

Private Equity Fund Operations

- Private equity funds give small and medium enterprises access to technology and equity capital. Asia is the dominant destination for private equity in emerging economies—annual fundraising rose from \$2.2 billion in 2003 to \$23.1 billion in 2007, concentrating in India and the People's Republic of China.
- Half of ADB's outstanding capital commitments to private equity funds were approved from 2003. The portfolio is concentrated, with two countries making up half of investment (and four countries accounting for three quarters.) Regional, non sector specific funds dominate, forming half of investments. Telecommunications, transport, and utilities explain half of investments. A recent evaluation study rated operations "partly successful."

Background

Almost all **multilateral development banks** and bilateral development finance institutions invest in **private equity funds** to promote **small and medium enterprises** in **developing countries**. The **Asian Development Bank** (ADB) made its first investment in 1983. Between then and 31 December 2007, investments in 75 private equity funds were approved for a combined value of \$900 million. Such investments are now a core activity of the **Private Sector Operations Department** in ADB: at 31 December 2007, it had 40 active funds with a total approved value of \$676.4 million.

In 2007, building on work performed in 2002, the Operations Evaluation Department in ADB conducted a **Special Evaluation Study on Private Equity Fund Operations**¹ to identify how their contribution to private sector development might be enhanced. The portfolio was examined in terms of: (i) development outcomes and impacts, (ii) ADB investment profitability, (iii) ADB work quality, and (iv) ADB additionality.

Summary of Findings

The *development outcomes and impacts* of ADB's private equity fund operations were evaluated from the standpoints of (i) private sector development; (ii) business success; and (iii) environment, social, health, and safety performance. The private sector development criterion was assigned a rating of "satisfactory" due to generally positive beyond-company impacts, especially with regard to resource

mobilization, and evidence of positive direct company outcomes. But business success was less evident and assigned a rating of "partly satisfactory." Issues of environment, social, health, and safety appeared to have been addressed effectively and were judged "satisfactory." As development impacts in the past appear to have been positive, private equity funds are profitable (even if financial internal rates of returns have not exceeded their cost of capital), and environment and social performance met expectations, an overall rating of "satisfactory" was given to the development outcomes and impacts criterion.

ADB investment profitability has been improving but overall performance has been poor. The nominal financial internal rate of return for the portfolio was 7.5%, slightly more than 50% of ADB's average required rate of return for private equity funds of 14.3%. ADB investment profitability was rated "unsatisfactory."

ADB work quality was evaluated in consideration of (i) screening, appraisal, and structuring; (ii) monitoring and supervision; and (iii) ADB's role and contribution to the projects. The study noted that the screening process had demonstrated a lack of strategic focus, and the identification of investments has been primarily reactive in response to sponsors approaching ADB. Appraisal and structuring had been satisfactory. However, post investment approval, funds had often departed significantly from approved investment concepts and few mechanisms were available to the Private Sector Operations Department to mitigate this risk. Monitoring and supervision had been weak,

primarily due to disparity in the quality of reporting and weak information management systems. Once funding is committed, the department is largely dependent upon fund managers to achieve positive development and financial results by relying upon a combination of commercial incentives and a set of high-level investment restrictions that have little relationship with development objectives. As a result, the overall rating for ADB's work quality was "partly satisfactory."

ADB *additionality* was examined based on whether ADB finance had been a necessary condition for the timely realization of investments, and ADB's contribution and function had improved development impact. The study indicated that in the past ADB's participation had provided additionality by catalyzing private investment in private equity funds. However, this impact had been declining over time due to the continued focus on **India** and the **People's Republic of China**, where ADB's demonstration and risk mitigation impacts for private equity funds have been declining in recent years, as demonstrated by the rapid growth in private equity in these markets. Due to resource constraints, the Private Sector Operations Department had had limited ability to directly add value to private equity fund operations and strengthen their development impacts. The rating for ADB additionality was judged "partly satisfactory."

Assessment of ADB's Private Equity Fund Operations

Criterion	U	PS	S	E
Development Outcomes & Impacts			X	
• Private Sector Development			X	
• Business Success		X		
• Environment, Social, Health & Safety Performance			X	
ADB Investment Profitability	X			
ADB Work Quality		X		
ADB Additionality		X		

Legend: E = excellent, PS = partly satisfactory, S = satisfactory, U = unsatisfactory.

The overall assessment of ADB's private equity fund operations, as justified by the underlying ratings for development outcomes and impacts, ADB investment profitability, ADB work quality, and ADB additionality was "partly successful."

The study discerned issues touching: (i) the development justification of funds, (ii) the balance in ADB's portfolio between private equity funds and direct equity investments, (iii) lack of strategic focus of fund operations, (iv) style drift, (v) weaknesses in management reporting, (vi) the organizational framework for private equity fund operations in ADB,

and (vii) the adequacy of resources for managing the private equity fund portfolio.

Recommendations

ADB's Management was invited to consider:

- Strengthening country programming arrangements so there is better coordination within ADB at the country and sector level when seeking to develop the nonbank financial sector for private sector development.
- Preparing an operational strategy for private equity funds that would set out principles for managing the overall portfolio, and identify targeted countries and subnational regions, sectors, stages of firm development, styles and sizes of funds, and desired development impacts, for circulation to all regional departments.
- Upgrading portfolio planning and management and reporting systems for private equity funds to facilitate management as a standalone portfolio and reinforce development impact monitoring.
- Strengthening the risk-management systems for private equity funds by putting in place capacity to independently monitor projects post-approval from a financial, social, and environmental perspective.
- Clarifying organizational roles and responsibilities, with particular regard to making greater use of resident missions for operations in private equity funds, and the need to complement regional department operations.
- Allocating sufficient resources in the areas of budgeting and staff to efficiently and effectively manage operations in private equity funds.

Feedback

At the time of preparation of these *Learning Curves*, **ADB Management's Response** and the **Chair's Summary of the Development Effectiveness Committee Discussions** were not yet available for disclosure to the public. The study was completed in July 2008.

¹ ADB. 2008. *Special Evaluation Study on Private Equity Fund Operations*. Manila. Available: <http://adbweb/Documents/SES/REG/SST-REG-2008-17/SST-REG-2008-17.pdf>