ADB

Validation Report

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Project Number: 27727
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Regional: Asian Infrastructure Fund

Independent Evaluation Department

Asian Development Bank

ABBREVIATIONS

ADB	–	Asian Development Bank
AIF	–	Asian Infrastructure Fund
DMC	–	developing member country
XARR	–	extended annual review report

NOTES

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

Key Words

asian development bank, extended annual review report, independent evaluation department, private sector operations, validation report

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EXTENDED ANNUAL REVIEW REPORT VALIDATION

A. Project Description

1. On 12 April 1994, the Board of Directors of the Asian Development Bank (ADB) approved an equity investment of up to $20 million into the Asian Infrastructure Fund (AIF or the Fund) and $100,000 into the Asian Infrastructure Fund Management Company (AIFMC). The primary justification for ADB's investment into AIF was the inadequacy of risk capital among ADB developing member countries (DMCs). ADB's participation in the Fund was expected to attract large institutional investors from capital-rich countries seeking viable investment outlets for their surplus funds. The Fund was designed to mobilize such long-term capital to help bridge the risk capital funding needs of infrastructure projects in ADB DMCs.

2. AIF was structured as a 10-year, closed-end fund with a provision for an extension by as long as 4 years to facilitate orderly exit. The Fund took a pan-Asian approach that distinguished it from other funds. It was to invest into companies undertaking infrastructure projects in DMCs such as power generation, transmission, and distribution; gas production and distribution; transportation; telecommunications; water supply; and waste material treatment. Considering the relatively high fixed cost for their identification, evaluation, and supervision, it would target large infrastructure projects. Infrastructure projects may take a number of years to yield returns, and the Fund was therefore expected to be a long-term investor.

3. AIF was able to secure a total of $779.5 million in commitments from its target investor groups, exceeding the targeted fund size of $750.0 million. ADB's $20.0 million commitment was equivalent to a 2.57% stake. The main sponsor of the Fund was Peregrine Investments Holdings Limited, which went into receivership in January 1998. The Fund was co-sponsored by Frank Russell Company with initial investors being ADB, International Finance Corporation (IFC), and Asian Infrastructure Development Holdings Limited, a member of the Quantum Group of Funds.

4. The Fund invested in 14 portfolio companies totaling $683.5 million, which was 93% of the total capital drawn from the shareholders and 88% of committed capital. Of this amount, 47% went to the telecommunications sector, 38% to the transportation sector, and 15% to the power sector. Deal sizes ranged from $12 million to $75 million. The Fund invested in 8 companies in the telecommunications sector, 4 in the transportation sector, and 2 in the power sector. It often used intermediate holding companies, which were its subsidiaries, to hold its interest and those of any co-investment partners in a portfolio company. The countries the Fund invested in and their shares of the total invested amount were the People's Republic of China (31.7%), Indonesia (24.3%), Hong Kong, China (11.0%), India (9.4%), the Philippines (6.8%), Pakistan (5.6%), and Thailand (1.9%).[1] The above allocations were all in line with the investment policies and strategies of the Fund, although the sector limit of 50% was nearly breached.

5. The Fund drew $734.8 million from the shareholders, equivalent to 94% of total commitments. As of 31 December 2008, the Fund had effectively exited from 13 of its portfolio companies and achieved partial exit on the remaining investment. Thus far, the Fund has realized $1,012.8 million from the divestment of its investments, equivalent to 130% of committed capital and a gross internal rate of return of 5.3% in US dollar terms. The remaining investments in the Fund's portfolio had a value of $16.8 million.

[1] The remaining 9.2% was invested in a "global" company. The total will be 99.9% due to rounding errors.

B. Issues, Lessons and Recommendations

6. The extended annual review report (XARR) identified the following issues: (i) the Fund was overexposed in the telecommunications sector, where occurred most of the Fund's unprofitable investments; (ii) the Fund's investments were not spread evenly over the commitment period; (iii) the majority of the Fund's investments were in ordinary shares of its portfolio companies instead of equity or equity-linked securities as outlined in the report and recommendation of the President (RRP); and (iv) the infrastructure projects were vulnerable to circumstances beyond the Fund's control.

7. This validation believes that only the first item is a valid issue, and this was due to the Fund's high sector limit of 50%. The second item is not an issue since it was never an objective of the Fund to spread its investments over the commitment period. If it is imperative that private equity funds should spread out investments over the commitment period then there should have been (and should now be stated in the form of a recommendation) investment policies and restrictions to implement this. It is not clear why the third item is an issue because ordinary shares are equity securities. The final item is likewise a nonissue since it is a given that infrastructure projects, or other types of investments for that matter, are subject to political, regulatory, economic, and global factors and risks.

8. The XARR combined the lessons and recommendations. These were as follow:

(i) Avoid making investments based on the popularity of certain transactions or sectors, and thoroughly analyze markets for demand trends to avoid venturing into sunset industries.

(ii) Diversification of the investment portfolio—geographically and by industry—is vital to mitigate the unexpected performance shortfalls of a specific industry.

(iii) The sector diversification strategy should be reevaluated, because the 50% exposure limit for a single industry is very high. This has been taken into account in subsequent funds into which ADB has invested.

(iv) In infrastructure funds, it is essential to spread investments across different stages of project development (i.e., early stage and fully operational).

(v) Avoid further losses, and do not invest additional money in nonviable activities.

(vi) ADB should continue to participate more actively in fund structuring (especially in terms of a fund's investment policies to ensure alignment with ADB's objectives), in appraising fund managers, and in supervision.

(vii) ADB's investment in funds can effectively mobilize larger sums of capital that complement ADB's direct investment efforts. Although AIF represents a small fraction of the region's infrastructure requirements, ADB has demonstrated the viability of this means of mobilizing capital while ensuring that projects are aligned with ADB's development objectives.

(viii) Investing through investment funds can be equally effective as, and has advantages in comparison with, direct equity investments. Investment funds can make simultaneous investments, as opposed to direct investments into a single project.

9. First, this validation finds that for clarity the lessons should have been separated from the recommendations. Second, pertinent points were identified but the quality of the lessons and recommendations statements is poor and could have been stated better by providing more context. For instance, item (ii), as stated, is neither a lesson nor a recommendation but merely a definition of what is diversification. Similarly, items (vii) and (viii) are basically just describing what investment funds are and their advantages over direct investments. On the other hand,

item (iv) does not explain why it is essential to spread investments across different stages of project development. Item (iii) is confusing because the first part says the sector diversification strategy should be reevaluated but then the second part states that it has already been taken into account in subsequent ADB fund investments. It is not clear from the statement whether the 50% single-industry exposure limit is a standard ADB investment policy or specific to AIF.

C. Overall Ratings

Criteria	XARR	IED Review	Reason for Disagreement/Comments
Development Outcomes and Impacts	Excellent	Satisfactory	The validation downgraded three of the subcriteria ratings and this affected the overall rating.
1. Private sector development	Excellent	Excellent	
2. Business success	Satisfactory	Unsatisfactory	The XARR compared the FIRR to a benchmark while the validation compared the FIRR to the Fund's WACC.
3. Economic development	Excellent	Partly satisfactory	The XARR did not calculate the EIRR. The validation was able to estimate the EIRR in conformity with the guidelines.
4. ESHS performance	Excellent	Satisfactory	Only 2 of the Fund's 14 investments had prominent ESHS performance, and the XARR did not provide sufficient evidence that these were attributable to the Fund and/or ADB participation.
ADB's Investment Profitability	Satisfactory	Satisfactory	
ADB's Work Quality	Excellent	Satisfactory	The guidelines require all three sub-indicators to have excellent ratings for overall work quality rating to be excellent.
1. Screening, appraisal, and structuring	Satisfactory	Satisfactory	
2. Monitoring and supervision	Excellent	Excellent	
3. ADB's role and contribution	Excellent	Excellent	
ADB's Additionality	Excellent	Excellent	
Overall Assessment	Successful	Successful	
Quality of XARR		Partly Satisfactory	

ADB = Asian Development Bank; EIRR = economic internal rate of return; ESHS = environmental, social, health, and safety; FIRR = financial internal rate of return; IED = Independent Evaluation Department; WACC = weighted average cost of capital; XARR = extended annual review report.

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

On 13 January 2012, 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 agree with the overall assessment of Regional: Asian Infrastructure Fund, but would like to add the following remarks:
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> We feel that for a reader with private equity experience, our arguments read sufficiently well and were to the point. We would therefore not recommend to cater the language more to readers without such background as you had suggested. Technical issues will remain relevant as ADB continues to invest in private equity funds.