

The Long Distance Call: Due Diligence Challenges of Investing Abroad

Panhavat Chhun, Vice President, StepStone Group
Michael Elio, Partner, StepStone Group

Disclosure

This document is meant only to provide a broad overview for discussion purposes. All information provided here is subject to change. This document is for informational purposes only and does not constitute an offer to sell, a solicitation to buy, or a recommendation for any security, or as an offer to provide advisory or other services by StepStone Group LP, StepStone Group Real Assets LP, StepStone Group Real Estate LP, Swiss Capital Invest Holding (Dublin) Ltd, Swiss Capital Alternative Investments AG or their subsidiaries or affiliates (collectively, "StepStone") in any jurisdiction in which such offer, solicitation, purchase or sale would be unlawful under the securities laws of such jurisdiction. The information contained in this document should not be construed as financial or investment advice on any subject matter. StepStone expressly disclaims all liability in respect to actions taken based on any or all of the information in this document.

This document is confidential and solely for the use of StepStone and the existing and potential clients of StepStone to whom it has been delivered, where permitted. By accepting delivery of this presentation, each recipient undertakes not to reproduce or distribute this presentation in whole or in part, nor to disclose any of its contents (except to its professional advisors), without the prior written consent of StepStone. While some information used in the presentation has been obtained from various published and unpublished sources considered to be reliable, StepStone does not guarantee its accuracy or completeness and accepts no liability for any direct or consequential losses arising from its use. Thus, all such information is subject to independent verification by prospective investors.

The presentation is being made based on the understanding that each recipient has sufficient knowledge and experience to evaluate the merits and risks of investing in private equity products. All expressions of opinion are intended solely as general market commentary and do not constitute investment advice or a guarantee of returns. All expressions of opinion are as of the date of this document, are subject to change without notice and may differ from views held by other businesses of StepStone.

All valuations are based on current values provided by the general partners of the Underlying Funds and may include both realized and unrealized investments. Due to the inherent uncertainty of valuation, the stated value may differ significantly from the value that would have been used had a ready market existed for all of the portfolio investments, and the difference could be material. The long-term value of these investments may be lesser or greater than the valuations provided.

StepStone is not in the business of providing tax or legal advice. These materials and any tax-related statements are not intended or written to be used, and cannot be used or relied upon, by any taxpayer for the purpose of avoiding tax penalties. Tax-related statements, if any, may have been written in connection with the "promotion or marketing" of the transaction(s) or matter(s) addressed by these materials, to the extent allowed by applicable law. Any taxpayer should seek advice based on the taxpayer's particular circumstances from an independent tax advisor.

Prospective investors should inform themselves and take appropriate advice as to any applicable legal requirements and any applicable taxation and exchange control regulations in the countries of their citizenship, residence or domicile which might be relevant to the subscription, purchase, holding, exchange, redemption or disposal of any investments. Each prospective investor is urged to discuss any prospective investment with its legal, tax and regulatory advisors in order to make an independent determination of the suitability and consequences of such an investment.

An investment involves a number of risks and there are conflicts of interest. Please refer to the risks and conflicts disclosed herein.

Each of StepStone Group LP, StepStone Group Real Assets LP and StepStone Group Real Estate LP is an investment adviser registered with the Securities and Exchange Commission ("SEC"). StepStone Group Europe LLP is authorized and regulated by the Financial Conduct Authority, firm reference number 551580. Swiss Capital Invest Holding (Dublin) Ltd ("SCHIDL") is an SEC Registered Investment Advisor and Swiss Capital Alternative Investments AG ("SCAI") (together with SCHIDL, "Swiss Cap") is registered as a Relying Advisor with the SEC. Such registrations do not imply a certain level of skill or training and no inference to the contrary should be made.

All data is as of October 2017 unless otherwise noted.

PAST PERFORMANCE IS NOT NECESSARILY INDICATIVE OF FUTURE RESULTS. ACTUAL PERFORMANCE MAY VARY.

Overview

- I. Workshop Objectives
- II. Investing Outside Your Home Market
 - Introduction/Approach
 - Case Study
 - Summary
- III. Operational Due Diligence
 - Private Equity Operational Due Diligence
 - Due Diligence at a Distance
 - Outsourcing Due Diligence

I. WORKSHOP OBJECTIVES



Workshop Objectives

This workshop is designed to inform investors of the nuances involved with investing outside your home market

THE RATIONALE IS STRAIGHTFORWARD:



DIVERSIFICATION

Broader exposure can aid in portfolio diversification



GROWTH

Global growth is not universal; growth can vary widely across geographies and industries



STRATEGIC OPPORTUNITIES

Availability of LP specific synergies (e.g. co-investments) can lie outside the local area



RETURNS

Local markets can be limited in depth, scope, and performance. Outsized returns are often in distant or unknown markets and sectors

THE CHALLENGES ADD COMPLEXITY:



LOCAL EXPERTISE

Understanding local players, regulations, and roadblocks are critical to investing anywhere



ALLOCATION SIZING

Understanding the capital available to invest will drive many of the decisions of how these investments are made



BUDGET

What is the budget to tackle this market? Travel? Monitoring?



STAFFING

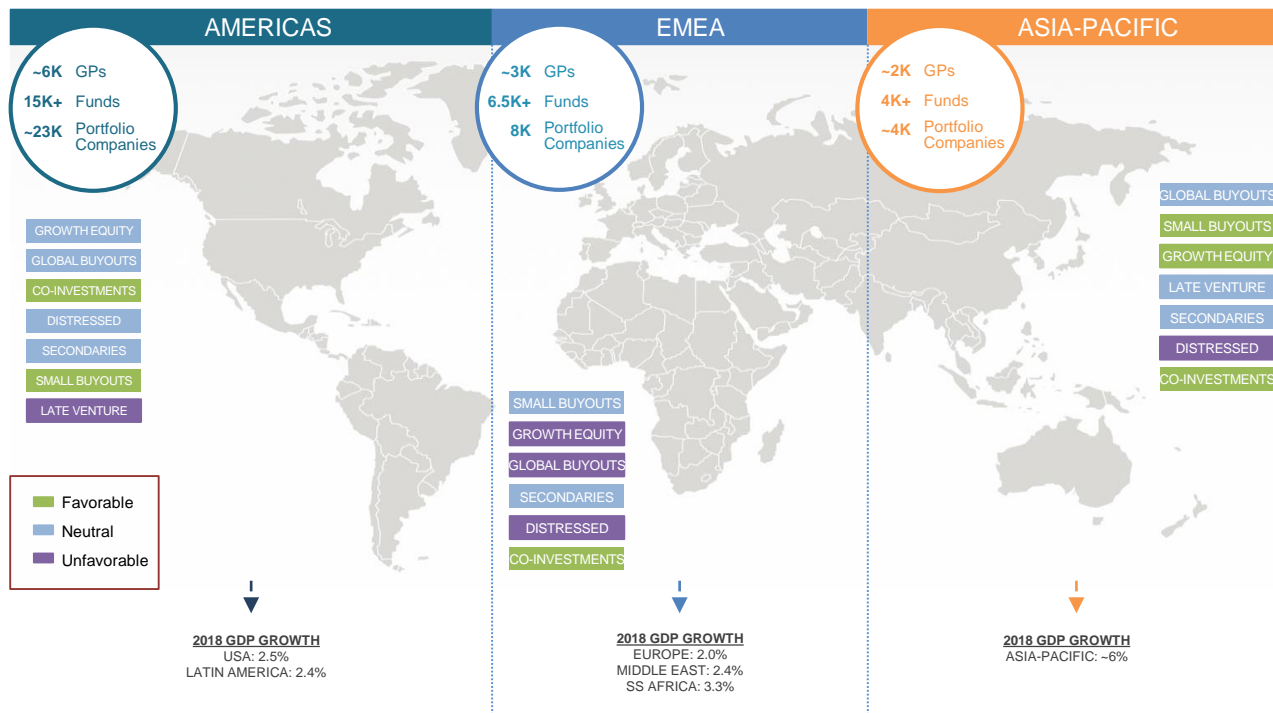
What level FTE will be available to learn, execute, and monitor a distant investment's portfolio?

II. INVESTING OUTSIDE YOUR HOME MARKET



Global Private Markets Universe

The global private markets universe spans **10,000** GPs, **26,000** Funds, and **36,000** portfolio companies with **2,000** funds in the market at any given time



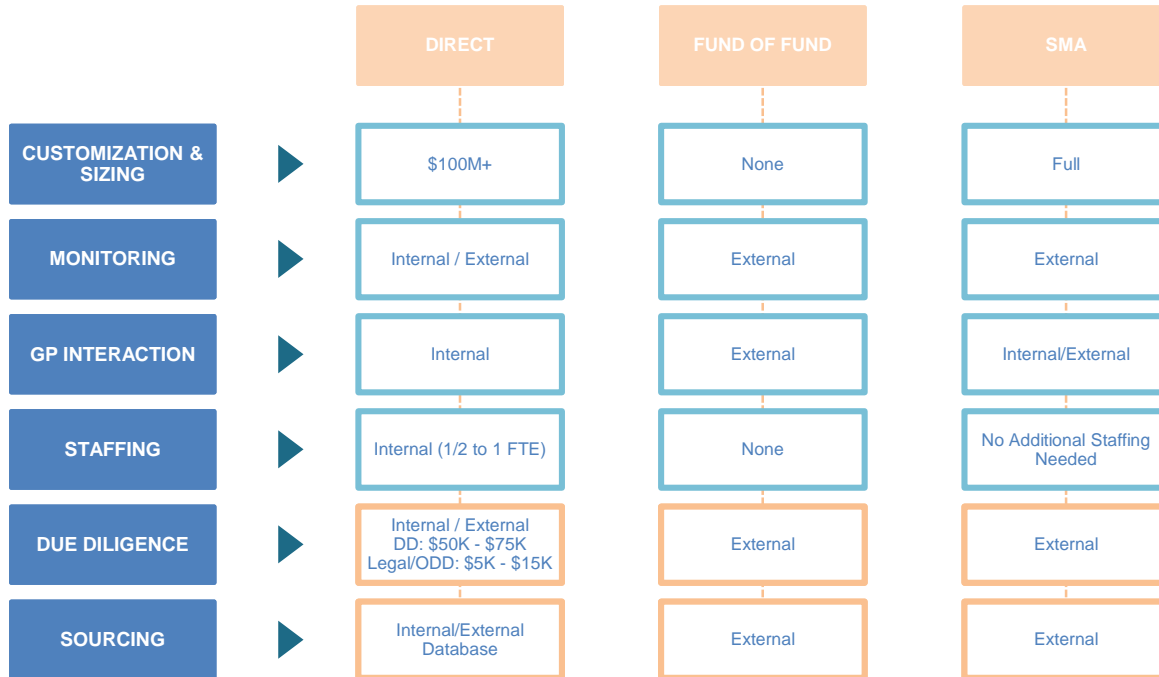
Investment Options

There are three core structures available for investors to access local market opportunities with each carrying their own set of considerations



Investment Options Comparison

The necessary components of a successful program vary across the three core structures



Investment Options Comparison - Summary

- **Allocation:** Over \$100M drives to SMA solution
- **Budget:** Lack of FTE and travel budget drives to FoF or SMA
- **Control:** Leans to Direct or SMA and away from FoF

	DIRECT	FUND OF FUND	SMA
# OF FUNDS	1 Fund	~25 Funds	5 - 15 Funds
GENERAL PARTNER EXPOSURE	1 GP	~15 GPs	5 - 7 GPs
PORTFOLIO DIVERSIFICATION	Dependent - based on available capital	Significant - "buying an index"	Customized - geography, industry, and company size
OPPORTUNITY SET	Large – strong, highly actionable transaction flow, ability to be selective	Extensive – covers broad spectrum	Targeted – select opportunities that meet investment criteria
INVESTMENT PERIOD	4 Years	4 - 6 Years	Customized: 2 - 4 Years
MANAGEMENT FEES	• 2%	• 2.5% - 3% (0.5%-1% FoF, +/- 2% PE Fund)	• 0.5% - 1%
CARRIED INTEREST	• 20%	• 25% (5% FoF + 20% PE Fund)	• Customized: 0% - 10%
MGMT FEES & CARRIED INTEREST COMPARISON	Low – narrow gross-net spread	Greater than direct	Low - Customized
CONCLUSION	<ul style="list-style-type: none"> • <u>Lower Fees</u> • <u>Balanced Diversification</u> 	<ul style="list-style-type: none"> • <u>Higher Fees</u> • <u>Over-Diversification</u> 	<ul style="list-style-type: none"> • <u>Lower Fees (Higher Min.)</u> • <u>Targeted Diversification</u>

Note: The parameters described above are general and any conclusions drawn above reflect the views and opinions of StepStone.

III. OPERATIONAL DUE DILIGENCE

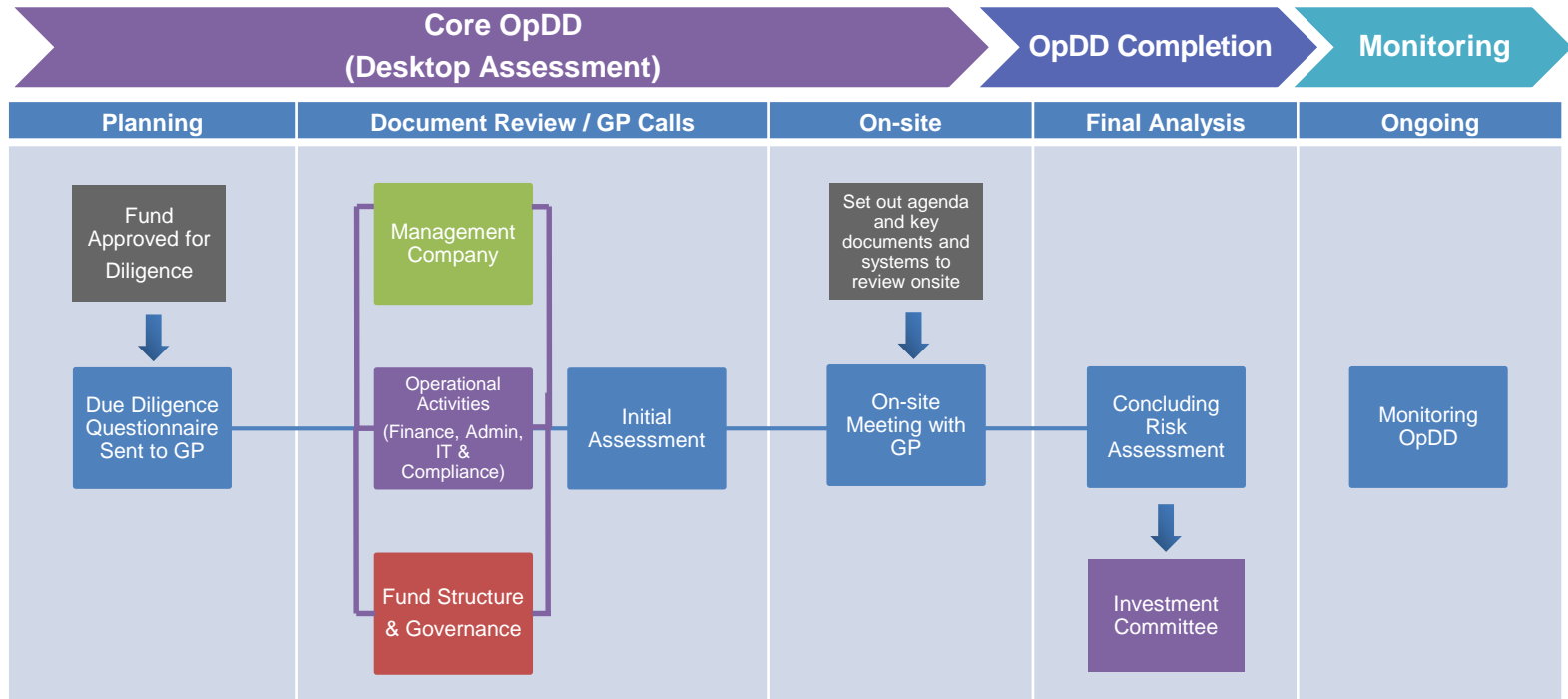


Operational Due Diligence Core Assessment

The following operational risk areas should be assessed in operational due diligence of private equity GPs and funds structures



Operational Due Diligence Process



DUE DILIGENCE AT A DISTANCE

A local Team is Crucial:

- A team that can interact on the ground, understand the culture and know the players is a key advantage
- A local team will also have experience in local regulations and know how they should apply
- If a team is not available, assistance from local counsel is imperative

Demand adherence to global transparency standards:

- Transparency levels can differ, but do not bend to local approaches
- Always enforce global transparency standards at a minimum over the books and records and compliance framework of the GP
- Lack of institutionalization in today's market is no longer an excuse

Background Checks:

- Will be difficult to impossible in certain jurisdictions
- The GPs reputation is very important when background checks are not reliable (the local team comes in handy!)
- Seek as many investor references as possible

Regulatory Framework:

- Local regulatory standards and enforcement in emerging markets can vary widely. Seek GPs that adopt global standards
- Be aware that without an active local regulator, risks remain
- Seek access to local counsel for best advice

There are commonalities however...

- English is typically spoken throughout, although it may only be a few persons and communication can still be a challenge
- Most investment structures and fund terms are similar regardless of jurisdiction
- Most GPs are flexible to cover key financial centres working hours

Due Diligence Notes from the Road...

DUE DILIGENCE BY MARKET TYPE		
	MATURE	DEVELOPING
Compliance and Regulatory	<ul style="list-style-type: none"> Regulators and policy makers are active and rules are ever changing GPs should have at least annual compliance review procedures in place and separate independent compliance teams 	<ul style="list-style-type: none"> Developing regulatory frameworks that are improving as markets mature and globalize <ul style="list-style-type: none"> Brazil: ICVM 558 is a step in right direction Hong Kong: Senior Managers regime improves accountability Singapore: MAS is very active Too often key documents such as compliance manuals and policies are not in place
Key Persons and Transparency Levels	<ul style="list-style-type: none"> Talent pool is abundant, especially in the key financial centres Transparency levels are generally good, although exceptions exist especially for top GPs Passive engagement: due to sheer size, it may be rare to participate in the LPAC 	<ul style="list-style-type: none"> Talent pool can be decent in a few jurisdictions, but otherwise most markets are relatively young and talent can be scarce <ul style="list-style-type: none"> Brazil, India & China: only a handful of managers with predecessor funds and with realized portfolios Developing: most GPs less than 10 years experience There is a focus on key persons (owners, investment teams, marketing teams) and as a result fund raises are smaller Active engagement: more likely to become a member of the LPAC and drive positive change
Background Checks	<ul style="list-style-type: none"> Proven process for most jurisdictions with easily accessible public or private databases Language can be a barrier in some markets 	<ul style="list-style-type: none"> Can be difficult and costly to access information and take a long time Language can be issue Need to rely on third parties and local network of investors
Controls vs. Outsourcing	<ul style="list-style-type: none"> Valuations based on fair value, taking into account mature market inputs Third party administration continues to improve, but most managers still choose to in-source it 	<ul style="list-style-type: none"> Valuations based on fair value (consistent with international standards), taking into account developing market inputs (additional volatility will creep into the returns) <ul style="list-style-type: none"> Asia: usually avoid funds using DCFs. Public market comps can be more reliable, however volatile. FX can be an issue Third party administration is mostly outsourced
Tax	<ul style="list-style-type: none"> Significant tax considerations apply, although there are plenty of structures designed to mitigate tax liabilities where possible 	<ul style="list-style-type: none"> Liaise with local counsel to better understand potential tax leakage Greatly differs by jurisdiction Tax code can change during the life of investment

OUTSOURCING DUE DILIGENCE

OUTSOURCING DUE DILIGENCE

Outsourcing ODD Outside Your Home Market

Conducted By A Local Team

- Supported by a local team that is familiar with the local market, local regulation and market players
- But you still need to do your due diligence on that team...

Save You Time And Money

- Operational due diligence personnel and travel costs can be high, especially post investment
- Time lost to get to further jurisdictions is also an indirect expense
- Getting to know a local market can be very expensive and time consuming

Peace Of Mind, Reducing The Risk Of Bad Surprises

- Making mistakes can be the most expensive of them all
- By outsourcing this work to operational experts, you will know that a thorough and tested process will be applied reducing the risk of bad surprises

Summary

Pro: Operational due diligence cannot be a core activity for every LP and accordingly it needs to be outsourced where it makes sense to do so

Con: Does not impart knowledge within your team, however consider joining a local team meeting due diligence, or at least dialing-in for the meeting or debrief

Final Thoughts

- An onsite visit is a must
- Always apply a risk based approach when considering next steps on a GP

Questions?



THANK YOU

Panhavat Chhun

Vice President

e pchhun@stepstoneglobal.com

Michael Elio

Director

e MElio@stepstoneglobal.com