Validation Report

Reference Number: XVR-18
Project Number: 34907
Investment Number: 7170
December 2013

Regional: Mekong Enterprise Fund

This is a redacted version of the document that excludes information that is subject to exceptions to disclosure set forth in ADB’s Public Communication Policy 2011.

Independent Evaluation Department

Asian Development Bank
ABBREVIATIONS

ADB               — Asian Development Bank
CAGR              — compound annual growth rate
CCP               — concept clearance paper
ESHS              — environmental, social, health, and safety
FIRR              — financial internal rate of return
GMS               — Greater Mekong Subregion
IED               — Independent Evaluation Department
IFC               — International Finance Corporation
IMF               — International Monetary Fund
Lao PDR           — Lao People’s Democratic Republic
MCL               — Mekong Capital Limited
MEF               — Mekong Enterprise Fund
MDPF              — Mekong Private Sector Development Facility
RRP               — report and recommendation of the President
SME               — small and medium-sized enterprises
TA                — technical assistance

NOTES

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

Key Words

asian development bank, extended annual review report, fund, greater mekong subregion, gms, independent evaluation department, private equity, private equity funds, private sector operations, validation report, viet nam, sme, fund, private equity

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In preparing any evaluation report, or by making any designation of or reference to a particular territory or geographic area in this document, the IED does not intend to make any judgments as to the legal or other status of any territory or area.
## PROJECT BASIC DATA

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</tr>
<tr>
<td>C. Kim</td>
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<td>2001</td>
</tr>
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<td>P. Marro</td>
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<td>2003</td>
</tr>
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<td>D. Wiedmer</td>
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<td>2006</td>
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<td>J. Klein</td>
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<td>2008</td>
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<td>J. Brett</td>
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<td>2012</td>
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<td><strong>Validator:</strong> J. Lufkin, Consultant</td>
<td><strong>Peer Reviewer:</strong> N. Gamo, Senior Evaluation Officer, IED2</td>
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<td><strong>Quality Reviewer:</strong> H. Feig, Lead Evaluation Specialist, IED2</td>
<td><strong>Director:</strong> H. Hettige, Officer-in-charge, IED2</td>
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ADB = Asian Development Bank; IED2 = Independent Evaluation Department (Division 2); BIO = Belgian Investment Office; SECO = Swiss Secretariat for Economic Affairs; XARR = extended annual review report.

## I. PROJECT DESCRIPTION

### A. Project Background

1. To help promote small and medium-sized enterprise (SME) development in the Greater Mekong Subregion (GMS), the International Finance Corporation (IFC)-managed Mekong Private Sector Development Facility (MPDF)\(^1\) conducted a feasibility study in 1999 for an equity investment fund to complement its existing SME business development services technical assistance (TA) program in the region. The study determined that (i) SME growth in the region was crucial for job creation, (ii) attempts to promote economic development were being hampered by the difficulties in obtaining SME expansion capital, and (iii) an equity investment fund would promote the economic development of SMEs.

2. In January 2000, the Asian Development Bank (ADB) began discussions with International IFC to develop a means of ADB support for MPDF. In December 2000, ADB approved a TA grant

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\(^1\) At the time of the report and recommendation of the President (RRP) preparation, MPDF was a $29 million multi-donor project development facility created in 1997 by IFC with funding from Australia, EU, Finland, Japan, Norway, Sweden, Switzerland, the United Kingdom, and the to support SMEs in the GMS to obtain commercial financing by raising management standards through capacity-building training and other business development services.
to support the MPDF. The TA project aimed to assist the development of an enabling environment for private enterprise growth and to provide practical assistance to SMEs in the areas of (i) access to capital, (ii) management and staff training, (iii) business development, and (iv) access to market information. The TA was designed to support (i) the cost of consultants recruited by MPDF in undertaking its project-related activities, and (ii) the related cost of project support programs for private SMEs and local financial institutions in Cambodia, Lao People’s Democratic Republic (Lao PDR), and Viet Nam. The MPDF was to act as the investment advisor of the proposed private equity fund, hence, by supporting the MPDF, the TA project was indirectly supporting the proposed fund.

3. On 7 September 2001, the ADB Board approved an investment in Mekong Enterprise Fund (MEF) of up to $5 million or 25% of total MEF commitments, whichever is lower.

B. Project Features

4. MEF was structured as a 10-year closed-end fund with two possible 1-year extensions. It had a target capitalization of $20 million—$25 million. The objectives of MEF were to (i) achieve a positive development impact on SMEs in the three countries by providing equity capital, and (ii) achieve long-term capital appreciation.

5. The fund manager of MEF is Mekong Capital Ltd. (MCL), which was formed in March 2001 specifically to serve as manager of MEF. A management fee of 2.5% per annum of committed capital was payable by MEF to MCL for the first 5 years and, thereafter, 2.5% per annum of net assets at the end of the previous quarter, plus a carried interest in 20% of realized capital gains above a hurdle rate of 8%. MPDF was contracted as the investment advisor of MEF.

C. Progress Highlights

6. MEF held its first close on 15 May 2002, with commitments from ADB, the State Secretariat for Economic Affairs of Switzerland, the Nordic Development Fund, and the Finnish Fund for Industrial Cooperation. Individual Gary Brinson, founder of a fund management group in the United States, was the only non-development financial institution (DFI) investor and had a 10.8% stake in the fund’s capital. MEF initially closed with commitments of $16.0 million and ADB committed $4.0 million. Total MEF commitments later rose to $18.5 million.

7. In 2005, MEF requested and obtained approval from shareholders to remove the 75% single-country limit. MCL established an office in Ho Chi Minh City, Viet Nam, but did not establish offices in Cambodia or the Lao PDR. MEF invested $15 million in 10 companies in various industries (furniture, gas distribution, information technology, wooden toys, kitchenware, and plastic), all in Viet Nam. At the time of the extended annual review report (XARR), the portfolio of MEF held remaining positions in seven companies. As of end-August 2013, MEF held positions in two remaining investees. With the consent of shareholders, MEF life was extended to May 2013 and then again to May 2014.

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3 Effective 1 January 2008, this was the lower of 2.5% of the net asset value of the MEF at the end of the previous quarter and 2.5% of the shareholders’ equity of the MEF, as stated in its unaudited financial statement as of either 30 June or 31 December. MCL requested approval from MEF investors in August 2012 to reduce of the hurdle rate from 8% to 0%, entitling MCL to its carried interest on any capital gains, with a waiver of its 2.5% management fee. Given the negative returns of the fund, it seems unlikely that any carried interest will be paid.
II. PROJECT EVALUATION

A. Development Outcomes and Impacts

1. Contribution to Private Sector Development

8. The XARR rated the project’s contribution to private sector development excellent. It stated that MEF (i) was the first fund to be launched in the Mekong region after the 1997 crisis; (ii) contributed to private sector expansion by raising the profile of the local private equity fund industry through its participation in industry organizations, public relations, research, media coverage, and dealings with authorities; (iii) participated in the development of its investees by recruiting management teams, introducing modern management techniques, promoting good corporate governance, and assisting three through initial public offerings (IPOs) on the Ho Chi Minh City stock exchange; and (iv) attracted $22.3 million of loans and other investments to its investees.

9. This validation downgrades the project’s contribution to private sector development to satisfactory. With only $15 million in investments and 10 investee companies, MEF was too small to have any significant impact on private sector expansion in general and on SME growth in particular. The project also failed to invest in Cambodia and the Lao PDR as originally envisaged. This validation also notes that some of the fund’s investee companies were not SMEs—four companies had more than 300 employees at the time of the fund’s investment. The other investee companies may not be SMEs as well if their registered capital was more than D10 billion at the time of the fund’s investment but this could not be confirmed by this validation because the registered capital information was not provided in the XARR.

10. Nonetheless, this validation recognizes the project’s contribution to the development of the private equity fund business in Viet Nam as mentioned in items (i) and (ii) in para. 8. When MEF was launched in 2002, it helped revive an industry that was severely affected by the Asian financial crisis. Several funds were established after MEF although it is difficult to ascertain whether or not these funds were influenced by the entry of MEF. MCL itself has grown into a team of around 20 full-time personnel and has established two other funds aside from MEF.

2. Business Success

11. The XARR compared the fund’s net financial internal rate of return (FIRR) to a market benchmark, using the compound annual growth rate (CAGR) of the Standard & Poor’s index of 500 US listed stocks from 2002–2010. The XARR concluded that since the net FIRR of MEF is greater than the benchmark minus 200 basis points but less than the benchmark minus 50 basis points, business success was rated partly satisfactory.

12. The guidelines state that comparing the FIRR to a market benchmark should only be used in exceptional circumstances and that there should be a clear justification as to why this alternative is being used instead of the preferred standard of comparing the FIRR to the weighted average cost of capital. No such justification was made by the XARR. The net real FIRR of MEF was recalculated as of the end of 2012. Since the real FIRR was negative, this validation downgrades the business success rating of the project to unsatisfactory.

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4 The definition of SMEs was not provided in the RRP and other project documents. Government Decree 90/2001/ND-CP, which was promulgated in 2001, defines an SME as a business establishment with registered capital of no more than D10 billion (approximately $630,000) or with a workforce of no more than 300 regular employees.
3. Contribution to Economic Development

13. Although it acknowledged that the MEF gross FIRR (as a proxy for economic internal rate of return EIRR) as of 30 June 2010 per the project administration instruction guidelines indicates a rating of only *partly satisfactory*, the XARR raised the rating of MEF for contribution to economic development to *satisfactory*. The XARR argued that MEF investees have generated employment and made increasing tax payments, and broadly increased aggregate annual revenues.

14. The gross FIRR of MEF was recalculated as of 31 December 2012, the date of most recent audited financial statements available. Although recalculated gross FIRR warrants a rating of *unsatisfactory* per guidelines, this validation rates the project’s contribution to economic development *less than satisfactory* considering that the EIRR is near the threshold limit of 5.0% and that the project has other economic benefits. For instance, investee companies reportedly employed an additional 3,000 people and increased tax payments by $1.5 million between 2003 and 2009.

4. Environment, Social, Health, and Safety Performance

15. The XARR stated that MEF has implemented environmental, social, health, and safety (ESHS) standards in investee companies in compliance with applicable Viet Nam regulations and ADB safeguards. XARR also enumerated improvements in workplace health and safety conditions specifically in investees Tan Dai Hung, Ngo Han, Duc Thanh, and Minh Hoang as a basis for a rating of *satisfactory*.

16. This validation concurs with the XARR rating of ESHS as *satisfactory*, noting that investees were in compliance with applicable regulations.

5. Overall Development Impacts and Outcomes Rating

17. The XARR rated overall development impacts and outcomes *satisfactory*.

18. This validation rates the overall development impacts and outcomes of MEF *less than satisfactory* based on the *unsatisfactory* rating for business success, the *less than satisfactory* rating for contribution to economic development, and the *satisfactory* ratings for the other two subcategories.

B. ADB Investment Profitability

19. The XARR stated that the RRP did not set an expected level of return for MEF, and as long as returns are reasonable, MEF could be considered a successful investment. It calculated an interim net FIRR (as of 30 June 2010) and mentioned that net returns to ADB and the other investors had been depressed because return on investments had not even been adequate to cover contractual management fees to MCL. The XARR rated the investment profitability of ADB *partly satisfactory*.

20. As of the end of 2012, the FIRR of ADB was negative. This validation downgrades ADB investment profitability to *unsatisfactory*. A more recent calculation by the Credit Portfolio Monitoring Division of the Office of Risk Management showed the fund’s net internal rate of return also negative. In the comments of the Private Sector Operations Department (PSOD) to the draft validation report, it pointed out that MEF had fully exited from one of the two remaining investees in October 2013 and that the ADB interim net FIRR had improved but still negative.
C. ADB Operational Effectiveness (Work Quality)

1. Screening, Appraisal, and Structuring

21. The XARR rated the screening, appraisal, and structuring of ADB satisfactory. It stated that ADB was involved in structuring the fund and provided inputs on governance, ESHS safeguards, investment requirements, and coaching MCL to track development impact metrics.

22. This validation downgrades the rating of ADB screening, appraisal, and structuring to less than satisfactory. The selection of a new fund management company may have helped in the development of the private equity fund business in Viet Nam but this might have been at the expense of achieving the original intentions of the project. SME was not defined in the RRP or in any of the project documents. This resulted in the fund investing in non-SMEs.

2. Monitoring and Supervision

23. The XARR enumerated several functions that ADB performed for MEF, such as the ADB representative regularly attending board meetings, review of quarterly performance reports and annual audited financial statements, and responding to questions and requests for approvals by MCL. The XARR rated ADB monitoring and supervision satisfactory.

24. This validation downgrades the rating for monitoring and supervision to less than satisfactory. ADB approved MCL requests, which largely had the effect of diluting the original terms of the fund approved by the ADB Board, including dropping the requirement to invest in Cambodia and the Lao PDR, extending the life of the fund, and eliminating the 8% hurdle rate for carried interest fee to MCL. ADB allowed MEF to invest in companies that were not SMEs (as defined by the government). It is also unclear from the XARR to what extent ADB ensured synergies between MEF and MPDF (on which ADB had a board seat after 2001), and why ADB was unable to provide inputs that would have helped MEF invest in Cambodia and the Lao PDR.

3. Role and Contribution

25. The XARR rated ADB role and contribution satisfactory, noting the ADB participation in MEF fund raising, board meetings, training, and providing feedback on how to improve the fund’s quarterly reporting and environmental and social management system. It also mentioned that ADB helped MEF negotiate key terms (without mentioning with whom these were negotiated), provided feedback on improving the ESHS systems, and organized a training workshop on ESHS compliance.

26. Given the reported improvements in MEF investees’ environmental and workplace standards, this validation concurs with the XARR rating of satisfactory for the ADB role and contribution, but observes that ADB time might well have been spent also on coaching MCL staff on improving the profitability of investees.

4. Overall Work Quality

27. The XARR did not discuss overall ADB work quality, but rated it satisfactory.

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5 The last two requests were after the date of the XARR.
28. This validation downgrades the rating of overall work quality to less than satisfactory due to less than satisfactory ratings in two of the three subcomponents.

D. ADB Additionality

29. The XARR rated the additionality of ADB excellent, stating that ADB involvement attracted other investors in MEF. It also stated that its original commitment of $4 million in MEF paved the way for the establishment of Mekong Capital, which was instrumental for subsequent funds to be raised, and that Mekong Capital has raised another $150 million through various successor funds.

30. All but the smallest of the other investors in MEF were development agencies that were already funding MPDF. It is not evident that ADB mobilized any additional investment. The MCL second fund, in which ADB invested $9 million, was raised at a time MCL was stating its return expectations for MEF to be around 30%, and was able to raise funds based on unsubstantiated projections rather than actual performance. This validation, therefore, lowers the XARR rating of ADB additionality to satisfactory.

E. Overall Assessment

31. The XARR rated the overall assessment of MEF successful, considering its excellent rating for ADB additionality, the satisfactory rating for overall development impact and ADB work quality, and partly satisfactory rating for ADB investment profitability.

32. This validation downgrades the overall assessment to less than successful, based on its ratings of the individual component indicators, noting especially the less than satisfactory development outcomes, and because the MEF investment has been unprofitable for ADB.

Table 1: Overall Ratings

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<th>Criteria</th>
<th>XARR</th>
<th>IED Review</th>
<th>Reason for Disagreement and/or Comments</th>
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<tr>
<td>Development outcomes and impacts</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1. Private sector development</td>
<td>Excellent</td>
<td>Satisfactory</td>
<td>MEF was too small to make any perceptible contribution to private sector development in Viet Nam and did not invest in Cambodia or the Lao PDR as originally intended, but it helped revive the private equity fund business in Viet Nam. The recalculated net real FIRR was negative. The recalculated gross FIRR was below 5.0%.</td>
</tr>
<tr>
<td>2. Business success</td>
<td>Partly satisfactory</td>
<td>Unsatisfactory</td>
<td></td>
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<tr>
<td>3. Economic development</td>
<td>Satisfactory</td>
<td>Less than satisfactory</td>
<td></td>
</tr>
<tr>
<td>4. ESHS performance</td>
<td>Satisfactory</td>
<td>Satisfactory</td>
<td></td>
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<tr>
<td>Overall Development Outcomes and Impacts Rating</td>
<td>Satisfactory</td>
<td>Less than satisfactory</td>
<td>Business success was unsatisfactory and contribution to economic development was less than satisfactory.</td>
</tr>
</tbody>
</table>

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6 According to a Harvard case study on Mekong Capital Limited, Gary Brinson was enlisted by Chris Freund (founder of MCL).
### Criteria

<table>
<thead>
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<th>Criteria</th>
<th>XARR</th>
<th>IED Review</th>
<th>Reason for Disagreement and/or Comments</th>
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<tr>
<td>ADB investment profitability</td>
<td>Partly satis</td>
<td>Unsatisfactory</td>
<td>Negative return to ADB</td>
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<td>ADB Work quality:</td>
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<tr>
<td>1. Screening, appraisal, and</td>
<td>Satisfactory</td>
<td>Less than</td>
<td>ADB role in manager selection is uncertain; ADB neither screened nor appraised, as this fund was an ADB–IFC–MPDF initiative; structuring was industry-standard and MEF being small in size, failed to anticipate the economics of MCL and undercut the ability of MEF to invest in Cambodia and the Lao PDR.</td>
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<td>structuring</td>
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<td>2. Monitoring and supervision</td>
<td>Satisfactory</td>
<td>Less than</td>
<td>ADB approval of MCL requests diluted the original terms of the fund.</td>
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<td>3. ADB’s role and contribution</td>
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<td>Overall ADB Work quality</td>
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<td>Less than satisfactory ratings in two of the three sub-indicators.</td>
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<tr>
<td>ADB Additionality</td>
<td>Excellent</td>
<td>Satisfactory</td>
<td>ADB did not mobilize investors for MEF.</td>
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<td>Overall Assessment</td>
<td>Successful</td>
<td>Less than</td>
<td>Less than satisfactory ratings in development impacts and outcomes and ADB work quality and unsatisfactory rating in investment profitability.</td>
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<td></td>
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ADB = Asian Development Bank; ESHS = environment, social, health, and safety; FIRR = financial internal rate of return, IED = Independent Evaluation Department, IFC = International Finance Corporation, MCL = Mekong Capital Ltd.; MEF = Mekong Enterprise Fund; MPDF = Mekong Private Sector Development Facility; XARR = extended annual review report.

Note: From May 2012, the Independent Evaluation Department has replaced categories for evaluation rating and criteria labeled “Partly” or “less” by “less than” (e.g., “partly satisfactory” to “less than satisfactory”, and “less successful” to “less than successful”) to improve clarity of this third category within a four point scale.

Source: ADB Independent Evaluation Department.

### III. ISSUES, LESSONS, AND RECOMMENDATIONS

#### A. Issues and Lessons

33. The XARR stated that the main issue faced by the project was the inexperience of the investment management team and its reluctance to exit investments when the market was most favorable. It also mentioned the problem of remitting distributions from Viet Nam to foreign investors due to regulations existing in 2004 that required pre-approval from the tax department. This problem was resolved only in 2006 with lobbying from MEF.

34. This validation agrees with the issues and lessons presented in the XARR but also finds other issues and lessons. Firstly, the manager selection process was not documented in either the RRP or the XARR. Although several qualified firms had been interviewed beginning at the time of the concept clearance paper, the winning manager (MCL) was created during the year between concept clearance and RRP approval by a departing employee from one of the major firms interviewed, in a process contrary to representations in the CCP—which stipulated that the
fund manager selection must be transparent—and was not described in the RRP, XARR, or other documents available to this validation.

35. Secondly, the fund deviated from its main objective of investing in private sector SMEs as stated in the RRP and the investment management agreement. SMEs were not defined in the RRP and the investment management agreement but at least 4 of the 10 investee companies of MEF were not SMEs as defined by the Government of Vietnam. ADB was on the Board of MEF and the fund manager has been providing regular reports to ADB so ADB should have been able to detect this.

36. Thirdly, the project did not fully utilize its relationship with MPDF, which was supposed to provide valuable support particularly in identifying potential investee companies for the fund. The completion report of the TA project that is supporting SME growth in the Mekong region stated that the MPDF assisted 129 SMEs in preparing bankable business plans—9 in Cambodia, 16 in the Lao PDR, and 104 in Vietnam. The total project costs amounted to $109.0 million of which external financing raised was $60.4 million.

37. Finally, the fund and the resulting management fees were too small. MCL management fees were so small that it could only afford one office, in Vietnam, and the fund never invested in Cambodia or the Lao PDR. More thought should have been given to the management of firm operations and economics.

B. Recommendations

38. The XARR recommended that ADB (i) be more assertive in championing a profit growth and/or cost control discipline in investee companies of funds in which ADB invests, (ii) be more aggressive in convincing fund managers to exit from investments when opportunities arise, and (iii) fully assess remittance regulations when processing projects.

39. In addition, this validation recommends that (i) ADB rethinks its policy of hiring new fund managers in lieu of more experienced ones when the primary objective of the fund is to promote the development of SMEs, (ii) ADB insists on a strict definition of SMEs in RRP's and legal documents when investing in private equity funds and other financial intermediaries that support SME development, (iii) ADB carefully monitors fund managers and prevent them from deviating from the fund's original objectives, and (iv) funds that ADB invests in the future be large enough to generate fees adequate to cover reasonable expenses of the manager.

IV. OTHER ASSESSMENTS AND FOLLOW-UP

A. Monitoring and Evaluation Design

40. The RRP did not contain any monitoring and evaluation design.

B. Other Aspects

41. None was identified.

C. Data Sources for Validation

42. In addition to the CCP, RRP, and XARR for MEF, this validation also reviewed the following:
D. Comments on XARR Quality

43. The XARR could have described which of the ADB or IFC procurement processes were used to evaluate candidates and select MCL as MEF manager. Whichever process was used resulted in the selection of a new management company whose team was described in the XARR as being headed by “an accomplished investment professional with prior experience in the region,” “inexperienced,” “reluctant to exit investments,” “youthful,” who “had never seen a major economic crisis,” and “assumed prices would continue to rise.” These issues could have been explored in the “Issues, Lessons, and Recommended Follow-up Actions” section of the XARR.

44. The XARR could have discussed the way in which MEF grew out of MPDF and the ongoing operating relationship among MEF, MPDF, and MEF investee companies. MEF did not invest in either Cambodia or the Lao PDR, and was therefore never a GMS regional fund—one of the key selling points of the fund as described in the RRP. The XARR could have discussed how and why this happened despite the advisory relationship between MEF and MPDF. The XARR could also have mentioned if MEF investees were actually recipients of MPDF business development services advice, and any attempts by MPDF to address unprofitability issues at MEF investees, whether MPDF offered any investment opportunities to MEF in the Lao PDR or Cambodia, and, if so, why MEF made no investments in those countries despite having been approved by the ADB Board as a regional GMS fund.

45. Overall, this validation rates XARR quality less than satisfactory.
### Table 2: Extended Annual Review Report Quality

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<th>Excellent</th>
<th>Satisfactory</th>
<th>Less than Satisfactory</th>
<th>Unsatisfactory</th>
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<tr>
<td>Quality and completeness of evidence and analysis to substantiate ratings</td>
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<td></td>
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<td>X</td>
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<tr>
<td>Consistency with XARR Guidelines (PAI 6.07B)</td>
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<td>Plausibility of assumptions underlying economic and financial analyses, including calculations of EIRRs, FIRRs, and assumptions on project sustainability</td>
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<td>Quality of lessons identified and recommendations</td>
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</tbody>
</table>

EIRR = economic internal rate of return, PAI = Project Administration Instruction, XARR = extended annual review report.

Source: ADB Independent Evaluation Department.

### E. Recommendations for Independent Evaluation Department Follow-Up

46. None is required.