



Report and Recommendation of the President to the Board of Directors

Project Number: 40913
May 2006

Proposed Equity Investment Asia Healthcare Fund L.P.

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

ABBREVIATIONS

ADB	– Asian Development Bank
CSP	– country strategy and program
DMC	– developing member country
GPS	– good practice standards
IPO	– initial public offering
IRR	– internal rate of return
LBO	– leveraged buyout
M&A	– merger and acquisition
PRC	– People’s Republic of China
PSOD	– Private Sector Operations Department
R&D	– research and development
SCPA	– Schroder Capital Partners (Asia)
SME	– small- and medium-sized enterprise

NOTE

In this report, “\$” refers to US dollars.

Vice President	L. Jin, Operations Group 1
Director General	R. Bestani, Private Sector Operations Department (PSOD)
Director	W. Willms, Private Sector Operations Division, PSOD
Team leader	V. John, Principal Structured Finance Specialist, PSOD
Team member	J. Klein, Structured Finance Specialist, PSOD

CONTENTS
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	Page
I. THE PROPOSAL	1
II. MARKET OPPORTUNITY	1
III. THE PROPOSED FUND	4
A. Objectives and Description	4
B. Fund Management	4
C. Governance Structure	5
IV. INVESTMENT BENEFITS, IMPACTS, AND RISKS	5
A. Justification	5
B. Measuring Development Effectiveness	7
C. Environmental Protection and Social Safeguard Policies	8
D. Anticorruption Policy; Combating Money Laundering and the Financing of Terrorism	8
V. ASSURANCES	9
VI. RECOMMENDATION	9
APPENDIXES	
1. Performance Measures for Development Outcomes	10

I. THE PROPOSAL

1. I submit for your approval the following report and recommendation on a proposed equity investment in Asia Healthcare Fund L.P. (the Fund) of up to \$20 million or 25% of the Fund's total capital, whichever is less.

II. MARKET OPPORTUNITY

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2. The current dynamics of the health care industry in Asia are creating great opportunities for a private equity fund focused on health care. The drivers for this phenomenon include (i) rapidly escalating demand for health care services within Asia and abroad, (ii) comparative advantage for production and delivery of health care services in Asia, (iii) increasing supply of companies meeting health care needs, (iv) significant requirements for health care financing, and (v) lack of appropriate financing modalities for the health care industry.¹

3. **Escalating Demand for Health Care Services in Asia.** Demand for health care services is rising dramatically across Asia because of pressures from within Asia and overseas. Within Asia, the sharp escalation in demand is due to fast economic growth and increases in income in large emerging economies such as the People's Republic of China (PRC) and India. This has resulted in (i) large numbers of people moving out of poverty, (ii) increased consumer spending by a growing middle class, and (iii) huge unmet demand for world-class facilities and medical care.² In addition, in developed overseas markets such as the United Kingdom and the United States, macroeconomic trends—particularly rising costs related to every aspect of the health care industry—are putting huge pressure on the health care system.³ These cost increases are gradually leading companies to seek lower-cost alternatives, and the need to outsource and move various activities offshore has increased dramatically. American and European companies are looking aggressively toward Asia's emerging economies as a new location for research and development (R&D), manufacturing, drug discovery, and medical services.⁴

4. **Comparative Advantage of Emerging Asia.** India and other emerging economies in the region are well positioned to capitalize on this dramatic increase in demand. In particular, India's advantages include the following: (i) a well-educated pool of scientific and engineering talent, (ii) a large number of US Food and Drug Administration-approved facilities, (iii) intellectual property that conforms to World Trade Organization patent standards, (iv) a growing variety of biopharmaceutical business models, (v) increasing recruitment of overseas affiliates, and (vi) superior growth potential for the services sector. Perhaps the most pronounced comparative advantage in emerging Asia is cost. In India, as compared to costs in

¹ Analysis of the background and opportunity will focus primarily on India, where the majority of the Fund's capital will be invested.

² Health care spending represents only 5.5% of gross domestic product (GDP) in the PRC and 5.1% of GDP in India, compared with 13.9% of GDP in the US. This low level of spending is also reflected in health care expenditures per capita, number of hospital beds per 1,000 people, and other figures.

³ These include (i) rapidly rising medical costs, increases in drug prices, and poor hospital cost containment; (ii) rising cost of medical innovation (cost of new drug now as high as \$800 million or more, high cost of medical device development); (iii) patent expiration (\$15+ billion exposure to patent expiry by 2010); and (iv) gaps in the drug discovery pipeline.

⁴ According to HSBC Global Research, global outsourcing and moving offshore of health care services is an industry currently worth about \$220 billion, with annual growth prospects of 8–10%. A conservative HSBC forecast predicts that India should be able to claim \$12 billion annually by 2015.

more developed economies, overall R&D costs are about one eighth; manufacturing costs are 20–40%; and overall clinical development costs are about 40–50%.

5. Growing Supply of Health Care Services in Asia. The high demand for health care services and advantageous positioning (paras 2–4) has led Asian developing countries, particularly India, to develop an increasing, high-quality supply of health care services. For example, India's pharmaceutical exports have grown by about 22% per year for the last 10 years, and are projected to double between 2004 and 2007. The number of Indian companies in the top 10 pharmaceutical companies operating in India has grown from 4 out of 10 in 1994 to 9 out of 10 in 2005. With regard to medical services, the quality of India's hospitals is rising, to the point of now being certified and benchmarked against their global counterparts. In terms of drug discovery, Pfizer Inc. intends to enter into R&D in India, citing the Government's pro-innovation stance as a motivating factor, while Merck & Co., Inc. (which has been absent from India for 18 years) has announced that it will set up a subsidiary in the country. All along the value chain, more companies in India and other economies in the region are emerging to supply health care services to meet escalating global demand.

6. Rapidly Increasing Need for Capital for Health Care Companies. The emerging strength and positioning of the Indian health care industry—bolstered by the country's strong macroeconomic growth and pressures from abroad—can only be solidified through huge capital investment. The requirements for financing the health care industry are enormous. In India alone, it is estimated that dramatic improvements need to be made over the next 5 years in key aspects of the health care services industry (including coverage, purchasing, and delivery) at an estimated cost of \$22 billion—80% of which will have to come from the private sector.⁵ A similar scale of financing requirements can be estimated for other countries in emerging Asia. Clearly, a number of financing modalities are essential.

7. Constraints to Financing for Health Care Companies. Despite the huge need for financing, companies in the health care industry in India and other countries in the region face serious funding constraints.

- (i) **Bank borrowing.** Banks typically prefer lending to more mature companies, so smaller companies face high borrowing costs and frequently unacceptable loan conditions (e.g., personal guarantees and excessive collateral). In addition, banks often rely on lending methodologies that require immediate commencement of loan repayments, which are not viable for fast-growing companies.⁶
- (ii) **Debt-to-equity ratios.** Banks monitor debt-to-equity ratios strictly, so equity is often a precondition for loan disbursement even if banks are willing to lend. This makes bank loans unavailable in the absence of equity.
- (iii) **Public offerings.** Initial public offerings (IPOs) are more easily achieved in India than other emerging markets in Asia. However, a public listing is no guarantee of liquidity, and a premature IPO can bring the burden of compliance with listing regulations without the associated benefits of listing.⁷

⁵ CII and McKinsey & Company. 2002. *Healthcare in India: The Road Ahead*. New Delhi: CII & McKinsey.

⁶ In the pharmaceuticals industry, for example, investments in plants and machinery can often take several years to yield cash returns, but banks often require interest and principal repayment to begin upon loan effectiveness.

⁷ Although India's stock market has over 7,000 listed companies, only 100 companies account for over 99% of trading volume across India's stock markets, and more than half of listed companies are not traded at all.

Given these constraints, companies in the health care industry in India can benefit from taking private equity.

8. **Shallow Private Equity Market in India.** India's private equity industry is segmented into different investment ranges and each segment is populated by only a small number of funds. Several dozen funds are operating in India, but no other fund specifically addresses the \$10 million–\$40 million investment range in the health care sector, which the Fund would target. Although other funds have health care, biotech, and pharmaceuticals companies as small portions of their portfolios, no other fund has the deep industry knowledge that is the Fund's comparative advantage. The Fund will focus on creating deals by providing not only capital, but also technology, operational expertise, access to markets, and a manager's viewpoint from ex-chief executive officers.

9. The Fund will capitalize on the dynamics of significant unmet demand for private equity financing of burgeoning health care industries in Asia's emerging economies to generate profits and deliver developmental impact for its portfolio companies throughout the region.

III. THE PROPOSED FUND

A. Objectives and Description

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10. The primary objective of the Fund will be to achieve superior returns for its investors—primarily in the form of long-term capital appreciation—through investments in health care companies in India and other emerging Asian markets. The Fund will make investments in companies focused on manufacturing of pharmaceutical and biotechnology drugs, medical technology and devices, health care services, and drug development services.

B. Fund Management

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11. The Fund will be managed by the general partner (the General Partner), East West Capital Partners Ltd, a company established in the Cayman Islands (the Fund Manager). The General Partner will enter into an investment advisory agreement with East West Capital Partners Pte Ltd (the Investment Adviser), a company incorporated in Singapore. The Investment Adviser, in turn, will enter into a research services agreement with East West Capital Partners India Pvt Ltd (the Research Company), an Indian company based in Bangalore. The relationships between these entities will be described under governance structure (section E).

12. The Fund will have a panel of advisers and will benefit from relationships with other individuals and organizations within the industry. This will serve to deepen its intellectual and operational resources.

C. Governance Structure

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1. Fund Manager

13. The Fund Manager will be responsible for managing the Fund and making investment decisions on its behalf.

14. The Fund Manager will establish an investment committee (the Investment Committee), and will enter into an investment agreement with an investment adviser (the Investment Adviser). The Investment Adviser is responsible for identifying and researching suitable investments pursuant to the investment policy, advising the General Partner on the merits, structure, and financing of investments, and negotiating and arranging such investments. The Investment Adviser submits investment recommendations to the Investment Committee.

15. To support its activities, the Investment Adviser will enter into an arms-length agreement with the Research Company, which will render market research services helpful for making investment recommendations.

IV. INVESTMENT BENEFITS, IMPACTS, AND RISKS

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A. Justification

1. Development Impact

16. By providing financing for this transaction, ADB intends to achieve the following developmental objectives at the portfolio company level:

- (i) **Improvement of health care services.** The Fund will invest in high-caliber, rapidly growing companies in the health care sector. This will have the effect of improving the quality of and access to health care for the local population.
- (ii) **Creation of jobs.** The Fund's investments in portfolio companies will support such companies' growth and expansion, creating jobs and sustainable employment in the community.
- (iii) **Building of higher quality companies that raise overall industry standards.** The Fund's investments will support portfolio companies' financial planning, business expansion strategies, human resource development, technology, environmental and social issues, and implementation of international corporate governance best practices. This will raise the quality of individual companies. As companies are forced to compete for market share and financing, the degree of sophistication and efficiency of the industry will rise. This is particularly relevant in the pharmaceuticals industry where factories and production processes must meet international standards so that firms may produce for global markets.
- (iv) **Knowledge transfer and management skills training.** In addition to contributing to stronger, more sustainable companies, the Fund's representation in the management of portfolio companies will develop a class of local business professionals with much-needed managerial skills. These local professionals will either stay with the portfolio company or leave to join another firm, thus "pollinating" the industry with skilled managers. This is particularly useful in the

health care services sector, which requires managers with highly specialized knowledge.

- (v) **Financial diversification.** The Fund's investments in portfolio companies will diversify the sources of finance available to these companies. Their increased equity capital will enable them to (a) obtain bank loans based on their improved debt-to-equity ratio, 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.
- (vi) **Contribution of indirect effects and externalities.** In addition to the direct contributions to economic development listed above, the Fund will also 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 governments can direct toward social services and infrastructure requirements;⁸ (b) the Fund will invest in innovative, demand-driven products and services, whose availability will improve 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 those inputs; (d) private sector jobs created at portfolio companies will contribute to an employed, therefore increasingly stable, middle class, which will in turn contribute to long-term economic progress and overall stability, and indirectly support poverty reduction, for countries in the region.

17. In addition to contributing to various developmental outcomes at the portfolio company level, investment in the Fund would also develop the private equity industry itself in four specific ways.

- (i) At the level of the asset class, ADB's investment would help demonstrate the credibility and potential of private equity in India and other DMCs. The rate of private equity investment in India and other Asian emerging markets is still well below the levels of more economically developed countries⁹ that actively utilize private equity to foster local management capacity and demonstrate a return on investment in entrepreneurial SMEs.¹⁰ By demonstrating the potential of the asset class, ADB's investment in the Fund would attract more private equity firms to enter the market, deepening the penetration of the asset class.

⁸ In this way, the Fund could help extend the health care sector via both the private sector and, indirectly, the public sector.

⁹ Private equity investment rate (as percent of GDP) in 2003 was 0.59% in Singapore, 0.47% in the Republic of Korea, 0.31% in Indonesia, 0.14% in India, 0.12% in PRC, 0.08% in the Philippines, 0.03% in Thailand, and 0.03% in Viet Nam. (The relatively higher rate in Indonesia reflects larger cross-border transactions but the private equity industry in Indonesia is still insignificant.) *Venture Capital Journal*. 2004. The 2004 Guide to Venture Capital in Asia. Hong Kong, China; and World Bank; 2004. *World Development Indicators*. Washington DC. It should be noted that private equity investment in India has increased significantly in the last couple of years, reaching about 0.30% of GDP in 2005 (Private equity data from Venture Intelligence India 2005, GDP data from Economist Intelligence Unit).

¹⁰ The following research papers provide insights into this subject: Doran, A. and Graham Bannock. 2000. Publicly Sponsored Regional Venture Capital: (i) 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.

- (ii) At the level of 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 will raise the amount and quality of deal flow for all private equity firms operating in the market.
- (iii) At the fund level, ADB's investment in the Fund will help to develop fund managers and financial professionals in Asia's developing economies.
- (iv) At the portfolio company level, 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.

18. In addition to the developmental impacts mentioned above, investment in the Fund would contribute to the abilities of DMCs to achieve their health care targets for the Millennium Development Goals.

2. Value Added by ADB

- (i) **Catalytic and demonstration effect.** Given the significant risks and challenges facing potential investors, as well as the emergent nature of the private equity industries in India and other emerging economies in the region, ADB will serve a catalytic role in attracting additional local and foreign long-term private investments to the region. ADB will demonstrate by its intervention the credibility of private equity in India and other DMCs and mobilize capital to support other private equity funds.
- (ii) **Private sector development.** The Fund, similar to others in which PSOD invests, will make a direct contribution to private sector development. The Fund will employ market-based mechanisms to develop profitable and sustainable enterprises. Its focus on emergent sectors at the very early stages of consolidation will provide capital, management skills, and corporate governance oversight to assist in rationalizing and developing these highly fragmented industries. ADB's contribution to this type of initiative helps its DMCs to implement their country-specific private sector development strategies.

B. Measuring Development Effectiveness

19. PSOD and the Operations Evaluation Department of ADB are formulating guidelines for implementing the Good Practice Standards (GPS) for Evaluation of Private Sector Investment Operations, which were prepared by the Evaluation Cooperation Group¹¹ of the multilateral development banks. GPS cover (i) the roles of the independent evaluation department and the private sector department, (ii) the evaluation dimensions for private sector operations, (iii) the nature of annual reporting, and (iv) dissemination of reports and lessons. According to the GPS, the three main dimensions for private sector evaluation are (i) development outcome, (ii) investment profitability for the institution, and (iii) operational effectiveness. PSOD will measure the expected development outcome of this Fund at both the Fund and investee

¹¹ The Evaluation Cooperation Group was formed by the multilateral development banks to design common evaluation standards for private sector operations. The group's work is ongoing and some aspects of the present evaluation framework might change to correspond to best practices.

company level as well as beyond the Fund by monitoring certain performance measures throughout the life of the Fund. The performance measures are grouped into three key areas.

- (i) **Business performance.** The extent to which the Fund has reached its objectives in terms of the overall profitability and commercial viability of the Fund and its investments.
- (ii) **Economic sustainability.** The effects of the Fund and its investments on the DMC's economy, and the associated benefits and costs. On the one hand, these measures assess the extent to which the Fund improved the allocation of resources and provision of financial services to viable private enterprises. On the other hand, these measures evaluate whether the investments directly generated positive effects on the local economy.
- (iii) **Private sector development.** The impact of the Fund on private sector development beyond the Fund itself and its immediate stakeholders, e.g., the Fund's contribution to the growth of viable financial institutions and financial markets development.

20. Quantitative and qualitative measures of performance are in Appendix 4.

C. Environmental Protection and Social Safeguard Policies

21. ADB's investment in the Fund is classified category FI (financial intermediary) under ADB's environment policy¹² and no investments by the Fund are anticipated to result in significant environmental impact. However, the Fund Manager will be required to adopt an environmental management system in accordance with the guidelines set out in Appendix 5.¹³

22. ADB's investment in the Fund is classified category C under ADB's involuntary resettlement policy¹⁴ and no involuntary settlements are foreseen in relation to any investments by the Fund.

23. ADB's investment in the Fund is classified category C under ADB's indigenous peoples policy¹⁵ and no investments by the Fund are expected to have impact on indigenous peoples.

D. Anticorruption Policy, Combating Money Laundering and the Financing of Terrorism

24. The Fund Manager was advised of ADB's anticorruption policy¹⁶ and policy relating to the combating of money laundering and the financing of terrorism.¹⁷ 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

¹² ADB. 2003. Operations Manual. Section F1/OP: Environmental Considerations in ADB Operations. Manila (29 October), para. 6.

¹³ The capacity and experience of the Fund Manager to implement an appropriate environmental management system was assessed during due diligence; the due diligence team was comfortable with the fact that the Fund Manager is willing and able to implement such a system, given appropriate support from ADB.

¹⁴ ADB. 2003. Operations Manual. Section F2/OP: Involuntary Resettlement. Manila (29 October), para. 21.

¹⁵ ADB. 2003. Operations Manual. Section F3/OP: Indigenous Peoples. Manila (13 May), para. 4.

¹⁶ ADB. 1998. *Anticorruption*. Manila.

¹⁷ ADB. 2003. *Manual on Countering Money Laundering and the Financing of Terrorism*. Manila.

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 Manager will further allow ADB to investigate any violation or potential violation of these undertakings.

V. ASSURANCES

25. ADB will enter into suitable documentation that will indicate ADB's commitment to invest an amount up to the lesser of \$20,000,000 or 25% of the Fund's capital following approval of the investment by ADB's Board of Directors. ADB will not be the largest investor in the Fund. ADB will satisfy itself with the terms and conditions of all the principal documents associated with its investment in the Fund.

VI. RECOMMENDATION

26. I am satisfied that the proposed investment in Asia Healthcare Fund L.P. as described in this report complies with the Articles of Agreement of ADB and recommend that the Board approve the investment in Asia Healthcare Fund L.P. of up to the lesser of \$20,000,000 or 25% of the Fund's capital from ADB's ordinary capital resources.

Haruhiko Kuroda
President

May 2006

PERFORMANCE MEASURES FOR DEVELOPMENT OUTCOMES

Concept	Impact	Performance Measures (Qualitative and/or Quantitative)
Business Performance (Fund)		
• Financial objectives	• Overall profitability of the Fund	• Gross internal rate of return (database) ^c • Net internal rate of return (database)
Economic Sustainability (Fund and Subprojects)		
• Efficient allocation of finance and/or provision of financial services to economically viable enterprises	• Subproject economic performance • Stronger local entrepreneurship • Contribution to widening the access to finance of SMEs • Provision of value-added services, enhancing the viability of SMEs	• 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) • 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)
• Additional direct contributions of subprojects to the local economy	• Contribution to government revenues • Employment generated • Adoption of new technologies and production processes	• 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) • Increased investment in new technologies and/or in improvement of production processes by subprojects (PCR) • Number of subprojects implementing successful new technology (PCR) • Increased quality and/or lower price of subproject's product due to investment in technology (PCR)
Concept	Impact	Performance Measures (Qualitative and/or Quantitative)
Private Sector Development (Impact Beyond Fund and Subprojects)		
• Contribution to the growth of viable financial institutions and financial market development	• 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 ^d	• Number of companies enabled to expand regionally through the Fund's provision of equity capital • Number of companies enabled to expand regionally through the Fund's support in upgrading management systems • Number of local investment professionals in SME private equity trained by the Fund (PCR) • Number of Fund's investment professionals raising a subsequent fund in financial sector of a DMC (PCR) • Mobilize domestic finance for investments in productive SMEs by the Fund (at closing of the Fund) • Mobilize international finance for investments in productive SMEs by the Fund (at closing of the Fund) • Growth in private equity market in the domestic financial sector (PCR) • Increased access to long-term finance (PCR)

ADB = Asian Development Bank, DMC = developing member country, IRR = internal rate of return, PCR = project completion report, SME = small- and medium-sized enterprise.

^c Performance measures followed by "(database)" will be monitored regularly in the framework of the Private Sector Operations Department's database for funds. Performance measures

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

Source: Asian Development Bank, Private Sector Operations Department.