is no set standard, many institutional investors note that they like to see the collection of KPIs conducted on a quarterly basis and reported on an annual basis.

In an emerging market context, it will often be the case that a fund will not have very robust ESG policies in place, or they may not have any policies at all—particularly if it's in the early stage of development. However, most institutional investors argue that this should not be viewed as a deal-breaker as long as the fund manager is willing to work with USAID and other investors to

establish proper processes and systems to identify, measure and address ESG concerns—both at the fund level and (as best as possible) at the portfolio company level. In addition, the fund manager should demonstrate that it has the capacity, capability and diligence to rigorously apply and monitor these processes and systems. Popular benchmarks to assist funds in developing an ESG approach include the IFC Performance Standards and the Principles for Responsible Investment framework (see Annex C:). Some of the more mature fund managers may have a dedicated staff member (and in some cases with larger funds, a team) spending a portion of their time on ESG. A few LPs have reported that in certain instances, should a specific fund be focused on investments that need extremely close ESG management, such as agriculture, they may require the fund to hire a dedicated ESG person as a condition of their support.

IV. Multiplier Effect of Capital

An important factor in determining whether or not to proceed with a potential fund partnership is the ability for USAID's role to be catalytic and incent other investors to support that fund. It is also important to ascertain whether USAID's role is additional or if another investor or private sector entity would be capable and willing to provide a similar level of support to the fund.

V. Compliance and Reputational Risk

Early in the due diligence process, USAID will want to confirm that the individuals involved with the fund being evaluated do not pose any reputational risks to the organization. While the USAID team will do an independent analysis around reputational risk, it should ask the fund manager directly to provide any information related to litigation (prior, current or pending), bankruptcies filed, presence on any watch or sanctions lists, etc. Should the independent analysis differ from what the fund manager reports, it should be considered a red flag. Google and database searches on a name associated with the fund may reveal something questionable (for instance, involvement in an undisclosed legal matter or an appearance on a sanctions list). The person in question should be given an opportunity to clarify as it may either be untrue or there may be reasonable explanation. It is a further red flag if they are unable to provide such an explanation.

In addition to having a clean history, it is important that a fund manager puts in place policies and systems around compliance; in other words, ensuring that funds are being used appropriately, and not for personal gain or to finance criminal activities. A fund that is early stage in development may not have such a process in place but should demonstrate a willingness to work with USAID and other investors to establish one.

VI. Overview of Firm

USAID should collect and document as much information as possible on the firm being evaluated for knowledge management purposes. Many of these questions will not be relevant for a fund that is early in terms of its development stage. For those that are more mature and perhaps tied to a larger entity, it will be important to get a sense of how the fund fits within the overall organization, and how this may evolve over time. Potential red flags may include discovering a firm is seeking to aggressively expand into other asset classes and /or geographies, which may come at the expense of the current fund in terms of resources, or having a parent entity that appears to be exercising significant and undue influence over the investment decisions of a fund. These pressures could lead to frustrations within the management team and potentially a spin-out of the firm from its parent (if applicable).

VII. Overview of Fund

USAID should also collect and document as much information as possible on the fund for knowledge management purposes. A few key definitions related to private equity funds are included below:

- **Fundraising cap:** The maximum amount of capital a fund manager intends to raise from limited partners. In certain cases, fund managers are able to secure LP commitments in excess of their fundraising target; however, accepting all of these commitments could have

serious negative implications on executing the fund's investment strategy by affecting the target size of investments and / or the total number of transactions in the portfolio.

- *Closing date:* The date that a fund manager announces the aggregate of all secured LP commitments. Fund managers will often hold a first / initial closing to signal that their fund is viable and advertise some of the LPs who have chosen to support the fund. A final closing will mark the final round of commitments to the fund, while there may be instances where a fund will hold second or third closings in the interim.
- *Jurisdiction:* Jurisdiction refers to the legal location of a fund and is often chosen to minimize the tax burden on investors. Common jurisdictions for emerging market private equity funds include the Cayman Islands, Jersey / Guernsey, Mauritius, Singapore, England, South Africa, Delaware, etc.
- *Management fee:* The management fee refers to an annual fee that the limited partners pay a general partner as compensation for operating and managing the fund. This fee is typically calculated based on a percentage of the total capital committed to the fund. The industry standard is 2%; however, smaller funds may charge more than 2% to ensure the fund's financial sustainability.
- *Preferred return:* Also known as the hurdle rate, the preferred return is the minimum return a limited partner must receive from a private equity fund investment before the general partner can begin to share in the profits; typically set at 8%.
- *Carried interest:* Carried interest refers to the share of profits from a fund's investments allocated to the general partner once the investors have received the hurdle rate; typically set at 20%.
- *Placement agent:* A placement agent is a firm that specializes in assisting fund managers in raising capital from limited partners during the fundraising stage. Placement agents vary in the depth and breadth of services on offer; for example, some provide a full suite of services including fundraising strategy, firm positioning, offering materials, and brokering meetings with investors, while others limit themselves to making capital introductions to investors.
- *Management fee offsets:* The degree to which any expenses related to the portfolio company, including monitoring and transaction fees, that are paid to the fund manager are offset against the management fees.

USAID will want to ensure that the basic tenets of the fund are generally in line with best practices. For instance, while there will be variations, a typical private equity fund will have a life of 8 to 12 years, with the investment period approximating 4-6 years. ILPA recommends that fund extensions only be permitted in one-year increments. For additional guidance on preferred fund terms, refer to the ILPA Private Equity Principles (see Annex A:).

With regard to fee structures and remuneration, fund managers are compensated via two components: carried interest and the management fee. As noted above, the industry standard for carried interest or "carry" is 20%, and there is broad acceptance that this creates a significant alignment of interest between the fund manager and the investor. A typical distribution (also known as the "waterfall") is outlined below:

- Phase 1: 100% of the fund distributions is allocated to the limited partners until their original contribution is returned.
- Phase 2: 100% of the fund distributions is allocated to the limited partners until they have realized their preferred return (typically set at 8%).
- Phase 3: The fund manager is allowed to "catch up" with 100% of the fund distributions going to it until it reaches the 80 / 20 split with the investors (in other words, the fund manager's share will equal 20% of total distributions).

- Phase 4: All remaining distributions are allocated based on the carried interest, with typically 20% going to the fund manager and 80% to the limited partners.

By allocating capital to the institutional investors first, this structure is designed to encourage the fund manager to maximize the return of a fund. If an investor receives less than the agreed upon share upon liquidation of a fund, it often has the right to “claw back” the difference from the fund manager’s carried interest through a claw-back clause.

On the other hand, the management fee may require a bit more discretionary judgment. While the industry standard is 2%, as previously noted, smaller fund managers may require a larger percentage to ensure the fund’s operations can be supported, while larger fund managers may require less. The best way to assess whether a management fee is reasonable is to review the operating budget, which should canvass all expenses for running the fund through the end of its proposed life. While carried interest is designed to serve as a source of profit should the fund do well, management fees are solely intended to cover reasonable operating expenses. Of course, in emerging markets, the question of what defines a reasonable operating expense can sometimes be difficult to answer.

Institutional investors relay that the cost of certain factors such as clerical staff, rent and supplies, for example, are relatively easy to verify. However, the biggest variable is often the amount allocated in payroll to the key executives and investment managers. In many emerging markets, talent can be scarce and subject to strong competition, thus placing upward pressure on salaries. An LP can attempt to benchmark these costs by placing calls to competitor funds or other market participants, or by relying on benchmarks produced by firms such as Mercer or Hay, with the understanding that none of these benchmarks are complete or perfect. While a discretionary call will likely be involved in determining the reasonableness of a management fee, the review of the operating budget can significantly assist in making this decision.

VIII. Fund Investment Strategy

Regardless of its development stage, a fund manager should be able to clearly articulate its strategy and why it has a competitive advantage in sourcing and executing investment opportunities.

Sample potential red flags:

- The pipeline does not match to the investment strategy; for example, a fund manager claims to be focused on early-stage investments but is investing in a US\$100 million Series C round. While some deviations from a strategy may make sense for a particular fund, the fund manager should be able to outline the conditions under which such a scenario would take place.
- The fund size does not match the investible market; for example, a US\$750 million consumer-focused fund on a country located in Central America is unlikely to find a sufficient number of companies that merit investments of up to US\$75 million. That being said, investors should be aware that companies may require tranches of capital injections throughout the investment period, and that though the investible market may appear small, some fund managers have demonstrated an ability to create platform companies that can achieve scale quickly.
- A fund manager claims to be focused on a regional or multi-country strategy but the majority of its team is primarily knowledgeable on only one market. While having numerous offices and teams in different countries may look attractive on paper, it is a red flag if their team doesn’t know those markets very well.
- A fund claims to be opportunistic but cannot demonstrate any specific sector or market expertise. It is important for a fund to have an idea of which segments it will be investing in and how, and that it is not going to result in adverse selection of portfolio companies.
- Several institutional investors have noted that in instances where teams have spun-off from some of the more mature private equity firms, the deal pipeline needs to be strongly tested,

as many resemble those of the firms they came from and are therefore not proprietary in nature or competitive.

IX. Fund Track Record

Funds early in their development stage will likely not have a robust track record to share with USAID. However, USAID should still assess the background and work experience of the team to ensure that it has the skill-sets needed to be successful. Oftentimes, one or more of the partners will have previously managed a pool of money—whether on a proprietary basis, at an investment, merchant or commercial bank or for a high net-worth individual or family office. In such cases, it is important to understand the track record, how it is attributable to the individual fund team members, and whether it can be independently verified by an auditor. Many limited partners advise that if the track record cannot be independently verified by an auditor, then it should be heavily discounted. In addition, members of the fund may claim to have been the main architects of certain deals but these assertions should be verified by others familiar with the situation.

More mature funds should provide USAID with a list of their prior and current investments so that USAID can evaluate a number of items:

- Do their investments match to their strategy? For instance, if they claim to be focused on control deals, are most of the ownership stakes over 50%? Are most of their deals proprietary if they claim the ability to source deals through their local networks?
- Does the manager exhibit strategy drift? If so, what is driving it? For example, if the manager is transitioning from a growth equity strategy to a leveraged buyout strategy, why is it doing so now, and what edge does the team have to execute the new strategy successfully?
- Have they demonstrated discipline around the volume and size of their investments?
- Has the overall performance of their deals been in line with expectations?
- Can the fund manager articulate exactly how it has added value to investments?
- To what can the fund manager attribute the performance of each deal? For example, were organic revenue growth and operational efficiency gains responsible for the investment returns, or did the manager get lucky in timing their investment and capture value exclusively through multiple expansion (i.e., selling at a higher price than originally paid)?
- Has the manager demonstrated that it has a “repeatable model?” Are returns driven by one or two outsized successes in spite of the rest being losses, or does the manager deliver steady returns with low loss ratios?
- Have exits been executed in a reasonable timeframe?
- Perhaps most importantly, can the fund manager detail important lessons learned through case study examples?

While USAID may not need to actually evaluate certain items such as annual changes in the financials of the portfolio companies (e.g., operating income), it is still important to confirm that the fund manager is tracking such details in a regular and appropriate manner.

X. Investment, Monitoring and Reporting Process

A fund manager should have a clear sense of how it will be sourcing, executing and monitoring portfolio company investments—and who within the team will be responsible at each phase. In addition, the team should have a process established around documentation and the approvals process for investments.

One of the hardest parts of reviewing a fund manager’s investment process is gaining comfort in their approach to valuing any unrealized investments—particularly as the unrealized portion may represent a large component of the overall portfolio. One LP advises that it may be difficult to do an independent analysis but you should proactively ask the investment professionals at the firm in

charge of the valuations to explain their process and rationale to you as many times as possible until you reach a level of comfort with their position. One good way to know if a fund manager is being appropriately conservative is to review their projections prior to selling previously owned assets—for example, if they kept an asset on the books at 1x cost but then sold it at 1.5x cost, they were being conservative. USAID may seek to consult with other investors in a fund to ensure they are comfortable with the fund manager’s process.

XI. Competitive Landscape

While it will likely conduct its own independent analysis of the fund manager’s competition, USAID should confirm that the fund manager has a strong and thorough understanding of the players operating within its market(s) and how it offers differentiation from those entities.

XII. Alignment of Interests

Having an alignment of interest between the LP and GP is vitally important to the success of a fund. This is best reflected in the level of the fund manager’s commitment to the fund, or in other words what percentage of the total fundraising total they will pledge of their own money (known as their “skin in the game.”) As a general guideline, one investor notes, “The industry minimum standard is to see a 1% commitment from the fund manager. However, we believe that 2-5% is good, and anything between 5-10% is fantastic.” Nonetheless, most LPs will argue that there isn’t a magic number when it comes to demonstrating whether a fund manager / general partner has pledged an appropriate level of commitment to the fund. What is most important is to see that the level of commitment—whatever it is—represents a significant portion of the fund manager or executives’ total wealth; and therefore they will be incented to work as hard as possible to ensure the fund’s preservation and growth. This commitment is expected to be in cash rather than through the deferral of management fees, or a waiver in the carry (profits) of the fund. Some principals have been known to take out personal loans to finance a capital commitment.

USAID should also review the ownership and compensation structure of the firm to ensure that ownership is not concentrated too highly in one individual and that profits will be distributed well across the team. An extreme imbalance in compensation, particularly amongst the key members of the fund team, may represent a red flag and present a challenge in terms of ensuring the team works well together over the life of the fund.

XIII. Conflicts of Interest

Avoiding reputational risk around a fund partnership is closely tied to ensuring that the fund actively avoids any potential conflicts of interest. Examples of potential conflicts of interest include:

- A managing partner of the fund allocating time to outside and conflicting business interests
- A managing partner of a fund prematurely seeking to raise capital for a follow-on fund when the current fund requires his / her attention. (Most Limited Partner Agreements will stipulate limitations on the exact timing of when a GP is permitted to raise a subsequent fund to ensure that such activities are not diluting the current fund’s portfolio, typically after the end of the investment period and following initial distributions)
- An investment / advisory committee representative allocating time to conflicting business interests
- Allocating an investment opportunity to one fund when the fund manager is operating additional parallel funds
- Making an investment in an entity that is associated with a fund manager’s parent company or a separate business line within the broader firm

The fund manager should demonstrate thoughtfulness around such potential conflicts of interest and should have policies and procedures in place to swiftly address any issues that arise. Most fund managers will establish a Limited Partner Advisory Committee (LPAC) to advise it on a

number of fronts, including potential conflicts of interest. (Additional focus areas may include the valuation of investments, the review of new key hires and the waiving of investment restrictions). In cases where USAID wishes to play a more active role in supporting a fund it has backed, it should embrace an active role on the LPAC. In addition, the LPAC is often the main conduit for effectively monitoring a fund and understanding factors such as the team dynamics, deal origination, value creation and performance. The ILPA Principles offer guidance on best practices around LPACs.

ANNEX A: LIST OF INTERVIEWED ORGANIZATIONS

Following is a list of organizations interviewed in the course of developing this document.

- Accion International
- CDC Group plc
- Department for International Development (DFID)
- Fondo de Fondos (Corporación Mexicana de Inversiones de Capital)
- International Finance Corporation (IFC)
- IFC Asset Management Company
- Lockheed Martin Investment Management Company
- Netherlands Development Finance Company (FMO)
- Ontario Teachers' Pension Plan
- Overseas Private Investment Corporation (OPIC)
- Sarona Asset Management
- The Rockefeller Foundation
- The University of Texas Investment Management Co. (UTIMCO)

ANNEX B: NOTABLE QUOTES FROM RESEARCH INTERVIEWS

While not necessarily reflective of opinions shared widely by the group of interviewees, we wanted to highlight some of the quotes sourced during our conversations with institutional investors as they provide valuable nuance that may be of interest to USAID:

On the due diligence process:

- ❖ *“In this industry, due diligence is 50% looking at the team, strategy and track record and the other 50% is an assessment of whether or not you can work with a fund manager for the next 8 to 12 years; and this review has to be done on a personal level. You have to be in contact with the entire team—not just the managing partners—and get a true feeling for the culture of the organization. It’s not quantifiable. This is something you have to learn over time but reference calls are critical as they help to ensure that everything adds up.”*
- ❖ *“Private equity in emerging markets can be a big problem in that people do not know how to market themselves well. It is really important to keep an open mind when conducting due diligence.”*
- ❖ *“It is better to spend a lot of time finding out that a fund manager is not a suitable partner, than to engage with a team that performs poorly and requires significant time and resources to monitor—employing a deep due diligence process is extremely important.”*
- ❖ *“In addition to taking a top-down and bottoms-up approach to due diligence, we will also go to the countries in which we are interested in order to undertake a market mapping exercise. In this way, we are able to identify funds that would have fallen through the cracks otherwise because they are not great at marketing themselves or don’t have much experience approaching international investors.”*
- ❖ *“While it is important to get everyone on your team involved in the due diligence process early, one of the risks of doing so is that you end up with a groupthink mentality. We therefore ensure that there is one outsider (a partner who has not met the fund team or been directly involved in the process) participate in the last investment committee in order to bring a fresh perspective.”*
- ❖ *“In the due diligence process, first ask for a clearly articulated strategy and then request to see evidence on the processes and systems that support what the fund manager has told you. For example, you say this is how you source deals—let me see your pipeline. You say this is how you structure deals—let me look at your term sheets. You say this is how you exit deals—let me see your cash-on-cash returns. Being disciplined and systematic is what distinguishes success.”*
- ❖ *“As an entity that is tied to a government, it is crucial that we are able to defend the transparency and competitiveness of our decisions to partner with / invest in any specific fund. Therefore, we will often use a third-party private equity consultant to help us assess funds and offer an independent view, in addition to providing market intelligence. Using such a consultant helps us do our job better.”*
- ❖ *“At the end of the day, the due diligence process boils down to how comfortable you are with the fund manager and what they are able to accomplish—and the latter is largely based on what they have accomplished in the past as well as their overall place in the market. It is a judgment call.”*
- ❖ *“Follow the money—economics drives all of these GPs, so understanding how economics is being shared will help mitigate any potential pitfalls down the road.”*

- ❖ *“Adequate resources must be devoted to the due diligence effort. You don’t necessarily need a six-person team, but if you have a very small group, you should consider bringing in outside help such as a consultant. The problem is that you could end up with a sliver of a view when it comes to the fund manager universe, and with limited bandwidth it becomes very easy to simply take what comes to you rather than being proactive and seeking out the right investments.”*
- ❖ *“The more descriptive you are in terms of your investment thesis, the more you narrow your list of potential partners. For example, several years ago off-grid energy was nowhere near as advanced as it is now. Your mandate needs to give some space to adapt as technologies advance.”*
- ❖ *“Anyone would be falsely bragging to claim there is a formula to finding a good investment. It is a combination of diligence, timing and luck.”*

On fund manager qualities:

- ❖ *“Alignment of interest is extremely important to us. The industry minimum standard is to see a 1% commitment from the fund manager. However, we believe that 2-5% is good, and anything between 5-10% is fantastic.”*
- ❖ *“We have found that those fund managers who are closely monitoring their investments and exercising good discipline around producing frequent and detailed reports are most of the time the most successful funds.”*
- ❖ *“Investing in this asset class isn’t about the macro—the macro has a cyclical impact but it is much more about the fund manager’s ability to understand the macro and invest around it. For instance, South Africa performed very well for years but recently growth has slowed to 1-2%, while the rand has depreciated significantly. Nonetheless, the better fund managers in the market are still performing well.”*

On impact / environmental, social and governance (ESG) concerns:

- ❖ *“It is clear that many of the DFIs and multilateral / bilateral organizations have similar goals in terms of promoting economic development or poverty alleviation, but it is frustrating that they each have a different way to measure and report this, which creates needless work for a fund manager. My biggest frustration with the impact community is that we’re all running around trying to be precise in how we measure impact, rather than actually having an impact—it is energy misplaced.”*
- ❖ *“We believe that funds—even if they are not classified as impact funds—can have a significant positive impact on their local environments by creating jobs, putting the right governance standards in place and making sure that their portfolio companies adopt proper environmental policies. We end up looking at a lot of funds that do not define themselves as impact funds, but in the end they do business the right way, which inherently has an impact.”*
- ❖ *“It is important to screen for ESG, and to ensure that a firm has robust policies in place; however, the buy-in component often gets lost in the process. For example, we invested in an Eastern European private equity firm that had been backed by development finance institutions for a long time. But as soon as they were able to raise money without DFI support, they dropped their ESG reporting. Making sure your fund managers believe in these policies—and are not going through the motions simply to raise capital—is critically important.”*
- ❖ *“As an industry, we have to be really thoughtful when it comes to ESG. For instance, the notion that you are impactful based on how many women are in your portfolio companies is a difficult goal to impose on a fund manager. The reason there are not more women working in certain industries [in emerging markets] is because of societal pressures and a culturally and economically reinforced system that will take decades to change. This doesn’t mean that you shouldn’t have a gender lens (and insist on having the right non-discrimination and*

harassment policies in place), but we have to be careful in terms of what we are asking our fund managers to be held accountable for so they are not being set up for failure.”

- ❖ *“It is all about accountability. Every impact fund should have an investment thesis—whether it is reducing poverty, improving gender equality or reducing the carbon footprint. Whatever the objective is, the fund manager should be measuring itself against its strategy—in a way that they have explicitly defined—as well as reporting on these metrics periodically and sufficiently.”*
- ❖ *“Quite often, the investment and impact thesis are well aligned—you’re just taking on extra layers of risk with the focus on impact. For instance, if you’re trying to reach an underserved population, first you need to reduce the cost of the service or product you are providing, which is inherently hard and potentially taking place in a difficult environment. And even if you get all of that right, you will likely have a big customer acquisition problem. It’s just much harder compared to a more typical investment where you know something can be done at a certain cost and people will pay for it. However, if you can crack a market segment and be a first mover, the investment case can be quite compelling.”*

On first-time teams / funds:

- ❖ *“We are considering investing in a firm’s third regional fund that is targeting up to US\$1 billion in total commitments. Our due diligence criteria in this case is extremely strict—there cannot be one single reason not to do this deal. On the other hand, we are also evaluating an inexperienced single country, first time fund manager hoping to raise US\$35 million. In this case there are 99 reasons not to do the deal but we are trying to make it work given our mission and mandate to promote investments in frontier markets.”*
- ❖ *“It is extremely challenging to invest in first-time teams within the emerging markets, as you are layering risk upon risk. This really is the riskiest investment space, and we’re not in the early 2000s anymore when you could throw anything in the ground and watch it grow. If you feel that you need to go to the frontier from a developmental perspective, try to work with someone who knows what they are doing, such an advisor, consultant or fund of fund.”*
- ❖ *“Our due diligence process is roughly the same across markets—any differences have less to do with geographic location than with the maturity of a given market. For instance, Latin America and India are more mature private equity markets and have been through more cycles than Africa. So in Africa, we are more likely to be looking at first-time funds, which increases both the intensity of the due diligence and the amount of time spent up front with a team before we even get to our first Investment Committee process. In less developed markets, we find ourselves often putting together teams, finding the right people, making sure those people fit together and ultimately doing more fund creation work than we would do otherwise.”*

On venture capital:

- ❖ *“Venture capital is a very different game than private equity—in private equity, you can look at a balance sheet and apply some good rules of thumb to determine if a deal might be interesting. In venture capital, there is no magic growth rate or formula; it’s a unique combination. Someone who has been an entrepreneur or who has previously worked in the venture capital field is going to be best placed to evaluate those opportunities. I always laugh when I see an individual who thinks that because he or she worked at Goldman Sachs, they will be a great venture capitalist. It’s equivalent to someone saying that because they are a great tennis player, they will be an awesome shortstop.”*
- ❖ *“In venture capital, you typically expect two or three deals to carry an entire fund; therefore, you will want to see expected IRRs on the investment memos that are well above your portfolio IRR. If the target IRR on the portfolio is 20%, the hurdle rate on each deal should be 35%-40% with the realization that most of these deals will not achieve that threshold.”*

On due diligence challenges:

- ❖ *“If you are not comfortable with a fund manager and have a feeling that they are not telling you everything that you want to know, trust your gut. If it doesn’t feel right, it usually isn’t. Of course, this requires a familiarity with different cultures as the average Chinese GP is not going to tell you the color of his underwear before the third meeting; you can’t expect the same level of forthrightness you will get with interviewing someone from a U.S.-based GP that has been around for 30 years.”*
- ❖ *“The hardest part of the due diligence process is not knowing what you don’t know; and not knowing if there are questions you should be asking but are not. The key to appropriately reviewing the answers to your due diligence questions is to remember that fund managers mean what they write and not what you think they mean—so if there is any ambiguity in what they submitted, it needs to be followed up. General partners are very good at pseudo answering a question.”*
- ❖ *“When an investment goes wrong, it is rarely the result of something completely surprising. Of course, certain things will always be black swans; for instance, a key Managing Partner passing away or suddenly leaving the firm when you thought he was the most grounded person there. This is why private equity is interesting—a lot of what you see is very gray; it’s not black and white. You have to simply look at the risks and the merits and then try to determine if you are being adequately compensated by those merits to take on the risks.”*
- ❖ *“The more difficult of a potential LP you present yourself to be, the less attractive you are going to be to the good managers. Don’t front-load too much depending on the market, particularly as the best fund managers are raising larger funds and the bad fund managers can’t. You don’t want to be in those funds, even though they will be easier to do.”*

On working with other investors:

- ❖ *“If I were just beginning to build a private equity / venture capital portfolio in emerging markets today, I would initially lean upon well-established faces and co-invest alongside LPs that know the space very well in order to build up my knowledge base.”*
- ❖ *“Assuming that you want to partner with a number of private equity and venture capital funds in a given year, you should try to create a good mix whereby you are following the lead of knowledgeable investors in some funds and serving as a lead / anchor in others. In addition, you should not restrict yourself to only participating in a first close as there is no evidence that this is the only way in which you will have an important role to play.”*

ANNEX C: ADDITIONAL RESOURCES

Following is a list of additional resources that may be helpful to USAID as it undertakes due diligence activities on private equity funds:

- CDC. *CDC ESG Toolkit for Fund Managers*. London: 2016. <http://toolkit.cdcgroup.com/>.
- EMPEA. *EMPEA Integrity Due Diligence Brief & Directory*. Washington, DC: October 2016. <http://empea.org/research/publications/empea-integrity-due-diligence-brief-directory>.
- FMO. *ESG Risk Management Tool for Private Equity Investment*. The Netherlands: 2016. <https://www.fmo.nl/esg-tools>. IFC. *IFC Performance Standards on Environmental and Social Sustainability*. Washington, DC: January 2012. http://www.ifc.org/wps/wcm/connect/Topics_Ext_Content/IFC_External_Corporate_Site/IFC+Sustainability/Our+Approach/Risk+Management/Performance+Standards#2012.
- Institutional Limited Partners Association (ILPA). *ILPA Private Equity Principles*. Toronto, Ontario: January 2011. <https://ilpa.org/best-practices/overview-and-history/>.
- Institutional Limited Partners Association (ILPA). *ILPA Due Diligence Questionnaire*. Toronto, Ontario: September 2016. <https://ilpa.org/best-practices/due-diligence-questionnaire/>.
- Leeds, Roger. *Private Equity Investing in Emerging Markets: Opportunities for Value Creation*. New York: Palgrave Macmillan, 2015.
- Meyer, Dr. Thomas and Pierre-Yves Mathonet. *Beyond the J Curve: Managing a Portfolio of Venture Capital and Private Equity Funds*. West Sussex: John Wiley & Sons, 2005.
- Principles for Responsible Investment (PRI). *Limited Partners' Responsible Investment Due Diligence Questionnaire*. London: December 2015. <https://www.unpri.org/news/pri-launches-private-equity-due-diligence-question>.
- Swensen, David, *Pioneering Portfolio Management: An Unconventional Approach to Institutional Investment*. New York: Free Press, 2009.
- The World Bank Group. World Bank Group Environmental, Health, and Safety (EHS) Guidelines. Washington, DC: April 2007. www.ifc.org/ehsguidelines.

**USAID Financing Growth Project
Implemented by Deloitte Consulting LLP**