ADB

Report and Recommendation of the President to the Board of Directors

Project Number: 39924
April 2006

Proposed Equity Investment in AIF Capital Asia III, LP

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
AIF	–	Asia Infrastructure Fund
CFA	–	chartered financial analyst
DMC	–	developing member country
EDRD	–	European Bank for Reconstruction and Development
GAAP	–	generally accepted accounting principles
GDP	–	gross domestic product
IPO	–	initial public offering
IRR	–	internal rate of return
M&A	–	mergers and acquisitions
PRC	–	People's Republic of China
PSOD	–	Private Sector Operations Department
PSOP	–	Private Sector Operations Division
SME	–	small- and medium-sized enterprise
US	–	United States

Note

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

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I. INVESTMENT PROPOSAL

1. I submit for your approval the following report and recommendation on a proposed equity investment in AIF Capital Asia III, Limited Partnership (the Fund) of up to $30 million or 15% of the Fund's total share capital, whichever is less. The Asian Development Bank (ADB) will not be the single largest investor in the Fund.

II. RATIONALE: BACKGROUND, CHALLENGES, AND OPPORTUNITES

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A. The Critical Role of Private Equity in Economic Development

2. In 2004, Asia benefited from strong global growth with gross domestic product (GDP) rising an estimated 7.3%. Growth is expected to slow to 6.5% in 2005.[1] Over the long term, Asia is projected to experience high economic growth supported by favorable demographics and increasing economic, trade, and political and social liberalization. The World Bank projects real GDP annual growth during 2006–2015 for East Asia and the Pacific at 6.1%, almost double that of global growth, which is projected at 3.1%.[2]

3. However, as Asia develops along this robust long-term growth trajectory, it will experience periods of above- and below-trend growth. During times of below-trend growth, temporary economic dislocation combined with the fickleness of public equity and debt markets creates attractive investment opportunities for private equity. Further, ensuring that private equity financing continues to be made available to entrepreneurial companies is important as this is long-term capital that does not disappear during economic downturns, but is there to weather the bad times and reap the financial benefits during the good times.

4. The environment for private equity investment exits in Asia is continually improving with increased mergers and acquisitions (M&A) and initial public offering (IPO) activity. For the first half of 2004, private equity divestments reached $3.1 billion, higher than the average full year divestment of $2.7 billion for 2000–2003.[3]

5. Asia's robust long-term growth prospects and strengthening capital markets have created a positive environment for private equity investing. The supply-demand dynamics of Asian private equity remain favorable. Economic growth and industrial transformation are generating ample deal flow, yet global private equity allocations to Asia are still low compared with the United States (US) and Europe.

6. Accordingly, the following features of the Asian private equity industry persist:

(i) **Asian private equity as a whole is under penetrated relative to the rest of the world.** Asia accounted for only 18% of the $96 billion of the estimated global private equity investment in 2004, while Asia, excluding Australia and Japan, accounted for less than 10%. Asian private equity investment as a percentage of

[1] International Monetary Fund. 2004. *World Economic Outlook*. Washington, DC.
[2] World Bank. 2004. *Global Economic Prospects.* Washington, DC.
[3] *Asia Private Equity Journal*. 2004. October.

GDP is only 0.2%[4] compared to 0.5% in North America and 0.4% in Europe.[5] If Asia applied the average of US and Europe of 0.45% to its GDP of $10 trillion, then its implied annual private equity investment capacity would be $45 billion versus the current level of $17 billion.

(ii) **The capital overhang (capital remaining for investment) of universal private equity accumulated since 1998 is relatively low and declining.** In other words, Asia has been investing more capital than it has been raising.

(iii) **Asian midsize deal activity is under penetrated.** Much of the recent Asian private equity fundraising and investing activity has focused on larger buyouts and restructurings in Australia and Japan. Of the $11 billion raised for Asia in 2004, approximately 70% was for buyout-focused investing in Australia and Japan. Of the $17 billion invested in Asia in 2004, 64% went into buyout deals, while only 19%, or $3 billion, went into expansion capital investments.

(iv) **Companies with enterprise valuations of under $200 million tend to lack public sources of financing.** To achieve a successful IPO, Asian companies typically need to reach an equity valuation upward of $200 million–$500 million. Despite improvements in the banking system and debt capital markets, lending activity continues to focus on larger companies.

(v) **Institutionally intermediated M&A activity in Asia tends to focus on large size deals.** Less than 8% of the US dollar amount of M&A traced by Bloomberg during 1999–2004 was within the deal size range of $10 million–$50 million. The diminished role of financial intermediaries for this size creates a better environment for deal sourcing, pricing, and negotiation.

(vi) **The environment for exits via trade sales and IPOs has improved considerably.** With regional merger and acquisition IPO activities strengthening, private equity divestments increased significantly during 2004. Regardless, Asian M&A as a percentage of GDP is relatively low at 2% versus the US at 6% and Europe at 4%. Such increased activity will create more exit opportunities.

7. While Asia's economies continue to grow rapidly, certain market segments must still struggle to gain access to capital. This reality creates very interesting investment opportunities as well as justifies a continued role for ADB as an investor in the private equity markets of its developing member countries (DMCs).

8. Asia's continuing integration into the global supply chain is inevitable as it continues to produce everything from raw materials to high value-added technological goods and services. Indeed Asia's share of trade increased from 14% in 1990 to 21% in 2004. This compares with the US's constant share at 13% and Western Europe's share, which has increased only marginally from 36% to 39% despite the formation of the European Union.[6] With Asia's low-cost and increasing skilled labor force, its improving infrastructure, and the ongoing liberalization of

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[4] This includes Australia and Republic of Korea, where private equity investment rates are much higher than in ADB's developing member countries. In the People's Republic of China and India, private equity investment was only 0.14% and 0.17% of GDP.

[5] PricewaterhouseCoopers. 2004. *Global Private Equity 2004.* London.

[6] World Trade Organization database, October 2004.

trade flows, Asia's continuing global integration is likely to continue to create opportunities to invest in entrepreneurial companies that ultimately contribute to sustainable economic growth, improved living standards, and poverty reduction.

B. Challenges and Opportunities

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9. Although a majority of investors anticipate increasing their exposure over the next 3 years, currently only about a quarter actually invest in emerging markets private equity. The main reasons cited for the current tentativeness focus on a shortage of credible fund managers, and lack of a proven track record for emerging markets private equity as an industry. Other key reasons include the perception that the risk/return trade-off is better in more developed markets, and that liquid quoted equities offer a better or safer exposure to emerging markets.[7]

10. The current dynamics of Asia's private equity industry, particularly in the middle market space, are creating unique opportunities for a fund manager with regional experience and a proven track record of adding value. The Fund aims to capitalize on these dynamics to make investments in high-potential companies throughout the region. Many midsize companies are well-positioned to benefit from global supply change integration and rising domestic consumption, but lack of access to equity capital to expand their operations to capitalize on these trends remains a critical problem despite all the publicity being generated in the press with respect to private equity activities in emerging markets. Most of the money is being invested in much larger deals, whereas the middle market remains underserved or underinvested.

11. Evaluation studies show that multilateral development banks can achieve a high development impact in the context of an underserved middle market by fostering investments in entrepreneurial companies and by catalyzing the growth of a nascent private equity industry. The European Bank for Reconstruction and Development (EBRD) has played a central role in stimulating and catalyzing the private equity industry in Eastern Europe. EBRD, the largest private equity investor in central and Eastern Europe, has supported many private equity companies in the region where managers are now setting up their fourth and fifth funds as the market grows in maturity. Indeed, EBRD's investments in private equity funds are a successful example of a multilateral development bank acting as a catalyst.[8] ADB's Operations Evaluation Department did an impact evaluation study of ADB's investment funds in 2002.[9] It concluded that private equity funds achieved "major development impacts" in five areas: (i) mobilizing significant financial resources for infrastructure development, direct investments in industrial enterprises, and portfolio investments; (ii) supporting small- and medium-sized enterprises and new entrepreneurs; (iii) supporting technology development; (iv) developing capital markets; and (v) generating employment.

12. The proposed Fund is an excellent opportunity to institutionalize and formalize private equity financing in the middle market, and therefore have a positive influence on the enabling environment for private sector development. An investment in the Fund will also contribute to mobilizing financial resources for industrial enterprises and to developing capital markets for the following reasons:

[7] Coller Capital. 2005/06. *Global Private Equity Barometer* (Winter): 12.
[8] Evans, Julian. 2004. What next for the EBRD? *Euromoney*. 35: 108–113.
[9] ADB. 2003. *Annual Review of Evaluation Activities in 2002*. Operations Evaluation Department. Manila.

(i) **Proactively creating opportunities for expansion.** The Fund Manager has used its networks to proactively achieve expansions when it perceived an entrepreneurial opportunity. The Fund Manager is expected to help entrepreneurial companies to grow into regional multinational corporations.

(ii) **Upgrading management practices and oversight.** The Fund Manager has an impressive track record in improving oversight and reporting standards, and transferring best management practices to its investee companies. It has, for example, restructured its investee companies' boards of directors, appointed professional managers, and encouraged sharing of knowledge and cross-learning among its investee companies. The Fund Manager is expected to help improve the efficiency of the region's capital markets by improving the oversight and transparency of its investee companies.

(iii) **Establishing sound financial structures to support growth.** The Fund Manager has supported the companies' expansion by introducing additional added-value investors. Not only has the Fund's equity injection improved investee companies' financial leverage ratio and enabled them to seek additional finance from commercial banks, the Fund Manager has also directly advised companies in risk management practices and in ensuring stable cash-flow patterns, which make them more attractive for lenders.

III. THE PROPOSED FUND

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13. The Fund will focus its investment strategy on maximizing medium-term capital appreciation by means of equity or quasi equity instruments invested in private companies in the region. It will target companies benefiting from Asia's economic growth, with a focus on two key trends: (i) the continuing integration of Asia into the global supply chain, and (ii) rising domestic demand driven by the emerging Asian middle class.

14. The Fund will broadly pursue the following types of transactions: influential minority expansion capital; expansion financing (to develop an attractive market niche or to strengthen the existing business as a platform to consolidate a fragmented industry through acquisition); and acquisition financing. The Fund will make minority investments in proven business models with strong growth potential provided sufficient minority rights can be negotiated. With much of the recent Asian private equity activity focused on larger buyout deals, the Fund Manager believes many attractive yet overlooked opportunities for expansion capital are available in the Fund's target size. In addition, given the Fund's investment range of $10 million–$50 million, it will target buyouts for companies with enterprise values between $50 million–$200 million. Such opportunities could include privately held companies lacking the capital and managerial resources to develop their growth potential, or ignored public companies that can be taken private and reorganized to extract value or similar unrecognized divisions of larger companies. There will also be special situations for opportunistic distressed investing. Such investments could take many forms including distressed debt converted into equity, acquiring quality assets from distressed owners, and refinancing strong operating businesses with overleveraged capital structures.

15. The Fund aims to invest broadly across Asia with an initial focus on the PRC; Hong Kong, China; India; Indonesia; Republic of Korea; Malaysia; Singapore; Taipei,China; and Thailand given their economic growth potential. ADB's capital commitment will be invested into

its DMCs provided that a maximum of 15% of ADB's committed capital may be invested in other member countries. The legal documentation will include the necessary opt-out clauses to ensure that ADB funds are not invested in non-DMCs beyond the limit of 15%.[10] The Fund will not be permitted to invest in companies engaged in activities on ADB's prohibited investment list.[11]

16. The Fund anticipates exits from its investments through a variety of avenues including strategic sale to an operator; sale to other financial investors; an IPO; or a buyback with coinvestors, partners, or the promoters of such portfolio companies. The Fund may reinvest the cost part of the exit proceeds in new investments during the investment period in accordance with its investment objectives and relevant legal provisions.

17. The Fund will be managed by AIF Capital III GP Ltd (the General Partner), a company incorporated under the laws of the Cayman Islands. The General Partner will in turn enter into a management agreement with AIF Capital Asia Management Ltd (the Manager), also incorporated under the laws of the Cayman Islands. The Manager, in turn, will enter into an investment advisory agreement with AIF Capital Ltd (the Advisor), a company incorporated under the laws of Hong Kong, China.

18. The Fund Manager consists of 14 investment professionals, of which 7 have been with the Fund Manager since 1995, while all of the senior members have been with the Fund Manager since 1998. The team has over 170 years of combined experience in Asian private equity, investment, corporate finance, and industry.

19. The Fund Manager has consistently used a fundamental, value investing approach to capitalize on opportunities arising from Asia's economic and industrial transformation in under-penetrated segments of the Asian private equity spectrum. The Fund Manager has invested and managed its portfolios through some of the most tumultuous times in Asia, and has achieved strong returns for its investors. The performance of two other funds managed by the Fund Manager, Russell AIF Asia II (Fund II) and Asian Infrastructure Fund (Fund I) compare favorably with Asian private equity funds of similar vintages and with Asian public markets over similar periods. The Fund Manager operates out of Hong Kong, China, with an office also in Delhi, India. The Fund Manager may also open an office in Shanghai depending on deal flow opportunities in the PRC.

IV. ASSURANCES

20. Following the approval of the proposed investment by ADB's Board of Directors, ADB will enter into suitable investment documentation for its investment of up to the lesser of $30 million or 15% of the Fund's total share capital and will ensure that such documentation and other principal agreements relating to the Fund will be on terms and conditions acceptable to ADB and incorporate all relevant ADB policies.

[10] The Fund Manager has developed a pipeline of advanced investment transactions: Of all investment transactions in the pipeline 50% by investment amount are in the PRC, 17% in India, 23% pan-Asian DMCs, and 11% in non-DMC countries.
[11] ADB. 2003. *Operations Manual,* Section D10/BP, paras. 14.

V. RECOMMENDATION

21. I am satisfied that the proposed investment in AIF Capital Asia III would comply with the Articles of Agreement of ADB and recommend that the Board approve the investment of up to the lesser of $30 million or 15% of the total share capital of AIF Capital Asia III from ADB's ordinary capital resources.

Haruhiko Kuroda
President

28 April 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)[a] • 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	• Annual net profit of subproject (database) • Annual net revenue of subproject (database)
	• Stronger local entrepreneurship	• 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)
	• Contribution to widening the access to finance of SMEs	• Additional debt raised by subprojects as a result of the equity investments (database)
	• Provision of value-added services, enhancing the viability of SMEs	• 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	• Increased amount of taxes paid by subprojects (database)
	• Employment generated	• Number of jobs created by subprojects (database) • Quality of jobs created by subprojects e.g., technical jobs (PCR)
	• Adoption of new technologies and production processes	• 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/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	• 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
	• New technology, development of management skills, and employee training in domestic financial sector	• Number of local investment professionals in SME private equity trained by the Fund (PCR) • Number of the Fund's investment professionals raising a subsequent fund in financial sector of a developing member country (PCR)
	• Resource mobilization through private equity	• Mobilized domestic finance for investments in productive SMEs by the Fund (at closing of the Fund) • Mobilized international finance for investments in productive SMEs by the Fund (at closing of the Fund)
	• Growth in financial services in the domestic financial markets[b]	• Growth in private equity market in the domestic financial sector (PCR) • Increased access to long-term finance (PCR)

PCR = project completion report, SMEs = small- and medium-sized enterprises.

[a] Performance measures followed by "(database)" will be monitored regularly in the framework of the Private Sector Operations Department's database for funds. Performance measures followed by "(PCR)" will be measured at the PCR stage.

[b] 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.