

DEVELOPMENT EFFECTIVENESS COMMITTEE

Chair's Summary of the Committee's Discussion on 27 August 2008

Special Evaluation Study on Private Equity Fund Operations

Financial Internal Rate of Return

1. **DEC** requested elaboration on the ADB's investment profitability rating of "unsatisfactory" given the 7.5% financial internal rate of return (FIRR) for the private equity fund (PEF) portfolio. **Staff, OED** explained that comparator institutions do not include the operating cost in their formula. Given the difficulties in obtaining the information, which was confidential in nature, it was difficult to conduct a comparative analysis. Management response on low FIRR on PEFs was that ADB's objective is not only to maximize profit; its operations must also have a development impact. The management further pointed out that the investment climate in Asia had also been disruptive to returns on funds due to the currency crisis.

Development Impact and Outcome and Safeguard Policies

2. **DEC** acknowledged the difficulty in measuring the development impact of PEFs. **DEC** took note of OED's assessment that the broader environment for PEF investments has changed substantially and that the leverage effect of ADB's participation in PEF has declined in emerging economies, particularly India and China. The focus for PEF for both country/region and sectors needs to be reassessed so also the balance between PEF and direct equity investment. **Director General, Private Sector Operations Department (PSOD)** responded that PEFs play a fundamental role in development of small and medium-sized enterprises (SMEs) in particular during the startup stage of business development. **DEC** noted that challenges will include striking a balance between a more pro-active PEF portfolio management, which includes facing style drift, and overseeing adherence to safeguard standards during the full PEF life-cycle.

Strategy for PEF

3. **DEC** emphasized that a detailed strategy with clear objectives, quantifiable indicators, and target benchmarks should be prepared. The strategy should indicate the countries, sectors, and types of firms ADB should engage in and also how the anticipated development impact could be measured. In doing so, information in the private investment securities management system (PRISMS) should be updated, and coordination with Regional Departments would be vitally important. The OED, together with the PSOD, could develop a template for annual reporting of the development impact of the ongoing PEFs.

4. **Director General, PSOD** noted that there currently exists a high degree of alignment between the PSOD portfolio and ADB's strategic and thematic priorities. Future PEF investments would be evaluated and managed to ensure alignment with these priorities. In addition, PSOD aimed to further explore the catalytic role that PEF investments play in so called "frontier" economies. He noted that outreach to Regional Departments would be high on PSOD's agenda, moving forward in order to strengthen harmonization of PSOD operations with country partnership strategies (CPSs). **Director General, PSOD** also noted that a strategic review of PEF would be undertaken in the months ahead and that this would help define themes and areas of engagement with high development impact. **Staff, PSOD** noted that the bulk of PEF transactions had been undertaken after 2002 and that these transactions had produced an

FIRR of over 20%. **Staff, PSOD** further noted that Management had produced a development impact study on PEF that was completed in the first quarter of 2007. This study had indicated a positive impact on employment, governance and environmental safety.

Resources

5. **DEC** noted that the adequacy of staff resources for the PEF portfolio would need to be examined to efficiently and effectively manage the operations, taking into consideration portfolio management, reporting, risk management and overseeing adherence to ADB safeguard policies.

Chair's Conclusions

6. **DEC** commended OED for the report. It urged Management to come out with a detailed strategy that could be in line with CPSs and implemented in operational as opposed to conceptual terms. These details should include the countries, sectors, types of firms, and styles of funds, in which PSOD intends to invest in PEF and form the basis of its business plan.

7. **DEC** noted the rate of return on PEF as 7.5% over the last 20 years, as opposed to the weighted average cost of capital, calculated by standard methodology, as 14.3%. Given this FIRR and the impact of PEF operations on the financial return in achieving development impact, it seems imperative to have a quantification of the development impact, as well as a comparison of the FIRR with those of other MDBs.

8. **DEC** recommends to Management and PSOD to develop an appropriate mechanism for quantification of development impact. It noted the lack of information regarding development impact in PRISMS.

9. The issue of change in the scope of various PEF investments in recent years was noted. Such changes may be unavoidable given the nature of the business, but what was important was to maintain proper reporting line on such matters. In this context, **DEC** endorsed the idea of a brief annual report on the individual funds and the portfolio, which would compare achievements with clearly identified major milestones and target benchmarks specified for the year.

10. **DEC** also noted that if PEF operations were to continue on an efficient basis, it would be essential to look at the issue of staff resources for such operations.

Ashok K. Lahiri
Chair, Development Effectiveness Committee