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# China Private Equity Fund of Funds Report 2010

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### Case Study: Private Equity Fund of Funds ----A Shortcut to Investment in PE

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# Case Study: Private Equity Fund of Funds ----A Shortcut to Investment in PE<sup>①</sup>

## 1.1 Overview of PEFOFs

### 1.1.1 Definition

Fund of Funds (FOF) refers to the fund to invest in the fund portfolio. The biggest difference between FOF and other funds is that FOF takes “funds” as investment objectives while the other funds mainly take stocks, bonds, options, equity and other financial products as investment objectives. As an indirect investment form, FOF is widespread in such fields as mutual funds (That is, the domestic securities investment funds), investment trust funds, hedge funds and private equity funds. Therefore, FOF has been accordingly divided into the fund of mutual fund, fund of investment trust fund, fund of hedge fund (FOHF), and private equity fund of funds (PEFOF).

PEFOF is an important investment type in the field of Private Equity (PE). By putting the raised funds into different types of PE funds, PEFOF diversifies the investment portfolio so as to lower down the overall risk for investment. As PEFOF usually maintains good cooperation relations with a lot of PE funds with excellent performance, some investors who have limited resources choose to participate in the PE funds which are usually difficult for them to enter through PEFOFs.

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Note: <sup>①</sup> The private equity fund refers to an investment fund featured by raising funds from a small number of institutional investors or individuals in a non-public way, then carrying out equity investment in unlisted enterprises, and finally obtaining benefits through the withdrawal from listing, merger and acquisition, or management buy-out of the invested enterprises. The PE funds referred in the case study are the ones in general that are involved in the equity or quasi-equity direct investment in seed-stage, early-stage, expansion-stage and late-stage enterprises before and after IPO (referring to the PIPE investment).



In the whole investment value chain, PEFOF plays the dual role of general partner (GP<sup>①</sup>) and limited partner (LP<sup>②</sup>). When facing enterprise, wealthy families, donated funds and social security funds and other investors, PEFOF serves as the GP to manage funds for investors and make investment in PE funds. In face of VC funds, buyout funds and growth funds and other PE funds, PEFOF also acts as the LP and becomes the investor of various PE funds.

## 1.1.2 Operating Mode

PEFOF follows the organization form of PE industry adopted in overseas mature markets and usually takes the limited partnership, because it can avoid double taxation, make clear the rights and liabilities among the partners, and enhance the incentives, and increase the efficiency of funds.

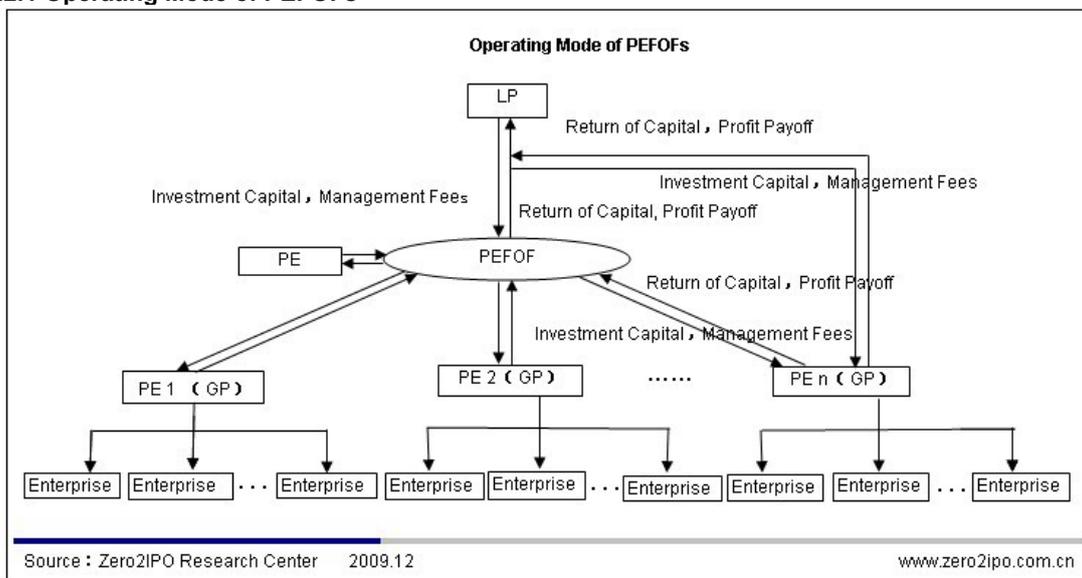
Different from the case of directly investing in PE funds by LP, PEFOF first raises money from LP and then invests into different types of PE funds. In terms of the direction of fund flow, Chart 1.1.2.1 shows two main funding chains: one is flowing from LP to PEFOF and then flowing from PEFOF to the “investment capital and management fees” of PE funds; the other one is flowing from the PE funds to PEFOF and then flowing from PEFOF to the “return of capital and profit payoff” of LP.

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Note: <sup>①</sup> General partner (GP) refers to the partner who is responsible for the operation and management of the limited partnership enterprise and bears unlimited joint and several liabilities for the debts of the enterprise. A GP may invest and occupy a small portion of the capital in the enterprise.

<sup>②</sup> Limited partner (LP) is the partner who is only responsible for his investment in the enterprise, but does not participate in the daily management, and bears limited liabilities for the debts of the limited partnership enterprise to the extent of his capital contribution in the enterprise. The limited partner does not participate in the operation and management of fund and has no rights for decision-making as share holders usually have. However, in case of important events, such as the revision of partnership agreement, advanced dissolution of the fund, extension of duration of fund, asset valuation, etc., and the limited partners usually have the right to vote.

Chart 1.1.2.1 Operating Mode of PEFOFs



In terms of the business mode, PEFOFs mainly makes investment through PE funds and obtains returns via the profit brought by the exits of PE funds. Currently, PEFOF has already evolved into an asset management concept and will dabble in more business in the near future.

Throughout the world, in addition to investment in PE funds, the large-scale PEFOFs will also get involved in direct investment and the investment in PE secondary market.

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