



The French
Private Equity
Association

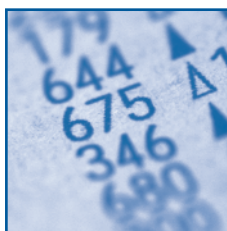
FUNDS OF FUNDS

A GUIDE FOR
INSTITUTIONAL INVESTORS

Association Française des

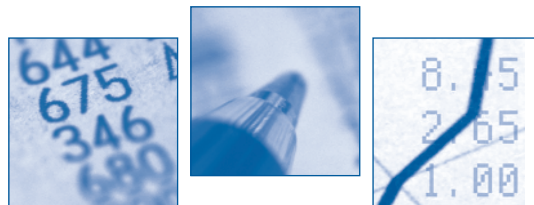
INVESTISSEURS
EN CAPITAL

CONTENTS



**FUNDS OF FUNDS,
A GUIDE FOR
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INTRODUCTION	2
APPEAL OF PRIVATE EQUITY	3
THE VARIOUS INVESTMENT APPROACHES TO PRIVATE EQUITY	4
1. Direct investment in unlisted companies	4
2. Investment in a single fund	4
3. Investment in a fund of funds	4
THE DEVELOPMENT OF THE FRENCH FUNDS OF FUNDS MARKET	6
DIFFERENTIATION OF FUNDS OF FUNDS	8
1. Investment strategy	8
2. Structure of investment vehicles	9
THE FUNDS OF FUNDS BUSINESS	10
1. Due diligence	10
2. The performance report	11
TERMS AND CONDITIONS OF PRIVATE EQUITY FUNDS OF FUNDS	12
1. Stretched cash flow management	12
2. Compensation for the funds of funds investment company	12
3. Carried interest	12
APPEAL OF FUNDS OF FUNDS	13
SUMMARY	14
AFIC PROFILE	15
ACKNOWLEDGMENTS	15



INTRODUCTION



This guide presents a summary of the various methods for institutional investors to approach the Private Equity market and the growing role played by funds of funds as investment vehicles for this asset class.

In France, funds of funds first began to be created some 10 years ago to meet the needs of some French institutional investors who lacked the expertise and means to select funds and manage their fund investments.

Whether institutional investors have Private Equity experience or not, a fund of funds provides diversity in terms of geography, investment stages and investment methods.

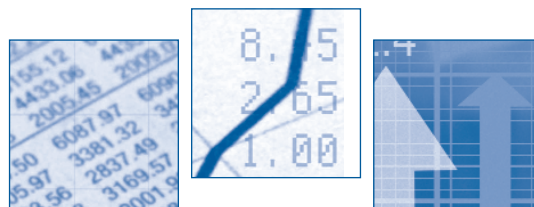
The 10 French Private Equity funds of funds first entered the business around five years ago. The founders of these funds and some investment managers had previous experience investing in unlisted companies.

This summary of information on Private Equity funds of funds is especially timely, since French and foreign investors are showing significant interest in this asset class, especially in light of the higher returns offered by Private Equity compared to traditional assets.

Charles Soullignac
Chairman 2004-2005
Funds of Funds Committee

Hervé Legoupil
Chairman 2004-2005
Investor Relations Committee

APPEAL OF PRIVATE EQUITY



Over the years, Private Equity has become a separate asset class, to which institutional and “family office” investors are allocating a growing share of investment capital.

In Europe, and in particular in France, the amounts raised and invested in this asset class have increased substantially in the past 10 years. As of December 31, 2004, €27,5 billion had been raised and €37 billion invested in Europe⁽¹⁾, of which €2.4 billion was raised and €5.2 billion invested in the French market⁽²⁾. Despite a sluggish economic environment over the past four years that negatively affected the financial markets as a whole, Private Equity continued to strengthen its position as an asset class and continued to be a driver of European growth.

It should be noted that Private Equity allocations by European institutional investors increased from 2.5% to 4.5% in 2003 (compared to an increase from 7.2% to 7.5% in the United States)⁽³⁾.

In addition, the superior returns generated by Private Equity over more traditional bond and equity market investments were confirmed during this same period. For these reasons, many investors are taking a closer look at Private Equity, regardless of whether they have already invested in this asset class.

In addition to its superior return, Private Equity, when included in a global portfolio, enhances diversification, reduces volatility and generally improves the overall risk profile.

Aside from the financial aspect, Private Equity investments in mature companies at the time of their transfer also contribute significantly to job creation.

In France, equity interests in companies are generally held through Venture Capital funds, which are themselves managed by investment companies approved by the AMF.

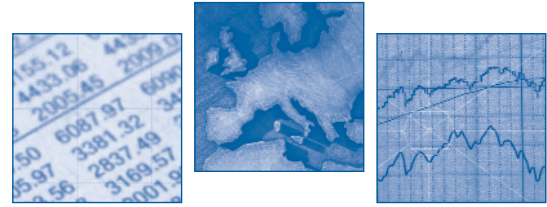
As a rule, the average holding period for investments in the companies is around three to four years, which gives the company managers and Private Equity firms time to create value and achieve a sizeable capital gain. Private Equity is therefore suited to investors with a medium-to long-term investment horizon.

The growing interest by investors in this asset class resulted in the substantial growth of the funds of funds business (around 100 in Europe), as was already the case for other financial products. Currently, investments by funds of funds account for nearly **13,5% of the total amount raised by the funds in Europe⁽⁴⁾ in 2004, and 10.6% of the total in France⁽⁵⁾**. This type of investment meets a real need within a complex industry. Funds of funds have made a major contribution toward enhancing the business, and are always designed **to protect the interests of investors** as their first priority.

The purpose of this guide is to demonstrate the appeal of funds of funds in Private Equity. Information on the Private Equity business tends to be more difficult to obtain and understand than information on listed markets. Thus investors who want to diversify into this asset class need to have access to a guide informing them of how original Private Equity investments function.

(1) Source: EVCA / TVE
(2) Source: AFIC / PwC
(3) Source: Goldman Sachs
(4) Source: AFIC / EVCA
(5) Source: AFIC / EVCA

THE VARIOUS INVESTMENT APPROACHES TO PRIVATE EQUITY



An institutional or “family office” investor interested in Private Equity may invest in any of three ways:

1. DIRECT INVESTMENT IN UNLISTED COMPANIES

This type of investment requires that several conditions be met:

- Identify an investment strategy (France, Europe, business sector, venture capital, development capital, buyout capital, size of target companies, etc.) and assign it a risk;
- Identify an annual allocation, over several years, that must be significant;
- Recruit a skilled team of professionals;
- Be in a position, thanks to the team or the investor’s own network, to ensure sufficient deal flow to achieve the desired return.

Corporate and institutional investors have developed these types of investments, either for strategic reasons or as extensions of their own business (such as banks).

The annual allocation needs to be at least €50 million.

2. INVESTMENT IN A SINGLE FUND

This type of investment must meet the following conditions:

- Identify an investment strategy based on the risk and return;
- Determine an annual allocation in order to smooth over the cyclical nature of Private Equity in terms of the investments and divestments;
- Select the management teams capable of making the investments to generate the returns;
- Recruit several people to select the funds and provide back office staff.

Very few institutional investors in France have succeeded in building this type of model over the long term such that its viability and performance can be demonstrated.

With minimum fund subscriptions of between €5 million and €10 million, the annual investment allocation should be between €50 million and €100 million.

3. INVESTMENT IN A FUND OF FUNDS

This type of investment involves meeting the following condition:

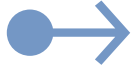
- Choose a fund of funds manager.

The minimum subscription in a fund of funds is between €2 million and €5 million, which makes it possible to invest in funds invested for the upcoming two or three years.

Funds of funds are suitable not only for investors who do not wish to invest in the first two above-mentioned categories, but also for institutional investors with Private Equity experience.

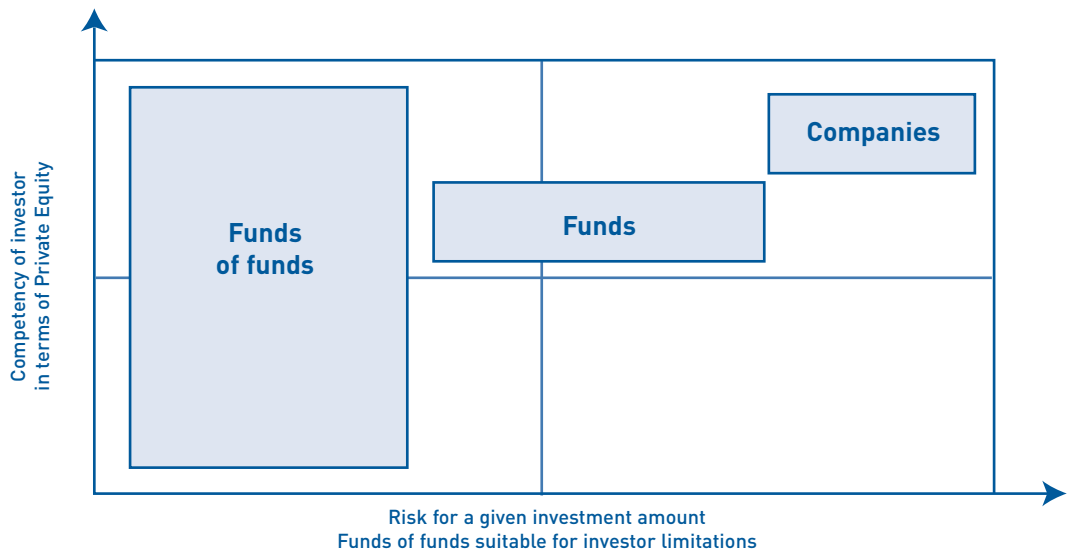
In fact, experienced investors used funds of funds to invest in:

- market segments not covered by their own activities;
- local funds;
- funds of a different size than those targeted by their investment strategies;
- secondary funds of funds whose profitability components differ from the primary funds.

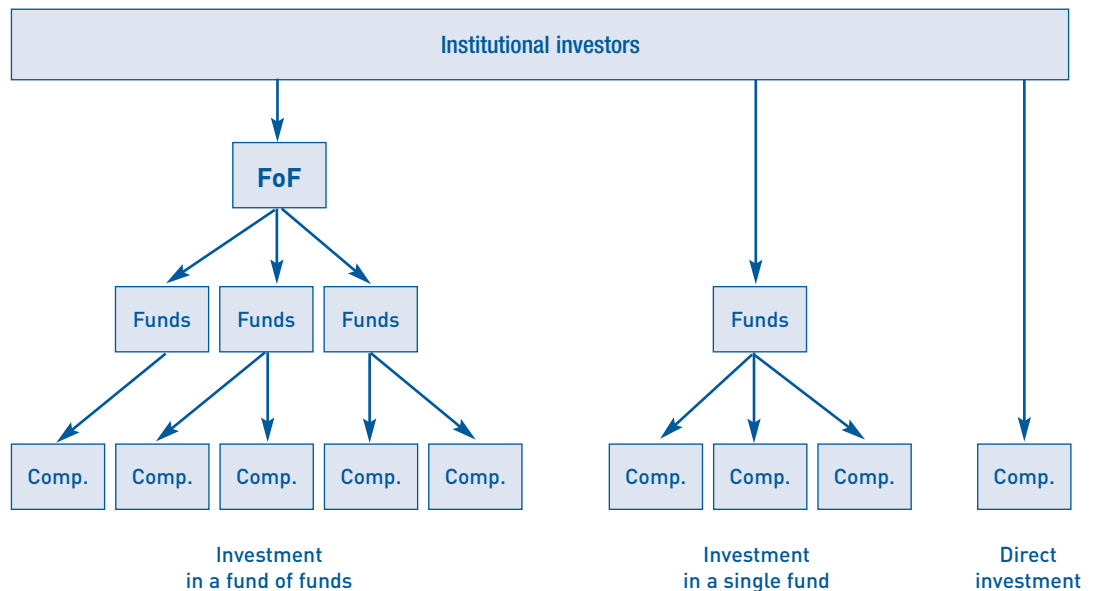


For institutional investors, the Private Equity market therefore offers three main types of investment management, depending on the financial resources, human resources and Private Equity experience (see graphs below).

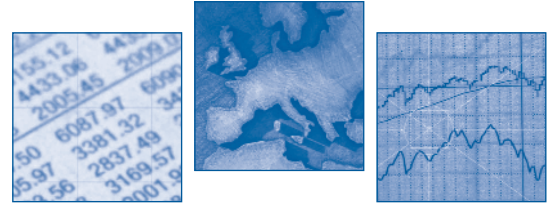
Breakdown of investments by risk and competencies of investor



Breakdown of the three main types of investment management



THE DEVELOPMENT OF THE FRENCH FUNDS OF FUNDS MARKET



The results presented below are derived from a Deloitte Finance survey of French funds of funds. The French market consists of nine funds of funds investment companies with registered offices in France. These nine funds of funds companies are organized into 36 legal structures broken down as follows:

- 22 venture capital funds;
- 14 limited partnerships;

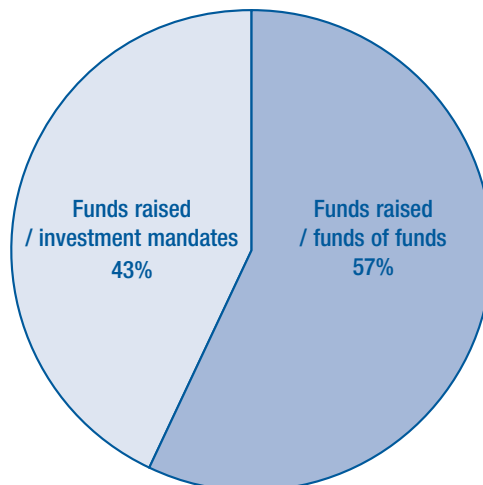
	LEGAL STRUCTURE	%
VENT. CAP.	22	61
L.P.	14	39
TOTAL	36	100

These investment companies have 200 employees, including 114 investment professionals.

The relatively new nature of the funds of funds in France is reflected by the fact that 45% of all funds of funds managers started up their activities within the past seven years, whereas the comparable activities in the United States date back nearly 25 years.

The market can be broken down into companies that are exclusively funds of funds and investment companies with specific investment mandates in funds. The funds raised break down as follows:

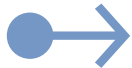
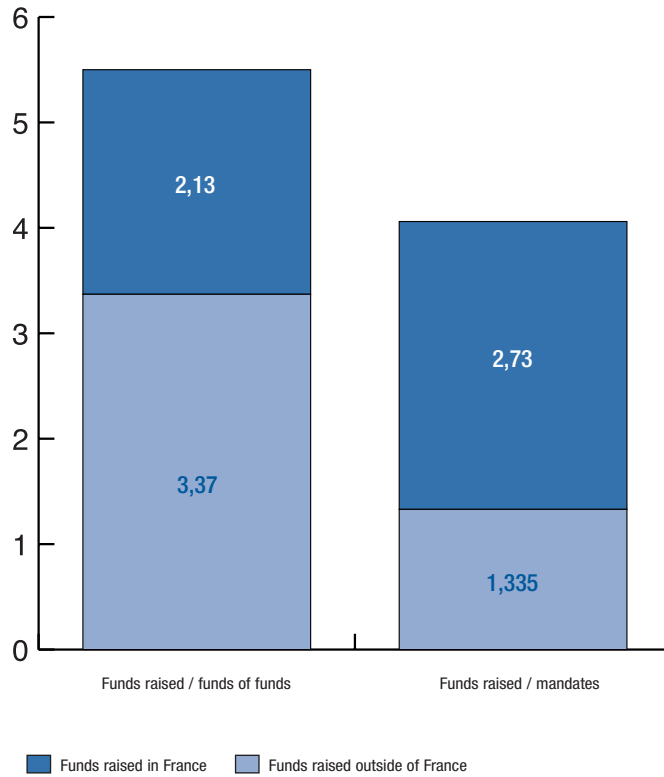
Breakdown of funds raised by type of investor



The total volume of funds raised by companies focused exclusively on funds of funds is nearly €5.5 billion. Of that total, 40% were raised from foreign institutional investors. These funds were invested in 752 funds, with France representing approximately 47% of the investments carried out.

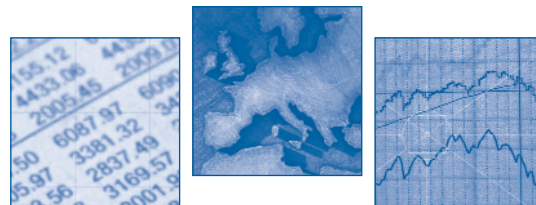
In addition, some investment companies have specific investment mandates for investment programs into funds. There are a total of 14 such programs, representing €4.1 billion in funds raised, of which 67% from French institutional investors. This investment volume is invested in 242 funds, of which 52% in France.

Breakdown of funds raised by geographic area



Overall, the funds of funds investment business has €9.6 billion in assets under management, of which 51% from French institutional investors. These assets are invested in just under 1,000 funds (994 to be exact), of which 49% are located in France.

DIFFERENTIATION OF FUNDS OF FUNDS



Funds of funds offer significant differentiation, which reflects the growing maturity of the business. They can nevertheless be divided along two main lines: investment strategy and structure of investment vehicle.

1. INVESTMENT STRATEGY

- **Geographic coverage**

A fund of funds may invest globally, on a single continent or even in a single country. The more limited the geographic coverage, the greater the fund's return will depend on the economic performance of a given country.

- **Investment stages**

All the Private Equity categories - seed funds, venture capital, development capital, buyout capital, turnaround, mezzanine - may be covered by a fund of funds. The differentiation among the funds of funds will reflect the weighting chosen between the various categories within an investment vehicle. Some categories may even be excluded if they appear to have a high risk/return profile, or conversely some categories will be overweighted.

- **Investment methods**

There are three different methods.

- **Primary investment:** investment in funds raised by investment management teams to apply a specific strategy. In that case, the fund of funds participates throughout the life of the fund, up until the gradual divestment period of the portfolio, which can last up to 10 years.
- **Secondary investment:** purchase from investors of their investment interests in funds, and acquisition of residual investment, during the life of the fund. In that case, the fund of funds limits the investment holding period in the fund, and thus the overall duration of its investment.
- **Co-investissement:** investment alongside of funds with direct investments in companies. In general, the fund of funds plays a passive role and lets the lead investor, i.e. the fund management team, manage the transaction.

Primary and secondary investments have different return-on-investment profiles.

The differentiation among funds of funds will result from the weighting chosen among these various investment methods within a given vehicle. Funds of funds are often dedicated to a primary or secondary investment.

The relative pace of the investment rate and the various investment return profiles will depend on the weighting among the various categories.



Each fund of funds manager may combine these three main types of differentiation depending on the competencies of his investment team, his knowledge of the market or a category and his special access to the best funds and opportunities enabling him to deliver superior performance to that of the sector as a whole.

2. STRUCTURE OF INVESTMENT VEHICLES

● Life of the investment vehicle

The fund of funds strategy may be applied using an investment vehicle with a limited life, or a so-called unlimited term, also known as an “evergreen” fund. The first option often offers tax advantages as well as a defined objective in time, whereas the second makes it possible to re-allocate and reinvest the proceeds from the funds and to benefit from the corresponding leverage effect.

In an evergreen investment vehicle, liquidity is more limited, and is therefore more suitable for investors searching for a dedicated investment vehicle, for which the decision to cut off the investment period can be made easily, at the expense of a significant investment volume.

● Liquidity: open or closed investment vehicle

A fund of funds may offer investors different liquidity solutions. The listing of an investment vehicle is the means used most often by fund managers. Liquidity therefore depends on trading volume on the security and the rating offered by analysts. The drawbacks of this type of investment vehicle are that the funds often trade at a discount to their net asset value along with the potentially sharp volatility in the funds of funds shares. No funds of funds of this type exist in France.

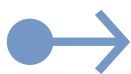
Most funds of funds vehicles today are unlisted entities, and investors who wish to exit the vehicle during the life of the fund cash out through secondary transactions negotiated on a case-by-case basis.

● Leverage effect: amount raised / invested

In the case of a closed investment vehicle with a limited life, the amount raised is fixed. In most of these cases, the teams call in the committed investment funds as the need arises to make the investments in the underlying funds. The fund’s organization may be structured in such a way as to enable it to invest all of the commitments received from subscribers by attributing management fees to the first distributions received by the fund of funds.

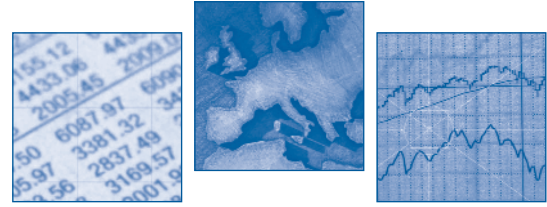
An additional leverage effect may be implemented, which corresponds to an amount of commitments in underlying funds that is higher than the total amount raised. In that case, the first distributions received will make it possible to meet capital calls under way.

The authorized leverage effect in the investment vehicle has a direct impact on the fund’s performance in the event of success, but also significantly adds to the degree of risk depending on the overcommitment rate. Generally, the teams choose a reasonable excess allocation designed to offset the impact of the management fee.



Each of these choices will enable the managers to invest in a variety of assets and meet the specific needs of investors.

THE FUNDS OF FUNDS BUSINESS



1. DUE DILIGENCE

Fund of funds managers select their investment teams based on their knowledge of the market, the requests of fund-raising teams and intermediaries.

Each fund of funds manager develops his or her own due diligence procedure, based on its own experience and market knowledge.

The investment in a fund is, to be sure, designed to achieve a net return for the investor, but the investment team's ethical conduct and compliance along with regular and detailed reporting are also key considerations.

The research process is focused on specific areas:

- the investment strategy (investment stage, suitability for the targeted market, economic situation of the selected market, type of companies sought);
- the competencies, quality and cohesion of the team, (exhaustive review of manager's CV, personal track record and joint track record, incentives, financial involvement);
- the business flow of the investment team (targeted network, established or prospective partnerships);
- the financial and legal investment methods (investment vehicle methods and administrative expenses, by-laws, specific measures);
- the proposed internal procedures and reporting, (administrative, legal and financial structure of the investment company, decision-making body, reporting periods and content, internal procedure manual of the investment company and code of ethics, etc.);
- subscription terms (presence or not of a sponsor, objective of fund-raising, share categories, hurdle rate, carried interest, etc.).

To complete such a study, the fund of funds investment manager draws on:

- documentation provided by the fund manager: prospectus, by-laws, existence of agreements;
- information obtained from the fund manager, in particular the performance components;
- joint and individual meetings with the fund management company;
- analyses of portfolio companies with prior investments, including the possibility of meetings with some managers, and analyses of portfolio companies currently in the process of receiving financing.

This due diligence phase can last three to six months, depending on the importance of the investment, the fund's geographic location and the degree to which the investment team is known.

2. THE PERFORMANCE REPORT

In the interest of transparency, clarity and fairness to subscribers, a fund of funds team agrees to draw up and submit a quarterly performance report to all subscribers.

Thus it complies with the professional practices defined by the French (AFIC) and European (EVCA) professional associations (valuations and reporting).

For their part, funds of funds subscribers agree to uphold the confidentiality of the information submitted.

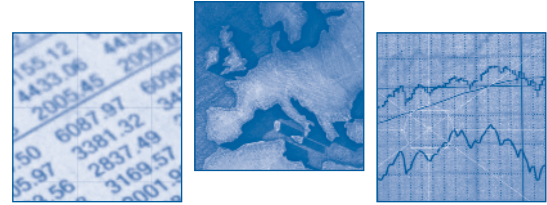
This report comprises:

- general information on the life of the fund in terms of activity and investment team;
- a presentation of the investment portfolio holdings, with the main characteristics of the investments carried out;
- a report of the performance of the underlying funds and funds of funds, following the market practices (internal rate of return, effective return on investment and return as of the reporting date, etc.);
- a financial and accounting report of the fund of funds, with a bi-annual audited report, if it is located in France.

When preparing the performance report, the fund of funds manager carries out:

- a review of the consistency of the information provided;
- a control of the valuations of the funds and the underlying assets;
- a control of the current and future performance of the underlying funds;
- a consolidation of the information of the equity interests in the various funds.

TERMS AND CONDITIONS OF PRIVATE EQUITY FUNDS OF FUNDS



Investments in a Private Equity fund of funds (“the Fund”) are made in accordance with specific methods related to the specificities of the asset class. These methods differ significantly from those used in other funds of funds, for example alternative and classic multi-management fund management. Thus investments in Private Equity funds of funds are made gradually, and liquidity is recovered over time. The fund management involves just-in-time cash flows.

For the Fund management, the investment company is compensated by an annual Management Committee. Finally, a carried interest system for the Fund ensures that shareholders and the investment team share the same interests.

1. STRETCHED CASH FLOW MANAGEMENT

When investors select a Fund, they enter into a **Subscription Agreement**. Through this subscription agreement, they commit themselves to respond to the various capital calls made by the investment company depending on the pace of the investments in the Funds. The amount of each capital call is generally between 1% and 10% of the Subscription Agreement.

As the Fund receives distributions from the underlying funds, these distributions are paid out to the funds of funds shareholders.

Given the movement of these two-step capital calls and distributions, the maximum cash exposure of the shareholder is less than the initial commitment, and varies by fund between 50% and 70% of the original commitment.

2. COMPENSATION FOR THE FUNDS OF FUNDS INVESTMENT COMPANY

The investment company is compensated through an **annual Management Fee**. The procedures for calculating this fee vary during the life of the Fund.

During the **Investment Period**, which generally corresponds to the first four or five years of the Fund, the **Management Fee** is calculated by applying a rate to the Fund’s total subscription amount. This rate varies depending on the Fund’s policy and its investment strategy, and is well below that of the underlying funds.

At the conclusion of the Investment Period, the management fee is calculated based on a reduced rate applied not to the total **subscription amount** but instead to the Fund’s net asset value.

3. CARRIED INTEREST

In order to motivate funds of funds managers to achieve the highest return, a portion of the performance realized by the funds of funds is attributed in the form of carried interest.

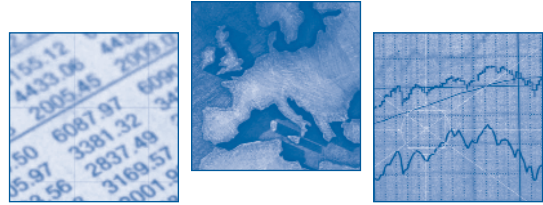
In most cases, this fee is paid to shareholders following the allocation of the **Preferred Return**, which consists of a capitalization of the payments made through successive capital calls. It is generally referred to as the hurdle rate.

Carried interest generally consists of the allocation of a portion of the capital gains generated by the Fund.

The claim on carried interest is based on the subscription by the investment team of specific shares that cement its financial involvement in the Fund’s management.

This carried interest is attributed to the main investment team members as an incentive and to involve them in the management of the fund of funds. The attribution of this carried interest is linked to the presence of the investment team member over the life of the fund of funds, and is managed through a vesting system (in the event of a departure by a team member, that member receives only a potential share of the total allocation).

APPEAL OF FUNDS OF FUNDS



Funds of funds offer their investors

● Diversification

- in the number of funds subscribed;
- in the number of portfolio companies;
- in the type of investments (Venture Capital, Development Capital, Buyout Capital);
- in the business sectors and size of the portfolio companies;
- in vintages (generally the investments in underlying companies are made for a period of 7 years);
- in geographic sectors.

● Competency in terms of analysis of these funds

The funds of funds investment management teams meet regularly with fund management teams, and can thus compare them. They base their analyses on well-defined criteria.

● The saving of resources and administrative simplification both in terms of the analysis and reporting, to the extent that only one investment is monitored.

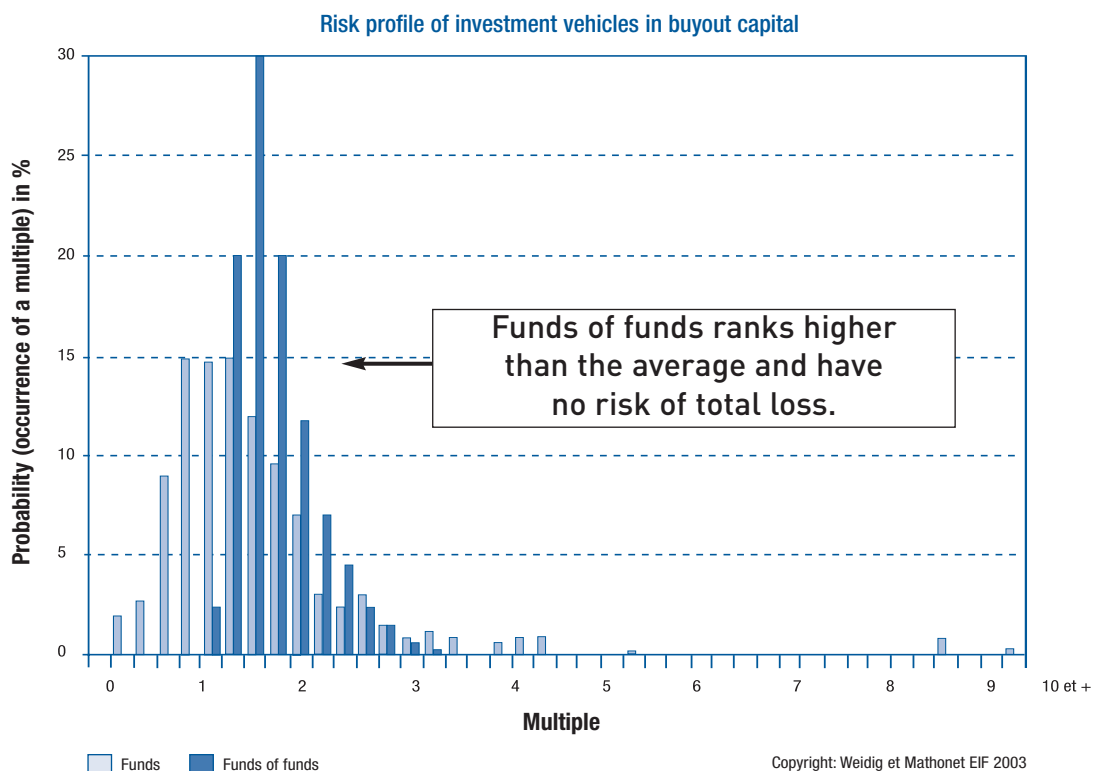
The performance report makes it possible to have a view of the fund of funds portfolio and the underlying assets.

● Access to some funds in which investors would not have been able to invest, for lack of market knowledge or sufficient financial resources.

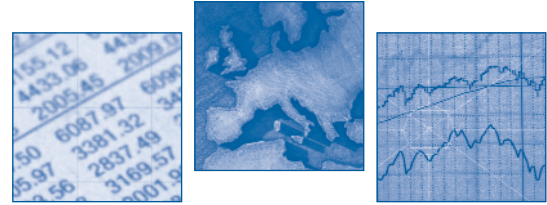
The fund market knowledge by the funds of funds investment teams makes it possible to combine investments in various funds as part of a defined strategy.

Private Equity funds of funds enable experienced and inexperienced investors alike to outsource all the investment management tasks to funds.

A study conducted by the European Investment Fund highlights the appeal of funds of funds.



SUMMARY



Institutional and “family office” investors are investing more and more in alternative investment products, including Private Equity.

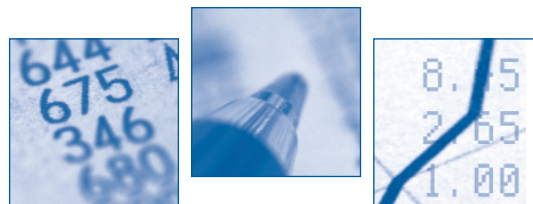
Ten years ago, this demand gave birth to a funds of funds investment management activity that offered investors diversification, selection and simplification of the investment management tasks. Funds of funds are an ideal and essential vehicle for investing in a complex asset class.

The French funds of funds profession that arose 10 years ago, and that has been growing rapidly in the past five years, consists of some 10 investment management teams and has invested in more than 1,000 European funds.

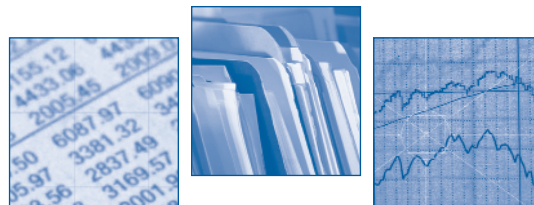
It offers French and foreign institutional investors a broad range of products, both in terms of strategy and structure, capable of meeting their specific needs.

It is based on investment processes specific to each investment management company and is consistent with the security and compliance practices of the profession in France and Europe.

Funds of funds have met and will continue to meet the demand from all categories of investors interested in incorporating Private Equity in their asset management and/or growing in new market segments.



AFIC PROFILE



AFIC

Association Française des Investisseurs en Capital
French Private Equity Investors Association

Virtually all private equity professionals in France are members of **AFIC**. The association assists and facilitates the rapid growth of private equity through the following efforts:

- updating and circulating the rules of ethical behavior that frame the profession
- promoting private equity with French and foreign institutional investors, as well as with private investors;
- carrying on a dialogue with the public authorities for the purpose of improving the regulatory environment in which private equity operates;
- gathering, analyzing and publishing the profession's benchmark statistics;
- training private equity professionals – more than 600 individuals were trained in 2004.

AFIC currently has **214 active equity investor members**, and **126 associate members** from professions related to private equity, such as lawyers, independent auditors, strategic consultants, etc.

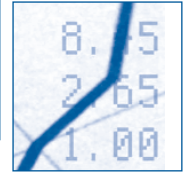
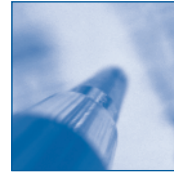
For further information, you may consult our web site:

www.afic.asso.fr

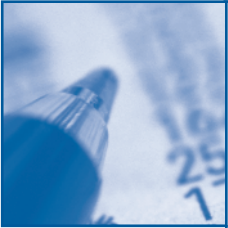
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NOTES





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