EvD Special Study: Achieving Equity Investment Objectives: A Review of Initiatives Since 2007

Management Comment

1. Summary

The Study includes a number of observations of the sample projects and uses them to illustrate the key discussion points. Management has noted that some of those observations may warrant clarification and/or corrections and amplification. Likewise, the Study contains 39 suggested measures for improvement and 11 'aspects of governance to be considered', a number of which are broadly covered in the bigger theme of the three recommendations discussed further in the Study. On this occasion, Management has chosen to focus on the three main conclusions and recommendations laid out in the Executive Summary, rather than to comment on sample-specific issues as they would be better addressed when the subject projects are reviewed separately in one of EvD's products.

As the Study has acknowledged, observations, findings and recommendations are drawn from a limited and not fully representative sample. Notwithstanding, Management has found the attention of the Study highly relevant to the on-going discussions of the Bank's equity approach and largely concurs with the Study's observations broadly summarised as follows:

- At the portfolio level, there has been strengthening of oversight by the Equity Committee and of middle office processes and functions. This has improved timely formulation of exit strategies and the ensuing decision-making process for exits;

- Conversely, at the project/project team level certain weaknesses persist, such as a lack of rigor in designing a coherent investment thesis, insufficient due diligence, inconsistent implementation/application of value creation and a lack of discipline in executing the exit strategies, etc.

- Important work and improvements are underway, including the wider operational process efficiency/effectiveness review, overhaul of Project Monitoring Module (PMM) system, and a review of Board documents. It is expected that the on-going work endeavours to address the remaining weakness in line with the study's three recommendations.

2. Comments on the Three Recommendations

The Study made the following three recommendations:

- Review the Equity Approach
- Review the Equity Monitoring Report
- Modernise Board Documents for Equity Content

2.1 Review Equity Approach

The inter-departmental discussion on the management of equity investments has already been taking place and is on-going. This was instigated subsequent to the changes in key senior management positions, namely First Vice President and VP Risk. At the same time, given the monitoring intensity normally associated with equity, the Bank's handling of equity projects will also be reviewed in the broader context of enhancing the monitoring capability/efficiency of the Bank. As such, while the Study pertains solely to equity, the review will be considered within a wider operational process efficiency/effectiveness agenda[1].

In addition, in response to the recommendation by Internal Audit (IAD), Management has recently proposed that it reviews the Bank's credit monitoring processes, including equity investments and possibly the future role of the Corporate Equity unit, in the fourth quarter 2013. FVP Banking and VP Risk have undertaken the organisation of this review. As it makes little sense to separate the life cycle of equity investment into different phases such as origination and monitoring, a comprehensive review of equity investment processes is expected to be part of this review.

It is envisaged that the review will take into account several key factors such as the prevailing successful operation model. Management agrees with the observation made by the Study that for example the Financial Institutions business group has developed equity expertise ahead of the other three business groups and that best practices could be drawn from its model.

2.2 Review Equity Monitoring Report

Management agrees with the recommendation that the monitoring report needs updating. In fact the necessity of improvement of monitoring reports (both debt and equity) is one of the most acute work-process efficiency issues pending. Improving the substance of monitoring does not necessarily need to wait for the completion of the review of Equity Approach above. Nonetheless, monitoring work-processes are comprised of highly complex work flows, involving multiple control points, which have grown exponentially over time. Untangling them and creating new processes will be a resource intensive, Bank-wide exercise, and changing even a few aspects of the monitoring report is not a simple undertaking. Therefore the review of the equity monitoring report will inevitably need to be sequenced with (if not done in parallel) with the review of Equity Approach.

In the meantime, due to the acuteness of the issue, a number of incremental improvements are being implemented on an on-going basis. As regards equity, because of associated high risk, the highest priority is the inclusion of credit monitoring features in reporting which has been done (as mentioned below) and the issues concerning value creation, which are yet to be dealt with.

- The entire Project Monitoring Module (PMM) has been under review. In the past 18 months, as part of the interim upgrade on PMM a number of adjustments were made and put into practice in April 2013;
- The initial stage of the improvements have been focused on (i) credit issues and reduction of delivery time of the report to Risk Management and (ii) the reduction of process burdens such as elimination of obsolete/irrelevant information and reduction of duplication of sign-offs; and

[1] It has recently been decided that the separate initiative to review work processes Bank-wide should include a monitoring process review which in turn includes an equity processes review.

- Changes in report substance have been introduced, especially in equity, focusing on capturing essential financial information of the portfolio companies in order to track the projected performance.

2.3 Modernise Board Documents for Equity Content

At present, as part of the effort under the Board task Force, Management is in the process of enhancing documents for OpsCom with the view to reflect the enhanced information in the Board reports. The areas of enhancement are listed below; although not all areas will be immediately included, it is envisaged that they will be adopted gradually when equity projects are reviewed by OpsCom and will be selectively applied to the Board document according to applicability and subject to commercial confidentiality requirements.

- Better presentation of the business case, differentiating it from the investment case.
- For the business case, highlight of the quantum of value to be created in key drivers (turnovers, EBITDA, etc) and the corresponding objectives in the form of KPIs.
- For the investment case, the key investment parameters, including not only IRR but also cost (money) multiples, should be differentiated from the Bank's profitability model.
- Realistic assessment of the various exit routes and the conditions required to implement them, including related rights of the Bank to drive the exit process.
- Improvement of risk factor presentations, such as inclusion of quantification of the impact of the risks and low or worse business case, accompanied by risk mitigation measures (in terms of actions to be taken by the company or by the Bank in terms of its rights)
- Descriptions of value creation plans to have a higher relevance to those risks identified and where applicable, integrate with Transition Impact.

3. Comments on 'Suggested Measures for Improvement'

Without commenting individually on the suggested measures for improvement, management notes the following.
Some of those detailed suggestions are related to the on-going discussion of recent performance metrics, "EvD Special Study –Performance Metrics-How well do EBRD projects specify Expected results?" for which Management has provided extensive comments (SGS13-113). In particular, the recommendation to *'Integrate transition objectives and benchmarks that are competition, market expansion or corporate governance based with value creation drivers. Apply a common assessment ex ante and during monitoring'* is related to discussion of the links between operational objectives of an investment and its transition impact. Management agrees that commercial/financial success is closely linked to the transition impact objectives in the case of an equity investment. Therefore, integrating transition objectives and benchmarks with value creation drivers makes sense so long as the latter are deemed relevant to the transition impact *ex-ante*. Indeed, transition impact benchmark table of equity investments often includes commercial performance measures.

Nevertheless, not all and always the commercial/financial success measures related to competition, market expansion and corporate governance are transition impact relevant of "sufficient" importance for the targeted transition objectives of a particular project. If the equity investment is helping transition because it substantially increases competition (supporting an entrant in an oligopolistic market), then the market share performance is relevant for transition impact and would be integrated in the benchmark table. Whereas, in the case when the market where the client operates is mature, i.e. already competitive, the market share performance measure is important for commercial/financial performance (value creation), but not from the transition impact perspective. This is because increase in competition would not be a source or target of transition impact in that case. Similar examples could be brought for the other sources of transition impact.

Management agrees that a common understanding of the shared objectives in the drivers of value creation and transition objectives is important and necessary. Development of a well-defined value creation plan and a common understanding of and integration with overlapping transition objectives would helps to strengthen the transition impact case at the ex-ante stage and its on-going monitoring ex-post. For example, the commercial outcome of an exit should often also be a transition goal and should be consistently benchmarked.

Management cautions that it is not possible to implement a number of suggestions in the short-to-medium term with the existing resources. In the immediate future, Management plans to triage the available resources on the most acute, immediate needs for improvement of the equity management processes and structure but it is likely that not all the items will be tackled in the foreseeable future. For example, as recognised in the Study, thorough corporate governance assessments for each equity investment during due diligence, and a qualitative principle-based assessment of transition impact on this dimension ex-post, while important, need significant resources and expertise, requiring some time for the Bank to build such capability.