PRIVATE EQUITY FUNDS

Overview, stakeholders, market study, and applicable legal frame-work.

In the Capital Fu-nd Study Report 2015 EY-Colcapital, the participation of 7.8 million consumers and more than 9.5 million tourists that annually visit our city, demonstrates diversity of the capital's market for investment in any product or service[13].

Overview

Private equity funds refer to a legal form of investment managed by a professional team, whose main purpose is to provide a medium- or long-term return to their investors through capital investments in companies that are not listed in the stock market.

Private equity funds are also known as "smart money". In addition to offering capital to companies and/or projects, they provide value added through networking, sophisticated management schemes, and better corporate governance schemes for value creation

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In Colombia, private equity funds are regulated by Decree 2555 of 2010 (as amended by Decree 1242 of 2013), which classified them as closed-end Mutual Funds. A Mutual Fund is any mechanism or legal form of collection or management of money or other assets that are made up with the contribution of several individuals, collectively managed to obtain joint economic results.

It is of closed-end nature because redemption of investors' shares occurs once the term set is completed, which is generally ten (10) years, unlike open mutual funds, where redemption of shares may occur at any time.

Private equity funds must allocate as a minimum two-thirds (2/3) of investors' contributions to the purchase of assets or rights of economic content other than securities registered with the National Registry of Securities and Issuers (RNVE).

Stakeholders Participating in a Private equity fund

Investors: A private equity fund must have as a minimum two (2) investors, which may be individuals or legal entities. The minimum investment in a private equity fund is set at 600 SMLMV. The main governance bodies are as follows:

- Investors appoint a Meeting of Investors, which is composed of 100% of investors; it is the most important body of the fund.
- The Meeting of Investors, in turn, designates a Surveillance Committee formed by some of the investors and independent members. Its main functions are to ensure compliance with the fund's regulations and solve conflicts of interest.

Professional Manager (GP as per its acronym in Spanish): Is a national or foreign individual or legal entity with expertise in the management of portfolios and acceptable assets for investment as contained in

the regulations of the fund. Its main responsibilities are management, decision-making, assessment, monitoring, control, and management of fund investments.
The Professional Manager creates an Investment Committee and elects its members, among which there may be independent members. The Investment Committee is responsible for the analysis of investments and definition of investment limits and policies for purchase and liquidation of fund investments.

Management Company: This is a particular concept of the Colombian industry. It may be a stockbroker, trust company, or investment management company, which is surveilled by the Financial Superintendence of Colombia and must report share units of the funds they manage on a daily basis. They identify, measure, control, manage and administer fund risks, assessing share units, provide necessary information to investors, convening the Meeting of Investors and Surveillance Committee and keeping their minutes. In the conduct of their business, they must comply with strict regulations on prevention of money laundering and terrorism financing (SARLAFT) and operating risk management (SARO).

Evolution of the private equity fund industry in Colombia

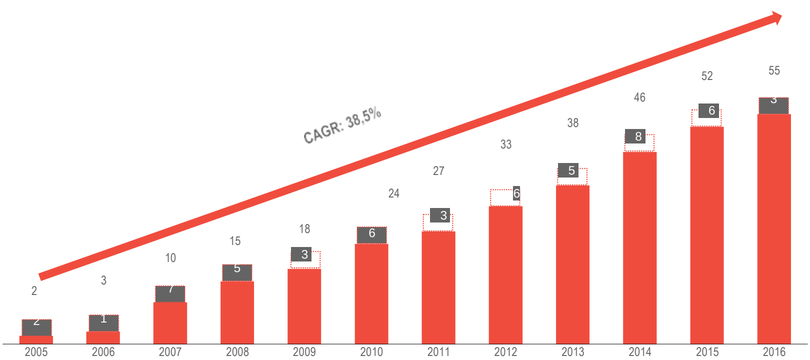
During 2015, the private equity fund industry had a global slowdown after the financial crisis in the United States that affected the world market, as well as the European crisis. While 2014 was a record year for the private equity fund industry in Latin America, in which USD 10,391 million funds were raised, the outlook for 2015 was not very encouraging and had a 30.6% drop in the funds raised by these vehicles (USD 7,231 million). According to the LAVCA Score Card 2015, Colombia retained the fourth position in the Overall Score of the private capital industry in Latin America, after Chile, Brazil and Mexico, despite a decrease in the score related to the regulation indicator.

Evolution of professional managers
The private equity fund industry has shown an extraordinary growth from its inception 11 years ago. As of May 2016, Colombia has 55 active professional managers, both local and international, out of which 53 reported detailed information for the purpose of the study conducted. As shown in Graph A, the number of professional managers has grown at a compound annual growth rate of 38.5% between 2005 and 2015 and, for 2016, it started with a similar growth trend, which resulted in the creation of three new professional managers as of the closing date of the study.

The evolution of professional managers has been accompanied by the development of local managers and the arrival of international managers. As of May 2016, the total percentage of local professional managers operating in Colombia represents 55%, while international managers account for 45%.

During 2015, the creation of professional managers focused on infrastructure, particularly through debt funds to leverage financing of fourth generation (4G) projects by the Colombian government, prevailed. Out of the six new managers created this year, three are focused on infrastructure investment and the remaining 50% is divided into growth and venture fund manager, with investment focus on technology-based companies. However, during 2016, the incorporation of three new managing firms focused on real estate private equity funds have been registered.

Graph A – Number of active professional managers



It should be noted that, in 2015, the industry completed a decade of operations and has had tangible results for both investors and the economy in general. The first private equity fund structured in the country in 2005, the Oil & Gas Private equity fund of Colombia, of the managing company LAEFM Colombia, whose purpose involved the purchase, investment, development and subsequent sale of oil blocks in the Department of Casanare, completed its full investment and divestment cycle and had an excellent financial performance for investors.

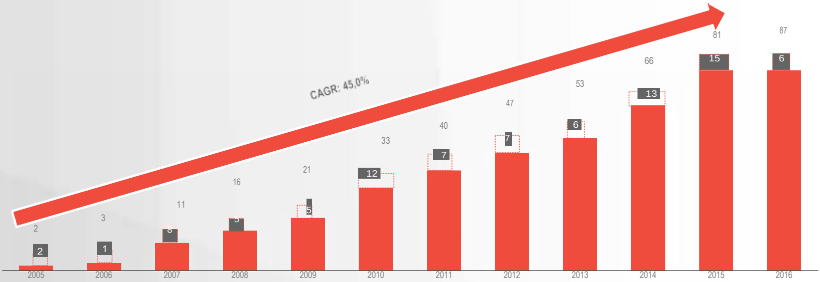
Evolution of private equity funds

In the history of the Colombian private equity fund industry, 90 private equity funds have been created to leverage the growth of companies and/or projects at different stages and in various economic sectors. However, Graph B shows the information of 87 private equity funds, which reported data related to the year of start of operation.

EThe growth in the number of private equity funds has been substantial. The results in Graph B show that, after having only 2 funds created and operating in 2005, the industry has shown a compound annual growth of 44.8% between 2005 and 2015, with an average of 7 funds created a year. With a figure of 15 new private equity funds, 2015 was undoubtedly a record year in the creation of new funds in the history of the industry in Colombia. The numbers are quite positive because this figure exceeds the successful 2010 and 2014, in which 12 and 13 funds, respectively, were created—years of two-digit growth. This result delivers a very encouraging message: despite the difficult macroeconomic situation the country went through during 2015, the creation of private equity funds continues to increase. This shows the interest of investors in this type of investment vehicle and of international players in having an active role in investments in Colombia, expecting differential returns that counteract the effects of economic cycles.

Years 2014 and 2015 were very active in the creation of private equity funds in the country. Particularly, during 2015, we highlight the creation of infrastructure (26.6%), real estate

Graph B – Evolution in the number of private equity funds



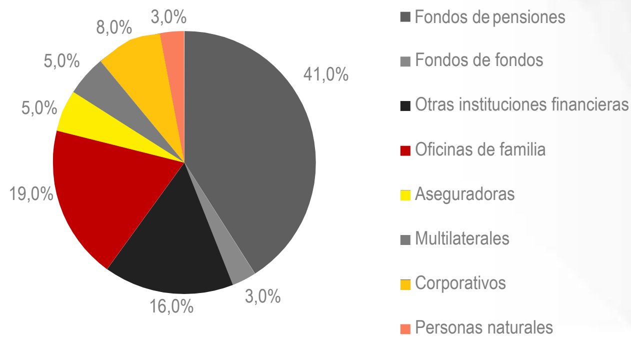
(26.6%) and growth funds, followed by venture (13.4%) capital funds and, finally, purchase (6.7%) and impact (6.7%) funds. Apparently, the growing trend continues in 2016, because at the end of the study in May 2016, 6 new funds had started operations in Colombia, mainly real estate fund structuring (40%), followed by infrastructure, venture and natural resources funds (20% each category). Nonetheless, for the analysis of the study conducted, a sample of 82 operating private equity funds will be considered, which reported sufficient information to be part of the sample.

In this context, the industry in Colombia and, especially, in Bogotá, its capital, where the most significant number of operators concentrate, completes its first decade amidst a changing macroeconomic environment.

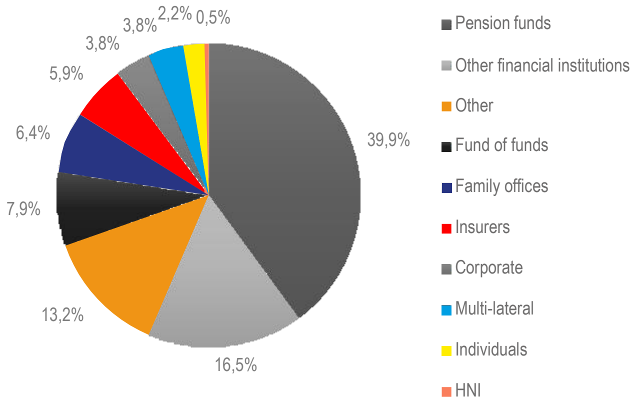
The preferred currency in the structuring of private equity funds has been the United States dollar, which accounts for 54% of vehicles, followed by the Colombian peso (45%) and the Peruvian sol (1%).

Regarding jurisdiction of private equity funds operating in the country, 62.2% have been incorporated as local vehicles under Decree 2555 of 2010, and 37.8% in other jurisdictions, such as Ontario, Delaware, etc.

Graph C – Capital by investor type, 2015



Gráfica D - Capital por tipo de inversionista a mayo de 2016



Capital by investor type
To estimate the share of investors in the aggregate of the industry, a sample of 54% of total commitments of private equity funds, which reported information on the profile of their investors, was taken. This sample shows that pension funds, with 39.8% of total commitments, are the main fund channels, which are represented by four players only: (i) Protección, (ii) Porvenir, (iii) Colfondos, and (iv) Old Mutual. This category is followed by other financial institutions (16.5%) and other (13.2%), in which we have identified profiles such as the Government, universities, professional managers and other confidential private investors. Fund of funds have had an increase in their share with respect to 2014, because they came to represent 7.9% vs. 3% in the past. This demonstrates a dependence of the majority of funds to leverage the growth of the industry on few investors.

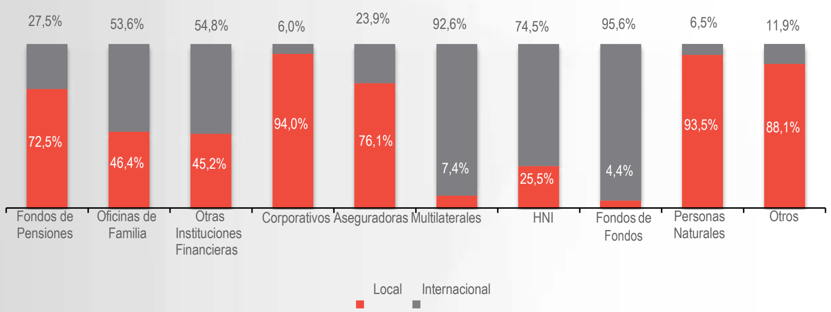
After these profiles, comprising most of the invested capital (77.5%), we find family offices (6,4%), whose share has decreased with respect to the immediately preceding year, followed by insurers, whose share increased from 5.0% to 5.9% of total capital commitments. This category includes companies such as Seguros Bolívar, Suramericana de Seguros and Global Seguros, which have been active in the industry since their inception and represent an important potential source of funds for the second round of capital fundraising.

Finally, there are the multi-lateral, corporate investors, individuals and high net worth individuals, which have found in the capital fund industry a profitable and attractive investment. Some of them include corporate investing groups represented by Colombian business groups, such as Grupo Empresarial Antioqueño (GEA).

Local vs. international investors
Colombia has become a focus of investment in Latin America and is increasingly receiving capitals through foreign investors. This has been possible mainly due to the improved macroeconomic and political context of the country, as well as the environment to do business, the protection of minority investors, and the strengthening of the entrepreneurial ecosystem. However, an atmosphere of uncertainty has been perceived in the last months, particularly among foreign investors, who prefer to wait to make decisions until they are sure about the conclusion of the peace process.

The private equity fund industry has been favored by the macroeconomic stability through investments of local actors, who account for 72.4% of capital commitments of the industry as of May 2016, despite a decrease with respect to 2014. This has meant a higher participation of international investors with respect to 2014, year in which they represented 19% of total commitments of the industry. The international investor profiles that stand out in the industry are the fund of funds, multi-lateral, high net worth individuals, financial institutions, family offices, among other categories.

Graph E – Number of local vs. international investors by investor type



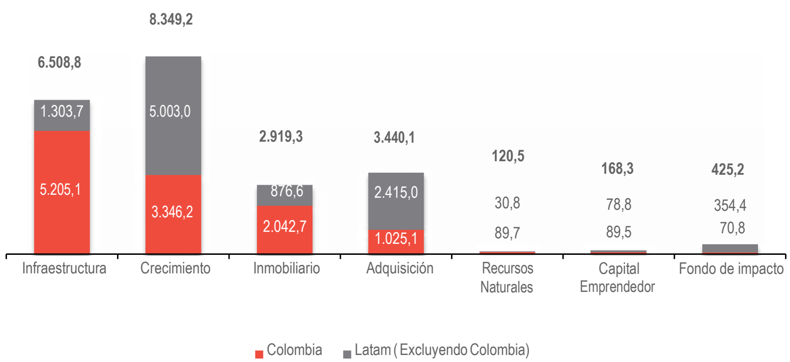
Capital commitments

After completing 11 years of activity, capital commitments of the private equity fund industry operating in Colombia as of May 2016 amount to 21,931.6 million for investments in Latin America; the amount increased by 15% with respect to 2014. This is represented by 82 active funds of which information is available. Now, if we only analyze the percentage of funds estimated to be allocated to investments in Colombia (23%), the size of the industry is quite favorable, because it accounts for 54.1% of total capital commitments, equivalent to the size of the local industry for USD 11,869 million.

As of May 2016, the industry has 44 funds with a regional focus (53.7%), 20 more funds than in 2014, and 38 funds with a local focus (46.3%) which, in different proportions, plan to allocate funds to leverage the growth of companies and projects in Colombia. Local funds allocate 100% of their funds to Colombia, while funds with regional focus distribute their funds to countries such as Colombia, Brazil, Mexico, Chile, Peru, Argentina, among others.

If we analyze the estimated capital commitments to invest in Colombia by fund type, infrastructure private equity funds have moved to the first position concerning the amount of commitments, a place that had been held by real estate funds. Capital commitments by fund type are shown in Graph F, where infrastructure private equity funds amount to USD 5,205.1 million, followed by growth funds with USD 3,346.2 million, real estate private equity funds with USD 2,047.7 million. Then, with lower amounts, we find purchasing funds with USD 1,025.1 million, natural resource funds with USD 89.7 million, venture capital funds with USD 89.5 million and, finally, impact funds with USD 70.8 million.

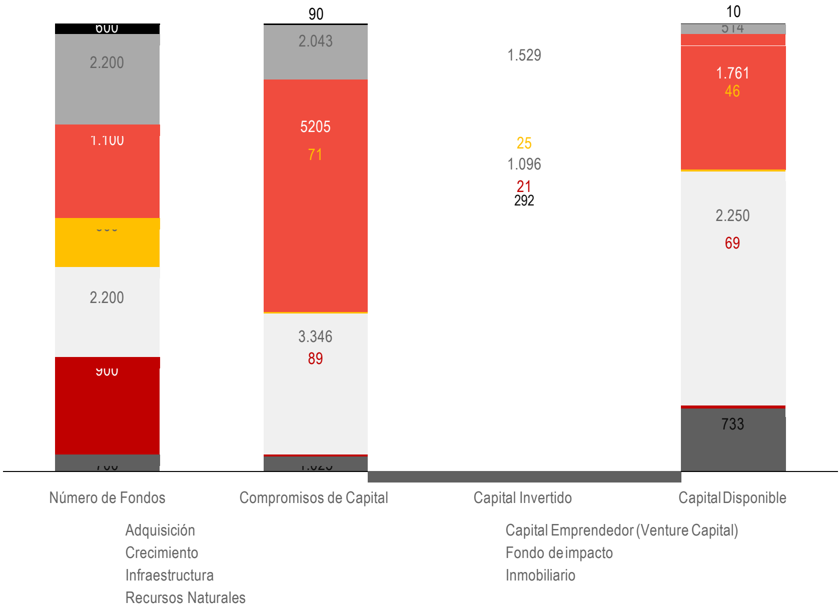
Graph F – Capital commitments 2005-2016 by fund type (millions of USD)



Below is a summary of the Colombian private equity fund industry by category, considering number of funds, estimated capital commitments for investment in Colombia and funds available to continue leveraging assets in the country in various sectors of the economy and different states of development (see Graph G).

Out of the 83 private equity funds, which have estimated capital commitments to be invested in Colombia, equivalent to USD 11,869 million, it is estimated that around USD 6,777.4 million have been invested and USD 5,383.4 are still available for investment. This shows the strong tendency of financing towards the infrastructure sector, compared to other resources distributed among the different fund categories.

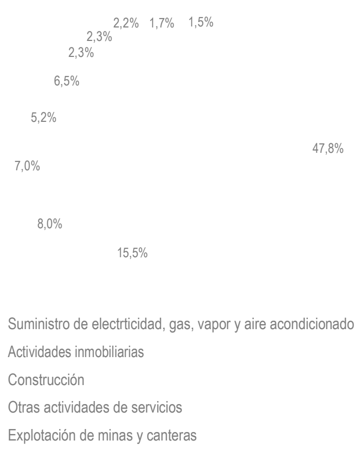
Graph G – Concentration of capital commitments by fund type (millions of USD)



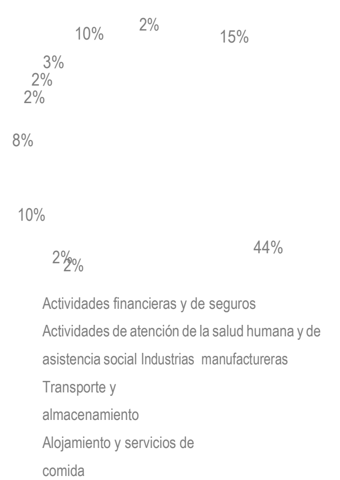
Investments by sector

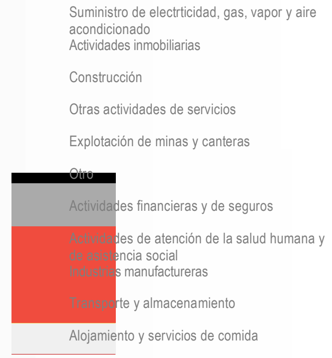
In Colombia, private equity funds have historically invested on the real estate and construction sectors primarily, a trend that has remained during 2014 and 2015. Nonetheless, for the study period, the ISAGEN purchase transactions marks a clear tendency towards investment in the energy sectors, as shown in Graph H.

Graph H – Historical investment by sector in Colombia (millions of USD) for 2016



Graph I – Historical investment by sector in Colombia (millions of USD) for 2015




Suministro de electrticidad, gas, vapor y aire acondicionado
Actividades inmobiliarias
Construcción
Otras actividades de servicios
Explotación de minas y canteras
Otro
Actividades financieras y de seguros
Actividades de atención de la salud humana y de asistencia social
Industrias manufactureras
Transporte y almacenamiento
Alojamiento y servicios de comida

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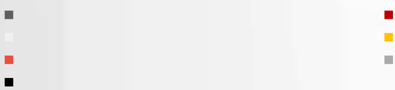

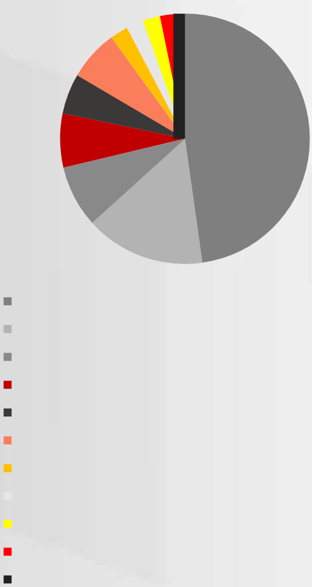

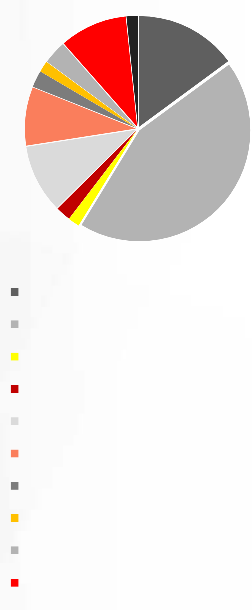

Investments in the energy, real estate, construction and services sector represent 78.3% of total investments made by private equity funds in Colombia, amounting to USD 5,304 million. This is followed by sectors of interest such as oil & gas, financial activities, health, manufacturing, transportation and storage, lodging and food services, and agriculture, accounting for 20% of investments that mobilize resources for USD 1,353.5 million. Finally, there are other sectors of the economy such as commerce, technology, water distribution, education, among others, which make up the remaining 1.7% for USD 120.2 million.

Investment expectations

In regard to forecasts of investment expectations in different Latin American countries, Colombia is currently the country of preference for the investment of funds with operations in the country (80.5%), followed by Peru (53.7%), with a significant difference compared to the investment interest in other countries of the region, such as Chile, Argentina and Brazil (26.8%, 18.3% and 13.0%, respectively), among others.

Concerning the prospect of investment in Colombia for 2016, the trend is for professional managers to maintain their investments (38.7%) and increase them by more than 10.0% (46.8%), expecting a good outlook in terms of future investments in the country.

Outflows

Between 2005 and May 2016, 128 outflows in Colombia and 43 outflows from private equity funds, both regional with operations in Colombia and local, have been identified in different countries in Latin America. Given the state of development of the industry in Colombia, outflow activity is expected to grow over the next four years due to the completion of entire life cycles by a significant number of private equity funds.

Major regulatory changes in the industry

The private equity fund industry has been very active on the regulatory front during the period between 2015 and the end of May 2016. However, according to the update of the Latin American Balance Score Card, published by LAVCA, while Colombia maintained the fourth place in the region, it decreased its rating in regulation standards. This is mainly due to the unequal treatment between real estate private equity funds and real estate mutual funds, the mandatory nature of an independent appraiser and the delays in the startup process of a private equity fund.

Many of these variables have been corrected by the Government as od the date of publication of this report. In addition, it is worth mentioning that the Financial Superintendence of Colombia has made an effort to meet the term of fifteen (15) business days from the filing of regulation for the issuance of a non-objection letter, which allows the fund to start operations. In this way, the procedure for creating private equity funds has been streamlined. In addition, regulatory changes made it possible once again to use private equity funds to invest in real estate assets, with tax efficiencies related to the possibility of deferring the distribution of profits for the duration of the vehicle, as well as the possibility of the capital private fund being managed by a professional manager not surveilled by the Financial Superintendence of Colombia.

Below is an overview of the major regulatory changes:

1. Real estate funds: Decree 1403 of June 2015 was issued, which establishes the possibility of investing up to 100.0% of the capital commitments of the private equity funds in real estate assets, equalizing the investment policy for real estate mutual funds and private equity funds. This corrects the market failure evidenced by LAVCA at the time of publishing its Balance Score Card.

2. **2. Modification of the investment system for compulsory pension and severance funds:**

   i) Decree 1385 of June 2015 was issued, which modifies the investment system for compulsory pension and severance funds, insurance companies and capitalization companies, in order to allow investment in private equity funds that in turn invest in infrastructure projects under Public-Private Partnership (PPP) schemes. In addition, an independent investment ceiling was created for the pension funds investment system to invest in private equity funds that in turn invest in infrastructure under PPP schemes**.**

   ii) Decree 765 of May 2016 was issued, which defined the categories of alternative assets, asset requirements under management for private equity funds abroad, limits on alternative assets, maximum share of a pension fund in a private equity fund, the regulation adjustment plan and the new category called “restricted assets”.

3. Independent appraiser: External Circular 015 dated March 2016 was issued, which amends Chapter XI of the Basic Accounting and Financial Circular, in relation to the rules for the valuation of assets included in the investment portfolios of private equity funds. This circular states that the assets in which private equity funds invest must be valued in accordance with the rules laid down in Chapter I-1 of the Basic Accounting and Financial Circular, unless such methodologies are applicable to a specific investment. In this case, different methodologies may be applied, provided they are technically recognized by the Financial Superintendence of Colombia. In addition, External Circular 015 establishes that the assets in which private equity funds invest must be valued by the price suppliers recognized by the Financial Superintendence of Colombia, unless the supplier does not have the valuation methodology or the technical capacity to conduct it. In this case, the company managing the fund may delegate the valuation to the professional manager of the vehicle or to an independent valuator.

4. Impact of tax reform on private equity funds: An analysis of the impact of the tax reform on the private equity fund industry was carried out, in the face of a major tax reform. The main concern of the industry was the possible elimination of the fiscal transparency principle that governs private equity funds through the tax reform. This could cause that, at the time of redeeming share units, investors receive profits first and used them to pay the income tax from initial redemption, without it necessarily reflecting the reality of the investments of the fund and considering that private equity funds are long-term closed-end investment funds.

5. Analysis of the modification to the National Pension Fund of Territorial Entities (FONPET as per its acronym in Spanish): The association supported the Government in the analysis of the FONPET investment system, in order to open the possibility of investing in private equity funds. In addition, it commented on the draft decree modifying the FONPET investment system, and suggested that FONPET be allowed to invest in any private equity funds, instead of private equity funds that only invest in road infrastructure under the Public-Private Partnership (PPP) scheme, whose contracting entity is the National Agency of Infrastructure (ANI as per its acronym in Spanish).

6. In the written replies to communications sent by some industry actors, the Financial Superintendence of Colombia stated that the term of six months from authorization of the fund regulation to start operations is not applicable to private equity funds, since the regulations of private equity funds are not subject to authorization, but to a non-objection process. In this sense, private equity funds may start operations at any time after receiving the non-objection letter on the regulation.