MINARET

NETWORKING FOR THE FUTURE

Access to Finance Activity

Designing Municipal Investment Funds

in Jordan, Lebanon, and Tunisia

November 2019

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EXECUTIVE SUMMARY

The purpose of this exercise was to design a municipal investment fund for the three participating municipalities. The design captured the essence of the end goal, which is to enable municipalities to have access to financing instruments they can use to invest and improve their, and by extension their residents' economic status. The design is of an impact investment fund, which is what a municipal fund should be. The focus is not only on making profit, but also on ensuring that profit making coincides with a positive socio-economic impact that improves the livelihoods of residents.

The fund design also captured other potential means of access to finance, including the possibility to get donor support through technical assistance or blended finance mechanisms. As an example, a municipality can seek loan guarantees for debt portions of projects thus de-risking commercial lenders and encouraging more lending to municipal development projects. Another mechanism which has recently become more available are first-loss equity investments by international partners. Several of these partners have created such instruments and have designed them with the goal of supporting equity investments focused on development, very similar to the intended municipal funds.

The design included in this report captured the main elements needed for any fund including:

- Definitions of key terms.
- A clear investment thesis for a municipal impact fund.
- Design of a robust fund structure and a strong management team.
- A transparent governance model for the fund that extends to portfolio investments.
- An economic model for the fund operations.
- An incentive-based management fee structure.
- A marketing plan for attracting investors.
- A management plan for pre and post investment phases of the fund including due diligence, deal generation and selection, and exit.

The report also includes a specific design for the Karak investment fund that leverages local competitive advantages of the city towards attracting investors, government, and donor support to make the intended fund a success. The design suggests external fund management for the first fund to be augmented by members of the investment committee. The expected investments will include companies operating, intending to operate, or intending to start-up in Karak. Target sectors include tourism, cleantech, ICT, industrial, agricultural, and services. Deal size is suggested to be between JOD 100,000 – 1,000,000. The fund risk appetite will be average and de-risking will be done through first-loss equity from donor or local support mechanisms. The fund will utilize pro bono services where possible from retirees and graduate students, or through donor support.

The report should encourage municipalities to seriously consider local investment funds as means to own the development of local economies and partner up with private sector for mutual success. This design concludes the second step of our engagement and sets the stage for the next step, which is designing investment funds for the three municipalities.

BACKGROUND

This report follows a detailed legal review for the three participating municipalities in the MINARET project in Jordan, Tunisia, and Lebanon, which are Karak, Monastir, and Jdaidet El Chouf, respectively.

The legal review revealed the following:

- In Jordan, both municipal and public private partnership (PPP) laws are expected to be amended early 2020 and should provide more autonomy and higher flexibility for municipal leaders to enter or create investment funds. It was also revealed that national institutions like the Cities and Villages Development Bank (CVDB) are interested in joining such investment funds when they are formed.
- In Lebanon, the municipal law is quite dated and, although municipalities are autonomous in day-to-day operational decision-making, they are not empowered to take financing decisions including setting up investment funds, or even opening bank accounts at commercial banks. The current political situation in Lebanon, in addition to this limitation, may hinder Jdaidet El Chouf's ability to set-up or join investment funds, however, direct investments using municipal assets is allowed by law and we will pursue these opportunities.
- The Tunisian constitution was modified in 2014 and currently includes strong decentralization and autonomy for municipal leaders. A new PPP law was issued allowing municipalities great flexibility in joining PPP projects, and even accepting unsolicited proposals from potential private sector partners. Monastir has recently set-up an investment committee which is tasked with identifying investment opportunities and seeking out potential partners and investors. However, Monastir's mayor indicated they are not interested at this time to set-up or join investment funds despite their legal ability to do so.

This report includes a design for a municipal investment fund along with details about the Karak intended fund. The report includes the major components of (1) designing the fund including the investment and impact thesis, fund foundation and structure, and coherent economics, (2) marketing the fund to attract investors, (3) fund management, and (4) the Karak fund design.

DESIGNING A MUNICIPAL INVESTMENT FUND

This report seeks to answer the following questions:

1. What is a municipal investment fund?
2. What is the most optimal design of a municipal investment fund?
3. How does a municipal investment fund raise capital?
4. What is the best governance model of a municipal investment fund.
5. How to market a municipal investment fund?
6. How to manage a fund pre and post investment?

Definition of Investment Funds

An investment fund is defined as a pool of capital owned by several investors used to collectively purchase securities while each investor retains ownership and control of their own shares. The investment fund structure allows investors the flexibility to select from a broad spectrum of potential investments, lowers risks of investment by bringing on board investment experts to manage the fund, and, through the sharing of investments, lowers investment fees than if each investor acts alone.

Investment funds can be mutual funds (each investment includes a balanced portfolio of securities), money market funds (which deals in large short-term debt trading), or hedge funds (which are pooled funds that invest locally or internationally to maximize yield and minimize risks).

Investors participating in an investment fund are called limited partners (LP), while the founder and (potentially) manager of the fund is called a general partner (GP). A GP or fund manager (if the same) is usually given the authority by LPs to make investment and sale decisions on their behalf. LPs usually have no say when it comes to investments so long as such investments follow the fund's goals, risk profile, fees, governance model, and other design factors, which is why designing a fund in a clear and transparent way is essential to attracting investors.

Designing a Municipal Investment Fund

The design of an investment fund follows several logical steps, including the creation of a strong and compelling thesis, foundation, and structure. The thesis for a municipal investment fund is very sound and is based on profiting through the provision of local services, which in terms of business planning shows sustained demand capable of anchoring a business and potentially supplying local, regional, and international growth potential.

A typical investment fund structure can be seen below. The fund is managed by the GP and funds come in through several LPs. A fund can have internal or external investment committees/advisors, and it invests in several businesses/companies. Fund design should cover several aspects related to investment size, risk appetite, types of investments, percentage to be purchased in existing or newly established businesses, level of involvement in operating portfolio companies, etc.

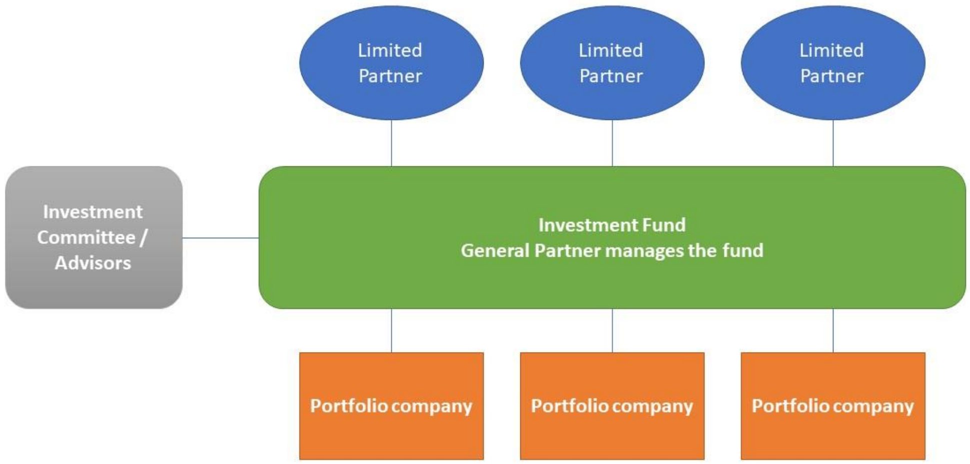

Figure 1: Typical Investment Fund Structure

The initial goal of an investment fund design is to attract investments from LPs. To do so, a clear strategy and a well-defined implementation plan must be drafted. A clear strategy should include (1) a clear thesis for intended investments, (2) a well-defined structure, and (3) proof that a pipeline of investment-worthy opportunities can be created by the GP. This is very specific in the case of municipal investment funds because the GP is the municipality or an entity/person assigned by the municipality, and investments are leaning more towards local service provision, which means that designing a municipal investment fund has to override typical investment risks by leveraging municipal autonomy and generating rather than waiting for investment opportunity. A smart design will also look at potential public private partnerships with the public/municipal share coming through the fund.

The Investment Thesis

A compelling thesis for intended investments is important to attract investors, especially as more municipal funds get created, and more regional and national funds compete for investor funds. A clear investment thesis must be based on actual evidence and data and must lead to clear differentiation and the ability to easily pitch to investors. Some key questions that can help define an investment thesis include:

1. What needs will the fund address? Which in the case of a municipal fund should be tied to local economic development, with potential extension to bigger geographies.
2. Are key assumptions about deal size, investment type, sector focus, etc. based on proper market research?
3. What is the fund's theory of change? Especially as it relates to a mind-shift causing municipal leaders that are used to traditional service provision to become savvy investors. A simple answer to this important question is that those leaders are well-informed about local needs and opportunities, and all the fund needs to do through its design is to offer the chance to turn

those needs into real feasible opportunities and create sustainable growing income in the process of doing so.

4. Is there evidence such a need exists? A question that can be answered by actual data related to local service provision, unemployment rates, townhall meetings, etc.
5. What are the assumptions we are basing the fund design on? These could include central government support, availability of investor appetite to support the city/region, availability of several investment-worthy opportunities, leadership capabilities, etc.
6. Are suggested exit strategies supported by market data and investor behavior?
7. How does the fund fit into a competitive market? How unique is this fund?
8. What type of LPs will the fund attract? For example, will funds of funds or institutional investors be interested or will it only be individual investors from the city or region?
9. What is the risk appetite for the fund? For example, if the focus will be on start-ups or newly developed businesses, expected LPs will be ready for high risk against potential high returns.

Answering these questions clearly helps fund managers develop a clear pitch to deliver when meeting potential investors; one that is both believable and compelling. Any vagueness in fund designs can easily deter potential investors, who typically first look for clarity and confidence in GPs before they dive deeper to assess fund designs.

The intended municipal investment funds can be considered impact funds, which usually invest in early stage and growth businesses. Impact fund managers usually help shape strategies and plans of portfolio companies and need to be savvy enough to align fund objectives to these strategies and plans.

Fund Structure

Once a strong thesis is developed, it will need to be operationalized through a solid foundation. The fund structure is essential for longevity and proper execution of the thesis. A well-designed structure needs to include the following elements:

1. A strong fund structure.
2. A strong team.
3. A deal flow that shows the team strength and proves the fund thesis.
4. Attention to details such as legal agreement terms, ability to improve returns, support mechanisms to portfolio companies, etc.

A typical legal structure of an investment fund is a **limited partnership** usually registered in a tax-friendly country. In the case of municipal investment funds, they are usually registered in their home countries but also follow a limited partnership structure. A typical limited partnership is usually made up of (1) a general partner; who is authorized to manage the company and is personally responsible for all liabilities related to the partnership, and (2) limited partners who contribute capital without having the right to manage the company, and whose liabilities are limited to their share in the capital of the company.

Limited partnerships allow enough flexibility for LPs to sell their shares to other LPs without the approval of the GP. This structure also allows GPs the right to amend company objectives and offers them full discretion related to management decisions.

The laws of Jordan and Lebanon allow the formation of general partnerships along the same legal boundaries highlighted above. The Tunisian corporate law, however, does not have a general partnership as a lawful form of company. If the law, which was ratified in 2000 (Law number 93) does not change, it may be prudent for any Tunisian municipality intending to set-up an investment fund to register it elsewhere.

In a limited partnership, the GP usually receives a management fee and an agreed percentage of the profits, which could be paid in cash or as shares in portfolio companies. LPs receive their shares of profits/income and any capital gains related to increased valuation of portfolio companies. General partnerships are usually governed by partnership agreements, which manage the GP/LP relationship, includes terms, fees, investment structure, and any other details that need to be agreed on before commencing to invest.

In a municipal set-up, the municipality usually acts as the GP, and the municipal council decides on fund management. It is also normal for limited partnerships having municipal GPs to hire advisory and investment committees in order to augment the company with needed subject matter expertise.

Building a Strong Fund Management Team

A strong fund management team is necessary to implement the fund strategy, follow the investment thesis, and bring about positive financial results to the fund partners. A typical team includes three main roles: a senior leader, an associate, and an analyst. Of course, a fund can have more than one associate and/or more than one analyst but must have one leader. While experts and advisors are not considered members of the core fund management team, they are a necessary compliment to the team, especially for deal evaluation and negotiations.

A fund management team should also include specific functions related to inclusion, diversity, socio-economic investment impact assessment, fair trade, legal and regulatory support, operational improvement, and investment relations. For smaller funds, these roles are distributed among the three main roles, while for larger funds, special teams are hired to cover these functions.

Skills and experience are essential for the core team, especially relating to selection of investments, management, exit strategy, fund-raising, marketing, and investor relations. Other functions can be retained on part-time basis or as needed.

For municipal investment funds, we believe the following skills to be important:

- Local development experience and knowledge.
- Experience in start-ups or entrepreneurship.
- A commitment to the city and to creating positive socio-economic impact.

Based on the above, the most suited municipal fund managers are those with experience in both social and private sectors because they tend to take social impact into consideration when looking at potential investments, which is a factor that is designed into the fabric of the fund.

Fund managers should also be able to demonstrate a consistent deal flow early in the fund life to enable quick capital injection and trust building between the GP and LPs. For this reason, the previous track record of fund mangers weighs highly in the evaluation criteria of candidates. A key skill is balancing the timing of potential investment commitments with funding timing expectations, especially during the early months of a fund life and before LPs join the fund.

Another key skill a fund manager and team should possess is proper presentation of investment opportunities. Such presentations should clearly show the following:

1. The potential investment financial needs and potential use of proceeds, which should include in the case of municipal investment funds positive socio-economic impact.
2. How the potential investment matches the fund mandate in terms of industry type, stage of company, investment size, etc.
3. The level at which the fund management team intends to interact with the business after the investment is made.

Governance

When designing fund governance, GPs should take their time to think about the governance structure. Specifically, the following questions should be answered and integrated into the governance model:

1. Who should be on the board of directors of the fund?
2. Will the fund have a board of advisors in addition to the board of directors?
3. Will the fund board of directors act as advisory or governance body and why?
4. How are investment decisions made? What levels of approvals are needed?
5. How are investment committee members selected?
6. Is there alignment of interests across the fund stakeholders and local community?

For municipal investment funds, a governance structure will include municipal actors. As an example, the municipal investment committee may overlap with the fund investment committee. Reporting will be to the fund board(s) and to the municipal council. These layers of transparent reporting will increase LP confidence and avail a higher level of support and advice to the management team.

Legal and Financial Design Aspects

Although it is preferred for a municipal investment fund to be domiciled in the country where the municipality exists, it is prudent to consider the following aspects before making such a decision:

1. Legal structure flexibility. For example, we mentioned that the current Tunisian corporate law does not have a limited partnership type, so it is important to look at other locations or further investigate local legal structure options.
2. The location of the fund registration must match the requirements and expectations of the LPs, especially as they relate to tax considerations. Tax implications can sometimes be considerable for LP returns and hiring a tax consultant may be needed to investigate tax treaties signed by the country in which the fund will operate and countries where the LPs are expected to come from.
3. Legal issues such as securities laws should be studied to ensure LP rights are protected. For example, some countries have repatriation restrictions which could affect LPs' cash flow post exit.
4. Currency risks, if any, should be considered, especially in countries that have high currency fluctuations or that may float their currencies. This consideration affects the fund currency that is used for investments and profit distribution and should be considered in the fund design.

5. Accounting of fund activities must be done in transparent way and by trusted accountants and auditors. Accounting activities affect both valuations of portfolio companies and day-to-day fund activities including profit distribution, and LP confidence in accounting practices is paramount for their entry into the fund.
6. The terms that end up controlling how a fund is managed need to be considered and covered in the limited partnership agreement. There are standards issued by the Institutional Limited Partners Association (ILPA) called the Private Equity Principles which offer standards that need to be considered. LPs need to see that such standards are considered when the fund is designed to boost their confidence in the fund management team.

Developing an Economic Model

The economics of an investment fund should show sustainability regardless of number and size of investments. A well-designed fund should show potential LPs that the fund can pay for its operational costs. Fund economics take into consideration all elements of design to show any inter-dependencies between these elements and how trade-offs and prioritization can be made to sustain the model. LPs usually inspect the economics of a fund design to ensure every potential cost is accounted for. A strong economic model increases confidence in the investment strategy. The fund manager should show in the economic model the expected levels and payment schedules of management fees, capital deployment, and carried interest. A poor allocation or higher than expected payout may result in investor flight risk. Key elements to consider in a fund economic model are:

1. Keeping in mind potential inter-dependencies between cost items. For example, management fees should be tied to investment closing and capital deployment should be over the longest possible period and may be tied to company performance and needs.
2. A clear model needs to be built that integrates all fund management factors along with investment strategy components.
3. All funds start with limited budgets, and thus fund managers must design a model that can sustain the fund until the first investment injection is made.
4. The size of the fund in terms of expected capital commitments from LPs and the type and size of investments should be finalized and included in the model.
5. Cash flows are critical to any start-up, and more critical as investments are made and cash is received from LPs. A clear projected cash flow model needs to be integrated as a key component of the economic model. The expected gross margins from intended investments along with net returns to LPs should also be considered in the economic model.
6. The cost of running the fund (operating budget) needs to be clear and projected for at least three years in advance. This cost should overlap with projected cash flows to give assurance to investors that the fund will survive even if investments are not made for some time. To do so, the base management fee (not tied to performance) should be able to cover operational expenses without investments being made.
7. Consideration should be made for intended investment instruments. For municipal funds as an example, fixed assets can be put up as investment instruments (e.g., land, buildings), which are not liquid and need minimal cash injections.

In addition to the above, there are actions that can be taken to make the economics work, especially in our target countries where there is abundance of business academic institutions and donor support. Some of these actions include:

1. Using interns or graduate students to help in deal due diligence, data gathering, and general administrative support in order to reduce operational cost.
2. Seeking grant money from donors to support in technical assistance, studies, etc.
3. Seeking first loss protection through donor or national institution equity investment facilities. As an example, the Jordanian Cities and Villages Development Bank may enter the fund as a first loss LP.
4. Fund managers may seek the support of retired government employees or academicians who will be happy to support funds helping their localities.
5. Developing local projects based on availability of value to both increase local benefit and reduce cost of deal sourcing.

The economic model should also show potential investors how it plans to maximize their returns. This maximization of returns can happen in one of four ways as follows:

1. High earnings from operations and exits. Earnings can improve if the fund managements chooses to support portfolio company management teams by helping them improve revenues. Positioning portfolio companies for exit through merger or acquisition will also lead to higher LP returns.
2. Revenues can also improve by increasing prices through a price redesign based on updated market analyses.
3. Geographic expansion can also be support by the fund management team to improve revenues of portfolio companies.
4. Support to portfolio companies can also happen through cost restructuring and reduction. A fund manager can engage in economic modeling for portfolio companies to support them in cost reduction and efficiency improvements, including cost allocation on activities that follow well-defined market needs.

Investors joining a municipal funds not only look for financial returns, but also for social and environmental impact through localized projects that return profits by improving the livelihood of residents. A fund economic model should take social impact into consideration, even if the quantification of such impact cannot always be financial, but it needs to be shown as a factor in any municipal fund economic design. Impact assessments can also help portfolio companies grow because they may reveal unknown customer needs or upselling opportunities.

Another key factor LPs ask to understand before they commit to participate in a fund is the expected gross-net gap, which is the difference between gross profits earned from portfolio companies and the net profits distributed to LPs. This gap typically includes operational expenses, management fees, interest on debt (which is affected by cash flow management), and professional fees. Funds have negative internal rates of return (IRR) during their start-up phase and until they start receiving profits from fund investments, and even then, LPs may wait years before they start making profits when the fund starts exiting its investments.

Designing the Management Fee Structure

A smartly designed fee should align the interests of the fund manager and LPs. A fee is usually split into two components and are usually negotiated and incorporated in the fund's private placement memorandum (PPM):

1. **Management fees**; which are usually in the range of 2% of invested A and committed funds and should cover all operational expenses of the fund. Management fees are thus tied to actual investments and fund managers may end up getting only a small amount of management fees if no investments are made. These fees are considered money borrowed from LPs to be returned with interest before any distribution of profits. Management fees are usually paid as 1% upfront fees for fund launch expenses, and the remainder as the fund begins its investment operations.
2. **Performance fees (or carried interest)**; which are tied to the fund performance and are usually high enough to incentivize fund managers to maximize these fees, thus resulting in maximizing LP profits. Normally performance fees are around 20% of the fund's investment profits.

Structuring of fees is important because management fees are low during the post-investment period, especially as the fund begins exiting from investments, when the fees may go down to zero, which may disincentivize fund managers from exiting. Thus, funds should pace out their investments or have limited durations, after which a second and third funds are raised to keep the management team incentivized and well-paid.

Fee disbursement is another issue that needs to be well-designed. In a typical investment fund, fund managers do not receive any carried interest before the LPs receive their invested capital plus a minimum profit called the **hurdle rate.** The remaining funds are then called capital gains and are usually split on 80/20 basis between the LPs and fund manager, respectively.

Summary

The design of a municipal investment fund should take into consideration key elements including:

1. A clear and concise investment thesis detailing what the fund plans to invest in. A typical thesis for a municipal fund should focus on fulfilling local needs or taking advantage of local competitive advantages to improve the socio-economic situation of the locality that is plans to serve.
2. A robust structure that aligns the interests of the municipality (GP) with the interests of the investors (LPs) while at the same time focusing on serving residents.
3. A strong fund management team that includes key skills related to local development, entrepreneurship, and a strong commitment to the city the fund intends to serve.
4. Clear and transparent governance at all levels of the fund, and in conjunction with the governance model of the municipality (GP).
5. Proper selection of location that factors in taxation, currency risks, legal limitations, and any potential advantages related to selected location.
6. A strong economic model that aligns with the financing model and utilizes support mechanisms such as free or "cheap" expertise, donor support, first-loss investments, etc.
7. A management fee structure that keep the management team incentivized and well-paid and aligns the interests of the fund manager, the municipality (GP), and the LPs.

ATTRACTING INVESTORS

After a municipal investment fund is well-designed and structured, the fund needs to be sufficiently and efficiently marketed to potential LPs. Marketing a fund follows certain steps and timelines similar to those depicted in Figure 2 below.

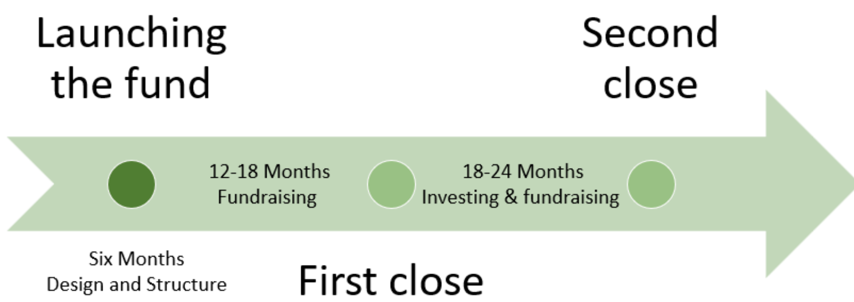

Figure 2: Fundraising and Marketing Timeline

The launching phase includes the completion of all designing activities as described in the previous section. This phase also includes listing potential investors and certain launch activities including:

1. Identifying an anchor investor; which can be a local development bank or fund in the case of a municipal fund.
2. Preparation of marketing material for the fund.
3. Identifying and prioritizing potential investments, especially local investments capitalizing on competitive advantages of the fund locality.
4. Identifying co-investment opportunities, potential partners, potential donors, and potential government support.

The targeting of investors is both a science and an art. The science part should be completed through a clear pitch the includes all design elements as previously indicated. The art part should be designed individually based on a clear understanding of the targeted investor's priorities. As an example, a pitch to an investor that hails from the city being served by the fund may have his eyes set on a fund the primarily serves that region, and a pitch to such an investor should put this priority front and center in the pitch. A second investor may want to see investments in a certain one of the targeted sectors, and a pitch should highlight potential investments in that sector.

Finding potential investors can happen through different ways including public calls by international investors to funds, which can be found online, a direct call to potential investors, especially first-loss investors in the case of municipal funds, direct calls to local investors coming from the region the fund intends to serve, or through government relations with local and international investors/funds.

Investor Types and Priorities

Being designed as impact funds, municipal investment funds attract investors from several categories, and also provides opportunity for cooperation among investors having different priorities. These funds also attract several classes of investments including blended finance facilities, which work to de-risk certain investments. Some of the investor types targeted by municipal investment funds include:

1. **Individual investors**: which include high net-worth individuals and family offices. These investors can best be attracted if they have an affinity to the locality the fund intends to serve or by de-risking them through blended finance facilities.
2. **Development Financial Institutions (DFIs)**: which include banks like the Africa Development Bank (ADB), the European Bank for Reconstruction and Development (EBRD), the Islamic Development Bank (IDB), etc. These institutions focus their investments on developmental projects and companies and have affinity towards investments in rural areas that can result in local development.
3. **International Development Agencies**; such as USAID, DFID, the European Union, etc. These agencies usually provide grants, but sometimes provide financial instruments such as first-loss or loan guarantees that can support municipal investment funds. They can also provide free technical support to fund managers that can help reduce operational costs.
4. **Local Development Institutions:** which may include public funds of funds (e.g., the Innovative Start-ups & SMEs Fund in Jordan) or local development banks (e.g., the Jordanian Cities and Villages Development Bank).
5. **Foundations**: Although foundations used to focus their operations on philanthropy, they have more recently shifted their focus to include targeted investments, especially in impact areas and funds.
6. **Institutional Investors**: which is the most sophisticated group of investors and includes large funds of funds, large investment banks, corporations, insurance companies, and pension funds.

When targeting potential investors, a fund manager should study their priorities, previous investments in the country and area of operations, deal size of previous investments, etc. Once a target investor is identified and well-researched, a pitch should be prepared, and a meeting set to deliver to the investor decision makers.

The advantage of attracting different types of investors can be used by municipal fund managers to develop co-investment opportunities. These opportunities can also lead to the attraction of different investment classes, allowing the fund manager greater flexibility in profit disbursement by delaying some disbursement of investors with longer-term tenures. In general, a fund can combine capital in ways to attract investors that may otherwise have less interest to participate. For example, a de-risking through first-loss investment may attract investors with low risk tolerance.

Preparing a Pitch

Fund managers usually prepare an investment teaser, which is a short document or presentation with very clear bullet points that describe the fund design and investment strategy. The purpose of an investment teaser is to filter out investors who are not likely to be interested in the fund based on its design and investment strategy. Potential LPs that like the teaser will be added to the list of investors to visit during the “roadshow” usually taken by fund managers to present a detailed investment pitch presentation.

The investment pitch presentation usually includes details about the business model, a concise description of the fund operations, investment strategy, and investment pipeline (if any). The presentation should be customized to the potential investor being presented to, and based on the stage of the fund development.

A typical investment pitch presentation includes the following components:

- A clear problem statement the fund intends to address, which in the case of a municipal investment fund can be that a city has strong investment opportunities based on local competitive advantages but does not have enough capital to invest in these opportunities.
- A clear fund strategy statement.
- A summary of financial expectations including expected deal size, returns, tenure, etc.
- A clear statement about the impact intended by the fund.
- The management team including their experience and capabilities.
- The board of directors (and advisors if any) and the investment committee members.
- A high-level pipeline of investment opportunities and a zoom-in on high priority opportunities.
- Exit strategy.
- A clear economic model including expected capital stack, financial returns, cash flow projections, operating budget, and expected returns.
- Legal and operational plan.

The presentation should not be long and should allow ample time for discussions, but at the same time should have all required details to allow informed assessment by a savvy investor. The presentation, and all other marketing material, should have consistent messaging and no conflicts between them.

Interested investors need to be presented with a third important document which includes the key terms governing the fund. This document should include (1) the size of the fund, (2) requested fee structure, (3) suggested hurdle rate, (4) suggested carried interest percentage, (5) expected returns, (6) and detailed operational costs.

Between the three documents above (teaser, pitch presentation, and terms document), an investor should have enough information to make an informed decision about committing capital to the fund.

In parallel to investment pitches, other material should be prepared and ready including a website that can help attract investors and potential investments, a term-sheet to present to serious potential investors detailing their rights and responsibilities as LPs in the fund, and a draft investment memorandum (or private placement memorandum) in case it was requested as part of investor due diligence process.

Preparing for Investor Due Diligence

Interested investors that believe in the fund pitch may decide to move to the due diligence phase, which shows seriousness and considerable resources will be allocated by the potential investor. This phase requires the fund manager to be ready for any questions that may be raised by the due diligence team. Questions usually asked during the due diligence phase include validation of the investment thesis, details related to the investment strategy, a socio-economic impact assessment, team experience, pipeline, fund economic model, and operational excellence.

If the fund passes due diligence, this can lead to the fund’s first close with investment commitments being made. A first close is very important because it usually covers operating costs and the fund’s initial investment(s). A first close should not lead to fund managers slowing fund raising activities, on the contrary, it should encourage more discussions with interested investors, and should help timid investors follow suit. A second close usually happens within a year of the first close.

MANAGING A MUNICIPAL INVESTMENT FUND

Raising investments into a fund is only half the skills needed by a successful fund management team. Investing those funds successfully is the second half, and this takes certain managerial skills that all LPs look for. Some of these skills include the ability to build and effectively show LPs a real pipeline of potential deals that both match the strategy and goals of the fund and show promising financial prospects.

Building a Deal Pipeline

Just like selling a fund to investors, sourcing deals is both a science and an art. Successful deal sourcing requires the science of selling the fund to potential investees, and the art of convincing investees of a fair valuation and deal terms. A fund's reputation plays a vital role in attracting potential investees. Results like supporting portfolio companies to gain bigger valuations, transparency, sticking to announced strategy, and a human touch all play a role in attracting potential investees.

The science of deal sourcing requires constant and strong relationships with bankers, corporate CEOs, other fund managers, SME incubators, and a finger on the pulse of the economy where most deals are expected to be sourced. In the case of a municipal investment fund, the fund manager needs to be close to the local business community and needs to have the skills to develop businesses based on existing competitive advantages.

The art of deal sourcing takes many forms including striking success fee agreements with strong business developers, meeting serial successful entrepreneurs and encouraging them to establish businesses that match the fund's investment strategy, seeking help from local community players to encourage local business establishment, etc.

Selecting the Best Deals

While working on developing a pipeline, it is equally important to qualify opportunities before adding them to the pipeline that will be shown to LPs, who always measure success as a percentage of deal closing. Qualification is a skill that must always be sharpened. It entails an initial high-level duel diligence of business concept, strategy, objectives, plans, and people. A process to filter through a deal pipeline is important and sticking to the process is equally important. A typical process includes going through a typical sales funnel, which starts with deal identification, then filtering potential investees based on their fit to the fund strategy and potential success, then negotiating with that group of potential investees to reach a list which the fund investment committee approves for due diligence investment. Investees that pass due diligence are then invited for a second round of negotiations based on the results of their due diligence, and if agreement is reached, the investment committee will proceed with legal agreements and investment commitments. Figure 3 shows a typical investment funnel with deal sourcing generating a large number of potential investees (1,000 as an example). The number is then reduced through a basic strategy matching exercise to around 250 companies. A deeper investigation about the companies' leadership teams, their financial performance, market strategy, etc. yield a smaller list of around 100.

A third filter through a deeper dive by meeting the leadership teams and asking questions about future plans usually leads to around 20-30 companies that are selected for due diligence. Reducing the number to a reasonable minimum is important because due diligence is a costly process and a fund cannot run due diligence on a large funnel before filtering out low potentials. The results of due diligence usually lead to around 5-10 commitments, a mere 1% of the number of companies that started out in the funnel. This process is ongoing, and a fund team become more effective over time to shorten the cycle of taking companies through the funnel.

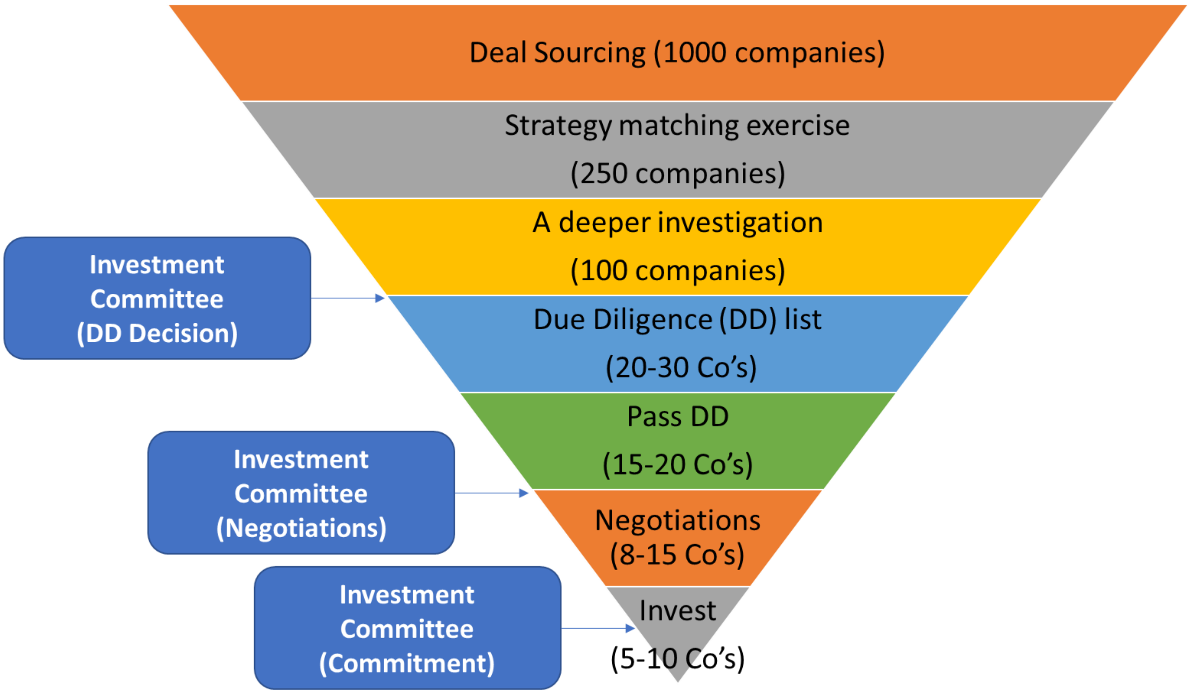

Figure 3: a typical investment funnel

The investment committee plays an important role in the filtering and reduction of potential investment opportunities. The committee looks for certain tell-tale signs about real potentials including (1) the reason the business was started (socio-economic impact potential), (2) the size of the market opportunity, (3) the team capabilities and affinity between the team and leader(s), (4) the level of transparency, and (5) performance against declared goals. Figure 3 shows key committee involvement milestones in the investee selection process.

Although Figure 3 depicts a typical investment funnel and investment committee (IC) involvements, fund ICs differ in the level they want to be informed from a passive level where the IC only wants to see a formulated deal to approve or disapprove, to a deeper involvement throughout the process. For a municipal investment fund, IC involvement is expected to be similar to that depicted in Figure 3, especially that overlap is expected between the fund IC and the municipal IC, which tends to be heavily involved in municipal investment decisions.

Running an Effective Due Diligence

A due diligence (DD) process is essential to arrive at well-informed investment decisions. A DD process includes four core objectives, which are (1) to reduce the risk associated with investments, (2) to identify the potential socio-economic impact an investee would produce, (3) to identify growth opportunities the fund can exploit if it ends up investing, and (4) to answer and potential questions posed by LPs. A typical due diligence answers the following questions:

1. Who are the business owners and sponsors?
2. What is the company's strategy and market position?
3. What are the projected financials of the business?
4. Are there any risks associated with the business?
5. Who is the team running the business? And how close are they to the leader?
6. Is the business being run efficiently?
7. Are there any financial and legal liabilities that may lead to risks?
8. How is the company governed?
9. How are the financials managed? Has the company had any negative cash flow periods?
10. What is the company's appeal in the market?
11. What impact will the company have on the social and economic environment where it operates?
12. What are the growth opportunities the fund should consider?
13. Are there any internal or external factors (e.g., owner resistance, market pressures, etc.) the fund manager should be concerned about?

A typical due diligence runs through several tracks in parallel. For examples, a legal DD could be running in conjunction with a financial DD and a team background assessment. The end result would be a consolidated DD report that should be structured the same way for all potential investees to enable LPs and ICs to compare opportunities in an effective manner.

Risk management is a key reason DDs are conducted. Risks identified by a DD process are usually assessed, and mitigation strategy is formulated and executed if such a risk can indeed be mitigated. As an example, if buying insurance can mitigate a certain risk, the cost of insurance would be factored in the company valuation. Risk mitigation is one of the key reasons LPs invest through funds, which is why it should be a core function of any successful DD.

Structuring a Deal

If a company passes the due diligence process, negotiations start between the fund manager and investee management team to reach a deal. Any deal should at least fulfill the following key criteria:

1. Meet the financing requirements of both the fund and investee.
2. Have an agreed schedule for fund infusion.
3. Have an agreed exit strategy.

There are several instruments a fund can use to structure a deal. It is assumed that a municipal investment fund will only be interested in equity investments that lead to an ownership stake in the investee, and which inherently assumes key returns coming from the investee success, rather than any cash commitment. There are several equity investment instruments a fund can use including:

1. Preferred stock; which give their holders a preferred status with the company ownership structure in terms of when they get payouts. Preferred stocks allow funds to have a more predictable cash flow through fixed dividends.

2. Common stock; which puts the fund on equal footing with all other common stockholders in terms of rights and liabilities. Investee management prefers this type of investment because it shows a fund's commitment to be part of the company at the same level as the existing owners.
3. Convertible Debt; is usually structured as debt with agreed debt terms, that also allows the lender to convert the debt to equity at a pre-agreed valuation and within a pre-agreed timeframe. This type of instrument is usually used when an investor wants more flexibility in exiting a certain investment but is unlikely to be used by a municipal investment fund.
4. A warrant of option is a one-sided commitment that allows an investor to purchase equity shares at a certain valuation within a certain period. It is usually offered when an investor is unsure and needs more time to decide.
5. Mezzanine financing combines debt and equity and offers a higher expected return against a higher risk exposure. A mezzanine instrument usually has lower priority of payout in the case of bankruptcy than senior debt.

An exit strategy is an important part of any successful deal structure. An exit is a means to liquidate a fund's investment through sale to another entity. An exit strategy requires both the fund and the investee to agree on a time, expected valuation, and a means to sell out the fund's share in the company. For a municipal fund, an exit strategy should always include an impact assessment and a design to ensure continuation of positive impact post-exit. Typical modes of exit include a merger or an acquisition of the investee, a public sale through an initial public offering, sale of shares to another equity investor, or a management buyout where the company management buy out the fund's equity stake.

Post-investment Management

Smart fund managers should participate in the management of portfolio companies in ways that do not interfere in day-to-day operations, but that support the company leadership team and help improve its performance, and ultimately, valuation.

A key skill a fund manager should possess is being able to deal with multiple portfolio companies, while still maintaining efficient fund operations. To do so, the fund manager should be highly organized and should staff the operational team with similarly organized team members who build predictable interactions with portfolio companies, and report back following structured reporting templates that aggregate to summary reports to LPs. A fund manager should also seek the help of external consultants and organizations that specialize in management support.

Key functions a fund management team need to keep in mind while managing relationships with portfolio companies include:

- **Governance;** which includes transparent reporting from portfolio companies to the fund manager and leads to fund reporting to LPs.
- **Monitoring;** which includes both risk management activities and growth support. Professional reporting takes place through a clear monitoring cycle (e.g., quarterly reviews), early identification of risks and actions to mitigate them, and potential support through shared services that may include human resource management, recruitment, and accounting.

- **Advisory;** which could take place through the fund advisory committee extending their services to portfolio companies. Members of this committee are usually composed of retired executives, lawyers, and senior advisors.
- **Board oversight;** which takes place by having a seat on the portfolio company board of directors. This helps fund managers be part of planning, executing, and monitoring of company operations in a more efficient and more hand-on way.

As for managing relationships with LPs, fund managers need to both set proper expectations, and keep LPs informed through a structured and transparent reporting structure. The most important report to deliver to LPs is the annual report, which culminates three previous quarterly reports in a concise and clear way. An annual report usually includes the following topics:

1. A summary update from the fund manager.
2. Audited reports detailing the financial status and valuation of the fund and portfolio companies.
3. A socio-economic impact report.
4. Expected transactions and relevant pipeline status.
5. A risk assessment.
6. An agenda for expected investor meetings or any important dates related to portfolio companies in the coming year.

In addition to the four formal reports, fund managers should keep investors abreast of key developments that take place from time to time, especially if these are important to be learned about in a timely fashion.

Figure 4 shows how a fund manager can add value to portfolio companies across the investment cycle.

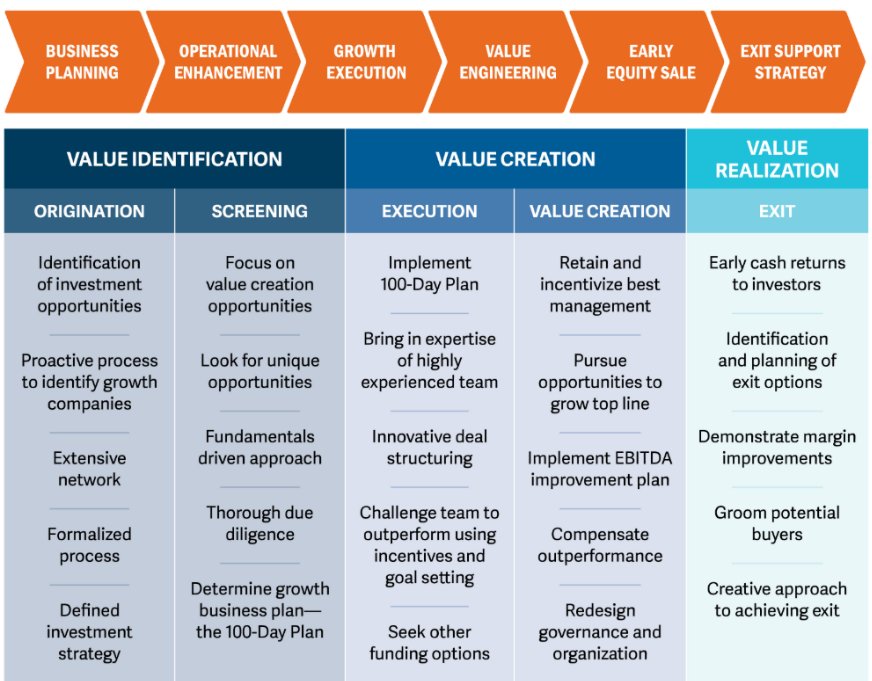

Figure 4: Adding Value Across the Investment Cycle (Schiff, 2016)

DESIGNING A MUNICIPAL INVESTMENT FUND FOR KARAK MUNICIPALITY

The Karak Investment Fund (KIF) will be designed to follow the following design.

KIF Investment Thesis

Researching the economic situation in Karak City and Governorate shows high unemployment (15.9%), coupled with strong opportunities and competitive advantages, including:

1. Substantial mining resources.
2. Strong ecotourism opportunities.
3. A highly educated pool of potential employees and skilled labor.
4. Enough water resources that can be used for agricultural projects.
5. Sizeable municipal land that can be used towards investments.
6. A location that can support industry for the local market and exporting (close to the airport and closer to the Aqaba seaport than the capital Amman)
7. The ability to make local investment decisions under the updated municipal and PPP laws.
8. Availability of potential LP partnerships through local public funds, the CVDB, and successful businesspeople who hail from Karak and have interest in supporting their hometown.

These advantages can be used to address key socio-economic needs in Karak and result in visible impact if financing is available to turn them into successful commercial business establishments.

To do so, the KIF design will include the following elements:

- The **General Partner** (GP) will be the Karak Municipality.
- The **Fund Manager** will be recruited from the private sector for the first fund, possibly changing to municipal investment committee leader for subsequent funds.
- Needs addressed by the KIF will include:
    - improving municipal revenues through successful investments, which will lead to improved municipal service provision;
    - improving local economic development by investing in companies intending to operate in Karak and hire residents; and
    - having high social impact by bringing new industries and growing existing industries in Karak including ICT, cleantech, agri-food, etc.
- The KIF **deal size** will range from JOD 100,000 – 1,000,000.
- **Types of investments** will include:
    - companies in the following industries: tourism, industry, mining, argi-food, renewable energy, municipal services, and ICT;
    - local start-ups supported by the municipality, government, or donors; and
    - companies intending to expand into Karak, or into Jordan and the region through Karak.
- The KIF **risk appetite** will be average with the goal to minimize risk by attracting grants and first-loss equity investments, and through blended finance mechanisms.
- KIF's target **investment percentage** will be 26%-49%.
- The KIF **level of involvement** in portfolio company operations: moderate through planning and execution support and board presence.

KIF Theory of Change

- The fund must be initially managed by an external expert fund manager with management team being a mix of private sector and municipal experts.
- The investment committee will be led by the fund manager and will also include external and municipal staff.
- The municipality leadership team will be engaged through their formal roles in the fund and will build skills locally over the life of the first fund (3-5 years) to allow for local management of the second fund onwards.
- A key focus will be on developing opportunities for investment locally rather than wait for opportunities in the traditional way.
- Another key component leading to positive change will be the involvement of the local community directly and through community-based organizations to identify and prioritize high-impact investment opportunities.

KIF Structure

The Karak Investment Fund will be based on the following suggested structure:

- **Domiciliation**: The fund will be domiciled in Jordan through a Limited Partnership Company with the Karak Municipality as the General Partner (GP) and several investors as Limited Partners (LPs).
- **Fund Manager**: will be hired from outside the municipality and should have strong experience in fund management, deal generation, entrepreneurship, and corporate leadership, in addition to being very interested in the development of Karak.
- **Fund management team**: will be hired by the fund manager and should include members from the Karak Investment Committee.
- **Fund Investment Committee**: will be appointed by the fund manager and should include members of the Karak Municipal Council and Investment Committee.
- **Advisory Committee**: should comprise sector experts who are interested in developing Karak and who would hopefully offer their services pro bono.
- **Governance**: The fund board of directors (BoD) will include members of the Karak Municipal Council, in addition to any large LPs. Initially, the fund BoD may be the same as the fund investment committee to remove any unnecessary overheads and keep close governance control over the fund operations.

KIF Economic Model

- **Initial funding** from municipal sources using a skeleton team until the fund is duly registered.
- Attracting **donor support** early on to help with fund set-up, fund manager recruitment, technical support for deal identification/generation, and possibly first-loss equity to attract risk-averse investors. There are several donors who are interested in supporting decentralization in Jordan and will be more than happy to support such a novel idea through financial and technical support.
- **Deal generation** will follow socio-economic impact priorities and should support the fund return thresholds and investment horizons.

- **Municipal assets** will be used as equity shares in investments, especially through PPP developed deals.
- Pro bono **experts** and **graduate students** will be brought in to support deal generation and due diligence.
- Leveraging **government support** through available protectionism policies, tax incentives in special economic zones, labor cost support, and other mechanisms to reduce operational costs and improve competitiveness.
- **Shared services** will be available to the fund through municipal staff including all back-office generic operations.
- A **management fee** equal to 2% of invested funds will be offered to the fund manager to attract expert fund managers. An additional 20% **performance fee** will be offered to incentivize success. Investment.

KIF Potential Investors

The Karak Investment Fund will attract a lot of attention as it will be the first municipal investment fund in Jordan. The fund should attract many interested LPs including:

- The Jordan Cities and Villages Development Bank (**CVDB**), which has recently announced a 45 million Euro facility from the European Investment Bank that can be used as debt and possibly equity instruments to support municipal development. The Karak fund can attract part of this facility either as direct equity or convertible debt.
- The Innovative Start-ups & SMEs Fund in Jordan (**ISSF**), which is a private sector managed fund owned by the World Bank (US$50 million) and the Government of Jordan (US$48 million) and is structured as a fund of funds looking for innovative start-ups and early stage SMEs. The Karak Investment Fund can attract equity investments, technical support, and even management support from the ISSF.
- Jordanian businesspeople, venture capital funds, and financial institutions looking to invest in innovative ideas.
- International development banks like the **EBRD**, which has been actively investing in Jordan, and always seeks development investments that benefit cities outside capital cities.
- **International donors** such as SIDA, the European Union, Global Affairs Canada (GAC), and others, noting that SIDA and GAC have recently announced equity and blended finance instruments that nicely match the mandate of the Karak Investment Fund, and can help de-risk individual and institutional investors.

KIF Deal Sourcing

The KIF will look for, and develop deals that match the following criteria:

- Utilize Karak's competitive advantages.
- Be based in Karak or have operations in Karak.
- Have substantial job creation opportunities.
- Provide high socio-economic impact in Karak.
- Can produce IRRs of 10% or higher.
- Can be positioned for partial or complete exit in 3-5 years after investment.
- Match the fund's design and investment strategy.

Deals can be developed as start-ups or as existing businesses. Existing businesses can be Jordanian in other cities intending to expand into Karak, or international with the intent to expand into Jordan and the Middle East.

SUMMARY AND RECOMMENDATIONS

This report included a detailed design of municipal investment funds including a definition of the fund, a fund design including an investment thesis, fund structure, team structure and capabilities, fund governance, legal and financial design, and the development of an economic model.

The main design criteria governing municipal funds in their focus on socio-economic impact serving their constituents. These funds are designed to create jobs and improve the economy of the cities they serve.

The report also included details about the marketing activities associated with investment attraction to the fund including a review of the potential investor types that may be interested in these funds, how to prepare an investment pitch to these potential investors, how to pass investor due diligence of the fund, and how to close LP deals.

Management of municipal investment funds both pre and post investments in portfolio companies followed. This section included building a solid deal pipeline, selecting the best deals by going through the investment funnel and running due diligence on potential investment companies, structuring deals, and managing relationships with both LPs and leadership teams of portfolio companies.

The report ended with a specific design for a suggested Karak Investment Fund, which focused on Karak's competitive advantage and Jordan's availability of resources and support mechanisms.

We believe this report to be comprehensive and to enable municipal leaders to make informed decisions about investment funds for their cities. Along with the legal review submitted in the previous report, municipal leaders should seriously consider this financial mechanism if they are allowed to do so by law.

Being the only one of the three participating municipalities both legally able and intending to create a municipal investment fund, we believe the design included in this report to be a good start for this action to be initiated by the municipality. We also believe starting this action in Karak will attract the attention of the Government of Jordan to support other similar actions, or a general municipal fund creation. It will also attract the attention of regional governments including those of Lebanon and Tunisia to remove obstacles and encourage the development of such funds.

The intended Karak fund will also attract the attention of donors and international partners who have designed grants and blended financing facilities targeted at local development and specifically designed to support similar actions. This support will help make the Karak fund successful and thus encourage other cities to follow suit.

Lastly, we would like to encourage the MINARET team to seek the support of SIDA for further actions related to municipal fund creation and local investments through financial support mechanisms available by SIDA including the provision of loan guarantees and first-loss equity investment funds.

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