



Report and Recommendation of the President to the Board of Directors

Project Number: 40936
June 2007

Proposed Equity Investment in JS Private Equity Fund I LLC

In accordance with ADB's public communications policy (PCP, 2005), this abbreviated version of the RRP excludes confidential information and ADB's assessment of project or transaction risk as well as other information referred to in paragraph 126 of the PCP.

Asian Development Bank

CURRENCY EQUIVALENTS

(as of 7 December 2006)

Currency Unit	–	Pakistan rupee/s (PRe/PRs)
PRe1.00	=	\$0.016
\$1.00	=	PRs 60.77

ABBREVIATIONS

ADB	–	Asian Development Bank
CEO	–	chief executive officer
CSP	–	country strategy and program
DMC	–	developing member country
EMS	–	environmental management system
IPO	–	initial public offering
JS&Co	–	Jahangir Siddiqui & Co. Ltd.
PSOD	–	Private Sector Operations Department
SME	–	small and medium-sized enterprise

NOTES

- (i) The fiscal year (FY) of the Government of Pakistan ends on 30 June. FY before a calendar year denotes the year in which the fiscal year ends, e.g., FY2005 ended on 30 June 2005.
- (ii) In this report, "\$" refers to US dollars.

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I. INVESTMENT PROPOSAL

1. I submit for your approval the following report and recommendation on a proposed equity investment in JS Private Equity Fund I LLC (the Fund) of up to \$20 million or 25% of the Fund's total committed capital, whichever is less. The Asian Development Bank (ADB) will not be the single largest investor in the Fund.

II. RATIONALE: BACKGROUND, CHALLENGES, AND OPPORTUNITIES

2. Bounded by economic powerhouses the People's Republic of China and India, the improvement in Pakistan's economy in recent years may not have been equally captured in the media. Pakistan's economy, however, is on the move. Growth is strong, companies and corporate governance are maturing quickly, and entrepreneurial companies are hungry for diversified sources and types of financing. Key among the financial tools that Pakistan needs to help its businesses develop quickly and in a sustainable manner is private equity funding, an essential ingredient for helping small- and medium-sized enterprises (SMEs) strengthen corporate governance, improve environmental and social standards, develop their business models to boost exports (thus strengthening the country's balance of payments), and expand their operations to create jobs for people in the community (thus helping to reduce poverty). In a frontier economy such as Pakistan, these challenges are all the more pronounced, and private equity financing plays an even more profound development role.

A. Challenges and Opportunities

3. **Strong Macroeconomic Performance.** Pakistan's recent macroeconomic performance has been very strong, driven by an improved foreign exchange position, prepayments of expensive debt, and an economic agenda focused on governance reforms, privatization, and deregulation. Gross domestic product grew 8.35% in fiscal year (FY) 2005; the estimate for FY2006 is 6.5%, outstripping regional averages. The economy is anticipated to continue delivering strong growth in 2007. Per capita income in nominal terms has been growing at an average annual rate of 13.5% for the past 3 years. Foreign direct investment increased from \$949 million in FY2004 to \$1.7 billion in FY2005, and surged to \$2.22 billion during the first 9 months of FY2006.¹ In February 2004, Pakistan returned to the international capital markets after a gap of more than 5 years, with a \$500 million 5-year Eurobond that was oversubscribed by four times. Both Moody's and Standard & Poor's have upgraded their credit ratings of the country in the last 18 months by one notch, to B2 from Moody's, and B+ for foreign currency and BB for local currency from Standard & Poor's. According to the *Asian Development Outlook 2006*, this strong growth is anticipated to continue over the medium term.²

4. **Financial Sector Reform.** Benefiting from ongoing reforms, the financial sector has not only recorded visible changes in its size (growing larger) and ownership structure (increasingly dominated by the private sector in response to the Government's privatization policies), but also in its key performance indicators. Performance indicators reflect the sector's resilience to both internal and external shocks (as evidenced by its increased risk absorption capacity, measured by higher equity-to-liability ratios), and its increasing efficiency (evidenced by narrowing spreads and net interest margins). Additionally, the State Bank of Pakistan and the Securities and

¹ Wikipedia. 2006. *Economy of Pakistan*. Available: http://en.wikipedia.org/wiki/Economy_of_Pakistan.

² Unless otherwise footnoted, data in this paragraph are from ADB. 2006. *Asian Development Outlook 2006*. Manila. Available: <http://www.adb.org/Documents/Books/ADO/2006/pak.asp>.

Exchange Commission have put great effort into bolstering the country's financial infrastructure. The State Bank has undertaken a comprehensive revision of the prudential regulations framework, and issued separate sets of regulations for different participants in the financial sector (i.e., commercial lending, SMEs, consumer financing). The State Bank has also issued regulations for the financial derivatives business and started the process of implementing Basel II. Supporting these financial sector reforms, the legal framework has been updated to strengthen the mechanisms for recovery of outstanding dues by financial institutions. The economy has demonstrated strong recent growth in financial savings, bolstered by robust inflows of remittances. The interest rate scheme, which previously suffered from severe distortions, has become substantially less distorted over the last several years due to measures taken by the Government. Banking spreads have declined significantly over the last several years, as competition among banks has increased. Thus, Pakistan's financial sector has undergone significant reforms and has improved substantially over the last several years.³

5. **Strengthened Corporations and Corporate Governance.** This macroeconomic revival and increasing health of the financial sector is translating into improving corporate fundamentals and governance. Pakistan's corporate sector has repeatedly posted improved earnings results over the last several years, as reflected in a stock market that has outperformed all other Asian markets. An important factor behind the improved corporate performance has been the emergence of a new generation of Pakistani business leaders, often having been educated abroad and with experience in international companies; they are implementing world-class management practices, governance standards, and increased transparency. These improvements are translating into sustained improvements in corporate earnings and valuations attached to those companies. In its October 2005 *Journey to Pakistan* research report, CLSA Asia-Pacific Markets was "positively surprised by the high levels of corporate transparency. Listed companies publish quarterly balance sheets and income statements, disseminate a considerable amount of information through their websites, and follow international accounting standards."

6. **Expanding Financing Options—Availability of Debt.** Stronger, better managed corporations are increasingly able to source expansion capital in the form of debt. Historically, raising debt funding at the corporate level in Pakistan was relatively complicated; the banking institutions were primarily public sector owned and, through a combination of inefficiency and lack of incentives, were not active providers of debt finance. The debt capital markets in Pakistan were also relatively small, with the first corporate bond issue only taking place in 1995. However, with deregulation and liberalization of banking over the last 5 years, a greater range of private sector banking institutions is aggressively pursuing the corporate lending market, allowing corporations access to debt financing for the first time.

7. **Serious Financing Gaps.** Despite all of this positive news for the Pakistan business sector, growing companies need equity as well as debt, and the private equity industry is almost nonexistent. While corporate foreign direct investment in Pakistan has yielded healthy returns to international investors in the past 4 or 5 years, Pakistan has been largely ignored by emerging market private equity fund managers. Additionally, Pakistani financial institutions investing in private equity face regulatory and legal constraints: (i) investment banks require Securities and Exchange Commission of Pakistan approval on a deal-by-deal basis for any investment into unlisted equity, which is complicated and time-consuming; (ii) mutual funds are prohibited from investing in unlisted equity; and (iii) commercial banks may only invest up to a total of 30% of

³ State Bank of Pakistan Research Department. 2006. *Pakistan Financial Sector Assessment 2004*. Available: <http://www.sbp.org.pk/publications/FSA-2004/index.htm>.

their own equity in either listed or unlisted securities. These restrictions mean that private equity investing has effectively been left to high net worth individuals (either directly or through their business groups), securities firms, and some nonresident Pakistanis. Although several dedicated private equity funds are expected to close soon (one launched by Abraaj Capital and BMA Capital, another by Small Enterprise Assistance Funds and TMT Ventures, as well as several others such as Habib Group, Actis, and a few hybrid funds), these funds are very new and relatively small. Indeed, the *Asian Venture Capital Journal* does not list any dedicated funds currently operating in Pakistan, creating a huge constraint for companies seeking this form of financing. The absence of professional private equity funding has, in the past, forced growth companies to seek capital from the public markets at a relatively early stage.

8. **Opportunities for Private Equity.** While underdevelopment of the private equity industry is a major constraint for the economy, it creates a formidable opportunity for the Fund. Competition for the Fund is limited from either local or international institutions as the private equity industry is truly in its initial stages of development. The Fund Manager possesses the requisite private equity skills and experience, and will offer an attractive alternative to growth companies rather than premature initial public offerings (IPOs), allowing them a “breathing space” to build greater value before accessing public markets.

B. Development Impact

1. Development Objectives

9. **Portfolio Companies.** By investing in the Fund, ADB intends to achieve the following development objectives for portfolio companies:

- (i) **Create jobs and support growth of companies.** The Fund will invest in portfolio companies, which will use the invested money for growth and expansion, thus developing individual companies in the private sector, and creating jobs and sustainable employment in the community. In growing companies, jobs are needed at all skill levels, thus generating employment across the socioeconomic spectrum, including for the lower income tiers, particularly critical in a frontier economy such as Pakistan. These companies’ growth frequently results in entrance or deeper penetration into export markets, thus contributing positively to the country’s balance of payments position.
- (ii) **Build higher quality companies that raise overall industry standards.** The Fund will provide management advice to entrepreneurial companies on financial planning, business expansion strategies, human resource development, technology, environmental and social issues, and implementation of international best practices of corporate governance, thus raising the quality of individual companies. These international best practices encompass not only business models, but also standards for corporate governance and environmental and social compliance, thus creating not only more profitable, but also more sustainable, businesses. As companies in the industry are forced to compete on all of these fronts for market share and financing, the degree of sophistication and efficiency of the whole industry will increase.
- (iii) **Provide knowledge transfer and management skills training.** The Fund will provide advice to the management teams of portfolio companies. In addition to contributing to stronger, more sustainable companies, this management advice

will serve to develop a cadre of local business professionals with needed managerial skills. These local professionals will either stay with the company, or leave to join other firms, thus supplying the industry with skilled managers.

- (iv) **Support financial diversification.** The Fund's equity investments into portfolio companies will diversify the sources of finance available to them. Companies that have access to equity financing are then able to (a) obtain bank loans based on their debt-to-equity ratios, and (b) buy fixed assets to use as collateral for secured loans. This dynamic process of leveraging their expansion helps medium-sized companies graduate to larger enterprises and eventually raise capital by listing on the stock exchange.
- (v) **Contribute indirect effects and externalities.** In addition to the direct contributions to economic development, the Fund will make several indirect, but important, contributions: (a) the Fund's investments will be used for the growth and improvement of portfolio companies, which will result in increased taxable revenues that the Government can direct to social services and infrastructure requirements; (b) the Fund will invest in innovative companies that provide demand-driven products and services, the availability of which improves the standard of living for people in the community; (c) the Fund's portfolio companies will often use inputs to production, sourced from local companies, creating upstream linkages and benefits for the producers of the inputs; and (d) the private sector jobs created at portfolio companies will contribute to an employed middle class, which serves as a vehicle for the country's long-term economic progress and overall stability, and which indirectly supports poverty reduction.

10. **Private Equity Industry.** An investment in the Fund will develop the private equity industry, in four specific ways:

- (i) **Asset class.** ADB's investment will help demonstrate the credibility and potential of private equity in Pakistan. The private equity industry is severely underdeveloped as compared with those of more economically developed countries that actively utilize private equity to foster local management capacity and demonstrate a return on investment in entrepreneurial SMEs.⁴ ADB's investment in the Fund will help to develop the asset class and, by demonstrating the potential of private equity, will attract more firms to enter the market, deepening the penetration and growth of the asset class.
- (ii) **The market.** The Fund's interaction with companies in the market will help to educate the management teams of existing and potential portfolio companies with regard to the private equity asset class and its advantages as a financing tool. This will increase demand for the product, and increase the amount and quality of deal flow for private equity firms operating in the market.

⁴ The following research papers provide insights into this subject: (i) Doran, A. and Graham Bannock. 2000. Publicly Sponsored Regional Venture Capital: What Can the UK Learn from the US Experience? *Venture Capital* 2 (4): 255–285; (ii) Dossani, Rafiq, and Martin Kenney. 2002. Creating an Environment for Venture Capital in India. *World Development* 30 (2): 227–253; (iii) Harrison, R. and Colin Mason. 2000. The Role of the Public Sector in the Development of a Regional Venture Capital Industry. *Venture Capital* 2 (4): 287–311; and (iv) Kim, Seon-Jae and Youngki Hahn. 1998. Venture Capital Industry and Its Role in the United States Economy: Relevance of the United States Model to the Economy of the Republic of Korea. *Asia Pacific Development Journal* 5(2): 99–116.

- (iii) **The Fund.** The Fund will help to develop a class of fund managers and financial professionals in Pakistan. The majority of the Fund's management team is comprised of native Pakistanis. ADB's support of a truly local team helps ensure the growth and perpetuation of the private equity industry in Pakistan, which contributes to the development of the financial sector more broadly.
- (iv) **Portfolio companies.** ADB's investment will mobilize long-term risk capital for the Fund's portfolio companies from private sources for entrepreneurial companies to finance expansion and improvement.

11. **Information Collection.** The Fund will be required to collect consistent information on regulatory issues and challenges encountered by their portfolio companies. This information will be reported on a regular basis to ADB, to allow for better understanding of the key regulatory and legal constraints faced by entrepreneurial companies in the region. ADB is expected to use this understanding of the regulatory environment to have productive discussions with governments in the region, to help them address key constraints, and to encourage them to support regulatory frameworks conducive to entrepreneurship and SME development. Thus, in addition to its direct impact on employment and economic growth, the Fund will in this manner contribute to the development of an effective and well-functioning regulatory and legal environment in Pakistan.

2. Value Added by ADB

12. **Catalytic and Demonstration Effect.** Given the significant risks and challenges facing potential investors as well as the emergent nature of the Pakistan private equity industry, ADB will serve a catalytic role in helping to attract additional local and foreign private equity regionally. ADB will demonstrate by its intervention the credibility of private equity in its developing member countries (DMCs) and mobilize capital to support other private equity funds.

13. **Private Sector Development.** The Fund, similar to others in which ADB invests, will make a direct contribution to private sector development. The Fund will employ market-based mechanisms to develop profitable and sustainable enterprises. ADB's contribution to this type of initiative helps its DMCs implement their country-specific private sector development strategies, and through its focus on governance and environmental and social safeguards, helps its DMCs to implement these strategies in a responsible, sustainable fashion.

14. **First-Time Fund Manager and Work in Frontier Area.** Through this investment, ADB will be adding particular value by supporting a first-time fund manager in a country in which the lack of fund management teams is a serious constraint to the development of the private equity industry. Additionally, ADB will be supporting a transaction in one of its frontier DMCs, in which the challenges of attracting investment are among the most profound. This transaction, important in its own right, will increase knowledge of investments in frontier areas within ADB's Capital Markets and Financial Sectors Division, a key focus for the group.

3. Development Outcome

15. ADB will measure development outcomes of the Fund and subprojects, as well as beyond the Fund by monitoring certain performance measures for the duration of the Fund. Performance measures beyond the Fund will be monitored for indicative purposes, although the Fund on its own may be considered only a contributing factor among many other driving forces.

- (i) **Fund and subproject measures.** Performance measures to be considered during monitoring include (a) annual employment growth by subproject, (b) annual net profits of the subprojects, (c) value addition in terms of corporate governance improvement measures undertaken at the subproject level, (d) efforts to influence positive regulatory changes at the Fund and subproject levels, (e) ongoing access to debt and equity (including growth in retained earnings) financing for expansion purposes, and (f) annual taxes paid. Specific performance measures may be adapted for individual subprojects as relevant and useful for determining overall development effectiveness of the Fund.
- (ii) **Macro measures.** Performance measures employed and monitored beyond the Fund will include (a) growth in private equity in the Fund's target area, and (b) improvement in the region's overall employment rates by SMEs.

16. Quantitative and qualitative measures of performance are detailed in Appendix 1.

III. THE PROPOSED INVESTMENT

17. The Fund Manager's investment objective for the Fund is to achieve long-term capital appreciation by investing in companies with high potential that are operating in Pakistan. The Fund will make equity, quasi-equity, and debt investments using a variety of instruments, including ordinary or preferred shares, warrants, options, convertible debt, and debt in various forms. The Fund will invest in companies that derive a substantial portion of their revenues or profits from Pakistan in order to capture the value created during the current upward economic trend and deliver attractive returns to the Fund's investors.

18. The Fund will enter into a management agreement with JSPE Management LLC (the Fund Manager), which will employ the management team, based in Pakistan and Dubai. The Fund will have an investment committee that recommends investments to the Fund Manager.

19. One of the most important aspects of the Fund's competitive advantage derives from the past and ongoing relationships that the individuals of the fund management team have with JS&Co. JS&Co is one of the largest and best regarded financial services groups, and a diversified investor in Pakistan.

IV. INVESTMENT BENEFITS, IMPACTS, AND RISKS

A. Social and Environmental Safeguard Policies

20. The Fund will not invest in excluded activities, such as weapons, tobacco, gambling, pornography, activities involving forced labor or child labor, or in any other industry falling within ADB's list of exclusions.

21. ADB's investment in the Fund is classified as category FI (financial intermediary) under ADB's *Environment Policy* (2002). The Fund Manager will be required to adopt an environmental management system.

22. ADB's investment in the Fund is classified as category C under ADB's policy on *Involuntary Resettlement* (1995); no involuntary settlements are foreseen in relation to any investments by the Fund. The Fund will adopt a resettlement framework that defines the policies, procedures, roles, and responsibilities of the Fund for screening and managing involuntary resettlement by portfolio companies, if any.

23. ADB's investment in the Fund is classified as category C under ADB's *Policy on Indigenous Peoples* (1998) and no investments by the Fund are expected to have an impact on indigenous peoples.

B. Anticorruption, and Combating Money Laundering and Financing of Terrorism

24. The Fund Manager was advised of ADB's policy paper *Anticorruption* (1998)⁵ and policy relating to the combating of money laundering and the financing of terrorism.⁶ Consistent with its commitment to good governance, accountability, and transparency, ADB will require the Fund Manager to institute, maintain, and comply with internal procedures and controls following international best practice standards for the purpose of preventing corruption or money laundering activities or the financing of terrorism, and covenant with ADB to refrain from engaging in such activities. The investment documentation between ADB and the Fund will allow ADB to investigate any violation or potential violation of these undertakings.

V. ASSURANCES

25. Following the approval of the proposed investment by ADB's Board of Directors, ADB will enter into suitable investment documentation, and ensure that such documentation and other principal agreements relating to the Fund (including the Management Agreement between the Fund and the Fund Manager) will be on terms and conditions acceptable to ADB and incorporate all relevant ADB policies.

VI. RECOMMENDATION

26. I am satisfied that the proposed investment in JS Private Equity Fund I LLC as described in this report complies with the Articles of Agreement of ADB and acting in the absence of the President, under the provisions of Article 35.1 of the Articles of Agreement of ADB, I recommend that the Board approve the investment in JS Private Equity Fund I LLC of up to the lesser of \$20,000,000 or 25% of the Fund's total committed capital from ADB's ordinary capital resources.

Liqun Jin
Vice President

22 June 2007

⁵ ADB. 1998. *Anticorruption*. Manila.

⁶ ADB. 2003. *Manual on Countering Money Laundering and the Financing of Terrorism*. Manila.

PERFORMANCE MEASURES FOR DEVELOPMENT OUTCOMES

Concept	Impact	Performance Measures (Qualitative and/or Quantitative)
A. Business Performance (Fund)		
<ul style="list-style-type: none"> • Financial objectives 	<ul style="list-style-type: none"> • Overall profitability of the Fund 	<ul style="list-style-type: none"> • Gross internal rate of return (database)^a • Net internal rate of return (database)
B. Economic Sustainability (Fund and Subprojects)		
<ul style="list-style-type: none"> • Efficient allocation of finance and/or provision of financial services to economically viable enterprises 	<ul style="list-style-type: none"> • Subproject economic performance • Stronger local entrepreneurship 	<ul style="list-style-type: none"> • Annual net profit of subproject (database) • Annual net revenue of subproject (database) • Number of entrepreneurial projects receiving finance from the Fund (database) • Number of returning entrepreneurs and skilled workers from industrialized countries receiving finance and transferring skills (database)
	<ul style="list-style-type: none"> • Contribution to widening the access to finance of small- and medium-sized enterprises • Provision of value-added services, enhancing the viability of small- and medium-sized enterprises 	<ul style="list-style-type: none"> • Additional debt raised by subprojects as a result of the equity investments (database) • Number of enterprises advised (database) • Quality of advice in financial planning, expansion strategies, human resource development, accounting standards, corporate governance, and management training (PCR)
	<ul style="list-style-type: none"> • Contribution to widening infrastructure companies' access to finance 	<ul style="list-style-type: none"> • Additional debt raised by subprojects as a result of the equity investments (database)
<ul style="list-style-type: none"> • Additional direct contributions of subprojects to the local economy 	<ul style="list-style-type: none"> • Contribution to government revenues • Employment generated 	<ul style="list-style-type: none"> • Increased amount of taxes paid by subprojects (database) • Number of jobs created by subprojects (database) • Quality of jobs created by subprojects, e.g., technical jobs (PCR)
	<ul style="list-style-type: none"> • Adoption of new technologies and production processes 	<ul style="list-style-type: none"> • Increased investment in new technologies and/or in improvement of production processes by subprojects (PCR)

Concept	Impact	Performance Measures (Qualitative and/or Quantitative)
	<ul style="list-style-type: none"> • Positive externalities of the subprojects in the targeted sectors, such as additional handling volumes in ports, and passengers and cargo transported through airports 	<ul style="list-style-type: none"> • Number of subprojects implementing successful new technology (PCR) • Increased quality/lower price of subproject's product due to investment in technology (PCR) • Actual capacity utilization of infrastructure company once operations have started (PCR) • Comparison of actual capacity utilization achieved by each infrastructure subproject with capacity utilization originally targeted (PCR)
C. Private Sector Development (Impact beyond Fund and Subprojects)		
<ul style="list-style-type: none"> • Contribution to the growth of viable financial institutions and financial market development 	<ul style="list-style-type: none"> • Positive impact on regional integration • New technology, development of management skills, and employee training in domestic financial sector • Resource mobilization through private equity • Growth in financial services in the domestic financial markets^b • Financial institutions induced to provide long-term equity to private equity funds and infrastructure subprojects by demonstrating commercial viability 	<ul style="list-style-type: none"> • Number of companies enabled to expand regionally through the Fund's provision of equity capital (PCR) • Number of companies enabled to expand regionally through the Fund's support in upgrading management systems (PCR) • Number of local investment professionals trained by the Fund (PCR) • Number of the Fund's investment professionals raising a subsequent fund in financial sector of a developing member country (PCR) • Mobilized domestic finance by the Fund (at final closing) • Mobilized international finance by the Fund (at final closing) • Growth in private equity market in the domestic financial sector (PCR) • Increased access to long-term finance (PCR) • Number of Fund's investment professionals raising a subsequent fund in financial sector of a developing member country (PCR) • Fund manager raising a subsequent fund (PCR) • Enhanced future private sector funding for infrastructure subprojects (PCR)

PCR = project completion report.

^a Performance measures followed by "database" will be monitored regularly in the framework of the Private Sector Operations Department's database for funds. Performance measures followed by "PCR" will be measured at the PCR stage.

^b Growth in financial services in the domestic market will be measured at the level of the economy, not of the Fund.

Source: Asian Development Bank's Private Sector Operations Department.