



# Validation Report

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Project Number: 30702  
Investment/Loan Number: 7136  
December 2010

Regional: Kula Fund Limited  
(formerly Pacific Investment Capital Fund)

Independent Evaluation Department

Asian Development Bank

## NOTES

- (i) In this report, "\$" refers to US dollars.
- (ii) For an explanation of rating descriptions used in ADB evaluation reports, see: ADB. 2007. *Guidelines for Preparing Performance Evaluation Reports on Nonsovereign Operations*. Manila.

### Key Words

adb, asian development bank, extended annual review report, economic internal rate of return, financial internal rate of return, independent evaluation department, kula fund, private equity fund, private sector operations

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## Extended Annual Review Report Validation

### A. Project Description

In April 1997, the Board of Directors of the Asian Development Bank (ADB) approved an equity investment of \$3 million in Pacific Investment Capital Fund, which, after its incorporation as a Vanuatu limited liability company, became known as Kula Fund. The Kula Fund was ADB's first private sector operations project in Pacific developing member countries (DMCs). It was established to provide long-term risk capital—primarily equity and equity-linked investments—to private sector projects in the Pacific. All Pacific DMCs were eligible for investment from the fund, which could invest in greenfield as well as existing projects in such industries as agribusiness, food processing, tourism, fishing and marine resources, transportation, forestry, minerals, and financial services. The fund was also to attempt to identify investment opportunities arising from the privatization efforts of Pacific DMC governments and infrastructure projects.

The fund was structured as a 10-year, closed-end fund with a provision for a 2-year extension. It was managed by Pacific Capital Partners Limited, a wholly owned subsidiary of Aureos Capital Limited, which was a joint venture of the United Kingdom's Commonwealth Development Corporation (CDC) and the Norwegian Investment Fund for Developing Countries (Norfund). Kula Fund was established in August 1997 and was then the only provider of risk capital for small and medium-sized private business in the region. Kula Fund secured commitments of \$16.9 million from various multilateral and bilateral institutions and a local pension fund. By April 2001, Kula Fund had drawn \$16.7 million from the shareholders. The investment period ended in August 2002.

The fund invested in eight companies with deal sizes ranging from \$0.3 to 2.0 million. The aggregate cost of the investments was \$11.2 million or 68% of the total capital drawn from the shareholders. Three investments were made in the Fiji Islands and five in Papua New Guinea. The investments in Papua New Guinea included a management buy-in, a privatization, and management buyouts, while all investments in the Fiji Islands were transactions for expanding capital. The investments were well-diversified across industries and included investments in mining, furniture manufacturing, palm oil processing, printing, warehouse retailing, fishing and fish processing, and helicopter support services. As of the date of the extended annual review report (XARR), the fund had divested from six investments and partially exited from the other two. Shareholder approval had been obtained to extend its life until 2008 to maximize the returns from the two residual investments.

### B. Issues, Lessons, and Recommendations (Validation of XARR Assessment)

#### 1. Issues and Lessons

Some of the issues presented in the XARR were (i) the lack of geographical balance in the investment portfolio, (ii) unrealistically high hurdle rates for fund investments, and (iii) the fund's limited ability to influence investee companies where it had minority shareholding. Key lessons were as follows: (i) it is important to use self-liquidating instruments in Pacific DMC markets to avoid dependence on a single exit event in an extremely volatile economic and political environment; (ii) the fund's assistance in corporate governance, human resources development, financial planning, and managerial practices is crucial in the context of Pacific DMC's rudimentary managerial practices and lack of small- and medium-sized enterprise (SME) transparency; (iii) the provision of support in accounting and management practices is crucial for successful SME equity investments in the smallest Pacific markets; and (iv) drawdowns in large increments rather than on an as-needed basis have a negative effect on the net internal rate of return to investors as the fund has too much cash that is not productively deployed.

This validation agrees with the issues and lessons identified in the XARR. In addition, this validation considers the need for more realistic upfront assessments of fund investment pipelines. Padding the list of

potential investments with subprojects that do not meet fund requirements may help sell the project but in the end is counterproductive.

## 2. Recommendations

The XARR did not provide any additional recommendations other than those implicit in above lessons, which this validation agrees with. The identified need for complementary technical assistance is being addressed in conjunction with the follow-on fund, Kula Fund II, which has access to a donor-funded technical assistance facility.

C. Ratings	XARR	Independent Evaluation Department Review	Reason for Disagreement/Comments
Development Impacts and Outcomes	Excellent	Satisfactory	The fund has had a material positive and sustainable impact on private sector development, although its financial performance was unsatisfactory.
ADB's Investment Profitability	Unsatisfactory	Unsatisfactory	
ADB's Operational Effectiveness	Excellent	Satisfactory	As per PAI 6.07B, a rating of <i>excellent</i> can be given only if performance is <i>excellent</i> for all three sub-indicators.
ADB's Additionality	Excellent	Excellent	
Overall Assessment	Satisfactory	Partly successful	Overall ratings of projects should be highly successful, successful, partly successful or unsuccessful per Guidelines. PAI 6.07B also require a minimum rating of <i>partly satisfactory</i> for investment profitability to qualify for an overall rating of <i>successful</i> .
Quality of XARR		Satisfactory	

**PRIVATE SECTOR OPERATIONS DEPARTMENT'S RESPONSE TO THE  
EXTENDED ANNUAL REVIEW REPORT VALIDATION REPORT**

On 26 November 2010, Director, Independent Evaluation Department, Division 1 (IED1), received the following comments from the Capital Markets and Financial Sectors Division (PSCM), Private Sector Operations Department (PSOD).

We appreciate IED's work on the validation report. After reviewing the final report, reflecting some incorporated comments from PSCM, we agree with the overall assessment and have no further comments on REG: Kula Fund Limited.