ADB

Validation Report

Reference Number: XVR-14
Project Number: 28708
Investment Number: 7105
December 2012

India: South Asia Regional Apex Fund

Independent Evaluation Department

Asian Development Bank

ABBREVIATIONS

ADB	–	Asian Development Bank
CVF	–	Creditcapital Venture Fund
ESHS	–	environment, social, health, and safety
EIRR	–	economic internal rate return
FIRR	–	financial internal rate of return
IPO	–	initial public offering
IRR	–	internal rate of return
IVCL	–	IL&FS Venture Corporation
PAI	–	project administration instruction
RRP	–	report and recommendation of the President
SME	–	small and medium-sized enterprise
SVCF	–	state venture capital fund
VCF	–	venture capital fund
WACC	–	weighted average cost of capital
XARR	–	extended annual review report

NOTE

In this report, "$" refers to US dollars.

Key Words

adb, extended annual review report, fund, ied, private sector, validation, venture capital

In accordance with ADB's Public Communications Policy (2011), this report excludes information referred to in paragraph 97 of the PCP 2011.

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PROJECT BASIC DATA

Project Number: 28708		**XARR Circulation Date:**	Apr 2010	
Investment Number: 7105		**XARR Validation Date:**	Dec 2012	
Project Name: South Asia Regional Apex Fund			**Approved** ($ million)	**Actual** ($ million)
Country:	India	**Fund Size:** :	32.12	26.16
Sector:	Finance	**ADB Equity Contribution:**	4.82	3.57
Other Fund Contributors:	CVF, IDBI, IFC, NIFMS, OECF, PHL, PSB, SIDBI	**Other Fund Contributions:**	27.30	22.59
Approval Date:	20 Sep 1994	**First Disbursement:**		22 Apr 1996
Signing Date of Equity Agreement:	15 Nov 1995	**Final Disbursement:**		31 Jan 2001
Project Officers:	V. Velasco T. Kho P. Marro C. Kim J. Klein	**Location:**	ADB headquarters ADB headquarters ADB headquarters ADB headquarters ADB headquarters	
Validator:	N. Gamo, Senior Evaluation Officer, IED2	**Peer Reviewer:**	R. Subramaniam, Senior Evaluation Specialist, IED2	
Quality Reviewer:	C. Kim, Principal Evaluation Specialist, IED2	**Director:**	H. Hettige, IED2	

ADB = Asian Development Bank, CVF = Creditcapital Venture Fund (India), IDBI = Industrial Development Bank of India, IED2=Independent Evaluation Department (Division 2), IFC = International Finance Corporation, NIFMS = NIF Management Singapore, OECF = Overseas Economic Cooperation Fund, PHL = Parameswara Holdings, PSB = Punjab and Sind Bank, SIDBI = Small Industries Development Bank of India, XARR = extended annual review report.

I. PROJECT DESCRIPTION

A. Project Background

1. In early 1993, the idea of setting up venture capital funds (VCFs) in several states in India was initially discussed with the Asian Development Bank (ADB). During subsequent discussions, it was suggested that the state-level funds be structured under an apex fund so that money to be raised from institutional investors could be efficiently channeled to the state funds.

2. In 1994, ADB approved the investment of Rs150 million ($4.82 million) in the equity of the South Asia Regional Apex Fund. The Fund was envisaged as an apex fund for Rs1.0 billion ($32.12 million) to seed state venture capital funds (SVCFs) in ten selected states in India. The SVCFs would in turn provide risk capital to small and medium-sized enterprises (SMEs) in their respective states. Aside from ADB, whose investment represented 15% of the committed capital, the other original investors in the Fund included the following: International Finance Corporation (25%), Overseas Economic Cooperation Fund (25%), Industrial Development Bank of India (11%), Creditcapital Venture Fund (CVF) (11%), Abu Dhabi Investment Authority (10%), and NIF Management Singapore (3%).

B. Project Features

3. **Fund Structure.** The Fund was formed in 1995 as a closed-end fund with a committed capital of Rs1.0 billion and a life of 15 years. The plan was for the Fund to provide 50% of the SVCFs' funding while the remaining 50% would be filled by the private sector (40%) and the concerned state industrial development corporation (10%). The Fund initially invested in two SVCFs—Uttar Pradesh Venture Capital Fund with a committed capital of Rs200 million and Orissa Venture Capital Fund with a committed capital of Rs100 million. However, the fund manager did not find any viable investments in the state of Uttar Pradesh and only two investments in Orissa. In 1998, it was decided that the Fund would make investments directly and that no additional SVCFs would be formed. The two SVCFs that the Fund had invested in were subsequently terminated and the capital was returned to investors, including the Fund. The main purpose for the consolidation of the fund was to achieve operational efficiencies and reduce costs.

4. **Management.** The Fund's original fund manager was CVF. In September 1996, the Infrastructure Leasing and Financial Services (IL&FS) took over CVF and renamed it IL&FS Venture Corporation (IVCL). In 1997, implementation arrangements were revised, including the following: (i) reduction of structuring fees; (ii) revision of success fees; and (iii) increase in group exposure limits.

5. **Investment Approach.** The Fund's investments were targeted at SMEs. These included innovative projects at the start-up stage as well as companies already in operation that need venture capital financing before going public. The projects may involve technological innovation, modernization, expansion or diversification, or may be export-oriented or companies needing turnaround financing. The portfolio also aimed to be diversified across industries and by type of project.

C. Progress Highlights

6. Total contributions to the Fund increased from Rs1.0 billion to Rs1.1 billion. There were also some changes in the ownership structure of the Fund with the exit of the Abu Dhabi Investment Authority and the entry of several Indian financial institutions. There were four drawdowns of the committed capital from 1996 to 2001.

7. The Fund invested in 39 companies and had exited from 26 of these at the time of extended annual review report (XARR) preparation. The Fund has since fully exited from six other companies leaving seven remaining investments as of 31 March 2012. Total investments in the 39 companies amounted to Rs1.8billion.[1]

8. The Fund invested in companies of different sizes in diverse industries such as telecommunications, software services, shipbuilding, power, information technology, education, and textiles. Most of the investments were early stage investments but there were also some growth stage investments and initial public offering (IPO) investments. The Fund was likewise expected to invest mostly in SMEs but 8 to 10 investee companies are deemed large companies.

[1] Although the Fund was capitalized at Rs1.1 billion, total investments in the 39 companies reached Rs1.8 billion because profits from divestments were distributed to investors but the principal was reinvested within the investment period.

II. PROJECT EVALUATION

A. Development Outcomes and Impacts

1. Contribution to Private Sector Development

9. The XARR rated the Project's contribution to private sector development *satisfactory*. The XARR stated that the Fund was one of the pioneers in the private equity industry in India and was successful in attracting capital for its investee companies, assisting some of them with the IPO process, and introducing now-standard structures and instruments. Other assistance to investee companies included developing strategies for the business, attracting strategic partners, and establishing systems and processes. The project also contributed to knowledge transfer and competition as several investment professionals from the Fund eventually left the Fund to join other funds as senior investment professionals or fund managers.

10. This validation generally agrees with the assessment of the XARR and confirms the *satisfactory* rating of the project. However, the XARR could have provided more evidence that the Fund was indeed one of the pioneers of the private equity industry in India. For instance, it could have included a brief discussion of when the first VCFs were established and how many were operating at the time the Fund was established. As for the Fund introducing new structures and financial instruments, the XARR could have provided examples of these to give more credence to the statement.

2. Business Success

11. Given the negative net IRR of the Fund, the XARR rated the business success of the project *unsatisfactory*.

12. Based on financial statements and the fund manager's reports, this validation also calculated the real net IRR to be negative. Therefore, this validation maintains the *unsatisfactory* rating for business success.

3. Contribution to Economic Development

13. The XARR rated the Project's contribution to economic development *satisfactory* citing increased payments of taxes by some investee companies, increased employment, successful IPOs, successful trade sales, and raising additional capital for investee companies.

14. Project Administration Instruction (PAI) 6.07B[2] requires the calculation of economic internal rate return (EIRR) since this will be the basis for rating the project's contribution to economic development. The XARR did not calculate the EIRR for the Project. In accordance with PAI 6.07B, this validation used the gross financial internal rate of return (FIRR) derived from the portfolio investments of the Fund as the proxy EIRR. The calculation would have involved adding back in the cash flows all income taxes paid by the Fund but since it was treated as a pass through entity, no income taxes were paid and no adjustments were made in the calculation. The calculated real EIRR was unsatisfactory so the project's contribution to economic development is rated *unsatisfactory*.

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[2] ADB. 2008. *Project Administration Instructions 6.07B: Extended Annual Review Reports for Nonsovereign Operations.* Manila.

4. Environment, Social, Health, and Safety Performance

15. The XARR rated the Project's environment, social, health, and safety (ESHS) performance *unsatisfactory*. ADB's investment in the Fund predated approval of ADB's safeguard policies but the XARR believed that the Fund invested in a number of companies (those involved in shipbuilding, textiles, mining, thermal power, and steel) that may have warranted environmental assessments but there is no information whether these were done or not.

16. An *unsatisfactory* rating is given if a project does not materially comply with either the statutory laws and regulations or ADB's requirements at approval. There were no ADB requirements at approval so the project cannot be faulted for this. There is also no evidence that the project or the investee companies of the Fund failed to comply with the host country's ESHS laws and regulations, caused substantial damage to the environment, or exposed workers and the community to excessive health risks or worsened socioeconomic conditions. The XARR also reported that the IVCL conducted environmental and social audits when it took over management of the Fund. This is believable considering that IL&FS, IVCL's parent company, developed its environmental and social report as early as 1995. A *satisfactory* rating is therefore more appropriate in this case.

5. Overall Development Impacts and Outcomes Rating

17. The XARR rated the overall development impacts and outcomes of the project *satisfactory.* This validation downgrades the overall rating to *less than satisfactory* because the project's contribution to private sector development was only *satisfactory* and not strong enough to compensate for the *unsatisfactory* ratings for business success and contribution to economic development.

B. ADB's Investment Profitability

18. The XARR rated ADB's investment profitability *unsatisfactory* because it significantly underperformed in relation to the target return in the report and recommendation of the President (RRP) of 14.9%.

19. The basis for the investment profitability rating should be the FIRR based on actual cash flows plus the fair market value of ADB's share in the unrealized investments and not the FIRR based on the pure cash flows. Nonetheless, this validation maintains the rating of *unsatisfactory* for ADB's investment profitability because the recalculated FIRR as of 31 March 2012, which although higher than that calculated in the XARR, was still much lower than the target return.

C. ADB's Operational Effectiveness (Work Quality)

1. Screening, Appraisal, and Structuring

20. The XARR stated that ADB helped screen, appraise, and structure the fund at its inception. However, the XARR also pointed out the weaknesses of the project design, specifically the original structure as an apex fund and the timing of the capital calls and drawdowns, which eventually led to inferior returns. Accordingly, the XARR rated ADB's performance in screening, appraisal, and structuring *partly satisfactory*.

21. This validation agrees with the XARR's assessment, which was detailed and insightful, and maintains the *less than satisfactory* rating. Indeed, more upfront work could have been done to help ensure (i) the availability of matching funds from state agencies, financial institutions, and private companies for the state level funds, and (ii) a pipeline of possible investments.

2. Monitoring and Supervision

22. The XARR rated ADB's performance in monitoring and supervision *satisfactory*. ADB was represented in the Board of the Fund and was highly involved during the Fund's restructuring during its early life. Subsequently, ADB involvement was less intensive but consistent.

23. This validation partly agrees with the assessment. ADB was represented and participated in the Fund's Board. Records also showed that regular reports, including investor reports and financial statements, were regularly and consistently submitted to ADB. However, ADB could have improved project supervision to ensure that the original objectives of the Fund were achieved. For instance, the original intent of the Fund was to invest in ventures, nurture them, and then take them to the stock market for IPO. It was noted, however, that 11 of the Fund's 39 investments (28%) were IPO investments, which while generally profitable, was not in line with the Fund's objectives because investee companies were already set and no longer needed venture capital and nurturing. In fact, some of the IPO investments were disposed of within a couple of months from their investment. The Fund was likewise supposed to focus its investments in SMEs but many of its investments were in larger companies. In view of the foregoing, this validation downgrades ADB's performance in monitoring and supervision to *less than satisfactory*.

3. Role and Contribution

24. The XARR rated ADB's role and contribution *satisfactory* because it was in line with ADB operating strategies, policies, and standards as they existed at the time of investment.

25. This validation concurs with the assessment and maintains the *satisfactory* rating for this category. The project was aligned with ADB's overall private sector development strategy and ADB's financial sector development strategy in India.

4. Overall Work Quality

26. The XARR rated ADB's overall work quality *satisfactory* based on *partly satisfactory* ratings in screening, appraisal and structuring, and *satisfactory* ratings in monitoring and supervision and in role and contribution. This validation downgrades the overall ADB work quality rating to *less than satisfactory* in view of the downgrade in the rating of monitoring and supervision.

D. ADB's Additionality

27. The XARR rated ADB's additionality *satisfactory*. It noted that ADB was a co-promoter of CVF, which was the original manager of the Fund, and that ADB provided assistance in conceptualizing and developing the project. The XARR also stated that ADB was instrumental in getting other financiers to participate as an equity investor in the Fund.

28. This validation concurs with the XARR's assessment and confirms the *satisfactory* rating for ADB's additionality. There is sufficient evidence that ADB finance was a necessary condition in the timely implementation of the project.

E. Overall Assessment

29. The XARR rated the Project *partly satisfactory* overall in view of the *satisfactory* ratings in development impacts and outcomes, ADB work quality, and ADB additionality, and the *unsatisfactory* rating in ADB investment profitability.

30. This validation agrees with the overall rating but changes the final rating to *less than successful* as this is the appropriate term per IED guidelines. There are also changes in the component ratings as earlier discussed and as shown in Table 1.

Table 1: Overall Ratings

Criteria	XARR	IED Review	Reason for Disagreement and/or Comments
Development Outcomes and Impacts	Satisfactory	Less than satisfactory	The *satisfactory* rating cannot be justified because the contribution to private sector development was only *satisfactory* and not strong enough to compensate for the *unsatisfactory* ratings in business success and contribution to economic development (paras. 9–14).
1. Contribution to private sector development	Satisfactory	Satisfactory	
2. Business success	Unsatisfactory	Unsatisfactory	
3. Contribution to Economic development	Satisfactory	Unsatisfactory	This validation downgraded the rating to *unsatisfactory* on the basis of EIRR calculation results (para. 14).
4. ESHS performance	Unsatisfactory	Satisfactory	There were no ADB requirements or safeguard policies at approval and there were no known violations of ESHS regulations (para. 16).
ADB's Investment Profitability	Unsatisfactory	Unsatisfactory	
ADB's Work Quality	Satisfactory	Less than satisfactory	Overall work quality rating is downgraded due to the downgrade in monitoring and supervision rating (para. 23).
1. Screening, appraisal, and structuring	Partly satisfactory	Less than satisfactory	
2. Monitoring and supervision	Satisfactory	Less than satisfactory	ADB should have ensured that the fund manager adhered to the fund's objectives (para. 23).
3. ADB's role and contribution	Satisfactory	Satisfactory	
ADB's Additionality	Satisfactory	Satisfactory	
Overall Assessment	**Partly satisfactory**	**Less than successful**	

ADB = Asian Development Bank, EIRR = economic internal rate of return, ESHS = environment, social, health, and safety, IED = Independent Evaluation Department, XARR = extended annual review report.
Note: From May 2012, IED views the XARR's rating terminology of "partly" or "less" as equivalent to "less than" and uses this terminology for its own rating categories to improve clarity.
Source: ADB Independent Evaluation Department.

III. ISSUES, LESSONS, AND RECOMMENDATIONS

31. The XARR combined the issues, lessons, and recommendations. The main points discussed were the following: (i) the idea of creating an apex fund to seed 10 state-level funds was not successful and this could have been subjected to greater scrutiny during appraisal; (ii) the fund manager should have been given the flexibility to draw down the capital of the fund in accordance with its investment needs rather than at four pre-determined capital calls as this resulted in misallocation of resources; and (iii) the fund's investment in smaller companies did not perform well and this underscores the necessity of having rigorous due diligence processes in place for any fund.

32. This validation agrees with the issues, lessons, and recommendations identified by the XARR. In addition, it was noted that the fund manager strayed from the original intent of the Fund to focus its investments in SMEs and to invest in ventures with a view to taking the investee companies to the stock market. It is therefore recommended that ADB be more vigilant in monitoring and supervising fund managers of private equity funds to ensure that they adhere to the intended purposes and objectives of the Fund.

IV. OTHER ASSESSMENTS AND FOLLOW-UP

A. Monitoring and Evaluation Design

33. The XARR did not discuss the monitoring and evaluation design for the project. Although regular valuation reports and financial statements were submitted by the fund manager to ADB, ADB should have required the submission of cash flow statements since this is necessary for the calculation of the project's business success per guidelines.

B. Other Aspects

34. Safeguard issues were already discussed in the ESHS performance of the project.

C. Data Sources for Validation

35. Aside from the RRP and XARR, the validation also reviewed other project documents including the minutes of the staff review committee meeting, the Contribution Agreement, valuation reports, investor reports, and audited financial statements.

D. Comments on XARR Quality

36. In general, the XARR provided sufficient evidence to support its assessments and ratings, particularly in the discussion of the Project's contribution to private sector development (Table 2). The appendixes containing the review of the Fund and the review of the Fund's sub-investments were likewise very good as they provided ample details about the Fund and its investments. The XARR was internally consistent and clear for the most part.

37. The quality of the XARR could have been better had it (i) provided more evidence that the Fund was indeed one of the pioneers of the venture capital industry in India and that it introduced new financial structures and instruments; (ii) independently verified the IRR calculation for business success; (iii) calculated the EIRR as required under existing guidelines; and (iv) included a definition of SMEs in the project country and identified which Fund investments were SMEs and which were not.

Table 2: Extended Annual Review Report Quality

	Excellent	Satisfactory	Less than satisfactory	Unsatisfactory
(i) Quality and completeness of evidence and analysis to substantiate ratings		X		
(ii) Consistency with XARR guidelines (PAI 6.07b)			X	
(iii) Plausibility of assumptions underlying economic and financial analyses, including calculations of EIRRs, FIRRs, and assumptions on project sustainability		X		
(iv) Quality of lessons identification and recommendations		X		
(v) Clarity and internal consistency of the XARR		X		
	Highly satisfactory	**Satisfactory**	**Less than satisfactory**	**Unsatisfactory**
Overall Assessment		X		

EIRR = economic internal rate of return, FIRR = financial 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

38. None.