Achieving equity objectives: a review

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This evaluation study assesses the extent to which initiatives taken in equity investment and management by the EBRD since 2007 are contributing to better achievement of the Bank's equity investment objectives. It follows a 2009 EvD report that highlighted areas where equity practice could be strengthened. It also considers how far equity objectives are specified at entry in a way that is measurable and supports effective monitoring.

Approach

The study is based on a desk review of core project records for a sample of 17 out of 116 direct equity investments made from 2007 through to June 2011. It is presented around the three components that form the 'equity story' in the EBRD and need to come together to support sound equity investment: value creation; transition impact; and risk. Corporate governance and shareholder interaction is at the heart of the EBRD's rationale for equity investment and this study gives particular attention to effectiveness of the corporate governance approach in achieving equity value creation and transition impact.

The full report is available at: www.ebrd.com/evaluation

Results

Initiatives since the 2009 study are having a positive impact on equity management. There is now a more structured approach to valuation at the individual project level (clearer presentation of investment pricing analysis) and on a portfolio basis. Supported by improved data, better liaison with the Office of the Chief Economist and periodic reviews, the Equity Committee is able to exercise improved scrutiny. Reporting of equity performance to the Board in the Quarterly Risk Report is also considerably more informative than found previously, but is more risk- than results-orientated.

Opportunities to strengthen practices

There is both need and opportunity to further strengthen equity practice. Presentation of strategic and financial analysis has improved but the drivers of value creation, interdependencies and risk factors are not presented explicitly. A clearer narrative is needed to define value creation objectives at entry, which should be integrated with monitoring. The introduction of 'Company value creation plans' (and other formats) which commenced in 2012 will encourage clearer definition of value creation opportunities, actions and objectives. Monitoring and reporting were recommended for review by the 2009 EvD study. Project level equity monitoring (as opposed to portfolio monitoring) has continued largely unchanged. There is a clear case for a full redesign of the EBRD automated project monitoring system for equity use, to ensure that monitoring and reporting formats suit equity needs.

Transition impact

The introduction of the Transition Impact Monitoring System at the EBRD has made the setting and monitoring of measurable benchmarks a standard practice. Equity dimensions of benchmarks usually relate to strategic and commercial goals and corporate governance actions. The setting of objectives and benchmarks is helpful to monitoring but the Transition Impact Monitoring System approach would benefit from greater integration with the equity story and drivers of value creation. As of writing, a review by Management of the project monitoring system, including its fit with the separate Transition Impact Monitoring System, is underway.

Corporate governance

The articulation of corporate governance as an equity-specific transition objective has become more evident since the 2009 EvD study. However, approaches in practice have not developed in line with the greater prominence. There is no structured and coherent approach to securing corporate governance gains through equity investment. Sample review indicates an insufficient understanding of governance and the influences on its effectiveness: analysis of governance factors is sparse and the formal setting of specific objectives for nominee directors is not common practice.

Transition benchmarks overwhelmingly focus on 'measurable' governance indicators such as appointment of a Nominated Director. They only rarely address the numerous other factors which influence governance effectiveness. Monitoring reports barely capture meaningful aspects of good governance.

The corporate governance due diligence checklist now being developed could provide a basis for improved assessment, gap analysis and establishing the basic principles of governance expected by the EBRD. Wide and consistent implementation as an evident Management priority would be a positive step forward. The opportunity exists to integrate governance objectives with the drivers of value creation, transition impact and the monitoring process.

Risk analysis

Risk analysis has improved in its extent and operational risks are included more frequently than in the earlier study. However, significant gaps remain: political and regulatory risk assessment is often limited, even though it clearly has a major impact in many cases in the sample; key operational risks such as people risk, systems development and compliance are not presented; description of the mitigants is often more of an explanation as to why a risk is not relevant than a description of what will be done to address the remaining risk; and risk profiles and key risk indicators are not used.

Initiatives to strengthen oversight

This study confirms that important initiatives in the way the equity portfolio is managed are contributing to stronger oversight of equity investments and better information for decision taking. In particular:

– A strengthened equity portfolio review process, supported by more useful data and interaction over exit readiness from a transition perspective;

– Substantial progress on portfolio and investment financial performance monitoring (related to the Equity Portfolio Monitoring Unit);

– Improved financial and strategic analysis and commentary in investment approval documents;

– Enhancements in risk analysis and the setting of equity related measurable benchmarks (from the Transition Impact Monitoring System).

Other initiatives currently in process (establishing value creation plans and developing an approach to corporate governance due diligence and monitoring) will contribute further to the progress made. These are all steps in the right direction but the study raises important issues for further consideration by the Board and Management of the EBRD. Most significant are limitations identified in the tools, processes and practices for investment and monitoring at the level of the individual investment.

Value creation and transition objectives

Limitations in the specification of equity investment value creation and transition objectives undermine the establishment of measurable benchmarks at entry, which is compounded by an equity monitoring approach ill-suited to equity requirements. It follows that if there is scope for strengthening equity management process and practices, then it is likely that results are not being maximised, project level risks are not being fully recognised, institutional learning is not being captured and accountability is not being fully maintained. The study finds:

– The equity approach lacks a clear emphasis on value creation from pre investment to exit and is undermined by the monitoring report structure;

– Monitoring reports and the existing project monitoring system are no longer fit for the purpose of equity monitoring. Arguably a redesigned approach is required for equity monitoring;

– The investment process does not define expected equity results ex ante in an integrated way across the EBRD (linking the related dimensions of returns, risk, and transition);

– Corporate governance underpins the equity rationale for EBRD equity investment but is not being adequately incorporated into the EBRD's equity approach. There are also questions around the effectiveness of engagements with nominee directors.

The equity investment portfolio now represents the most volatile component of the EBRD's financial results. The main reports for communicating aggregate equity results to the EBRD's Board are arguably risk, rather than performance orientated and fall short of what is needed for Directors to apply effective oversight through well directed challenge to management. The Board may therefore wish to take stock of its role in equity oversight.

Recommendations

Review of the equity approach

It is recommended that Management undertake a review of the business process for equity investment with the objective of enhancing the focus on results. Placing value creation and transition impact at the heart of equity investment should be central to the review. The opportunity exists to streamline the investment process by establishing unified approaches between the multiple departments, teams and stakeholders involved in overlapping aspects of equity investment (such as value creation, corporate governance, engagement with nominee directors and risk management). A business process review would provide the opportunity to establish a joined-up approach from pre-investment, through value creation and exit and to share good practice between teams and departments where multiple approaches have been developed.

Review of the equity monitoring report

Within the complexities and practical limitations of existing management tools and structures, it is recommended that the equity monitoring report and reporting process is redesigned. As a first step the monitoring process needs to be reviewed, in conjunction with the equity investment business process, to define the requirements the monitoring report needs to fulfil for the multiple stakeholders it serves. It should be left for the review to determine how the monitoring process and reporting format needs to be developed but it is clear that there are complex and interlinked dimensions that will need to be considered. It may be concluded that the monitoring report needs to be refocused around a smaller number of equity results, value creation drivers and key performance indicators, rather than to try and satisfy multiple users in multiple ways as at present.

Modernisation of Board documents for equity content

It is recommended that the working group reviewing the Board document template incorporate equity specific elements into any new format considered. As a minimum, equity content should reflect current initiatives in Banking to introduce value creation plans for all equity investments and enhanced corporate governance approaches. These two elements alone provide an opportunity to strengthen the results framework presented in the Board document but a wider opportunity exists to present the equity story as a more accessible, better signposted narrative that brings clarity to the drivers of value creation, interdependencies, expected results, risk factors (and for the final review document, their impact on valuation).

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