



Corporate Evaluation

Comparative Study of Equity Investing in Development Finance Institutions

Comparative Study of Equity Investing in Development Development Finance Institutions (DFIs)

Office of Evaluation and Oversight (OVE)

March 2017





This work is distributed under a Creative Commons license <https://creativecommons.org/licenses/by-nc-nd/3.0/us> (CC BY-NC-ND 3.0 US). You are free to share, copy and redistribute the material in any medium or format, Under the following terms:



Attribution - You must give appropriate credit, provide a link to the license, and indicate if changes were made. You may do so in any reasonable manner, but not in any way that suggests the licensor endorses you or your use.



Non-Commercial - You may not use the material for commercial purposes.



No Derivatives - If you remix, transform, or build upon the material, you may not distribute the modified material.

No additional restrictions - You may not apply legal terms or technological measures that legally restrict others from doing anything the license permits.

The link provided above includes additional terms and conditions of the license.

© **Inter-American Development Bank, 2017**

Office of Evaluation and Oversight
1350 New York Avenue, N.W.
Washington, D.C. 20577
www.iadb.org/evaluation

CII/RE-20-2

ACRONYMS AND ABBREVIATIONS

ACKNOWLEDGEMENTS

EXECUTIVE SUMMARY

1. CONTEXT OF THE STUDY	1
A. Rationale and methodology of the study	1
B. Scope of the study.....	6
C. Challenges for EI in LAC	8
2. EQUITY INVESTING AT DEVELOPMENT FINANCE INSTITUTIONS	13
A. DFIs' rationale for doing equity investments.....	13
B. DFIs' approach to equity: funds vs. direct investments.....	14
C. Use of EI in DFIs.....	16
D. Financial performance.....	18
E. Development results	23
3. HOW DFIs INVEST IN EQUITY	27
A. EI origination	27
B. EI structuring	30
C. Supervision and value-adding.....	33
D. Exiting and lessons learned	35
4. IMPLICATIONS FOR IIC.....	39
A. Articulating specific objectives for EI	39
B. Managing the trade-offs of EI	40
C. Achieving organizational specialization and critical mass.....	41
D. Ensuring EI continuity and long term horizon.....	45
E. Revamping incentives and metrics for EI	46

NOTES

ANNEXES

ANNEX I: [Equity Experts Interviewed](#)ANNEX II: [Interview Questionnaire](#)

ACRONYMS AND ABBREVIATIONS

ADB	Asian Development Bank
AMC	IFC's Asset Management Company
AMEXCAP	Mexican Association of Private Equity and Venture Capital Funds
Bancóldex	Colombia's Development Bank
BNDES	Brazil's National Development Bank
CAF	Development Bank of Latin America
CIEF	China-IIC SME Equity Investment Trust Fund
DEG	German Investment Corporation
DFI	Development finance institution
E&S	Environmental and social
EBRD	European Bank for Reconstruction and Development
EI	Equity investment
ESG	Environmental, social, and governance
FMO	Netherlands Development Finance Company
GP	General partner
ICT	Information and communication technology
IDB(G)	Inter-American Development Bank (Group)
IFC	International Finance Corporation
IIC	Inter-American Investment Corporation
IRR	Internal rate of return
LAC	Latin America and the Caribbean
LAVCA	Latin American Private Equity & Venture Capital Association
LP	Limited partner
MIF	Multilateral Investment Fund
OVE	Office of Evaluation and Oversight
PE	Private equity
SG	Sovereign-guaranteed
SME	Small and medium-sized enterprise
VC	Venture capital
WB(G)	World Bank (Group)

This document was prepared under the guidance of Cheryl Gray (OVE Director) by a team composed of Roland Michelitsch and Alejandro Soriano (team leaders), Ernesto Cuestas, Rocío Funes, Danya Li Churanek, Patricia Sadeghi, and Jack Glen. Additional OVE staff—Monika Huppi, César Bouillon, Jonathan Rose, Oliver Azuara, and Patricia Oliveira—also provided valuable comments during OVE’s internal review process.

OVE is grateful to Javier Barsantini, Andres Ackermann, and Lina Peña (IIC) for their constructive contributions to the evaluation process, and we would like to thank the staff of other development finance institutions who were interviewed in the context of this study.



The study draws on a comprehensive review of nine global, regional and national comparators, plus selected lessons from various other equity investing industry players.

Executive Summary

The Board of Executive Directors of the Inter-American Investment Corporation (IIC) requested that the Office of Evaluation and Oversight (OVE) produce this technical study to support IIC's renewed interest in equity investing (EI). IIC has invested in equity since its creation, but the level of EI has been relatively limited. With a total of 130 EI operations for US\$383 million since IIC's creation in 1989, IIC has averaged only about 5 operations per year. IIC also has had little continuity, stopping and restarting EI several times, including the last time in the wake of the 2001 Argentina crisis.

After missing the region's rebound, IIC slowly returned to EI in 2009, buoyed by a new US\$75 million China Fund for equity co-investment managed by IIC. About 50% of these investments were in the form of quasi-equity (e.g., preferred shares or subordinated debt), which has likely limited losses but also curtailed the additional upside typical of EI. However, the results of these and other IIC equity investments cannot be precisely ascertained, because IIC does not customarily revalue its holdings in direct investments, and pre-2011 cashflows cannot be easily reconstructed due to a change in IIC's information technology systems.

IIC's business plan allocates between US\$25 and US\$50 million annually to EI, amounts negotiated as a compromise amid the recent merge-out of the IDB Group's private sector activities into a larger IIC. A good part of the merge-out discussions focused on maintaining a minimum level of total private sector approval volumes flowing into the region. With initial IIC capital scarce and a schedule of capital contributions extending into 2023, the space for capital-consuming EI was revised down to about US\$250 million over the next decade. IIC's most recent Business Plan 2017-19 targets US\$50 million per year to EI. With the merge-out now complete, the Board requested this study in part to explore whether that compromise needs to be revisited in light of the strategic, organizational, and operational implications of executing EI at IIC.

Since other entities use EI more intensively than IIC, the study benchmarks their EI strategies, results, and processes to extract useful lessons for IIC. OVE selected comparator entities guided by factors indicating the degree to which their experience could be relevant to IIC: (i) Equity depth: track record of substantial equity volume, number of operations and income; (ii) Debt-equity mix: preferably with a significant debt business operated along with equity investing; (iii) Capital: as a key, potentially constraining factor; (iv) Geographic mix: regional experience and work in both large and small countries; (v) Investment focus: on specific final beneficiaries, e.g., SMEs, both directly and through funds; and (vi) Social responsibility: expertise and commitment to sustainability and environmental and social safeguards.

The study draws on a comprehensive review of nine global, regional and national comparators, plus selected lessons from various other EI industry players. The comparators operating globally were the IFC (International Finance Corporation), DEG (German Investment Corporation), and FMO (Netherlands Development Finance Company). The comparators with a regional focus were EBRD (European Bank for Reconstruction and Development), CAF (Development Bank of Latin America), and ADB (Asian Development Bank). OVE also considered national entities doing EI: BNDES (Brazil's National Development Bank), Bancóldex (Colombia's Development Bank), and Fondo de Fondos (Mexico's national vehicle to promote EI). Finally, OVE compiled selected lessons from fund managers and impact investors, including Advent International, Darby Overseas Investments, and Bridges Ventures in the UK.

OVE interviewed about 50 EI experts and used a mix of other methods to collect and analyze the practices of these comparators and derive implications for IIC. To assess IIC's starting point in EI, OVE did a desk review of IIC's equity projects and interviewed key officers. OVE selected the comparators relevant to IIC and analyzed their public documents, such as financial statements, websites, evaluations and operation manuals. Given that the level of public disclosure on EI varies, OVE conducted structured interviews with comparators' senior staff to distill their lessons in EI. OVE also reached out to institutional investors and selected fund managers to characterize LAC's EI environment. Finally, OVE interviewed industry experts, including those in the Latin American Private Equity & Venture Capital Association (LAVCA), to gather information about lessons and experiences.

OVE found that DFIs usually invest in equity to provide capital to companies with high developmental potential, to develop a local equity market, and to generate income for themselves. Development finance institutions (DFIs) invest in these companies because they have the potential to grow and generate positive social benefits, such as creating employment, increasing exports, or producing a product or service otherwise not available. DFIs also seek other benefits like increased competitiveness, productivity, or demonstration effects. DFI investments also aim to attract additional commercial capital by providing a positive signal to the market, partly because of DFIs' thorough due diligence on clients that otherwise might not

have been considered by private investors. When working through funds, DFIs aim to creating an industry of professional fund managers. At the same time DFIs have played a key role in developing private sector environmental, social, and governance (ESG) standards. By requiring such standards for investing in EI, DFIs have fostered their implementation in investee companies. Finally, income generation has been an important objective for DFIs.

DFIs have invested on average about 20% of their portfolio in equity, usually through well diversified portfolios. Most DFIs are loan-making institutions that gradually began developing complementary equity programs. Most DFIs acknowledged that developing these programs was a gradual process that took several decades, during which they had to learn the business, and particularly how to manage EI alongside loans. Most DFIs have achieved well diversified portfolios, especially at the sector level. Geographically, however, regional DFIs tend to be disproportionately concentrated in their largest member country. Global DFIs like IFC, DEG, and FMO can diversify their portfolios across more countries and regions, and adverse shocks in individual economies tend to have smaller effects on portfolio performance.

EI has provided DFIs with higher returns than loans, but with higher volatility. With the caveat that IIC's valuation practices delay the recognition of actual results, IIC equity returns averaged 7% between 2001 and 2015, slightly above the loan yield of 6%, but with much more volatility. By contrast, most DFIs obtained double digit returns before the 2008 financial crisis, but then suffered major losses. Returns only partially recovered after the crisis, in part due to the depreciation of holdings denominated in falling emerging market currencies and the generally high market valuations for entering new investments. Overall, DFI equity returns have also been highly sensitive to macroeconomic conditions. Finally, DFIs report that gross returns and volatility for direct investments have been even higher than for funds, which at least benefit from some inherent diversification.

The study draws on lessons distilled from comparator organizations in five areas:

- (i) **Objectives:** understanding the reasons for DFIs to do EI, which in turn affects their approaches toward EI.
- (ii) **Trade-offs:** managing the trade-offs involved in EI, including its use of capital.
- (iii) **Specialization:** recognizing that EI is very different from debt.
- (iv) **Long-term horizon:** ensuring sufficient time and capital to develop a successful EI business.
- (v) **Transparency and incentives:** developing transparent EI metrics that help align internal (staff) and external (investees) incentives amid the higher uncertainty and longer (compared to debt) investment periods inherent to EI.

Objectives, clearly set up-front, are the basis on which comparator organizations approach EI. Potential objectives for EI may include, among others, improving the menu of services for existing and prospective clients (as EI availability may be a differentiating factor for IIC in the marketplace); helping enhance access to EI for target beneficiaries in LAC by demonstrating the viability of the product to others; or helping IIC earn higher returns on capital (even with increased volatility of returns). Regardless of the combination of objectives selected, comparators emphasize that the choice must be deliberate and upfront, even if it centers on less developmentally appealing issues such as obtaining higher returns, which comparators often justify to subsidize other more developmental projects. These objectives are not necessarily mutually exclusive.

Objectives also drive key decisions in comparator organizations, including the mix between direct EI and EI through funds. Direct EI and EI through funds have clear differences, including the degree of control and engagement with clients; the volatility and return profiles; the required organizational and administrative cost structures; and the ability to influence the EI industry and broader access to EI in LAC. Thus, if an organization's objective were to better engage existing clients, it would likely choose direct EI. If instead it sought to promote the EI industry, it would likely prefer working through funds and promoting the participation of other actors, such as local institutional investors. There may be synergies and learning derived from working both directly and through funds. For example, fund managers often offer direct co-investments opportunities to investors.

Identification and management of trade-offs is also key at comparator organizations doing EI. EI is very different from debt also in terms of the intensity of its use of resources, such as capital and people. Comparator organizations start by defining their risk appetite for EI in terms of capital at risk, understanding that a significant part of it can be lost. In organizations that also have a debt business, every dollar in EI reduces their capacity to do debt by between US\$3 and US\$5. Furthermore, EI consumes capital for the first 5 to 7 years of the investment period, and only then does an organization typically reap potential rewards in terms of higher returns. Comparators report that current EI conditions present historically lower EI returns (in line with lower yields for other asset classes) and longer maturity periods, lengthening the time needed to reap rewards from EI. At IIC, this investment period may coincide with IIC's weakest capital position, as significant merge-out capital contributions are still scheduled through 2023.

Trade-offs also include demands on organizational resources and systems, as EI will occupy a considerable portion of management's attention and space in the budget. By some estimates equity is twice as expensive to administer as debt and requires developing separate systems, policies, and procedures. A well-designed EI program may compensate for these additional risks and costs over the long run, and provide a DFI with an opportunity to enhance its developmental results and returns.

Comparators emphasize that EI is a specialized business, very different from debt. Comparators argue that EI even requires a different organizational mindset, which some illustrate as an ability to “see the glass half full”, or in other words envision the yet to be realized upside potential of investees. This contrasts with the mindset of debt organizations, whose focus is on foreseeing the downside risks in projects, or the “glass half empty”. The EI mindset needs to be accompanied by a commitment to help investees realize their potential. This requires an organization willing to pursue this long term, dynamic, and often uncertain engagement with investees. This usually involves a greater time commitment, due to much closer supervision and the need to frequently reappraise the investments and reassess their future potential.

Specialization, as the means to add value to clients, is central to comparator organizations’ EI business models. Debt focuses on compliance with covenants and ensuring repayment, while EI is fundamentally about adding and capturing future value. Successful comparators clearly articulate what additionality they envision providing from the start of their engagement with investees. Some comparators base their value-added on becoming “honest brokers” allowing a better coordination of public and private sector stakeholders. Others are able to lend a “seal of quality” to investees as perceived by other market players, and yet others are able to have “longer term investment horizons” that better fit the investees’ business cycle. Private equity investors typically view their value-added as including industry technical knowledge and general knowledge regarding operational, managerial and marketing improvements.

Specialization requires accumulating a number of scarce skills whose attraction is only feasible with a critical mass of EI business. Comparators indicate that the basic skill-set required for EI – origination and structuring – is often obtainable, but differs between direct and fund investments. The real challenge is to concurrently deploy origination and structuring expertise with the required corporate governance skills, country knowledge, and industry experience. Comparators add that only top expertise in all of these areas leads to superior returns, and such expertise can be attracted only if an organization has (or is on a clear path to having) a critical mass of EI business.

A long-term horizon, patient investing, and staying power are also central to successful EI at comparator organizations. Comparators emphasize that EI is a long-term business. In fact, macroeconomic factors, such as GDP growth, capital inflows and currency valuation, account for a large part – estimated at about 60% – of total returns at comparable entities. Thus, organizations that engage in stop and go behavior or that set hard annual approval quotas often have substandard returns, missing opportunities to buy low during crises, instead buying high to meet quotas or selling early during crises. Conversely, organizations that stay the course – neither missing investment vintages nor feeling compelled to enter EI to meet annual approval quotas – fare better. Similarly, organizations that use self-adjusting mechanisms such as portfolio rebalancing (with preset bands for total EI as a percentage of total portfolio) tend to buy low and sell high, thus improving returns.

Transparency in valuations and other EI metrics is essential to align incentives over the longer periods inherent to EI. Frequent and accurate valuations underpin decision-making in comparator organizations. Fund managers tend to provide frequent valuations, and investors only need to ensure their quality. By contrast, while accounting standards may allow for direct investments to be carried at cost, proper decision-making requires that the comparators have in-house capacity to frequently and accurately assess them at fair market value. The need for transparency extends to other EI metrics besides valuations. Good cost accounting of operating costs is needed to compare net profitability, but few development institutions have it. Capital charges or some other carrying cost needs to be assessed to avoid holding investments for unnecessarily long periods and to trigger timely exits. In addition, measuring developmental results is more complex for EI (particularly for funds), because of the long maturity, and the indirect nature of the mechanism that relies on investees and fund managers to produce results.

Finally, evidence from comparator institutions suggests that the incentives provided to staff and investees have a significant impact on their behavior and the success of EI. At origination, incentives that encourage volume targets lead staff to value potential investments too highly, reducing future returns. Conversely, incentives to maintain relationships with clients to produce future volume can limit staff willingness to liquidate equity investments when valuations are attractive, also reducing returns. Debt investments are less exposed to these incentive issues, and reconciling the need for appropriate incentives between the two products is a major challenge. Some DFIs have experimented with long term performance awards for staff engaged in EI. Similarly, investees (including both the management of direct investees and fund managers) need to be engaged in a manner that clearly aligns incentives. Potential conflicts of interest – particularly when investee companies run into difficulties, when dealing with listed companies and when managing third-party funds – also need to be carefully managed.

This study highlights challenges in these five areas that IIC needs to address:

- **Objectives:** IIC has yet to clearly define what it seeks to achieve through EI. Such objectives will affect the mix and sequence of direct and fund investments. If IIC's objectives include, as is likely, a desire to use EI to support specific clients, it will need to include at least some direct investments as part of its approach to EI. Similarly, if an expectation of capital gains is also to be part of the rationale for doing EI, IIC will need to clearly state this as an objective and disclose the risks and opportunities involved.
- **Trade-offs:** Trade-offs in the use of IIC's capital have so far been only cursorily analyzed. Timing trade-offs, including whether to fully restart EI now or wait for a stronger capital situation, have not yet been analyzed. IIC will need to weigh the pros and cons of these decisions. IIC should expect that its equity portfolio could lose up to 20-30% in any given year.

- **Specialization:** IIC can leverage its rich sectoral and regional expertise, but it lacks an established EI track record, particularly in direct investments. Thus, IIC needs to make a deliberate effort to acquire the required specialized capabilities. OVE estimates that to reach a critical mass to support this effort, IIC would need to originate an EI portfolio of at least US\$200 million – or US\$300 million if it decides to do both direct EI and funds – over the next 5 years.
- **Long-term horizon:** IIC needs to seek ways to ring-fence its commitment to EI over at least the next 10 years, typically with 5-year investment and 5-year divestment periods. This can be furthered by generating a commitment to joint-EI with a significant strategic partner or through an express EI mandate from IIC's shareholders.
- **Transparency and incentives:** IIC needs to significantly beef up its current portfolio and risk management capabilities for EI, possibly by cooperating with partners offering training and technical assistance or by securing the temporary services of secondees from leading DFIs. Understanding the current incentive structure and how it needs to be amended to promote successful EI is a prerequisite for any significant EI program, given the impact that incentives have on the financial performance of EI and the differences between debt and EI in this regard.



LAC equity investing markets lag those of other regions, both in terms of access and depth. Over the last 20 years, a professional equity investing industry has started to develop, but it still manages investments equivalent to less than 1% of the region's GDP.

1 Context of the Study

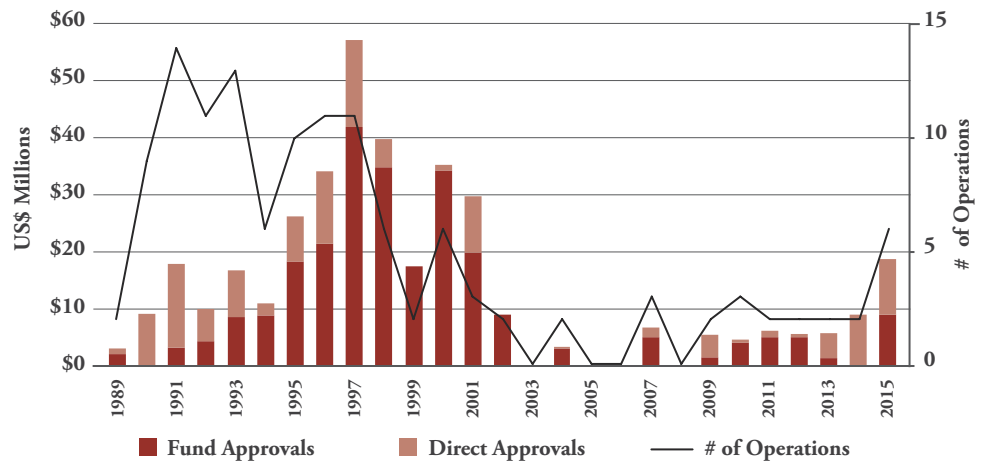
A. RATIONALE AND METHODOLOGY OF THE STUDY

The Board of Executive Directors of the Inter-American Investment Corporation (IIC) requested that the Office of Evaluation and Oversight (OVE) produce this technical study to inform IIC’s future equity business. In January 2016, the private sector activities of the Inter-American Development Bank Group (IDBG) were combined into an expanded IIC. This new IIC was recapitalized, absorbing personnel and responsibilities over all non-sovereign-guaranteed operations of the IDB and the existing IIC, including equity investments (EI). The Board of the new IIC approved a business plan with growing EI over the next 10 years. The Board expressed interest in supporting IIC’s new equity strategy with a technical study by OVE, focusing prospectively on what the IIC could learn from its own experience and from that of comparable entities. Rather than being a full evaluation of IIC’s past experience, this study aims at supporting IIC’s EI going forward.

IIC has invested in equity, though with little continuity, since its creation over 30 years ago. IIC’s Establishing Charter expresses a “preference” for capital, over debt investments. With a total of 130 EI operations for US\$383 million since IIC’s creation in 1989, IIC has averaged only about 5 operations per year (Figure 1.1). In the early years, equity played a larger role, peaking at almost US\$60 million in annual approval volume in 1997. By the early 2000s, IIC faced significant write-downs—mostly because of a high concentration of EI in funds without experience in the region and an economic crisis that led most equity investors to sustain losses. On the advice of an external review panel convened to preserve IIC’s financial viability, IIC virtually stopped EI for the next ten years and thus missed the ensuing market rebound.

FIGURE 1.1.
IIC had limited equity investments over the past 10 years

Source: IIC Data warehouse, IDEAS
 Note: Data only includes investments in common and preferred shares. It excludes subordinated debt.

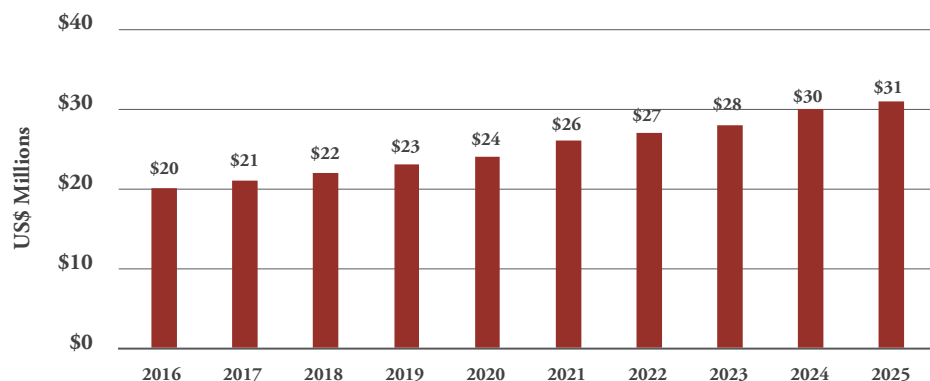


A co-investment fund negotiated with China upon its entry as an IIC shareholder in 2009 helped IIC restart EI, as did IIC’s 2016 recapitalization that envisions more active EI. Helped by a new China Fund for equity co-investment, IIC slowly returned to EI in 2009, but with limited annual approvals of about US\$5-6 million. Only in 2015 did equity approvals exceed US\$20 million, signaling IIC’s interest in reengaging in the equity business. IIC’s most recent Business Plan 2017-19 targets US\$50 million per year to EI. Overall, IIC has co-invested *pari passu* with the China Fund US\$66.2 million in 27 equity and quasi-equity investments. Results to date cannot be ascertained, because IIC does not customarily revalue direct investments and pre-2011 cashflows were not available in IIC’s systems at the time of this evaluation. About 50% of these EIs took the form of quasi-equity (i.e., preferred shares or subordinated debt), which has likely limited any potential losses but also curtailed the additional upside typical of EI.

IIC’s 2016 recapitalization – in a merge-out process that joined all private sector operations of the IDB Group – set aside US\$252 million for EI over the next 10 years (Figure 1.2). This amount was the result of high-level negotiations that focused on keeping total private sector approvals at a certain level, without necessarily focusing on the implications in terms of a viable equity business.¹

FIGURE 1.2
IIC’s annual equity approvals projections average US\$25 million in the next 10 years, according to the Private Sector Merge-Out Proposal

Source: Proposal for IDBG Private Sector Merge-Out (CII/CA-165)



Since other comparable entities have invested in equity more systematically than IIC, this study centers on benchmarking their equity strategies, results, and processes. The study draws parallels and contrasts between the comparators' and IIC's EI experience over the last 10 years. The following key questions underlie this comparative analysis:

- **DFI role and strategy:** Why do comparators invest in equity? What are the key considerations when deciding to invest directly or through funds? How do they decide how much capital to allocate to equity? How do they handle conflicts of interest when they do both debt and equity investments with the same investees?
- **Results:** What development and financial results have comparators achieved through equity? How were these results measured? Did results differ by type (e.g., funds vs. direct investments), and if so, why?
- **EI process and organization:**
 - **Due diligence and client selection:** How do comparators assess and select direct investees and funds? What are the key differences between direct and fund EI?
 - **Structuring:** How do comparators structure EI to balance their interest in both financial and development goals? What is the incentive structure for staff, how do the incentives for debt and equity differ, and how are they reconciled?
 - **Monitoring and supervision:** How do comparators add value during the supervision stage? How do they appoint board directors and exercise voting rights? How does the monitoring of EI differ from that of loan investments?
 - **Divestment:** What are the best practices regarding equity divestment, in terms of criteria, responsibilities, and processes? How do comparators ensure objectivity?
 - **Organization:** How are equity teams internally structured and staffed? What is needed to attract the right talent? What performance metrics and compensation policies are used? What is the governance of EI decision-making?
- **Lessons learned and implications for IIC:** What lessons have comparators learned from their experience with EI? To what extent do they differ for direct EI and EI through funds? How can IIC benefit from these lessons to inform its future EI program?

In selecting comparators, OVE was guided by the degree to which their experience could be relevant for IIC (Box 1.1). To be relevant for IIC, comparators had to be substantially engaged in equity (at least about 10% of their total portfolio), while still having a dominant debt business and thus needing to consider the trade-offs between debt and equity due to constraints in total capital. Like IIC, at least some of comparators also had to face the lack of diversification inherent in serving primarily one geographic region with countries of uneven size, along with a mandate to use equity to serve the needs of specific final beneficiaries and to promote socially responsible and sustainable business practices. While these criteria pointed mostly to development finance institutions (DFIs), OVE also included private equity funds as comparators to draw lessons on investment structuring, management, and divestment. Finally, the selection of comparators was purposely not random, but rather oriented toward learning from successful institutions. For that reason, the equity results from these comparators are likely positively skewed.

Box 1.1. Comparator selection criteria

- **Equity depth:** track record of substantial equity volume, number of operations, and income
- **Debt-equity mix:** preferably with a significant debt business operated along with equity investing
- **Capital:** a key, potentially constraining factor
- **Geographic mix:** regional experience, e.g., LAC, involving work in both large and small countries
- **Investment focus:** on specific final beneficiaries (e.g., SMEs), both directly and through funds
- **Social responsibility:** Expertise and commitment to sustainability and E&S safeguards

The comparators used in the study include global and regional DFIs, national EI entities, and other recognized fund managers and impact investors. OVE selected comparators from among peer DFIs, including not only global but also regional entities facing issues like those IIC faces. OVE also reviewed some national entities promoting EI in specific LAC countries. Finally, OVE reviewed the practices of selected private international equity funds recognized for their performance or development focus, so IIC could gain further insights on innovative practices and ways to adapt to market conditions. In all cases, OVE considered the suitability of these practices for IIC, given its capital constraints, organizational capabilities, and mandates. The selected comparators are shown in Table 1.1.

TABLE I.1. COMPARATORS USED IN THE STUDY

<i>Comparator</i>	<i>Equity business size^a</i>	<i>Sector strategy</i>	<i>Geographic focus</i>
Global DFIs			
IFC – International Finance Corporation	Eq. portfolio: US\$13B % of tot. portfolio: 36%	Midmarket-focused growth equity. Also, supports infrastructure, climate change, and SME funds; selectively supports small business funds in frontier regions	Africa, Asia, Eastern Europe, Latin America, and Middle East
DEG – German Investment Corporation	Eq. portfolio: US\$1.3B % of tot. portfolio: 23%	SME and midmarket equity investments focused on growth strategies; sector-agnostic, limited number of sector-focused funds	Frontier markets in Africa, LAC, Eastern Europe, and South and Southeast Asia
FMO – Netherlands Development Finance Company	Eq. portfolio: US\$1.6B % of tot. portfolio: 25%	Strong focus on private equity fund investing, with emphasis on financial institutions and energy	Africa and Asia, LAC, Central Asia, and Eastern Europe
Regional DFIs			
EBRD – European Bank for Reconstruction and Development	Eq. portfolio: US\$5.6B % of tot. portfolio: 18%	Strategy-agnostic; seeks to build a diversified portfolio	Central Europe, Central Asia, North Africa
CAF – Development Bank of Latin America	Eq. portfolio: US\$0.39B % of tot. portfolio: 8%	Strong focus on infrastructure and fund investing	Latin America
ADB – Asian Development Bank	Eq. portfolio: US\$0.9B % of tot. portfolio: 16%	Focuses on financial services, infrastructure, clean energy, and agribusiness	Asia
National DFIs			
BNDES – Brazil	Eq. portfolio^b: US\$1B % of tot. portfolio: less than 5%	Focuses on funds and direct investments. Sectors: innovation, infrastructure, capital markets, and sustainability	Brazil
Bancoldex – Colombia	Eq. portfolio: US\$0.02B % of tot. portfolio: 1.2%	Focuses on funds. Sectoral focus: retail/distribution, manufacturing, tourism, services	Colombia
Fondo de Fondos – Mexico	Eq. portfolio: US\$0.7B % of tot. portfolio^c: 90+%	Midmarket-focused growth equity funds. Also, supports energy, infrastructure, venture capital, and SME funds	Mexico
Other comparators			
Recognized private fund managers, impact investors, and other DFIs	Eq. portfolio: N/A Avg. ticket size: N/A	A few other entities not directly comparable to IIC, but having interesting practices. These include Advent International, Darby Overseas Investors, The Abraaj Group, Bridges Ventures (UK), Proparco, and the CDC Group	Global

Notes: ^a Total portfolio includes loans to private sector and equity investments. Equity investments include only common and preferred shares, and exclude subordinated debt that might be converted into equity.

^b OVE focused on reviewing the experience of BNDES *Participacoes* (BNDESPAR), and within it only Entrepreneurial Capital Department (ACE) which deals with non-publicly traded equity holdings.

^c *Fondo de Fondos* acts mostly as a fund manager for third-party resources of about US\$700M. Most of them are targeted for EI, with a small portion (expected to rise to about US\$100M) in quasi-equity (mezzanine debt).

Source: OVE elaboration, based on data from EMPEA (Emerging Markets Private Equity Association) and comparators' financial statements.

OVE used a mix of methods to collect and analyze information from these comparators. First, OVE did a desk review of IIC's equity projects and interviewed relevant officers to extract lessons learned from IIC's equity experience. Second, OVE analyzed comparators' public documents, evaluations, and operation manuals to understand their strategies, map their investment practices, and identify their organizational arrangements. Third, OVE conducted interviews with comparators' senior staff to gather lessons from their experience in equity. Fourth, OVE reached out to institutional investors, fund managers, regulators, and venture capital (VC) and private equity (PE) associations to characterize the EI environment and identify areas where IIC can add value to investees. Finally, OVE sought to collect promising practices from peers and industry experts, including those in relevant VC/PE associations (e.g., LAVCA).

B. SCOPE OF THE STUDY

This study focuses on private equity (PE), rather than on publicly traded equity. EI refers to the buying and holding of ownership stakes in existing businesses with the expectation of financial gains. Ownership can be gained by either acquiring public equities listed in market exchanges where the public can invest directly,² or by negotiating among private investors the purchase of shares not listed in public markets. IIC will likely focus on the latter, since the most capital-constrained companies in LAC—that is, small and medium-sized enterprises (SMEs) and mid-size companies—are often unlisted. Furthermore, and in line with its 2017-2019 business plan, IIC will likely consider using PE to continue supporting its three priority segments: financial markets, infrastructure, and corporate.³

The study covers EI negotiated both directly and through specialized intermediary funds. Investors can acquire ownership stakes directly with investee companies' owners. Alternatively, investors can commit resources to specialized funds that invest in companies (Figure 1.3). Direct investing allows the funder more control than investing through funds, but an institution needs to be able to support the cost of managing individual investments. Investing through funds relies on specialized third-party expertise (by the funds' general partner) and facilitates portfolio diversification. However, investing as a limited partner into a fund structure implies much less control over individual investees. This raises the importance of ensuring that the investor's incentives are aligned with those of fund managers or general partners—not only to maximize returns, but also to invest in projects that are consistent with the funder's (development) mandate and objectives. Chapter 3 presents a detailed discussion of the differences and implications of direct versus fund investments.

Furthermore, the study centers on non-controlling growth-equity stakes because this is also likely to be IIC's target. EI markets are usually defined according to the investees' lifecycle (Table 1.2). For example, *seed funding* and venture capital (VC) refer to funding provided at a company's very early stages, usually to cover start-up costs. VC is often accompanied by management and networking support. *Growth-equity* covers

later stages, referring to capital and support provided to existing businesses, taking either controlling or non-controlling (less than 50% of voting shares) stakes. *Growth-equity* usually targets mid-sized businesses that are ripe for expansion or whose value is under-optimized. At later stages, *mature* or *distressed companies* also require fresh capital to revamp their operations and regain profitability.

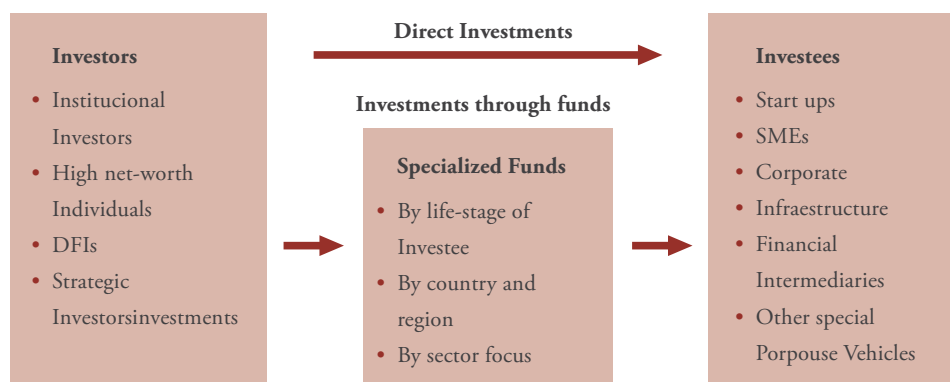


FIGURE 1.3

EI can be done both directly and via funds

Source: OVE with information based on literature review.

TABLE 1.2. TYPES OF PRIVATE EQUITY INVESTMENTS

Type		Description
Seed funding		<ul style="list-style-type: none"> Typically, individuals investing their own funds (“angel investors”) High risk (usually in start-ups), but also high potential returns
Venture capital		<ul style="list-style-type: none"> Typically funds pooling resources from (institutional) investors Often follows angel investment to help investee companies grow A few blockbusters compensate for many failed investments
Growth-equity	Mezzanine financing	<ul style="list-style-type: none"> Debt and equity hybrid, used by established companies in need of growth finance, but without collateral or desire to dilute ownership Allows lenders to share some upside potential with the company while providing some downside protection to investors
	Minority stakes	<ul style="list-style-type: none"> Companies seeking growth finance without giving up control (<50%) Key issue for investors is protection of minority shareholders’ rights
	Controlling interest	<ul style="list-style-type: none"> Often executed in combination with debt (leveraged buy-out) Exits conducted via public offerings or strategic buyer sales
Distressed assets		<ul style="list-style-type: none"> Buyout of either whole distressed companies or parts (assets, debt) Companies that need liquidity or that cannot maximize asset values

Source: OVE, with data from literature review.

This study also presents information on the financial returns and volatility of EI to underscore a key characteristic in which these investments differ from loans. EI is different from debt because returns are inherently more volatile and are not predefined or limited. Lenders contractually limit their risk exposures by predefining periodic repayments of interest and principal and establishing contractual covenants to increase the likelihood of repayment. Equity investors share the investee companies’ risks and

potential profits, as well as capital gains and losses. Equity cash flows are less certain as they are “residual”—that is, they depend on the investee’s ability to first pay suppliers, employees, and the tax authorities, then cover debt repayments. Equity returns also depend on the dividend policy and ultimately the profitable sale of the EI position.

Similarly, the study highlights the developmental role of DFIs’ EI, but it excludes other DFI activities to improve the institutional ecosystem for equity, because these are also unlikely to be IIC’s focus (Table 1.3). EI can provide risk capital in markets with limited fundraising options. EI also helps deepen capital markets and improve exit options, thus attracting additional funds. However, the availability of an adequate institutional ecosystem at the country level plays a key role in enabling EI. To increase the size and number of players in equity markets, countries need to offer an environment that provides sufficient investment protection and adequate regulatory frameworks for the creation, operation, and taxation of EI. In a survey conducted by LAVCA, investors stressed the importance of institutions as a binding constraint to doing more investments in LAC.⁴ Within IDBG, the Multilateral Investment Fund (MIF) has focused on these topics.

TABLE 1.3. USING THE RIGHT TOOL TO HELP DEVELOP EI MARKETS

Barriers to EI mentioned by institutional investors	Potential DFI tools to address them
Uncertain political, macroeconomic, or currency environments	Non-equity operation (sovereign guaranteed – SG – policy loan): Supports macroeconomic reforms and stability.
Underdeveloped regulatory institutions and uncertain tax environments	Non-equity operation (SG policy loan/technical assistance – TA – to governments): Support stronger EI ecosystem.
Weak contract enforcement and uncertain legal systems	Non-equity operation (SG policy loan/TA to governments): Supports creation of a stronger enabling environment.
Underdeveloped capital markets limiting fundraising and exit options	EI: Provide funding and deepen capital markets. Non-equity operation (SG policy loan/TA for governments): Supports development of capital markets.
Limited equity business track record and capabilities	EI and TA: Built track record and increase local EI capabilities.
Poor corporate governance practices	EI (direct or through fund managers) combined with advice: support corporate governance improvements.

Source: OVE, with information from LAVCA’S Limited Partner Opinion Survey.

C. CHALLENGES FOR EI IN LAC

LAC EI markets lag those of other regions, both in terms of access and depth. Risk capital providers in the region are few—mostly large corporations buying other companies as part of their growth strategies, and “high-net-worth-family investment offices” investing in their group companies. Most SMEs and mid-size companies with growth potential do not have access to this capital. Over the last 20 years, a professional

EI industry has started to develop, but it still manages investments equivalent to only a small share of the region’s GDP (less than 1%).⁵ Not only is this ratio at least an order of magnitude lower than in developed countries, but also LAC’s EI industry is still not well connected with other key players—banks (for leveraging investee companies) and capital markets (to transition from private to public equity).

LAC’s small share of the global EI industry is concentrated in only a few countries (Figure 1.4). All emerging markets combined accounted for less than 20% of global EI over the last decade. Between 2008 and 2014, emerging Asia accounted for a majority (average of 66%) of emerging market EI, while LAC had an average 16% share.⁶ Within LAC, Brazil and Mexico were the largest markets for EI, together representing 84% of total investments. The balance was split among Colombia (6%), Peru (6%), Chile (3%), and the rest of the region’s countries (less than 1% each).⁷

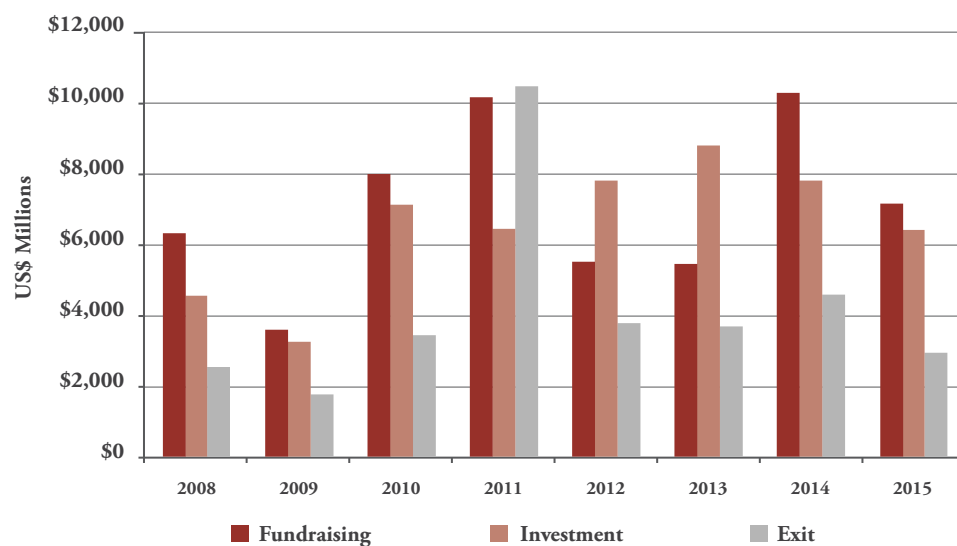


FIGURE 1.4A
Trends in fundraising, investments, and exits in LAC

Source: 2016 LAVCA Industry Data.

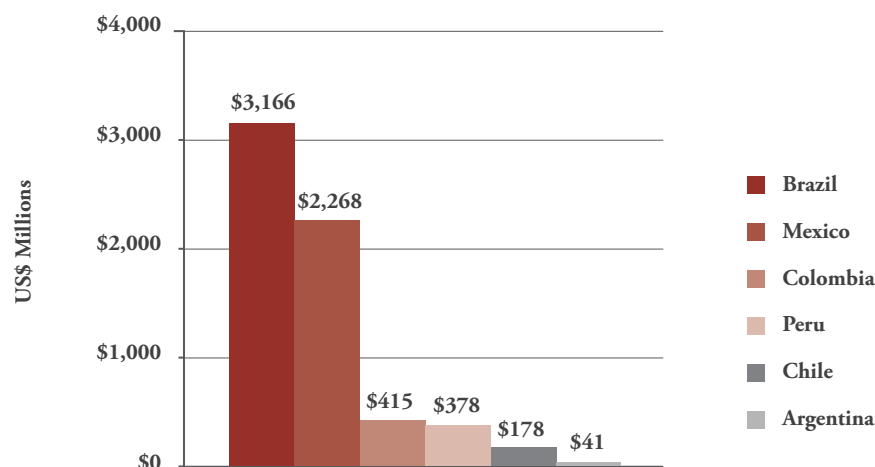


FIGURE 1.4B
LAC Equity Investments (2015, by Country)

Source: 2016 LAVCA Industry Data.



Development financial institutions have had an important role creating equity investing markets, but this has decreased as the industry matured.

© [Nick Youngson](#)

Better institutional ecosystems are correlated with higher EI industry development. LAVCA created a scorecard with which it annually measures and tracks the quality of the EI institutional environment in LAC. The scorecard measures the quality of countries' investment and legal frameworks, the corporate governance practices of local companies, and the quality of country-level institutions (e.g., protection of property rights, fairness of judicial system, development of capital markets). In 2015, Chile, Brazil, and Mexico received the higher scores in institutional environment (with a score of 7.0 out of 10 points). LAVCA's data show a positive correlation between high scores in a country's institutional ecosystem and the penetration of EI as a percentage of GDP (Figure 1.5). Finally, LAC's institutional environments lag compared to economies like UK, Spain, or Israel, which received an average score of 8.5.⁸

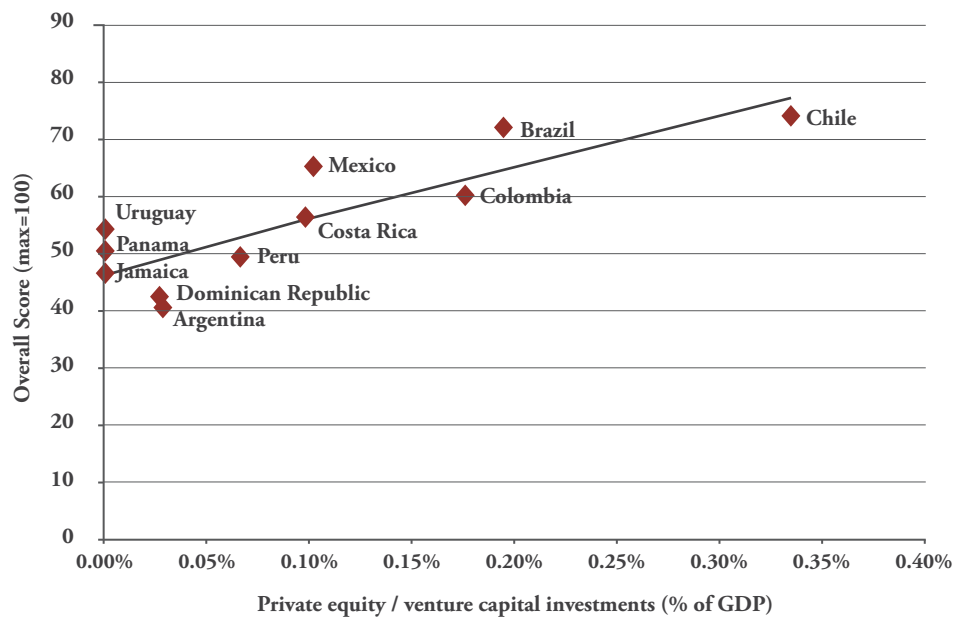


FIGURE 1.5
Better ecosystems
correlate with more EI

Source: LAVCA.



Development financial institutions invest in underserved companies because they have the potential of growing and generating positive social benefits, such as creating employment, increasing exports or producing a product or service otherwise not available.

2 Equity Investing at Development Finance Institutions

A. DFIs' RATIONALE FOR DOING EQUITY INVESTMENTS

DFIs report doing EI for five broad reasons. First, DFIs use EI to help underserved but economically important investees. DFIs often emphasize specific investees -such as SMEs, infrastructure, or clean energy- that have an important economic effect but, because of market failures, enjoy limited access to EI. DFIs invest in these companies because they have the potential of growing and generating positive social benefits, such as creating employment, increasing exports or producing a product or service otherwise not available. DFIs also seek other benefits like increased competitiveness, productivity or demonstration effects. Often DFIs start a relationship with these clients through loans, but at one point clients need an additional equity injection to be able to finance further growth. DFIs' extensive international networks give investees access to market intelligence and industry contacts.

Second, DFIs can provide a signaling effect to other potential providers of capital, and thus help build local equity markets. DFI investments also aim to attract additional commercial capital by providing a positive signal to the market, partly because of the DFIs' thorough due diligence on clients that otherwise might not have been considered by private investors. When working through funds, DFIs also aimed at creating an industry of professional fund managers. DFIs have often supported first and second-time fund managers, helping them professionalize and attract additional capital.

Third, DFIs play a key role in fostering environmental, social, and governance (ESG) best practices. DFIs have played a key role in developing private sector ESG standards. By requiring such standards for investing in PE, DFIs have fostered their implementation in investee companies. For example, because fund managers that receive multilateral financing are required to incorporate ESG standards in their fund documentation, ESG standards are integral to the principles and policies of those funds. Through the “Equator Principles,” many DFIs have agreed on common environmental and social (E&S) standards, and through a Corporate Governance Development Framework they have agreed on shared corporate governance principles.⁹

Fourth, EI plays a key role in allowing DFIs to pursue their dual mandate of maximizing development impact while generating financial returns. Comparators consider these objectives to be not mutually exclusive. For example, IFC has been a first-time investor in many regions, obtaining sizable returns (about 15% in the last 20 years). Furthermore, IFC’s equity returns have allowed IFC to contribute an average of US\$500 million annually to IDA.¹⁰

Finally, EI provides DFIs with additional opportunities to influence the private sector from inside companies, and through them promote development outcomes. DFIs have recognized the private sector’s role in providing employment and driving economic growth. They use EI to support companies so that they can deliver job creation and business expansion and improve market functioning. EI also allows DFIs to influence investee companies, voting as a shareholder or as a Board representative in the governing body of the company, which can also help strengthen development outcomes.

B. DFIs’ APPROACH TO EQUITY: FUNDS VS. DIRECT INVESTMENTS

When DFIs decide to do equity, they report that the first key decision is whether to invest directly (thus conducting all investment stages in-house) or invest through funds (thus delegating the process to experienced managers). Some DFIs, like CDC Group, have historically avoided direct investments in favor of outsourcing EI to third-party fund managers.¹¹ Most other DFIs have a combined approach that includes both funds and direct investments. Direct investing avoids the need to pay fees and other forms of compensation to fund managers, but requires extensive investment in internal capacity building and information systems. These additional investments can be amortized only with a critical mass of operations.¹²

DFIs usually use direct investments when they can leverage some comparative advantage that compensates for the higher costs of managing all the investment stages in-house. Comparative advantages include existing relationships, local presence, and sector expertise. For example, DEG prefers to use direct investments where it has a local presence. IFC prefers to engage in infrastructure through direct investments, since it has the in-house expertise to deal with increased regulatory and ESG risks.

Other DFIs take advantage of their existing loan relationships to mitigate the risk of follow-on equity investments. Finally, most DFIs leverage their ability to work also with governments (e.g., as honest broker or influencing the enabling environment).

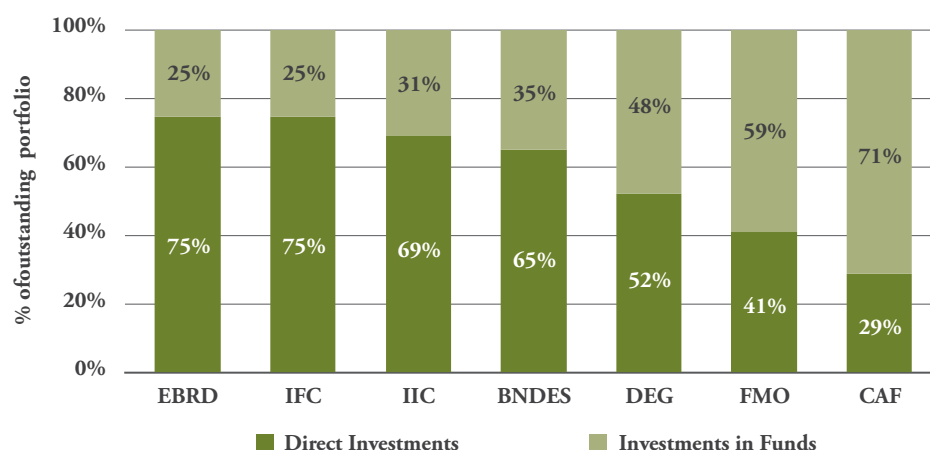


FIGURE 2.1

DFIs combine direct investments with investments through funds

Source: DFIs’ financial statements and corporate presentations. Note that equity valuations differ among DFIs (e.g., at cost minus impairment or marked to market), which affects the percentages. Total portfolio excludes sovereign-guaranteed lending. Data typically includes only equity (common and preferred shares) but excludes quasi-equity.

While DFIs use funds as a cost-efficient way to reach multiple investees, learn from fund managers’ expertise (in EI or in a specific country or sector), diversify risk, and provide co-investment opportunities. DFIs channel resources through funds to reach investee companies that are financially constrained. This investment mechanism allows DFIs to take advantage of the fund managers’ track record to select investment opportunities and add value to those investments in sectors or countries in which a DFI may not have presence or experience (Box 2.1). For example, most DFIs use funds to enter countries where they lack a strong field presence. At times DFIs also rely on fund managers to learn about sectors, with the prospect of co-investing along with them and investing directly in the future.

Box 2.1: How is an EI fund structured?

Funds are special purpose entities structured as partnerships between financial investors (limited partners, or LPs) and managers (general partners, or GPs). LPs mainly act as fund financiers and focus on providing resources (hands-off approach). Usually the GP manages the day-to-day-business and conducts the whole investment process (fundraising, due diligence, structuring the deals, committing resources, supervising, exiting). GPs charge a base commission and a share of the profits above a certain hurdle rate (carried interest).

From a developmental point of view, DFIs use direct EI—often jointly with debt—to help advance sector goals. Most DFIs organize their development work across sectors of interest (e.g., infrastructure, industry, SMEs) and see equity as a financial instrument complementary to debt to advance that work. Most DFIs use direct equity when they want to be closer to a company (e.g., to provide technical support), or to

help them manage the capital structure (e.g., increase the headroom for debt). By contrast, with loan investments DFIs have more limited influence over companies, mostly reduced to compliance with preset loan covenants.

While funds have often been used to develop the EI industry more generally, and leverage the fund managers' expertise and specialization. DFIs have also supported funds in markets where funds were almost nonexistent. By providing funding to first-time funds, DFIs helped establish the industry, attract other investors, and advance the discussion on fund investing. For example, in the mid-1990s and early 2000s, when the EI industry was just starting in developing and emerging economies, MIF was very active in building the EI industry in LAC, and DFIs like IFC and EBRD were also working mostly with first-time funds.¹³ IFC currently places less emphasis on this strategy. Managers interviewed agreed that today IFC invests in funds with the primary objective of reaching investee companies; the development of fund markets is a secondary goal.

C. USE OF EI IN DFIs

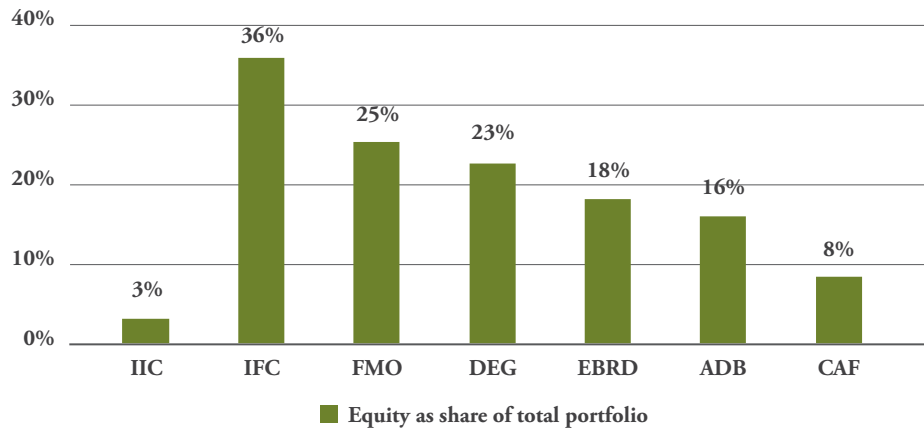
DFIs have invested on average about 20% of their portfolio in equity, compared to 3% at IIC (Figure 2.2). IIC has been relatively more capital-constrained and has focused on restraining its risk appetite to safeguard its existence. Among DFIs, those with global presence (IFC, FMO, DEG) tend to have a higher share of EI as a percentage of their portfolio (28% vs. 14% in regional DFIs). Global DFIs' broader geographic scope increases the pool of available opportunities to invest and to diversify risk. In turn, this allows them to allocate more resources to EI. Additionally, these DFIs made a conscious strategic decision to invest in equity to achieve long-term financial sustainability.

FIGURE 2.2

Other DFIs have used equity investing more intensively than IIC

Source: DFIs' financial statements. Equity valuations differ among DFIs (e.g., at cost minus impairment or marked-to-market), which affects the percentages. Total portfolio excludes sovereign-guaranteed lending.

Note: Data typically only includes only equity (common and preferred shares) but excludes quasi-equity.



Most DFIs are loan-making institutions that gradually began developing complementary equity programs in the early 1980s.¹⁴ Most DFIs acknowledge that developing these programs was a gradual process that took several decades, during which they had to learn the business, and particularly how to manage EI alongside loans. Most DFIs had to make the case for EI with their boards (showcasing that equity investments are developmental and that they also can provide financial results). As DFIs gained a

track record, they increased their equity businesses. For example, according to financial statements, IFC increased the share of the equity portfolio from 17% in 1989 to 36% in 2015.¹⁵ Furthermore, in 2009 IFC founded a wholly owned subsidiary—the Asset Management Company (AMC)—to manage third-party funds. This reflected IFC’s increased strategic interest in equity and the power of its long equity track record.¹⁶

Most DFIs report they have sought broad sectoral diversification (Figure 2.3). The two main reasons have been reaching most sectors of the economy and diversifying portfolio risk. Aside from traditional agribusiness, manufacturing and services, most DFIs emphasize the financial sector (particularly investments in banks and non-banking financial institutions) because they play an important role in increasing access to finance by underserved populations (particularly microfinance institutions), and also because these companies have inherent diversification and are regulated and thus tend to be less risky.¹⁷ DFIs also indicate that they see a strong role for themselves in support of infrastructure projects, especially when they involve concessions, because the private sector sees them as an “honest broker” to mitigate political risks. In these projects support of a DFI can send a positive signal to the markets, including regarding compliance with ESG standards.

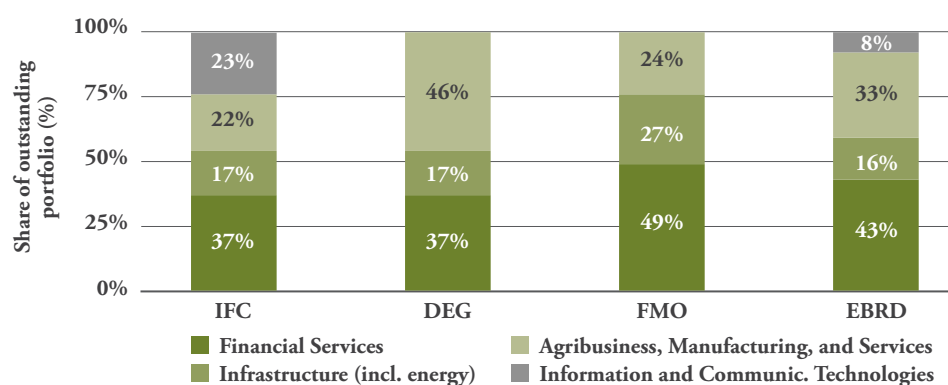


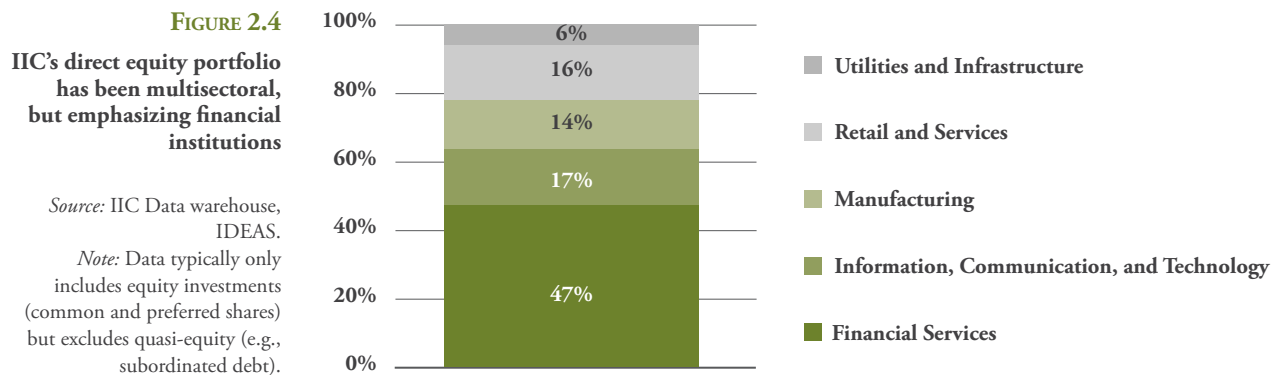
FIGURE 2.3
Sectoral distribution of DFI portfolios

Source: DFIs’ financial statements, corporate presentations, and interviews with management.

IIC also has aimed to diversify its EI with relative success at the industry level (Figure 2.4). In recent operations IIC has focused on investing in multisector funds, with an emphasis on working with experienced fund managers. When investing directly in companies, IIC focused on financial institutions, in part to leverage existing relations and to mitigate the volatility of other high-risk sectors like infrastructure or construction. IIC’s typical EI operation averaged US\$2.8 million in the 2006-2015 period, and no individual operation exceeded more than 8% of the period’s approval volume.

Geographically, regional DFIs tend to be disproportionately concentrated in their largest member country. For example, Russia represented 21% of EBRD’s portfolio in 2015, and Mexico represented 31% and 15% of the equity portfolios of IIC and CAF, respectively. Compared to other member countries, these large economies tend to offer better institutional environments and larger investment opportunities, allowing DFIs to better amortize operational costs. Because of this concentration, regional DFIs are more affected by external shocks to individual countries (e.g., financial crises). By contrast,

global DFIs like IFC, DEG, and FMO can diversify their portfolios across more countries and regions, and adverse shocks in individual economies tend to have smaller effects on portfolio performance. A former senior IFC portfolio manager emphasized the importance of geographical diversification, estimating that IFC’s portfolio had benefited more from geographic diversification than from sectoral diversification.



DFIs, including IIC, have also relied on quasi-equity instruments to manage the risk/reward profile of investments and better adapt to investees’ financing needs. For example, EBRD uses what they call “portage equity”, which limits potential losses by adding put options, but also restricts the investments’ upside. In other cases, DFIs have provided subordinated loans to strengthen the capital structure of FIs. For example, IDBG provided a bank in Costa Rica with a subordinated loan as an immediate solution to solve short-term capitalization needs.¹⁸ Furthermore, most of the direct investments of IIC through the China-IIC SME Equity Investment Trust Fund (CIEF) have been through quasi-equity instruments to manage downside risks and provide earlier cashflows (Table 2.1). For example, IIC often structures preferred rights clauses to facilitate exit by ramping up the level of preference over dividends after year 5 and thus motivate other shareholders to repurchase IIC’s shares.

D. FINANCIAL PERFORMANCE

EI has provided DFIs with higher returns than loans, but with higher volatility.¹⁹ DFIs’ equity returns have been particularly sensitive to macroeconomic conditions (Figure 2.5). Both FMO and EBRD (as well as other DFIs) had double-digit returns in the years before the global financial crisis, namely 23% and 26% (2003-2008). During the global financial crisis (2008-2009) returns plunged. After the crisis returns have recovered somewhat, but not to pre-crisis levels. Even global DFIs (FMO and IFC) have seen diminished returns due to the negative effects on emerging markets of low commodities prices and the depreciation of local currencies.²⁰ A former officer of IFC confirmed that historically about 60% of that institution’s returns could be attributed to macro performance, underscoring the importance of macroeconomic analysis in the assessment of investment decisions.

TABLE 2.1. QUASI-EQUITY WAS IIC'S PREFERRED INSTRUMENT TO ALLOCATE CIEF'S DIRECT INVESTMENTS

CIEF approvals (2009 – 2016)	% of CIEF's approved amt.
A. Direct Investments	82%
1. Common Shares	33%
Mid-Market Infrastructure	9%
Financial Institution	12%
Corporate	13%
2. Preferred Shares (quasi-equity)	9%
Financial Institution	7%
Corporate	2%
3. Subordinated Loan (quasi-equity)	40%
Mid-Market Infrastructure	18%
Financial Institution	15%
Corporate	6%
SME	2%
B. Fund Investments	18%
1. Common Shares	18%
Total	100%

Source: IIC's Management.

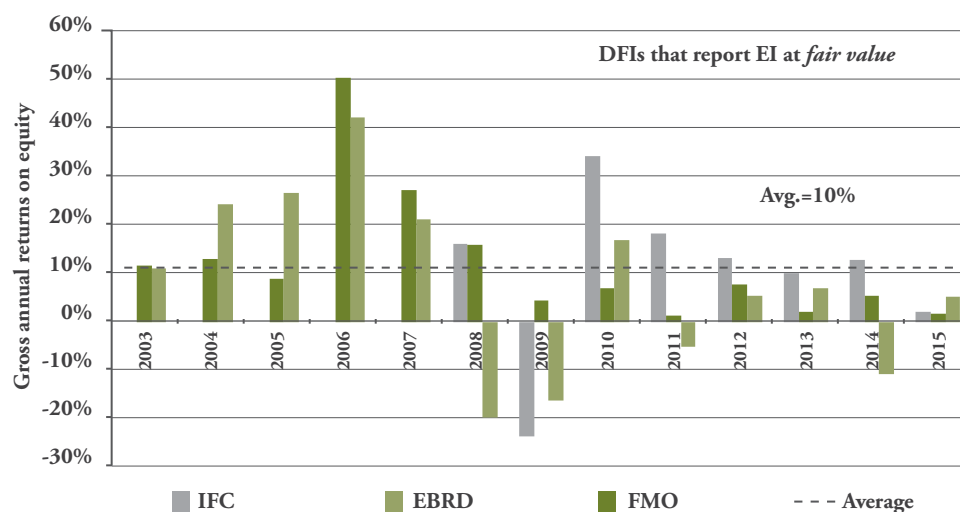


FIGURE 2.5A

Equity returns are more sensitive to economic cycles than to investee choice

Source: DFIs' financial statements.

Notes: ^a Returns presented for direct investments are gross, thus not net of administrative expenses.

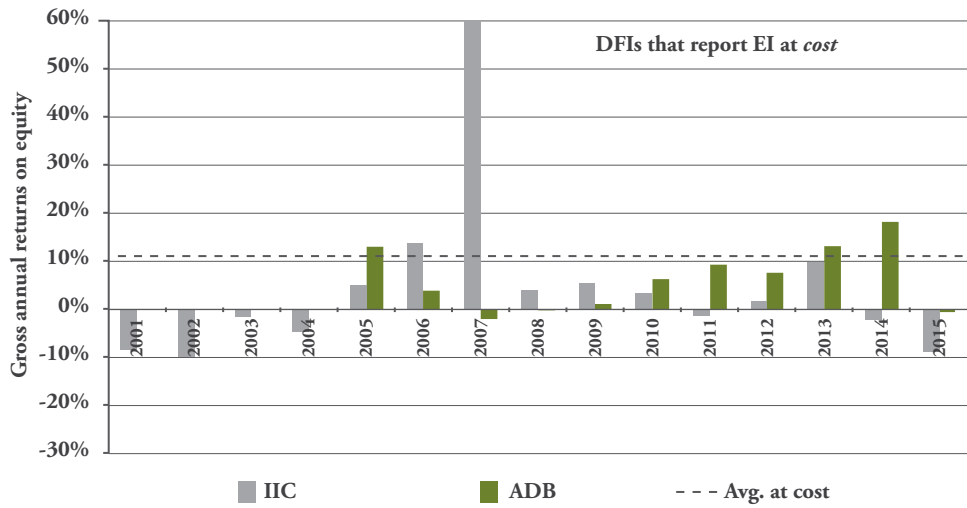
^b IFC returns before 2008 are not comparable, as financial reporting did not include unrealized gains/losses.

^c IIC's returns of over 100% in 2007 were driven by an outlier (sale of a single investment).

FIGURE 2.5B

Equity returns are more sensitive to economic cycles than to investee choice

Source: DFIs' financial statements.
 Notes: ^aReturns presented for direct investments are gross, thus not net of administrative expenses.
^bIFC returns before 2008 are not comparable, as financial reporting did not include unrealized gains/losses.
^cIIC's returns of over 100% in 2007 were driven by an outlier (sale of a single investment).

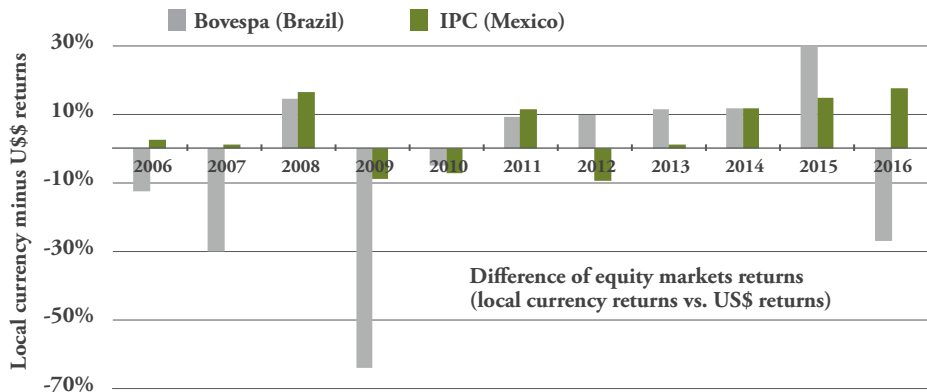


Currency fluctuations can account for an important share of returns (Figure 2.6). Equity investments (including through funds) are usually in local currency and proceeds are also received in local currency and then converted (e.g., to dollars). DFIs thus confront foreign exchange risk when repatriating investment returns.²¹ OVE assessed the difference in public equity markets returns in local currency vs. US\$ in Brazil and Mexico. For Brazil's BOVESPA, annual returns in local currency averaged 5% in the 2006-2016 period vs. 2% in US\$. Similarly, for Mexico's IPC annual returns in local currency averaged 13% vs. 5% in US\$. In both cases, US\$ returns (which are the relevant ones for DFIs) were heavily affected by currency fluctuations and the year-to-year variance was even higher, ranging from about minus 60 to plus 30%.

FIGURE 2.6

Fluctuations in local currency have important effects on equity returns

Source: OVE, with data from BOVESPA and IPC.



As expected, equity returns also have been sensitive to DFIs' portfolio composition and strategy. Managing the combination of funds versus direct investments is critical to performance. For example, FMO's strategy of predominantly investing in funds provided lower average returns but helped stabilize performance during the crisis. Controlling geographic concentration also affects performance. For example, returns for globally diversified DFIs have been less volatile: during the crisis IFC and FMO

performed better than IIC and EBRD. Finally, single investee concentrations also play a role in portfolio diversification. The more concentrated the portfolio in single funds or single investees, the more vulnerable the portfolio is to company-specific events.

The financial returns of IIC's equity investments are difficult to assess, precisely because direct investments are not tracked at fair value.²² In line with its accounting standards, IIC tracks direct EI at cost less impairments. Other DFIs (e.g., IFC and EBRD) continuously update the value of their EI (both direct and through funds). This process, although an estimate, allows them to assess unrealized gains and losses in the portfolio and ultimately make managerial decisions on how to rebalance the portfolio.

With the caveat that IIC's accounting standards understate the volatility of EI, IIC equity returns averaged 7% between 2001 and 2015, slightly above the loan yield of 6%, but with much higher volatility (Figure 2.7).²³ IIC equity returns varied widely, ranging from a low of -17% (2002) to a high of 101% (2007).²⁴ The volatility (standard deviation) of equity returns was driven not only by the seven negative annual returns over the period, but also by a very high positive return in 2007, due to gains from the sale of one highly profitable investment in a financial institution. During the same period, IIC's loan portfolio returns yielded almost the same average return (6%), but with less volatility. Only in 2002 did IIC report losses in its loan portfolio.

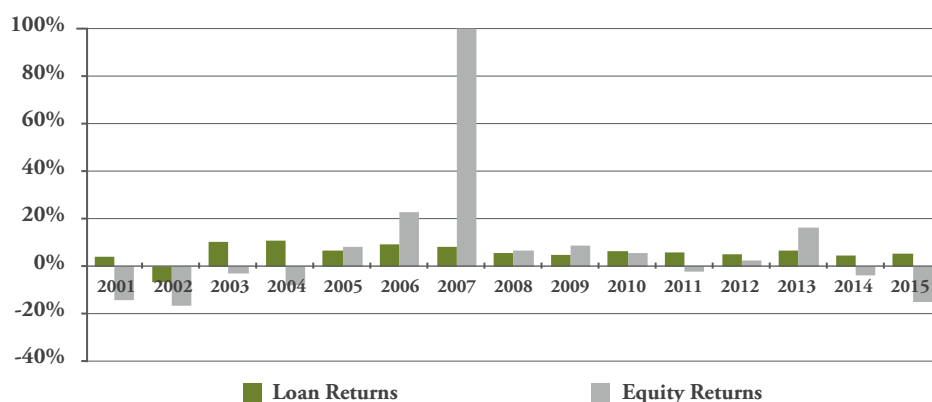


FIGURE 2.7
Evolution of IIC's equity
returns

Source: IIC Financial Statements.

OVE also found that IIC's loan and equity returns are positively correlated, indicating limited diversification effects from having both instruments. The returns of these two portfolios are positively correlated (0.3) as both respond in a similar fashion to positive and negative country, regional, and global economic events. Thus, in times of economic distress the results of one type of investment are unlikely to hedge the other.

Recently, equity returns have had little impact on IIC's net income, but they contributed to its volatility and in 2001-2002 to major losses. Because of the recent small size of the EI portfolio (about 4% of the total investment portfolio in 2015), equity returns have had a small impact on overall income. However, volatility of returns has been important.

For example, in 2007 US\$45 million in gains were realized on the sale of a single equity investment, constituting a significant part of that year's US\$83 million net income. Furthermore, in 2001 and 2002 EI constituted only a small part of assets (19%), but, affected by one of the worst economic crises in LAC, it was the main driver of IIC's net losses in these years (154% and 95% of losses, respectively). In those two years, IIC lost almost two-thirds of its equity portfolio (27% and 36%, respectively). In fact, IIC reported losses from equity during 7 of the 15 years between 2001 and 2015.

To adequately compare returns between direct investments and investments in funds, overhead costs and management fees need to be considered. When investing through funds, DFIs must pay a base commission to the fund manager for administering funds (usually around 1.5-2% of the fund size) and another fee ("carry") for returns above a minimum return (a hurdle rate, usually around 8%). On top of these are any in-house administrative costs associated with the origination and supervision of the funds. When investing directly, DFIs receive returns without paying fund management commissions. However, direct investments typically have higher processing costs (sourcing, structuring, monitoring, and divestments) because these processes are conducted in-house. Therefore, the correct comparison between instruments should compare management fees of fund investments against the administrative overhead of managing investments in-house. Only then are returns between the models comparable. Unfortunately, IIC and other DFIs lack the cost-accounting systems needed for these comparisons.

IIC fund investments have returned about 1.3 times the initial investment, although returns on direct investments are not available. Fund investments are assessed periodically at fair market value by fund managers. Though OVE was unable to obtain IIC's historical investment cashflows to analyze past returns, current active fund operations have yielded US\$1.3 on average for every dollar invested. Returns for direct EI and closed fund operations are not available because IIC does not value its investments on an ongoing basis, and because OVE could not obtain cashflows due to changes in information systems.

DFIs reported that gross returns and volatility for direct investments have been higher than for funds. At IFC the median internal rate of return (IRR) on fund investments was about 1.7% per annum below the median IRR for non-fund investments;²⁵ but accurately comparing profitability would require adjusting for administrative costs, which are likely lower for funds than for direct investments. By one estimate, after considering operating costs, fund investments ended up with a slightly higher net return than direct investments. Furthermore, direct investments tend to be more volatile since they do not have the natural diversification of funds. According to interviews with senior IFC staff, IFC's experience seemed to confirm that direct investing tends to be riskier as measured by write-offs on the downside. Furthermore, the higher volatility of direct investments might also reflect the impact of portfolio supervision, which is much more complicated than for funds. In direct equity investing, a few investments with very high returns usually compensate for many investments with negative returns (Figure 2.8).

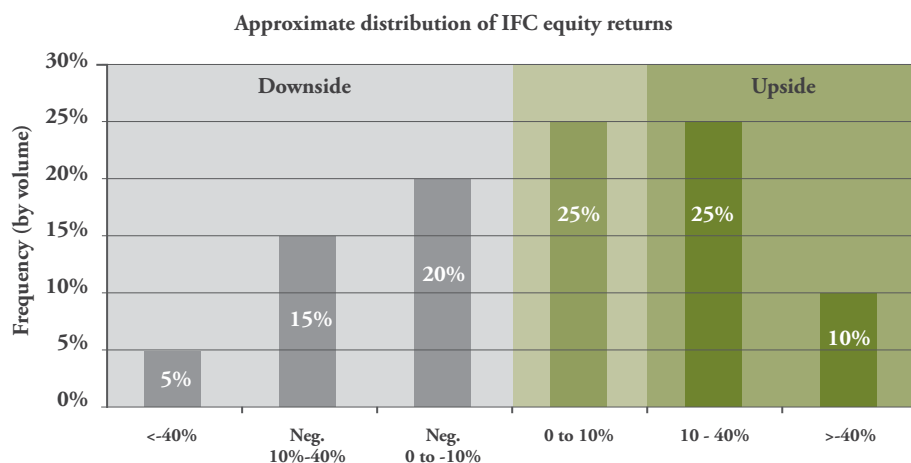


FIGURE 2.8

High-return equity investments must compensate for projects with negative returns

Source: Approximation, based on interviews with current and former IFC staff.

DFIs also reported that returns of fund investments are mostly driven by market conditions (Figure 2.9). For example, EBRD-backed fund returns have been driven mostly by market conditions rather than by the value-added provided by fund managers. This is critical, since DFIs invest in funds with the expectation that fund managers will provide expertise that can help them outperform market benchmarks. In the case of EBRD, it seems that fund managers could add more operational value to companies in sectors like retail and ICTs than in more traditional and mature sectors like financial institutions or manufacturing.

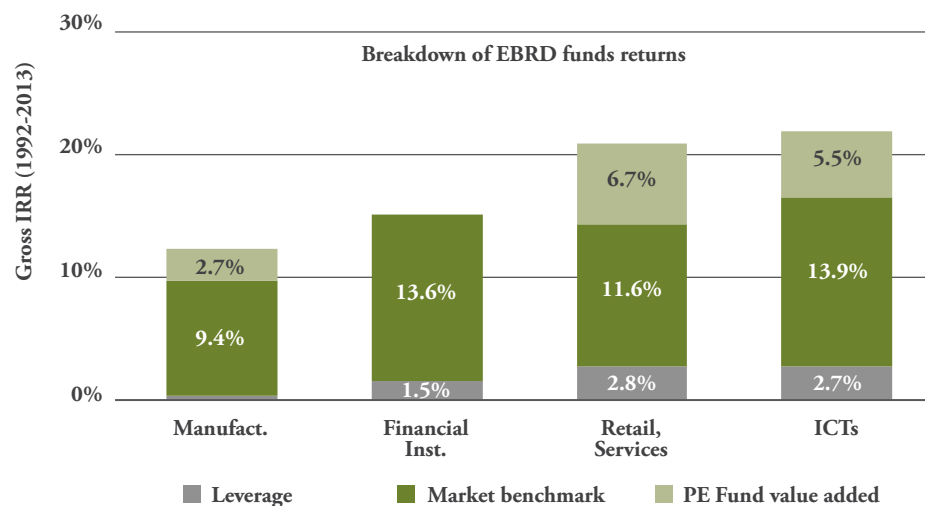


FIGURE 2.9

EBRD funds returns are largely influenced by market conditions

Source: EBRD.

E. DEVELOPMENT RESULTS

Most DFIs keep track of development effects at the project level. DFIs often track project outcomes (including those for EI projects), mostly in terms of investees' financial performance, economic returns to society (e.g., provision of basic services or investees' contribution to job creation), and ESG performance. They also attempt to assess the additionality of their interventions (including those using EI) in terms of

private sector development. For example, fund managers interviewed by OVE agreed that a DFI's participation in a fund's first closing plays a key role in attracting investors and sending positive market signals in terms of governance and ESG compliance.

Yet DFIs usually do not analyze development results separately for EI, with the notable exception of EI through funds that most DFIs manage as a specialized "sector". OVE found it challenging to reconstruct development results for EI because DFIs do not break them down separately. In part, because DFIs do track aggregate sector and country performance, but do not break down performance by specific financial instrument (in this case, equity and quasi-equity instruments.) Confidentiality issues particular to EI, such as the potential for disclosure of non-public material information, further compound the difficulty of accessing other DFIs' specific project results. The notable exception is results related to fund investments, which most DFIs track separately because funds are often treated and managed as a separate "sector".

Available independent evaluations show that DFIs have had an important role creating EI markets, but this has decreased as the industry matured. For example, an independent evaluation of IFC's activities supporting EI funds found that during the 2000s the institution accelerated its participation in EI funds, but that as markets matured IFC's role as a fund provider diminished.²⁶ The evaluation also found that IFC continues to play a catalytic role in supporting first-time managers and in setting ESG standards. A study conducted by ADB's independent evaluation office in 2008 highlighted ADB's role in demonstrating the concept of EI funds in Asia and in strengthening corporate governance, technology transfers, and employment generation.²⁷ However, it also pointed to diminishing demonstration effects (as markets matured) and found that ADB's financial returns were significantly below those of comparators.²⁸ Likewise, in 2015 CDC published a comparable evaluation report on their investments in funds.²⁹ According to the report, CDC-supported funds had a positive impact on four measures of business success: revenues, profits, taxes paid, and employment. Additionally, they had a "pioneering role in establishing the EI industry in emerging markets" and allowed the London-based organization to reach difficult to access geographies.

IFC also found that investing in funds can have strong job creation effects. (Box 2.2). IFC's Jobs Study found that EI funds had a very strong impact on job growth despite their relatively small size in IFC's portfolio, presumably because the incentives of fund managers were aligned with the growth of investee companies. The funds returns were positively and significantly related to job growth. Small firms had the fastest job growth rates, but relatively larger firms created the greatest numbers of jobs.³⁰

IFC's equity investments had lower financial success rates, but development success rates were at par with loans. IFC found that about two-thirds of its equity investments had high development results, only slightly less than for loans. But the incidence of "highly successful" projects was much higher for equity than for loan investments—12% vs.

8%—demonstrating that EI can be associated with exceptionally high development results.³¹ In part this is because equity provided much higher leverage. While EI is relatively more capital-intensive, in IFC’s experience the median ratio of project cost per dollar of investment was US\$12 for equity but only US\$4 for loans. On balance, the ratio of project cost per dollar of capital was thus about the same for loan and equity.³² Finally, some developmentally valuable projects can be supported only with equity because they cannot prudently carry debt financing. In that sense, equity can be particularly “additional.”

Box 2.2: The relationship between funds and job creation

DFIs seek to support EI funds not only to bridge a gap in firms’ access to finance, but also to create benefits in the overall economy. Job creation is usually one rationale for supporting private sector firms. In 2013, as part of a larger job study, IFC used data from its Development Outcome Tracking System to show job growth for companies financed through IFC-supported funds.

For this exercise, IFC analyzed 69 growth-equity funds supported from 2000 to 2010 as well as the employment growth of 494 investee companies supported by these funds. The study found that investees of IFC-backed equity funds had annual average employment growth rates of 14.7%.

The study had important results by firm size. Large firms created more jobs (about 239,000) and received most of the EI fund financing (67.5% of the US\$4 billion invested). However, SMEs achieved faster growth rates than larger firms (18% growth compared to 9.7% for larger firms).

Furthermore, the study found a positive and significant correlation between job creation and fund returns (see the graph below). This conclusion suggests that for DFIs, profitability in the equity business is positively linked to achieving development outcomes. One of the likely reasons is that the incentives of fund managers lead them to try to identify firms with significant growth potential, and to help them achieve that potential.

Source: [IFC. Measuring the job creation effects of IFC-supported private equity funds.](#)

3



The assessment of potential investment opportunities is a high-churn process by which only 2-5% of initial candidates are cleared for potential investment.

© Ken Teegardin

3 How DFIs Invest in Equity

This chapter presents how DFIs have organized and managed their equity investments operations. OVE reviewed how DFIs conduct the investment process and spelled out the differences between investing directly (i.e., managing the process in-house) and investing equity through funds (i.e., outsourcing the investment process to external fund managers). OVE identified 4 critical steps to manage the equity investing process: (i) project origination, (ii) project structuring, (iii) project supervision and value-adding, and (iv) exiting (Figure 3.1). This chapter also discusses the organizational arrangements DFIs use to conduct their equity operations, highlighting the differences with loans, the need of specialization, and DFIs' experience managing internal incentives.



FIGURE 3.1
The EI process

A. EI ORIGINATION

DFIs reported that the first critical step in the investing process is identifying adequate investment opportunities, a process that usually combines bottom-up and top-down approaches. Only a few DFIs (e.g., IFC) use a top-down approach to inform sourcing. IFC periodically tries to first identify sectors and countries with relative under-penetration relative to income levels. From this list, it retains only those where it expects healthy GDP growth. Then it retains only those where the regulatory and business environment is favorable for EI. It further narrows down the list to only those countries and sectors where there are companies with good scale and prospects. Finally, it retains those companies that have shown excellence in execution, usually measured by their having cost advantages that place them

in the lowest percentile of unit cost worldwide. Most frequently, DFIs rely on a bottom-up approach, identifying individual investment opportunities as they arise. For example, IFC's investment officers also source projects based on local demand and the fit with their sector strategies.

The assessment of potential investment opportunities is a high-churn process by which only 2-5% of initial candidates are cleared for potential investment. This selectivity — much greater than for loan operations — requires specialized skills and processes. In fact, most DFIs have a special equity committee, headed by a top manager such as the Chief Operations Officer or a VP in Charge of Equity. DFIs differ slightly in terms of the stage at which they perform different parts of their investment analysis, depending on the source of the potential project (e.g., existing debt clients or top-down targets), but they all result in an essentially similar “screening funnel.” For example, BNDES (Figure 3.2) has four stages: (i) assessing fit with its own mandate, (ii) analyzing prefeasibility, (iii) analyzing the business, including developing a valuation and draft contractual terms, and (iv) closing and setting of supervision arrangements.

When sourcing investment opportunities, DFIs carefully consider potential conflicts of interest with loan investments. Being simultaneously a debt-holder and a shareholder may lead to conflicts of interest. Debt-holders may, through covenants, actively pursue their interest in minimizing risk to get paid, possibly jeopardizing growth prospects that would benefit EI. Conversely, shareholders may engage in projects that debt-holders consider too risky. Given that debt and equity interests may differ, most DFIs deal with these conflicts of interest by establishing “Chinese walls” between the teams structuring debt and those dealing with equity.³³ At times DFIs also have avoided entering debt-holder and shareholder positions at the same time, while others actively seek to place equity with existing debt clients with whom they already have a strong relationship. Conflicts tend to be more acute in two situations: (i) when listed equity is involved (because of potential non-public, material information), and (ii) when the client enters distress situations (because of opposing interests on the company's assets between debt- and equity-holders), particularly when investments for third parties are involved (e.g., B-loans).

When investing through funds, DFIs focus on selecting the right fund manager instead of specific investments. All DFIs interviewed agreed that the quality of the fund manager, as evidenced by the track record, is fundamental to superior financial performance. Working with experienced fund managers usually reduces risk and improves return prospects. For example, when selecting fund managers, EBRD looks at the management team experience, complementary skills, and execution capacity. The fund's strategy also needs to be aligned with the managers' experience and target market opportunities (e.g., DFIs typically check the quality of the fund prospective pipeline). In fact, IFC estimated that its outperformance in fund returns is almost exclusively attributable to manager selection (Figure 3.2).

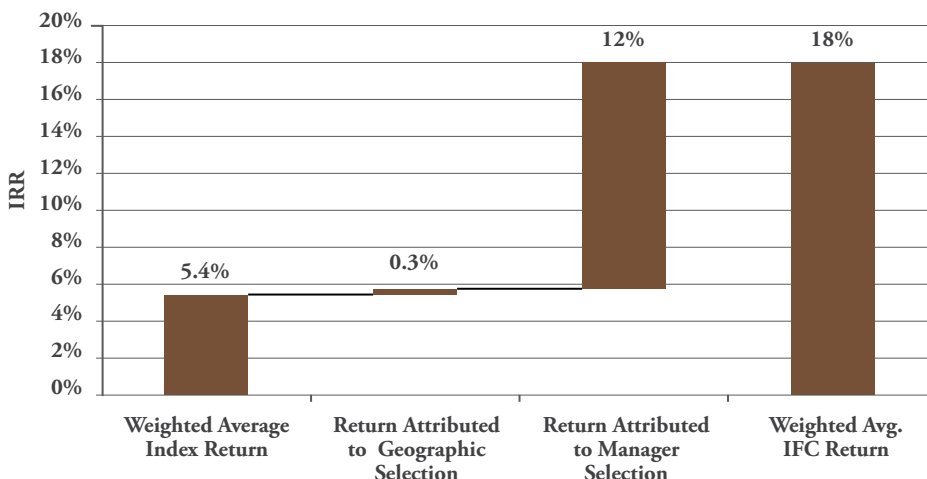


FIGURE 3.2
The majority of IFC's fund returns are attributed to management selection

Source: IFC. IFC compared its fund investing performance against the MSCI Global Emerging Markets Index.

A key decision is whether to invest with first-time or experienced fund managers. Most DFIs agree that follow-on funds tend to provide higher returns than first-time funds. This is in part because fund managers create a track record that allows them to learn, and access more capital sources and a larger pool of investment opportunities. EBRD returns seem to reflect this observation (Figure 3.3). However, DFIs interviewed also agreed that when entering markets where no EI industry is established, they usually invest with first-time funds. Even in those cases, DFIs indicated that it is crucial to select experienced managers (usually investment professionals who have led successful investment careers in other geographies, but who also have knowledge of the local market).

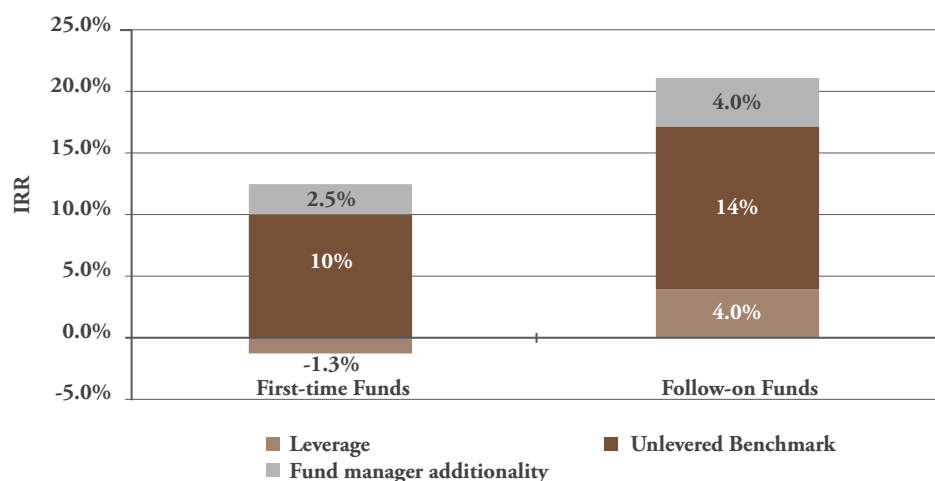


FIGURE 3.3
EBRD – significantly higher returns with follow-on funds vs. first-time funds (1992-2013)

Source: EBRD.

Occasionally, funds invite DFIs to co-invest in specific companies, or the DFIs themselves negotiate upfront the right to co-invest. Most interviewed DFIs agreed that co-investments help increase returns, as direct co-investments can be done without incurring significant additional costs, taking advantage of funds' screening and monitoring processes. Furthermore, co-investments can be

beneficial to learn about the specific industries in which the fund is investing. DFIs like FMO have based their direct EI strategies mostly on executing co-investment opportunities.

Co-investments can be beneficial for DFIs, but in practice it has been challenging to take these opportunities because they require a fast response that DFIs often can't provide. DFIs have not been able to co-invest as much as senior managers would like. In part, they tend to miss these opportunities as their regular approval mechanisms do not match the timing required by these deals. However, DFIs like IFC have developed approval models that facilitate co-investment approvals. Usually, they obtain Board approval for a larger commitment than the investment in the fund, to leave room for co-investments. That way co-investment can be approved relatively quickly by management and does not have to be separately approved by the Board—a process that usually takes much longer.

B. EI STRUCTURING

Key decisions in structuring are the desired initial shareholding (usually 5-20%) and the resulting ticket size.³⁴ DFIs usually do not seek to control the operation of investee companies, in part because they explicitly want to avoid displacing private investors. They see their role as catalysts to attract other investors and to support companies in improving their business practices. DFIs also seek to invest in minority positions to manage portfolio risk and concentration, which in turn leads to a limitation in ticket size.³⁵ At the same time, DFIs also seek to avoid too low a share because they aim to influence companies' governance, strategy, and business practices. Some DFIs' engagement includes the appointment of a board director, and many actively vote their shares.³⁶

Also, all interviewed DFIs agreed that the expected holding period and exit alternatives need to be anticipated up front during structuring. DFIs enter direct EI with the expectation of investment horizons typically between 3 and 10 years. According to interviewed DFIs, exit options are usually anticipated and carefully scrutinized at the time of approval. A fund manager indicated that they discuss exit alternatives with investee companies during the negotiation process. However, exit is usually a process, and market conditions often lead to delays.

To address investees' funding needs, some DFIs also include quasi-equity or mezzanine debt among their offerings. Quasi-equity generally refers to financing with hybrid traits between a company's senior debt (lower risk and lower return in the 5-12% range) and equity (highest risk and highest expected return in the 15%+ range). Quasi-equity is subordinated in priority to senior debt, but senior to equity (so it has intermediate risk and expected returns of 10-20%). Quasi-equity financing includes subordinated debt, convertible debt, profit-sharing debt, and private "mezzanine" securities (debt with warrants or rights to equity conversion).

Box 3.1.: Key types of quasi-equity investments

Quasi-equity (or mezzanine financing) usually refers to hybrid financial instruments that lie between equity and debt, depending on their characteristics (i.e., providing holders with potential claims on the company's assets, earnings, or ownership stakes, depending on future conditions). The most common types of mezzanine debt or quasi-equity are described here.

Subordinated loans: Loans that have lower repayment priority compared to senior loans, in case of default (i.e., subordinated debt-holders are not paid until senior debt-holders are paid in full). Usually these loans do not offer collateral. Given the increased credit risk, these instruments usually earn higher interest than senior loans.

Convertible debt: Instruments are structured in such a way that the initial investment is a loan with periodic interest and capital repayment. However, the contract offers the investor the option to convert the loan to a certain number of shares at a predefined price at some future date.

Preferred stock: A shareholding position that has higher seniority (i.e., higher claim on earnings and assets) than common stock. Preferred stock usually receives a defined dividend that is paid out before dividends to common shareholders. However, preferred stockholders usually do not have voting rights. In some cases, preferred stock carries the option of conversion to common shares.

FIs have used quasi-equity as a starting point of their EI business, but the viability of this approach is demand-sensitive. Quasi-equity provides a less risky transition from the DFIs' traditional debt business. However, it depends on the investees' willingness to accept giving a DFI the revenue enhancers involved in quasi-equity. Situations appropriate for mezzanine financing are specific and usually transitory. Typical situations matching quasi-equity include the investee company funding a growth opportunity such as an acquisition, the company owners cashing out of the company, or management buying out the company owners. The demand for quasi-equity is highly dependent on prevalent interest rates. Low interest rates usually "squeeze out" the middle range between the cost of debt and the returns expected by equity investors. Finally, quasi-equity instruments (Box 3.1) can be complicated to structure and supervise, raising their own risk issue beyond pure credit risk.

When structuring investments in funds, DFIs report that term negotiation tends to be standardized, yet it is still critical to set the proper incentives. Fund managers and DFIs interviewed mentioned that term sheets for LPs are by now largely standardized. Most fund contracts are standardized in terms of fee structure and the distribution rights of LPs and GPs, participation in fund governance, capital call procedures, and liquidation clauses. In fact, all DFIs interviewed agreed that if a GP is too open for modifications it may be a sign of a weaker team or investment proposition. Interviewed

managers mentioned the following as best practice: (i) making sure fund manager fees and expenses are aligned with desired financial performance; (ii) a tangible commitment by fund managers (e.g., by investing their own resources, or by tying a large portion of their income to the fund's returns); (iii) clear governance no-fault divorce clauses; and (iv) an income distribution waterfall that ensures that the LP's interests are satisfied first. For example, a European waterfall ensures that after paying the fixed fees to the GP, investors get back all of their expected returns (capital plus a predefined hurdle rate of about 8%), before fund managers can start getting their carried interest (usually with a catch-up clause, before distributions go back to an 80/20 ratio between LPs and the GP).

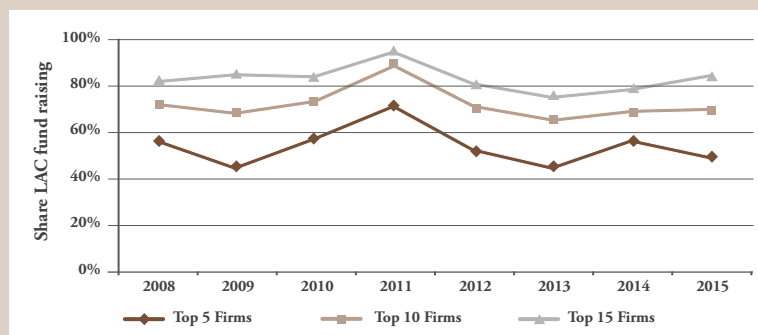
Box 3.2. LAC's fund management market has been maturing over the last 15 years, and DFIs are now able to work with experienced global and local fund managers

Large global EI firms now managing LAC funds

Name	AUM (US\$ Bn.)	AUM LAC (US\$ Bn.)	% Portfolio in LAC
Advent International	US\$29.0	US\$6.0	21%
The Abraaj Group	US\$9.0	US\$0.2	3%
Northgate Capital	US\$4.8	US\$0.5	10%
ACON Investments	US\$4.4	US\$1.4	33%
The Rohatyn Group	US\$4.2	US\$0.5	13%

Source: OVE, with data from LAVCA. AUM refers to assets under management.

Funding is highly concentrated



Source: 2016 LAVCA Industry Data.

DFIs also have been able leverage additional resources by administering funds for third parties. DFIs can act as intermediaries to channel resources to companies in developing or emerging markets, bridging the information asymmetries that international investors face when investing in emerging markets. DFI-managed funds can provide additional funding to companies. IFC created an Asset Management Company (AMC) as a separate entity to manage over US\$9 billion for large institutional investors like sovereign wealth funds and pension funds. In attracting institutional investors from the private sector, IFC's most important selling point has been its strong 20-year track record investing in equity, usually outperforming emerging market benchmarks. Other DFIs, such as OPIC, have specialized in providing debt to funds managed by external managers.

The model for co-investing assets under a DFI's management usually involves the right to participate in all investments with the possibility of opting out. In most cases DFIs give third-party investors the right to invest in all their deal flow opportunities with certain characteristics, e.g., above a certain ticket size. This is intended to prevent adverse selection by the DFI. Furthermore, to allow third parties to customize their portfolios, investors are permitted to opt out of certain investment opportunities. Other DFIs, like IFC's AMC, adopt a more active fund management approach, where about 13 AMC fund management teams pick investee companies from IFC's deal flow to create customized portfolios according to the mandate of each fund. By contrast, at EBRD third-party investors follow EBRD on each deal, replicating its allocation.

C. SUPERVISION AND VALUE-ADDING

EI supervision focuses on enhancing upside while managing risks, so DFIs usually detail value-adding approaches and some even incorporate them as part of their closing agreements with investees. For example, EBRD documents its approach in Value-Adding Plans that are made part of closing documents with every investee. EBRD usually cannot require these plans to be executed exactly, but rather on a best-efforts basis—because the business situation evolves and such detailed imposition could be equated to “managing” the business. Nevertheless, these plans serve as the basis for the ongoing follow-up of investments.

EI risk mitigation activities have aspects that need to be tailored to the EI's risk profile. In loan investments, the monitoring function is a more hands-off approach focused on reducing the downside risk (i.e., establishing, tracking, and enforcing covenants that ensure timely repayment of debt obligations). However, supervision of EI is more complex because, in addition to credit, liquidity, market, and funding risks, EI needs to carefully watch exit options (since there may only be brief windows of opportunity for profitable exits). Also, many decisions by investee management may affect equity valuations long before they have an impact on the ability to repay a loan. Risks in private EI are even more acute than those in publicly traded equities.

The monitoring and risk management of EI requires specialized capabilities. The economic value of debt investments is usually predetermined, and value deterioration is narrowly managed in the event of (potential) default. EI, however, presents no such certainty; its value is potentially highly volatile and difficult to establish in the absence of recent, deep market transactions in the same equity. Therefore, organizations engaged in EI require more sophisticated capacities to continuously assess the fair value of investments, develop future scenarios, and classify investments according to their expected future upside.

This role is usually discharged by portfolio management units, which in organizations like IFC have a high degree of power over the EI business. These units are complemented by risk management staff specialized in EI, and, in IFC, by an “equity desk” that monitors

public markets and the value of investees and comparables. Proper valuation is also essential from a fiduciary perspective, since equity valuations can affect the financial statements of the financial institution and be subject to external audit. It is thus essential that the DFI have sufficient expertise and appropriate processes, with checks and balances, to value EI.

As part of their risk management systems DFIs seek to ensure ESG safeguards, but tools differ between loans and equity. DFIs are required to ensure minimum ESG standards in all their investments—which is difficult in EI because they do not control the investees. Unlike with debt investments, DFIs cannot impose strict covenants requiring adherence to ESG standards. Several DFIs thus usually negotiate “policy” puts with the investees’ controlling shareholders that would allow them to exit the investment in the event of material noncompliance with ESG issues. While they rarely exercise them, they can strengthen the DFIs position in trying to enhance ESG performance. On the positive side, equity allows DFIs to influence management as a shareholder (exercising their vote) and board member (influencing the management of the investee company). DFIs mention that they usually seek to persuade investees that “good ESG practices are also good for business,” and they very rarely take an active position as shareholder (e.g., by proposing issues for annual meetings).

Value-adding at the company level can be through both business management and governance levers. For example, BNDES further details five drivers of value of the investees’ business: growth, profitability, project execution, financing structure, and divestment. On the management and governance side, BNDES also identifies key functions that usually need to be strengthened in investee companies (Figure 3.4). In some cases, BNDES helps investees identify outside talent to support these functions.

FIGURE 3.4
BNDES adds value as an active investor

Source: BNDES.

OBJETIVES: BE ACTIVE AND PRESENT, HELPING INVESTEES GROW FASTER AND THEN DIVEST.	
Areas of Support	Activities of Involvement
Corporate Governance	<ul style="list-style-type: none"> • Conflict resolution • Succession plan creation
Talent management	<ul style="list-style-type: none"> • Board member selection • Senior management selection and feedback • Talent retention and remuneration
Operations	<ul style="list-style-type: none"> • Strategic planning • Annual Budgeting • Internal control improvement
Financial activities	<ul style="list-style-type: none"> • Financial restructuring • Attraction of investors • Mergers and acquisitions
Divestment	<ul style="list-style-type: none"> • Preparation for IPO • Preparation for strategic sale

From the organizational point of view, EI requires creating and staffing value-adding functions. Unlike debt, for which the focus is on contractual covenants, EI financial performance depends on earnings growth, which requires continuous adaptation to the evolving business conditions facing investees. Here there are two clear organizational choices: to leave the value-adding with the officers that originated the transactions, or to hand off operations to different officers charged only with monitoring investments. The first approach maintains the people that know the most about the investees and helps build longer-term relationships. The disadvantage is that these origination officers tend to be driven by new business volume incentives, detracting from their ability—and time—to work continuously with existing investees. The latter disadvantage is a relatively bigger issue for EI.

Dedicated value-creation teams are being introduced by organizations like BNDES and EBRD. Dedicated value-creation staff (the staff designation recently introduced at EBRD) are meant to specialize, with their sole mission being to leverage the resources of the organization and its partners to add value to investees according to a predefined “Value Creation Plan” that specifies focus areas, activities, responsibilities, and deadlines. Overall EBRD plans to dedicate 3-4 full-time-equivalent staff (about 10% of total EI dedicated staff) exclusively to value creation and have them work within the “equity network” made up also of “equity execution leaders” and “sector bankers.” BNDES has gone even farther by dedicating a larger proportion (over 50%) of their EI team to value creation.

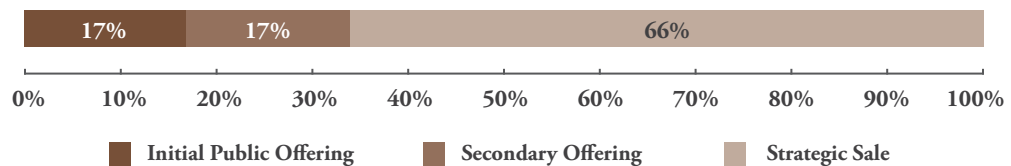
On the other hand, fund investing is a more hands-off approach than direct investing, and the supervision role focuses on a general oversight of the fund managers’ performance. Most DFIs interviewed agreed that the supervision of funds is mostly focused on assuring that managers stay within the fund mandate and established limits. Since the focus is also on adding value, DFIs usually participate in the advisory committee with an eye to collecting information about potential co-investment opportunities, and they support managers to extend their networks with other financiers and investment opportunities. However, DFIs only rarely participate in the investment committee, which makes the actual investment decisions.

D. EXITING AND LESSONS LEARNED

DFIs exit their direct EI through three basic mechanisms: strategic sale, public offer, and buy-back. A sale to another private company or investor is usually called a strategic sale; this type of sale accounts for the greatest number and volume of divestments in LAC (Figure 3.5). A less common alternative in LAC is listing the equity position in a stock market so that the public can invest in the company (initial public offering). This alternative is particularly difficult to achieve because LAC’s capital markets are generally less developed, except in a few countries like Brazil, Chile, and Mexico. Finally, DFIs can also predetermine a sale price at which existing shareholders can buy the DFI’s shares, or they can negotiate a private sale to existing or new shareholders (secondary offering).

FIGURE 3.5
Frequency of exit types in LAC (2013)

Source: CAF, with data from LAVCA.



Shareholder agreements often provide special rights to protect minority shareholders and make DFIs' exit easier. For instance, tag-along rights are contractual obligations used to protect a minority shareholder. If a majority shareholder sells its stake, it gives the minority shareholder the right to join the transaction and sell its minority stake under the same terms. A similar agreement is the drag-along clause, which requires the main shareholder to also sell its stake when the DFI has found a buyer. Compared to tag-along clauses, drag-along clauses are usually more difficult to negotiate. A third type of clause is a put-call arrangement, which stipulate a "put price" at which the DFI can sell back (typically to the main stakeholder), and a—typically higher—"call price" at which the main shareholder can ask to buy the DFI's stake.

DFIs stress the importance of adequate governance of the divestment process. Unlike loans, which generate periodic income, equity generates most returns when it is sold at a multiple of the original investment (e.g., selling an original investment of US\$1 million for US\$10 million). Therefore, just as buying when equity valuations are low is important, divesting at the correct time, when prices are high, is critical. DFIs agreed that they have struggled to establish adequate divestment governance. Most agreed that the best practice is to predefine investment milestones after origination to avoid subjectivity (e.g., "falling in love" with the investment) and overly risky behavior (e.g., attempting to speculate in the market).

Compared to direct investments, exiting from funds is easier, as managers are in charge of executing the divestment strategy. Funds are usually structured in such a way that they auto-liquidate at the end of the investment cycle. At the moment of inception, fund managers model and define the expected life of the fund and plan the divestment strategy. Funds are usually structured with a life of 7-10 years with annual extensions if necessary. As the divestment strategy is executed, the fund is self-liquidated.

DFIs need robust EI valuation practices to accurately measure financial returns, classify portfolio operations in terms of their maturity, and ultimately trigger exits via predefined, objective targets. For example, DFIs like EBRD and IFC constantly conduct valuations of their equity portfolio and do rebalancing exercises to ensure an adequate risk/reward profile. In addition, DFIs usually classify their portfolio into maturity "buckets" (e.g., early, growth, and mature). This allows them to identify actions to take at the different stages of the investment maturity. The DFIs surveyed also highlighted the importance of discipline and of having predefined, objective triggers for initiating and completing investment exits.

DFIs need to establish a process to deal with impaired assets, particularly because direct equity investments do not auto-liquidate (like funds), and they create potential liabilities. For example, one DFI was the shareholder in a mining operation with significant costs for mine closure. In this way the “value” of an equity investment could not only be potentially negative, but could also expose the DFI to significant reputational risks. Internal incentives also matter: For example, almost two decades ago IFC started to introduce an equity “carrying” cost for departments, to appropriately reflect the capital cost of keeping equity costs and to prompt exit from mature investments.

Similarly, EI presents singular challenges at exit, because unlike debt uncertainty in exit, timing and conditions require enhanced assessment and governance. Portfolio management units are at the center of this process. They play a role in setting EI strategy and allocations and in classifying investments for holding or divestment, and they also usually lead the exit strategy. One key organizational decision is whether investments are divested while under the watch of originating departments, or whether they are handed off to a “divestment unit” whose sole responsibility is obtaining the best value while ensuring proper compliance with regulations—for example, not using “insider” (material, non-public) information. Others rely on ad hoc teams formed by the portfolio management unit and the business areas. Another challenge is that—unlike for loans—writing off an investment may not be the end of the story. The DFI remains the “owner,” and is potentially exposed to financial and reputational liability. DFIs have thus had to put in place processes to actively manage “deadwood equity” to guard against such risks.³⁷

Because of EI’s generally longer maturity periods—which make it harder to link results to staff—EI results management presents organizational challenges. Results assessment standards for EI are usually in line with those of other private sector operations. The same good practice standards for private sector evaluation apply equally to EI operations. However, the critical difference between EI and most other private sector operations is EI’s longer investment, divestment, and results-creation process. It may take more than 10 years for a fund to fully divest. This longer lifecycle, combined with staff mobility, makes it harder to keep a connection to operations. In addition, information on investee companies tends to be harder to get, especially if EI is done through funds. More recent efforts have tried to generate common standards for results reporting by funds—efforts that have usually been supported by the DFIs’ portfolio monitoring or results management units.



IIC will need to be proactive to ensure access to prime deal-flow, particularly until it gains market recognition as a relevant equity investing player.

© *M&A*

4 Implications for IIC

Undertaking EI at IIC has implications that Management and the Board need to consider. First, despite the preference for EI expressed in IIC’s establishing charter, IIC will still need to clearly articulate what objectives it pursues through EI. Second, IIC will need to address the numerous trade-offs – including much less ability to do loans – implicit in this decision to do EI. Third, IIC will need to achieve the degree of organizational specialization and critical mass required to be successful at EI. Fourth, IIC will need to ensure that this time it commits to EI with the degree of continuity and long term horizon essential for success. Fifth, IIC will need to rethink its incentives – and the transparency of the underlying metrics, including those linked to the ongoing valuation of EI – because EI’s greater time horizons and uncertainty present challenges beyond IIC’s traditional lending business.

A. ARTICULATING SPECIFIC OBJECTIVES FOR EI

A clear definition of what IIC expects to achieve through EI should drive strategic decisions. There are various types of objectives that comparators consider as a rationale for doing EI, which IIC may want pursue: (i) expand its ability to support existing debt clients with equity and through them deepen its development results; (ii) provide a positive signaling effect to other investors; (iii) support IIC strategic priority sectors and gain access to first-hand knowledge on private sector needs and emerging trends; (iv) promote good investing, governance and management practices, including on environmental and social issues; and/or (v) increase return on capital, and thus IIC’s capital accumulation. The degree and combination of these objectives that IIC chooses to embrace will determine the right approach for IIC—for example, direct EI to support debt clients, direct and funds EI to gain private sector knowledge, or a diversified portfolio for stable returns.

Any commitment to EI should help support IIC's priority business areas and IDBG's country strategies, as well as clarify IDBG-wide coordination arrangements. The decision to engage in EI should be not only financial, but also based on EI's suitability to pursue IIC's business goals in priority areas. IIC will also need to ensure that country diagnostics and strategies include EI, and consider such characteristics as the ecosystem for EI (e.g., capital markets, minority shareholder protection), which may require IDBG work, including on developing specific opportunities for EI (e.g., in public-private partnerships in infrastructure). IIC will also need to clarify organizational roles and responsibilities with the rest of IDBG, seeking to make greater use of country office staff for operations in EI, complement the work of IDBG country and sector departments, and possibly access concessional resources in the context of joint debt and EI operations.

Perhaps one of the most critical decisions for IIC will be whether to do EI through funds or directly, or to do both simultaneously. Direct EI would provide IIC with more control over the selection of investees and potentially better financial and development results, but it would also involve higher costs, internal capacity needs, and volatility. By contrast, investing through funds outsources the selection and management of investments to third-party managers, but relinquishes control over the selection of investees and entails fees to fund managers. Doing both has potential synergies, but also the highest requirements in terms of both capital and staffing, if each side of the business is to be undertaken and managed professionally.

Overall, since debt is the predominant business of IIC and most of its comparators "choice"—the critical role of any strategy setting activity—is even more crucial for EI than for debt. Part of that "choice" involves defining a risk appetite for EI and deciding where the institution has a comparative advantage. Leadership of the process depends on the organizational model adopted. If a dedicated EI area exists, it usually leads the process. Otherwise, usually a multidisciplinary working group develops a strategic proposal. Business sectors play a key role in scoping market opportunities and proposing focus areas (as in IFC). Input for the strategy is also typically provided by portfolio management areas that usually also monitor strategy implementation. EI strategy setting is reviewed periodically, often to accompany multiyear planning cycles (as in EBRD). As of today, IIC lacks a formal EI strategy that addresses these issues.

B. MANAGING THE TRADE-OFFS OF EI

IIC needs to be explicit in its risk appetite for EI, because the risk of losing capital allocated to EI is much higher than for loans. The amount of IIC capital set aside for EI needs to be defined according to the risk appetite of IIC's shareholders and the expected equity return performance. Risk and return scenarios need to be constructed and discussed, including such key variables as IIC's expectations for GDP growth, sector allocation ratios, EI sector betas, and potential currency depreciation.

Any capital allocation to EI implies 3 to 5 times less room for debt. Because IIC has a finite amount of capital, there is clear trade-off between EI and debt. Each dollar committed to EI represents US\$3 to US\$5 of debt business that cannot be supported. This trade-off is more constraining now, when IIC has about US\$800 million in capital, than in 2025 when capital is expected to rise to about US\$3 billion. In addition, financing capacity may be further constrained by risk correlation between IIC's debt and EI portfolio at the client, sector, and country levels, further reinforcing the need for strict portfolio exposure limits. Quasi-equity and certain other products, such as credit lines for funds, may be less capital demanding options that can play a role in IIC's equity strategy going forward.

EI has the potential for higher returns than debt, but also implies higher volatility, less liquidity, and higher operational demands. Given higher return expectations for equity, IIC could expect a gross return of 3-7% more than the expected return on debt from a well-managed equity business. The flip-side is income volatility and less liquidity due to EI uncertainty in terms of value and exit. In addition, operating an EI business will use budgetary and management's attention space, that could have been devoted to debt.

C. ACHIEVING ORGANIZATIONAL SPECIALIZATION AND CRITICAL MASS

Similar to other DFIs, IIC's EI approach will likely involve progressive stages in terms of the relative use of funds versus direct EI, as well as in the use of transitional, quasi-equity products. Comparators like CDC have used funds for years to learn about EI, before transitioning to doing some direct investments. EBRD sometimes uses a structure called "portage" that effectively converts EI into sort of quasi-debt, by setting floors and ceilings through options. Other entities like IFC started in EI using a variety of quasi-equity instruments, seeking to capture some of the upside of debt clients; however, this is subject to the client's willingness to enter such arrangements. Yet these quasi equity instruments require careful management to ensure the negotiated rights, e.g., warrants, are timely and properly exercised.

IIC will need to be proactive to ensure access to prime deal-flow, particularly until it gains market recognition as a relevant EI player. Sourcing of direct EI deals relies on good in-house knowledge, which usually requires strong contacts in the local markets and a critical mass of sector expertise. For EI through funds, IIC will need to develop the appropriate expertise to assess the quality of fund managers and fund structuring. IIC could potentially benefit from existing fund expertise at the IDBG—for example, at MIF, but with the strong caveat that MIF focuses on venture capital and market development, rather than the type of EI IIC is more likely to pursue. IIC could also develop co-investment agreements with potential strategic partners, such as IFC, who are always looking for ways to manage their regional exposure.

IIC will also need to work on expediting approval processes, particularly if it decides to co-invest with funds. IIC will face a dilemma because its relatively low experience in EI may lead to longer approval processes, whereas it will likely be required to

respond quickly if it is to take advantage of investment opportunities alongside other experienced investors. One typical example of the approval speed required is in the context of co-investments, in which fund managers call on selected investors to also invest directly. In these cases, response times need to be in the order of 4-6 weeks. Comparable institutions like IFC address this issue when the investment in a fund is approved, granting a delegated authority to management to co-invest an additional amount with each fund.

The supervising and ongoing value adding process for EI is much more involved than for debt, and needs to work both ways: by IIC giving advice and by investees helping IIC learn. For direct EI operations, the most successful comparators, like IFC, leverage their internal knowledge networks to provide sectoral expertise, including on access to technology and markets. For funds, the process is likely to be the reverse for the type of experienced GPs IIC would engage. In that case, IIC needs to be prepared to invest the time and effort to learn from these GPs. When appropriate, IIC can also be a proactive shareholder (e.g., on topics of corporate governance or E&S).

To reach a critical mass and be able to attract qualified staff and amortize the fixed costs of EI, IIC will likely need an EI portfolio of at least US\$200-300 million. Incentives to attract highly qualified EI staff do not need to be in the form of compensation, but will likely include some assurances that IIC is committed to developing an EI portfolio with critical mass.³⁸ IIC's current EI portfolio (now at about US\$40 million) is insufficient for these purposes. IIC will need to attempt to permanently maintain annual EI approvals of at least US\$50 million to build up an EI portfolio able to sustain a minimal EI team. Yet this needs to be considered carefully, as it could also contribute to IIC's income volatility. Fixed costs, such as specializing staff in EI, also need a critical mass to be amortized.

IIC will also need to nurture the organizational skills and culture required for EI, which differ from debt. While debt focuses on mitigating potential losses, EI is mainly about the "upside potential." In fact, it is about the stellar upside potential of a handful of investments that usually account for most of the returns of the whole portfolio. EI also requires much more continuous attention than debt, and an ability to adapt to enhance value. The organization also needs to be able to manage the relative uncertainty and complexity of the EI exit and results reporting processes, because—unlike debt—EI has no preset schedule for repaying principal and interest.

This contrast presents an added challenge for debt-focused entities. Like most of the comparators, IIC is predominantly a debt-focused organization. Debt requires a set of organizational capabilities—standardization, capital preservation, risk mitigation, and contractual compliance—that differ in nature and emphasis from those of EI. For EI, the focus is on identifying attractive opportunities (often during difficult economic times), identifying areas where the DFI can add value, and optimizing the exit to maximize returns.

This difference is often reflected in a different composition and dependence of the “credit committee”. At debt-driven organizations, check-and-balance structures, often embodied in credit committees are designed to anticipate potential downsides and risks, rather than proactively look for upside potential. The timing of debt decisions is also often slower given that debt providers tend to be part of an overall financing package. By contrast, EI decisions are much more involved, specialized, and requiring a much more in-depth assessment of the investee’s prospects. But fast response times are also often essential. Thus, most comparators have specialized credit committees for EI, headed by a high-level executive – often the entity’s Chief Operating Officer or somebody of similar organizational seniority.

Overall, comparators use one of two organizational approaches to deal with EI: equity as a “service” to business areas or equity as a separate organizational area. DFIs with a high participation of public sector finance, like CAF or ADB, have tended to provide equity activities—including due diligence and structuring—as a technical service to the business areas (usually organized by sector or country). Entities with larger private sector exposures, like EBRD and FMO, have opted for creating a full “equity area” with responsibility over EI. There are also “hybrid” models—for example, IFC has created a specialized EI area, while still leaving important EI roles with the sectors.

Each organizational approach has pros and cons that need to be weighed against the objectives and development stage of the organization adopting them. “EI as a technical service” brings EI technical expertise and leaves EI as a tool to be used by all business sectors when appropriate, but lacks a unified business perspective on EI. “EI as a separate organizational area” brings a unified perspective, but can lead to pressures to generate EI deal flow, potential tensions in allocating capital, and may make it harder to draw on the necessary country and sector expertise. In practice, most organizations have started with a few EI professionals as advisors providing technical expertise to the business areas. As the EI grew, they evolved into separate EI areas.

Multisectoral project teams are the preferred organizational arrangement to carry out the origination, structuring, and approval process of direct EI. Organizations like EBRD designate certain staff as “equity leads” within business sectors and rely on them as sort of a virtual network working closely with, and being paired in teams with, staff from the equity area. The typical qualifications required of equity leads include prior outside EI experience. Risk and portfolio staff—ideally dedicated to EI—also form part of these project teams.

Most DFIs have separate teams dedicated to investing through funds because this expertise is specialized. Fund EI requires staff with strong knowledge of the investment fund market, how to select top managers and structure funds. Team size depends on the expected deal flow with funds, but an important consideration is the need for these staff to have a connection (and often physical presence) in local markets. Organizations like CAF consider funds as one more “sector” of activity. Funds teams, despite their relative stand-alone nature, still consult with the sectors on the rationale for investing in sector-focused funds, but overall, they retain more control.

According to the experience of comparators, areas that IIC would also need to consider reinforcing are portfolio and risk management. EI relies heavily on portfolio planning and management capacities, and it requires tailoring reporting systems to capture results of funds and investee companies quickly and over longer time spans. Currently, IIC was even unable to provide cashflows or current valuations for equity investments. IIC will need to considerably strengthen the risk-management systems for EI by putting in place capacity to independently monitor projects post-approval from the financial, social, and environmental perspectives.

In sum, EI requires not only the right processes, but also an appropriate organization (Table 4.1). EI requires an organization with the patience to wait for the right investment opportunity without the pressure of preset quotas, the resilience to absorb repeated losses in a good number of investments, the vision to see the upside (and not only the risks) in the usually very few investments that will produce stellar performance, and (for balancing portfolio returns) a willingness to double up on these investments even if from a developmental standpoint they no longer seem to need a DFI's participation.

TABLE 4.1. FUNCTIONS REQUIRED FOR EQUITY INVESTING AND ILLUSTRATIVE SIZING ^{A/}

EI required functions	Organizational size	Alternative 1: Shared organizational structure with loans	Alternative 2: Independent equity departments
Sourcing direct clients (sectoral expertise)	About 3 to 5 operations per year per officer, thus about 2 FTEs would be needed at IIC	Most DFIs rely on their “sector” investment officers (IOs)	A few DFIs (e.g., EBRD) have dedicated EI IOs and often pair them with sector IOs, e.g., EBRD
Investing through funds	Minimum dedicated staff – 1 FTE needed at IIC	Only a few DFIs (e.g., FMO) allow sector IOs to also do funds	Virtually all DFIs have specialized staff to deal with funds
Structuring (financial and legal expertise)	About 10 ops. per year (technical advice), i.e. about 1 FTE needed at IIC	Most DFIs specialize a few IOs on the structuring of EIs	Only as high-level advisors for complex transactions
Providing added ongoing support to investees (value creation)	Varies depending on engagement, but typically 5 to 20 per FTE, i.e. about 2 to 3 FTEs needed at IIC	Most DFIs rely on sector IOs	A few DFIs (EBRD, BNDES) are experimenting with dedicated staff
Portfolio management	Between 10 and 20 per officer, depending on complexity; i.e. about 2 to 3 FTEs needed at IIC	Some DFIs share the function	The DFIs with the highest EI exposure have dedicated staff
Risk management	Minimum dedicated staff with EI expertise – 1 FTE needed at IIC	Some DFIs share the function	The DFIs with the highest EI exposure have dedicated staff
Managing third-party funds	Could be shared with funds or other EI area, but depends on size	N/A	Separate entity or dedicated staff

Source: Illustrative estimates by OVE. FTE: Full-time equivalent staff.

Note: ^{A/} The table above assumes: (1) Annual EI approvals of US\$50 million, in about 7 to 10 individual EI operations; (2) Break down of about 3 fund operations (larger average size) and the rest direct; (3) EI Portfolio building up to about 50 active EI operations at a given time.

D. ENSURING EI CONTINUITY AND LONG TERM HORIZON

IIC would likely benefit from developing an EI strategy setting out principles, expectations and a clear long-term commitment to EI. Although other DFIs do not necessarily have a formal document setting their strategy, they do have strategic clarity about the role of equity within their business. Given that IIC is seeking to restart and build a long-term consensus around equity, it would benefit from a strategy setting out key principles for managing the overall portfolio; identifying targeted subnational regions, sectors, stages of firm development, types and sizes of funds; as well as defining targets for the desired development impacts, among other key strategic decisions.

Although IIC should be selective in adopting practices from comparators, it would benefit from collaboration agreements with its peers. Given IIC's stage of development and capital situation, IIC will need to be flexible in adopting suitable practices, and will need to continuously collaborate with comparators to keep accessing promising practices for EI. Some comparators suggested that one way to strengthen collaboration would be through joint investments or secondment of key personnel. In any event, a long-term commitment with a relevant external party may serve to solidify IIC's commitment and staying power in the EI space.

In start-up mode, IIC will need to “carve out space” for an equity team. One key question for IIC will be the extent to which it can justify dedicating staff 100% to equity. The advantage of full dedication would be specialization and accountability for EI results, but the drawback is that dedicated staff may feel pressured to generate volume—which can have particularly negative effects on the EI business. Alternatively, if it takes time to develop EI opportunities, equity staff may not be fully utilized at times.

A key challenge would be to attract top talent while IIC is still ramping up its EI business. Most DFIs use the same incentive system for EI and non-EI operations. IIC needs to consider this in light of its circumstances, particularly in terms of the incentives it will need to offer to the professional staff required to start up an EI business almost from scratch. Other options are secondments from and close cooperation with other DFIs (e.g., joint investments).

In any event, IIC should also anticipate a long transition period. Until EI reaches critical mass, potential losses and volatility may prompt calls for a change in course or even discontinuing EI. Potential options would include, among others, to try to “ring-fence” EI as a separate funding pool, to try to mobilize co-investment resources from partners or to enter into strategic partnerships with institutions with similar interests.



Development financial institutions usually seek to persuade investees that “good environmental, social and governance practices are also good for business,” and they very rarely take an active position as shareholder.

© *Housing and Urban Development Division, IDB*

E. REVAMPING INCENTIVES AND METRICS FOR EI

A prerequisite to aligning incentives is the setting up of a proper results tracking system that promotes transparency and accountability. IIC needs to be able to track financial and development results and report appropriately to its Management and Board—and potentially to third-party investors. This requires periodic (probably quarterly) valuations of equity, a process that is much more hands-on than that for debt. IIC should also better assess EI profitability, considering that the administrative costs of handling EI (especially direct EI) are significantly higher, but difficult to measure. Such analysis also needs to consider the higher capital cost of equity.³⁹ For both financial and development results, one of the key challenges is that EI typically take longer to produce results.

Overall, incentives for EI at DFIs face constraints that their private counterparts have been better able to resolve. Private sector funds have been able to develop an effective incentive structure under which GP goals are fairly well aligned with

those of LPs, because the majority of a GP's compensation is contingent on surpassing fund performance hurdles. By contrast, no DFI has been able to implement similar incentives, at least in part because there is a strong perception that staff at publicly supported institutions should not be compensated on a contingent basis, or benefit to the same extent from the strong potential upside.⁴⁰ Since development is hard to measure objectively and takes long to materialize, many DFIs doubt that it would be a sound basis for performance compensation. Some DFIs (e.g., IFC) have experimented with long-term performance awards but have kept them rather small compared to total compensation. In response to LPs' concerns, IFC's AMC—structured as a separate entity—has implemented a staff compensation scheme that explicitly rewards for fund's performance.

There is common agreement on what incentives are detrimental within DFIs. First, most DFIs indicated that the approval and disbursements targets that are so prevalent in the DFIs' debt business can kill a DFI's EI business. EI requires patience and appropriate timing, thus the pressure to approve a certain annual volume or to approve a certain type of investment in a certain place can lead to investing at times when valuations are excessively high, or in companies that offer poor risk-return trade-offs. Instead, institutions like IFC and EBRD set “soft targets” at the aggregate portfolio level, thus allowing flexibility to operate without short-term pressures. Second, herd mentality is also a highly detrimental behavior, often leading to stopping EI in “bad times” or increasing it in “good times” when markets may be overvalued.

There is also agreement on proper incentives. First, organizations like IFC set self-balancing mechanisms, such as defining a target share for its overall equity portfolio (with a floor and ceiling) and regularly value their EI portfolio, which in turns prompts the buying of EI at low prices (bad times) and its selling at high prices (good times). Second, while DFIs do not necessarily need to fully match private sector compensation (given the different motivations and profiles of DFI staff), they still need to build a critical mass of EI to be able to attract seasoned staff.

Managing EI requires a higher level of accounting transparency and objectivity. Although accounting standards allow some investments to be carried at cost, good management of EI requires each investment to be assessed regularly (usually quarterly) on a fair value basis. Comparators highlight the importance of promoting objectivity by instilling discipline into this assessment process, including independent checks.⁴¹ This is generally achieved through objective valuation methodologies, criteria, and access to high-quality data to be able to formulate proper assumptions, such as market projections. Accounting transparency involves not only the valuation side, but also an assessment of the

costs involved in originating and carrying EI that is as accurate as possible. In fact, comparators report that administrative costs can be twice as high for EI as for debt.

This objectivity needs to extend to the triggering and governance of the EI exit process, whose timing and conditions are a key driver of returns. Comparators indicate that the exit process requires particular discipline, which is usually imposed by predefining objective exit criteria that trigger the start of the exit process for each investment. IIC will need a process to set and enforce these criteria. At the portfolio level, IIC will need to have the staying power to endure the low part of economic cycles and continue investing—since these may be the years leading to the strongest return “vintages.” IIC will also need to be able to ride on positive cycles, since cutting gains short may also lead to a significant deterioration of returns. In more stable conditions, IIC will need to set some way to promote exit—for example, by assessing a “carrying cost” for equity on the sectors or departments holding equity with little remaining upside potential.

IIC will also need to continue sharpening the reliability of information reported, including on results and lessons learned. The uncertainty involved in EI will require IIC to enhance its ability to provide timely reporting on material changes. Procedures for internal disclosure and resolution will also need to be established, including ways to expedite decision-making. IIC already has a functioning results system, but it will need to work on increasing the reliability of information, standardizing data collection, and triangulating data with external sources. Similarly, IIC could benefit from compiling its own lessons learned and also learning from comparator DFIs.

The areas discussed above all present issues that require decisions by IIC’s management and Board, as illustrated in Table 4.2.

TABLE 4.2. SUMMARY OF KEY ISSUES FOR EQUITY INVESTING AT IIC

Issue	Strategic question	Options and considerations
Development rationale	<ul style="list-style-type: none"> • Why do equity? 	<ul style="list-style-type: none"> • Some reasons are to make money, to be closer to companies, to learn, to complement the instrument menu.
Investment vehicle	<ul style="list-style-type: none"> • What vehicles to use? 	<ul style="list-style-type: none"> • Funds are easier to do, less volatile, but not as close to investees. • Direct investments can broaden IIC's product range and are closer to investees, but require more expertise, more volatile.
Target portfolio	<ul style="list-style-type: none"> • What resources (including economic capital) to allocate to each investment modality? 	<ul style="list-style-type: none"> • Critical mass of EI is needed to attract good fund managers and/or investment officers. • Equity uses more capital early-on (when IIC more capital-constrained) and brings returns later (when IIC less constrained).
Organization	<ul style="list-style-type: none"> • Extent to which resources shared with lending arm? 	<ul style="list-style-type: none"> • Sharing can save costs. • Specialized staff are needed to add value to investee companies, select fund managers, and enhance upside potential.
Staffing and skills (investments, accounting)	<ul style="list-style-type: none"> • How to build IIC capacity to undertake investments and do proper valuations? 	<ul style="list-style-type: none"> • Options include outside expertise, technical assistance, secondments (at least during transition).
Managing funds for third parties	<ul style="list-style-type: none"> • Nature of client and value-added brought by IIC? 	<ul style="list-style-type: none"> • Private sector LPs require strong track record. • Public sector partners can provide development funds.
IIC commitment	<ul style="list-style-type: none"> • How to ensure long-term IIC commitment? 	<ul style="list-style-type: none"> • IIC Board could endorse longer-term commitment. • A significant strategic partner could solidify commitment.

- ¹ See CII/CA-165, *Delivering the Renewed Vision: Organizational and Capitalization Proposal for the IDB Group Private Sector Merge-Out*.
- ² Public equity markets allow companies to pool resources from the public in general. This allows them to draw large amounts of risk capital to fund firms' growth. However, public equity markets are subject to strong scrutiny from the public and regulators. Therefore, public companies need to have strong practices in place to bear the high demands of information disclosure, financial reporting, and minority investors' protection. Additionally, they need a track record and a relatively large size to become attractive to public investors.
- ³ See IIC's 2017-2019 Business Plan, 2017 Administrative and Capital Budget Proposal, and 2017 Funding Strategy. From Transition to Consolidation (CII/GA-77).
- ⁴ LAVCA created a scorecard to track key institutional factors required to attract EI (e.g., regulations to protect minority shareholders, tax treatment of funds, and well-established capital markets).
- ⁵ See [LAVCA Scorecard Report 2015/2016](#). For Mexico, Brazil and Colombia EI averaged 0.16% of GDP.
- ⁶ [CAF 2015. Trends in PE/VC in LAC.](#)
- ⁷ LAVCA 2016 PE/VC Industry Data.
- ⁸ See [LAVCA Scorecard Report 2015/2016](#).
- ⁹ See Equator Principles (www.equator-principles.com) and Corporate Governance Development Framework (www.ifc.org/corporategovernance).
- ¹⁰ IDA: International Development Association, the World Bank Group's concessional lending facility.
- ¹¹ CDC has recently changed its approach and is now also focused on investing directly in equity.
- ¹² Most DFIs indicated that they relied in part on existing capacity that could be shared between the loan and equity business, but that also additional specialized skills—different from those for debt—were needed.
- ¹³ In fact, IIC's early equity investments (late 1990s and early 2000s) were made with the rationale of supporting the nascent equity industry in LAC.
- ¹⁴ It is also important to mention that the awareness of EI was developed in emerging markets at about the same time and that the institutions and legal arrangements that make EI possible have only been in place for a couple of decades.
- ¹⁵ According to an IFC manager, asset allocation exercises were conducted for the institution's equity strategies of 2010 and 2016 based on the expected returns and volatilities of the different asset classes, and the discussions centered on how much to invest in equity versus debt and mezzanine instruments.
- ¹⁶ AMC is IFC's fund management business, managing third-party capital. As of December 2015, AMC had US\$8.4 billion in committed investments across 13 funds. AMC funds invest only in IFC transactions, which are selected by AMC fund managers among all IFC transactions.
- ¹⁷ An IFC manager explained that two decades ago IFC's portfolio was dominated by manufacturing, with nearly no financial sector exposure. Now, the financial sector is more than 40% of IFC's total exposure. That shift represents a deliberate strategy both to increase financial sector exposure for greater return and development benefits, and to reduce manufacturing exposure because of poor return performance.
- ¹⁸ See, OVE (2016), [Evaluation of SME Lending through Financial Intermediaries](#) (p. 12). Regulators usually consider FIs' long-term subordinated debt as second-tier capital. Therefore, is usually taken in consideration for estimating capital adequacy ratios. Subordinated debt ideally should be an intermediate vehicle to capitalize FIs while they raise common equity.

- ¹⁹ Measuring comparable financial returns for DFIs is not easy because many DFIs still present their equity investments in financial statements at cost, so that volatility is not captured. OVE compiled and analyzed the returns of three DFIs—IFC, EBRD, and FMO—that present their EI at fair value, which allows assessing variations in the valuation of investments. DFIs like DEG, ADB, CAF, IIC, and BNDES were not considered in the comparison because of the lack of comparable information.
- ²⁰ For example, see IFC’s FY16 Financial Statements, Management’s discussion and analysis (p. 4).
- ²¹ When providing debt, DFIs can partially hedge foreign currency risk by lending in US\$. However, equity transactions are made in local currency.
- ²² *Fair value* refers to a rational, unbiased estimate of the potential market value of a good, service, or asset. The approach is also referred to as “marking to market.” Some accounting standards (e.g., International Financial Reporting Standards) require fair value accounting, whereas others (e.g., Generally Accepted Accounting Principles) allow for accounting at cost minus impairment.
- ²³ OVE calculated returns from IIC’s audited financial statements. Returns are calculated by summing dividends, realized gains (i.e., gains obtained from the sale of equity positions), and unrealized gains (i.e., changes in valuation of the funds equity portfolio). Returns are then divided by the average of the outstanding portfolio at the beginning and at the end of the year. It is important to mention that since IIC keeps a record of its equity investments at historic cost (minus impairment), volatility is less than if it had them recorded at fair value. The same procedure was used for the loan portfolio. For loan returns OVE considered loan income less loan loss provisions.
- ²⁴ In 2002 IIC suffered losses in both the equity and loan portfolios. According to IIC’s 2002 annual report, these losses were the result of LAC’s economic downturn. High returns in 2007 are attributable to the profitable sale of a single equity operation (US\$45 million in capital gains, or 80% of the total equity business income).
- ²⁵ Based on interviews with current and former IFC staff.
- ²⁶ Independent Evaluation Group (2015), [The World Bank Group’s Support to Capital Market Development](#) (p. 40).
- ²⁷ ADB Operations Evaluation Department (2008), [Special Evaluation Study: Private Equity Fund Operations](#).
- ²⁸ Per the study, ADB’s average annual returns net of management fees for 1986-2005 were 6.9% compared to industry benchmark averages of 12.6% for Asia and 20.4% globally (excluding the United States).
- ²⁹ CDC, [What was the impact of CDC’s fund investments from 2004 to 2012?](#)
- ³⁰ Attribution is an issue. For example, it is not clear whether the funds selected companies with the potential to grow fast, or whether equity was essential for them to achieve that potential. It is also not clear what would have happened in the absence of IFC. However, given the scarcity of equity financing, it is reasonable to assume that at least to some extent the results were attributable to equity and IFC’s intervention.
- ³¹ Based on interviews with current and former IFC staff. However, attribution of results is difficult.
- ³² IFC: [Estimating the value-added of IFC-financed projects](#).
- ³³ For example, at IFC, the “Chinese wall” is much more in place at the portfolio supervision stage than at origination (and becomes particularly important for listed equity). This is because most conflicts of interest occur well after origination.
- ³⁴ To avoid crowding out other investors, DFIs tend to stay away from entering EI that is already listed, but they may end up with significant holdings of listed equities as investees go public. For example, EBRD’s equity portfolio now consists of almost 50% in listed equities, in good part as a result of its investing in utility companies that later underwent privatization. The noticeable exception to DFIs entering into publicly traded shares is when they participate in change of control (usually also involving privatization) or capital expansion processes, involving already publicly listed shares.

- ³⁵ There are also prudential rules why DFIs usually avoid seeking larger stakes: where DFIs exert control, sometimes defined as stakes of 20% or higher, they should consolidate the investee company's financial statements into their own, bringing significant potential legal issues that many DFIs seek to avoid.
- ³⁶ Some DFIs have started assessing the performance of the directors they appoint through a combination of surveying and independent reviews. They also seek to reinforce best practices and requirements—including that directors must act solely in the interest of the investee company shareholders, rather than of the DFI appointing them—by organizing training activities for directors.
- ³⁷ The exit decision can become embroiled in institutional politics. For example, investment departments may not want to sell to avoid upsetting client management with whom they would like to make additional (perhaps loan) investments. Because of the incentives they face, they may be more concerned with their relationship with the client than with financial returns.
- ³⁸ One way to assess the critical mass is to consider the minimum size of a fund. Typically, in the LAC region, nowadays a fund size of US\$200-300 million is the minimum to attract well-qualified fund managers. This would entail fund management fees of about US\$4-6 million, based on a typical 2% annual fee.
- ³⁹ Some DFI cost accounting systems accrue costs at the project level, not the product level, making it difficult to measure the costs of the various products.
- ⁴⁰ Practitioners question whether similarly high performance bonuses would be appropriate since DFI staff have the advantage of benefits not available in the private sector, such as higher job security, typically more leave, and lower-risk pension arrangements.
- ⁴¹ Independent checks should include at a minimum internal checks and balances. In institutions that are required by their accounting standards to report at fair value, the valuations are also externally audited.

ANNEX I. EQUITY EXPERTS INTERVIEWED**IFC**

- Flavio Guimaraes – Head of Equity, IFC
- Ruth Horowitz – COO, Asset Management Company
- Maria Kozloski – Global Head, Private Equity Funds
- Atul Mehta – Director, Global Manufacturing, Agribusiness and Services
- Umberto Pisoni – Global Portfolio Head, IFC Telecoms, Media, Tech and Venture Investing Department (previously PE Funds Department)
- Frank Taverner – Director, IFC Equity
- Damla Zeybel, Manager, Portfolio Management, IFC

DEG

- Mariana Barcena – Head, Private Equity & Mezzanine, Latin America

FMO

- Jaap Reinking – Director, Financial Institutions

EBRD

- Peter Bryde – Director, Equity Group
- Hassan El Khatib – Managing Director, Equity
- Barry Kolodkin – Deputy Chief Evaluator
- Anne Fossemalle – Director of Equity Funds Team
- Hans Peter Lankes – Managing Director, Corporate Strategy
- Andrea Leon – Director, Equity Risk Management
- Kanako Sekine – Managing Director, Portfolio

CAF

- Carlos Suñer – Director, Equity Investments

ADB

- Janet Hall – Head of PE Funds
- Enrico Pinali – Risk Management Officer
- Sherwin Pu – Principal Investment Officer

BNDES

- Bruno Aranha – Acting Head of Private Equity Management Department

Bancoldex

- Mauro Sartori – CRO and Head of Equity Funds

Fondo de Fondos

- Rubén Becerra Sánchez – Deputy Director, Equity
- Felipe Vilá – CEO

Funds and PE Associations

- Maria Ariza – CEO, Mexican Association Private Equity and Venture Capital (AMEXCAP)
- Baily Blair Kempner – Principal, The Abraaj Group
- Ragheb El Rami – Managing Director, The Abraaj Group
- Clovis Benoni Meurer – CEO, CRP Companhia de Participações (Brazil)
- Dalton Schmitt – COO and Managing Partner, CRP Companhia de Participações (Brazil)
- Juan Duarte – Principal, Advent International
- Robert Graffam – Former Sr. Managing Director, Darby Overseas Investment, Ltd.
- Juan Savino – Senior Advisor, LAVCA
- Leon de Bono – British Venture Capital Association

ANNEX II. INTERVIEW QUESTIONNAIRE

1. What is your institution's **rationale** for doing equity investments? What is the **strategy** for equity investing, and what are the **goals**?
2. Regarding the equity portfolio: What was the **latest equity investment portfolio** (a) **at cost**; and (b) at **fair value**?
 - o If available, what is the split of these commitments (e.g., **direct** vs. **funds**; **straight** vs. **quasi-equity**)?
3. What is your **organization and staffing** for equity investing?
 - o Are there specialized teams for (a) funds; and/or (b) direct equity investments?
 - o How large are these teams, and what are their typical qualifications?
 - o How do the equity teams interact with your other investment teams?
 - o What are the incentives for investment officers and managers for equity investing?
4. Only if your institution makes significant **direct equity investments**:
 - o Are there any specific goals for direct equity investments?
 - o What is the value added your institution adds in direct equity investments?
 - o Do you use technical assistance/advisory services (and under what circumstances)?
 - o **Process steps:** What are key considerations for selection, structuring, supervising (e.g.; taking board seats; voting shares; handling conflicts of interest; portfolio management) and exiting?
5. Only if your institution makes significant **equity investment through funds**:
 - o Do you have specific goals for your investments through funds?
 - o What is the specific value added your institution adds to funds?
 - o **Process steps:** What are key considerations for selection of funds and fund managers; structuring (e.g., incentive structures for fund managers, exit/dissolution); supervising funds; taking board seats, and if so in which role (e.g., investment committee)?

6. Only if your institution **administers funds for others**:
 - o Which are the main investors for which you manage equity investment funds?
 - o What are the key goals – for the investors and for your organization?
 - o How are these investments administered – in comparison with your own investments?
7. What have been the **results** of your equity investments – and how do you measure them?
8. What have been the **lessons learned** from equity investing? Best / worst operation and why?